First Trust
Capital Management

Insights on Private Credit

Alphabet Soup: Understand The Opportunities in Private Credit Driven by Regulations

Regulatory Capital Relief Trades Explained

RWA, CET1, AT1, CRT, CLN, Reg Cap, SRT

These are the acronyms or 'alphabet soup' which we hope to demystify by providing context into what we believe is one of the best risk-adjusted return opportunities within private credit. To understand the opportunity we see in capital relief deals, we first need to provide some background on how it relates to banks and the regulatory requirements prompting these trades.

OVERVIEW ON BANKS REGULATORY ENVIRONMENT

Let's start at the beginning, with risk-weighted-assets (RWA). RWA determines the minimum capital a bank must maintain in relation to the risk profile of its assets and lending activities. Simply put, it's a risk-based metric widely used by all banks and the Federal Deposit Insurance Corporation (FDIC).

In the U.S., the FDIC determines and enforces the minimum capital requirements needed to create financial stability under Basel III; a global banking standard introduced in response to the Great Financial Crisis. Basel III outlines the percentage of capital reserves a bank must hold.

And of course, as nothing can be simple in banking regulation, Basel III classifies capital into two tiers with three distinct categories. Broadly, *Tier 1 Capital* is a bank's core capital, equity and reserves that appear on the financial statements. If a bank experiences losses, Tier 1 Capital allows it to weather stress. *Tier 2 Capital* refers to a bank's supplementary capital and is less liquid than Tier 1.

HOW DO THESE TIERS RELATE TO RWA?

CET1: Common Equity Tier 1 Capital

CET1 capital is a measure of a bank's core capital, encompassing predominantly retained earnings and common equity. Importantly, this tier absorbs first losses and protects the rest of the capital structure. According to Basel III, CET1 must be at least 4.5% of its RWA.

AT1: Additional Tier 1 Capital

AT1 capital shares some equity-like characteristics with CET1 capital in addition to a debt component. Generally, these consist of convertible securities or trust preferred securities which can convert to equity if there is a shortfall in CET1. According to Basel III, CET1 + AT1 must equal 6% of its RWA basis.

Tier 2 Regulatory Capital

Tier 2 serves as a second layer of defense, absorbing losses before any depositor or creditors become impaired. Most commonly, think qualified subordinated debt. According to Basel III, CET1 + AT1 + Tier 2 must equal 8% of its RWA.

Below, is a simple example to illustrate how these tiers work:

Capital Requirements by Tiers

Using a hypothetical bank which we will call First Trust Bank (FTB), we will illustrate how tiers work. FTB has two assets on its balance sheet: $100 of U.S. Treasuries and $100 of corporate loans. Government securities are risk free, so they have a risk-weight of 0%. Corporate loans are riskier, they are not backed by the strength and taxpayers of the U.S. government and could default. Therefore, we will assign 100% risk-weight to the corporate loans. FTB now has a RWA of $100 or ($100 * 0% + $100 * 100%).

- According to Basel III, FTB must hold capital reserves to protect depositors in case the risk assets defaulted.
- Banks are required to hold a capital conservation buffer of an additional 2.5% to bring total tier one and tier two capital percentages to 10.5%.
- Based on the two assets on the balance sheet, FTB must hold total capital reserves of $10.5.

CET1 capital	(4.5%* $100 of total RWAs) = $4.5
AT1 capital	(6% - 4.5%)* $100 = $1.5
Tier 2 capital	(8%-6%)*$100 = $2
Buffer capital	2.5% * $100 = $2.5
Total capital	$10.5

On the surface, 10.5% does not seem rather material and it is important for banks to maintain sufficient liquidity to protect depositors. Now imagine, a bank of $500 billion of risk assets. They need to hold $52.5 billion of capital reserves, that cannot be used to finance any type of activity within the bank, no investments, no corporate projects, no income - essentially, $52.5 billion in cash.

So what? It is important for a bank to hold reserves. We would agree. However, the final set of rules Basel III, Endgame, are expected to take effect by mid-2025. We believe these rules will have significant impacts on bank capital ratios. We expect capital requirements will increase, and banks will need to meet higher standards by increasing nominal capital or reducing RWA.

Two highlighted changes:

- Common standards and models. Previously, banks had their own risk models to assess capital adequacy, however, going forward all banks will face the same standards and risk models. This impacts how banks previously would classify their RWAs.
- Accumulated other comprehensive income (AOCI), or mark-to-market losses, will directly factor into CET1 capital calculations for all banks.

WHAT'S DRIVING THE OPPORTUNITY NOW?

So what has accelerated the rapid growth of CRTs (credit risk transfers)? Why have we not heard about these sooner?

In the previous macro regime of lower interest rates, many banks added duration to balance sheets to generate incremental yields. However, with today's rates, those decisions have led to an uptick in unrealized mark-to-mark losses. Since 2022, capital ratios at banks have come under pressure, and we expect them to increase with the changes to Basel III. What options does a bank have?

1. Sell Assets: *Directly Reduce RWA*

Today, that would mean only high-quality, short duration floating rate assets would be considered as they would receive prices closer to par and avoid most of the capital losses. Fixed-rate investments, due to a rise in interest rates, are being held below par. Moreover, banks do not want to lose lending relationships which can lead to additional revenue generation through other business verticals. Therefore, in the current environment, banks are incentivized to hold on to these assets.

2. Issue Additional Equity: *Increase CET1 and AT1 Capital*

This is very costly right now. Most banks are trading below their book value, meaning issuing additional equity would be highly dilutive to their capital structure and important profitability ratios. For example, most banks use return on equity (ROE) as a measure of profitability (both for public equity investors and often for their executive compensation). As a reminder, it measures net income generated from its shareholder equity. Due to this, banks do not want to issue additional equity that would dilute ROE ratios which could cause pressure on their stock or diminish their bonus packages.

3. Execute a CRT (or its cousin an SRT):

This option allows a bank to retain assets while decreasing their weight in RWA calculations. Like it sounds, this is the best option for banks and has led to a material increase in CRT activity.

What is a CRT, RegCap, CLN, or SRT?

More alphabet soup of course. CRT (credit risk transfer), RegCap (regulatory capital relief trade), CLN (credit linked note) and SRT (significant risk transfer) are essentially equivalent as they refer to the same transaction. The predominate difference is in the accounting rules for which the assets are sold through securitizations, credit default swaps or credit linked notes. CRTs are typically referred to in the U.S. whereas SRTs are the nomenclature in international markets.

CRTs are not a new financial engineering product; they actually date back to the 1990s. CRTs share common features:

- A bank transfers (sells) asset risk associated with its RWAs to one or more parties. This can be a private credit firm or fund.
- The transfer of risk typically occurs on a tranched basis. A bank sells a subordinated tranche (not always, but often a first loss tranche) and the bank retains the senior tranche.
- Investors acquiring the tranche, must do so on a collateralized or funded basis, mitigating counterparty credit risk.
- In exchange for "insurance" on the tranche sold, the banks pay a quarterly premium to the third parties.

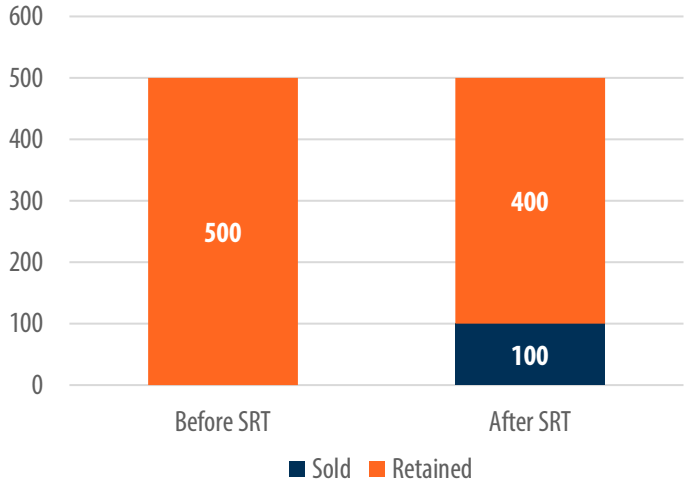
Tranche Example

How does this help free up regulatory capital for a bank?

The tranche sold now receives a weight of 0% in the RWA calculations. The senior tranche of the bank retained, since it now has a loss buffer, receives a risk weight of ~20%.

In this trade, the bank lowered its capital requirements from $52.5B to $8.4B or by 84%. Freeing up $44.1 billion in regulatory capital, while maintaining their lending relationship and avoiding any capital losses through the sale of assets.

Before SRT - 500 billion	($500B * 100% RWA * 10.5%) = $52.5B
After SRT - 400 retained and 100 sold	(400* 20% *10.5%)
	(100*0%*10.5%)
Total capital	$8.4B



HOW CAN ALLOCATORS TAKE ADVANTAGE OF THIS?

Still with us? Yes... that is a sweet deal for banks.

Why is this an attractive opportunity for private credit investors?

Previously, pensions and insurers were the primary purchasers of CRTs. However, with the rapid adoption of these products and the allure of attractive risk-adjusted returns, private debt funds have entered the arena. These funds receive exposure to illiquid assets that offer robust diversification, steady income, and access to banks' tightly held assets. Given that other options for banks are considerably costly, banks offer an appealing spread or premium above the secured overnight financing rate (SOFR) to these private managers. Typically, each deal is secured by hundreds of loans, with purchasers receiving returns ranging from SOFR plus 7% to 10%. It's important to note that this premium remains expensive for banks, as the underlying loans are typically priced much lower, thus the bank is fronting the premium. Said differently, this premium paid by the bank is significantly higher than the credit risk transferred would originally imply.

REG CAP: HIGHER YIELD VS. OTHER FIXED INCOME AS OF 3/31/24

	Current Yield
Bank Reg Cap	14.50% (13-16% range)
Leveraged Loan	9.05% (SOFR + 375bps)
High Yield	7.04% (5Yr T + 315bps)
FNMA/FHLMC MBS	6.50% (5Yr T + 225bps)
Investment Grade Corporate	4.72% (5Yr T + 47bps)
5-Year Treasury	4.25%

Source: Bloomberg.

Additionally, due to the banks need for these trades, we believe the trends we are seeing in the market make them even more attractive:

Trends we are seeing in today's CRTs vs Traditional use:

- Widespread activity among banks – both in the EU and U.S.
- The borrowers in the tranches today are much more diversified across credit portfolios, lowering the risk in the pool.
- Traditionally, CRTs have been used to extend bank balance sheets rather than capital optimization. Today, banks are motivated primarily by capital stress leading to CRT opportunities in some of the bank's highest quality portfolios.

There is no guarantee that past trends will continue in the future or will be profitable.

It is important to highlight, these opportunities are arising from stringent regulations rather than bank or loan distress. So, while CRTs can be complex and not as widely understood, by breaking down the basic motivations of these trades, they are more easily understood.

As long as banks are highly motivated to reduce their RWA, we believe we will continue to see an attractive opportunity set to acquire low risk loans with the potential to receive an attractive premium.

Please reach out to the First Trust Capital Solutions Group to learn more about how to access and take advantage of the opportunity set in Regulatory Capital Relief Transaction across our investment platform.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Capital Management at 1-800-988-5196 or visit www. firsttrustcapital.com to obtain a prospectus which contains this and other information about a fund. The prospectus should be read carefully before investing.

Risk Considerations

You could lose money by investing in a fund. An investment in a fund is not a deposit of a bank and is not insured or guaranteed. There can be no assurance that a fund's objective(s) will be achieved. Please refer to each fund's prospectus and Statement of Additional Information for additional details on a fund's risks. The order of the below risk factors does not indicate the significance of any particular risk factor.

A fund that invests in securities with limited or no secondary market is deemed to be illiquid. Valuation of illiquid securities is extremely limited. Portfolio holdings are priced either on a daily, monthly, and/or quarterly basis utilizing a variety of valuation methods such as proxy, matrix and third-party pricing. The accuracy of these valuations will vary, and actual tender price of a fund may be materially lower than any past valuation.

Alternative investments may employ complex strategies, have unique investment and risk characteristics and may not be appropriate for all investors.

First Trust Capital Management L.P. ("FTCM") has entered into a contractual agreement with an affiliate, First Trust Portfolios L.P. ("First Trust"), to solicit investors in private funds managed by FTCM and offered through the First Trust Private Investment Platform. For private funds issued by FTCM for which First Trust is the placement agent, First Trust is paid 20% of FTCM's management fee, performance shares or other incentive fees or allocations received by FTCM with respect to each investment in a private fund. In addition, since First Trust's affiliate, First Trust Capital Partners LLC, owns 50% of FTCM's parent, First Trust Capital Solutions L.P., First Trust will indirectly benefit from an increase in fees received by FTCM. Since FTCM's management fees or other incentive fees are based upon a percentage of assets under management, the more assets under management, the higher fee income to both FTCM and First Trust. In addition, due to such compensation, First Trust has an incentive to sell private investments issued by FTCM or offered through the First Trust Private Investment Platform, resulting in a material conflict of interest which should be considered when making a decision to invest in private funds offered by or through FTCM. First Trust will not be involved in the provision of services by FTCM.

The information presented is not intended to constitute an investment recommendation for, or advice to, any specific person. By providing this information, First Trust is not undertaking to give advice in any fiduciary capacity within the meaning of ERISA, the Internal Revenue Code or any other regulatory framework. Financial professionals are responsible for evaluating investment risks independently and for exercising independent judgment in determining whether investments are appropriate for their clients.

DEFINITIONS

Leveraged loans are represented by the **Morningstar LSTA US Leveraged Loan 100 Index** which measures the performance of loans within the Morningstar LSTA US Leveraged Loan 100 Index.

High yield bonds are represented by the **Bloomberg US Corporate High Yield Bond Index** which measures the USD-denominated, high yield, fixed-rate corporate bond market.

FNMA/FHLMC MBS is represented by the **Bloomberg Barclays US Mortgage Backed Securities (MBS) Index** which tracks fixed-rate agency mortgage backed pass- through securities guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Investment Grade Corporate Bonds are represented by the **S&P 500® Investment Grade Corporate Bond Index** which measures the performance of U.S. corporate debt issued by constituents in the S&P 500® with an investment-grade rating.

5-Year Treasury Yield is represented by the **5-Year Treasury Rate** which is the yield received for investing in a U.S. government issued treasury security that has a maturity of 5 years.

Bank Reg Cap transactions involve the sale of the credit risk on a specific tranche of a specific portfolio of assets in exchange for payment of an ongoing risk premium.