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Reg Cap Recap

A biweekly update on the Regulatory Capital Relief/ Significant Risk Transfer sector

August 6, 2024

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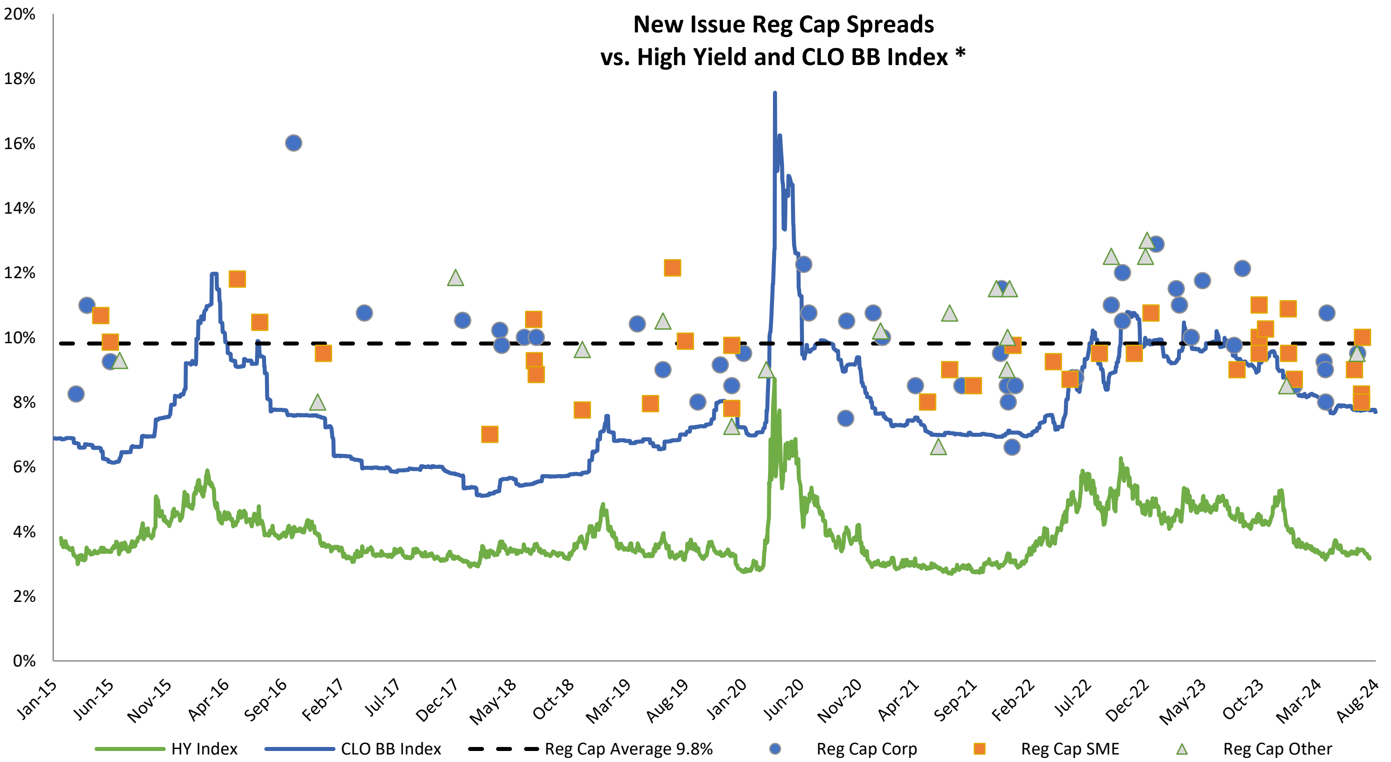
Reg Cap Spread Trends

Reg Cap spreads for new issue ranged from 800 to 1000 bps over the past couple months, marginally tighter than recent prints, while HY spreads tightened by 1 basis point on the month and the BB CLO index tightened by 5 basis points.



** Source: Seer Capital Research / Bloomberg. Reflects selected first and second loss tranches but excludes mezzanine and thick (i.e. 0-12.5%) tranches. As of August 1, 2024.*

Recent New Issue Activity

The following is a representative listing of recent new issue activity.

		ASSET			PORTFOLIO SIZE		
Closing Date	**Spread (bp) [1]**	**Type**	**Jurisdiction [2]**	**Disclosure [3]**	**Currency**	**Amount (bn)**	**First Loss [4]**
Jul-24	795	Jumbo Mortgages	US	No	USD	1.73	Yes
Jun-24	1000	SME	UK	No	GBP	1.68	No
Jun-24	800	SME	Portugal	No	EUR	1.635	No
Jun-24	825	SME	Spain	No	EUR	1.16	No
Jun-24	950	Lev Loan	Global	No	USD	1.5	No
Jun-24	950	Corporate	UK	Yes	GBP	1.35	Yes
Jun-24	900	SME	Germany	No	EUR	2.562	No
Jun-24	825	Auto	US	No	USD	4	No
Jun-24	875	Auto	US	No	USD	2.3	No
Jun-24	825	Auto	US	No	USD	2.5	No

[1] *Spread to SOFR*
[2] *Asset jurisdiction and issuer jurisdiction may vary*
[3] *Disclosure of obligors in the reference pool of assets by name*
[4] *Indicates whether the Reg Cap issue is in the first loss position*

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Market Commentary

We believe Reg Cap/SRTs to be one of the most attractive opportunities within fixed income. Regulatory and business pressures on banks globally continue to drive issuance growth. US regulatory clarification in 2023 opened the domestic market, triggering an initial wave of issuance, along with a lot of press coverage and discussion.

Spreads for most European first and second loss deals remain in the high single digits, reflecting some tightening over the past 6-12 months but less than for many other credit assets. Volatility appears to have returned to the markets as of early August, but the impact on Reg Cap remains to be seen. We contrast the attractive returns available in European transactions with the US market, where large banks are printing 0-12.5% tranches referencing subscription lines at spreads inside 5%. These deals are being sold to large investors who may have limited prior experience investing in Reg Cap but have access to and willingness to apply aggressive leverage arrangements. Seer Capital portfolio managers have been involved in the Reg Cap space for over two decades, which we believe is essential to source and identify transactions with the most attractive risk/reward profiles.

We have recently published a 4-part series delving further into the Reg Cap market, see: https://seercap.com/regcap/

Reg Cap News

Pnfp Reports 2q24 Diluted Eps Of $0.64 And Net Interest Margin Of 3.14 Percent (pnfp.com, 7/16/24)

Pinnacle, the $50bn Nashville-based bank, reported that they had closed a Reg Cap deal in Q2. Pinnacle executed a credit default swap with a notional amount of $86.5 million. The transaction consists of a 0-5% tranche with a reference pool of $1.73bn of jumbo single-family mortgages. Pinnacle will pay an annual loss protection fee equal to 7.95%. The bank noted that loans subject to the CDS now qualify for reduced risk weights, improving their capital position.

SRT Volumes Grow Even as Basel Uncertainty Persists (Citi Research, 7/19/24)

Despite the expectation that Basel III capital rules will be revised in favor of banks, taking the edge off of required capital increases, the Reg Cap market continues to grow. Though the market is rooted in Europe and commercial lending, the fastest growth has been in US consumer credit. US banks transferred credit risk on $15B of auto and student loans risk this year, triple FY 2023's volume even as some banks are waiting on the sidelines until regulatory uncertainty dissipates.

The research quantifies SRT benefits under various assumptions about the cost of equity capital, the cost of protection and deal structure. The authors note that the capital relief benefit is maximized for a low-risk reference pool with a narrow first-loss tranche, and, of course, relatively low cost of protection.

The article also included information about the Reg Cap investor base, estimating that the universe of European SRT investors is ~45% dedicated credit funds and ~30% asset managers. The US is broadly similar, with an expansion in the investor base toward more asset managers and dedicated credit funds as the market develops.

Private credit defaults rise to 2.71% in Q2 (*PitchBook*, 7/22/24)

Private credit default rates rose to 2.71% in the second quarter, the third consecutive quarterly increase, according to Proskauer's Private Credit Default Index. The index tracks senior-secured and uni-tranche loans in the United States and includes 980 active loans, representing ~$150 billion in original principal amount. Default rates were up 87bp from 1.84% for Q1 2024.

F***DIC vice chair calls for complete "reproposal" on Basel III endgame*** (Bloomberg News aka "BN,", 7/24/24)

Travis Hill, vice chair of the FDIC board, argued that all three major federal banking agencies, i.e. the Fed, FDIC and Office of the Comptroller of the Currency, need to be in sync and should recommend a "full 'reproposal'" rather than piecemeal edits of the existing proposal for increased bank capital requirements.

Goldman Sachs Sells SRT Tied to $2 Billion of Private Fund Loans (BN, 7/24/24)

Goldman Sachs Group is placing a significant risk transfer bond tied to a portfolio of about $2 billion of subscription lines. Subscription lines, a type of short-term bridge financing, are loans taken out mostly by closed-end private market funds, secured by a fund's investor commitments. It is reported that the structure will utilize a 0-12.5%tranche and is likely to be priced at a spread inside of 500bp. Facing higher regulatory capital requirements, Wall Street firms are expected to become active issues of SRT, with deals from JPMorgan Chase & Co. and Wells Fargo & Co. et al.

Morgan Stanley Selling SRT Tied to More Than $4 Billion of Loans (BN, 8/1/24)

Shortly after word broke of a Goldman Reg Cap deal referencing subscription lines, Morgan Stanley announced their own SRT deal referencing subscription lines, at double the size — $4bn. Conversations are in the preliminary stages and no details were available.

We believe that issuers may be limiting their distribution by issuing a single 12.5% thick tranche. Thick tranches are less risky and hence offer lower spreads. As a result, they tend to attract only those investors who can use significant leverage to meet return hurdles.

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Reg Cap News (continued)

That limits the investor pool and also raises concerns that risk does not fully leave the banking system if banks are providing the leverage for non-bank investors. Splitting deals like this into two tranches, e.g. a 0-6%, tranche that would price in the 6-7% range, and a mezzanine 6-12.5% tranche that would price in the 3% range could broaden distribution and be more efficient for issuers.

Santander Targets €500 Million Gain in 'New' Capital Strategy (BN, 7/24/24)
In a recent earnings call, Banco Santander highlighted its growing use of Reg Cap as a "new way" of managing capital. The bank noted that they used Reg Cap (along with sales and hedges) to dispose of the equivalent of €30 billion in risk-weighted assets already this year. The cost of these transactions was about half what it earned from reinvesting the released capital, boosting profitability. Santander is one of Seer's favorite Reg Cap issuance partners. They have an effective execution machine churning out Reg Cap transactions referencing multiple asset classes from multiple jurisdictions. Their commitment to Reg Cap as a capital management tool means that they structure their transactions tightly and select reference portfolios carefully in an effort to ensure strong performance.

Heard on the Street: Lenders Tout a New Way to Transfer Risk (*Wall Street Journal*, 7/24/24)
Ally Financial joined the small but growing number of banks issuing Reg Cap deals, with a $330mn notional amount SRT, referencing a $3bn pool of prime auto loans. The attachment/detachment points were 1.5%/12.5%. The transaction reduced the risk weighting for the pool of auto loans from 100% to 38%, and increased Ally's CET-1 (common equity Tier 1) ratio 10bp. One complexity the article noted is that Ally is required to book credit losses when they are deemed "expected," but Reg Cap investors only cover actual, realized losses. Because of this timing mismatch, Ally's earnings could be adversely impacted by credit losses before Reg Cap protection kicks in.

Valley National Enters Synthetic Risk Transfer on Auto Loans (BN, 7/29/24) In their quarterly results New Jersey-based regional bank Valley National disclosed that they had completed a Reg Cap deal in June. The transaction was related to about $1.5 billion of the company's $1.8 billion auto-loan portfolio. The article noted that, even with expectations of less strict capital requirements than initially feared, banks continue to find Reg Cap an attractive and cost-effective method for boosting their capital ratios. Interestingly, although most auto deals are structured as credit linked notes, which require approval from the Fed, and the Fed posts notices of approvals on their website, there is no notice of approval for Valley on the Fed's website.

UK Government-Owned Firm to Use SRTs to Boost SME Lending (BN, 7/29/24)
British Business Bank ("BBB"), a state-owned economic development bank established by the UK Government is planning to use SRTs to help stimulate lending to small businesses. The bank, which currently supports about £50 billion ($64 billion) of financing by guaranteeing mezzanine and senior portions of bank SME loan portfolios, is looking to the Reg Cap market to cover junior risk. By reducing the amount of regulatory capital UK banks need for their SME business, the BBB hopes to boost lending. At Seer we are eager to see new applications of the Reg Cap product, although we note that government programs can be complex and take a long time to implement.

The article also cites research suggesting that Reg Cap spreads are 200 bps tighter since the wides of 2022. We note that the greatest tightening has taken place in the crowded large corporate space, whereas in off-the-run assets like SME loans, spreads are only ~50-100bps tighter in our experience.

Merchants Capital Executes Credit Risk Transfer on $543+ Million Multifamily Bridge Loans (PRNewswire, 8/1/24) Financial services provider Merchants Capital announced that they had placed a $543.5 million Reg Cap deal, secured by 41 performing multifamily bridge loans. This is Merchants' third Reg Cap issue. The deal was $76mn in notional amount and was structured as a first-loss tranche. It closed in March and involved a single, large institutional investor. A Merchant's spokesman noted that "providing capital relief … provides Merchants Capital with capacity for additional loan growth." Merchants is unusual in that they have now issued Reg Cap deals referencing a very significant proportion of their total assets-- $2.9 billion of a total of $14.4 billion of loans and $18.2 billion of assets on balance sheet.

Swedish SRT Finalised (structuredcreditinvestor.com, 8/1/24)
Sweden's Marginalen bank completed a RegCap deal, known as "Project Argo." The SEK1bn reference pool consisted of non-performing consumer loans. It was reported that the transaction provided ~SEK100mn in capital relief to Marginalen.

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About Seer

Seer Capital Management LP is a diversified, credit-focused investment firm founded by Phil Weingord in 2008 that primarily invests in structured credit and loans. We allocate capital opportunistically across all major asset classes within structured credit in the U.S. and Europe, including: bank regulatory capital risk transfer (SRT), residential and commercial mortgages, syndicated and SME loans, and a variety of consumer loans (personal, auto, credit card, student, housing). These investments are executed through active trading in both legacy and new issue securitizations, purchase and securitization of whole loans, and direct lending joint ventures.

Seer Capital believes it is well positioned to capitalize on opportunities in structured credit as a result of our highly experienced senior investment team, which has on average more than two decades of experience working in structured credit.

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