

Regulatory Capital: Long-Term, Stable Income



Summary

Securities backed by bank loans provide a stable, diversified and attractive income – up to 14% – alternative.

Additionally, these securities' floating-rate nature can help mitigate interest rate and inflation risk.

A wide range of the bank loan universe has been traditionally not available to investors.

Investors may now access the asset class through a Regulatory Capital structure: banks share some of their loan risk and, in exchange, provide investors with stable income.

By sharing risk, banks and investors' interest are aligned.

Bank loans traditionally have a lower default rate than High Yield bonds. Default is the strategy's primary risk.

Selection, quality and diversification help mitigate risk.

RegCap's main **benefits** include:

- 1 Stable income
- 2 High quality collateral
- 3 Floating-rate
- 4 Low volatility
- 5 Low correlation
- 6 Diversification

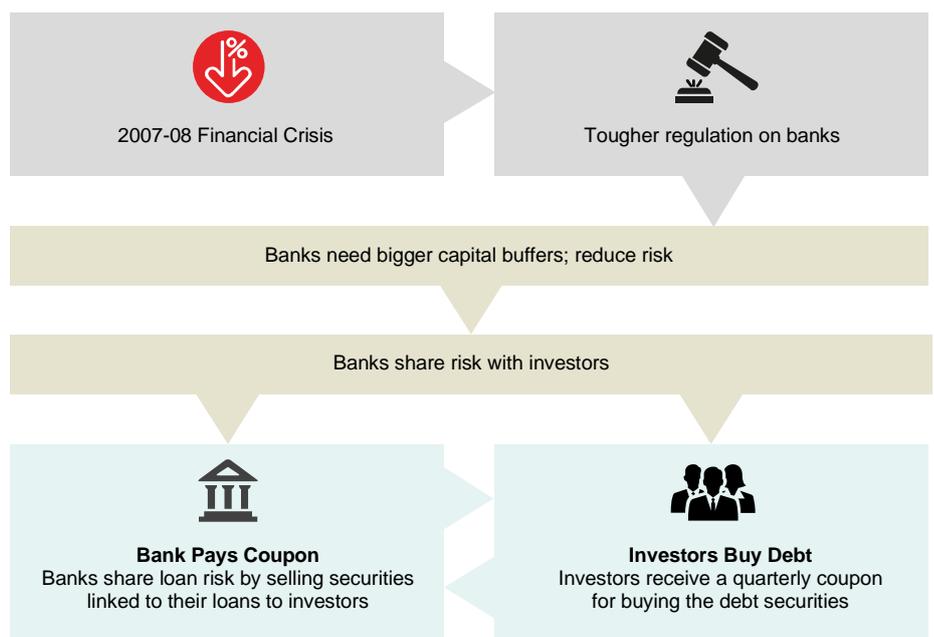
Investors seeking alternative sources of income and a lower correlation to uncertain public markets may consider bank loans.

More stringent bank regulation following the 2007-08 Global Financial Crisis (GFC) requires banks to increase their capital buffers. To free-up capital – and therefore be able to lend more – banks in Europe and North America have partnered with strategic investors to share risk, creating an asset class previously not available to most investors: through a Regulatory Capital (or RegCap) structure, investors now have the opportunity to access the bank loan universe, which typically provides high-quality, stable income from a diversified pool of borrowers.

Apart from corporate loans to large, small and medium-sized companies, banks' books also include trade receivables, auto loans, mortgages, housing, farming and infrastructure projects.

As seen in **Figure 1**, the RegCap mechanism is simple: banks share loan risk by selling debt securities backed by a pool of their core, high-quality loans. Banks keep the most senior tranches of those loan packages (created through a securitisation process). Investors buy the higher-yielding, more junior tranches of those high-quality loan packages in exchange of regular coupon income. If the loan defaults, investors at the bottom of the capital structure will absorb the first losses. Bank loans, however, have a lower average default rate than publicly traded corporate bonds (more detail in p3).

Figure 1: RegCap: Banks and investors swap credit risk for regular coupons



Source: CQS

The structure, also known as Credit Risk Sharing, works for both sides because their interests are aligned: by keeping loan risk, or having *skin in the game*, banks keep the loans on their balance sheet and continue to manage the customer relationship. To mitigate the risk of loan defaults, banks monitor a borrower more closely and also have dedicated workout units that may help, extend or restructure a loan in order to prevent default.

The Regulatory Capital structure is then designed to provide the following benefits:

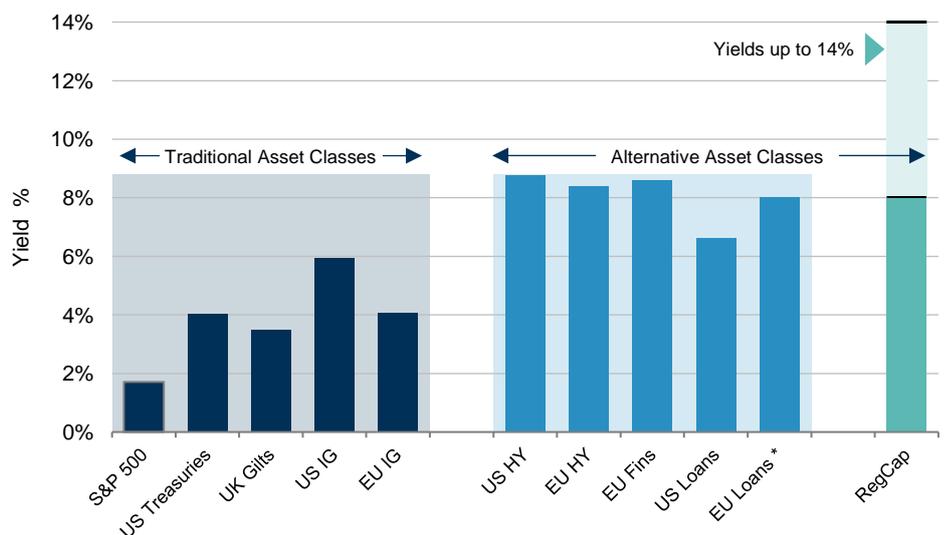
Benefits for investors:

1. Stable income

RegCap typically provides quarterly coupons of between 8% and 14% per annum

RegCap typically provides quarterly coupons of between 8%-14% *per annum*, depending on the geography and subsector. Apart from compensation for the risk taken, investors also receive an illiquidity premium, as bank loans typically have a long duration. Combined, and as seen in Figure 2, the asset class provides a high income level relative to mainstream asset classes.

Figure 2: RegCap provides high, regular income



Source: CQS as 31 October 2022 * EU Loans data as at 30 September 2022.

2. Senior, high-quality collateral

Bank loans tend to be backed by senior, high-quality collateral, leading to superior recoveries in case of defaults. For example, during the 2007-08 Financial Crisis, Moody’s corporate losses were in excess of 3%, whereas European Bank Loan charge-offs peaked at around 1%.

Among the pool of loans offered by banks, only the better loans are normally included in Regulatory Capital deals. RegCap transactions consist of 100% performing loans at origination (predominantly secured on assets), providing dependable collateral for investors. Also, and because of the alignment of interests between banks and investors, the loans in RegCap deals have gone through a rigorous due diligence and underwriting process, and they are also subject to ongoing risk monitoring throughout the life cycle of the loan.

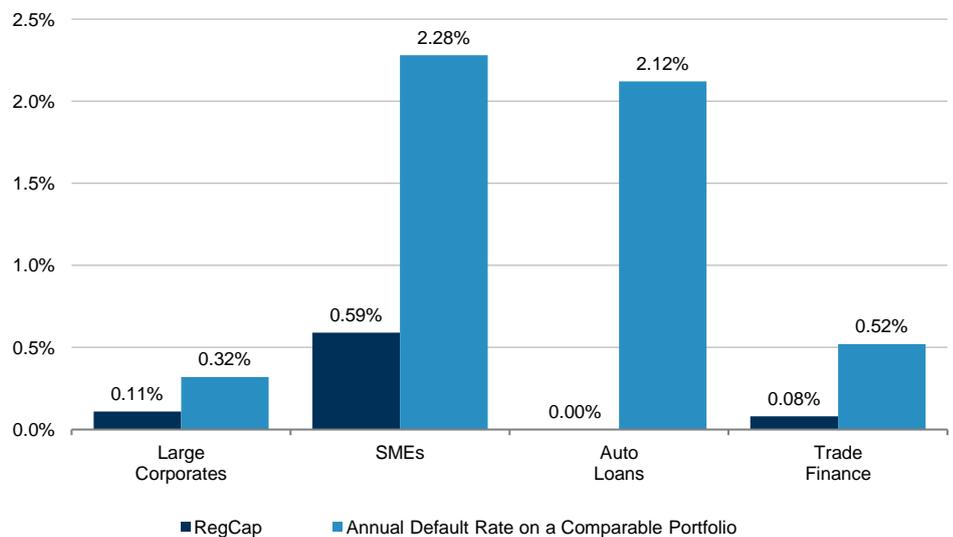
RegCap loans have consistently exhibited low default rates

In general, the loans underlying RegCap deals have an equivalent credit rating of BBB- (the lowest Investment Grade ranking) or BB+ (the highest non-Investment Grade category). In Europe, underlying RegCap loans are typically from European-based, Investment Grade-rated borrowers. This, for example, helped the asset class outperform High Yield and the broad European bank indices during the COVID-19 crisis in 2020/21.

Figure 3 shows that underlying RegCap loans have consistently exhibited low default rates.

Figure 3: RegCap: lower default rate

(Realised annual default rate and observed annual default rate on a similar but broader portfolio of the bank).



Source: EBA: Report on STS Framework for Synthetic securitisation (6 May 2020).

3. Floating-rate

Most bank loans have a floating-rate nature, which mitigates interest rate risk – a timely attribute in the present rate-rising environment.

4. Low volatility

Regular high and stable income throughout the market cycle substantially reduces the volatility of the asset class.

5. Low correlation to major asset classes

The regular and diversified cash flow stream makes RegCap low correlated to volatile public markets.

6. Diversification

Some investors add a RegCap allocation to a wider portfolio in order to increase diversification and mitigate risk. Some of the assets in RegCap structures are hard to source, as they may be originated by banks with a strong expertise or market share in a specific sector (ie. social housing, project finance etc.). This increases the diversification of the asset pool.

Benefits for banks:

Free up capital

- By sharing risk, banks need to keep less capital, freeing resources to lend more. Banks welcomed the RegCap structure as raising additional equity can be expensive and dilute existing shareholders, while lending less hurts income and market share.

Share risk

- Banks reduce default risk by selling the junior tranches of the RegCap structures, while keeping the most senior, which gets paid first in case of default.

Reduce volatility

- By sharing risk, banks have less need to increase provisions and write-downs, reducing earnings volatility.

Strengthen client relationships

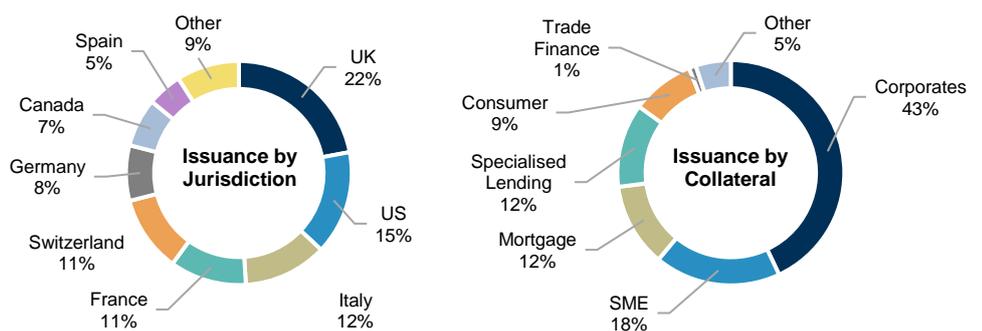
- Sharing risk helps banks support their clients more, potentially extending their relationship.

The opportunity, today

Banks issue about \$12bn worth of Regulatory Capital bonds every year, and the figure keeps climbing as more financial institutions see RegCap as an efficient solution to improve capital ratios and lend more. RegCap has evolved from a niche option, used by a limited number of primarily European banks, to a widely adopted tool for balance sheet optimisation and applied by an increasing number of issuers across a widening range of subsectors. The growing number of bank participants, consistent issuance and the wider range of underlying subsectors provide more opportunities and greater diversification benefits.

RegCap has evolved from a niche option to a widely adopted tool for balance sheet optimisation

Figure 4: RegCap issuance: Diversified in terms of country and sectors



Source: EBA Report on STS Framework For Synthetic Securitisation, 2021. Chart may not sum to 100 due to rounding.

Mitigating Risk

Like all security investments, Regulatory Capital requires specialised management to minimise risk. In this regard, managers usually implement the following strategies:

Thorough due diligence and selection

In order to mitigate default risk, RegCap managers look at bank loans either one by one (for disclosed pools), or as a pool – which is then analysed with statistical tools. Managers may favour loans whose rating has been stable over a 10-year period rather than those with an unstable rating history. For small and medium enterprises (SMEs), where loans are packed together and sometimes the name of the company is not disclosed, managers employ comparative analytical techniques.

Thicker tranches

While still paying attractive coupons, some tranches stretch to a wider part of the capital structure, reducing the potential loss in yield in case of default.

Diversification

RegCap portfolios that hold loans from a variety of industries, credit ratings and countries tend to be more resilient. Managers also favour sectors in which the bank has a strong market share and long-standing strategic relationships with customers.

Quality

The present uncertain environment, with high inflation and rising interest rates, may lead to a rise in defaults. To minimise default risk, RegCap managers may be more cautious and choose top-quality assets. In real estate deals, for instance, managers may select transactions where the loan-to-value ratio is about 50%, giving the borrower plenty of margin to absorb market shocks.

Bank relationships

Keeping strong, long-term relationships with banks helps access a wider choice of hard-to-source, high-quality loan options.

Sustainability

Having ample choice increases the chances of selecting sustainable companies and sticking to Responsible Investment guidelines. Over the past few months, there has been more issuance in ESG-related deals coming out of European banks, given the increasing number of underlying loans for social housing, renewable infrastructure and green commercial real estate projects.

Conclusion

Regulatory Capital is a stable, long-term solution that provides investors with a high income, low-volatility and time-tested alternative. These features may help investors in the present, uncertain environment.

RegCap has been a strong source of income and stability over recent major crisis (Global Financial Crisis 2008-2009, sovereign crisis 2012-2013, oil crisis 2016, and more recently, Covid-19). By having a low correlation to public markets, the asset class has acted like an income shelter through different market cycles.

For almost a decade, CQS has invested c. \$1.4bn in the asset class with consistent performance: our disciplined underwriting process has led to less than 0.1% of cumulative credit losses since 2014 (6.39bps) in the asset class. With a rigorous and selective investment process (we reject 70% of transactions), our scale provides the ability to drive structures, especially within bespoke bilateral deals. Our investment process also incorporates ESG and carbon footprint analysis, including individual borrower screening.

We believe RegCap is a long-term partnership between market-leading banks and specialised investors, such as CQS, where banks share the risk on a selected high-quality collateral pool and investors receive long-term, stable income.

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