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Reg Cap Recap

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

SEER CAPITAL

November 19, 2024

Reg Cap Fundamental Credit Trends

The Reg Cap 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 the banks' balance sheets have generally outperformed assets in generic credit indices. Further, investors impose selection criteria and originators, when selecting assets for a reference pool, are motivated to help ensure the success of their Reg Cap program on the most attractive terms.

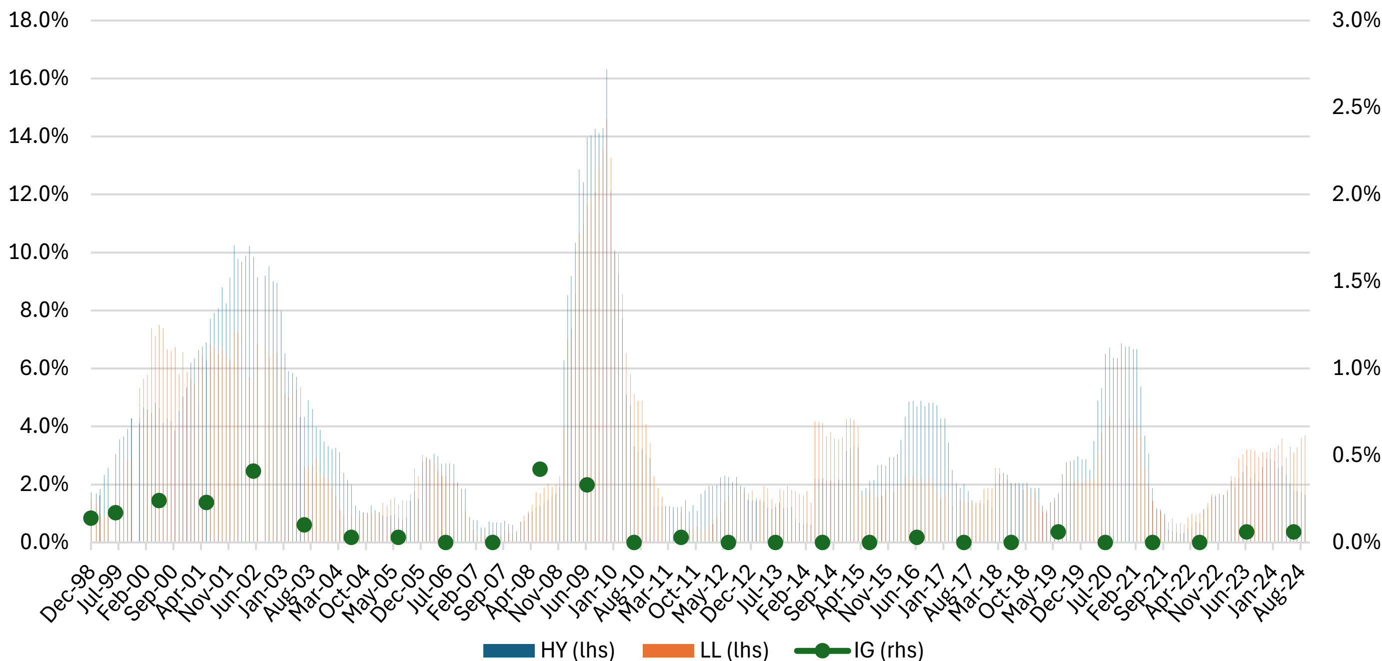
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 33 deals that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we are 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 to be consistent with very low or no IG defaults.

In October, the par-weighted US high-yield bond default rate fell 24bp MOM, while the loan default rate increased 11bp MOM, to 1.39% and 3.78%, respectively. While HY defaults are well below their 25-year average (3.4%), loan defaults are higher than their average (3.0%). Looking forward, analysts are generally constructive on credit. For one, the share of bonds/loans that are trading at distressed levels continues to decline. In addition, the economy and corporate fundamentals are both strong, and capital markets activity is robust.



Source: Standard & Poor's, JPMorgan Research, as of October 31, 2024.
** HY and LL on a trailing 12-month basis, dollar-weighted. Includes distressed exchanges. IG on an annual basis.*

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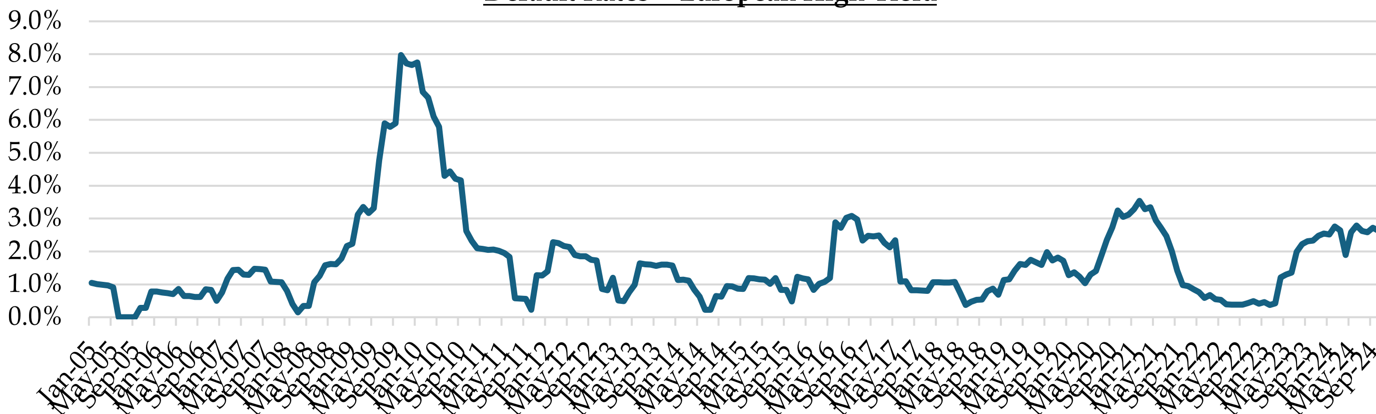
Reg Cap Fundamental Credit Trends (Cont.)

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.

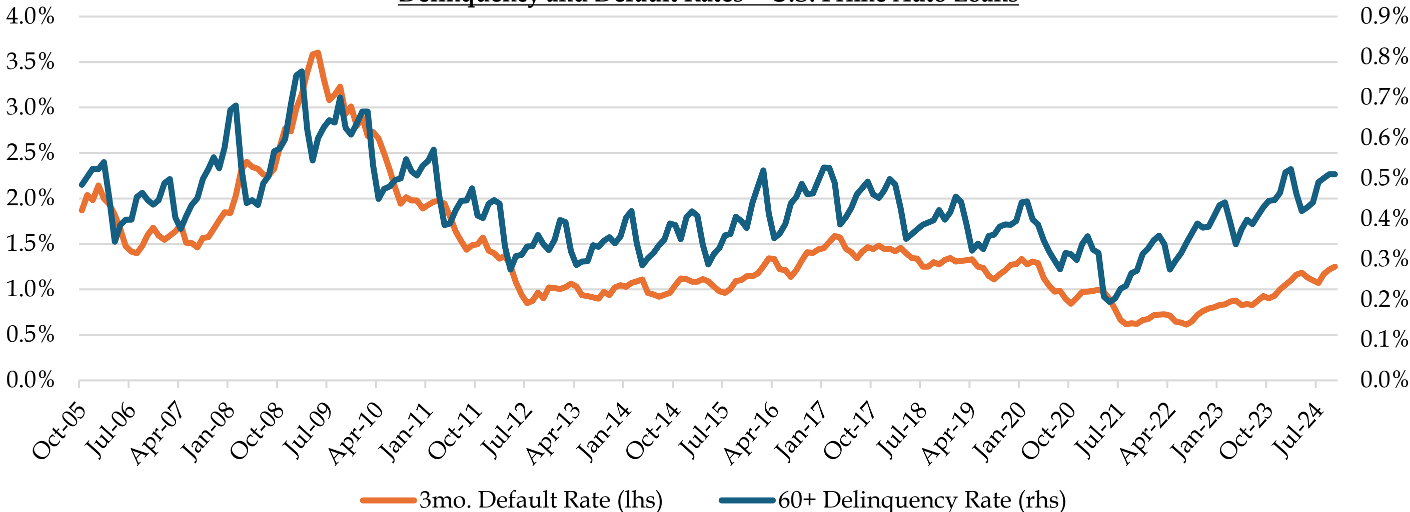
As of September 2024, the trailing 12-mo. default rate for European HY is 2.63%, down 9bp MOM but 92bps above average. While GDP growth in the Euro area has been slow, at just 0.4% in 2023 and 0.8% (estimated) in 2024, the European Commission forecasts a pickup to a 1.4% rate in 2025. Meanwhile the share of distressed Euro HY bonds (trading at 1000bp+) fell sharply MOM, and is at 5.6%, a two and a half year low. Lower levels of distress augur 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.



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

US Prime Auto Loans

As of the end of October, the 60+ delinquency rate for securitized US prime auto loans is 51bps (unchanged MOM) and the 3-month default rate is 125bps (up 3bp MOM). This leaves delinquencies slightly above their long run average (42bps), but with fewer delinquencies rolling into defaults, 3mo CDRs are *below* their long run average of 143bps. Auto loan delinquencies bottomed in 2021, reflecting the impact of stimulus payments and a shortage-induced spike in used car prices. With this latest data, credit performance has returned to the pre-COVID status quo ante. We expect consumer credit to remain robust, given full employment, real wage growth, and rising household net worth.



Source: Morgan Stanley, as of October 31, 2024.

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Reg Cap News

Issuance News:

Commerzbank Sells SRT as CEO Embarks on Plan to Free Up Capital (Bloomberg News, 11/5/24)
Commerzbank is selling a Reg Cap deal linked to a portfolio of €2 billion in corporate loans. The size of the deal is ~€150 million. Commerzbank is seeking to free up capital to create capacity for investor payouts and investments including acquisitions, and increasing use of SRTs is an element of that plan. Commerzbank is working to optimize its balance sheet in an effort remain independent, as Unicredit has expressed interest in taking over the bank.

Raiffeisen International Sells SRT Tied to €2.8 Billion of Loans (BN, 11/18/24)
Austrian bank Raiffeisen completed a Reg Cap deal tied to €2.8 billion of corporate loans in Austria, Slovakia, Germany and the Czech Republic, retaining first loss and senior portions. A mezzanine tranche was sold to international investors, including alternative investment funds and an insurance company. The deal adds ~16bps to their CET1 capital ratio.

Reg Cap News:

Banks gain traction with reg cap trades (IFRE.com, 11/1/24)
Citigroup, Deutsche Bank and Natixis are among several banks that have used Reg Cap in the past year to buy credit protection for CVA, or "credit valuation adjustment" risk, in which banks must account for the possibility of losses from derivatives counterparties. "CVA is one of the largest capital charges banks face," and is often difficult to hedge by other means, For example, there may not be an active credit default swap market for many counterparties. Reg Cap can provide an effective hedge "for some of banks' thorniest (and often least liquid) derivatives exposures."

Significant risk transfer (SRT) securitizations are an established part of European banks' capital and risk management toolkits (Standard & Poor's, 11/6/24)
Standards and Poor's writes that "well-designed SRTs (are) an effective capital and risk management tool" and that they expect issuance will grow and become more broadly based. One of the most newsworthy statements in their research was that they "have not found evidence of material leverage or direct bank financing of investors' positions," a topic which has fueled much speculation. Other key points from their research:

1. Issuers' motivations have evolved to view Reg Cap as a tool for proactive management of loan books, to improve capital efficiency and shareholder returns.
2. Corporate loans remain the traditional focus of European Reg Cap but activity in other wholesale asset classes and retail loans is on the upswing.
3. Reg Cap contributes to the trend of transferring of traditional banking risks to non-banks.
4. European regulators are generally supportive of Reg Cap and the broader securitization market.
5. Most European Reg Cap deals are funded structures. The U.K. regulator has proposed joining the EU in recognizing unfunded credit protection, generally provided by highly rated investors such as certain insurers.
6. Reg Cap deals are likely to become more expensive for issuers (see below).

SRTs to Get More Costly for Banks on Rising Supply, S&P Says (BN, 11/6/24)
S&P expects that SRTs will become more costly, for two reasons. One, the rating agency expects more issuers to enter the market, creating less favorable supply/demand technicals for issuers. Secondly, they expect that banks will probably have to sell thicker tranches to free up capital when the Basel endgame rules are finalized. They note that the number of issuers globally has already doubled over the past five years to 70, with Barclays and Santander dominating the market in Europe. Loans referenced in Reg Cap reached ~$1 trillion globally as of end-September. We see plenty of demand to absorb the current level of supply but agree with S&P that continued supply growth is likely given the myriad benefits that can be derived from Reg Cap by banks in the US and globally.

SRTs are the celebrity of loan markets —What Lies Ahead? (LMA.com, 11/12/24)
Reg Cap is "the loan market celebrity of the moment" and has become the "credit risk distribution tool of choice…with more than 500 synthetic Reg Cap transactions issued between 2016 and 2023" referencing "more than €1 trillion of underlying loans." The author, a representative of the Loan Market Association ("LMA") argues that Reg Cap is effective because it allows banks to transfer a portion of their credit risk in a manner that is efficient, investable and, crucially, beneficial from a regulatory standpoint. For issuers, Reg Cap gives banks "the right amount of cover for the right amount of risk" while investors get access to a different slice of loan markets and attractive risk-adjusted returns.

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Reg Cap News (Cont.)

The author admits that it takes a lot of effort for an issuer to start a Reg Cap program, from structuring to due diligence down to data analytics and data clean up. But repeating the process is easier. Notably, the author argues that Reg Cap "is not a risk shift enabling a bank to escape if things go wrong. Rather it is a "risk share, with investors looking to benefit from the success of a portion of a bank's balance sheet of loans."

Lastly, the LMA argues for greater industry collaboration and education, facilitating discussion and tackling issues head on so that "we can make meaningful improvements as well as find solutions to challenges."

Informa's Super Return Private Credit Conference (informaconnect.com 11/13/24)
Seer recently attended this industry conference aimed at allocators in the private credit space. Reg Cap is an increasingly important sector within private credit and was the focus of a number of the panels and discussions. Panelists argued that, while Reg Cap spreads have tightened considerably, they are not significantly lower on a risk-adjusted basis given strong economic fundamentals and more careful selection of credits. There was also discussion about barriers to entry in SRT investing, including analytical expertise and, in some cases, superior access to deal flow for long-time "club investors" like Seer. In addition, it can be easier for small / targeted managers to generate alpha vs. large managers who need to deploy much larger sums in what is still a niche market.

Several participants agreed that, notwithstanding a change in the administration and presumably less regulatory zeal, they expect that US banks will continue to be interested in issuing Reg Cap, even without further regulatory changes. Reg Cap remains the best way to manage capital on their core loan book, to free up lending capacity, manage dividend distributions, and free up capital for M&A activity. In Europe especially, with banks trading at ~70% of book and facing profitability issues, Reg Cap will be a mainstay. It was noted, however, by one panelist that we have "probably seen peak bank regulation;" that is, rules won't get any harsher, but they probably will not be rolled back significantly either.

'Flood of Money' Chases US Banks' Hot New Trade Despite Risks (BN 11/14/24)
This article, part of a run of recent negative coverage on Reg Cap by *Bloomberg News*, included several points that we believe demonstrate a significant misunderstanding of the market. For example, the article cites the need for central bank approval on each trade for the slower-than-expected development of the US market. However, this approval requirement only applies to deals structured as credit-linked notes issued directly from a bank's balance sheet. As the Fed FAQ published in September, 2023 makes clear, if the bank structures the deal by buying protection from an SPV, no approval is needed. We have seen a significant number of US banks issue transactions using the SPV structure (roughly half the total number of deals in the market) and don't see the approval requirement for direct CLNs as a major impediment. We do believe regulatory clarifications around the ability of banks to syndicate SPV deals more broadly would help grow the market and broaden the investor base.

The article goes on to claim that some banks are selling Reg Cap deals so broadly that they may no longer know the end buyer of the risk. This is also a misunderstanding--some SRT deals are distributed to a small club, while some are syndicated more broadly. But even in a broadly syndicated deal, the banks know and settle with all of the buyers. And, while there is not an active secondary market for SRT, these buyers may occasionally trade the bonds; this is normal and should not be problematic. Issuers wishing to track who owns the bonds require investors to sign representation letters at closing and notify the issuer on transfer of the bonds – generally a straightforward process.

The article further notes that "the influx of new investors has also meant more are willing to take a "quantitative approach" to SRTs and focus their efforts on blind pools" and even suggests that "newcomers who rely on statistics and probabilities could later prove fickle."

The newcomer to the market here is the author, it would seem. At Seer, we have completed 77 different SRT investments since 2010, all of which we have analyzed using a statistical approach to project performance based on the historical performance of similar loans originated by the bank. All 77 transactions have performed within a reasonable margin of our base case projections—indeed many have performed significantly better than our base case. We prefer to invest in granular portfolios based on a statistical approach rather than taking large exposure to individual credits which could impair a significant proportion of our investment if they default. Our statistical approach also aligns well with and draws on our decades of experience in structured credit.

Concerns About Credit Risk in SRTs Are Growing (BN, 11/16/24)
This article includes the hardly earth shattering revelation that "The Federal Reserve, Bank of England and European Central Bank have been discussing the (SRT) market as part of a larger dialogue on the nexus of risk between traditional lenders and non-banks,

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according to a person with knowledge of the matter." Reg Cap investors partner with banks to provide capital to support their core lending business. Imposition of additional regulatory constraints on banks, including on their ability to access the Reg Cap market, will push more lending into unregulated areas of the financial markets.

Bloomberg also cites the SRTx indices as alleged evidence of deterioration of credit quality in Reg Cap transactions. As we have frequently noted, these indices are compiled from contributions from an unknown, but we believe small, number of market participants and should be interpreted carefully. Because there is currently a high level of demand for Reg Cap deals, some index contributors may anticipate that issuing banks are likely to be tempted to issue deals referencing lower quality assets. 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.

Bloomberg Opinion Matt Levine's Money Stuff: Palantir Delivers the Tendies (Bloomberg Opinion, 11/18/24)
Columnist Matt Levine jumped on *Bloomberg News'* anti-Reg Cap bandwagon in his *Money Stuff* column. He writes of SRT, "...If your model is roughly 'banks have the sales force to make loans, and investors have the money to take the risk,' who is in charge of underwriting the loans? Who gets to decide which loans are a good credit risk? A reasonable answer ... is 'both of them' but a 'plausible' answer is 'neither of them.'" Of course, Levine and his colleagues should know what all Reg Cap market participants know, which is that Reg Cap deals are designed for banks to share a portion of the risk in their core lending to key clients. Banks retain the majority of risk on the majority of loans and sell investors a portion of the risk to make the lending more capital efficient. Reg Cap differs from a lot of direct lending products, including those originated in partnership with banks, in that the bank originates the loans with the intention of keeping them on its balance sheet, and keeps the majority of the risk. Seer and other Reg Cap investors carefully due diligence the loans, the bank's lending process, and the bank's motivations for the transaction to ensure they are purchasing high quality exposures alongside the bank.

Banking Industry News:
Bloomberg News Transcript: Can You Ever Really De-Risk the Banking System? (BN, 11/11/24)
Since the GFC, there has been a "migration of certain types of risks outside of regulated deposit-taking banks". In theory, it would seem that this disintermediation has created a stronger banking system by moving risk to less systemic institutions. But if these institutions are relying on the same deposit-taking banks for financial leverage, then has the risk effectively left the banking system, or not?

This is a question that has been raised several times in recent months with regard to Reg Cap, and we think this group discussion gets the answer right. First, they make the all-important point that the vast majority of Reg Cap are funded. So, the banks that issue Reg Cap are not exposed to the creditworthiness of Reg Cap investors. And, if Reg Cap investors choose to leverage their investment, it is still not a zero sum-game for de-risking the banking system. The authors note that any bank that might provide financing for a Reg Cap investor is "really …more protected …because they do have that firm's capital and they have that firm's, you know, alleged skill at managing these risks."

On another note, the point was made that the tighter Basel rules get, the more lending goes to private credit, which puts it outside of regulators purview. Some regulators argue that they "need more authority to regulate the non-banking sector like banks" or else they'd better "be nicer with Basel III… so you don't push all this stuff into private credit."

Citigroup CEO Fraser Says It's 'Game On' for Deals in the US (BN, 11/12/24)
Citigroup Chief Executive Officer Jane Fraser, in an interview with *Bloomberg Television,* said that Citigroup expects tighter capital regulations to be significantly eased—"if they're enacted at all." This sentiment was a common refrain post-election. As the prospect for less onerous bank capital requirements relates to the outlook for Reg Cap, we, and others, continue to expect increased participation by banks in the US and globally. Banks are motivated to tap the Reg Cap market by a variety of factors, including capital optimization, freeing up limits for additional lending, demonstrating liquidity and establishing pricing benchmarks for lending, etc.

JPMorgan AM and Voya See Risks Lurking Amid Credit Euphoria (BN, 11/13/24)
After a post-election rally, spreads on US investment-grade bonds plunged to the lowest level since 1998 and High Yield spreads fell to the lowest since 2007. Investors lamented that today's tight spreads fail to price in any volatility. Record-tight spreads in the broader fixed income market help put Reg Cap tightening in perspective, especially given the sector's excellent credit quality and inherent diversification.

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Trump and Musk's epic deregulation must preserve financial stability (Bloomberg Opinion, 11/13/24)
President-elect Trump has promised "the largest regulatory reduction in the history of our country" and to "slash 10 rules for every new one added," in what his appointee Musk calls "a bonfire of nonsense regulations." This editorial argues that "Where the financial system is concerned, deregulation may be especially fraught. Last time around, Trump scaled back several major rules adopted after the global financial crisis, an effort that may have contributed to last year's spate of bank failures". The author goes on to argue that banks "must be strong enough to weather turmoil." To that end, capital adequacy is paramount and a "bonfire" in banking regulations is ill-advised. At Seer we agree that targeted, careful regulation makes sense, and caution that increased regulations and restrictions on banks' activities has unintended consequences, such as pushing increased lending activity into unregulated sectors.

Bloomberg News Ed Altman Says Private Credit Has Broken a Junk Bond Barometer (BN, 11/14/24)
In the same vein as the article quoted earlier above, this article discusses the fact that high yield ("HY") spreads are tight vs. historical norms. For example, the article points out, the average HY spread is 255bp currently, down from ~520bp on average since 1986. Altman attributes these tight spreads to private credit, which he believes has made borrowing cheaper for HY borrowers because it has reduced supply in the HY market.

Fed Refuses to Back Basel Climate Plan, Leaving Talks in Limbo (BN, 11/14/24)
US regulators led by the Federal Reserve have refused to endorse a plan to push lenders to disclose their climate risk. Chairman Powell disagrees with the ECB, which wants to add climate risk to bank disclosure requirements. Powell argues that the Fed "doesn't have a mandate" for "fostering an energy transition or dealing with climate change." Meanwhile, French President Macron was quoted as saying the EU should "synchronize" banking regulation with the US, lest harsher regulation render EU banks uncompetitive, presumably more broadly speaking than just aligning climate change disclosure.

UK Argues Post-Crisis Crackdown on Wall Street Has Gone Too Far (BN, 11/14/24)
The UK's Chancellor of the Exchequer and the new Lord Mayor of the City of London are both arguing that the UK's crackdown on banks post GFC has gone too far, claiming "We need to reform attitude to risk within regulators and rethink our mindset" and "...regulators will increasingly need to focus not just on preventing failure, but actively encouraging success." This article and the previous one represent further evidence that, globally, bank regulation has likely peaked and the trend is toward rationalizing regulation to promote economic growth and avoid further migration of lending away from banks.

FDIC Chair Gruenberg Moves Up Departure to Eve of Inauguration (BN 11/19/24)
The head of the Federal Deposit Insurance Corp. has announced that he will step down Jan. 19, 2025.
His departure will allow Trump to appoint a replacement and give Republicans control of the agency at a time when banking regulatory reform is in flux. It is worth noting, though, that in many instances reforms must be jointly agreed by other federal banking regulators such as the Fed.

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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