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Reg Cap Recap

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

May 20, 2025

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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 the 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.

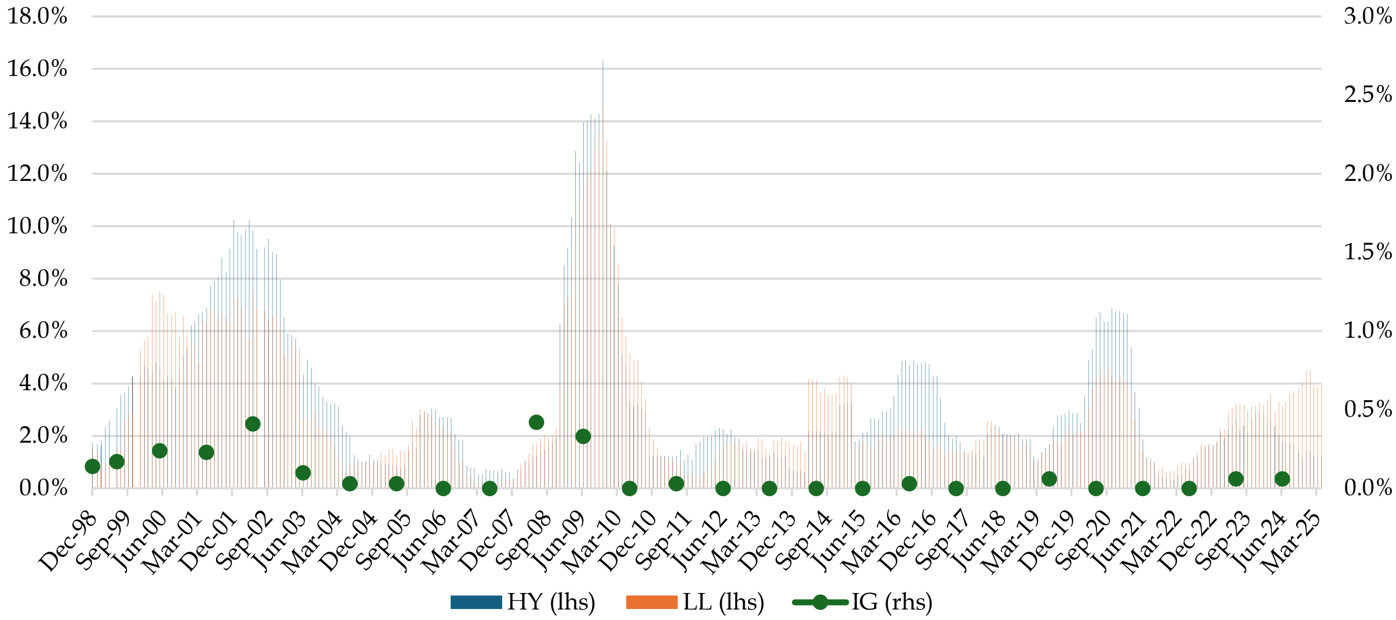
The indices we look at as broadly representative of some of the most common reference assets include US Corporate Debt, including Investment Grade, High Yield and Leveraged Loans; European Investment Grade Debt and High Yield; and US Prime auto loans. We would expect most reference asset pools to significantly 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 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.

Though April's default and LME activity ("Liability Management Exercises", aka "Distressed Exchanges") was a YTD high, it was still a relatively light month compared to recent history. There were two payment defaults in April totaling ~$1.8bn, comprised of $800mm in bonds and $1.04bn in loans. There were also three distressed transactions totaling $3.5bn ($334mm in bonds, and $3.18bn in loans). YTD there have been 21 defaults/distressed transactions totaling $16.6bn, down significantly from 30/$25bn over the first four months of 2024 and also well below 27/ $38bn over the same period in 2023. Including LME, the par-weighted US high-yield bond (HY) and leveraged loan (LL) default rates increased 5bp and 9bp MOM to 1.25% and 3.98%, respectively. For context, the 25-year average HY and LL default rates are 3.4% and 3.1%, respectively. With rising recession risk, JPM now forecasts 2025 HY and LL default rates of 1.50% and 3.25%, respectively, rising to 2.75% and 4.75%, in 2026.

Default Rates - US Credit*



Source: Standard & Poor's, JPMorgan Research, as of April 30, 2025.
** HY and LL on a trailing 12-month basis, dollar-weighted. Includes distressed exchanges. IG on an annual basis.*

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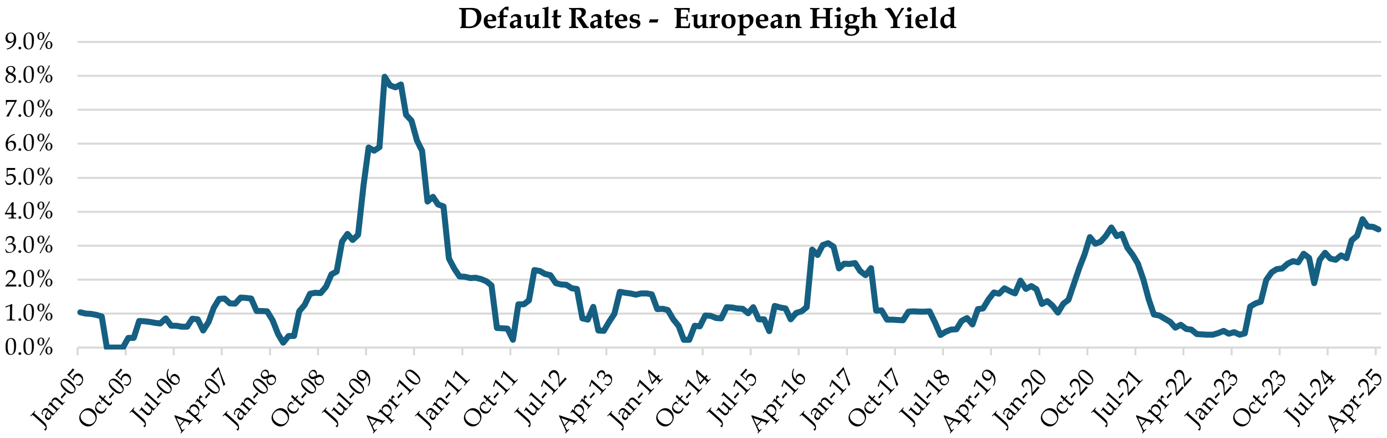
Reg Cap Fundamental Credit Trends (Cont.)

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.

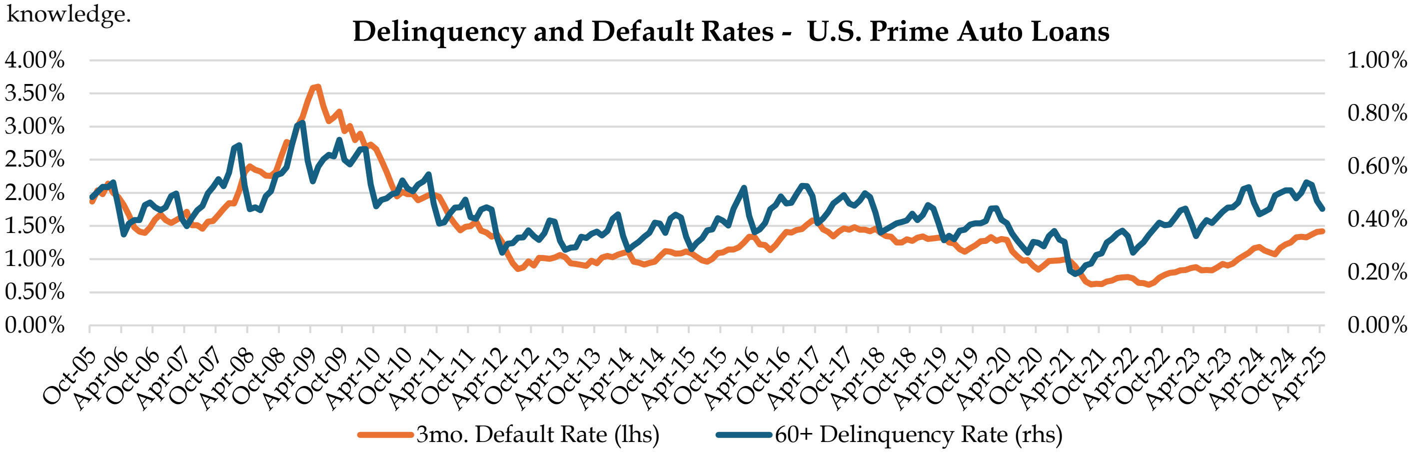
The trailing-12mo. default rate for European High yield was down 7bp MOM, to 3.48%, but remains 42bp above average for that metric over the last year. Meanwhile, given market softness and volatility, the amount of distressed European HY paper (defined as bonds trading at a spread of >= 1000bp) rose 121bp MOM to 6.65%, although we have already seen significant retracing since month-end as markets have stabilized somewhat. With nearly three-quarters of high yield companies having now reported Q4 2024 results (the most recent available), the data paint a stable picture. Net leverage was flat QOQ at 4.7x and 4Q profit growth was running at 6% annualized. European HY, like credit markets generally, were on solid footing leading up to the cataclysmic changes in tariff policy. It remains to be seen of course both how tariff policy evolves and how it impacts these borrowers.



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

US Prime Auto Loans

The 60+ delinquency rate for securitized US Prime Auto Loans fell 3bp MOM in April, to 484bp. The 3-month default rate is 141bp (up 4bp MOM). This leaves both delinquencies ("DLQ") and defaults elevated vs. their 5-year averages. However, as we have noted before, it appears that delinquent borrowers are avoiding defaults more often than in past cycles and so defaults and losses are growing more slowly than DLQ. Analysts believe that a relatively strong macro environment coupled with more sophisticated servicing of delinquent borrowers has reduced the share of delinquent borrowers who eventually default. Generally, prime auto loan performance remains within expectations, albeit on the higher side. However, subprime auto portfolios posted their highest April delinquency rate in 15 years. Notably, Reg Cap deals backed by auto loans are exclusively prime quality, not subprime, to our knowledge.



Source: Morgan Stanley, as of April 30, 2025

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Issuance News:

BNP Paribas Said to Plan SRT Tied to €10 Billion Corporate Loans (Bloomberg News, 5/14/25)
BNP Paribas plans a deal linked to a portfolio of about €10 billion ($11.3 billion) in corporate loans, with a Reg Cap (aka "SRT") issuance of ~€500 million. Preliminary price talk is ~800bp over Euribor. BNP Paribas will see a reduction of 35bp on its Common Equity Tier 1 ratio following the completion of the acquisition of Axa Investment. The SRT issuance is expected to come under the bank's Resonance program and follows a transaction last year linked to a portfolio of €17 bn of corporate loans. BNP also announced an SRT linked to about $2 billion of project finance loans. Notably, recent market volatility has not caused any issuers to shelve their plans.

UniCredit Plans Three SRT Deals Tied to €4.2 Billion Loans (BN, 5/19/25)
Italy's UniCredit is working on at least three significant risk transfers tied to loan portfolios totaling around €4.2 billion ($4.7 billion). It is known that one Reg Cap issue will be linked to a reference portfolio of about €2.3 billion of corporate loans, and there is also another, smaller deal planned linked to €700 million of loans out of its Croatian business, in addition to a third Reg Cap deal linked to a portfolio of factoring contracts. UniCredit's CEO has been seeking to grow the bank through acquisition, thus far unsuccessfully.

Reg Cap issuance has continued apace throughout the recent market volatility with deals from Spain's Caixa Bank and Banco Sabadell as well France's BNP Paribas all on the table right now. In fact, a moderate amount of volatility can be a driver of increased Reg Cap issuance, as it drives banks to focus more on prudent balance sheet and capital management.

Santander Plans SRTs Tied to Spanish, Danish and UK Assets (BN, 5/20/25)
Banco Santander SA is planning three new Reg Cap issues, referencing portfolios in Spain, Denmark, and the UK. The Spanish deal is linked to a portfolio of about €3.5 billion ($3.9 billion) of loans to small and mid-size companies in Spain. The article cited an anonymous source indicating that the transaction would price at a spread of "around 650 basis points". Based on our market information, we believe this pricing information to be premature and inaccurate.

The Denmark transaction is linked to auto loans, and no further information was available about the UK deal. "The ongoing SRT transactions are part of the bank's pipeline for this quarter and position us well," Sergio Gamez, Santander's global head of capital and profitability management, said, adding "....the securitization market is functioning normally, with pricing levels broadly in line with those observed at the end of 2024 and the beginning of 2025." Despite global market volatility in recent months, we may see record issuance in 2025.

Reg Cap News:

Unveiling the Impact of STS On-Balance-Sheet Securitisation on EU Financial Stability (European Systemic Risk Board, 5/5/25)
This 51-page report begins by noting that Securitization offers key economic and financial stability benefits for banks, for investors, and across the financial system. However, securitization also poses risks. In the wake of the GFC, the EU introduced a regulatory framework in 2017 aiming to capture the benefits while mitigating risks. This framework introduced STS (Simple, Transparent, and Standardized) criteria. In 2021, STS criteria were extended to synthetic securitization, including Reg Cap aka SRT. Since the introduction of the STS criteria for synthetic securitizations, the market has seen significant growth. In 2022, more than 30 banks issued 118 Significant Risk Transfer (SRT) securitizations, totaling over €170 billion, the report noted. Synthetic transactions accounted for over 85% of this volume.

The ESRB identified several financial stability considerations in their report, most of which will be familiar points to market participants. e.g.:

- Concentration and Interconnectedness: The market is concentrated among a few large originators and protection sellers. Because the vast majority of protection is funded, we do not see this as a major issue.
- Regulatory Capital Relief: While synthetic securitizations provide regulatory capital relief for banks, there is a risk that this could lead to increased leverage and risk-taking behavior if not properly managed. Agreed, but this could really be said about any number of tools banks use.
- Market Liquidity: The bespoke nature of synthetic STS transactions may limit market liquidity, making it challenging for investors to exit positions. Since most investors are buy and hold, this has not been an issue, over several market cycles. Furthermore, during the most recent period of dramatic volatility caused by COVID in March / April 2020, Reg Cap traded at more constructive levels than other structured credit products such as CLOs, which are thought to be more liquid.

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- Transparency and Disclosure: The complexity of synthetic securitizations necessitates robust transparency and disclosure practices to ensure market participants can accurately assess risks. We find transparency and disclosure to be entirely sufficient for investors who are active in the sector.

The ESRB report recommends:
- Enhanced Transparency: Implementing standardized reporting requirements to improve market transparency and facilitate better risk assessment.
- Diversification of Participants: Encouraging a broader range of originators and protection sellers to participate in the market to reduce concentration risks. This is happening organically, we would note, and we are looking forward to more originators entering the market.
- Monitoring and Oversight: Strengthening macroprudential oversight.
- Capital Adequacy Framework: Reviewing the regulatory capital framework to ensure it appropriately reflects the risks associated with synthetic securitizations.

Invisso (now FT Live) U.S. Risk Transfer 2025 Conference in Charlotte (5/7/25)
We recently attended this Charlotte conference. Key points discussed included:
- The Reg Cap market is gaining traction here, though U.S. adoption continues to lag Europe. Super-Regionals and even smaller banks are increasingly exploring Reg Cap, particularly those under pressure from commercial real estate exposure.
  - Reg Cap isn't just about capital relief and balance sheet optimization—it also enables pricing leverage that can help fuel growth, and it also transfers risk. It provides cheap capital, with added upside benefit for the issuing bank in a downturn.
- There's been a surge in investor interest, leading to tighter spreads.
  - Issuers used to test the market but now deals actually make economic sense at these levels.
  - Issuers are more programmatic, with some completing deals in 6 to 8 weeks.
- Synthetic is still a "bad word", and the industry needs rebranding.
- Some banks are still hesitant due to regulatory uncertainty—need for approval for CLN structure, restrictions around distribution of SPV deals, issues around P-Factor, etc.
- Reg Cap allows for more creativity in structuring deals, which can help banks tailor deals to capital and liquidity needs.
- Some banks use Reg Cap to keep prime, pristine assets on their books, which the regulatory regime over-penalizes from a capital standpoint (e.g., auto loans).
- Even banks that don't retain the first-loss tranche are aligned with investors because underperformance affects capital charges on retained senior tranches.
- Even with recent volatility, deals are still being executed, and Reg Cap and agency mortgage Credit Risk Transfer (CRT) remain less volatile than many competing products.
  - Market has already retraced ~2/3rds of April's spread widening.
- Europe has a healthy, growing, active Reg Cap market with a core base of investors focused partnering with banks to gain exposure to high quality core lending books. This contrasts with investors who view Reg Cap as another tool to gain exposure to specific asset types.
- Fannie / Freddie CRT performance has been strong:
  - Since January 2022, CRT has returned 44%, compared to 45% for the S&P 500 and 42% for BBB-rated CLOs.
  - While delinquencies have ticked up, defaults and losses remain very low due to better loss mitigation tools.
  - There have been notable upgrades from non-investment grade to investment grade.

<u>Regulatory Outlook and Structural Factors</u>
- Regulatory changes are expected to be limited in the near term—this is not a focus for the current administration.
  - Basel III is expected to arrive later this year or early next year and should be capital-neutral overall.
  - Agencies are becoming more familiar with Reg Cap, and rules are evolving to better accommodate it.
- Europe has more SRT activity due to regulatory, structural, and accounting differences:
  - U.S. GAAP is less favorable compared to European standards.
  - Europe "needs" Reg Cap more than the US. Europe lacks entities like the Small Business Administration and mortgage GSEs, so banks have more loans to SMEs and consumers on their balance sheets. European banks have greater capital constraints. They also have clearer, cleaner regulatory frameworks.
- Regional banks are slowly warming to Reg Cap but face a "first mover" dilemma—they don't want to be the first, but also not the last.

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- Cost remains a major factor for first time Reg Cap issuers in the U.S.:
  - Seven-figure expenses are common for underwriting and rating agency work, not to mention the infrastructure needed in Accounting, and Risk functions.
- More Reg Cap deals are being made to closely resemble ABS (asset-backed securities) to tap into existing demand. (eg referencing auto loans)
  - But there is a limited number of banks with a critical mass of auto loans to make Reg Cap worthwhile. Product needs to be expanded to other asset classes.
- The toolkit for banks to manage capital includes loan sales, equity raises, or Reg Cap—and more are choosing Reg Cap as it becomes more mainstream. Reg Cap competes with loan sales and also solutions involving cash sale of the portfolio with retention of the senior. Cash sale doesn't work where the interest rate on the assets is low. But some banks are looking to reduce CRE concentrations, and regulators haven't confirmed that synthetic deals reduce CRE concentration, but cash sale with retention of senior does.
- Market volatility is expected over the next 6 to 8 months, which may:
  - Make banks more inclined to issue Reg Cap to pro-actively manage their balance sheets.
  - Simultaneously reduce investor demand—potentially rebalancing the current supply-demand mismatch.

CFTC on Track for Industry-Wide Relief on Crucial Regulatory Obstacle for SRTs (9fin, 5/15/25)
The U.S. Reg Cap market is awaiting regulatory relief from the Commodity Futures Trading Commission (CFTC) concerning the classification of certain investors as commodity pool operators (CPOs). This issue arises when investors "re-tranche" thick Reg Cap credit protection tranches into smaller slices post-issuance to attract investors with different risk appetites. While this improves returns and market efficiency, it introduces regulatory ambiguity. The CFTC currently considers that some re-tranching structures might trigger CPO obligations, adding compliance burdens. Fannie Mae and Freddie Mac received a no-action letter in 2014 allowing them to issue CRTs without being classified as CPOs. Industry participants are now lobbying for broader, market-wide relief. The change in U.S. administration slowed these efforts, but market participants believe a favorable ruling is likely later this year.

Structurally, U.S. Reg Cap transactions often involve thick tranches (e.g., 0–12.5%) to comply with capital requirements under the Collins Amendment. These thicker tranches result in lower returns, leading investors to seek enhanced structures via mechanisms such as re-tranching or synthetic leverage. Compared to Europe—where tranches are often split at issuance—U.S. banks are more limited due to Volcker Rule concerns and regulatory limits on capital relief structures.

Re-tranching has emerged as a promising route to higher returns without leverage, allowing original investors to retain riskier portions and syndicate the mezzanine risk to insurers or conservative investors. However, uncertainty over whether these SPVs constitute commodity pools creates legal risk. Based on the basic principle of securitization, a regulatory framework that permits banks to divide risk into tranches and distribute those tranches to the widest universe of investors will provide the best execution.

Banking Industry News:
EU Considers Bank-Liquidity Tweak to Bolster Securitization (BN, 5/9/25)
The European Commission is considering reforms to make it more attractive for banks to hold asset-backed securities (ABS) as part of a broader effort to grow the EU's €1.2 trillion securitization market, seen as key to financing sectors like housing, energy, and defense.

Key proposals include:
- Broadening the types of securitizations eligible as high-quality liquid assets (HQLA).
- Reducing regulatory "haircuts" on the safest ABS in banks' liquidity buffers.
- Lowering capital requirements for banks investing ABS.
- Allowing residential mortgage ABS to face lighter capital charges than riskier assets.
- Making unfunded credit protection deals (e.g., risk transfers to insurers) eligible for the STS framework.

Trump Cuts Wall Street Cops as Markets Swing (BN, 5/9/25)
President Trump's administration is set to lay off more than 2300 staff at the top US financial regulators, impacting bank examiners, criminal investigators, and economists. These cuts are the steepest in decades for the Federal Deposit Insurance Corp., the Office of the Comptroller of the Currency, and the Securities and Exchange Commission, the primary agencies responsible for oversight of banks, trading houses, and the public markets. While supporters say the cuts will help Trump eliminate "unnecessary" rules, boost

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Reg Cap News (Cont.)

growth, and unleash lending, others argue that these changes are a harbinger of weaker oversight and an invitation to excessive risk-taking.

Sewing Calls on Regulators to Lower Bank Capital Requirements (BN, 5/12/25)
Deutsche Bank's CEO Sewing called on regulators to lower capital requirements and stimulate the economy. "Banks can play a key role in mobilizing investment, but only if they're not curtailed by excessive requirements," Sewing said in a speech as he addressed the Association of German Banks. The banking industry the world over is lobbying for a rollback of some of the rules put in place after the 2008 financial crisis. In an environment where the Trump administration has signaled an appetite for slashing regulation, the tide may be turning. Meanwhile German financial regulator BaFin lowered a capital buffer related to residential mortgages just last month.

SLR reform: Helpful, but Not a Panacea (JPM Research, 5/16/25)
The Supplementary Leverage Ratio (SLR) is a regulatory requirement that ensures large banks maintain a minimum level of capital, regardless of the riskiness of assets. During the COVID crisis, the Federal Reserve temporarily excluded U.S. Treasuries from the SLR denominator to ease strain on Treasury and markets. This exclusion expired in 2021, and now some argue that it should be reinstated and made permanent. Under the new administration, which has publicly stated that they are in favor of easing bank capital rules, SLR reform is now considered very likely. The regulatory process for SLR reform involves the Fed, FDIC and the OCC. With confirmation of representatives for these groups still awaiting Senate approval, it will take some time for any changes in regulation. SLR relief should be helpful for Treasury market liquidity in the long run.

UBS Set to Lose First Round of Fight Against Swiss Capital Hike (BN, 5/19/25)
UBS Group appears headed for defeat in the first round of its effort to water down a new Swiss law that could force it to maintain as much as $25 billion in extra capital. The government is set to propose a bill to parliament on June 6 that would, in its current draft form, require UBS to hold reserves sufficient to cover losses at foreign subsidiaries equal to 100% of the capital in those units (up from 60%). UBS executives have been pushing back against this new requirement, arguing that it would place them at a major disadvantage to global peers.

The law includes broad-ranging proposals to strengthen banking regulation in Switzerland and comes as part of the response to the collapse of Credit Suisse in 2023 and its subsequent takeover by UBS. The legislation still faces lawmaker approval or even, possibly, a referendum and in any event is not expected to come into force until 2029.

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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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