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Reg Cap Recap

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

March 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.

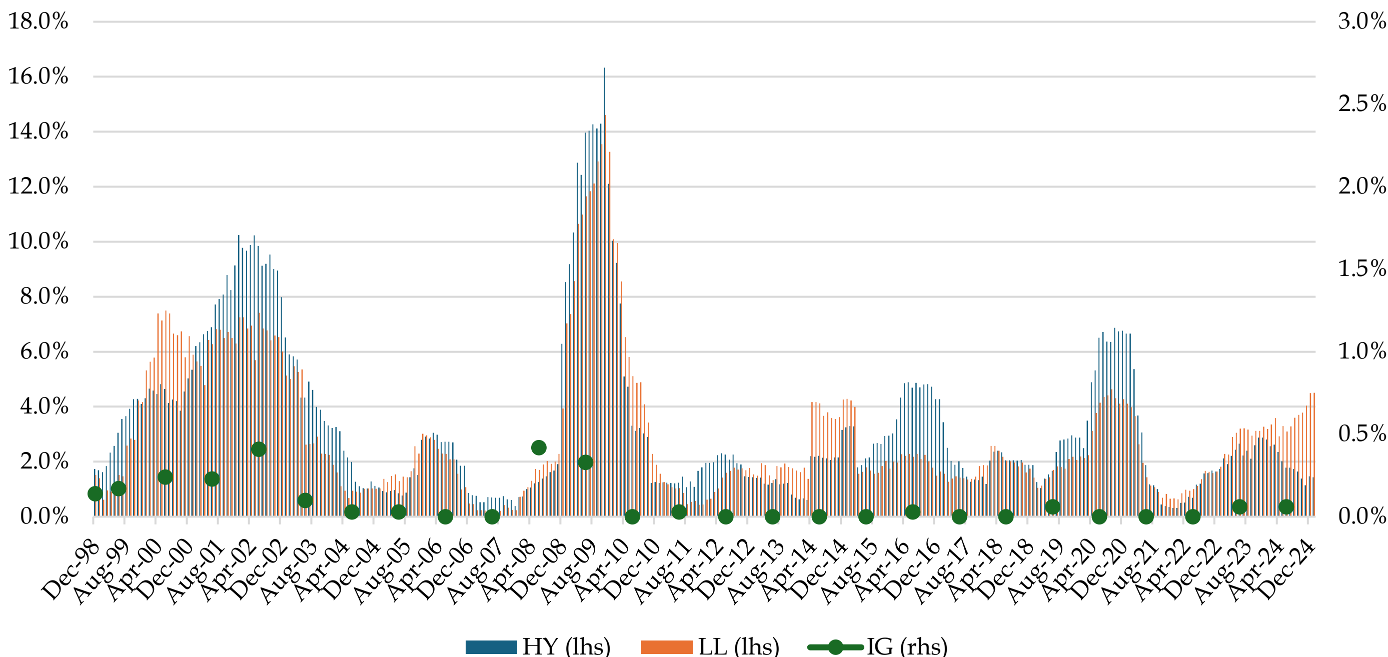
That said, we find it useful and important to track broad trends in asset performance in addition to deal-specific surveillance (which is non-public). Across 40 investments that we own and track, referencing corporate, SME, middle market, consumer, and auto loans in Europe, North America, and Asia, we 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.

In February, there were no payment defaults in either the leveraged loan market or high yield bond market but there were three distressed transactions, totaling $1.6bn in bonds and loans ($150mn and $1.5bn, respectively). This made February the lightest month since December 2022; defaults and distressed exchanges combined were less than half the 2023-2024 monthly average. The trailing-twelve-month par-weighted US high-yield bond and loan default rates decreased 28bp and 60bp MOM to 1.25% and 3.90%. The 25-year average leveraged loan annual default rate is 3.0%, and analysts expect losses to mean revert to that level over the next year.



Source: Standard & Poor's, JPMorgan Research, as of February 28, 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

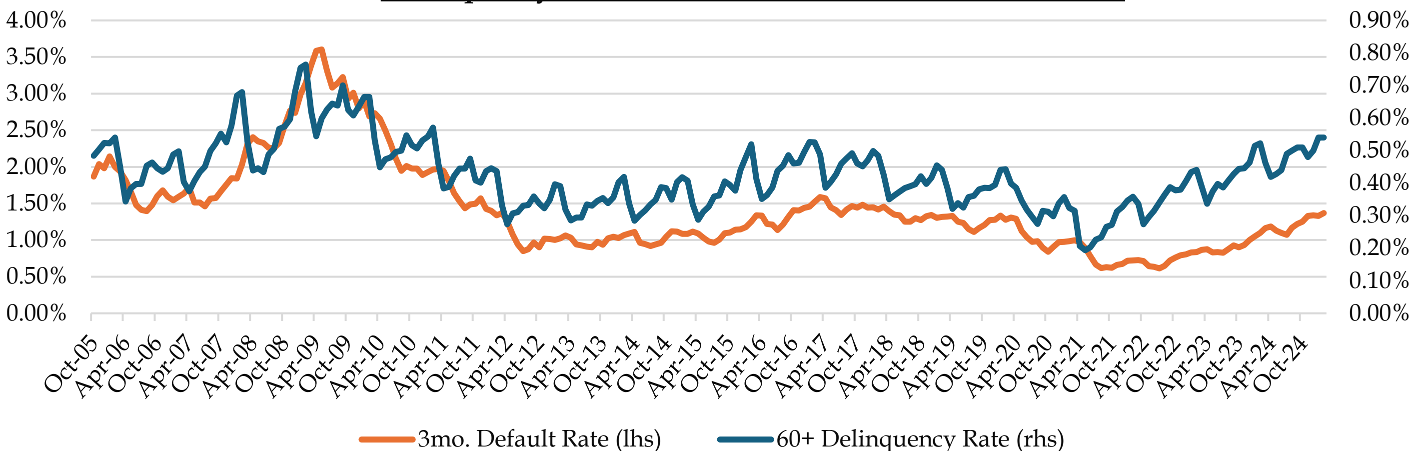
Historically, IG defaults in Europe have also been very low, with no defaults at all in most years. Our European HY default data goes back to 2005. Since 2005, the default rate for IG in Europe has been zero in every year but two; in both 2008 and 2009 the IG default rate was 11bp per annum. Again, as with the US market, with so little default activity in IG, we turn to the HY market as a bellwether.

There was one distressed exchange of €300mm in February and no defaults. This brings the trailing 12-mo. default rate for European HY to 3.56%. Though this is down 22bp MOM it is still more than double the historical average of 1.71%. Moreover, two recently announced restructurings suggest that more distressed exchanges are upcoming, including the recently announced restructuring of €5.9bn of euro-denominated SFRFP bonds (aka "Altice") and the unfolding restructuring of Thames Water Utility. Meanwhile, the amount of distressed paper in European HY continues to fall: the distressed ratio (defined as bonds trading at a spread of >= 1000bp as the cut-off) fell 50bp MOM in February, to 4.5%. An alternative measure of distress, a dollar price of 80 or below, has been stable at 6.2% for several months.

Source: JPMorgan Research, as of February 2025. Trailing 12-month basis, dollar-weighted. Excludes Banks/Insurers.

US Prime Auto Loans

As of the end of February, the 60+ delinquency rate for securitized US prime auto loans is 54bp (flat MOM) and the 3-month default rate is 137bp (up 4bp MOM). This leaves both delinquencies and defaults moderately above their 5-year averages (42bp and 99bp). Credit metrics are expected to improve in the upcoming months due to seasonality, but may still remain above the long run averages. Generally, prime auto loan performance remains within the bands of normal expectations, although subprime performance metrics have seen more significant deterioration. Concerns about an impending economic slowdown have begun impacting financial markets as of mid-March, it remains to be seen to what extent they will materialize.



Source: Morgan Stanley, as of February 28, 2025

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Reg Cap News

Issuance News:

SocGen Arranges SRT Linked to €2 Billion Portfolio for CaixaBank (Bloomberg News, aka "BN," 3/5/25)
Spain's CaixaBank SA is planning to sell a Reg Cap deal (aka " significant risk transfer" or "SRT") linked to a portfolio of €2bn ($2.1bn) of corporate loans. No further information or terms are publicly available. Separately, CaixaBank is seeking to sell a portfolio of non-performing mortgages worth about €600 million.

Deutsche Bank Nears SRT Deal Tied to $7 Billion Corporate Loans (BN, 3/6/25) Deutsche Bank is selling a Reg Cap/SRT linked to a $7bn corporate loan portfolio, with the SRT equaling about 8% ($560mn) of the reference portfolio. Preliminary pricing is 750bp over SOFR. Deutsche Bank is also exploring an SRT for €2 billion ($2.2 billion) in loans to German mid-cap companies. DB has said that securitizations will play an important role in improving its capital efficiency.

***U.S. Bancorp Sells $625 Million Bonds Tied to Corporate Loan*s** (BN, 3/6/25)
U.S. Bancorp sold $625 million of Reg Cap bonds tied to corporate loan risk on its books, under its new "Superior" program. The deal was so well received that the first loss piece priced 50-100bp below initial price talk (final pricing for the first loss tranche was 750bp over SOFR). U.S. Bancorp's bond deal is issued in the form of credit-linked notes (CLN) and is backed by a pool of investment grade corporate loans and revolving credit facilities. The deal is the bank's first credit-linked note expected to receive ratings from DBRS, ranging from AA down to BBB. At Seer, we believe this deal will serve as a benchmark—US Bank achieved very favorable execution on the first tranched, syndicated SRT deal referencing corporate loans from a US issuer. Volcker Rule concerns have until now restricted banks issuing corporate deals to large bilateral transactions, severely limiting the investor base. US Bank addressed the Volcker Rule issue by structuring the transaction as a direct CLN, but we understand some tranched, syndicated deals using the SPV structure may be in the works.

Italy's IBL Banca Eyes SRT Deal Arranged By UniCredit, Intesa (BN, 3/13/25)
Italy's IBL Banca is working on a Reg Cap transaction linked to a ~$2bn portfolio of salary-backed loans. The size of the SRT issue would be about 6% of the reference portfolio. Italian banks have been particularly active in SRTs against a backdrop of multiple potential M&A deals that may reshape the country's banking sector. Meanwhile UniCredit is working on a SRT linked to €4 bn of German corporate loans, Banco BPM is working on an SRT deal linked to portfolios worth about €4.5bn, and BPER Banca is considering its first SRT transaction. Separately, IBL Banca is issuing an ABS backed by a pool of salary-backed loans.

Reg Cap News:

SRTs to Mobilize €10 Billion-Plus in Banks' Capital (Bloomberg Intelligence, 03/05/25)
The use of Reg Cap aka Significant Risk Transfer technology (SRTs) is growing among European banks, helping them free up over €10bn annually in capital, facilitating new lending and share buybacks. SRTs are becoming a crucial tool for capital efficiency. Major European banks like Barclays, Santander, and BNP are leveraging SRTs to optimize their Risk-Weighted Assets (RWAs). Reg Cap issuers susignich as Santander, CaixaBank and Commerzbank have set dollar targets for reducing their RWAs via SRTs. The European Central Bank (ECB) is working on simplifying the approval process for SRTs.

The SRT market could grow 20% this year. As more and more banks make the initial investment in the risk management, IT, accounting and legal work necessary to do a Reg Cap deal, further growth becomes self-fulfilling. With European issuers still making up 60% of the market, most of the growth upside will depend on US activity. On the investing side, private credit funds are ~ 60% of the market, followed by pension funds, with close to 20%. Corporate and SME lending back up most Reg Cap issuance in Europe, whereas retail loans are a more common reference asset for US issuance.

Basel Committee to Probe SRTs as Popularity of Deals Surges (BN, 3/13/25)
The Basel Committee on Banking Supervision said it plans to carry out a "deep-dive" investigation into synthetic risk transfers to examine "the benefits and risks posed by SRT." This will be part of the Committee's "ongoing work to assess banks' interconnections with non-bank financial intermediation," it said. Regulators have generally welcomed Reg Cap as a way to shift risk outside of the banking system, but some have questioned whether the tool carries new risks. At Seer we hope and expect that the Basel Committee adheres to the principal, "if it ain't broke, don't fix it". The SRT market is healthy and growing, providing banks with a tool for managing risk and capital by buying protection on tranches of loan portfolios from sophisticated global institutional investors. SRT supports cost effective lending to businesses and consumers. We trust that the "deep dive" planned by the Basel Committee will not create uncertainty / hesitation among issuers—so far we are hearing about a robust pipeline for Q2.

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Reg Cap News (Cont.)

One of the issues they may be reviewing is leverage on SRT transactions, which has attracted some press coverage of late. We believe properly structured leverage on SRT is entirely appropriate and supportive of the market, as detailed here: https://seercap.com/wp-content/uploads/2025/01/Reg-Cap-Leverage-Clearing-Misconceptions.pdf

Basel Committee. Work to Strengthen Supervisory Effectiveness, Analytics and Risk Management on SRTs (BIS.org, 3/13/25)
The Basel Committee on Banking Supervision met virtually on March 12–13, 2025, to discuss key initiatives including:

- **Supervisory Effectiveness**: The Committee is developing practical tools to enhance supervision in response to lessons from the 2023 banking turmoil. An update will be published by mid-2025.
- **ICT Risk Management**: The Committee will analyze global practices and developments in information and communication technology (ICT) risk management, aiming to publish findings in 2026.
- **Non-Bank Financial Intermediation**: A deep-dive investigation into synthetic risk transfers (SRTs) will be conducted to assess their benefits and risks as their use grows.
- **Basel III Implementation**: The Committee reviewed and approved Türkiye's implementation of the Net Stable Funding Ratio and large exposures framework.

<u>Banking Industry News:</u>
FDIC to Seek Rollback of Bank Merger Rule (WSJ.com, 3/3/25)
The Federal Deposit Insurance Corp. plans to propose a reversal of a Biden-era policy that scrutinizes large bank mergers. Under that policy, mergers that would result in institutions of $100bn or more in total assets require "heightened financial stability analysis" and mergers that would result in institutions with $50bn or more require public hearings. Mergers would also be evaluated for their effect on market concentration. The FDIC's acting chair, Travis Hill, has called rescinding the Biden-era merger policy a priority. It would require a public comment period and then a final vote by the FDIC board. More bank mergers are likely to be supportive of the growth of the SRT market in the US. Larger banks are more likely to have a critical mass of assets and also internal resources required to complete SRT transactions.

Exploring Basel III/IV: Scenarios for Financial Stability and Growth (S&P Global, 3/5/25)
This panel discussion covers the latest developments in the implementation of final Basel III reforms, aka "Basel 4."
Bank regulators are tasked with striking a good balance between financial stability and competitiveness and ensuring a level playing field. While the EU has started adopting Basel IV (except for trading book rules) and Canada, Japan and Australia are reportedly moving ahead with Basel IV, the UK has delayed implementation to 2027 and the US is "reevaluating."

A few of the key points made by the panelists include:

1. Europe can not meet its capital needs without more securitization and a reduction in so-called "gold-plating" of their financial institutions (applying stricter rules and requirements than those agreed upon internationally). However, when we encourage securitization, we are making non-bank financial institutions a bigger share of the markets, which may also present risks.
2. Even though one aim of Basel was "standardized requirements," they are actually quite different from country to country, as there is discretion to make them higher than Basel minimums. CET-1 requirements range from 7.07% in the US to 10.38% in the UK and 9.10% in the EU (simple average, not weighted by asset size). Europe has more components to their capital requirements as well. There are more than 60 banking authorities in Europe that have a role.
3. It is nearly impossible for there to be a truly level playing field, but one area where there can only be one rule book is trading.
4. Pro forma assessment of how regulatory changes will impact capital requirements are usually wrong, because banks adapt and mitigate.
5. Basel 3 was a success
6. One panelist stated that he believed Basel 4 arose out of the belief that banks were using models to "cheat." However, the panelist argued, many European banks have much lower risk business models and that is not being sufficiently recognized. Basel 4 doesn't really raise the total amount of capital in the system, but rather allocates more of it toward certain banks - unfortunately those are very low risk banks, and so the reform is wrong-headed in this panelist's view.

Canadian Banks Have C$150 Billion For Tariff Risks (Bloomberg Intelligence, 3/6/25)
Canada's six major banks appear well positioned to weather a trade war with the U.S. Canadian banks' 1Q Common Equity Tier 1 ("CET1") ratios are 130-270bp above their regulatory requirement of 11.5%. The delay of a Basel III capital floor increase by regulators suggests that the "domestic stability buffer" portion of the capital requirements could also be lowered if needed. The

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Reg Cap News (Cont.)

authors estimate that it could release as much as C$96bn in CET1 capital. Proforma, that would create an estimated C$150bn in surplus capital to absorb potential economic shocks. Canadian regulators review bank capital requirements biannually (June & December), allowing for further adjustments as needed.

Goldman Sachs Says US Credit Spreads Will Get a Lot Wider **(BN, 3/11/25)**
Goldman Sachs strategists have raised their forecasts for U.S. credit spreads, citing tariff risks and signs of the White House's "tolerance" for "short-term" economic weakness. They now expect investment-grade bond spreads to widen to 125bp in Q3 (up from 84bp), while high-yield bond spreads could reach 440 basis points (up from 295bp). Investment-grade spreads have already climbed to their highest since September (94bp). President Trump's recent assertion that the US economy faces a "period of transition" has spooked markets. Goldman strategists refer to their changed forecast as a "realignment of risk premia to higher macro volatility" rather than a sign of recession.

Reviewing the Pillar 2 requirement methodology (www.bankingsupervision.europa.eu, 3/11/25)
Banks finance their operations primarily through deposits (64%), followed by bonds (17%) and capital (7%). Capital's role is crucial. It absorbs potential losses, protecting depositors, taxpayers and the financial system itself.

European law sets minimum capital requirements that all banks must meet ("Pillar 1"). But banks also face risks that are not covered by these Pillar 1 requirements. This blog post explains how the ECB addresses these risks through its "Pillar 2" requirements. The blog lays out three pillars of the Basel Framework:

- Pillar 1 – Minimum Capital Requirements: E.g., banks must maintain at least 8% of risk-weighted assets (RWA) in capital. Covers credit, market, and operational risks.
- Pillar 2 – Supervisory Review: Assesses additional risks not covered by Pillar 1 and determines extra capital needs.
- Pillar 3 – Market Discipline: Ensure transparency in banks' risk exposures and capital adequacy.

In the EU, both Pillar 1 and Pillar 2 are binding for banks. The ECB is revising its Pillar 2 methodology to enhance efficiency and adapt to evolving risks like macroeconomic instability, geopolitical tensions, climate risks, and digitalization. Two key goals of the revision: are "robustness" (ensuring risks are not counted twice) and "simplification" (reducing procedural complexity for better clarity). The new approach will streamline supervisory discussions and ensure fairness in judgment through benchmarking. It will be internally tested in 2025 and take effect on January 1, 2027. They do not expect the new methodology to lead to "abrupt changes in capital requirements".

Trump to Announce Bowman Soon as Pick for Fed's Top Bank Cop (BN, 3/12/25)
President Donald Trump will nominate Federal Reserve Governor Michelle Bowman to be the central bank's next vice chair for supervision, filling a post vacated by Biden-appointee Michael Barr. Bowman's nomination has to be confirmed by the US Senate. Fed Chair Jerome Powell told lawmakers last month that bank regulatory policy was less volatile before Congress established a vice chair for supervision position. He said that the central bank will "continue on until there's a new vice chair … and we can very much get our work done."

Republicans Urge Fed to Alter Supplementary Leverage Ratio (BN, 3/13/25)
House Republicans urged Fed Chair Powell to take steps to improve liquidity in the Treasury securities market, including changes to bank capital requirements. The SLR or "Supplementary Leverage Ratio" was introduced in 2014 as part of the Basel III banking regulatory reforms. It requires financial institutions to hold capital against their entire portfolio, including Treasuries. Because the SLR is not risk-weighted, it can constrain large banks' ability to operate in the Treasury market during market crises. Powell has expressed support for reducing the SLR.

Trump Nominates Bowman as Fed Top Bank Cop (BN, 3/17/25)
President Donald Trump nominated Federal Reserve Governor Michelle Bowman for the position of vice chair for supervision at the central bank. If confirmed by the Senate, she is expected to support lighter bank regulations compared to her predecessor, Michael Barr, and has criticized recent proposals requiring banks to hold more capital. Bowman will have to operate under a new executive order by Trump that limits the authority of independent agencies like the Fed, requiring them to submit draft regulations to the White House. Bowman's appointment all but confirms that if and when new Basel standards are implemented in the US, they will not include significantly higher capital requirements. Some expected higher capital requirements to be an important impetus for SRT, but we remain convinced that US banks have a need for SRT and expect the market to grow significantly. A more constructive regulatory approach will also facilitate SRT market growth.

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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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