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Regulatory Clarification Opens US Reg Cap Market

July 2024

This is the third article in a series devoted to explaining the bank regulatory capital space ("Reg Cap", sometimes referred to as "significant risk transfer" or "SRT").

Article 1 – https://seercap.com/wp-content/uploads/2024/07/Reg-Cap-A-Better-Way-for-Private-Credit-to-Partner-With-Banks.pdf
Article 2 – https://seercap.com/wp-content/uploads/2024/07/Reg-Cap-Market-Poised-for-Continued-Growth-web.pdf

US Reg Cap Issuance History

Historically, among US banks, Citi has been a regular Reg Cap issuer, JP Morgan has issued periodically, and Goldman Sachs has joined the fray selectively. Fannie Mae and Freddie Mac, government sponsored enterprises that guarantee credit risk on US mortgages, also transfer significant volumes of that risk to investors using Reg Cap technology.

However, for the past several years, regulators prevented most US banks from obtaining capital relief by issuing Reg Cap deals. A few regional banks completed deals, apparently with approval from regional Federal Reserve banks, but larger banks could not obtain capital relief. Santander's US operation issued several deals referencing US auto loans and mortgages, but these were aimed at capital relief at the parent level. For more on the regulatory regime that prevailed see https://seercap.com/wp-content/uploads/2022/08/US-Banks-to-Fuel-Significant-Growth-in-Reg-Cap-Issuance.pdf.

"Basel Endgame Proposal" – New Proposed Capital Regulations for US Banks

At the end of July 2023, US regulators announced their "Basel Endgame Proposal" to conform US capital regulations to international Basel standards. Regulators framed the proposal as a way to make banks safer in the aftermath of the failure of Silicon Valley Bank ("SVB") and the ensuing turmoil in the Spring of 2023.

The Endgame proposal was met with an unprecedented wave of criticism from banks and other market participants, who argued that it was formulated by regulators with little regard for its impact on markets and would constrain lending and increase costs for businesses and households.

Fed Clears Path for Reg Cap Issuance

In Sep 2023, US Fed released Reg Cap FAQ, reducing regulatory uncertainty

Regulators provided banks with some respite at the end of September 2023 when the Fed released Frequently Asked Questions ("FAQ") clarifying that Reg Cap deals are allowed under the current capital regulations.

The Fed made the distinction between SPV structures, which do not require specific approval, and CLN structures, which require approval but which the Fed indicated they are disposed to approve (see Appendix for more detail on these structural alternatives).

Seer Capital Management has prepared this memorandum using information gathered from third parties as well as its own independent research, all of which it believes to be accurate as of the date hereof. While this memorandum represents our current thinking, future events could lead to a change in our opinion, and there can be no guarantee that the opinions expressed herein will be borne out by the market or underlying asset performance. No offering of any investment product managed by Seer Capital Management is intended hereby.

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The Fed FAQ touched off discussion and press coverage anticipating massive issuance of Reg Cap by US banks. For the first time, the product captured constructive attention from outlets such as the *Wall Street Journal*, *Financial Times*, and *Bloomberg*. Heretofore, press coverage had been limited, simplistic and uninformed, along the lines of "Banks Conspire to Issue Complex Derivative Products in Rehash of the Great Financial Crisis." Many new investors of all sizes began exploring the market. An initial wave of issuance has followed, see Figure 1 below for a non-exhaustive list (note that public data are limited for many of the deals).

Figure 1: Reg Cap Transactions by US Banks Since 2023

Bank	Timing	Reference Assets	Structure (see Appendix)	Portfolio Size (USD bn)
US Bank	4Q23	Auto Loans	CLN	2.5
US Bank	4Q23	IG Corporate Loans	SPV	5.0
JP Morgan	4Q23	European HY Loans	SPV	2.0
JP Morgan	4Q23	Large Corp Revolvers	SPV	[25]
Morgan Stanley	4Q23	Capital Call facilities	CLN	[2.5]
Sofi	4Q23	Student Loans	CDS	2.4
Huntington	4Q23	Auto Loans	CDS	2.8
Citi	2Q24	IG Corporate Loans	SPV	[5.0]
Huntington	2Q24	Auto Loans	CLN	4.0
Ally	2Q24	Auto Loans	CLN	3.0

Source: Bloomberg, Seer Capital Research

Sep 2023 FAQ released massive pent-up supply in US Reg Cap, primarily referencing "on-the-run" assets

Many of the deals reflect clearing of pent-up supply from the period of regulatory uncertainty. Banks generally chose "on-the-run" assets, such as investment grade corporate loans, capital call facilities, and auto loans, to achieve tightest pricing.

Large banks, JP Morgan in particular, sought to complete a vast amount of issuance rapidly, so only engaged with large investors with bite sizes of several hundred million. In addition, concerns around the conflict-of-interest rule (see Appendix) steered banks issuing SPV deals that reference corporate loans to trade with single investors, rather than a syndicate.

Under the current regulations, US banks must issue tranches detaching at 12.5% to obtain optimal capital treatment for the retained senior risk (See Figure 2). Thick tranches referencing corporate loans and capital call facilities traded to large investors in the mid-single digit spread range.

<u>Revisions to Basel Endgame Proposal Expected</u>

In March 2024 Federal Reserve Chair Jerome Powell announced that the Basel Endgame Proposal would be modified substantially. "I'm confident that the final product will be one that has broad support at the Fed and in the broader world," he said, noting that the critical comments filed on the proposal were "unlike anything I've seen." It was reported in May 2024 that key Fed officials decided

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to adjust the original proposal rather than start over, and that a push was underway to finalize the proposal by August 2024.

In June 2024, the Federal Reserve was said to have shown other US regulators a brief document listing changes to the proposal that would reduce the capital increase on large banks from 16% to 5%. The final timing and content of the rules remains to be seen.

Key elements of the proposal and the final expected outcome are as follows:

	Original Proposal	Expected Outcome
1	Significantly higher capital requirements for trading businesses. Largest US banks required to hold an estimated 16% more capital overall.	Greater impact on larger institutions, but less than originally proposed.
2	Banks with assets between $100-250 billion required to include unrealized gains and losses in their Available for Sale securities portfolios in capital calculations.	This is in response to SVB's failure; expected to be kept as proposed
3	Banks would need to sell substantially more risk in Reg Cap transactions to obtain optimal capital treatment	TBD (see below for implications)

The Endgame proposal would change the treatment of Reg Cap deals (item 3 of the table above). Reg Cap transactions provide capital relief to banks because, rather than holding capital based on the risk weighting on the pool of assets, the bank only needs to hold capital based on the risk weighting of the retained (senior) tranche of the Reg Cap deal. The risk weighting on the retained tranches is based on the amount of enhancement below it.

Per Basel Endgame proposal, US banks would need to sell the bottom 25.5% risk in portfolios for optimal capital treatment.

European banks can obtain optimal capital treatment while selling less than 12.5% risk in portfolios.

The Basel Endgame Proposal increases the minimum enhancement to achieve optimal risk weighting on the retained senior to 25.5%, more than double the minimum enhancement of 12.5% that is currently required for US banks. See Figure 2 below.

Figure 2: Minimum Risk Weight and Enhancement to Retained Senior Tranche of US Reg Cap Deal

Item	Current	Proposed
Risk weight of underlying assets	100%	100%
Minimum risk weight of senior tranche	20%	15%
Minimum enhancement to senior tranche	12.5%	25.5%

Source: Seer Capital Research

European regulators recently settled on lower minimum enhancement to the senior than even the 12.5% level currently required in the US in response to input from banks and other Reg Cap market participants.

Either the US regulators need to follow suit, or a new deep and affordable market for mezzanine risk will need to develop if US banks are to rely significantly on Reg Cap.

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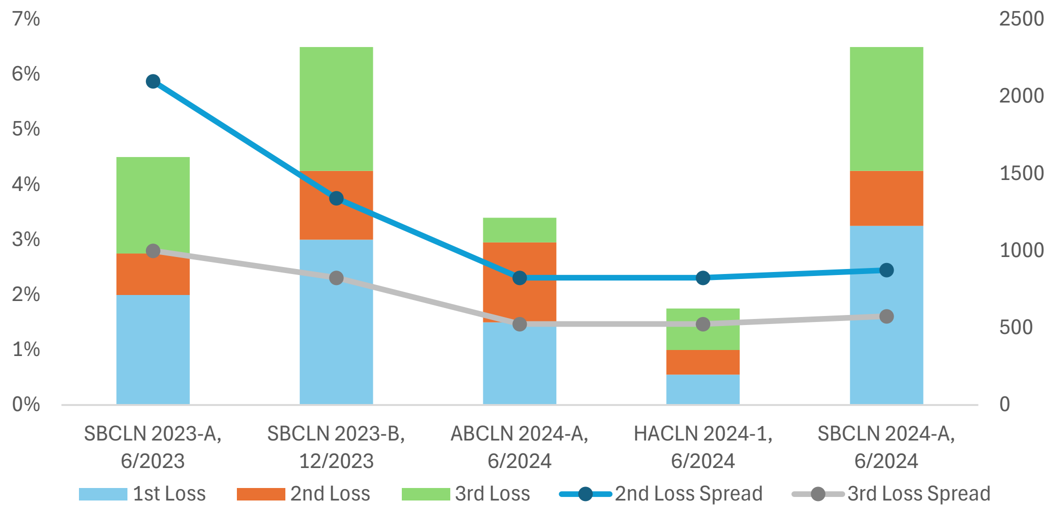
Seer Capital Market View

US Reg Cap market is less attractive vs. Europe currently

Thus far, Seer has not identified attractive relative value in US Reg Cap.

In US Auto CLNs, issuers typically retain a small first loss (bottom 1-3%) and issue many thin mezz tranches (0.5-2.25% thickness with ratings B, BB, BBB etc.) up to 12.5% attachment. These deals reference prime auto collateral, with tranching reflecting different loan characteristics and performance history among the programs.

Figure 3: Junior Tranche Thickness and Spreads of Recent US Auto CLNs



With such thin tranches, if losses exceed expectations, investors in the 2nd and even 3rd loss tranches risk losing a significant portion of their investment.

Figure 3 also illustrates the **dramatic spread tightening in US Auto CLN** in the past year, with 2nd loss spreads dropping more than 1100 bps, and 3rd loss spreads dropping more than 400 bps.

Given mid-single digits pricing and high minimum ticket sizes for deals backed by large corporate loans and capital call facilities, and dramatic spread tightening of the thin junior tranches of auto loan CLNs, Seer has found US Reg Cap deals less compelling than Reg Cap from other jurisdictions thus far.

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Key investment principles we apply to the sector are summarized below:

Principle	Description
Diversification within deals	o Invest in deals referencing granular underlying portfolios o Use statistical approach and long time series of historical data to project defaults o Limit exposure to idiosyncratic events at individual obligors
Diversification across deals	o Limit exposure to any one bank issuer and any one Reg Cap transaction from a bank issuer o Avoid risk concentrations in a handful of large investments
High yields with no or limited leverage	o Target high single-digit spreads and low-to-mid-teens levered yields o Avoid higher leverage, which would introduce higher mark-to-market volatility
Downside protection	o Target investments that generate positive returns even in downside cases with 2-3x our base case projected losses

We anticipate significant continued growth in the US market, and we foresee attractive opportunities as new banks, different asset classes and new structures come online.

The fourth and final article in this series will examine our forecasts for growth in the US Reg Cap market and explore the potential opportunities that arise from this expansion.

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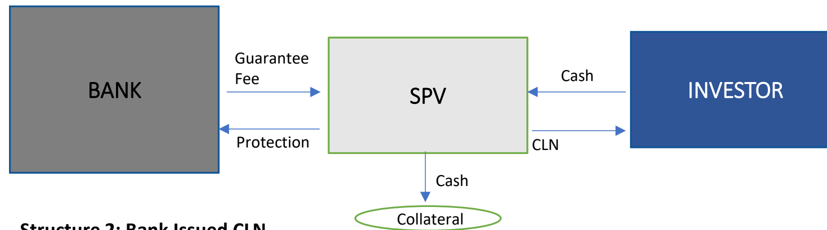
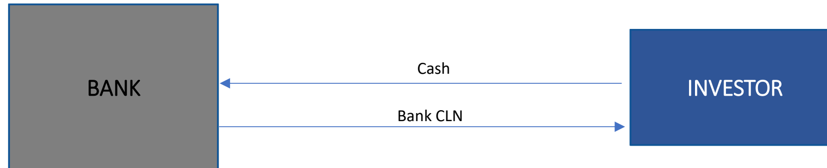
Appendix: US Reg Cap Structural Alternatives

Structure 1: SPV-Issued Note



Structure 2: Bank Issued CLN



The table below describes each of the structures and highlights the benefits and drawbacks.

	1. SPV-Issued Note	2. Bank Issued CLN
Description	SPV (special purpose vehicle) issues CLN and sells credit protection to the bank on the reference portfolio.	Bank issues CLN (credit-linked note) off its balance sheet, credit linked to reference portfolio.
Collateral	The SPV generally places the note proceeds on deposit with the bank. In some cases the SPV may place the deposit at a third party with a higher credit rating or invest in government securities.	The CLN investor is typically a creditor of the bank, but the bank may place the note proceeds in a segregated account to protect the investor from insolvency of the issuing bank.
Regulatory Status	Fed FAQ of September 2023 confirmed that banks can obtain capital relief by purchasing protection from an SPV which holds the proceeds of the notes as collateral for the CDS.	Fed FAQ of September 2023 indicated that CLN structure does not strictly comply with current capital regulations, banks may apply for approval to issue CLN, up to a limit of $20 billion of assets or the bank's equity capital, if lower.
Additional Factors	SPVs may be treated as Commodity Pool Operators and subject to CFTC regulation, except replenishable pools of corporate obligors. Third party service providers may be able to assume the obligations to the CFTC. Conflict of interest rules under Dodd-Frank restrict control by issuers over SPVs. Some issuers have taken the view that SPVs must be established by investors and SPV issued notes cannot be widely distributed. But market participants have indicated that correctly structured SPV deals can be broadly syndicated.	Issuers must obtain a reservation of authority from the Fed to claim capital relief for CLN. CLN structure currently preferred for consumer assets and non-replenishable portfolios of corporate assets due to CFTC regulation impacting SPVs. CLN structure exposes investor to more credit risk to the issuing bank, although this can be mitigated by segregated account structure.

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