REGULATORY CAPITAL RELIEF

Emergence of an asset class

Banks and select investment firms are increasingly partnering through regulatory capital relief transactions. **Kaelyn Abrell** of ArrowMark Partners explains how the securities create alignment by achieving the long-term objectives of both issuers and investors

Basel III implementation and ongoing regulatory changes are prompting banks to place a greater focus on capital generation, returns on invested capital, and optimisation of the balance sheet.

Regulatory capital relief (also known as significant risk transfer or SRT) transactions, involving diversified portfolios of performing loans, have proved to be one effective solution. The securities allow banks to maintain core lines of business while offsetting the deterioration in profitability from increased capital requirements. Investors benefit from the potential to earn returns in excess of liabilities and spending requirements through the securities' floating rate coupons.

PDI spoke with Kaelyn Abrell of ArrowMark Partners, which has invested over $1 billion in 18 transactions since 2010, to find out more about the regulatory capital relief market – and why 2017 is shaping up to be the most active year yet.

"REGULATORY CAPITAL RELIEF OFFERS INVESTORS THE POTENTIAL TO EARN ATTRACTIVE INCOME-DRIVEN RETURNS WITH EXPECTED RESILIENCY DURING PERIODS OF MARKET STRESS"
Kaelyn Abrell

Q What are the options that banks have to optimise their balance sheets, and when are regulatory capital relief transactions the best choice?

KA: One of the most significant challenges to bank profitability is the more than doubling of required capital levels under Basel III. Given the magnitude of the change and the size of bank balance sheets, there is no single solution. Instead, most banks are employing a multi-faceted approach involving three primary options.

Option one: raise capital through equity and junior debt offerings. Banks can finance themselves through the public markets but it is relatively expensive and dilutive to existing shareholders.

Option two: sell assets and/or limit asset growth. Outright asset sales can reduce balance sheet size, leverage, and risk. However, transactions involving collateral such as non-performing loans, which we don't include in our definition of regulatory capital relief, typically occur at discounted valuations and force banks to realise losses.

Additionally, banks either don't want to sell certain balance sheet exposures, in order to maintain relationships with borrowers that are important clients across the banking franchise, or can't sell due to various legal restrictions. Banks can attempt to moderate asset growth but have to balance the expectations and servicing needs of clients along with the inherent capital intensity of certain business lines.

Option three: improve the capital efficiency of balance sheet exposures through regulatory capital relief transactions. Transactions make economic sense for banks and allow them to continue lending to core clients.

Q From an investor perspective, what are the key characteristics of these transactions? How does exposure to the asset class fit in a diversified portfolio?

KA: First, the underlying collateral pool is diversified across sectors, geographies, and borrowers. Weighted average credit quality ranges from BBB+ to BB with limited exposure to lower credit quality tiers. Diversification helps mitigate idiosyncratic credit risk. Credit quality metrics provide a helpful indication of collateral fundamentals.

Second, securities are structured to create alignment between issuing banks and investors. Banks are incentivised to maintain disciplined underwriting standards through the retention of meaningful exposure to the collateral pool.

Third, performance is driven by securities' floating rate coupons, which are comprised of three-month LIBOR plus a contractual spread. Recent investments offered low double-digit spreads for securities with three- to five-year expected lives.

We believe these characteristics position the asset class as one of the most asymmetric risk/return opportunities available across capital markets today. Regulatory capital relief offers investors the potential to earn attractive income-driven returns with expected resiliency during periods of market stress due to collateral characteristics and structural enhancements.

In terms of fit, investors approach regulatory capital relief with varying perspectives, similar to other private credit strategies. Some allocate from traditional fixed income or high yield to capture higher returns and lower portfolio duration while sacrificing liquidity. Other investors position exposure with other private strategies but recognise that the required return hurdle differs from private equity due to the shorter maturity profile and quarterly coupons.

Regardless of where it is positioned, investors highlight the benefits of high current income and low correlation to their portfolio construction efforts.

Q How long have banks utilised regulatory capital relief transactions? Do you expect a pick-up in activity and, if so, why?

KA: While a small number of banks have been active since the late 1990s, the market really started to take hold following the financial crisis. Growth accelerated over the last few years with increased issuance from existing participants and the arrival of new entrants.

We expect the trend to persist as a growing number of banks and regulators gain comfort with the structure of regulatory capital relief securities. Issuers continue to extol the benefits of the transactions to their Basel III compliance efforts, management of balance sheet concentrations, and adaption to changing regulations.

Barring a dramatic change in the market environment, issuance in 2017 should surpass the prior peak set in 2015. Not including bilateral transactions that are executed between one bank and one investor, we anticipate $3 billion to $3.5 billion of syndicated transactions in 2017. Syndicated transactions typically involve five to ten investors.

In terms of overall market activity and the opportunity for investors, I would also highlight the continued development of the secondary market. We've been able to purchase seasoned transactions at a discount in the secondary market and benefit from the securities' shorter maturity profiles and vintage diversification.

Q How is issuance regulated? Are there any challenges on that front?

KA: Banks work closely with their regulators throughout the issuance process. Coordination ensures a transaction structure satisfies regulatory requirements and provides the bank with the intended level of regulatory capital relief.

The primary challenge for investors is maintaining a comprehensive understanding of relevant financial industry regulations, differences across geographies, and the impact on issuers and securities. Subtle nuances can have a material impact on a security's risk/return profile. We tailor our structuring and fundamental diligence processes to account for differences in the regulatory framework applicable to each issuer.

Q What are the keys to investing in this market successfully?

KA: The first key is sourcing. Relationships and experience in the asset class are obviously important. But banks also want to make sure there is two-way alignment with investors. The ideal partners have long-term investment horizons and no potential conflicts with a bank's core businesses, among other characteristics.

The second key is related to structuring and fundamental diligence of security terms, the collateral pool, and an issuer's underwriting process. Investors need to have the ability to analyse all aspects of a potential transaction and evaluate tradeoffs between different terms and collateral. We discuss attractiveness of the asset class but issuer and security selection are of vital importance.

The final key is a flexible and opportunistic approach. The opportunity in regulatory capital relief evolves with the market environment, credit cycle, and regulations. In order to capitalise on the asset class' long-term return potential, investors need the expertise and resources to pursue a variety of transactions types with differing underlying collateral. ■

***Kaelyn Abrell** is a partner and portfolio manager at ArrowMark Partners*