Seer Capital Management LP
1177 Avenue of the Americas, 4th Floor
New York, NY 10036
212 850-9068
investorrelations@seercap.com
www.seercap.com

Reg Cap Recap

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

December 17, 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.

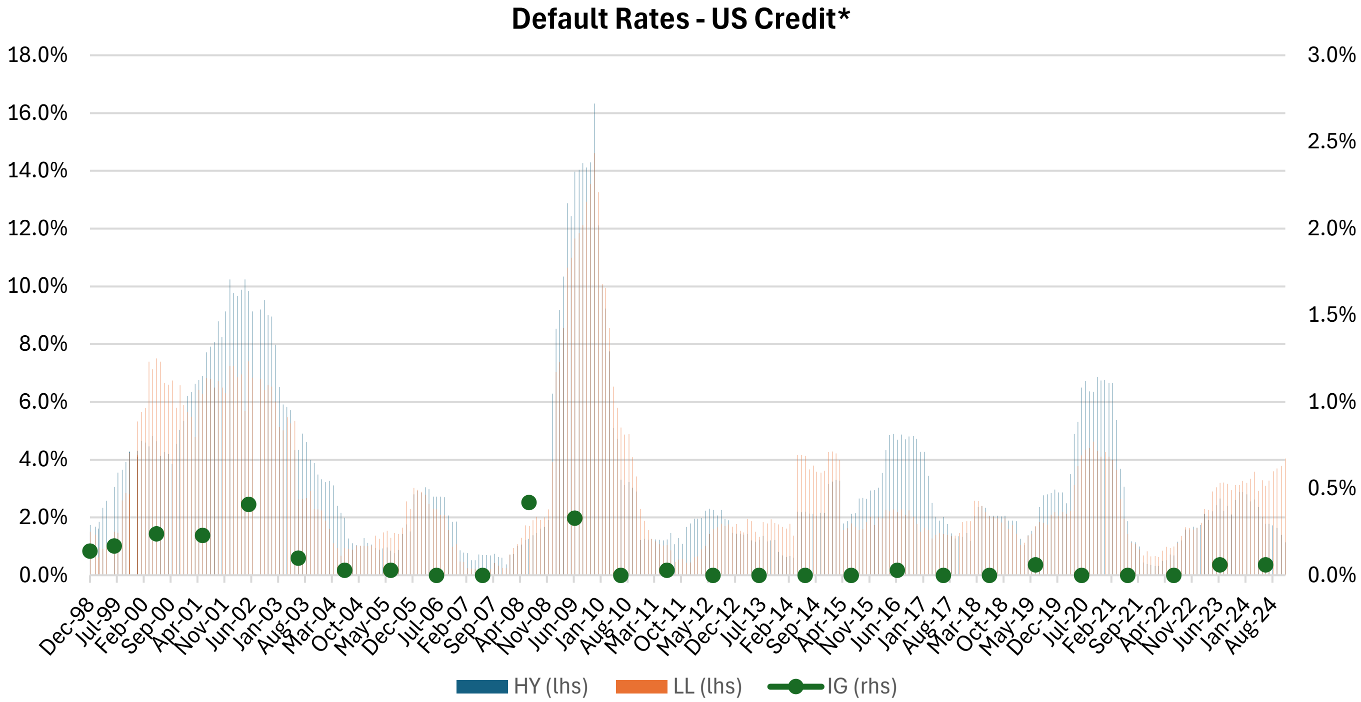
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 33 deals that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we are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

After an unusually heavy slate of defaults last month, default activity moderated in November. There were seven defaults/distressed exchanges this month, down from thirteen last month, which was in line with the YTD monthly average. Including distressed exchanges, the par-weighted US high-yield bond and loan default rates decreased 25bp and increased 26bp MOM to 1.14% and 4.04%, respectively, The leveraged loan default rate is widely expected to moderate in 2025, mean-reverting closer to its long run average of 3%, while the default rate for high-yield bonds is expected to stay essentially flat YOY.



Source: Standard & Poor's, JPMorgan Research, as of November 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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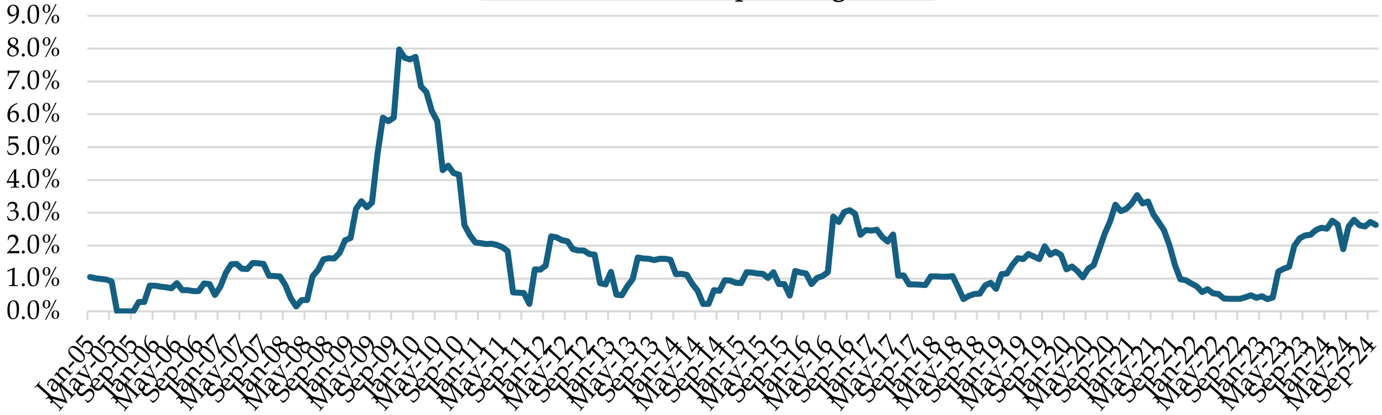
Reg Cap Fundamental Credit Trends (Cont.)

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 2.63%, 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.

Default Rates - European High Yield

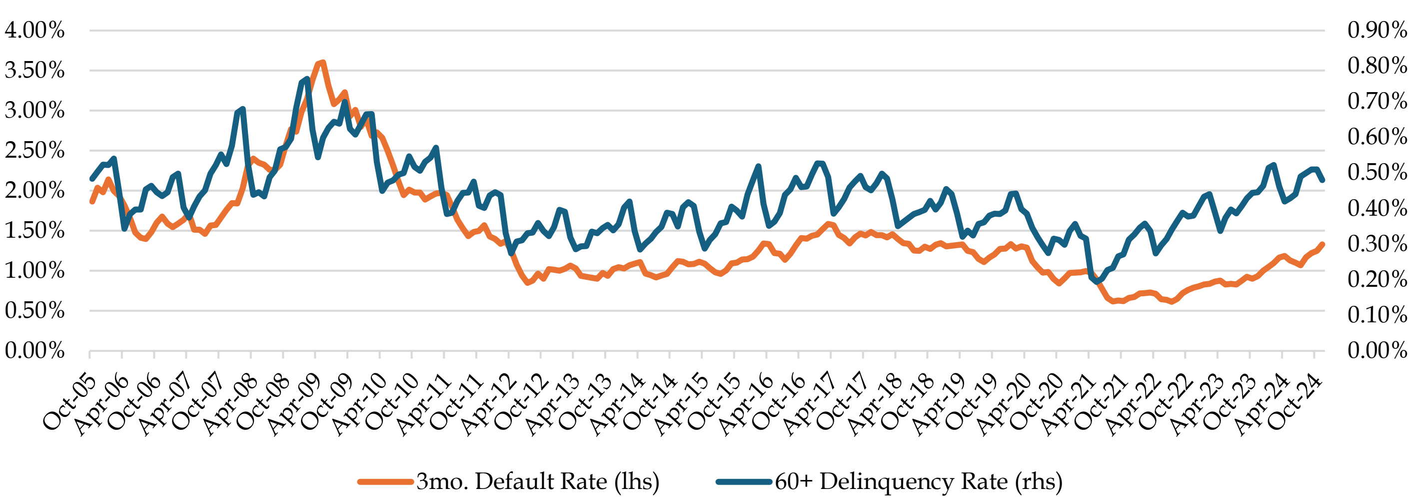


Source: JPMorgan Research, as of October 2024 (latest data available). Trailing 12-month basis, dollar-weighted. Excludes Banks/Insurers.

US Prime Auto Loans

As of the end of November, the 60+ delinquency rate for securitized US prime auto loans is 48bps (down 3bp MOM) and the 3-month default rate is 133bps (up 8bp MOM). This leaves delinquencies slightly above their long run average (42bps), but with fewer delinquencies rolling into defaults, 3mo CDRs are still below their long run average of 143bps.Consumer credit performance is well supported by full employment, real wage growth, and rising household net worth.

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



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

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Reg Cap News

Issuance News:

BBVA Bolsters SRT Deal by €1 Billion on Strong Demand (Bloomberg News aka "BN," 12/3/24)
Amid continued strong investor demand, Banco Bilbao Vizcaya Argentaria upsized their most recent Reg Cap deal. The Spanish lender increased the underlying portfolio to €3 bn from €2 bn of loans, bringing the size of the deal to €190 mm, up from €127 mm. Separately, the bank also recently announced that Dutch pension fund manager PGGM agreed to invest in a new Reg Cap deal linked to €2 bn in loans to large corporate clients across the US, Spain and other European markets. BBVA's CEO has stated that the bank plans to be more "engaged" in Reg Cap as a means to increase profitability.

Scotiabank Plans SRT Tied to $5 Billion of Corporate Loans (BN, 12/6/24)
Bank of Nova Scotia is premarketing a Reg Cap deal linked to a $5 bn portfolio of USD corporate loans. It is estimated that the Reg Cap deal offered would be roughly 7% or ~$350 mm in size. Banks in Canada have been active in Reg Cap in part because regulators have been near the forefront in implementing Basel III reforms around bank capital. Earlier this year Toronto-Dominion Bank brought a Reg Cap deal backed by a pool of $3 bn of loans.

BNP Boosts SRT a Second Time to Back €17 Billion of Loans (BN, 12/9/24)
BNP Paribas upsized their corporate loan Reg Cap deal for a second time. Initial discussions pegged the portfolio size at €8 bn to €12 bn, which was then upsized to €14 billion and then upsized again to €17 bn. The size of the Reg Cap transaction is now ~€764 mm, up from €650 mm during initial discussions. BNP Paribas also placed €103 mm of Reg Cap using unfunded credit protection.

Deutsche Bank Plans SRT Deal Tied to €2 Billion German Loans (BN, 12/11/24)
Deutsche Bank is planning a new Reg Cap issue linked to a €2 bn portfolio of loans to German mid-cap companies, a mix of investment and sub-investment grade, to be completed in Q1. While industrial production figures show that Germany's economy is struggling to recover, S&P said in a recent report that Deutsche "can cope" with Germany's underperforming economy and global trade uncertainties" and that they expect lower provisioning for credit losses next year and improving capitalization.

Attica Bank Completes First Synthetic Securitization of €220M (BN, 12/12/24)
Attica Bank successfully completed a €220 mm Reg Cap deal linked to a performing SME and large-corporate portfolio. This was the first Greek Reg Cap deal structured as a direct CLN off a bank's balance sheet.

Germany's Helaba Sells SRT Linked to €2.3 Billion of Loans (BN, 12/16/24)
German bank Helaba Completed a Reg Cap translation tied to a pool of €2.3 bn of corporate loans, allowing Helaba to release about €1 bn of risk-weighted assets. Helaba will hold a small first loss and the senior tranche of the deal. This is Helaba's second Reg Cap issuance--their first was in 2022.

Banks Pitching SRT Deals Find ESG Is Fast Route to Investors (BN, 12/16/24)
Significant risk transfer bonds (aka Reg Cap) are increasingly being marketed as ESG (Environmental, Social, and Governance) investments, according to the International Association of Credit Portfolio Managers. In 2023 (the most recent data available), ESG had grown to 11% of the SRT market. While the intertwining of sound banking regulation with ESG goals is controversial, the article asserts that lenders are doing ESG deals "because investors are asking for it." These deals help meet ESG goals by transferring risk from a portfolio of ESG loans, or by pledging to allocate freed-up capital to ESG projects or by tying pricing to ESG criteria. A lack of standards as to what qualifies as ESG is an issue for some. Deutsche Bank, Société Generale and BNP Paribas have all issued ESG SRT.

Reg Cap News:

Structured Credit Investor New York Networking event (12/4/24)
We attended this event. Market participants discussed the potential impact of the incoming administration on bank regulations and the SRT market. Onerous bank regulation scenarios seem unlikely, but the primary focus of regulators is not expected to be on adjusting/completing the Basel Endgame, so banks will likely need to proceed based on the regulations currently in place. Concerns were raised about leverage, including the treatment of SRT financing by counterparties as short-term market risk, rather than credit risk. At Seer, we have only seen relatively conservative financing arrangements offered. Moreover, in our experience, Reg Cap trades at much more constructive prices than other structured credit assets during market stress, such as in the early days of COVID. We chatted with officials from the Federal Reserve Bank of New York, who appeared receptive to the SRT product and optimistic about the development of the market.

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ECB Is Said to Quiz Some Banks About SRT Buyers' Leverage (BN, 12/6/24)
The European Central Bank is researching the use of leverage by Reg Cap investors to finance their positions. At issue is whether Reg Cap is fully mitigating risk in the banking sector, or, by banks financing those who buy Reg Cap, if we are imply shifting the risk across the banking sector. The ECB supervisor sent a questionnaire last month to top European banks, "asking about policies and conditions they attach if investors want to buy their SRTs with borrowed money "as well as financing terms. There is debate about the need for regulatory guardrails on the financing of Reg Cap investment. We find some of this concern to be misguided. The same features of Reg Cap that make it an attractive investment mean it is suitable for judicious leverage.

ECB Seeks to Speed Up Approvals for SRT Deal as Demand Grows (BN, 12/6/24)
and ***ECB Seeks to Speed Up SRT Approvals, Supervision Head Buch Says*** (BN, 12/17/24)
The European Central Bank is seeking to accelerate its approval process for Reg Cap. Currently, issuers are required to submit their deals for approval at least three months in advance; that could be shortened to as little as two weeks. The ECB would also require fewer details about proposed transactions. A 6-month pilot of the new approval system begins in January. We applaud the supportive and constructive approach that European regulators adopt toward Reg Cap, which has developed in a virtuous cycle with the growth of the market over the past 10-15 years. We look forward to US regulators adopting a similar approach, but note that it is likely to evolve over time.

An old strategy is being reinvented on Wall St (ft.com, 12/7/24)
The author argues that, with Reg Cap, banks are "once again moving risk off their balance sheets…to make room for taking on more risk" and draws parallels to the Credit Default Swap market in the run up to the Great Financial Crisis. We would argue, and the author even allows, that risk that arises out of "normal course lending activities" is wholly different than the raw speculation that CDS facilitates, and thus these parallels break down quickly.

The author notes that ,in the case of Reg Cap, "Hopefully, it's a virtuous cycle of reducing risk at depository institutions and housing it at other financial behemoths" but goes on to argue that "just because risk is being removed from the balance sheets of the big Wall Street banks doesn't mean that risk disappears from the system," a point on which we agree. Of course the risk cannot disappear; Reg Cap involves the sharing of risk by banks with sophisticated investors managing long-term, locked-up capital. Cohan cites a letter asking the Fed to "address the growing systemic vulnerabilities posed by" the use of CRTs, as well as a letter suggesting "additional guardrails", but does not enumerate any of these alleged systemic vulnerabilities or potential guardrails. Lastly, and as has become customary in most such articles, Cohan raises the issue of leverage provided by banks for Reg Cap investment. As discussed above, we believe leverage has a legitimate place in the Reg Cap market and is not counterproductive to the goals of issuers or regulators, despite arguments to the contrary.

Pimco Warns of Potential 'Hidden' Hazards of Bank Risk Transfers (BN, 12/12/24)
Pacific Investment Management Co. garnered headlines by urging caution in Reg Cap investing, along with a handful of other asset-based finance sectors, claiming "hidden risks that have yet to be tested," although the article does not enumerate any such risks. Pimco's concerns are surprising, given that they employ a very knowledgeable and experienced professional who is active in the Reg Cap market. They further note that they do not consider Reg Cap an asset class, so much as a means to access the underlying asset class when "whole loans are less accessible, trading at rich levels, or offer less scale." Despite the word of caution, Pimco allowed that asset-based lending is one of their "highest-conviction investment themes."

Two's company... More buyers than before but less of them see reg cap trades, says research (StructuredCreditInvestor.com, 12/12/24)
This article, citing Seer's own research, notes that even though many investors have entered the Reg Cap sector in recent years, the sellers, paradoxically, are showing new trades to fewer and fewer buyers. SCI highlighted our argument that issuers want to be able to execute deals consistently through ups and downs of the market to avoid risk "flowing back" onto the balance sheet when deals mature. "Issuers need to rely on a stable, tried and trusted group of investors." As a rule of thumb, European issuers prefer club deals while US issuers have so far generally gone for the bilateral route, but we noted that large US banks who are in it for the long haul will likely also develop the syndicated approach. See the original research piece here: https://seercap.com/wp-content/uploads/2024/12/Reg-Cap-Inexperienced-Players-Need-Not-Apply.pdf

The Economics of Synthetic Risk Transfers (Bank Policy Institute, 12/17/24)
The BPI notes that Reg Cap is a useful tool for banks to manage lending exposures while keeping the relationship with the customer. Assets in respect of which regulatory capital requirements significantly exceed the actual risk of the loans constitute perfect candidates for inclusion in Reg Cap deals, as the disconnect between capital and risk creates an incentive to either reduce

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Reg Cap News (Cont.)

lending or find ways to align capital with risk. The article notes that under the standardized approach "the capital requirement for an auto loan to a customer with a perfect credit score is the same as for a borrower who frequently misses car payments…" The article includes a plot of Return on Tangible Common Equity (ROTCE) vs. Price / Total Book Value for banks with more than $100 billion of assets, and indicates that the correlation between these two measures is 0.87, meaning that higher ROTCE generally leads to higher share prices. It continues with an illustration of the ROE of a given prime auto loan portfolio under the standardized approach, which is 9%, but can be improved to 13% with the execution of a Reg Cap deal. The article ends by noting that "In Europe, where internal ratings-based approaches already align capital more closely with risk, banks still actively use SRTs to diversify their funding sources, manage concentration risk and optimize their overall capital structure." We think the BPI piece very effectively captures the appeal of Reg Cap for banks.

Banking Industry News:

Citizens 'Won by Losing' First Republic to JPMorgan, CEO Says (BN, 12/3/24)
Speaking about his bank's unsuccessful fight with JPMorgan to acquire First Republic Bank, Citizens CEO Van Saun said: "We might have won by losing." Citizens avoided having to absorb undesirable assets and instead went on offense by targeting First Republic's talent. Van Saun went on to discuss the post-election bank stock rally fueled by expectations of lower taxes, lighter regulation and a pro-business environment. He also noted that banks should be watchful of the ripple effect of nationalism on inflation and the supply chain, and uncertainty around tariff policies. More certain is the new administration's support for less-onerous capital rules, and a supportive environment for bank mergers.

Swiss Probe of Credit Suisse Nears With UBS Capital at Stake (BN, 12/9/24)
Switzerland is expected to publish its inquiry into the causes of Credit Suisse's 2023 demise, which is expected both to apportion blame and set the tone for the banking reform. The government has already put forward suggested financial regulatory changes, most notably, "sharply higher capital requirements" for UBS, Switzerland's largest bank. The government has said it is waiting until after the investigation's outcome; reforms are expected by the end of Q1. Meanwhile the Swiss Banking Association is arguing that Swiss regulation is already relatively strict and that new regulations could weaken the Swiss economy.

Canadian Banks Ready for Higher Capital Burdens (Bloomberg Intelligence, 12/10/24)
and ***Canada Keeps Capital Levels Unchanged for Biggest Banks*** (BN, 12/17/24)
The Canadian banking regulator reviews the domestic stability buffer "DSB" twice a year in June and December, (though it can also change between meetings if deemed necessary). At the June meeting, regulators held the DSB constant (at 3.5%), though they did cite "low but rising near-term risks to lenders." The concern was that the "elevated risks from highly leveraged households with variable-rate mortgages" and office sector woes might dictate a higher DSB. The domestic stability buffer is held as CET1 capital. With CET1 ratios at all leading Canadian banks exceeding 13%, they appear well able to comply with a higher DSB.

Update: On December 17th, regulators announced that the domestic stability buffer will remain at 3.5% of banks' risk-weighted assets. This means Canada's banks are required to have Common Equity Tier 1 capital >= 11.5% of risk-weighted assets; all six large banks easily exceed that ratio.

Santander's Botin Says Regulators Need to Stick With Mandate (BN, 12/10/24)
Banco Santander Botin joined the chorus of those calling on regulators to "hew more closely to their given remit" and "prioritize growth over regulation."Botin also claimed that agencies are interpreting rules in such a way that they are "de facto making new rules." Botin urged the European Union to "show restraint in financial rule making and instead focus on boosting the competitiveness of its banking Sector" and wryly noted "…one thing that works in Europe and Brussels is, 'Oh my God, the Americans are going to get ahead again…That's the one thing that seems to work."

European securitization dreams of transformation via regs reform in 2025 (globalcapital.com, 12/11/24)
The European Commission has been working on new EU Securitization Regulation ("EUSR"). A EUSR framework was released in October, with a public draft expected in March 2025, which will culminate in a proposal to the European Parliament by the end of August.

The EURS is "extremely comprehensive," covering everything from p-factors and risk-weight floors to due diligence and reporting requirements to market standardization. Those working on the EUSR stated that "a combination of measures is needed to revitalize securitization." The article noted that the proportion of securitization transactions placed with investors is running at €60bn-€80bn per year, down from €300 n+ before the GFC. They highlighted the need to remove any legal uncertainties, and the need for greater liquidity (perhaps by making it more attractive to banks to hold senior tranches in order to transform to a true-sale, publicly placed securitization market.

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Trump Advisers Seek to Shrink or Eliminate Bank Regulators (wsj.com, 12/12/24)
The Trump transition team is exploring shrinking, consolidating or even eliminating some banking regulators. One such proposal was the elimination of the FDIC, moving deposit insurance under the Treasury. The elimination of any agency would require congressional action. An easier sell may be the elimination of the Consumer Financial Protection Bureau, which is …less than popular among Republicans. In any event, the banking industry is optimistic that Trump will ease "a host of regulations on capital cushions and consumer protections, as well as scrutiny of consolidation in the industry."

Office Property Meltdown Begins to Show for Banks: Credit Weekly (BN, 12/15/24)
Falling property values in the Office sector have stymied refinancing, with lenders increasingly using loan modifications to deal with the crisis. For example, medium-sized banks modified nearly 2% of their CRE loans YTD, while the largest banks modified 0.79%. Regional banks have been "slower to confront declining commercial property prices" but are also more vulnerable because they tended to lend at high LTVs. The largest banks have been more proactive and are under greater regulatory scrutiny as well. The fallout of from Office sector woes is likely to be a source of weakness for banks, especially regional banks for the next several quarters if not years.

Thanks for reading and we wish you Happy Holidays and a prosperous 2025. Our next Recap will be distributed on January 7, 2025.

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.

For more information about Reg Cap or this publication, contact:

Terry Lanson
Managing Director
Reg Cap Portfolio Manager
212 850-9005
tlanson@seercap.com

Katya Bosshard
Director
Head of Investor Relations
212 850-9068
kbosshard@seercap.com

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