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Reg Cap Recap

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

October 15, 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.

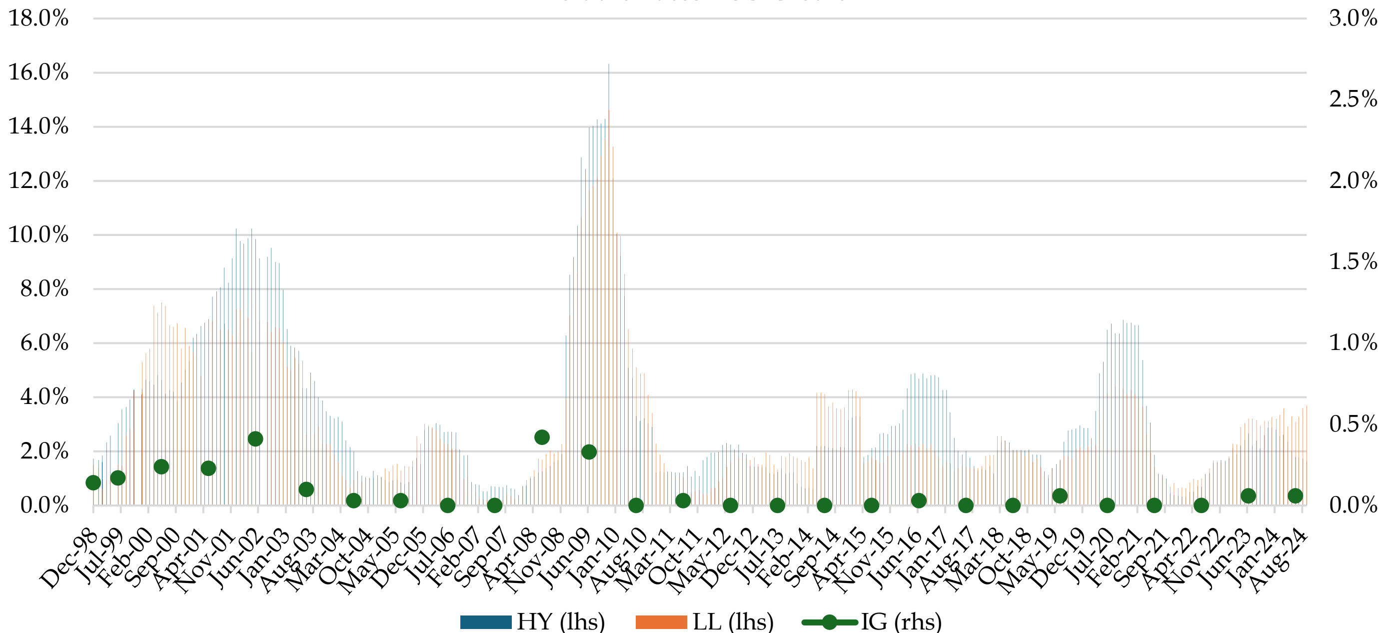
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 33 deals that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we are 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.

In the month of September there were three defaults totaling $1.4bn, all in leveraged loans, and six distressed exchanges totaling $2.7bn ($2.1bn in loans, with the balance in bonds). This monthly total was well below the $10.8bn of distressed transaction volume in August, and more in line with the level of activity we've seen in the past two years. The par-weighted US HY bond and LL default rates decreased 10bp and increased 10bp MOM to 1.64% and 3.70%, respectively. Looking ahead, the size of the distressed universe continues to shrink. The combined distressed universe of bonds/loans (trading at a spread >=1000bp or a dollar price sub-$80) at 5% is now down to a 28-month low. Based on history, a third of the distressed market defaults within 12 months. If that holds true, defaults could decline meaningfully in 2025.



Source: Standard & Poor's, JPMorgan Research, as of September 30, 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 September 2024, the trailing 12-mo. default rate for European HY is 2.71%, up 13bp MOM and 100bps above average. While GDP growth in the Euro area has been slow, at just 0.4% in 2023 and 0.8%(estimated) in 2024, the European Commission forecasts a pickup to a 1.4% rate in 2025. Meanwhile the share of distressed Euro HY bonds (trading at 1000bp+) fell sharply MOM, and is now just under 6%, also a 28-month low. Lower levels of distress augurs well for lower defaults going forward. As in the US, default expectations for European HY are consistent with very low levels of IG default, if any.

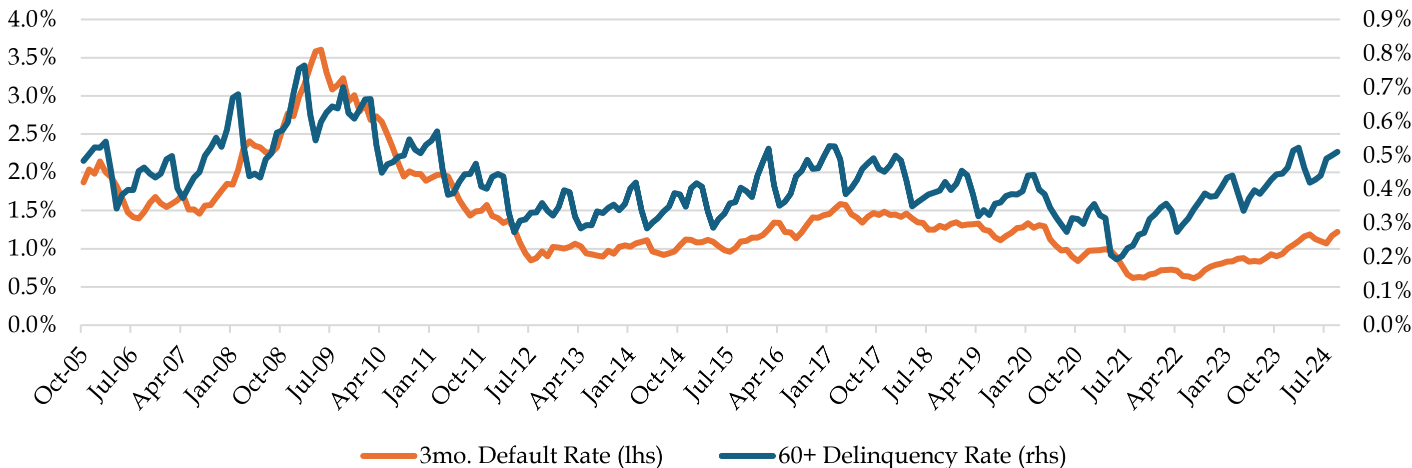
Default Rates - European High Yield

Source: JPMorgan Research, as of September 30, 2024. Trailing 12-month basis, dollar-weighted. Excludes Banks/Insurers.

US Prime Auto Loans

As of the end of September, the 60+ delinquency rate for securitized US prime auto loans is 51bps (up 1bp MOM) and the 3-month default rate is 122bps (up 5bp MOM). This leaves delinquencies slightly above their long run average (42bps), but with fewer delinquencies rolling into defaults, 3mo CDRs remain a bit below the long run average of 143bps. (The sub-100bp CDRs we saw during the pandemic were an anomaly, with consumers benefitting both from stimulus payments and a spike in used car prices.) The outlook for auto loan credit remains strong, in large part due to the very strong employment picture, with unemployment nearly at its structural floor (4.1% vs. a "natural floor" of 4%). Prime borrowers in particular have also benefitted from higher interest, dividend, and rental income in recent quarters.

Delinquency and Default Rates - U.S. Prime Auto Loans



Source: Morgan Stanley, as of September 30, 2024.

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Reg Cap News

Issuance News:

CIBC Eyes Risk Transfer Tied to $4.5 Billion of Corporate Loans (Bloomberg News aka "BN," 10/3/24)
Canadian Imperial Bank of Commerce is planning a new US-dollar Reg Cap deal linked to a portfolio of $4.5bn in corporate loans. Rival Toronto-Dominion Bank is also working on a deal linked to a portfolio of about $3bn of corporate loans. Canadian banks have been somewhat ahead in implementing many of the Basel III banking reforms, but in July Canada's regulator extended the implementation deadline.

HSBC Plans Risk Transfer Linked to €2 Billion of Corporate Loans (BN, 10/4/24)
HSBC plans to issue an SRT linked to a portfolio of about €2 billion ($2.2 billion) of European corporate loans, adding to a traditionally busy fourth quarter in Reg Cap. HSBC joins NatWest, which plans an SRT linked to a portfolio of about £1.4 billion ($1.8 billion) of corporate loans, as well as Greece's Piraeus Bank and Spain's Banco Bilbao Vizcaya Argentaria ("BBVA") in fourth quarter issuance this year.

BNP Boosts SRT Deal Size to Back €14 Billion in Corporate Loans (BN, 10/8/24)
BNP Paribas upsized a planned Reg Cap offering in response to strong demand. The bank priced an SRT deal linked to a pool of €14 billion ($15.4 billion) in corporate loans, up from a preliminary size of €8-12bn. "). In addition, pricing on the deal tightened 50bp since it was first talked in July, and the deal priced inside of 700bp over Euribor. BNP Paribas' deal was unusual in that they targeted investors using two formats, credit-linked notes ("CLN") and a guarantee. While most issuers structure SRTs by selling CLNs to investors ('funded credit protection"), insurance companies often take part in SRTs not necessarily by buying CLNs, but by issuing a guarantee (aka "unfunded credit protection").

Sabadell Plans SRT Via UniCredit Tied to $1.3 Billion Loans (BN, 10/9/24)
Spanish lender Banco Sabadell is looking to place a Reg Cap transaction linked to a portfolio of about $1.3bn of project financing and corporate loans originated by its Miami arm. This would be a follow-on from a deal Sabadell did earlier this year, tied to a portfolio of renewable energy project financing. Reg Cap transactions allow the bank to manage increased capital requirements without having to issue new stock or reduce dividends. This is particularly important as the bank tries to convince shareholders to reject a takeover bid from BBVA.

Other News:

Small-Business Banks Still Emphasize People Over Tech, FDIC Says (BN, 10/2/24)
US banks stress "in-person and high-touch practices" for developing relationships with their small-business customers, according to a recent study by the Federal Deposit Insurance Corp. "One of the reasons community banks are regarded as a foundation of support for their local communities is their strong ties to small businesses," the FDIC Chairman said recently, adding, "...a core function of many community banks, small-business lending is of enormous economic importance." There are over 33 million firms in the US with fewer than 500 employees, representing almost half of private-sector employment and over 43% of GDP. The FDIC notes that these small businesses "...thrive in no small part because of their access to credit, for which banks are a primary source." This article highlights the key role that banks continue to play in extending credit to the economy. Reg Cap is a good way of partnering with banks to gain exposure to the attractive market in small-business lending.

Five themes from the DealCatalyst US SRT conference (9fin.com 10/3/24)
The author noted that, even though this is a new event, there were 500+ attendees. The five themes discussed in a summary of the conference were:

1. Spreads are tight. With continued regulatory uncertainty, supply in 2024 fell short of expectations, while investor demand has grown. The result has been tighter spreads, although it bears mentioning that "everything credit has tightened a lot in 2024."
2. SRTs are (mostly) a creation of regulatory conditions. While the structures also can be used to manage concentration limits, to price risk, and to hedge, it is regulatory capital that truly drives the economics. That said, no matter the regulatory environment, "no bank has capital to waste" and every bank must make "the best use of its resources," which SRTs help do. Reg Cap drives ever-more sophisticated optimization of capital. In the meantime, the pendulum seems to be swinging back a bit toward less onerous regulation, and in the US, at least, the regulat*ed* are becoming more comfortable challenging the regulat*ors*, in and out of court.
3. Investors can facilitate issuance by creating their own SPVs. Despite progress, the US still presents unique and complex regulatory and tax challenges for Reg Cap issuers, and issuance still requires ad-hoc regulatory approval. One work-around may be for investors to provide their own structure, somewhat like managers issuing a CLO. "The bank faces an investor-sponsored SPV via a simple credit default swap contract." This would be a particularly attractive option for smaller regional banks who have not yet participated in issuing RegCap.

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4. What asset classes are we likely to see in Reg Cap reference pools? Regional banks are under pressure to reduce exposure to commercial real estate, however that is not necessarily a good fit for RegCap; CRE lending is very "high touch" and does not lend itself to an actuarial approach, unlike many common reference assets. For large banks, subscription lines have been the most popular asset class, because of the significant mismatch between the true economic risk and the capital treatment. For smaller banks, the nature of their business model is that they tend to have risk concentrations that are driven by whatever economic activities dominate their home markets. For these banks, Reg Cap can be a useful tool to help them "escape this concentration, and recycle capital."
5. Attracting Insurance Money to the Investor Base Insurance company investors have played only a small role in investing in European Reg Cap, and when they do participate it tends to be by writing unfunded insurance contract protection on portfolios. In the US, insurers have shown a growing interest in Reg Cap investing, preferably in the form of investment grade risk at the mezzanine level, and preferably rated (which is more efficient for insurers' capital requirements).

Push to Ease Bank Rules Gets Support of Biggest EU Economies (BN, 10/4/24)
Regulation is always a careful balance between safety and economic growth. With the 2008 GFC an increasingly distant memory, and the 2023 Silicon Valley Bank debacle proving quite contained, politicians and industry leaders are increasingly agitating for less stringent banking regulations, in favor of growth. The latest example of this comes from Germany, France and Italy, all of whom have urged the European Union to consider more lenient rules and be mindful of the competitiveness of the banking sector, especially in light of the apparent (though not yet final) regulatory pullback in the US and the UK. The EU's three biggest economies asked the European Commission to consider the need for "a level playing field" to allow their banks to be competitive. Analysts at Keefe, Bruyette & Woods concur, and argue that Europe's banking supervisors have "little regard for growth (and)... their risk aversion since the financial crisis is damping new lending." Meanwhile, a well-known regulation expert countered by noting "... the EU has learned the hard way that allowing banks to be under capitalized is not a good idea. A general relaxation of bank capital requirements would be harmful to the EU economy, not beneficial, irrespective of what bank lobbyists are saying about it."

Seer's view is that the US market will grow, and Reg Cap will become a key capital and balance sheet management tool for US banks, as it is for European banks. However, it has taken more than 15 years, since the financial crisis, for the European market to grow to its current level of maturity. Similarly, it will take time for regulators and banks to get fully onboard in the US. Hype around the US market, and an initial large wave of issuance in late 2023, brought a lot of new investors to the space, but many of these many not stick around long enough to see real growth in the US.

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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