NEUBERGER | BERMAN

IAN HAAS
Managing Director
NB Alternative Investment Management

ALEXANDER GOTTLIEB
Vice President
NB Alternative Investment Management

Basel III Endgame and the "Reg Cap" Opportunity

As the names suggest, Significant Risk Transfer or Regulatory Capital Relief transactions are risk-sharing deals between banks and investors aimed at strengthening a bank's regulatory capital position without reducing the amount of business it can do.

These deals have become a feature of the banking landscape since regulation and capital requirements were tightened following the Global Financial Crisis (GFC) of 2008 – 09. The knock-on effects of the 2023 mini banking crisis have already lent further impetus to this market and, in our view, the forthcoming "Basel III Endgame" proposals are likely to significantly increase banks' appetite for deals, especially in the U.S.

In this article, we look into the context around these deals and why we think they are an attractive proposition for investors.

A variety of factors have driven the significant rise in non-bank lending over the past two decades, helping create a $2tn market for private credit investing. Whether it be the increasingly onerous regulatory regime which has curtailed bank lending, or simply borrowers' needs for more timely and flexible capital solutions, a plethora of non-bank lenders have stepped in to help fill the gap.

However, investors are not only mitigating the impact of the new regulatory regime by providing capital solutions direct to borrowers. They are also helping the banks themselves by offering bank regulatory capital relief (or "Reg Cap") transactions, also known as Significant Risk Transfer (SRT) transactions.

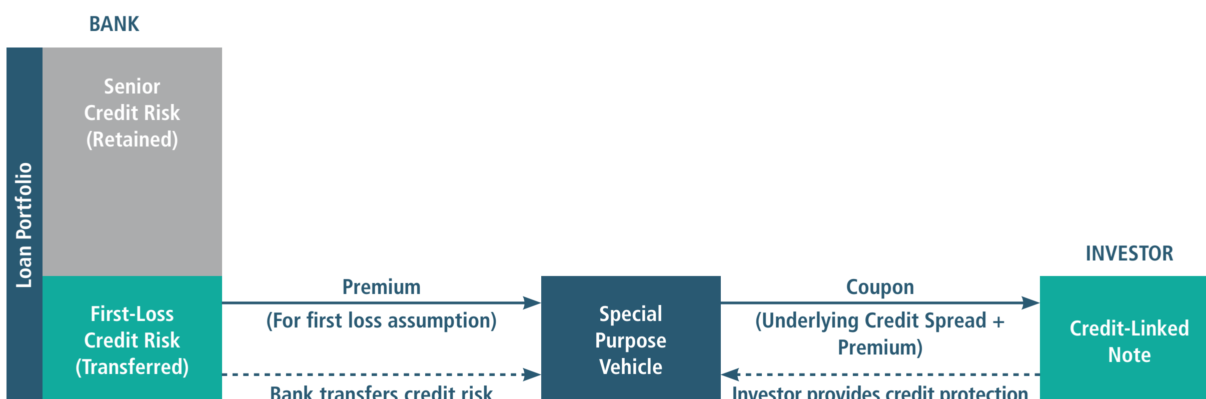
What Is "Reg Cap"?

A Reg Cap transaction is a synthetic risk-sharing deal between an issuing bank and investors. A portfolio of assets on a bank's balance sheet serves as the reference portfolio for the deal, with the bank selling off a subordinated, typically first-loss tranche to investors and retaining the senior tranche.

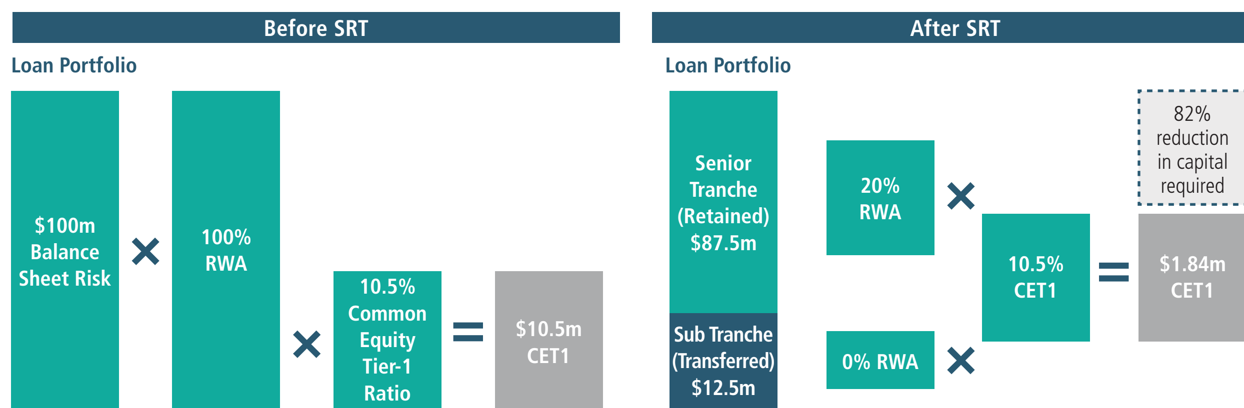
These transactions can significantly decrease the Risk Weighted Assets (RWA) charge against the bank's portfolio and, as a consequence, the amount of capital that must be held against the portfolio. In exchange for providing this capital relief and assuming a first-loss risk position, investors can receive a coupon that is, in our view, elevated relative to the actual credit risk being assumed.

FIGURE 1. HOW A SIGNIFICANT RISK TRANSFER WORKS

Typical structure



How an SRT lowers a bank's capital requirement



Source: Neuberger Berman. For illustrative purposes only.

The Reg Cap market has been active in Europe for most of the past two decades given Europe's regulatory guidance on the treatment of these transactions. We expect the pace of European issuance to continue, while the overall market at least doubles in size as more U.S. banks begin to participate.

"Basel III Endgame": The Major Catalyst for Reg Cap Growth

The "Basel III Endgame" is the name for a proposal issued last year by U.S. regulators that has the potential to lead to significant changes to capital requirements for large banks.

At over 1,000 pages, it is complex and many of its details are beyond the scope of this article, but we see three key aspects that are likely to lead to a further pullback in bank lending capacity and an increase in the issuance of Reg Cap transactions from U.S. banks:

1. **An Increase in RWAs.** Regulators estimate that the proposal will lead to a 20% increase in RWAs across banks that fall under the proposal's supervision. This would reduce a bank's regulatory capital ratios unless it raises extra capital or reduces portfolios by curtailing lending and other activities.
2. **Changes to Regulatory Capital.** The proposal has the potential to change how regulatory capital is calculated. For example, banks under the proposal's supervision would be required to reflect unrealized gains and losses on certain parts of their investment portfolios within their regulatory capital ratios.
3. **Universe of Impacted Banks.** Beyond the changes to RWAs and capital levels, the proposal applies new rules to a much larger subset of the U.S. banking sector. As of March 31, 2024, there were 33 banks with $100bn – $700bn of total assets that would be forced to adopt these changes—a much bigger universe than the Global Systematically Important Banks ("GSIBs") that previously have been the focus of the Basel regulatory framework.

The banking sector has undertaken intensive lobbying efforts against the new proposals, and most market participants think they will have some success curtailing parts of it. Even so, we are of the view that, over time, bank capital requirements will only continue to be tightened.

Moreover, Basel III Endgame is not the only incentive for banks to seek out Reg Cap solutions. One way banks have sought to enhance their capital ratios with more efficiency since the GFC is by issuing more hybrid securities, such as Additional Tier 1 bonds (AT1s), which can be changed to equity in the event of stress to capital ratios. However, the near-complete write-down of Credit Suisse's AT1s, in connection with the bank's near failure and eventual sale to UBS, reminded investors of the risks of these seemingly "safe" hybrid securities. Cooling demand for various hybrid securities could encourage banks to shore up their capital ratios by entering into more Reg Cap transactions instead.

Ultimately, we believe Reg Cap issuance will continue to be driven by the banking sector's rational economic decision-making. While Reg Cap deals come with attractive spreads for investors, the embedded risk transfer typically reduces required capital by 75 – 80%, relative to simply continuing to hold the exposures on balance sheet.

Reg Cap's Attractive Features

We would highlight five key characteristics of Reg Cap transactions that we believe underpin their attractive risk-adjusted return potential:

1. **Regulatory "Arbitrage".** Every "risky" asset on a bank balance sheet has some RWA charge assigned to it. Some of the best opportunities are created when assets of varying risk profiles are assigned the same RWA charge. For example, if a capital call facility to a blue-chip private equity manager has a similar RWA charge as a fully drawn term loan to a B rated middle-market corporate, this is likely to motivate a bank to explore a Reg Cap relief trade on the lower-risk capital call facility, given its relative capital inefficiency with respect to the B rated term loan. The transaction would enable it to stay in the business of providing capital call facilities to private equity managers because it would no longer tie up excessive amounts of the bank's regulatory capital. In exchange, the investor assuming the equity tranche in the deal would receive a spread that is attractive relative to the low risk of the underlying assets.

2. **Risk and Return Transformation.** Related to the point above, at their core, Reg Cap relief transactions have the potential to "transform" the return of a given credit risk that is assumed. The typical spread for the equity tranche of a diverse portfolio of private equity capital call facilities is 600 – 700 basis points. The underlying portfolio should be priced at some spread over the risk-free rate, and the first-loss position in the cash flows should be compensated by some further spread, but in our view 600 – 700 basis points represents an excess return relative to the risk.

3. **Partnership.** Reg Cap transactions feature strong alignment between issuer and investor. The assets underlying a Reg Cap deal continue to be held on the bank's balance sheet, as opposed to being sold. These transactions aim to solve the bank's regulatory-capital challenge—they are not about offloading unwanted or unattractive risk onto investors.

4. **Limited Competition.** The less-liquid nature of the Reg Cap relief market inherently serves to limit competition, thereby preserving a healthy balance between the demand for capital and its supply. In addition, it is not uncommon for a deal to feature a seven- or eight-year legal final maturity, a duration profile that limits many funds and investors from participating. (In practice, deals are usually shorter in duration than the legal final maturity, as banks are incentivized to call and refinance the transaction after the reinvestment or replenishment period.)

5. **Current Yield.** The coupons on Reg Cap deals are quarterly-pay and floating-rate, providing current income, a return of purchase basis that grows each quarter, and protection against interest rate and inflation risk.

Reg Cap's Key Risk Factors

The key risk factors that must be addressed when evaluating a deal include credit risk, portfolio migration (a subset of credit risk) and structural leverage.

1. **Credit Risk.** The two primary sources of risk are the issuing bank's credit risk and the credit profile of the underlying pool of assets. As most deals tend to be senior unsecured obligations of the bank, the investor would have direct credit risk to the issuer in a bankruptcy. The asset portfolio itself can be comprised of a wide variety of exposures, with different default and loss profiles. Investors can help mitigate these risks by working with higher quality banks and being selective on the underlying assets included in deals.

2. **Portfolio Migration from Replenishment.** Most transactions allow the issuing bank time to replenish credits in the portfolio that mature, are refinanced, or default. It is important to at least understand, if not directly negotiate, the terms that govern replenishment features to ensure they do not result in credit or ratings migration.

3. **Structural Leverage.** As these transactions most typically involve the investor buying a first-loss tranche, the investor is directly assuming some amount of structural leverage. While the structure of every deal is different, a common thickness for the first-loss tranche is between 5% and 15%, implying between seven- and 20-times structural leverage. This factor places an emphasis on selectivity and understanding the credit risk of the assets being included in the transaction, and trying to negotiate (or only invest in) deals with thicker equity tranches.

A Fast-Growing Niche in the Private Structured Finance Market

Reg Cap transactions, particularly non-widely syndicated Reg Cap deals, are a niche market, where participants need extensive relationships with issuing banks and specialist General Partners to access deal flow. A good understanding of the diverse underlying collateral types is also required.

Smaller asset managers may not have these relationships or the credit research teams necessary to assess the collateral properly. On the other hand, very large asset managers, investing from multi-strategy credit funds, may struggle to source enough deal flow that matches their credit-risk and duration needs. This leaves abundant opportunity for larger specialist managers that can build and support dedicated teams and investment strategies, and be more selective in the universe of opportunity.

Over the next couple of years, we anticipate very active issuance by U.S. banks, in particular, as they rethink their approach to managing their capital ratios in the light of new and tighter regulation.

This material is provided for informational and educational purposes only and nothing herein constitutes investment, legal, accounting or tax advice. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. Investment decisions and the appropriateness of this material should be made based on an investor's individual objectives and circumstances and in consultation with his or her advisors. Information is obtained from sources deemed reliable, but there is no representation or warranty as to its accuracy, completeness or reliability. All information is current as of the date of this material and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole. Neuberger Berman products and services may not be available in all jurisdictions or to all client types.

This material may include estimates, outlooks, projections and other "forward-looking statements." Due to a variety of factors, actual events or market behavior may differ significantly from any views expressed. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

Investing entails risks, including possible loss of principal. Investments in hedge funds and private equity are speculative and involve a higher degree of risk than more traditional investments. Investments in hedge funds and private equity are intended for sophisticated investors only. Indexes are unmanaged and are not available for direct investment. **Past performance is no guarantee of future results.**

This material is being issued on a limited basis through various global subsidiaries and affiliates of Neuberger Berman Group LLC. Please visit www.nb.com/disclosure-global-communications for the specific entities and jurisdictional limitations and restrictions.

The "Neuberger Berman" name and logo are registered service marks of Neuberger Berman Group LLC.

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

Z0575 08/24 1995395 ©2024 Neuberger Berman Group LLC. All rights reserved.

www.nb.com