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Investment Management

Regulatory Capital

April 2024

RCR transactions allow banks to continue to serve their core customers while improving capital ratios

Bank Regulatory Capital Relief transactions (RCR)[1]

Since the Financial Crisis, banks have been under intense scrutiny from many angles, in particular from their regulators. The regulators' goal has been to change the way banks underwrite loans ensuring the origination of stronger credit quality risk in order to avoid a repeat of the US subprime crisis. In addition, regulators have sought to safeguard balance sheets by having banks hold the appropriate amount of capital against the loans created.

Global regulations (captured in Basel III and IV frameworks) and local regulatory requirements all point to the necessity of banks to stand on a stronger footing (i.e. better capitalised) and be better prepared for stress periods. At the same time, regulators are conscious not to deter banks from their intermediating function within the real economy (providing loans to stimulate economic activity).

The tightening of the regulatory environment continues today, with banks continuously needing to keep adapting to this landscape and monitor their capital performance ratios.

Besides purely regulatory capital requirements, there are additional implications from changing accounting rules such as International Financial Reporting Standards 9 (IFRS9) and Current Expected Credit Loss (CECL) on banks' balance sheets. At the same time, banks are also confronted with changing economic circumstances impacting top line revenues, profitability and returns.

Banks have a number of instruments at their disposal to comply with these ever increasing capital requirements to strengthen their balance sheets:

- Increasing their capital base by issuing new capital, which can occur in a number of capital instruments ranging from core equity, additional Tier 1, Tier 2 etc. However, it could be expensive and dilute existing investors
- Reducing the asset size on the balance sheet through outright loan asset sales, or securitisations. Banks risk losing market share and strategic client relationships to rivals
- Alternatively, banks can issue credit linked notes via RCR transactions

RCR transactions are essentially a tool banks have at their disposal to manage their balance sheet. Since 2010, over 65–70 issuers have accessed the SRT market, with an annual placed notional amount in excess of €20bn.[2] It is important to stress that these trades are foremost a balance sheet optimisation, not risk or loss mitigation strategies. By utilising RCR transactions, banks can create a win-win situation: continue to serve their core customers through loan origination while at the same time improving their capital ratios. Banks can free up lending capacity where concentration limits exist and generate additional fee income. The immediate impact of RCR trades for banks is releasing regulatory capital, related specifically to a well-defined portion of their balance sheets assets.

1 Regulatory Capital Relief trades are also often referred to as Significant Risk Transfer deals or Credit Risk Sharing transactions. **2** SCI capital relief trades database.

Main characteristics of Regulatory Capital Relief trades

- **Core strategic assets—**RCR deals reference core strategic assets of the banks within sectors where the banks occupy significant market presence and wish to continue to do so.
- **Higher quality assets—**the higher quality loans are selected from the banks representative loan books.
- **Alignment of interest—**as the assets remain on the balance sheet and continue to be serviced by the bank. Importantly the servicing department is unaware through Chinese walls whether assets remain exposed on the balance sheet or whether they are part of these RCR trades, thereby guaranteeing the alignment of interest.
- **Risk retention—**5% – 20% of collateral exposures remain unhedged on the bank's balance sheet in compliance with capital requirements regulations (art 406), adding further importance to the alignment of interest thesis.
- **Capital efficient—**RCR deals are value accretive as the cost of issuing these deals is below the bank's cost of equity.
- **Diversification of risk for the investor—**RCR has exhibited low correlation to broader credit markets.
- **Asset class selection—**RCR trades provide investors with the opportunity to take exposure to specific well defined asset classes, where investors are actively involved to determine specific collateral characteristics.

Regulatory Capital Relief structures

These transactions use well established securitisation technology but unlike traditional securitisations are not driven by arbitrage motivations. Rather they are risk sharing transactions where the assets remain with the bank but the associated credit risk is synthetically transferred from the balance sheet.

- Typically, the bank purchases credit protection against a well-defined portfolio of its own assets through a credit default swap agreement or financial guarantee from a bankruptcy remote special purpose vehicle (SPV). The SPV issues Credit Linked Notes to the RCR investor. Investors can be a variety of counterparties, ranging from RCR strategies, Pension funds, family offices, institutional investors, endowment funds, etc.
- The investors' cash is deposited with the bank subject to certain triggers or fully collateralised with highly rated securities
- Alternatively, in lieu of a SPV, investors have an immediate financial guarantee from the bank
- Should an asset in the portfolio incur a loss, the investor reimburses the bank subject to the deal terms
- An attractive element of the RCR deals from an investor point of view is the risk–reward profile. This stems from the fact that the interest is paid by the bank and calibrated against the regulatory capital savings of the issuer in a wide range of economic scenarios (covering both expected and unexpected losses)

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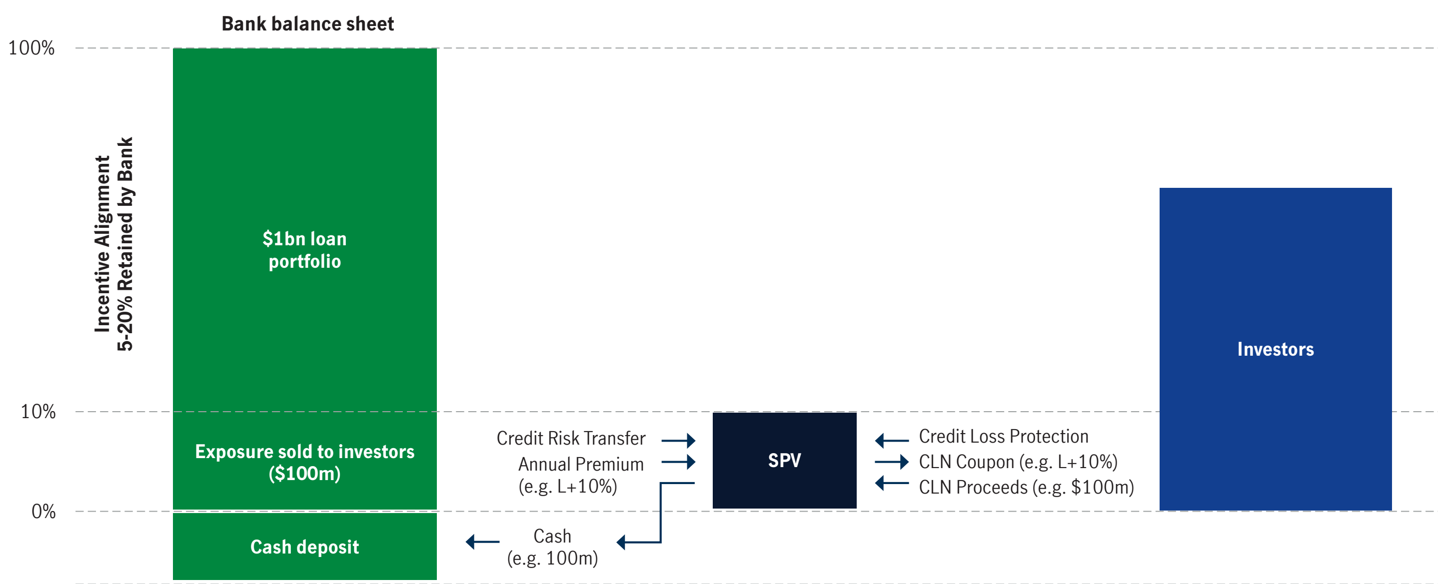
Example transaction



Regulatory Capital Relief landscape

The Regulatory Capital market has matured substantially in size and depth over the past few years. Whereas the technology was originally spearheaded by local European banking champions within a relative narrow asset range (mostly large corporates), today there is a diverse number of issuers, sectors, jurisdictions etc. This drives the creation of a diversified RCR Strategy portfolio:

Underlying sectors	Geography	Issuers	Issuance formats
• Large corporates • Commercial real estate • Trade finance • SME • Agriculture • ESG • Mortgages • Consumer lending • Renewables • Project finance	• UK • US • Continental Europe • Eastern-Europe • Asia	• Global Systematically Important Banks • Issuers with an established credit risk transfer platform vs new entrants	• Broadly syndicated, club deals and bilateral deals

The Regulatory Capital Market is at an attractive entry point

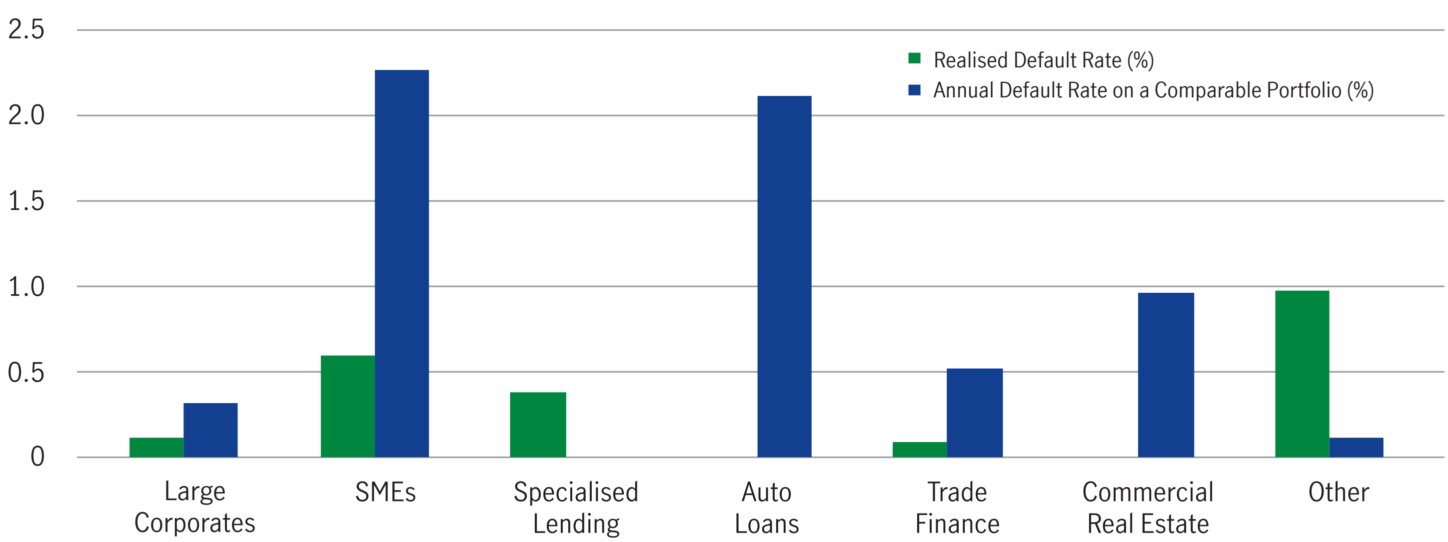
Historically speaking, RCR trades have performed very strongly through various credit crises: Global Financial Crisis (2008-2009), Sovereign Crisis (2011-2012), Oil & Gas Crisis (2015-2016) and Covid-19.

The referenced core assets and the strict selection criteria contribute positively to this outperformance. Additionally, the alignment of interest and the fact that these loans continue to be serviced by the bank itself through the whole economic cycle of the loans (proactively anticipating stress periods) further supports the strong performance. The historic track record underlines the outperformance of RCR trades versus broader but comparable bank portfolios and speaks to the strong asset quality and core nature of the assets.

Secondly, in response to recent uncertain macro conditions, structural features have substantially been enhanced: current RCR structures now come with far more restrictive replenishment criteria, less leverage, better protected tranches. This combined with substantially higher coupons has led to higher loss adjusted returns for post Covid-19 issuances.

Thirdly, respective regulators (e.g. European, North American) have fully endorsed Regulatory Capital as a standard toolkit for balance sheet management. We expect a substantial pickup of US issuers entering the market. As such **creating** steady technical support for investors.

Outperformance of RCR trades vs broader but comparable bank portfolios



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

Low correlation to wider markets providing attractive income driven returns

Conclusion

Regulatory Capital Relief is a fundamental part of a bank's capital management toolkit. This makes it distinct from many investment opportunities which are driven by financial arbitrage. This is also one of the core reasons why this sector compares favourably to competing opportunities in adjacent sectors.

The variety of core businesses and the flexibility of RCR structures result in a diversified investment opportunity set. At the same time, because of the diversity of asset types in a range of jurisdictions, it becomes important to have the experience and knowledge to analyse, and importantly, differentiate between different deals in order to select the very best investments and to achieve the best risk-adjusted returns.

As we discussed above, the regulatory scrutiny of banks continues. This is driving more changes with respect to how banks will manage their regulatory capital. In the coming months and years, we will see i) more banks issuing RCR deals; ii) as the regulatory rules change, banks will use a wider range of asset types, increasing investment opportunities; and iii) RCR deals are evolving to meet these demands and regulatory rule changes, resulting in yet more types of RCR transactions to consider.

For investors equipped with the expertise and knowledge to understand and analyse the RCR sector, they have the opportunity to access, stable risk-adjusted returns which exhibit low correlation to wider markets providing attractive income driven returns to their portfolio.

Approach to Regulatory Capital Relief

Manulife | CQS Investment Management has a long track record in RCR investments with the first investments dating back from 2014, covering the full range of underlying sectors. Our due diligence methodology is based on sophisticated and proprietary credit risk pricing models and a data driven bottom-up re-underwriting methodology that is specific for each asset class.

Regulatory Capital is a core strategy within the ABS team, which consists of 9 investment professionals. The team's due diligence is fully embedded in the wider Manulife | CQS IM platform, leveraging off extensive global corporate credit research, global corporate loans department and structured credit desk. Over the years, an extensive database of historic deal characteristics, structures and performance has been established which allows for an all-encompassing relative value exercise.

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