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Reg Cap Recap

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

February 18, 2025

SEER CAPITAL

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.

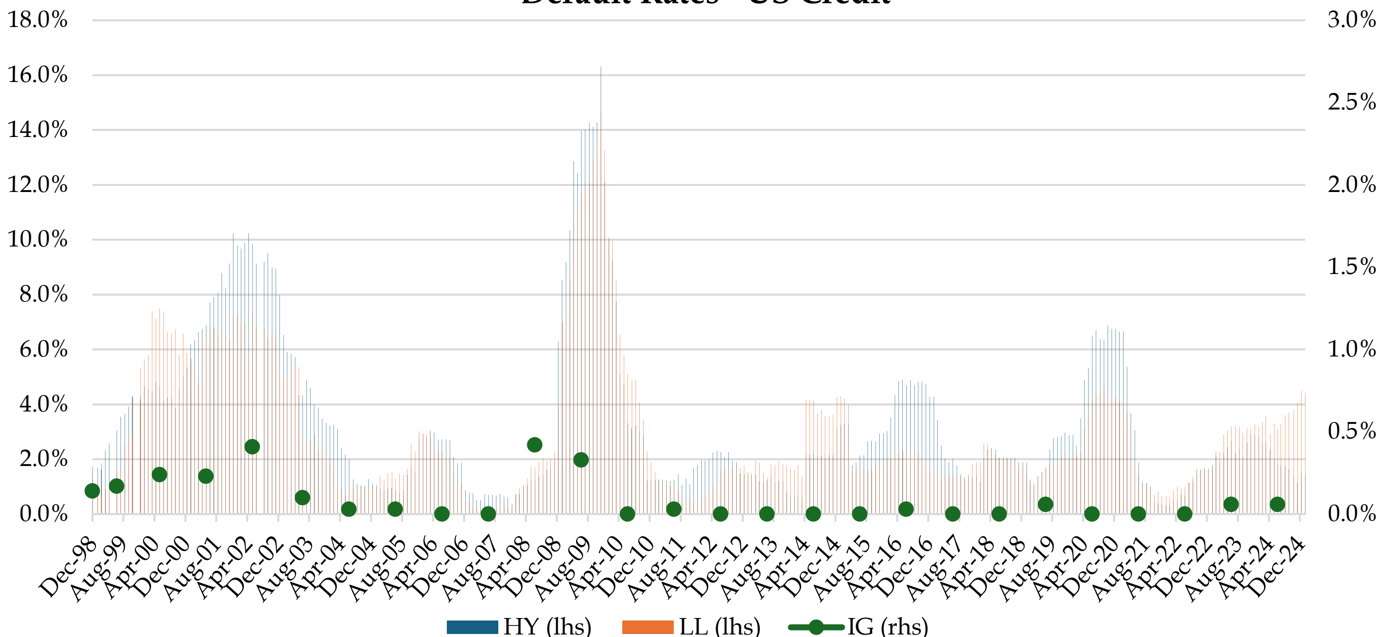
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 40 investments that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we 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 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 performance in HY and LL continues to be consistent with very low or no IG defaults.

January's default/distressed exchange volume was the lowest level in over two years. There was only one default in January, affecting $866mm in loans. There were two distressed transactions totaling $1.2bn in bonds and loans ($447mm and $732mm, respectively); by contrast the monthly average of defaults/distressed exchanges in 2024 was $7bn. Trailing-twelve-month par-weighted US high-yield bond and loan default rates decreased 4bp and 7bp MOM, to 1.43% and 4.42% (including distressed exchanges). The 25-year average HY and LL default rates are 3.4% and 3.0%, respectively. These LTM results represent a 122bp YOY increase for loans, while HY bond defaults are down 137bp YOY. Falling levels of distressed credit suggests that the peak of defaults has passed. For example, the share of distressed bonds is at 3.8%, down from 6.7% this time last year.



Source: Standard & Poor's, JPMorgan Research, as of January 31, 2025.
** HY and LL on a trailing 12-month basis, dollar-weighted. Includes distressed exchanges. IG on an annual basis.*

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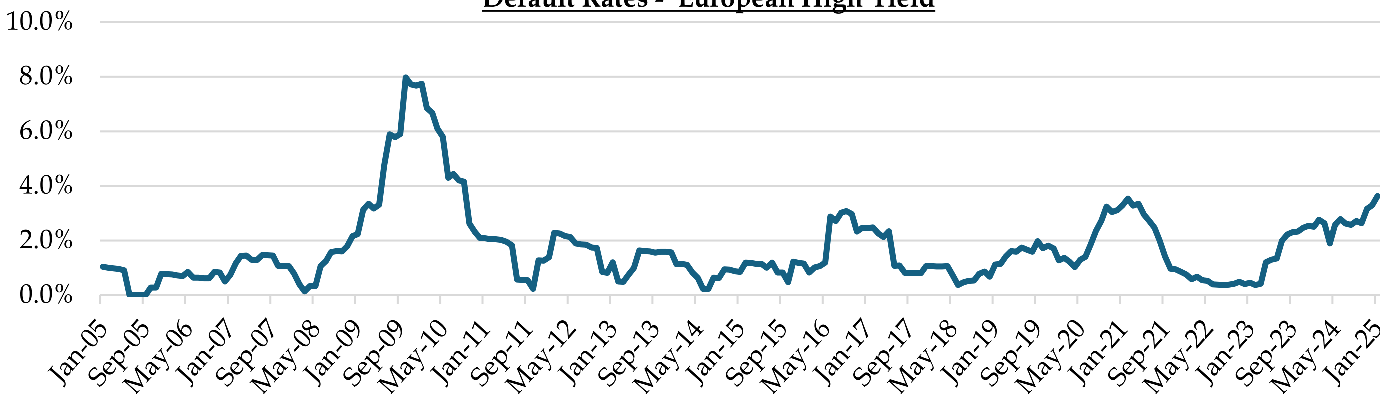
Reg Cap Fundamental Credit Trends (Cont.)

European High Yield

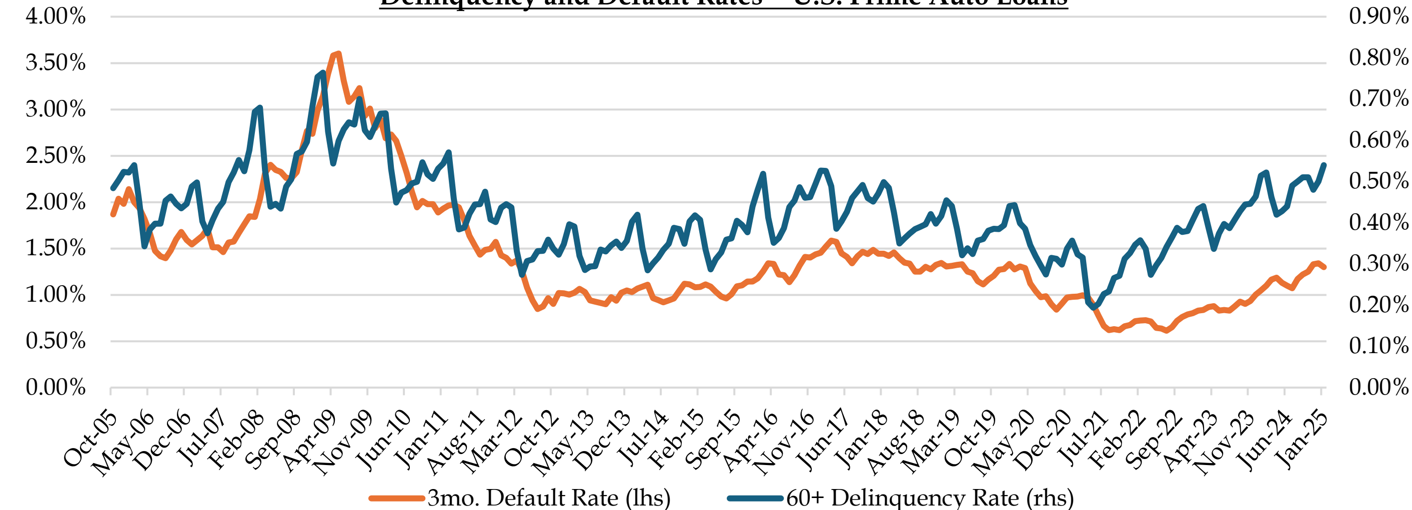
Historically, IG defaults in Europe have also been very low, with no defaults at all in most years. Our European HY default data goes back to 2005. Since 2005, the default rate for IG in Europe was zero in every year but two; in both 2008 and 2009 the IG default rate was 11bp per annum. Again, as with the US market, with so little default activity in IG, we turn to the HY market as a bellwether. As of January 2025, the trailing 12-mo. default rate for European HY is 3.63%, up 43bp MOM and more than double the historical average of 1.71%. With about three-quarters of European high yield companies having reported third quarter results, net leverage stayed broadly flat QOQ at 4.7x. There was both a marginal decline in overall net debt, which declined 0.4% QOQ, as well as a continued expansion in profits of 8% QOQ. However, nearly as many companies had EBITDA growth as contraction over the quarter. Meanwhile the share of distressed Euro HY bonds (trading at 1000bp+) was essentially flat MOM and is at 4.9%. This is 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 January 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 54bps (up 4bp MOM) and the 3-month default rate is 130bps (flat MOM). This leaves delinquencies slightly above their long run average (42bps), but with fewer delinquencies rolling into defaults, 3mo CDRs remain below their long run average of 143bps. Auto loan performance is highly seasonal, with delinquencies typically higher in the first two months of the year. After adjusting for seasonality, delinquencies are expected to improve. Solid household balance sheets overall and a strong job market should be supportive of continued strong credit for auto loans.



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

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Reg Cap News

Issuance News:

Italy's BPER Weighs First SRT as Deals Keep Getting More Popular (Bloomberg News, 2/10/25) As Reg Cap continues to become more mainstream, Italy's BPER Banca, a relatively small Italian bank (€140 billion in assets) is considering selling its first deal. BPER is considering issuing an SRT (aka "Reg Cap") deal linked to €2.5 billion in loans to small and medium-sized Italian companies. BPER recently made an all-stock takeover bid for Italy's Banca Popolare di Sondrio. BPER also recently said it's planning to use "synthetic securitizations" to offset new bank rules that would increase risk-weighted assets.

Reg Cap News:

BBVA Targets SRT Boom with New Team to Manage Balance Sheet (BN 1/31/25)
Spain's second largest lender, BBVA, is changing the way it manages its balance sheet as it taps into increased demand for deals that transfer risk out of banks. The bank has created a new unit with a goal to "define and execute the global strategy of capital optimization in the group." Prominent in that effort will be Reg Cap issuance, as BBVA is aiming to boost its use of significant risk transfers, according to management remarks on a recent analysts call. Banco Santander SA has made a similar move with its "Global Asset Desk. "

Barclays Names Four Bankers to Structure SRTs After Defections (BN, 2/3/25)
Barclays added four bankers to its desk structuring significant risk transfers. Barclays is restaffing after the departures of at least four bankers last year to investment firms. Barclays is one of the world's largest Reg Cap issuers, with about $75 billion of risk transfer transactions outstanding. "We are actively evaluating what other asset classes might be optimal for SRTs," said a Barclays representative.

SCIs 9th Annual Risk Transfer and Synthetics Seminar (New York, 2/5/25)
Seer attended the seminar with a reported 220 participants in attendance. A few European issuers made the trip across the pond, joining Canadian recent issuers, a smattering of representatives from large US banks, and some regional bank representatives new to the space. There is still a lot of structuring and regulatory work to be done on the US side, which is perhaps why the seminar was hosted by a law firm and well attended by other law firms as well. The consensus view among market participants continues to be that US issuance will grow over time as regulations are clarified and adoption grows among midsize banks, supported by a generally constructive regulatory environment which will allow increased M&A activity. Postponement of the Basel Endgame removes immediate capital pressures from the largest US banks, but they will likely continue to use Reg Cap selectively as a capital / balance sheet optimization tool. Reg Cap spreads tightened significantly in 2024 but given that nearly all credit market instruments did as well, many still see Reg Cap as attractive. We saw fewer unfamiliar faces representing large US credit managers than at recent Reg Cap conferences in New York, perhaps reflecting a moderation in demand among some large investors who seem to have grown impatient with supply growth out of the US and pulled back.

Deutsche Bank scales back SRT repo financing (9fin.com, 2/6/25) Deutsche Bank is scaling back new repo financing for Reg Cap (aka Significant Risk Transfer or "SRT") deals. In our experience at Seer, Deutsche has not been particularly active in this space in any event. There are three main forms of leverage that can be applied to SRTs: repo financing, NAV-line financing at the fund level, or other structures such as less than a 100% margin backing for a CDS contract. Repo financing, the most common leverage method for SRTs, allows investors to use credit-linked notes (CLNs) as collateral.

The IMF raised concerns in an October report about leverage in the Reg Cap market, warning that banks who finance Reg Cap may be, in effect, recycling risk rather than moving risk out of the system. Regulators, including the ECB and Fed, are reviewing SRT leverage practices. While the Fed is comfortable with SRT leverage as long as it's not provided by U.S. banks, non-US lenders like Nomura, NatWest, and Santander remain active lenders. As we pointed out in our recent research piece (https://seercap.com/wp-content/uploads/2025/01/Reg-Cap-Leverage-Clearing-Misconceptions.pdf), Seer believes that the financing of Reg Cap investing has been prudent and that leverage as it is typically structured does not bely the basic premise of Reg Cap, which removes credit risk from the banking system.

Commerzbank Plans to Sell More SRTs in Corporate Loans Push (BN, 2/13/25)
Repeat issue Commerzbank is looking to ramp up their use of Reg Cap, with plans to cut €10 billion in risk-weighted assets through significant risk transfer issuance by 2028. Reg Cap issuance will allow them to increase lending activity without tying up more capital. The bank's plan is part of the CEO's strategy to boost growth and profitability, as well as fend off a potential takeover bid from UniCredit.

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Banking Industry News:

UBS Joins BNP in Boom, But Capital Woes Linger (BN, 2/4/25) In the wake of UBS' forced takeover of failing Credit Suisse in 2023, Swiss banking regulators remain wary, as they look to safeguard against potential risks to domestic depositors. While European regulators have delayed new capital rules, UBS already operates under stricter Swiss trading-book regulations, which added $9 billion to its capital needs last year. CEO Sergio Ermotti remains concerned about further Swiss capital requirements, which could force UBS to hold significantly more capital at the parent level, limiting profitability and payouts. Critics of Swiss regulators argue that Credit Suisse's failure was due to liquidity issues, not just its aggressive capital structure. With UBS already subject to tougher rules than U.S. and European banks, policymakers must balance financial stability with competitiveness before imposing further constraints, they argue. In a subsequent Reuters article on 2/10/25, the CEO was quoted as saying that he anticipates the bank will gain more clarity on the new Swiss banking regulations being developed by May.

US Banks Tell Me They Want Basel Implemented, BOE's Bailey Says (BN, 2/6/25) The Bank of England's Governor Bailey shared the somewhat surprising aside that U.S. banks in fact support new capital requirements, despite expectations of more lenient regulation under the new administration. Bailey noted that American banks favor Basel implementation as it ensures prudential standards and competitive fairness. Speaking at a London dinner, Bailey emphasized that he does not see a trade-off between financial stability and growth, despite fears that too tight a regulatory regime might harm the UK and Euro economies, especially if regulations are tighter than US competitors. For this reason, the BOE recently paused implementation of Basel 3.1 capital rules, awaiting U.S. regulatory decisions.

FDIC Board Director Jonathan McKernan to Leave US Bank Watchdog (BN, 2/10/25)
Jonathan McKernan, a Republican director at the Federal Deposit Insurance Corp., resigned from the bank watchdog, adding "It has been a great honor to serve on the FDIC Board … I've every confidence that under the new FDIC leadership, the FDIC will succeed in its mission while also reversing the regulatory overreaches of the last few years." By statute, no more than three of the five FDIC directors can be from the same political party. The new administration's decision to bring in Rodney Hood (R) to head the Office of the Comptroller of the Currency (which includes a seat on the FDIC), would have resulted in Republican over-representation if McKernan had remained.

BlackRock, FDIC Seek to End Regulatory Row Over Bank Stakes (BN, 2/11/25) BlackRock Inc. and the FDIC are in negotiations to resolve a dispute over BlackRock's stakes in U.S. banks. The FDIC is interested in ensuring that asset managers don't exert undue influence over bank operations. The deadline for compliance has already been extended twice, and some expect a deal may be reached soon now that two FDIC board members, who had pushed for greater oversight, have since left their positions.

Powell Says Bank-Capital Plan Could Be Finalized Fairly Quickly (BN, 2/11/25)
Federal Reserve Chair Jerome Powell told lawmakers last Tuesday that he is hopeful a version of the long-awaited bank-capital plan could be reached "fairly quickly." "We remain committed to completing Basel III Endgame. We think it's good for US banks, it's good for our economy that there be a global standard beneath which foreign banks can't fall," said Powell at a Senate Banking Committee Hearing. Regarding whether the final form of regulation will be "capital neutral," Powell said, "it'll shake out somewhere in that area."

Lone Star-Backed Novo Banco Said to Tap Banks for Portugal IPO (BN, 2/12/25) Novo Banco SA, a Portuguese lender majority-owned by U.S. private equity firm Lone Star, has selected three global banks to arrange its long-anticipated initial public offering (IPO). Novo Banco was created in 2014 following the collapse of Portugal's largest lender at the time, which required a €5 billion bailout. Since then, Novo Banco has returned to profitability, strengthened its balance sheet, and reduced its non-performing loan ratio. The bank, then called Banco Espirito Santo, issued two Reg Cap transactions, in December 2012 and December 2013, which represented successful test cases of performance of Reg Cap transactions after the failure of the issuer.

Junk Bond Guru Fridson Sees Rising Distress Ahead: Credit Weekly (BN, 2/16/25) High-yield bond veteran Marty Fridson predicts that the distressed market is poised to grow. A recent Federal Reserve survey shows banks tightening credit standards at the highest rate in three years, making it harder for companies—especially smaller firms and riskier borrowers—to refinance their debt. The distressed ratio, which represents the proportion of bonds trading at a spread of 1,000 basis points or higher, is currently at 3.7%, well below the historical average (12.7%) and down from its recent peak of 10.4% two years ago, per Fridson. Lending standards and credit distress are highly correlated (0.7), and so the recent tightening, Fridson augurs, portends rising distress. While global demand for U.S. debt has been strong, there is a high level of geopolitical risks which has created more tail risk for markets.

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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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