Regulatory Capital Relief Securities Add Yield, Diversification To Banking Portfolios

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Dana Staggs, president of ArrowMark Financial Corp., a non-diversified, closed-end fund that trades under ticker symbol BANX. Read the Q&A below as Dana talks about why the fund has changed in recent years to where 87 percent of its holdings are now in regulatory capital relief securities, and what that esoteric asset can add to a diversified portfolio. Staggs also discusses his outlook for banking, where he acknowledges the potential for troubles but says they should not be systemic, disruptive problems, and how reg-cap securities are set up to weather the potential storms.

Dana Staggs

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: We're talking about the banking sector and investments in regulatory capital relief securities with Dana Staggs, president of ArrowMark Financial Corp., this is The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization representing all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator will point you in the right direction. And today we're looking in the direction of the banking sector and we're digging into it with Dana Staggs, president of ArrowMark Financial Corp., which is a non-diversified closed-end fund that trades under the symbol BANX. You can get more information on it at IR.ArrowMarkFinancialCorp.com. And if you want to size up closed-end funds, interval funds, and business-development companies generally, go to AICAlliance.org, the website for the Active Investment Company Alliance. Dana Staggs, welcome to The NAVigator.

DANA STAGGS: Chuck, thank you for having me. It's great to be here.

CHUCK JAFFE: I want to start with your outlook for banking and then dig into the regulatory capital relief securities that are kind of your bread and butter. My audience is going to need maybe a little bit of explanation for some of them to know what that's about, but banking, well, we've all heard from everything that was going on last year to plenty of folks saying there might be another shoe to drop. So first, give us your take on where the banking sector itself is and is there more trouble coming, and if so, what do you expect it to look like?

DANA STAGGS: The banking sector today is in a much healthier spot than where it was pre-Great Financial Crisis. I think there were a lot of great lessons learned during that time period. If one looks at the amount of regulatory scrutiny and the restrictions that have been placed on the banking sector, understandably one will get the perspective that broadly speaking the banking industry is in a much healthier position. In the past, the amount of equity capital and the amount of reserves that banks were required to hold were not as well optimized to manage against risk, but today they really do a good job of making sure that the banking sector is well capitalized. And there's a strong attempt by the regulators, and this is globally across all the international regulators, to ensure that the banks themselves will not repeat as a sector what had happened in 2006. The issues that we saw in 2023 were more idiosyncratic. If you think about where Silicon Valley Bank and Signature Bank were, a big cause, a big driver of what had happened to them was a very rapid rise in interest rates and how that affected the valuation of some of their longer term, long-duration assets, and there was just a lack of confidence I think in their ability to monetize some of those assets if needed in order to support liquidity and reserve requirements. As a result, there were some questions, concerns, and we saw what happened with Silicon Valley Bank. Could there be similar situations going forward? You know, I don't see this being systemic, I do see this being very isolated within a few names out there. As far as BANX, I will say that I feel very good about what we're invested in today, 87% of our investments are made in regulatory capital relief securities, those investments are issued by the largest money center globally systemic important banks, GSIBs. Think of GSIBs as household names like J.P. Morgan, Goldman Sachs, Barclays, Standard Chartered, they're issued by these well-known banks, consider them of the highest credit quality. As we get into more about the regulatory capital relief securities, you'll learn to appreciate that they're very well structured, they're underpinned by very high-quality loans that support the security itself, and effectively we feel like those will withhold pretty well in any kind of market downturn.

CHUCK JAFFE: I want to make sure that the audience does not get lost in the jargon. Because when we start to talk about regulatory capital relief securities, we're talking about deals that banks put together to pass on to investors, a way to reduce the bank's regulatory capital requirements. And in a world where, hey, we thought you were raising capital requirements for good reasons, to protect banks, et cetera, if you get lost in the jargon that sounds scary. But you obviously understand the jargon, and if 87% of the portfolio is there, you feel it is a great opportunity. And you guys are built to provide income, so help us understand what kind of income this provides, and how secure that income stream is if we get to, maybe not a banking crisis because you don't seem to think one is coming, but maybe a recession.

DANA STAGGS: A regulatory capital investment, at the highest level, these are floating-rate double-digit yielding securities with maturities around five years. As I mentioned earlier, the issuers are kind of your household names like a J.P. Morgan, Goldman Sachs, Barclays or a Standard Chartered, they benefit from what I would say is very good payment priority. So these reg cap securities are obligations that sit in the most senior parts of a bank's capital structure. They're either in the senior unsecured tranche, and sometimes they even benefit from depositor payment priority. The performance of reg cap security is underpinned by a portfolio of loans, they're held on a bank's balance sheet, think of the number of loans for this portfolio as consisting of anywhere between several hundred loans to several thousand. Typical credit rating for these reference portfolios on a blended basis would be BB+/BBB-, we get there by doing a dollar-weighted average credit rating. So these are very strong underlying loans that underpin a very attractive security issued by an investment grade money center bank. One of the things I think will be important to go through is why the money center banks why to do this. And as we go through our line of questioning, Chuck, understanding what the value is to the banks will make it better understood as to why these have very strong risk-adjusted returns.

CHUCK JAFFE: This is not something that a lot of folks do. How big is the market and how fluid is the market, and what does that mean in terms of opportunities? And why this opportunity in terms of changing the portfolio and moving from other banking products that were producing reasonable yields to this?

DANA STAGGS: I think the way to think about these is we shifted the book from what was around 10%, maybe less than 10% of our investment portfolio in regulatory capital securities with ArrowMark took over the management rights of BANX three years ago, to 87%. The reason why we did that is we believe that this provides very strong asymmetric risk-adjusted returns. The reason why it does that is because, put simply, it's a value-add product. Think of it this way, a globally systemic important bank, they provide loans but they do so many other things. They'll have Treasury management services, credit card programs, M&A advisory work, bond and equity underwriting, and placement services, and those product lines produce a lot of profitability for these globally systemic important banks. In order to win that type of business, the banks must also provide corporate loans to their customers, these corporate loans are table stakes and often the beachhead needed to win higher margin banking products and services, as I mentioned earlier, and without the loan the bank is not competitive for a credit card program. Before the Great Financial Crisis banks could make loans with less requirements, however after the Great Financial Crisis of 2008-2009, the regulatory restrictions imposed on the banks for such loans have gotten much tighter and continues to tighten. As a result, the banks can't make as many loans to top-tier companies, say Fortune 500 companies, as they once could. The dynamic is especially pronounced for the strongest credit clients, for investment-grade or near-investment-grade clients, the amount of capital that they have to allocate for those loans restricts the number of clients that they could much more heavily than what they would have done in the past. Well, reg cap allows them to free up some of that balance sheet, they're allowed to do a lot more of those corporate loans, and as a result, by doing more of those corporate loans you can win more of the higher margin business for that bank, the banks themselves can win the credit card mandates, the M&A advisory work, and so on. So this is a value-add product, and as a result of being a value-add product to the issuers, the issuing banks, the issuing banks are willing to pay up for something that's not really a commodity type of product, instead we're able to translate this value-add into strong risk-adjusted returns for our investors.

CHUCK JAFFE: Dana, really interesting. I've got more questions, I don't have more time. But as we watch the banking sector play out, I hope we'll get a chance to chat with you again and dig into it some more.

DANA STAGGS: Thank you, Chuck. It was great being on.

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