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Reg Cap Recap

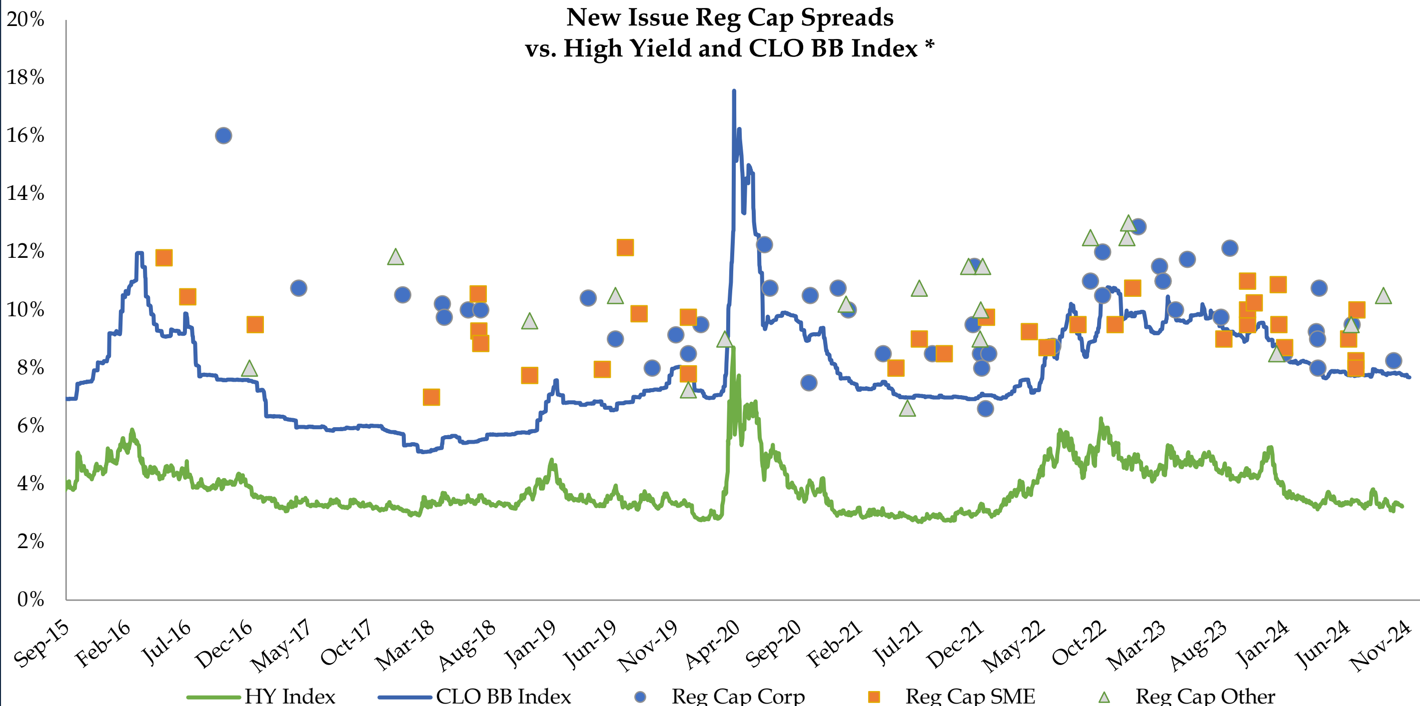
A biweekly update on the Regulatory Capital Relief/ Significant Risk Transfer sector

November 5, 2024

SEER CAPITAL

Reg Cap Spread Trends

Reg Cap spreads for new issue ranged from 700 to 900bps over the past couple months, around 100bps tighter than recent prints, while HY spreads tightened by 4 basis points during October and the BB CLO index tightened 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 Nov. 5, 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]
Nov-24	750	Auto	US	No	USD	3	No
Nov-24	750	Auto	US	No	USD	4	No
Sep-24	825	Corporate	Global	Yes	USD	4.5	Yes
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

There are at least a dozen deals in the market this quarter, representing a wide range of geographies, asset classes, and issuers. The volume and breadth of 4Q issuance reflects the continued growth and maturation of the market, with total 2024 issuance volume which we believe is sure to reach EUR 30 billion, as already projected by one market participant. Global banks are under increasing pressure to optimize use of their limited balance sheets and demonstrate ability to transfer risk. Regulatory changes, including the implementation of new Basel standards including the Output Floor, which sets minimum RWA at a percentage of the standardized approach, are creating additional capital pressures.

On the other hand, investor demand is strong—continued favorable credit performance in Reg Cap as well as press coverage around the anticipated growth of the US market have attracted a lot of capital to the space. Traditional Reg Cap investors, whom we have been working alongside for the past 10+ years, have raised significant amounts of capital, while new entrants, especially large fund managers looking to deploy capital raised for private credit, have entered the space. Repeat benchmark deals from established issuers are seeing bids 100+ basis points tighter than comparables from earlier in 2024.

The US market continues to be the wild card. Regulatory clarification in September 2023 triggered an initial wave of pent-up supply and parabolic growth projections for the market. 2024 has been spotty, with a few large banks completing bilateral trades with large asset managers at tight spreads and a handful of regional banks joining the fray, including two competing repeat auto transactions at tight levels at the end of October. We anticipate the market to grow more gradually than many had hoped, as remaining regulatory uncertainty will take time to resolve and smaller banks, in particular, will have long lead times to complete their first deals.

Reg Cap News

New Issue News

JPMorgan Plans Risk Transfer Linked to $3 Billion Loan Portfolio (Bloomberg News aka "BN", 10/16/24)
JPMorgan is bringing a $250mn significant risk transfer issue linked to a reference portfolio of ~$3bn in net asset value loans. Net asset value lending allows private equity firms to return cash to investors without having to exit their investments, by issuing debt secured by the "NAV" ("net asset value") of their portfolio.

Santander Plans SRT Linked to £1 Billion of UK Consumer Loans (BN, 10/17/24)
Banco Santander ("SAN"), Spain's largest lender, is planning to issue a £90mn significant risk transfer linked to a portfolio of about £1 bn ($1.3 bn) of UK unsecured personal loans). The SRT will provide credit protection on a mezzanine portion of the loan portfolio, with the junior most and seniormost tranches both retained. Santander's CFO said, on an earnings call over the summer, that the use of SRTs and other strategies improved capital efficiency and aided in an annualized profit boost of some €500mn.

Loans Tied to SRTs Reach $1 Trillion on Record Pace of Sales (BN, 10/21/24)
According to the article, SRTs outstandings have reached $70bn, up 40% YOY. Those SRT bonds are tied to ~$1trn in reference assets. European banks continue to dominate, with 69% of volume. Year-end should continue that be hectic, with deals in the works from Spain's Banco Sabadell (linked to a portfolio of about $1.3bn of loans originated by a US subsidiary), and Canadian Imperial Bank of Commerce considering an SRT tied to a portfolio of $4.5bn of corporate loans.

Hedge-Fund Veterans Do Rare SRT Deal in Emerging-Market Risk (BN, 10/23/24)
The Inter-American Development Bank ("IDB"), which assists Latin American and Caribbean countries in formulating development policies and provides financing, is entering the SRT market. The planned deal transfers a portion of the risk on a $1bn loan portfolio, with IDB retaining the first 3% of losses, an investor taking the next 7%, and another 3% placed with insurers. The use of SRT could become a new business model to help development banks increase lending and pursue their missions. The African Development Bank was the first to use SRT technology with a $1bn deal in 2018.

Germany's LBBW Sells SRT Tied to Loans as Deals Reach Record (BN, 10/29/24)
Landesbank Baden-Württemberg ("LBBW") is selling a €142mn significant risk transfer deal linked to a portfolio of about €2.8bn (~$3bn) of corporate loans. Separately, LBBW's sale of €750mn of AT1 (Additional Tier 1) securities was heavily oversubscribed. AT1, also known as contingent convertibles, can be converted into equity if the lender's capital levels drop too low and thus count toward a bank's capital requirements.

BBVA to Be More Engaged in SRT Market on Profit Push, CEO Says (BN, 10/31/24)
Banco Bilbao Vizcaya Argentaria "BBVA" plans to be more "engaged" in the significant risk transfer market as part of its goal to increase profitability, their CEO said in a recent conference call with analysts. "You will see us talking much more about capital generation, profitable growth and so on…In that sense, risk transfer is a lever," CEO Genc said.

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Reg Cap News (continued)

CRC, CQS Back Intesa Risk Transfer Tied to €2.5 Billion of Loans (BN, 11/04/24)
As SRT issuance continues at a record pace for the fourth consecutive year, Italy's Intesa Sanpaolo is joining in with a significant risk transfer deal linked to a debt portfolio of about €2.5bn ($2.7 bn) of Italian corporate loans. Separately, Intesa is also selling an SRT tied to €1.5bn of commercial real estate.

Reg Cap News
Bringing the market into the mainstream (SCI SRT Journal, October 2024)
SCI ("Structured Credit Investor"), a specialist publisher of news and analysis, recently published a 19-page report on SRT, in which Seer was extensively quoted. The report noted that the rapid growth in SRT has attracted attention and criticism, and that there continues to be a "lack of understanding "of the asset class. The report discusses market technicals, the participation of regional banks, unfunded SRT, and the outlook for SRT in LATAM countries. It starts by noting that SRT offers investors diversification and attractive risk-adjusted returns.

The report noted that a deluge of new investors in the sector, coupled with issuance that fell short of expectations, has some arguing that SRT is an issuers' market right now, while others contend that the spread tightening we have seen is a natural progression of the market (and, we would add, occurs in the context of dramatic tightening across markets). The report noted that SRT is tending to bifurcate into straightforward trades with broad investor participation, and the more traditional bespoke trades that involve a genuine partnership between investor and issuer. Investors (like Seer) with the skill set for the latter can differentiate themselves.

A lengthy discussion about regional banks' limited participation in SRT followed. Challenges for these banks include: 1. Deciding on a structure in light of regulatory questions and operational challenges; 2. Assembling the required historical loss and delinquency information; and 3. Creating reporting systems that can produce the loan-level information required

Unclear transfer language creates SRT loan challenge (9fin.com, 10/10/24)
The Loan Market Association is working on ways to "tweak loan docs" to better facilitate SRT issuance. There are two areas of concern. One is transfer restrictions, which are designed to give sponsors control of who their ultimate lenders are (at least up until an event of default). When docs are written in a way to also cover sub-participations, even an entity who is not a lender of record could be subject to transfer restrictions.

Disclosure and confidentiality are another area where loan docs may not contemplate the needs of an SRT transaction. While some SRT analysis is actuarial, in other cases investors want to go line-by-line and assess individual credit exposures. If the loan docs only allow information to be passed to "lenders of record," that leaves out SRT investors. This concern is most relevant for SRT transactions referencing leveraged loans, as transfer and disclosure restrictions most commonly appear in the documents for these loans.

SCI's Capital Relief Trades Seminar (SCI London conference, 10/16-17/24)
We joined this conference, which was well attended. It was broadly agreed that SRT spreads have tightened significantly on the strength of significant sums of capital that have been raised for the strategy, but the tightening has been in line with other assets. It was noted that regulators in Europe are very supportive of the growth of the SRT market, in contrast to the US where it remains somewhat controversial.

SRTs Pose Potential Risk to Financial Stability, IMF Says (BN, 10/22/24)
In a recent report the IMF expressed concern over the quality of assets being bundled into SRT and the opacity of the market. They claim that SRT could increase risks to financial stability. The IMF concluded: "financial sector supervisors need to closely monitor these risks and ensure the necessary transparency regarding the SRTs and their impact on banks' regulatory capital." We agree on the value of monitoring and transparency, as long as it does not create undue burdens on issuers and investors. SRT does not increase risks to financial stability, but rather provides banks with additional capital to lend to the economy, while distributing risk from the banking system to sophisticated investors.

Banks' New Trick Could Mean Trouble for Everyone: Editorial (BN, 10/29/24)
In this editorial, the author argues the rapidly growing SRT sector allows banks to "game" the rules and that regulators "seem all but oblivious." The authors further assert that banks, in beating back plans for higher capital requirements, have left the system with capital levels "far less than what experts and research indicate would be needed to weather a severe crisis" although those experts are not cited. The editorial goes on to draw parallels with the subprime-mortgage crisis, despite the fact that the broad array of reference assets in SRT bear no resemblance to the recklessness that was the subprime mortgage business. The author's assertion that SRT "could prove worthless in a crisis if the counterparty can't pay" ignores the fact that most SRTs, and nearly all in the US, are fully funded with no counterparty risk. In closing the authors takes the parochial view that regulators should "insist on equity, rather than settling for poor substitutes."

An Errata on a Recent Bloomberg Editorial on SRTs (bpi.com, 10/30/24)
Usually an erratum, a list of corrected errors in a published work, is provided by the original author in a subsequent publication. The Bank Policy Institute ("BPI"), rather cheekily, created one in response to the *Bloomberg News* editorial just above. We think the points made by the BPI were entirely apt.

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Reg Cap News (continued)

The BPI begins by explaining that higher equity costs following Silicon Valley Bank's failure created incentives for U.S. banks, like their brethren in Canada and Europe, to look toward SRT (a changing regulatory stance on the product in the US helped as well). BPI notes that U.S. banks executed 15 SRT transactions during 2023. Point-by-point BPI contradicts the BN editorial, to wit:

1. The editorial's assertion that SRT "...could prove worthless in a crisis if the counterparty can't pay," is factually incorrect because most SRT are funded and even in partially funded transactions, banks employ margin requirements to mitigate counterparty risk.
2. Unlike subprime, SRT issuers are not washing their hands of risky assets. Reference assets are chosen specifically because the regulatory capital charges are believed to overstate the risk of low-risk assets. That is why, for example, prime auto loans feature so heavily in SRT.
3. The editorial was not the first- or only-time concerns have been raised about SRT investors leveraging their investment by borrowing from banks, thereby recycling the same risk back into the banking system. BPI notes "little evidence that this practice is widespread" and goes on to argue that, in any event, such loans are secured and overcollateralized, significantly limiting potential bank losses. Lastly, unlike in the subprime crisis, these investors have long horizons "in contrast to the shadow banks (MMFs, CP investors, repo market participants, etc.) that ran during the GFC."

Banking Industry News

Global Banking Annual Review 2024: Attaining escape velocity (Mckinsey.com, October 2024)

In this 27-page report, McKinsey notes that these last two years post-pandemic have been the best days for the banking industry since before the GFC, based on profitability, capital and liquidity. They note that banks have "healthy levels of capital," e.g. 12.8% CET1 (common equity tier one) as a percent of RWA (risk-weighted assets). Despite this, global banking, "the single largest profit-generating sector in the world," trades at a price-to-book ratio of just 0.9x—the lowest of any industry. This suggests that the market is "skeptical of long-term value creation." The report goes on to examine those banks that have outperformed in the past decade for insight into best practices.

Global Financial Stability Report: Steadying the Course (imf.org, October 2024)

In this 128-page report, the IMF notes risks remain "contained" in the near term, but also allows that "economic and geopolitical uncertainty increases the likelihood of adverse shocks," perhaps an inarguable assertion on its face. In pages 44 and 45 of the report, SRT is highlighted. The IMF notes SRTs may "elevate interconnectedness and create negative feedback loops during stress" and calls for regulators to closely monitor these risks and also ensure the necessary transparency.

Our thoughts on this report are as follows:

1. The market has seen a lot of new entrants, especially on the investor side, in the last 12 months. This report strikes an overly cautious tone to us, but to the extent it deters some investors, that would be welcome to us as investors in competition for bonds.
2. One of the concerns raised by the IMF is around the use of leverage. US regulations require thick tranches (which will become thicker if regulators don't reduce the "p-factor" in the Basel Endgame), and SPV issued deals are subject to restrictions on broad placement due to Volcker Rule. Also, US regulations restrict the ability of banks to obtain capital relief by transacting with insurers. Resolving these issues in the US regulations would facilitate the development of a market for mezzanine risk, such as exists in Europe, and would limit the need for leverage.
3. The IMF notes that "overreliance on SRTs exposes banks to business challenges should liquidity from the SRT market dry up". This strikes us as illogical. Surely the more varied avenues a bank has to address capital needs, the better. What if the market for bank equity dries up and banks cannot raise capital that way? Does the IMF believe that government ownership of banks would be the best route?
4. The IMF also notes "signs of increased concerns regarding deterioration of asset quality" and cite the SRTx indices. These indices are compiled from contributions from an unknown but we believe small number of market participants and should be interpreted carefully. Likely, because there is currently a high level of demand for SRT deals, index contributors have expressed concerns about a deterioration in asset quality. This does not mean that a deterioration has or will take place. Moreover, the SRT indices show continued spread tightening for all asset classes, which is a sign of market maturation, high investor demand, and greater ability for banks to raise capital at effective cost to support lending. This is a clear positive for the banking industry.

Banco Santander SA wants to offload more risk to private investors as it seeks to free up capital (BN, 10/17/24)

In a presentation to analysts, Banco Santander ("SAN") shared that they are looking to speed up transactions that transfer risk to investors. By increasing the turnover of assets, SAN seeks to shift to a business model that "...makes more money from fees and consumes less capital." SAN is one of the most active banks in SRT and traditional securitizations. In just the first half of 2024, SAN moved ~€30bn ($33bn) of risk off its books, equal to the amount it moved in all of 2023. SAN is part of a global trend whereby banks seek to share risk in their loan books in order to reduce capital needs, playing into the demand for assets by buy side firms not subject to the same capital requirements.

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Reg Cap News (continued)

Goldman and Blackstone Team Up for Novel Fund Finance Bond (BN, 10/18/24) and ***Wall Street is cranking up its complex bond machine again****. (The Wall Street Journal, 10/23/24)*
Goldman Sachs did a $475mn capital call securitization, a new asset class for the market, though an asset that has been used in reference pools for SRT. Capital call loans provide interim liquidity for private equity and other investment vehicles, who prefer to delay drawing down commitments from investors until they have identified core investments. By contrast, drawing down the funds before they are deployed can harm fund return metrics. Securitizing these loans takes them off Goldman's balance sheet and frees up cash that they would otherwise need to reserve against potential losses.

Credit Spreads Flag Caution on US Economy Fairy Tale: Macro View (BN, 10/22/24)
Tight credit spreads suggest that investors are confident in the US economy. The spread between junk bond yields and the midpoint of the Fed's target rate is just about 230bps. The delta was as low as 171bp as recently as last month, the lowest spread differential in this century. To put these figures in perspective, in February 2007, the spread differential between Fed Funds and junk bond yields reached a then-low of 211bp. Of course, the GFC ensued, and junk bond losses exceeded 20% cumulatively over the next two years. In addition to noting just how tight credit spreads are, the article noted dual risks for credit investors. One, recession, and the concomitant rise in junk bond downgrades and defaults. Two, the lack of a recession (or at least a slowdown) … if the economy is stronger than expected, Fed rate cuts, which are already priced into bond prices, could fail to materialize.

BlackRock Says FDIC Plan Would Hurt Investors, Cost Banks (BN, 10/24/24)
Money managers' ownership of banks is limited by regulation, "because of concerns that concentrated ownership could give firms… undue influence over lenders." A new FDIC proposal seeks additional control and oversight over money managers' stakes in banks. BlackRock argues against this proposal on the grounds that it would "upend index funds, make it more costly for banks to raise capital and disrupt the economy." Our view is that banks play a vital role in the economy in terms of credit creation, and the fewer restrictions placed on their ability to raise capital in the public markets to support lending, the better.

Goldman, BNP See Credit's Blanket Rally Turn to Cherry Picking (BN, 10/24/24)
In another piece warning about the tightness of credit markets, this article notes that the risk premium between global corporate bonds rated single A and those at BBB- (just above junk) has fallen to the lowest level since 2008.
Part of this compression is simply supply and demand. When the Fed starts to cut rates, funds flow from the short end of the curve, such as money markets, into fixed income. Billions have been pouring into funds that invest in corporate bonds, and a record share of survey respondents expecting inflows into high-grade funds over the coming months.

On the fundamentals side, increasingly tight spreads beg the question as to whether investors are being appropriately compensated in a world with slowing economies and high geopolitical tension. Analysts at Goldman Sachs and BNP Paribas are forecasting the end of the credit rally.

JPMorgan CEO Jamie Dimon says 'it's time to fight back' on regulation (Reuters.com, 10/28/24)
Dimon continues on the warpath with regulators. "We are suing our regulators over and over and over." Although the Fed agreed last month to tone down the Basel Endgame proposal so that it would raise capital requirements for big banks by 9%, down from the original 19%, Dimon sees the need for more work, saying "the devil is in the details." In particular, Dimon called the capital surcharge for SIBs ("systemically important banks") "stupid, "and operational risk calculations "ridiculous." As a practical matter, the direction of bank regulation depends heavily on the outcome of today's election.

Asset-Backed Sales Top $313 Billion, Beating Post-GFC Record ((BN, 10/29/24)
The boom in the ABS market reflects the same drivers that we see in SRT; namely, banks' need to free up risk-based capital as regulations change (the so-called "Basel III endgame"). Issuers have brought ABS bonds backed by ever more exotic forms of collateral this year, as the article outlines, and investors have been receptive.

Private Credit's Banking Romance May Turn Sour (BN, 10/29/24)
Intuitively, banks and private credit are competitors. However, it can be beneficial to both to partner up and that is why "Seventeen of the biggest banks in the US and 12 in Europe now have some kind of private-credit linkup," with fourteen of those partnerships created just this year.

Most deals (~75%) have been with "direct lending" funds that lend to private-equity buyouts or to small- and mid sized companies that are underserved by banks, typically sub-investment grade credit. The rest do asset-based lending: anything from credit-cards and mortgages to equipment and commercial real estate. The synergy is as follows. Banks already have the relationships and staff to find companies and individuals to lend to. They are looking for fee income while trying to conserve their balance sheet. Enter private credit, which needs banks for the reach to these customers, but don't have to deal with bank regulators.

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Reg Cap News (continued)

In these partnerships, the banks make a senior loan to a basket of different credits, while the riskier, junior slice is held by fund managers, or other non-bank investors. This allows the banks to "originate loans, sell the riskiest parts, rinse and repeat." This increases the "velocity of banks' of capital — how often it gets reused to earn fees and interest in a given period" – which bolsters banks' profitability. We caution that investors in these partnerships must be careful to ensure that the interests of the bank partners are aligned with theirs. Investors should be wary of banks earning fees by getting investors to take on loans that the bank views as overly risky. We view SRT as an attractive way for investors to take exposure alongside banks to their core on-balance-sheet lending. We also note that overly aggressive, often politically motivated calls for increasingly stringent regulation on banks tends to shift more lending into the largely unregulated private credit space.

Wall Street Sees Lines Blur Between Private Credit and Bank Debt (BN, 10/29/24)
Like the article just above, this piece shows how the "worlds of private credit and traditional bank debt are continuing to collide." Moreover, though private credit traditionally provided capital to private, non-investment-grade companies (which couldn't get traditional bank financing) they are now also lending more to established businesses. Rather than view private credit as a threat, banks now see the attraction of partnering with big asset managers as a way to earn fees and revenue while freeing up their own balance sheets. "This is about just the efficient delivery of capital …Capital is like water coming down a hill. It will find its path. Sometimes it gets stuck, but it will find its most efficient path."

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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