

Karan Chabba

Episode 233: Regulatory Capital Relief (RCR): A Primer with Eagle Point Credit's Karan Chabba



GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Welcome back and thanks for joining us. I always love it when it's podcast day. And today's topic is Regulatory Capital Relief and Specialty Finance with Eagle Point Credit's Karan Chabba. Karan, man, thanks for taking the time. Thanks for being on. We're thrilled that you're here.

Karan: Stewart, it's a pleasure to be with you, and hopefully we can make it a fun podcast.

Stewart: Absolutely. There's no choice on the matter. I want to start this. I want to do a little... Something a little different than usual. I want to give some facts and figures upfront to set the stage of what's going on here. So Eagle Point Credit is a specialty investment manager focused on investing in CLOs, portfolio debt securities, regulatory capital relief, strategic credit, and specialty finance. And the reputation is very strong due to having, and this is my words, not yours, an enviable historical loss ratio. Your assets under management are around \$10 billion, and you've just received a couple of awards, including being chosen as Best CLO Equity Manager and Best US CLO Junior Debt Investor, to name a couple.

And so we've also had your founder and CEO on, Tom Majewski, and we're thrilled to have you on as well. Your background includes about 27 years in the investment business, but only about 20, I say only, 20 years in this particular niche, where you serve as the principal and head of regulatory capital relief, specialty finance at Eagle Point. So with that as a little bit of background, we want to start this one off the way we always do, but I want to get into your background before we get into the talking points. So first of all, where did you grow up and what was your first job? Not the fancy one.

Karan: Sure, Stewart. So I grew up in India, actually. And interestingly, my father had a transferable job, so I actually used to literally move schools every two to three years, which I even now think was one of the building blocks of my personality. Helped me adapt to change pretty well and get comfortable with new ideas and new people.

Stewart: That's super cool.

Karan: As I was growing up, I guess the first few jobs I did were just mostly volunteer work. The first real job I did, which actually paid me money, was at a bank, and that was the first time I started working. And it was literally grassroots banking, learning about operations, trade receipts, actually trying to understand how business happens at the grassroots of a bank, a real banking job rather than what you would these days call an investment banking job.

Stewart: But you were also a partner and portfolio manager at KLS Diversified Asset Management. You've also spent some time in the structured credit area at Bear Stearns, and you were ranked as a top-ranked analyst at Institutional Investor's All-American Fixed-Income Research Survey. So well done there. I want you to put on your professor-for-a-day hat because we're going to get into it right now. So it's interesting, this regulatory capital relief; it's also known as synthetic risk transfer. We've been talking about it a little bit lately on here. Is it true that the terms are interchangeable, what we call RCR, which is regulatory capital relief, and SRT, synthetic risk transfer? Is that the same thing?

Karan: Yes, Stewart. In fact, there are a few other terms that do get used. Also, synthetic risk transfer, regulatory capital relief, risk sharing transactions. They're all used interchangeably by the market, but essentially the thesis is the same. It's a form of a transaction in which a bank is becoming a partner with an investor like us. And we are both going forward with the transaction, in which both parties tend to have a benefit here.

Stewart: And so, can you help me understand why Eagle Point has decided that this is a good area, and how did you end up there?

Karan: Right. So Eagle Point, as you rightly pointed out earlier, they've got a history of being in the CLO space prior to this and the PDS space. What we've always tried to do is find niche opportunities, niche income-oriented opportunities, which are not that well-trafficked in the market. So when we first started investing in CLO equity, it was not the most well-understood product out in the market, similarly in PDS. And now we think regulatory capital relief is something else which complements our areas of expertise and what we are looking to generate for our LPs. That's how we decided to start investing in this space.

Stewart: And so this is not my jam. I mean, people who know me know that there's areas I can hold my own in, and this isn't one of them. So talk to me a little bit about what makes this space attractive, in your mind, and also, it seems like it's getting talked about more than ever right now. Why do you think we've gotten where we are, and where are we going?

Karan: Absolutely. So I guess the most important thing to understand about the regulatory capital relief segment of the market is that this is a structure that allows banks to get capital relief on a portfolio of assets that they own. And as you might have seen across a lot of the financial media, bank regulation has become much stricter, especially post-GFC. And we hear these terms banded about Basel III, Basel 3.1, or Basel IV, Basel III Endgame, as the Fed calls it. But every iteration has led to higher capital ratios that banks have to hold. Now, they can raise capital a few different ways. Obviously, they can always raise equity capital, but that's extremely expensive. And this is one structure which allows them to raise capital while sharing the risk of that transaction with investors like us. So what do they do? They take a portfolio of assets that they own from their core banking business.

As an example, banks to consumer lending. Banks lend to small and medium-sized enterprises. They'll lend to large corporates. So let's pick one segment. Lending to SMEs, small and medium enterprises. So they will pick a portfolio of loans that they've made to SMEs. They want to keep that portfolio of loans on their balance sheet. They want to maintain that relationship with SMEs. They don't want to sell that portfolio of loans. However, they're getting charged a lot of capital on that risky portfolio of loans. So what they tend to do is that they will approach an investor like us, show us that portfolio of loans, and we, after running our analysis on that portfolio of loans, will agree to underwrite the losses on that portfolio of loan for the first, let's say 10% of losses which happen on that portfolio of loans. In return, the bank will pay us a coupon for that.

Now, what has the bank achieved by this structure? What they've achieved is that they've shown the regulator that they're not on the hook for the first, let's say again, 10% of losses on that portfolio of loans. The regulator looks at it and say, "Okay, this portfolio is much less risky than it used to be, and the capital that needs to be held against this needs to be much, much lesser." And so they've generated a pickup in their capital right away, which changes their return on required capital right away. So it's a big win for them, and they're able to continue doing business with their clients as they were earlier without having to cut back on their lending business.

Stewart: It's interesting because it almost sounds like something that our listeners are quite familiar with, which is reinsurance. It's essentially reinsurance, where it's a private market way of de-risking the banks and allowing them to adhere to tighter capital standards without blowing their loans out and blowing their banking relationships away with them. I mean, the way that you explain that has allowed me to understand it at a level that I never did before. So somebody said to me, "You got to hear things seven times before you hear it." This is only about the fourth time for me, so I feel like I'm ahead of the game. So when I look out, what is it that Eagle Point does differently? What is your differentiator in the RCR space?

Karan: Yeah, I think, look, it's the DNA of the firm, which really comes to the fore when we think about investing in any space. And RCR is just one of those spaces where the DNA of the firm really is a big strength. And I would be remiss if I did not mention the immense amount of support I have internally from various teams. It's a very cross-functional way that we work here. So we have a CLO investing team, which has been, as you rightly pointed out, at the forefront of being one of the better teams out there. And so they have a huge amount of expertise in structures and in levered loans. Then we have a high credit team which has fundamental credit expertise in looking at corporate loans. We have an ABS, MBS, which is asset-backed securities, mortgage-backed securities team here which has had experience in looking at securities, which requires statistical analysis.

So when we look at all these three teams together, we can bring the strength of all these three teams to any transaction. What that allows us to do is look at transactions across a broad array of assets. There might be some firms who might look at only transactions that are backed by corporate loans. There might be others who might look at only transactions backed by consumer loans because they're used to doing asset-backed analysis. We have the ability to go across asset classes, which I think is a big strength.

Stewart: Yeah. And I mean, it's interesting you also focus on specialty finance. And so, can you help me with how that ties back to RCR and really how Eagle Point is evolving as a multi-credit investor?

Karan: Absolutely right. So I think it's again, to the point that I had raised earlier, that we are looking for opportunities, niche opportunities, where we believe that the probability of loss is very minimal. And so we like structuring transactions where we think we are getting risk-adjusted returns which are reasonably above what the market should be paying us for that level of risk we are taking. It's true in regulatory capital relief transactions where we think for the level of risk we are taking, we are earning a premium of anywhere from, let's say, three to 500 basis points risk-adjusted. And similarly, what we do in specialty finance is while regulatory capital relief allows us to work with banks, it is also true that the non-bank sector has grown a lot in the post-GFC era.

And so what we do within the specialty finance space is to work with non-banks, and that can be in a variety of forms. We can lend to them backed by again, a portfolio of assets. So very similar to what we are doing in the RCR space, a very similar set of analyses that we do, which is looking at loss histories and prepayment histories and coming up with our expected return, or we can buy loans of these non-bank originators. Again, similar sort of analyses. So the way we are trying to approach both spaces is very similar in trying to structure something which is reasonably loss remote and allows us to give our LPs risk-adjusted returns which are higher than what that risk entails.

Stewart: And is there any sort of commonality, or how is specialty finance defined?

Karan: That's a very good question. It actually is a very broad sector, and different asset managers probably encompass different things within specialty finance. But the way to think about it is it's essentially in our mind it's lending against a portfolio of assets or lending against some collateral, which we look to. Now we can lend directly to the originator backed by that collateral, or we can lend against that collateral in a special-purpose vehicle. But it's essentially lending in a structured manner where we are not taking large amounts of risk of loss.

Stewart: And so what sometimes happens, and I know maybe you've been in this situation yourself, where you're talking to an investment committee or a board of directors and somebody has read an article in wherever it is, and they've somehow made a tangential leap over to what you're talking about, and sometimes it's hard to undo that, right? Get the toothpaste back in the tube. So talk to me a little bit about how is this asset class being portrayed in the mainstream financial press for folks who are listening to this and thinking about, "Hey, that's an interesting asset class." What's the less learned, perhaps, coverage?

Karan: Yeah, I mean, look, regulatory capital relief has definitely, the coverage around the sector has increased, I would say, over the last one year. I think primarily driven by the fact that the Federal Reserve came up with a Basel III Endgame, which in some form and fashion gave US banks the ability to do these structures and transactions. For the longest time, they were not very active in this market. And obviously, since the US banking sector is so much larger than most other spaces, that brings out a lot more scrutiny into these structures. I think it's just the amount of coverage that you've gotten has suddenly increased. So you tend to get a few different things happening in that coverage, some positive, some negative.

The one thing I would definitely point out, which probably doesn't come out that well in some of the coverage, is that this structure is used by banks not to lay off a risk that they don't want. It is to share risk with investors like us so that they can continue doing that business. I think that's a very important point for people to understand. This is not something that will leave us holding the bag when the cycle turns. Banks and investors are partners in this transaction.

Stewart: That's super interesting. I think that is a misconception that banks are just laying off their bad risks, and that why would I want to own that? But it makes total sense to me that they're trying to manage their capital ratios, right? And so that they can keep lending to their best customers.

So there's nothing quite as exciting as the discussion about insurance investment regulation. So with that in mind, what is Eagle Point's view of the current banking regulatory environment? And what we can expect as we go forward here?

Karan: Yeah, look, the banking regulatory environment has been getting more and more restrictive ever since the GFC. We've gone through a few iterations of the Basel Accords, which were probably first set up in the 1980s, if I'm not wrong. And with every iteration, especially the iterations which have come after the banking crisis during the GFC, the capital ratios that banks have been told to hold have increased. In addition, the way that capital is charged for different asset classes has continued to change and become more punitive in many cases, which implies that if banks are to continue doing the business that they want to do, which is lend to customers, they will need partners to maintain that. And which is why this structure becomes extremely important going forward.

Stewart: And that sounds like a growing opportunity in front of us as opposed to an opportunity set that is narrowing. Personally, I agree with you. I don't think banking regulation is going to ease anytime soon. It seems like that opportunity set is going to grow as we go forward here. I don't want to put words in your mouth, but just are we kind of on the same page there?

Karan: We are definitely on the same page there, Stewart. I think the market has already started growing at a rapid pace over the past, I would say, year or two. We've seen a dramatic shift in how much volume has come out from the banks. And as I mentioned earlier, the US banking system is so large that if a lot of the US banks start issuing similar to what the European counterparts have been doing over the past few years, then we will see a dramatic shift up also. We are definitely excited about the opportunity set here and how much we can do here, which allow us to get risk-adjusted returns, which are pretty attractive.

Stewart: That's terrific. So are there any events in the market that were at any point surprising, or what are some of the most interesting opportunities that took place, and how did it unfold?

Karan: The one thing which was a little maybe surprising was that in terms of regulatory output, the Federal Reserve came up with their Basel III Endgame, but then they got a lot of pushback from the banking system, and they've been taking that feedback a bit seriously. So we are actually a bit intrigued to understand how they will take that regulation forward in terms of how much more stringent they will be or will they roll back some of what they've proposed. So that's something definitely, which is interesting to keep an eye out on. And then what has been interesting is to see the different kinds of asset classes that banks have been willing to use in doing these transactions. For the longest time, asset class, which was the most common here, was large corporate loans, which is what banks, let's say, lending to people like IBM or Apple, the names that are very familiar, whether they are investment grade names or below investment grade names.

Now banks are much more amenable to doing other parts of their businesses. We've seen transactions in subscription finance lines, which is lending that they do to PE funds backed by their LP commitments. We've seen transactions backed by trade finance loans. So these are some things which were not very popular earlier. And so as you see more and more diverse kinds of transactions, I think it allows investors like us to build a good, diverse set of risks, just that you're not beholden to just one sector of the economy.

Stewart: I have had a phenomenal time. I've gotten a great education. I understand this much better than I ever did. I've just really appreciated very much. I've got a couple of fun ones for you on the way out the door. In the spirit of folks who are earlier in their careers and thinking about guidance, right? So I want to take you back to when you were coming out of undergraduate school. What advice would you give someone a 21-year-old Karan Chabba? If you were starting out brand new right now, what advice would you give yourself?

Karan: That's a very interesting question, Stewart, and I think the advice would be, which is something which I got from my dad long back. Look, the industry we're in, by selection, we have a very smart set of people who come into this space. So it's not really about the intelligence. What you want people to understand is that integrity and hard work are probably the two things which hold you in the best stead in the long run.

Stewart: Yeah, so true. I think people who aren't in this business... I think people get a bad rap when people make mistakes, make ethical mistakes in our industry, it makes global headlines, and everybody looks and points fingers. But at the end of the day, this business is a lot about relationships and being a person of your word. I mean, you can buy \$100 million worth of treasuries, and you're done, right? And you get about one, I didn't mean that, in a career. There's no "Yeah, I was kidding," or "Oh, you heard me wrong," or... No, I didn't hear you wrong. I mean, it really matters.

And being a person of your word in this business, I think it is a non-negotiable. It is absolutely critical that you bring a level of integrity to this business. And hard work, I think, goes with it. The people around you, I think you made a great point. It's a very smart group of people. I'm blessed to have a lot of friends who are incredibly bright, and they all work really hard, and they're all very ethical and honest people. So I think that's a key to success. And so here's my second, my final fun one, out the door. It's lunch for you and three friends. You can have it with anyone you choose, alive or dead. Who's your lunch table of four?

Karan: That's an interesting question.

Stewart: That's why I get paid the big bucks, man. Come on.

Karan: I don't know about a lunch table of four, and my answer might be just a little too personal. If I had to have lunch with just one person, it would be with my dad, whom I lost last year.

Stewart: I'm sorry.

Karan: That's just something which is recent in my memory, and I would love to sit down with him again and chat.

Stewart: Yeah, no, for sure. I think that's great. It's been a pleasure to have you on. I've learned a bunch, and it's been fun to get to know you too. So thanks for taking the time with us today.

Karan: Thank you, Stewart.

Stewart: We've been joined today by Karan Chabba, principal and head of RCR, Specialty Finance, at Eagle Point Credit Management. We are super happy to have you. Thanks for listening. If you have ideas for podcasts, please shoot me a note at stewart@insuranceAUM.com. Please rate us, like us, and review us wherever you listen to your favorite shows. My name's Stewart Foley, and this is the insuranceAUM.com podcast.