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Reg Cap Leverage: Clearing Misconceptions

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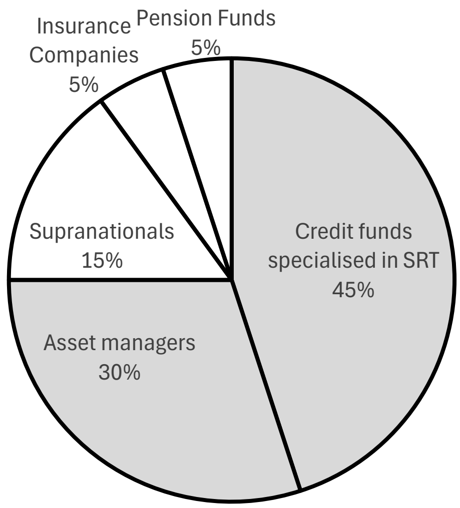
Leverage can be a vital financial tool for the economy, promoting home ownership, supporting small businesses, and contributing to economic growth. Excessive leverage has been a pro-cyclical contributor to market crashes, including the Great Depression and the Great Financial Crisis. Banks, investors, and regulators are faced with the constant challenge of ensuring that leverage remains constructive. Can leverage on Reg Cap fall into the beneficial category, or is it inherently excessive, as suggested by some recent press articles?

According to the latest figures from IACPM [1], Reg Cap issuance slightly exceeded €18 billion in 2023, bringing total outstanding to €55 billion by year end 2023. 2024 issuance was likely larger than 2023, although precise figures are not yet available. We estimate that current outstandings are perhaps €60 billion.

Figure 1: The Reg Cap investor base includes some types of investors that don't use leverage



Source: European Central Bank

In Figure 1, only the shaded categories, credit funds and asset managers, representing a total of 75% of the market, are potential users of leverage. We estimate that on the order of half of these investors use leverage. Under current market terms, leverage users generally borrow half or less of the amount they purchase. So total leverage outstanding against Reg Cap is likely on the order of €10 billion, hardly of a magnitude that could give rise to systemic risk (€60 billion x 75% x 50% x 50% = ~€11 billion).

[1] International Association of Credit Portfolio Managers, in its annual survey on risk sharing transactions by banks, May 2024

Reg Cap is an inherently stable and conservative asset class. Issuing banks and investors typically view Reg Cap as a partnership in which the banks share exposure to their core lending products and the investors provide capital relief. Regulatory and risk management requirements often mean that banks issue thick credit tranches relative to the risk being transferred. Historically, Reg Cap investments have exhibited stable mark-to-market performance across cycles, as discussed further below.

Some investors seek to borrow against Reg Cap transactions to enhance returns within their risk tolerance and make their capital go a bit further. Many investors have minimum return hurdles, which they can more safely meet by evaluating investments on a risk / reward basis and then applying judicious leverage to low risk investments, rather than considering only high risk / high return opportunities. Let's say an investor with a return target of 15% identifies a Reg Cap bond with a return of 12% and a very low risk profile. If the investor uses 40% leverage, assuming 7.5% financing cost, that brings the return on investment up to the 15% hurdle, with a minimal increase in risk. (see Figure 2)

Figure 2: Modest leverage increases the appeal of Reg Cap to a broader range of investors*

Item	Amount	Coupon/Return
Investment	$10mm	12.0%
Leverage	$4mm	7.5%
Equity	$6mm	15.0%

*(($10mm * 12%) - ($4mm * 7.5%)) / $6mm = 15%

The availability of leverage does not just benefit the investors themselves. It is also beneficial for Reg Cap issuers because it reduces investors' return requirements and increases the amount of capital available, leading to lower cost of issuance overall. This enables banks to generate capital more cost effectively using Reg Cap, hence they can lend to businesses and consumers at lower cost. Indeed, some banks use Reg Cap deal pricing as a benchmark for pricing lending products.

Reg Cap Leverage is attractive for financing counterparties because of i) the inherent stability of the asset class, and ii) structural protections and risk mitigations that help transform credit risk on the underlying positions into other risks, which they manage. For example, lenders often mark each position to market daily and call margin from their borrowers in the event of a decline in market value. Lenders require a significant amount of equity or "haircut" from borrowers, usually 50% or more, to cover both credit and mark-to-market ("MTM") risk. In addition, they generally require recourse not just to the subject Reg Cap position but to all investments in the particular borrowing fund, should the other protections prove inadequate. In that sense lenders are cross-collateralized. Some financing counterparties offer non-recourse financing options, usually in exchange for higher haircuts but also the ability to apply cashflows generated by a diversified portfolio of investments

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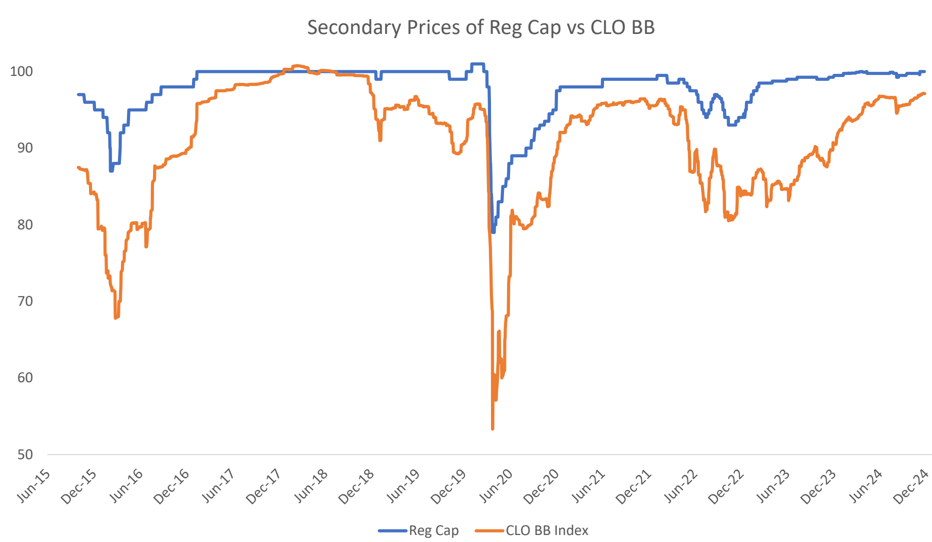
to reduce risk under adverse scenarios. For instance, a lender may finance a portfolio of 20 positions, and if one Reg Cap position suffers credit deterioration, they apply principal and interest cashflows on the other 19 to repay a portion of their financing. Understanding how Reg Cap leverage is typically structured makes it clear that there are many layers of protection that dilute the risk of such leverage.

It is fair to ask, of course, whether Reg Cap positions are sufficiently liquid that MTM margining requirements provide meaningful protection to financing counterparties. CLO BB-rated tranches, which are typically financed using repo with advance rates as high as 75%, are a good point of comparison. Dealers selectively make two-way markets in CLO BBs and even CLO equity tranches. Reg Cap bonds, in contrast, are rarely if ever subject to two-way markets, and are generally traded "by appointment." Liquidity in Reg Cap is constrained by the inability of issuers to take positions in their own bonds for regulatory reasons, in as much as a bank is not allowed to obtain capital relief by moving the risk elsewhere on its balance sheet.

In the most recent extreme market selloff, at the height of the COVID scare in March and April, 2020, Reg Cap junior tranches traded more actively, and at significantly higher prices, than CLO BB-rated bonds. In contrast to regular activity, trading in CLO BBs became very sporadic, with a few positions changing hands in the 50s price range. At the same time, Reg Cap bonds traded in the high 70s to low 80s, supported by a group of dedicated investors with confidence in the market who sought to add risk. The chart below illustrates the dampened MTM volatility exhibited by Reg Cap junior tranches compared to CLO BBs. Reg Cap's relative stability was most evident during the Covid selloff, but has prevailed during other periods of volatility as well, as Figure 3 shows.

Figure 3: Reg Cap bonds have proven unusually stable in periods of volatility



Source: Bloomberg, Seer Capital Research

Notwithstanding the benefits to Reg Cap Issuers, investors, and financing banks, various parties have raised concerns about Reg Cap financing based on the claim that Reg Cap risks must leave the banking system entirely.

Figure 4: Does Reg Cap risk need to be eradicated from the banking system for Reg Cap to be effective?

Statement	Source
"There is anecdotal evidence that banks are providing leverage for credit funds to buy credit-linked notes issued by other banks. From a financial system perspective, such structures retain substantial risk within the banking system but with lower capital coverage."	IMF [2]
"The lurking presence of Wall Street loans behind some of these complex trades suggests exposures that were meant to be shifted elsewhere remain tied to the banking system, an outcome that's starting to spook regulators."	Bloomberg [3]
"If a bank's lending against the SRT instrument as collateral, you're clearly not transferring the risk outside the banking system. Any counterparty investing in SRT using bank-provided leverage should be prohibited, full stop."	Sheila Bair [3]

These critics are off the mark in our view. As noted above, banks providing leverage for Reg Cap transactions assume risk to the investor / fund who is the borrower, but manage that risk by taking as collateral the Reg Cap position, as well as benefitting from structural protections such as cash haircuts and MTM margining requirements. Banks investing directly in Reg Cap deals issued by other banks is an entirely different matter—some banks are said to have entered into Reg Cap deals with each other on a quid pro quo basis during the financial crisis, but regulators have justifiably cracked down on this practice.

It is routine and entirely appropriate for banks to offer structured financing arrangements for assets that would be unsuitable for them to hold directly on balance sheet. Below is a list of some such assets, with financing instruments typically applied.

[2] Global Financial Stability Report, October 2024

[3] Bloomberg News, "JP Morgan's Risk Swap Ends Up at a Familiar Place: Rival Banks," 6/11/2024

Figure 5: Sample of assets financed by banks that are not appropriate for banks to hold directly

Asset	Financing Instrument
Public equities	Margin loan
Shares in banks	Margin loan
Cryptocurrency funds	Margin loan
Private equity investments	NAV loan
Venture capital investments	NAV loan
Bank AT1 capital instruments	Repo
BB and equity tranches of CLO	Repo
Middle market direct lending	NAV loan

If banks were prohibited from offering conservative financing structures against relatively safe Reg Cap deals, might they deploy their financing capacity in less conservative financing for other assets such as those listed in Figure 5?

Banks and regulators should, and do, track and carefully monitor all types of financing on bank balance sheets, including financing for Reg Cap deals, to ensure that they are structured and risk managed appropriately. In December, Bloomberg News reported that the European Central Bank had sent a questionnaire to several Reg Cap issuers asking about requirements they impose on investors who use leverage to buy their deals. Bloomberg noted "it's possible that the information it gathers will lead to a debate on whether regulatory guardrails are warranted." [4] We believe that such a review *is* appropriate, assuming it is aimed at ensuring that Reg Cap financing is risk-managed appropriately, in line with the financing of other products.

It is worth noting here that the regulatory environment in Europe creates less demand for financing Reg Cap than the US. Reg Cap deal structures are selected by European banks based on capital and risk management requirements, and many banks split the issuance into junior, for example, 0-7%, and mezzanine, say 7-10%, tranches. The junior tranches offer a risk profile and spread that are appealing to many investors, so fewer choose to apply leverage. The mezzanine tranches may be placed at much tighter spreads with insurers or other investors with different risk appetites and costs of capital.

The US capital regulations, in contrast, generally require banks to place 0-12.5% for the Reg Cap deal to be capital efficient. (The Basel Endgame proposal would increase that to 0-25%, although it

[4] "ECB Is Said to Quiz Some Banks About SRT Buyers' Leverage," 12/6/2024

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seems unlikely to be implemented in its current form by the incoming administration.) Further, US Reg Cap deals issued as direct credit-linked notes ("CLN"s) are subject to approval by the Fed and subject to a limit, while deals issued using special purpose vehicles ("SPV"s) do not require approval. Consumer assets, if referenced via an SPV, would trigger onerous reporting requirements to the Commodity Futures Trading Commission ("CFTC"), but corporate Reg Cap deals are typically issued using SPVs. However, some banks interpret the Volcker Rule conflict of interest provisions to mean that each Reg Cap deal can be issued using only a single SPV placed with a single investor, preventing both tranching and syndication. Consequently, the US market has seen several large, 0-12.5% deals issued at relatively low spreads to single investors. These large investors typically avail themselves of a range of financing arrangements within their fund complex to bring returns to target levels. Also, insurers are not eligible guarantors under the US capital rules. US regulators could reduce the need for leverage by i) clarifying that Reg Cap deals issued using SPVs can be tranched and syndicated, and ii) allowing insurers to participate in Reg Cap deals. See the Appendix for further detail on US legal and regulatory constraints.

Banks offering leverage on Reg Cap transactions transform and mitigate their balance sheet risk using a combination of tools such as cash collateral, mark to market margining requirements, and recourse to other assets. Banks routinely apply these same techniques to transform and mitigate risks on a range of other assets that they would not buy outright. Regulators should work to ensure that leverage on Reg Cap, like other leverage, is structured and managed appropriately, but there is nothing inherently wrong with leverage on Reg Cap.

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Appendix: US Legal and Regulatory Considerations for Reg Cap Issuers

Regulation	Description	Result / Workaround
Fed FAQ	Direct CLNs require Fed Reservation of Authority and are subject to a cap of the lower of $20 billion of assets referenced and the bank's total equity capital	Banks prefer to issue SPV deals where possible
CFTC Rules	SPVs for deals referencing certain consumer assets may need to register as Commodity Pool Operators (CPO), creating burdensome reporting requirements	Consumer assets are typically issued via direct CLN, although service providers may be able to assume CPO reporting requirements
Collins Amendment to Dodd Frank Act	US banks are constrained by the standardized approach	Banks must issue thick tranches, generally detaching at 12.5%, to obtain optimal capital treatment for the retained senior tranche
Volcker Rule	Conflict of interest rules restrict banks from controlling SPVs set up to issue Reg Cap deals	Several external law firms active in Reg Cap have outlined processes under which banks can syndicate SPV deals, but many banks take the view that the SPV must be set up for only one investor
Bank Capital Regulations	US banks cannot purchase protection from insurance companies directly in Reg Cap deals. By contrast, insurers often have a strong bid for mezzanine risk in European Reg Cap deals	Insurance companies are working on structures to invest in Reg Cap, and changes to the capital regulations are under discussion. In the meantime banks must place thick tranches with cash investors