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Investor Thinking

Regulatory Capital Transactions

Speed Read

- The RegCap transactions market has transformed into a full-fledged alternative investment opportunity that is being strategically utilised by issuers and investors alike.
- Regulatory support for the sharing of risks between banks and capital markets has led to an expanding issuer base and globally diversified collateral, allowing investors to be more selective and opportunistic in return generation.
- Access to diversifying credit assets and the potential for stable cash flows, combined with liquidity and complexity premia make RegCap transactions a risk-weighted opportunity worth considering for institutional investors.

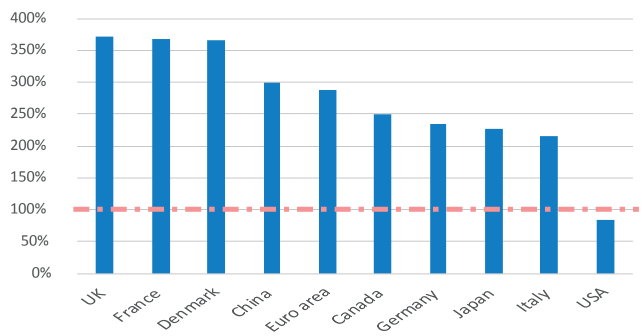
Introduction

The longstanding architects of most lending markets outside the US have traditionally been banks. This means that while lending in the US is primarily a function of well-developed capital markets, elsewhere most of this activity is carried out by banks. Figure 1 on the right shows the aggregate size of loans on bank balance sheets and how they compare to the respective country GDPs.

Despite disintermediation, lending activity has been continuously growing in Europe over the recent years in all sectors: corporate, consumer, mortgages[1]

However, the position banks have held has been challenged by regulatory pressures that have come into force over the course of the past few years. Many banks have needed to meet new and tougher capital, leverage and liquidity requirements. Deleveraging of balance sheets, retrenchment[2], retention of earnings or optimising their capital base have so far been the main ways in which banks have tried to navigate this challenge.

Figure 1: Bank Assets Size vs GDP by Country (2017)



Sources: FED, ECB, BoJ, World Bank

Optimising regulatory capital enables banks to hold on to their most lucrative lines of business where there are practical hurdles in gaining access to certain segments of the private credit market, such as small and medium sized enterprises (SMEs) or where

[1] Between December 2011 and November 2018: 9.5% growth in non-financial corporate credit, 9.0% growth in consumer credit and 14.7% in mortgage credit. Source: Bloomberg.
[2] Reducing the size of the business to smaller more manageable levels which has given rise to direct lending programmes, private placements and syndicated loan investment opportunities for example.

complexities in documentation result in bespoke due diligence and investment analysis in which banks have experience.

In a continuous effort to build more durable and diversified credit markets, regulators have recently provided a framework for banks to perform regulatory capital transactions, acknowledging de facto the contribution to the stability of the financial system that these transactions bring.

A growing number of investors are willing to participate in transactions that generate regulatory capital for banks i.e. providing protection for some of the banks' credit risk of lending in exchange for a premium.

> **"Banks usually look for long-term partners, typically institutional investors to whom they provide diversified credit exposures on their balance sheet."**

RegCap transactions – what are they and how do they work?

A RegCap transaction[3] involves a bank, a book of performing loans, and an investor willing to sell protection against a selected portion of that loan book defaulting. It is essentially a transaction with a bank that is seeking to improve its regulatory capital ratio (by buying credit protection) while carrying out its usual commercial development through lending activity[4]. It is a guarantee (ensuring the availability of regulatory capital) for a part of a loan portfolio selected by an investor. This guarantee is provided by the investor in return for a premium against the loss protection.

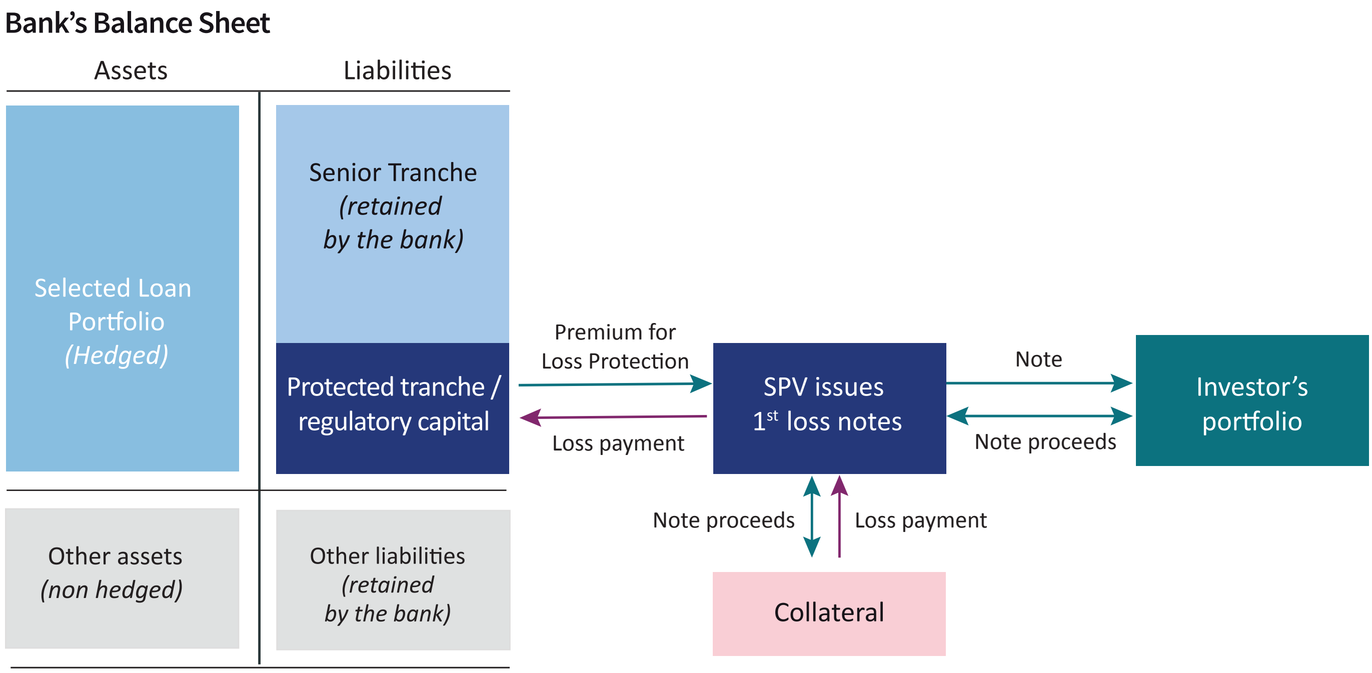
For such a trade, banks usually look for long-term partners, typically institutional investors to whom they provide access to diversified credit exposures on their balance sheet. The investors then identify suitable lending portfolios on the banks' balance sheets for which they would be willing to provide a regulatory capital guarantee, in return for exposure to the credit risk of those portfolios.

The underlying assets (loans) themselves remain on the balance sheet of the bank, and the originating bank continues to service the loans and keep their corporate relationships with the end borrowers.

Figure 2 provides a pictorial representation of a typical RegCap transaction in relation to a bank's balance sheet and an investor's portfolio.

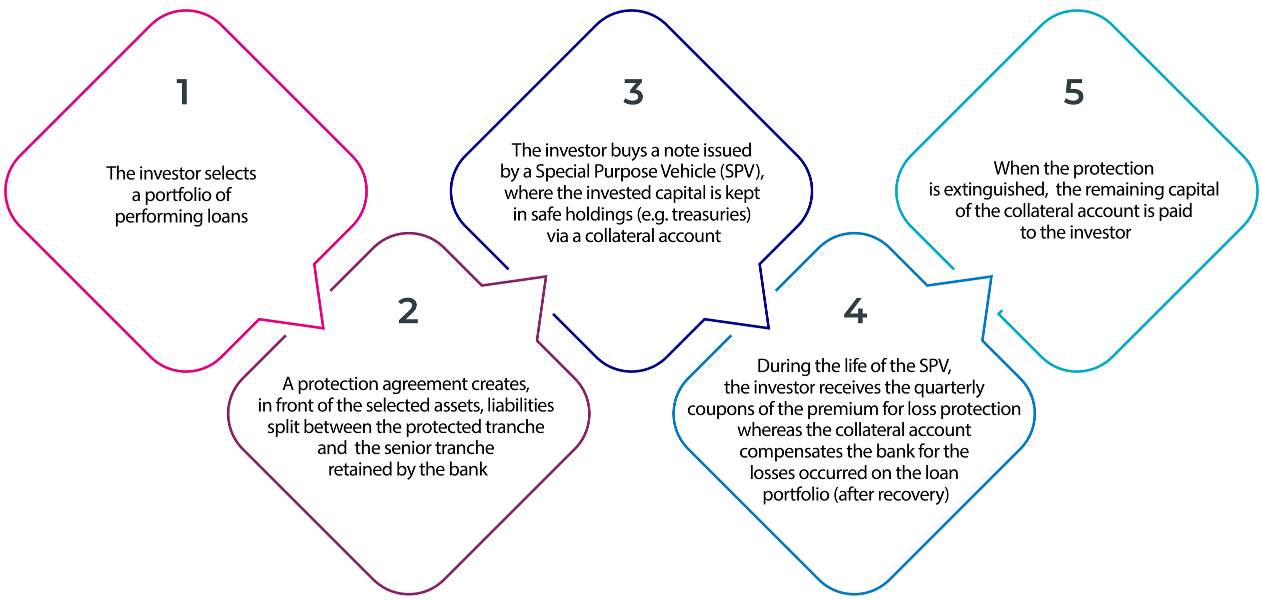
[3] Where we say RegCap we mean these to include risk-sharing transactions or synthetic securitisation transactions or capital relief transactions.
[4] For example, Jonas Bäcklund, Head of Credit Structuring and Execution, Treasury and ALM at Nordea Bank highlighted that the CST conducted in August 2016 "enhanced Nordea's CET1 ratio, allowing Nordea to recycle freed-up capital into additional lending to corporations and SMEs". Source: press release: "Nordea completes a EUR 8.4bn corporate and SME loan securitization", 24 August 2016. The Tier 1 common capital ratio compares a bank's core equity capital to its total risk-weighted assets and is a measure of its financial strength for investors and regulators.

Figure 2: Indicative example of a RegCap transaction



Source: AXA Investment Managers, 2019. For illustrative purposes only. SPV and first loss notes defined in footnote[5]. Please note that each structure is bespoke and the above is only an illustration of a structure for this type of transaction but is not limitative in any way[6].

The transaction typically comprises five steps:



[5] Special Purpose Vehicle (SPV): Legal entity created to isolate financial risk and to fulfil specific temporary objectives. The first loss notes bear a given amount or percentage of any losses from the selected loan portfolio.
[6] In particular, some features displayed in the real world are not represented here for simplification purposes. For example, to create an alignment of interest with investors, the bank must retain minimum 5% of the underlying portfolio unhedged, as well as the Senior Tranche. The bank can also retain the expected losses impacting the underlying portfolio.

“Regulators saw the benefits of a well-functioning RegCap transaction market. It is therefore no surprise that regulators set guidelines to strengthen the framework within which RegCap transactions operate.”

An opportunity – invigorated by regulation

While banks need to be encouraged to lend (for bank-dependent borrowers[7] to have access to the sort of bespoke lending that capital markets are unable to provide), capital buffers to support the credit risk is equally important to manage.

As such, regulators saw the benefits of a well-functioning RegCap transaction market to distribute risk away from bank balance sheets towards capital markets participants (institutional investors) while also:

- optimising bank balance sheets for further lending and
- providing an indication of the underwriting quality of a bank (given investor scrutiny).

It is therefore no surprise that regulators set guidelines to strengthen the framework within which RegCap transactions operate. The milestones that are noteworthy in this regard are provided below:

a) In November 2014, the ECB began its role in ensuring that a **Single Supervisory Mechanism (SSM)** put all European banks on a same level playing field. This prerequisite to align the former local situations under a common framework was the first step towards strengthening a European RegCap market[8] .

b) In December 2017 the European Banking Authority (EBA) clarified that a RegCap transaction would be allowed to form part of a bank’s own regulatory capital calculations only if **direct, explicit, irrevocable and unconditional risk transfer had taken place.** This clarification of the position of the regulator triggered certain banks to test their first RegCap transactions, contributing to develop this market. This provision aimed to ensure that credit risk calculation methods were consistent across jurisdictions, reducing the risk for the investor of arbitrage by the banks of the credit risk[9].

c) In September 2019 the EBA formally opened discussions on introducing an **STS (Simple, Transparent and Standardised)** type framework for RegCap transactions. This idea is therefore under consultation at the time of the writing of this document and if passed will possibly[10]:

- ensure an even more level playing field between traditional securitised assets and RegCap transactions due to the standardisation of information
- help less sophisticated banks participate in the RegCap market (thus increasing supply from smaller originators).

The direction that regulation has driven the market in is already showing many positive results. This is evident in the market evolution which is discussed in the section that follows.

[7] Banks specialise in information-intensive loans and can reduce the premium for bank dependent borrowers: Simon G. Gilchrist and Egon Zakrajsek, The importance of Credit for Macroeconomic activity: Identification through heterogeneity.

[8] (References: https://www.bankingsupervision.europa.eu/about/milestones/html/index.en.html 15 May 2014, SSM Framework Regulation comes into force and ECB supervision at five: re-charting the route, Speech by Ignazio Angeloni, London 2 May 2018).

[9] Reference: https://www.moodysanalytics.com/regulatory-news/Sept-19-EBA-Consults-on-Significant-Risk-Transfer-in-Securitization and https://eba.europa.eu/sites/default/documents/files/documents/10180/749215/5355e9d3-a565-4c58-bd93-0e888407306e/EBA-GL-2014-05%20Guidelines%20on%20Significant%20Risk%20Transfer.pdf?retry=1.

[10] EBA Discussion Paper. Draft Report on STS Framework for Synthetic Securitisation, 24 September 2019.

Market evolution: An expanding issuer and investor base

With a strengthened framework set by regulators combined with a market environment which has led institutional investors to hunt for yield, the RegCap market has become more active over the last five years. **What just a few years ago might have felt like a niche time limited opportunity** has transformed into a growing market offering full-fledged alternative investment opportunities that are being strategically utilised by banks and investors alike. These observations are demonstrated below:

a) **Depth and size of the market:** 2018 was a very active year in the RegCap transaction market with 56 transactions in 13 different jurisdictions and 11 different asset classes taking place through 28 counterparties totalling Eur 106 billion of protection and Eur 8Bn of tranches[11] . The long-term growth of this market is best demonstrated through Figure 3 which shows a slightly reduced scope of RegCap transactions post crisis as captured by the International Association of Credit Portfolio Managers (size on the left axis in EUR billion and number of trades on the right).

Looking forward, the continuation of this trend is fuelled by the further increase of capital buffer banks are required to provide to reinforce the sustainability of the financial system[12].

b) **A diversified issuer base:** While the largest issuers in the market still tend to be universal banks with highly sophisticated Asset-Liability-Management modelling and risk team's, smaller banks are also considering the market beyond synthetic transactions supported by the European Investment Bank/European Investment Fund.

c) **Underlying collateral diversified by asset classes, regions:** With RegCap transactions becoming more prominent and a greater number of counterparties entering the market the landscape of opportunities available to investors has diversified from an asset class and jurisdiction perspective. **Firstly**, While the breadth of asset classes remains wide already, there are alternative asset classes (e.g. infrastructure loans, commercial real estate loans, globally or regionally diversified corporate portfolios) which are already forming part of underlying portfolios (see Figure 4). This development allows investors to diversify their exposure to these asset classes.

Figure 3: European balance sheet RegCap issuance (in € billions)

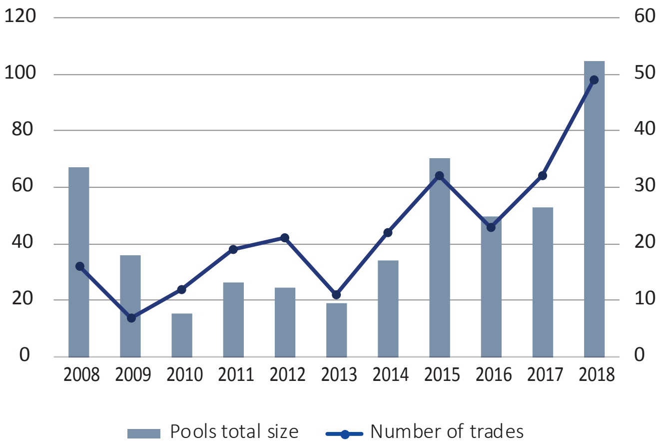
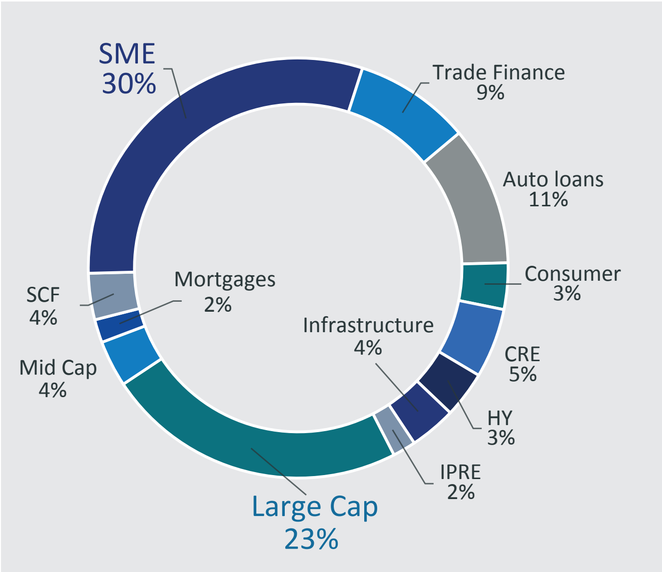


Figure 4: Strong supply in usual asset classes and emergence of new exposures



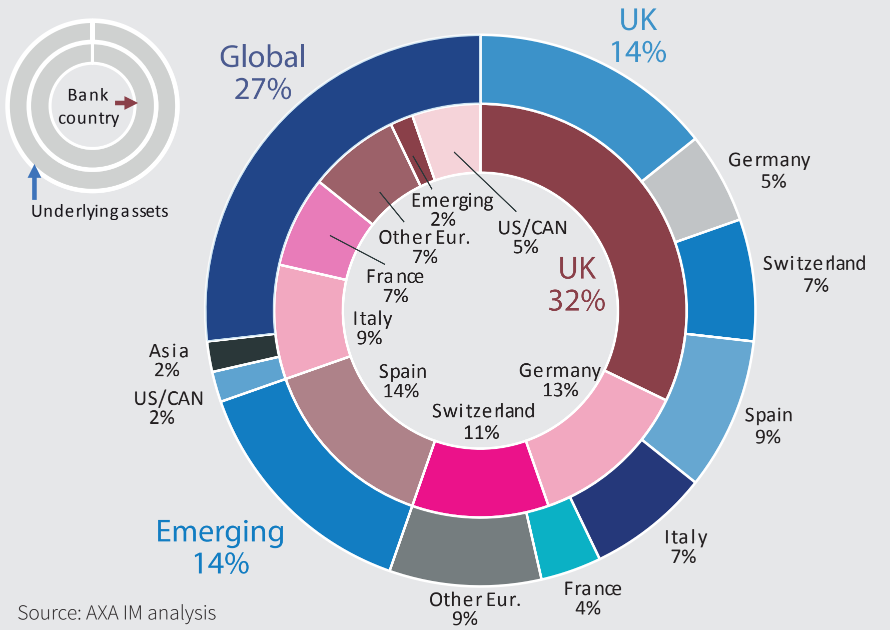
[11] Source AXA IM; 2018 figures.

[12] Basel III Reforms: Impact study and key recommendations, EBA, August 2019: "Under conservative assumptions, at its steady-state implementation scheduled for 2027, the reform could increase the tier 1 (T1) minimum required capital (MRC) amount, which includes Pillar 2 requirements and EU-specific buffers, by 24.4% with respect to the June 2018 baseline.

“The asset class benefits from a well-diversified investor base in particular with Pension Funds now representing 30% of investors and also certain public/ supranational entities.”

Secondly, while the source of transactions remains primarily in Europe, the underlying collateral is globally diversified. This is demonstrated in Figure 5.

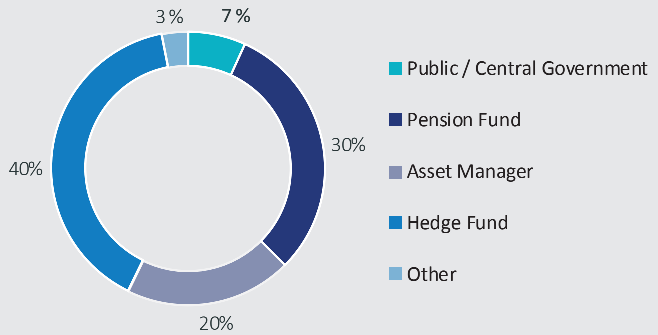
Figure 5: Bank and underlying collateral jurisdiction



Source: AXA IM analysis

d) **A strategic investor base:** The asset class benefits from a well-diversified investor base in particular with Pension Funds now representing 30% of investors and also certain public/supranational entities (figure 6).

Figure 6: Investors, % volume of distributed tranches



Source:EBA Discussion Paper. Draft Report on STS Framework for Synthetic Securitisation, 24 September 2019

The importance of sourcing, due diligence and negotiating terms

a) The ability to source deals efficiently - a step before detailed credit analysis - is an important consideration for investors. This is largely dependent on the depth and breadth of the investor relationship with the issuing banks. An ability to source from a broad range helps investors be selective.

b) There is no doubt an information advantage that exists in favour of the banks (on the loan book they want to sell). In practice, however defining eligibility portfolio criteria and having the ability to filter out names and fix loss thresholds with banks (for example, ensuring the bank would be typically responsible for a part/a fixed percentage of any losses) ensure that the bank keeps some skin in the game, which is vital for alignment of interest between the investor and banks.

c) Equally important are on site due diligence visits:
- to understand the bank's market positioning and lending philosophy, as well as
- their modelling/structuring of transactions around credit risk of the portfolio (to assess and strengthen the resilience of the investment).

d) Size, track record and experience, all factor into this equation and contribute to source transactions and drive bilateral deals which lead to lower losses (i.e. defaults after recovery).

Benefits of RegCap transactions for institutional investors

While some investors may allocate to RegCap transactions from traditional fixed income or high yield buckets others could consider the risk/return expectations akin to a growth portfolio allocation. Regardless of where it is positioned, some benefits of RegCap transactions are listed below.

a) **Credit diversification:** The collateral pool available through RegCap transactions, already highly diversified itself, can help diversify an existing credit portfolio across sectors, geographies, seniority and borrowers. In particular, the pool gives investors the opportunity to access core bank performing assets (without exposure to the credit risk of banks). It also gives access to a relatively closed, bespoke and relationship driven SME lending market, in a context where banks need to hold on to clients because of the fundamental value these accounts bring to their business.

b) **Potential stable cash flows:** Cash flows are based on the stable performance of underlying portfolios of performing loans at the start of a contract, although through time, loans' risk may change, and cash flows could be impacted eventually only by realised defaults.

c) **Resilient pricing:** Price from the point of view of the bank is determined by the combination of the default risk of the underlying portfolio and the bank's cost of equity capital. Price from the point of view of the investors is governed by risk, complexity and diversification considerations including where the allocation will (potentially) be funded from i.e. if the allocation is coming from alt credit or equity. From a supply demand perspective, the barriers to entry in this market help to maintain a good balance between new issuers and new investors. We believe the combination of these factors will help keep for some time the premium offered by banks in line with the premium required by investors.

d) **Credit event management:** investors benefit from the bank's workout experience to manage recoveries in case of a credit event as the bank remains incentivised to lower the impact of defaults.

Risk considerations

a) As with all investments, there are risks that need to be managed. One main risk for investors in the RegCap trade is the **credit risk of the underlying portfolio,** usually Investment Grade for large corporate names and non-Investment Grade for the pools of SMEs. Although investors can typically expect to be compensated by a risk premium superior to levels observed in traded markets,
- a good knowledge of local regulatory frameworks for lending combined with an understanding of bank processes to grant or refuse loans
- a robust selection of the pool of loans alongside the ability to negotiate appropriate covenants for them
- portfolio construction ensuring collateral diversification by asset class, region, seniority and structure.

are key ingredients for success, given heterogeneous loan books that need to be looked at opportunistically.

b) The due diligence process must also consider **counterparty risk managemen**t which, in the case of RegCap transactions, is linked to the payments of premium (for loss protection) due by the bank and can be mitigated by incorporating strict collateral management terms in the protection agreement. It can also be linked to the collateral if cash collateralisation is preferred over government bonds.

c) **Liquidity risk** is another consideration, since RegCap portfolios would generally offer no liquidity. To a large extent, the strategy's investment horizon of five to seven years reflects the liquidity constraints of the underlying transaction. This is something that investors need to be comfortable with even if a few secondary market transactions have recently started to take place.

d) Another element that merits consideration is that **regulatory changes** beyond those already planned could impact the way banks manage their regulatory capital. While the direction of travel of regulation does not represent unexpected risk to materialise, changes could potentially impact the reinvestment of a strategy's proceeds or lead to accelerated distributions.

e) While bespoke due diligence, investment analysis and negotiating terms of investment and protections mean there is little standardisation to rely on, this **complexity** also commands a premium. It acts as a barrier to entry for new supply of funds and as mentioned previously as a reward for those willing to take the time to understand them.

In summary, the ability to analyse all aspects of a potential transaction including the trade-offs between not just risk/return/liquidity but terms, covenants, structures and collateral are vital in addition to selection of the pools of loans.

Conclusion

Regulators globally have an incentive in ensuring a stable and sustained growth of capital markets. As such, the attention and support received by RegCap transactions is not surprising.

Guidelines to strengthen the framework within which RegCap transactions operate, have contributed to the emergence of a diversified issuer base, which in turn has nurtured the development of globally diversified collateral. These developments have taken place in a context where the liquidity and complexity premia have remained resilient.

The illiquidity, depth and size of the RegCap market is certainly institutional in nature but the format/structure in which this investment is executed is arguably new to a lot of institutional investors. Institutional investors who can get over the execution hurdle could stand to benefit from outsized premiums from banks willing to fiercely protect their core assets and lending business.

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