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Reg Cap Recap

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

September 17, 2024

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Reg Cap Fundamental Credit Trends

The RegCap sector spans a variety of reference assets and, of course, the performance of those assets varies among originators. Assets originated by banks to their clients for their own balance sheets generally outperform assets in generic credit indices. Further, investors impose selection criteria and originators tend to "cherry pick" assets for Reg Cap deals to help ensure the success of their RegCap program on the most attractive terms.

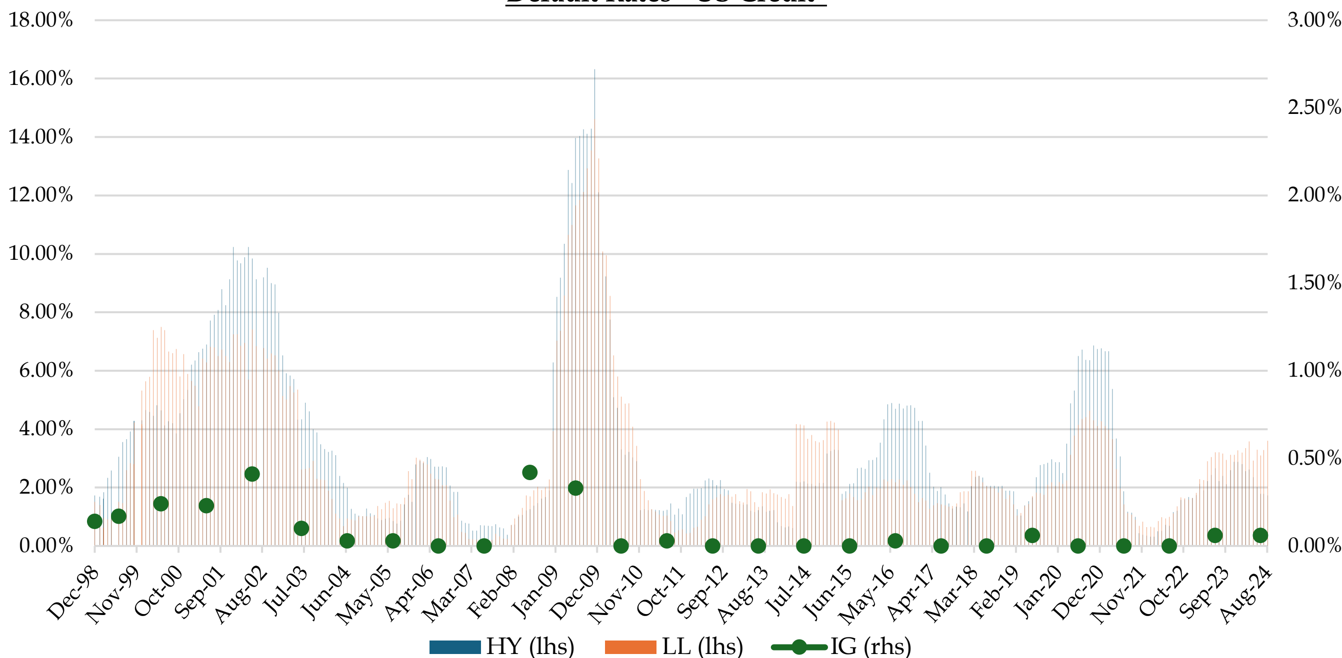
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 33 deals that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we are seeing continued strong credit performance almost across-the-board, with just a few positions that we are monitoring more carefully due to slightly higher negative credit migration and/or default trends.

The indices we look at as broadly representative of some of the most common reference assets include: US Corporate Debt, including Investment Grade, High yield and Leveraged Loans; European Investment Grade Debt and High Yield; and US Prime auto loans. We would expect most reference asset pools to significantly outperform these publicly available benchmarks. The following is a brief update on current credit trends for each.

US High Yield and Leveraged Loans

Most corporate credits in referenced pools are investment grade quality. Defaults of investment grade obligors are rare. While Investment Grade ("IG") defaults have been only a small fraction of the defaults in leveraged credit (i.e. US High Yield "HY" bonds and Leveraged Loans "LL"), there is a strong correlation (~75%). Therefore, it is useful to track the (far more numerous) default activity in HY and LL as a possible bellwether for IG. Current default activity continues consistent with very low or no IG defaults.

As of the end of August, the trailing 12-mo. default rates for HY and LL are 1.73% and 3.60%, respectively. Since year-end, HY defaults are down 115bp, but LL are up 33bp. HY defaults are significantly below their historical average (3.4%) while LL default rates are slightly above their historical average (3.0%). A leading indicator for credit is the "distressed universe" (i.e. loans trading below $80 and bonds trading at spreads over 1000bp). The distressed universe has been shrinking and is now down to a 5-month low of 6%. Based on history, one in three distressed credits default within 12 months. If that were to hold true, defaults could decline in 2025.



Source: Standard & Poor's, JPMorgan Research, as of August 2024.
** HY and LL on a trailing 12-month basis, dollar-weighted. Includes distressed exchanges. IG on an annual basis.*

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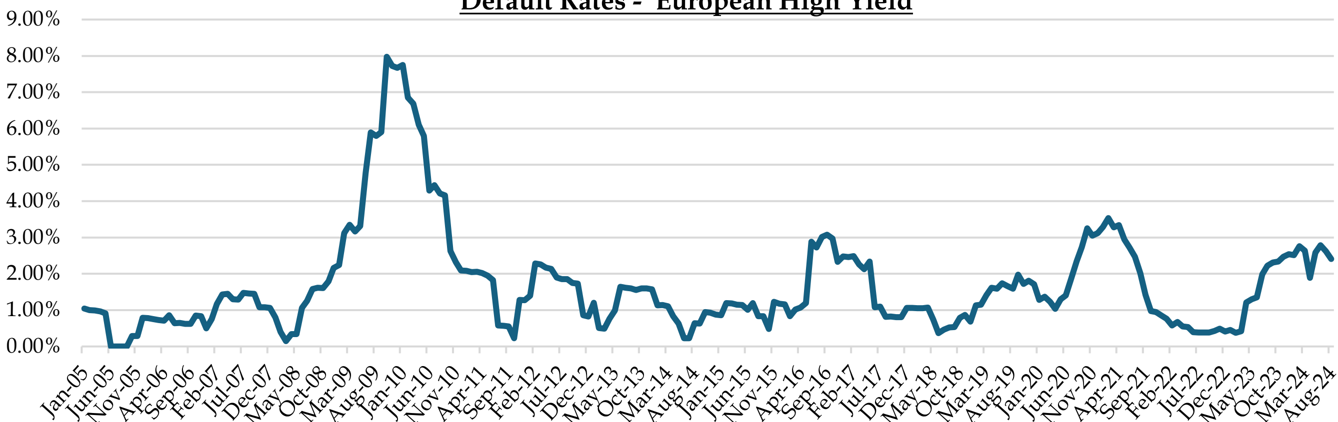
Reg Cap Fundamental Credit Trends (Cont.)

European High Yield

Historically, IG defaults in Europe have also been very low, with no defaults at all in most years. Our European HY default data goes back to 2005. Since 2005, the default rate for IG in Europe was zero in every year but two; in both 2008 and 2009 the IG default rate was 11bp per annum.

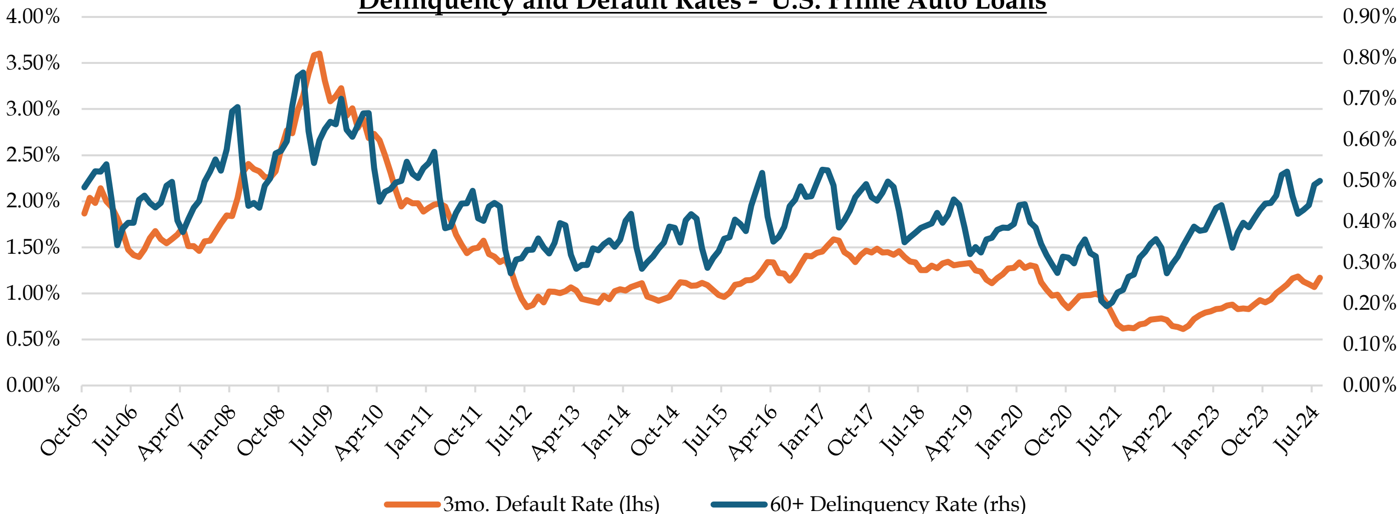
As of August 2024, the trailing 12-mo. default rate for European HY is 2.41%, down 21bp MOM but still ~100bps above average. While softening monetary policy expectations are a positive for the sector, volatility and slower growth have presented challenges. The share of distressed Euro HY bonds (trading at 1000bp+) has been rising, and is now at 8.5%,versus an historical median of 5.2%. Such levels suggest that HY defaults are likely to remain at least at today's levels throughout 2025. As in the US, default expectations for European HY are consistent with very low levels of IG default, if any.



Source: JPMorgan Research, as of August 2024. Trailing 12-month basis, dollar-weighted. Excludes Banks/Insurers.

US Prime Auto Loans

As of the end of August, the 60+ delinquency rate for securitized US prime auto loans is 50bps and the 3-month default rate is 117bps. This leaves delinquencies slightly above their long run average (42bps), but with fewer delinquencies rolling into defaults, 3mo CDRs remain below the long run average of 143bps. Unlike corporate credit, which suffered during the pandemic, consumer credit losses hit new lows in 2020/2021, as consumers benefited both from stimulus payments and a spike in used car prices. Thus the current period represents a normalization in delinquency and default rates, to "post-GFC-pre-COVID" levels. With unemployment essentially at its structural low, and homeowner balance sheets strong, we do not expect material increases in defaults.



Source: Morgan Stanley, as of August 2024.

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Reg Cap News

Issuance News:

Deutsche Bank Boosts Risk Transfer Portfolio by $1 Billion (MT Newswires, 9/9/24)
Deutsche Bank issued another $1bn SRT, linked to ~$3bn in leveraged loan exposures. The junior tranche priced at a spread of SOFR + 10.5% while the mezz priced at a spread of 3.75%. Reportedly, an anchor investor took down almost half of the deal.

Goldman Sachs to Sell SRT Tied to $3 Billion of Leveraged Loans (Bloomberg News aka "BN," 9/11/24)
Goldman Sachs is selling a significant risk transfer issue tied to a portfolio of ~$3 billion of levered credits, both in the form of revolving credit facilities and term loans.

TD Bank to Sell SRT Tied to $3 Billion of Corporate Loans (BN, 9/12/24)
Toronto-Dominion Bank is shopping a $300mn Reg Cap deal linked to a roughly $3bn in corporate loans. Banks in Canada have been particularly active in RegCap, in part because Canada has gotten ahead in implementing many of the Basel III reforms.

BBVA Plans SocGen-Arranged SRT on €2 Billion of Loans (BN, 9/16/24)
Banco Bilbao Vizcaya Argentaria is planning a Reg Cap transaction tied to €2bn of corporate loans. The SRT is linked to a pool of almost 2,400 loans and is expected to be at about €127 million in size. Global Reg Cap issuance in 2024 is on pace to reach $28-30bn, up from about ~$24bn in 2023, the highest annual volume on record.

Other News:

US to Propose Bank Capital Rule Revisions as Soon as This Month (BN, 9/7/24)
Presaged US regulators' release of a 450-page revised proposal for the bank-capital regime known as Basel III Endgame ("B3E"), in response to banking industry pushback against the original (July '23) bank capital proposal. The industry had threatened legal action and argued it would put them at a competitive disadvantage, harm the economy and consumers.

The rise of SRTs (Barclays Research- 9/9/24) Although SRTs (aka "Reg Cap") have been around ~20 years, the volume has picked up in recent years, with record high issuance in 2023 and now 2024. 25 of the 40 biggest banks in Europe/UK use synthetic SRTs. Over time, their use has gone from (defensive) capital raising to bank balance sheet optimization. Banks use SRTs to manage concentration risks, meet regulatory stress-testing requirements, and improve rating agency capital metrics. Even so, SRT is a small part of European banks' balance sheets and does not pose a threat to financial stability.

A hot take on the Fed's proposed revisions to its Basel III Endgame approach (Santander US Portfolio Strategy, 9/10/24)
A summary of Fed Vice Chair for Supervision Michael S. Barr's speech on intended revisions to B3E rules first proposed in summer 2023. Regulators walked back their initial proposed increase by about half. The key proposed revisions:

- Increase bank common equity "tier 1" capital requirements as follows:
  - for G-SIBs (Global Systemically Important Banks) a 9% increase (down from 19% in the July '23 version),
  - for large banks ($100bn-$750bn in assets) that are not G-SIBs a 3%-4% increase, and
  - for other non-GSIBs a 0.5% increase
- The threshold for the most onerous requirements has also been revised upward to reflect US$250bn in assets rather than US$100bn threshold that was in the July 2023 proposal.

Bank Bosses Head to Reeves Meeting With Capital Rules in Focus (BN, 9/10/24)
UK regulators are meeting with top bank executives to discuss new bank capital rules. UK banks fear capital rules might leave them at a competitive disadvantage vs. Europe and the US, both of which have less stringent bank capital regulations. The BOE will postpone its adoption of the capital rules to better align with other jurisdictions.

Called to the Barr (Structured Credit Investor, 9/10/24) The significant retrenchment of B3E should not materially affect issuance of Reg Cap deals by US banks. Seer's Terry Lanson noted that "no one expected the original proposals to be implemented in full" and the increase now suggested is in line with expectations. Moreover, though B3E is a factor in banks' SRT issuing plans, in the US the true impetus for growth has been clarification of the rules surrounding CLN issuance, in September 2023. With or without B3E, US regionals are facing capital challenges and are likely to continue to tap the Reg Cap market. And while the largest US banks might have a stronger capital base, their stakeholders expect them to have all the tools at their disposal to optimize balance sheet usage, including SRT. Initial evidence suggests the piece is correct -- the day after it came out, it was reported that Goldman Sachs is working on a deal (see above).

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Reg Cap News (Cont.)

Even under the revised plan, the proposal to include unrealized losses and gains on securities in the calculation of required capital remains in place and will affect not just G-SIBs but all banks with over US$100bn in assets. This provision has its roots in the failures of Silicon Valley Bank and Signature Bank last year. Both had racked up significant unrealized losses in long term Treasurys as rates rose.

The new proposal still faces a fair amount of uncertainty, and delay. With comment periods, adoption is unlikely to be before 2025 or 2026, and even then, changes may well be phased in over several years. In addition, Republicans are generally unsupportive of higher capital requirements and a victory in November may end up unwinding this latest proposal again.

Capital Relief Trades: How will the US regional bank market develop? (Structured Credit Investor, 9/10/24) Seer's Terry Lanson is quoted "...for the smaller regional banks the snowball is starting to roll down the hill. The more they do it, the more others will see it's possible and beneficial – especially for some regional banks whose shares are trading at discounted or even distressed prices due to challenges around commercial real estate, deposit flight to large banks, etc."

Other commenters added that "...regional banks need it (Reg Cap issuance) more than the big guys as they have less capital." Moreover, smaller banks generally have less options to address capital shortfalls. For example, they may not have access to the preferred stock market at efficient levels or at all. Lanson further notes: "Most larger US banks are trading significantly above book, so they can tap shareholders for capital, but it is different for regional banks."

Smaller banks tapping the RegCap market have some disadvantages, but they may also have some advantages. While it is true they may receive more scrutiny for undertaking such a transaction, generally won't have as much data, and may face more challenges attracting larger investors, at the same time they can be more nimble and both the regulatory and internal hurdles are lower for them.

US banks previously viewed CRT with suspicion and perhaps some disdain, seeing it as a tool used by European banks when they were forced to recapitalize after the GFC. But with changes in capital regulations, US Banks are now more balance-sheet-constrained, and bank managements understand these tools as integral to best practices in capital management.

Basel Endgame May Get Less Onerous for Big US Banks (Bloomberg Intelligence, 9/11/24)
Under the new proposal, most big banks except Goldman Sachs and Morgan Stanley would maintain a pro forma capital surplus. This could open the door to share buybacks, which have been muted by the need to build capital ahead of the full implementation of B3E.

Even Less Incentive for Mortgage SRT (Citibank Research, 9/13/24)
The revised proposal also includes lower capital requirements for residential mortgages. Currently the risk weight applied to prime mortgages is 50%. The new approach applies the RWA sliding scale from 20% to 70% depending on LTV; an improvement over the last proposal which had a sliding RWA scale from 40% to 90% (i.e. 20% higher across the board). Consumer loans have an 85% risk weight. Given the distribution of bank residential mortgage portfolios by LTV, this sliding scale would imply an overall risk weight of roughly 30%, down from 50% today. The net result is that residential mortgage SRT trades are less efficient for issuers and therefore an unlikely asset type. For example, assuming a bank retains a senior tranche, with a 15% RWA floor, a consumer loan SRT achieves 70% RWA benefit (85%-15%), whereas mortgage SRT achieves only a 15% benefit (30%-15%).

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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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