

Unlocking an Attractive, Niche Opportunity in Private Credit...An Introduction to Regulatory Capital Relief Transactions

Globally, banks are encountering stricter regulations on capital requirements as regulators strive to minimize systemic risk in the banking sector. Consequently, to maintain asset levels, banks need to increase equity levels and/or use tools like regulatory capital relief securities.

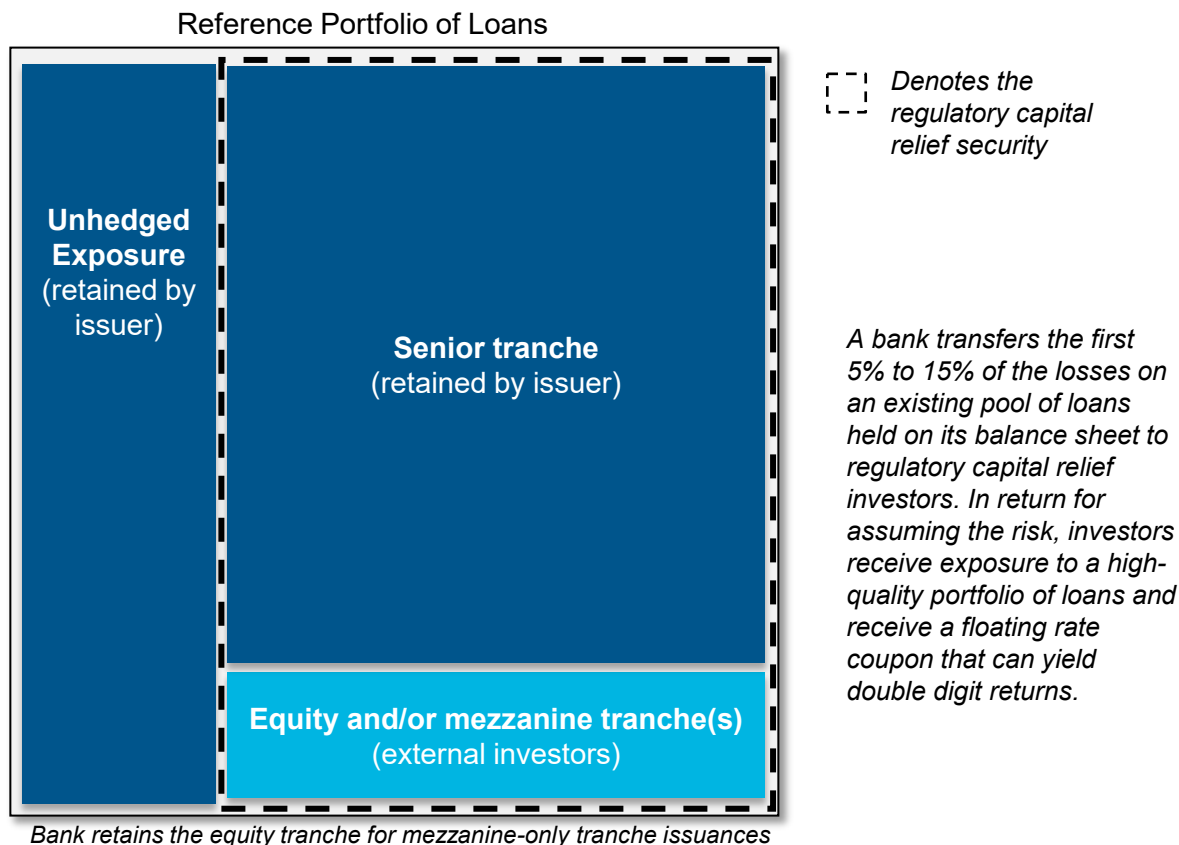
Regulatory capital relief transactions provide a way for banks to meet regulatory requirements while managing risk and freeing up capital for other business areas. These transactions reference a portfolio of performing loans in which investors receive a premium from the bank for assuming the credit risk.

Regulatory Capital Relief Offers a Tool for Banks and Investor Alignment

Regulatory capital relief transactions have been a tool leveraged by banks for over 20 years but have steadily grown in acceptance since the 2007 / 2008 Global Financial Crisis. Regulatory capital relief transactions provide an effective way for banks to transfer credit risk to non-bank lending investors to reduce and/or optimize the bank's regulatory capital requirements. In return, investors receive a floating-rate coupon comprised of a base rate and a contractual credit spread from the reference portfolio of performing loans.

Issuing banks are required to retain meaningful exposure to the underlying reference portfolio of loans, creating strong structural alignment between the issuing bank and investor. In contrast to securitized assets, the underlying assets remain on the bank balance sheet. This structure incentivizes the bank to maintain disciplined underwriting standards to monitor loan performance.

Exhibit 1: Investor and issuer alignment built into security structure





Key Characteristics of Regulatory Capital Relief

1. Attractive, steady income distributions from floating-rate coupons

- Contractual coupons comprised of a base interest rate plus a spread
- Distributions paid quarterly

2. Benefit from diversification and low correlation to other asset classes

- Reference loans are highly diversified across geographies, sectors, and individual borrowers
- With low asset price correlation to other investment classes, regulatory capital relief securities prove beneficial to further diversify investment portfolios

3. Relatively stable asset prices

- Reference portfolio consists of loan portfolios that are investment grade or near investment grade weighted average credit quality
- Floating-rate coupons limit security price sensitivity to changes in interest rates
- Underlying reference loans originated with the intention to be held on the bank's balance sheet and managed at the account level as bank balance sheet exposure

4. Large, global bank issuers

- The primary issuers are established financial institutions in the U.K., Europe, Canada, U.S., and Asia
- Most issuers are globally systemic important banks (G-SIBs) and money center banks



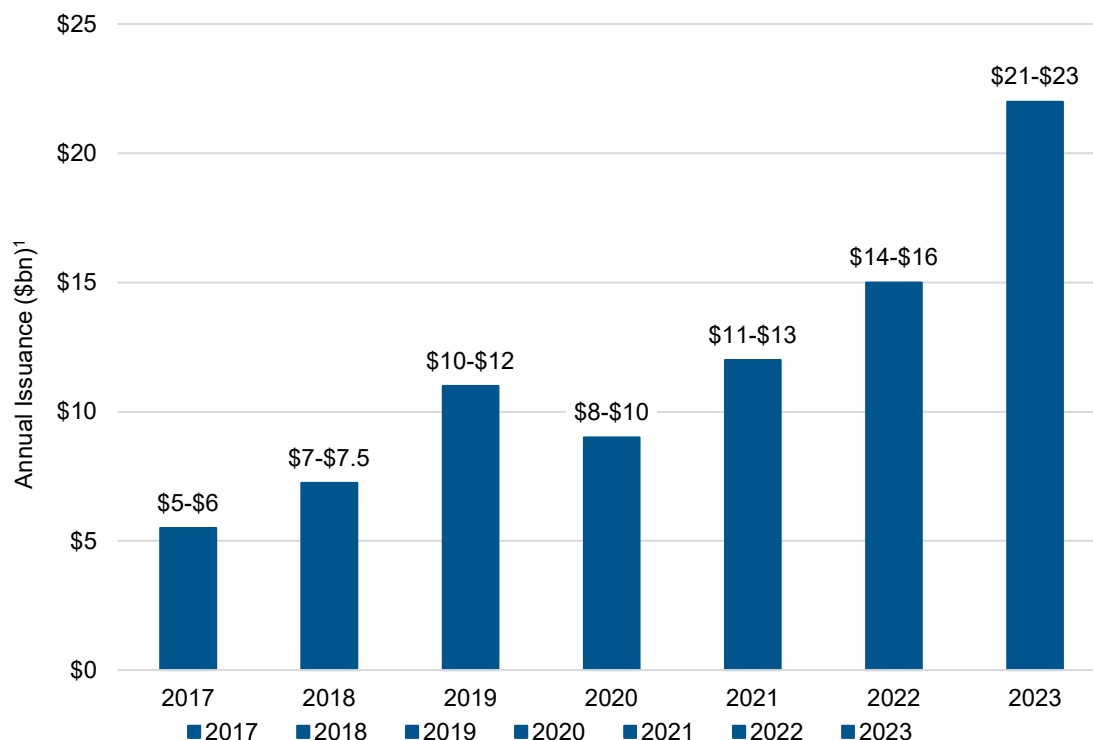
Value Add to Banks Translates into Strong Risk-Adjusted Returns

By keeping the loan on its balance sheet, banks can maintain and expand customer relationships with borrowers, enabling them to upsell banking products

Regulatory Capital Relief's Rapid Growth

As previously noted, the regulatory capital relief market's supply and demand continue to grow on a global basis. The most recent catalyst for issuance growth was increased regulatory guidance from the U.S. Federal Reserve and further broad recognition of the asset class being an efficient way for European banks to comply with regulatory capital requirements. We believe the number of banks issuing regulatory capital relief transactions will continue to increase, driven by their ability to deliver capital efficiency and reduce the need to sell assets at a loss or to raise equity.

Exhibit 2: Regulatory capital relief market experienced record issuance in 2023



¹Data through 12/31/2023. Based on ArrowMark's estimate of market activity.



Investing In Regulatory Capital Relief Securities

The primary advantage is the asymmetric risk/return profile regulatory capital relief provides to investors through a unique combination of double-digit yields, diversified high-quality reference portfolio, and alignment with issuing banks.

In an environment characterized by higher inflation and interest rates, elevated levels of volatility, and muted return expectations for traditional asset classes, we believe regulatory capital relief is a compelling opportunity for investors to generate highly attractive income-driven, risk-adjusted returns.

Security Return Profile

- Potential mid-double-digit unlevered, gross yields driven by coupon income, which is linked to the fundamental performance of underlying reference portfolio
- Transactions' floating-rate coupons, which are comprised of a base interest rate plus a contractual spread paid quarterly
- Historical resilience during periods of stress due to structural and reference portfolio attributes

Security Risk Profile

- Reference portfolio consists of performing loans with dollar weighted average investment grade or near investment grade
- Floating-rate coupons mitigate the impact of interest rate changes on security prices

Where Does Regulatory Capital Relief Fit Within An Investor's Portfolio?

For investors that don't have an explicit allocation to private credit, some will allocate from traditional fixed income or credit to capture higher income-driven returns and lower portfolio duration in lieu of liquidity. Others gain exposure through their private market allocation, recognizing the return hurdle differs from private equity due to the shorter maturity profile and quarterly coupon income. Regardless of where exposure to the asset class is positioned, investors highlight the key benefits of high current income and low correlation to traditional fixed income asset classes.

ArrowMark's Long History in the Asset Class

Over the last 14 years, ArrowMark has invested in 109 distinct regulatory capital relief transactions and deployed approximately \$8.5bn of capital into the asset class across several dedicated and multi-sector private investment vehicles and a closed-end investment company (NASDAQ: BANX). The team draws upon prior experience and real-time insights gained through the breadth of the firm's historical investments, ongoing engagement with the vast majority of active issuers in the market, and team members with prior roles leading bank issuance and arranging issuance on behalf of third-party banks.

IMPORTANT INFORMATION

The securities described herein are speculative investments that involve significant risks, and there can be no assurance that the objectives will be met or that the investors will not incur substantial or total losses. In considering investing in these securities, prospective investors should consult their independent legal, tax, financial, and other advisors, and should be aware of certain risk factors.

The investments described herein are noted for illustration purposes only and are included to illustrate the way in which the portfolio would invest in certain securities. The returns modeled on sample investments are not representations that other investments made by ArrowMark have similar return profiles. It should not be assumed that this example or future investments will be profitable. If any assumptions used do not prove to be true, results may vary substantially.

Weighted average credit quality and credit quality distribution are based on the credit quality of the underlying securities within the portfolio. In some cases, the portfolio can base this calculation on the credit rating assigned by an independent, nationally recognized statistical rating organization (an "NRSRO"; such as Moody's, S&P, etc.) In other cases, a credit rating for the individual asset held by the portfolio is not available. In these cases, the fund attempts to make a best-effort approximation of the credit quality of the asset by using the credit ratings or other credit quality metrics of the underlying reference portfolio loan constituents or a comparable asset as a proxy. Such investments, however, may perform differently and have different risk characteristics than a direct investment in the underlying reference portfolio loan or comparable asset. It is important to note that the fund's weighted average credit quality and credit quality distribution, as reported in this document, are good-faith estimates by the fund.

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