ArrowMark's Dana Staggs on regulatory capital relief securities

Dana Staggs, President of ArrowMark Financial Corp., sits down with Jane King to discuss bank-issued regulatory capital relief securities. Staggs provides a primer and income-investor perspective on these financial instruments, saying their relatively stable asset profiles and general lack of correlation to other asset classes makes them attractive. "Today, they're probably yielding somewhere around the mid-teens," he said. Staggs also goes over the risks associated with investing in these types of securities. Staggs then discusses ArrowMark Financial Corp., a listed closed-end fund with the ticker symbol BANX,.

Learn more about ArrowMark Financial Corp. and review the fund profile for BANX at CEFData.com.

Find here the video interview.

Jane King: Dana Staggs was elected president of ArrowMark Financial Corporation in June of 2022. He joined ArrowMark in June of 2017 as a member of ArrowMark's private capital solutions group where he sources, structures, manages private debt and non-controlled private equity investments. Prior to joining ArrowMark in 2017, he worked in similar capacities at firms like Goldman Sachs, Barclays, Private Credit Partners, and GE Capital.

Mr. Staggs previously served 10 years as a surface warfare officer in the US Navy, having attained the rank of lieutenant commander, and earned a bachelor of science degree in physics from the US Naval Academy and an MBA from the Mason School of Business at the College of William & Mary. So Dana, great to have you here.

Dana Staggs: Thank you for having me.

Jane King: We chatted a little before, we talked about how I don't know much about regulatory capital relief securities, so I'm curious to learn about this. So give me an overview, what are these?

Dana Staggs: Regulatory capital relief securities, they're a private security that are issued by banks. And so from an investor perspective, I think investors find this attractive because they have a relatively stable asset profile, they're generally uncorrelated with a lot of the other asset classes, and they've got a lot of high income generation potential.

So as I mentioned earlier, they're issued by banks, but they're typically the larger money center banks. So think of these as your household names like Citigroup, Goldman Sachs or Barclays bank. They have maturities that are about five years, but they start amortizing between three to five years, and the coupon on these are floating rate so they're a spread over a floating-rate index like Euribor or SOFR. Today they're probably yielding somewhere around the mid-teens area, so quite yieldy and very attractive for what I would think are income investors.

Jane King: And these really came about after the Financial Crisis, when banks started having more regulations, we had all the stress tests, things like that. So this kind of was borne out of that, right?

Dana Staggs: It has, and it has definitely evolved through that time period. If you think about what the banking sector looked like pre-Great Financial Crisis and compare it to where it is today, our view is that the banking sector is a much healthier sector, and that is a byproduct of what would be increasingly strong regulatory oversight, and more specific, restrictions on how the banks manage risk.

So as a result of that, what ended up happening is the regulatory capital relief security was borne out of that, and it provides the banks a tool to help them manage the risk, especially as they look to managing the risks that the regulators want to oversee.

Jane King: And the risk does I guess go to the investors.

Dana Staggs: That's right.

Jane King: But they are rewarded with the high coupon, as you mentioned.

Dana Staggs: That's right, and so the way I would think of it is the banks use this as a means to transfer the risk from a high-quality portfolio of loans. Think of these loans as anywhere between several hundred to over a thousand loans, they're typically on a risk-dollar weighted average basis around BB+ to BBB-, so these are the stronger loans within those portfolios. And so they're able to risk-transfer some of the risk from themselves to us, our investors get exposure to what I think are very high-quality loans.

But the benefits to the banks themselves is that they maintain the customer relationship, and the customer relationship is what I like to think of as the lifeblood of what these money center banks do. They are able to cross-sell and upsell into these customers through these customer relationships with products like the treasury management services, the corporate credit card program, investment banking services, M&A, so on and so forth.

As a result of being able to transfer the risk but also maintain that customer relationship, there's a value-add to this security that you don't see in something like the a corporate bond, a typical corporate bond where there's this natural tension of trying to get the best return for your investors while the issuer's trying to get the best cost of capital for themselves. In this particular case, it's a tool that helps them solve some balance sheet risk difficulties that they may have, and as a result, our investors get paid premium to what I think are more commoditized asset classes.

Jane King: Yeah, that's really the incentive for the buyer and the seller. So they move that risk somewhere else, the buyer gets, as you mentioned, the high interest rate. Are all sized banks able to take advantage? You mentioned some of the big ones, would a midsize or regional bank be able to do this?

Dana Staggs: They are capable of doing it, but most of the issuance today is done through the larger money center banks, and frankly, a lot of them are the globally systemic important banks.

Jane King: And mainstream investors can access this through a fund, tell me about that, that you operate, manage, right?

Dana Staggs: Yeah, so historically this was primarily a product that was offered to institutional investors. So when we started doing this in 2010, we were generating good returns for our institutional investors using this product, but in 2020, early 2020 we acquired the management rights to this closed-end fund that trades under the ticker BANX, it's ArrowMark Financial Corporation. And through that vehicle, we have today about 87-88% of our total assets are in regulatory capital relief securities, so retail investors can get access. As far as we know, this may be the only way that the typical retail investor can get meaningful exposure in this product.

Jane King: And how have the returns been?

Dana Staggs: Returns are very solid. Just to give you a few data points, right now I think our distribution yield, if you use the 2023 numbers, are somewhere between 9.5% and 10% based on our share price today. We moved our dividend from 38 cents to 39 cents, so the first two quarters of last year we were at 39 cents, and then we moved it up again to 45 cents and 45 cents, so all of 2023 we had a $1.78 of declared distributions plus a 10-cent special.

We've outearned our distribution since we've taken over this fund. And in Q4, just by way of an example, we had 67 cents of earnings per share relative to the 45 cents of declared distributions, so very strong income generation. I think that the average yield, I mentioned it's kind of mid-teens area, I think in our portfolio our average yield at the end of Q4 was somewhere around 14.6%.

Jane King: Okay, yeah.

Dana Staggs: That's before any kind of interest expense or fees and so on.

Jane King: And you mentioned there's not a lot of risk in these, so that's a good return for not a ton of risk to take on.

Dana Staggs: We do think it's asymmetric risk. And so just to sort of break down the risk profile on an issuer counterparty basis, what you're facing is the risk of the senior unsecured creditor class for a bank like Citigroup or Goldman Sachs. Sometimes these even have credit enhancements like you may benefit from some depositor, creditor class protection, so very high up in the capital structure.

Their performance are indexed though to a portfolio of loans, so think of it again as the 200 to over 1000 loans that are diversified by issuer geography and sector. And so the way the regulatory oversight works today, is the higher quality loans are the ones that we find that the banks are typically looking to risk-transfer to us, and again like I said, BB+ to BBB-.

Jane King: That's interesting that they would want to offload the higher quality loans.

Dana Staggs: You know, I think it's a byproduct of the fact that the higher quality loans don't yield as much.

Jane King: I see.

Dana Staggs: And the amount of capital that they have to allocate against those are expensive.

Jane King: Makes sense. So you kind of have a front-row seat to the banking industry.

Dana Staggs: Sure.

Jane King: Is it healthy? I mean, you mentioned healthier now than pre-Financial Crisis.

Dana Staggs: Yeah.

Jane King: How do you see things? We've dealt with interest rates, inflation, how do you see the industry right now?

Dana Staggs: We do think that the banks are, as a sector, in a very healthy position, especially relative to the Great Financial Crisis, but you can dial the clock back and even look in early 2023, Q1 and Q2 we saw some hits with some of the regional banks. We saw Silicon Valley Bank, we saw Signature Bank and the issues that they faced, but we view those as more idiosyncratic issues with those banks primarily driven by a very rapid rising interest rate environment and the interest rate sensitivity that they had in their portfolios.

But when you look at the issuers that we're managing, that we're investing in, these are the globally systemic important banks and the large money center banks, which are in a much, much healthier position today. But even if you see some spillover going forward with, whether it's commercial real estate or some other shock, we do think it's isolated, because the regulatory bodies globally have done a very good job of making these banks healthier over the last 12-13 years.

Jane King: Yeah, interesting. Dana, thank you so much for coming in, great to learn about this.

Dana Staggs: Thank you for having me. I appreciate it.

Recorded on April 18, 2024

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ArrowMark Financial Corp. is an SEC registered non-diversified, closed-end fund listed on the NASDAQ Global Select Market under the symbol "BANX." Its investment objective is to provide shareholders with current income. BANX's primary investment objective is to provide stockholders with current income. We attempt to achieve our investment objectives through investments in preferred equity, subordinated debt, convertible securities, regulatory capital relief securities and, to a lesser extent, common equity. Together with banks, we refer to these types of companies as banking-related and intend, under normal circumstances, to invest at least 80% of the value of our net assets plus the amount of any borrowings for investment purposes in such businesses. There is no guarantee that we will achieve our investment objective. The Fund is managed by ArrowMark Asset Management LLC ("ArrowMark").

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Founded in 2008, Destra Capital Advisors LLC ("Destra") was built to help independent thought leaders achieve better wealth outcomes by sourcing the next generation of investment solutions. Destra provides secondary market services for eleven listed closed-end funds by responding to investor inquiries, providing information about the Funds and their portfolios, assisting with communication efforts, and speaking with institutional investors and financial advisors.

Destra Capital Advisors LLC, a registered investment advisor, is providing secondary market servicing for the Fund. To learn more, visit ir.arrowmarkfinancialcorp.com or contact Destra Capital Advisors at 877-855-3434 or BANX@destracapital.com.