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Reg Cap Recap

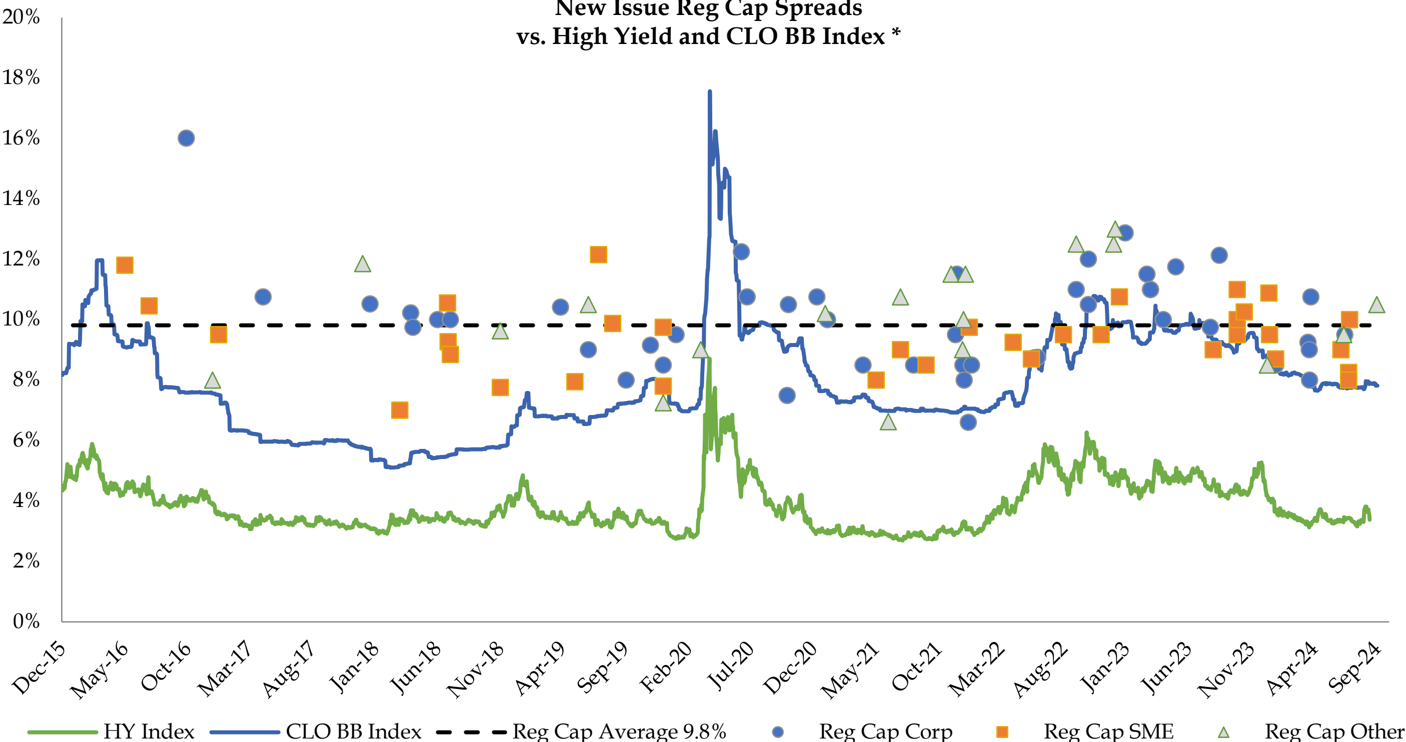
A biweekly update on the Regulatory Capital Relief/ Significant Risk Transfer sector

September 4, 2024

SEER CAPITAL

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 9 basis points during August and the BB CLO index widened by 12 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 Sept. 3, 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
Sep-24	1050	Lev Loans	Global	Yes	USD	3	Yes
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 are pleased to be back to work after a much-needed break. 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. The third quarter has been quieter as is typical-- issuers and investors prefer not to interrupt their summer vacations, particularly in the absence of half end / year end pressures. We did see a leveraged loan trade from a large European issuer print tighter than expected, likely based on demand from crossover CLO buyers who are relative newcomers to the Reg Cap market. A North American bank is in the market with a leveraged loan trade on the follow, and they appear set to achieve similarly tight pricing. Seer Capital prefers granular portfolio transactions which we can analyze based on a statistical approach, which typically also see less demand from crossover buyers. As summer comes to an end, we are beginning work on a number of interesting transactions from our longstanding issuance partners, the start of what promises to be an extremely robust 4th quarter. We are also looking forward to participating as a panelist at a conference hosted by Structured Credit Investor on Reg Cap issuance by US regional banks in Chicago on September 24.

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

Reg Cap News

Banks' Use of Credit Risk Transfer Transactions Is Opaque and Risky (American Banker, 7/1/24) The author, an academician, notes that when banks use Reg Cap to improve their capital ratio, it is not by increasing the numerator of that ratio (capital), but by reducing the denominator of that ratio —their risk-weighted assets ("RWA"). The author seems to imply that adding capital would be preferable; we do not agree.

The Fed's 2024 stress tests for large banks covered 32 banks, at least seven of which have Reg Cap issuance programs. The author asserts that financial reporting on the matter is inadequate and offers only "limited visibility" into banks' Reg Cap activities and that "information on CRT counterparties is another data gap." We question why that would be relevant when the structures are fully funded, and the banks are not relying on counterparty credit.

The author does note that today's Reg Cap market is meaningfully different from the CDS era in the GFC, when insurers couldn't meet their obligations to banks to absorb losses and the credit risk that was transformed into counterparty risk eventually became systemic risk. Reg Cap structures currently get cash up front and thus generally do not take counterparty risk.

The author raises three primary issues:

1. If the cash proceeds of CRT transitions are unregulated, the net effect is that banks are de facto borrowing against their capital or overstating their liquidity.
2. Reg Cap issuers tend to choose relatively lower-risk asset types and then cherry pick credits for inclusion in Reg Cap deals. This is attractive for investors, but the author points out, may overstate the amount of risk being transferred. The author notes "In essence, this is a classic 'adverse selection' problem where the CRT provides relief based on a risk-weight for the loan that reflects an average level of credit risk but transfers low risk due to CRT pricing. Thus, a bank may obtain RWA relief on good loans in excess of the underlying economics." We have made this very point in our own research, i.e. that investors benefit from *positive* selection. It essentially underscores the fact that capital requirements are overly conservative for many assets.
3. In a further contrast with 2008, the author notes, "banks shifted high-risk exposures like CDOs to AIG and paid for unlimited credit protection." Today banks, by contrast, "... are shifting low-risk exposures to nonbanks…(whom) only absorb a finite amount of credit loss, not unlimited loss."

In conclusion, the author notes that CRTs can yield double digit returns despite "being senior to both bank equity and unsecured bonds." Moreover, in a handful of cases where a Reg-Cap-issuing bank failed, their CRT issues were not impacted. While this article suggests that Reg Cap may not be as useful for banks as it seems, it (unintentionally) also underscores the many reasons the sector is attractive to investors.

Merchants Capital Executes Credit Risk Transfer on $543+ Million Multifamily Bridge Loans (Bloomberg Press Release, 8/1/24) Merchants' Capital announced the execution of a $543 million Credit Risk Transfer (CRT), their third Reg Cap issuance, secured by 41 performing multifamily bridge loans. Merchants' management noted than their Reg Cap program provides efficient capital relief and creates capacity for additional loan growth. We note that Merchants has now completed 3 Reg Cap deals referencing a total of almost $3 billion, an extremely high proportion of their total assets of $18 billion. Typically, large banks issue Reg Cap deals referencing a total of 1-2% of their total assets.

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Reg Cap News (continued)

Reed Urges Federal Reserve to Place Additional Guardrails Around Banks (www.reed.senate.gov, 8/2/24) U.S. Senator Jack Reed (D-RI), in a letter to Federal Reserve Chair Powell, raised concerns about the growth of the Reg Cap market in the US and argued that "widespread efforts to avoid stronger capital …requirements …could expose the financial system to new risks." Reed called on the Fed to take several steps, including:

1. Require greater public regulatory reporting on each bank's use of CRTs
2. Establish quantitative limits on banks':
   a) Use of Reg Cap to reduce capital requirements
   b) Use of Reg Cap proceeds as unrestricted cash (e.g. to pay dividends or buy back stock).
   c) Providing leverage to Reg Cap investors
3. Ensure that stress testing methodology expressly considers the impact of Reg Cap
4. Update an analysis of whether Reg Cap issuance has truly laid off credit risk and is working "as intended."

None of these requirements appear unreasonable in and of themselves, but to the extent that they are intended to constrain US banks from relying on Reg Cap as a risk and capital management tool, we object.

NatWest Transfers Risk on Energy Portfolio to Free Up Capital (Bloomberg News aka "BN," 8/13/24)
NatWest Group is planning to issue a new SRT bond to de-risk a $1.4 billion portfolio of 40 renewable energy project finance loans. A bank representative noted that renewable energy is one of the banks' core businesses, and that SRT issuance allows the bank to efficiently "recycle" their capital and "continue to grow and support our clients." The bank has already issued numerous SRT transactions, and this will be their second for their renewable energy lending portfolio.

Federal Reserve Chair recently attended a closed-door meeting with a group of big-bank CEOs, encouraging them to work with the Fed (Bloomberg News aka "BN," 8/17/24) Powell is increasingly seen as trying to get consensus from the industry and regulators and bring resolution on new capital regulations. Some regulators, however, are concerned that Powell has given too much ground.

The original draft, released in July 2023, called for an overall 16% hike in the capital that banks must hold as a cushion against financial shocks. Later versions shared by the Fed suggested an increase as low as 5%. Powell told US lawmakers last month that there had been no final decision — but "quite a bit of progress." Meanwhile some FDIC and OCC officials are pushing back on capital increases that they consider too low. Powell appears to be particularly sensitive to choosing a level that does not undermine global competitiveness of US banks. Powell noted, for example, that the Basel effort by the European Union would lead to an overall 10% capital hike, and the UK's average increase would be ~3%.

Meanwhile a consortium of banking industry trade groups has retained a litigator to fight regulators if all sides cannot find a mutually acceptable rule. The group has already sent a letter to regulators, claiming that the new capital plan violates the law which governs the process of developing regulations. Uncertainty around the timing and content of the final Basel Endgame is slowing the growth of the market. We would love to see regulatory clarity as soon as possible, but given the thicket of overlapping regulatory agencies, not to mention the impending election, we wonder how likely this can be.

How Banks Offload Risk from Their Balance Sheets A deep dive into synthetic risk transfers (Bloomberg News aka "BN," 8/22/24) Bloomberg News conducted an hour-long interview with a Mickey Shemi, a well-known participant and former regulator in the Reg Cap space who is as entertaining as he is knowledgeable. Some of the highlights of the wide-ranging discussion included:

1. Banks need to find more creative ways of lessening some of the burden of increasing capital requirements. The average number of banks that have been tapping the Reg Cap market has gone from ~8 in the 2014 to 2020 period to something like 37 now. Heretofore, US banks were less active in Reg Cap. Partly this was due to regulatory capital regime differences versus Europe and even versus Canada, part of it was a lack of regulatory clarity on the use of Reg Cap, but part of it was also economics. US banks are better capitalized with stronger balance sheets than their global peers and have been able to raise capital at attractive valuations.

2. A key difference versus 2008 is that Reg Cap "is not strictly about shedding credit risk" and is more of a capital management tool than a risk management tool. While the use of terms like "synthetic" and "derivative" may be reminiscent of some of the worst excesses of 2008 and the GFC, the interviewee argued that the Reg Cap market is entirely different. Firstly, "the point of departure for this transaction is … hedging…not uncapped leveraged speculation…This is about true distribution of credit risk … issuer(s)…have skin in the game in almost every tranche of these transactions." H added that Reg Cap issuers are not trying to lay off credit risk of "bad assets." Reg Cap issues do programmatic issuances referencing assets that the bank likes and wants to grow. Reg cap is a tool to support and protect that borrower relationship.

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3. Conceptually, credit risk in lending portfolios can be divided into "expected losses" and "unexpected losses." Expected losses are a cost of doing business, are priced into margins, and provisioned for, all in the normal course of business. Regulatory capital exists not to absorb expected losses, but for unexpected losses. Hence the purpose of Reg Cap is to transfer the unexpected portion of losses (as defined by regulators) for a given pool of assets. By doing so, banks need to hold less regulatory capital, and investors are offered an attractive opportunity.

The Federal Reserve slightly lowered Goldman Sachs Group Inc.'s stress capital buffer requirement after the Wall Street bank asked for modifications (Bloomberg News aka "BN," 8/28/24) Goldman's capital requirement was decreased to 6.2% (down modestly from a preliminary level of 6.4%), after the bank provided "additional information." While other banks have also appealed their stress capital buffer requirement, this is the first time regulators have agreed to reduce a capital requirement since it was imposed in 2020.

Regulator set to postpone UK bank capital reforms until at least January 2026 (www.cityam.com 8/29/24) The UK's main banking regulator is planning to further delay the latest series of bank capital reforms until at least January 2026, as it watches how the rules are developing in the US. The timeline for implementation has been delayed several times by the UK, as well as in the EU and the US. However, the EU has only delayed rules that deal with banks' trading businesses (likely awaiting US decisions), while Switzerland has stood by a January 2025 implementation date and Japan introduced their reform this past March. This only underscores the need for US regulators to complete their process in order to provide regulatory clarity to banks globally.

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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