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Reg Cap Recap

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

January 21, 2025

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.

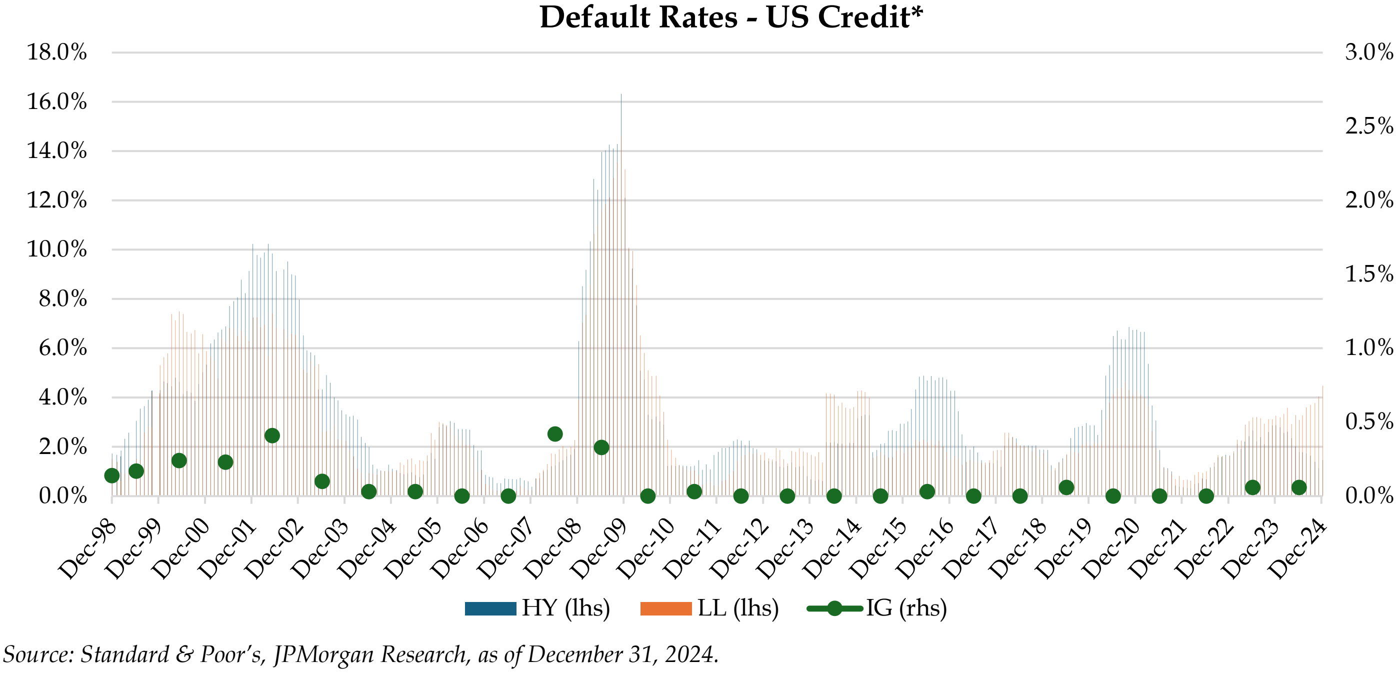
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 39 investments that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we 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 by 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 performance in HY and LL continues to be consistent with very low or no IG defaults.

There were only two defaults in December, totaling $427mm in bonds and loans. However, there were seven distressed transactions totaling $13.4bn in bonds ($4.5bn) and loans ($8.9bn). Including these distressed exchanges, the par-weighted US high-yield bond and loan default rates increased 32bp and 45bp MOM, to 1.47% and 4.49%, respectively. That represents a four-year-high for loans and a 122bp YOY increase, while HY bond defaults are down 141bp YOY. Higher interest rates over the hiking cycle negatively impacted leveraged loan borrowers, whose loans are in floating rate form, unlike HY. However, falling levels of distressed loans suggests that the peak of defaults has passed. The share of distressed loans is at 4.9%, down from a local high of 9.2% in May 2023. 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 December 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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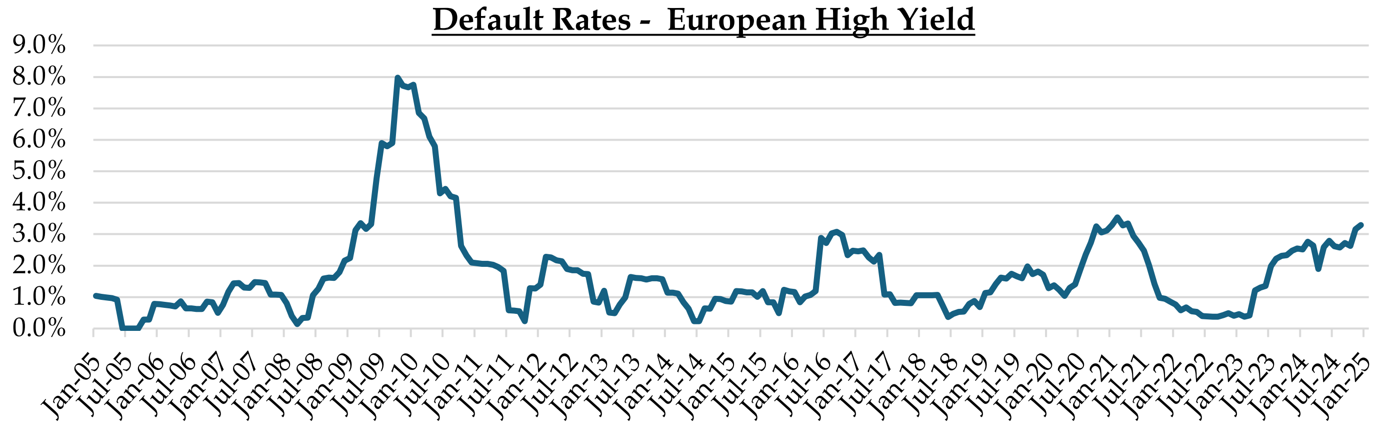
Reg Cap Fundamental Credit Trends (Cont.)

European High Yield

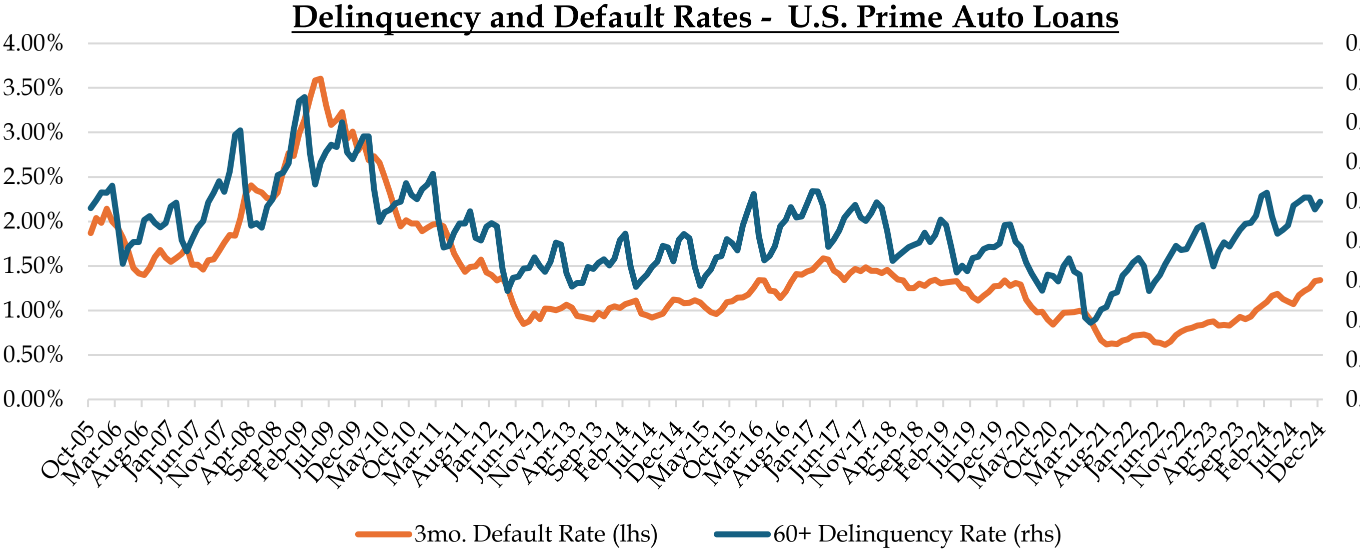
Historically, IG defaults in Europe have also been very low, with no defaults at all in most years. Our European HY default data goes back to 2005. Since 2005, the default rate for IG in Europe was zero in every year but two; in both 2008 and 2009 the IG default rate was 11bp per annum. As of December 2024, the trailing 12-mo. default rate for European HY is 3.29%, up 13bp MOM and 155bps above the historical average. While GDP growth in the Euro area has been slow, at .8% (estimated) in 2024, the European Commission forecasts a pickup to a 1.5% rate in 2025. Meanwhile the share of distressed Euro HY bonds (trading at 1000bp+) fell sharply MOM, and is at 4.85%, down from a local high of 12% in October 2023. Lower levels of distress augur well for lower defaults going forward. As in the US, default performance in European HY is consistent with very low levels of IG default, if any.



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

US Prime Auto Loans

As of the end of December, the 60+ delinquency rate for securitized US prime auto loans is 50bps (up 3bp MOM) and the 3-month default rate is 134bps (up 1bp 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. Auto loan performance is highly seasonal, and so we expect higher delinquencies next month. However, after adjusting for seasonality, delinquencies are expected to improve. Consumer credit performance is well supported by low unemployment, real wage growth (4.3% vs. 2.7% inflation), and robust household net worth.



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

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Reg Cap News

Issuance News:

BPM Plans SRTs Tied to €4.5 Billion in Loans Amid UniCredit Bid (Bloomberg News, 1/8/25)
Banco BPM SpA is seeking investors for two significant risk transfers, potentially boosting its capital strength at a time when it's trying to stave off a takeover. The SRTs offered by Italy's third-biggest bank are linked to loan portfolios worth about €4.5 billion ($4.7 billion) in total, in two transactions, one referencing large corporate loans, and the other referencing lending to small and medium-sized enterprises. Meanwhile competitor UniCredit announced its intention to take over Banco BPM, a move rebuffed by the CEO.

Natixis Begins Preparing SRTs Linked to €3 Billion of Loans (BN, 1/14/25)
Natixis SA is preparing to launch two significant risk transfers later this year, transferring the risks of a portfolio of about €1 billion of high yield loans and about €2 billion of small and medium-sized loans.

Reg Cap News:

Leave Synthetic Risk Transfers Alone (ft.com, 1/12/25)
This article discusses the Alternative Investment Management Association's open letter addressing the IMF's Global Financial Stability Report criticism of SRT aka "RegCap." The Financial Times says of the AIMA's letter "(it) goes through the main arguments raised by the IMF point by point, and—to be fair—some of its rebuttals seem reasonably valid." The FT goes on to say "...the issue isn't really whether the SRT market today is a big danger.… it isn't…one could even say that this leads to an overall safer financial system." The author agrees, however, that the market does bear watching and monitoring (like any market) and ends with: "After all, the long arc of financial history bends towards fecklessness."

SRTs' Rising Popularity Harbors Credit Crunch Risk, KBW Says (BN, 1/13/25)
In a recent report Keefe, Bruyette & Woods highlighted the risk that investor appetite for Reg Cap could wane, leaving banks that rely on the continued use of SRTs for capital relief in a "tricky position." "We could see a credit crunch occurring as a result of non-bank capital leaving the market," the KBW analysts said. If that were to occur, credit risks that banks have been transferring to investors could eventually return to their balance sheets, aka "flowback risk." Of course, any type of financing can become more or less tenable based on market conditions, so this is not a risk specific to the use of Reg Cap. In addition, in recent crises, the Reg Cap has proven to be more resilient than any other markets, for example during COVID.

ACC IMF comment letter re SRT in GFSR (acc.aima.org, 1/13/35)
The Alternative Investment Management Association Ltd (AIMA) responded to concerns raised around synthetic risk transfers (SRTs, aka "Reg Cap") by the IMF in their *2024 Global Financial Stability Report (GFSR)*. Some of the key points made in the article:

1. The IMF expressed concern that banks providing leverage for investors to buy Reg Cap undermines the goal of transferring risk out of the banking system. The letter makes many of the same points we did in our recent report. Namely that even with leverage, to the extent it is used at all, the use of haircuts, cross- collateralization, etc., significantly alters the risk profile and does not run counter to the goal of reducing financial system risk.
2. Data Availability. While there is no centralized public repository for Reg Cap data, a common lament of investors, regulators have more than sufficient visibility for oversight. SRT transactions are reviewed by federal banking regulators in the US and, in Europe, by the European Banking Authority, European Central Bank, European Systemic Risk Board.
3. The GFSR raises concerns that Reg Cap could "artificially inflate" regulatory capital ratios. The AIMA counters that Reg Cap transactions do improve banks' capital ratios — by reducing risk-weighted assets (RWAs). To imply that a bank's regulatory capital ratio can only increase by organic growth would effectively mean banks should never enter into any hedging strategy. Furthermore, regulators impose a "securitization surcharge" in the calculation of a bank's RWAs in connection with any securitization exposures (reflected in the p-factor) and hence, arguably banks are already over-capitalizing any retained risk on a securitized portfolio such as Reg Cap.
4. Liquidity Risks. The GFSR cautions that banks may face liquidity risk if the Reg Cap market were to contract. AIMR counters that Reg Cap has helped banks weather financial crises–even during the height of the COVID crisis, banks were still able to execute SRTs in size. Moreover, in a credit downcycle, the issuance of capital instruments of any kind may be limited - that is a not risk unique to Reg Cap. In fact, the risk of the market drying up is much less a factor for repeat Reg Cap issuers that have developed a programmatic issuance over time with a core group of sophisticated investors. Lastly, SRTs can help banks ride out credit crises by enabling them to buy credit protection in advance rather than being forced to resort to fire sales during a crisis.

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5. The GFSR expresses concern about possible deterioration in the quality of assets being referenced in Reg Cap. AIMA asserts that Reg Cap typically involves very high-quality collateral, but if in fact the credit quality of reference asset pools was slipping (which we do not think is the case), regulators should prefer that the risk on those asset pools is being transferred to third-party investors, who may have different risk/reward profiles and tolerances.
6. Lastly, GFSR asks if, despite the use of Reg Cap "overall risks remain essentially unchanged in the banking system." However, Reg Cap transfers risk to other parts of the financial system, i.e. non-banks. These entities may have very different funding models—including some with significantly more stable, long-term funding, less leverage, and fewer connections with payment systems or other critical functions that make banks inherently more systemic. That is a meaningful benefit for the banking system.

Banks Could Be Hurt By a Leverage Ban in SRTs, Hedge Fund Says (BN, 1/21/25)
This article summarized our recent research piece (https://seercap.com/wp-content/uploads/2025/01/Reg-Cap-Leverage-Clearing-Misconceptions.pdf). The use of leverage allows more money managers to invest in the deals at tighter spreads, benefiting issuers. "Various parties have raised concerns about reg cap financing based on the claim that reg cap risks must leave the banking system entirely…these critics are off the mark in our view", because the leverage providers manage the risk of an SRT investor defaulting through measures including collateral and mark-to-market margin calls. We estimate that about €10 billion ($10.4 billion) of leverage has been used to fund about €60 billion of SRTs…"hardly of a magnitude that could give rise to systemic risk."

Banking Industry News:
Banks Go 'Big and Early' in New Year Rush to Refinance AT1 (BN, 1/7/25)
European banks are taking advantage of favorable market conditions to refinance Additional Tier 1 (AT1) bonds. AT1 bonds, which were an outgrowth of the GFC, absorb losses if a bank's capital falls below a certain level. With heavy flows into credit funds, market technicals are strong, while the cost of raising capital is low. For example, European banks' AT1 bonds are trading spreads inside of 300bp, within 30bp of their tights. On a yield basis, the cost of issuing AT1s in Europe is at a ~3yr low. European banks have almost $40 billion in AT1 debt maturing this year, and traders expect most of these bonds will be called at the first opportunity and refinanced. AIB Group has a call decision in June, while BBVA and Standard Chartered have theirs in March and July, respectively.

What happens in Basel doesn't stay there (bankingjournal.aba.com, 1/8/25*)*
This author argues that the so-called Basel III "endgame" (B3E) international regulatory framework, which is designed to bolster the stability of the banking system, has implications for a wide range of stakeholders who are not being heard. By virtue of higher borrowing costs or more costly hedging, changes to banking rules (unsurprisingly) do ripple through the economy. But whether this means that, as the author argues, every possible special interest should opine on banking regulation, strikes us as highly questionable. The author also asserts that U.S. regulators often treat international banking agreements as a given, implementing them with minimal domestic revision, and that this may cause a disconnect between the standards set globally and domestic needs. The author's proposed solutions include: advanced notices of proposed rulemaking, actively seeking feedback from nonbank sectors and even Congressional oversight of banking standards. We think that politicization of this important process would be unfortunate and inefficient.

Big US Banks May Get Basel Break With Trump Win (BN, 1/8/25)
The Basel III Endgame (aka "B3E") is up in the air under a new administration. Many expect reduced regulatory pressure on large U.S. banks, allowing them to return more capital to shareholders. B3E was expected to increase capital requirements for large U.S. banks by raising risk-weighted assets (RWA). Pro forma, this change could have resulted in a ~$134 billion deficit in common equity tier 1 (CET1) capital across the eight largest U.S. banks. Under a less stringent regulatory scenario, many banks would maintain substantial capital surpluses. The article estimates that JPMorgan could have a $54 billion surplus. JPMorgan, Bank of America, Wells Fargo, and Citigroup are among the biggest beneficiaries of potential regulatory relief. Goldman Sachs and Morgan Stanley, with more exposure to investment banking, could face larger increases in RWAs and still struggle to meet capital requirements. We still expect significant growth in the US Reg Cap market, even if capital requirements aren't increased for the largest US banks. Large banks globally use Reg Cap to manage risk and concentrations and optimize capital deployment across their balance sheets, and US players will be under pressure to follow suit. US regional banks face additional capital challenges which Reg Cap can help address.

Sluggish Bank Lending Could Persist With Economic Uncertainty (BN,1/9/25)
Loan growth in the banking industry is expected to remain muted, with a projected 3% increase in 2025, although this could be overly optimistic if interest rates stay high due to fewer Federal Reserve cuts, or if changes in tariff policy prove disruptive. Regional

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banks like U.S. Bancorp, PNC, and KeyCorp experienced flat commercial lending in 4Q 2024, with commercial real estate declines partially offset by seasonal consumer card strength. Commercial loan demand remains weak, particularly for large and small businesses, with lower investment in equipment and inventory financing.

BlackRock Faces New Deadline from US Regulator Over Bank Stakes (BN, 1/12/25) BlackRock failed to meet a January deadline with the Federal Deposit Insurance Corporation (FDIC) as it maneuvered to delay talks into the new administration. The FDIC is focused on BlackRock's decision-making processes and its holdings in U.S. banks. BlackRock has argued that increased oversight could disrupt the index funds that dominate many investor portfolios and, potentially, make it more costly for banks to raise capital. The firm also emphasized the need for the FDIC to coordinate with the Federal Reserve, which already has a passivity agreement in place with BlackRock. With "passivity agreements," investors commit to not exert influence on the banks in which they have a stake. FDIC board members have expressed concerns over the potential influence of large asset managers and the risk of undue influence over the management and strategy of U.S. banks.

ECB Weighs Tougher Risk Model Approach That May Hit Bank Capital (BN, 1/12/25)
Guidelines laid down in 2017 by the European Banking Authority called on banks to consider a "mix of good and bad years" when modeling default probabilities for capital management purposes. In a November presentation, the EBA further defined that as the years 2008-2018. This has sparked debate. By incorporating data from the global financial crisis period, the ECB hopes to account for the full economic cycle, which includes periods of both boom and bust. The EBA pointedly excluded recent years, on the logic that period was influenced by heavy public support during the COVID-19. Banks are pushing back, especially those in Southern Europe (Spain, Italy, Greece), who suffered deep crises in the GFC. The banks are arguing that too conservative predictions about loan defaults reduce lending capacity and hurt the economy. The ECB is expected to issue more concrete guidelines around mid-year, including the possibility of requesting exemptions for banks that can demonstrate that the historical data does not fit their specific circumstances.

Italy Readying Review of UniCredit's BPM Bid Under Golden Power Rules (BN, 1/12/25) Italy's government is preparing to review UniCredit's unsolicited takeover offer for Banco BPM under its "Golden Power" rules, which could result in the imposition of conditions or even block the deal. This special process is aimed at protecting strategic assets, including Banco BPM's branches and jobs, and has been triggered by concerns within the government about the impact of the deal on the Italian banking sector. The Golden Power mechanism was used recently to impose restrictions on China's ownership of tire manufacturer Pirelli. The next steps will likely involve a closer look at the potential effects of the merger on the Italian financial landscape.

Banks Hand $100 Billion to Investors as Regulatory Threat Wanes (BN, 1/16/25)
After years of caution, the US' largest banks have significantly increased shareholder payouts in the form of dividends and buybacks. In 2024, the six largest U.S. banks returned over $100 billion to shareholders, the highest in three years. Banks are hopeful for more regulatory relief under the new administration, which could reduce the capital requirements under Basel III, freeing up more funds for both lending and shareholder payouts. "We've been increasing the amount of capital return over the last few quarters," Citigroup CEO Jane Fraser said on her company's conference call, "and I'm also happy to see a more aggressive Basel III scenario firmly off the table."

The PRA announces a delay to the implementation of Basel 3.1 (bankofengland.co.uk, 1/17/25)
The UK's banking regulator, the Prudential Regulation Authority (PRA), has decided to delay the implementation of Basel 3.1 by an additional year, i.e. to 1 January 2027. This delay provides more time for greater clarity around the US plans for Basel 3.1, with new uncertainty over its global adoption timeline. This allows the PRA to further consider the impact of regulation on UK competitiveness. The timeline for implementation remains the same, with 1 January 2030 set as the target for complete adoption of Basel 3.1 in the UK.

UBS CEO Says Switzerland Risks Overreaction With Capital Plan (BN, 1/21/25)
UBS has criticized Swiss government proposals that would require the bank to hold significantly more capital, particularly a 100% backing of its foreign units, calling it an extreme measure that could harm Switzerland's competitiveness as a financial hub. UBS argues that such a requirement is unnecessary and overly punitive. The proposals are part of a broader overhaul of Switzerland's financial regulations aimed at preventing risks like those that contributed to the need for UBS's emergency takeover of Credit Suisse in 2023. The Swiss government plans to finalize these proposals soon.

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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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