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Disruptive Regulation: A Secular Investment Opportunity

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It's been nearly a decade since the global financial crisis prompted an onslaught of regulations intended to abolish excessive risk-taking and make the financial system safer. Yet the implementation of reforms – and their disruptive effect on financial business models – will peak only over the next few years. As Dodd-Frank and Basel regulations come into force and a further wave of regulatory reform is announced, we believe banks will exit more non-core businesses, specific funding gaps will become more acute and dislocations between public and private markets will become more frequent. Each will create investment opportunities for less constrained and patient capital to capture economic profits being ceded by banks.

The lengthy process of financial sector reform is not a surprise given its complexity. Passed in July 2010, for instance, the Dodd-Frank Wall Street Reform and Consumer Protection Act runs to more than 350,000 words. Many details were left to administrators to define – and at the end of 2015, fewer than 60% had been implemented. Basel III regulations, intended to increase liquidity and decrease leverage at banks, were published in late 2009, but will not be fully implemented until 2019. Bankers are already fretting over "Basel IV," a collection of rules being contemplated that would tighten the screws even further.

For banks, the cost of new regulations is high

HIGHER CAPITAL REQUIREMENTS

- Standardization of risk-weighted asset floors has been proposed for Basel IV, following a similar approach to minimum capital ratios as in Dodd-Frank.
- Total Loss Absorbing Capacity (TLAC) is expected to require systemically important banks to raise incremental long-term debt by 2019.
- The Basel Committee expects its fundamental review of trading book (FRTB) regulation, effective 2019, will increase average trading book capital requirements by about 40%.

HIGHER LOSS PROVISIONING

- Expected loss accounting will be incorporated into IFRS Standards in 2018 and into U.S. generally accepted accounting principles (GAAP) by 2020, providing further motivation to dispose of non-pristine banking book assets.

HIGHER COMPLIANCE COSTS

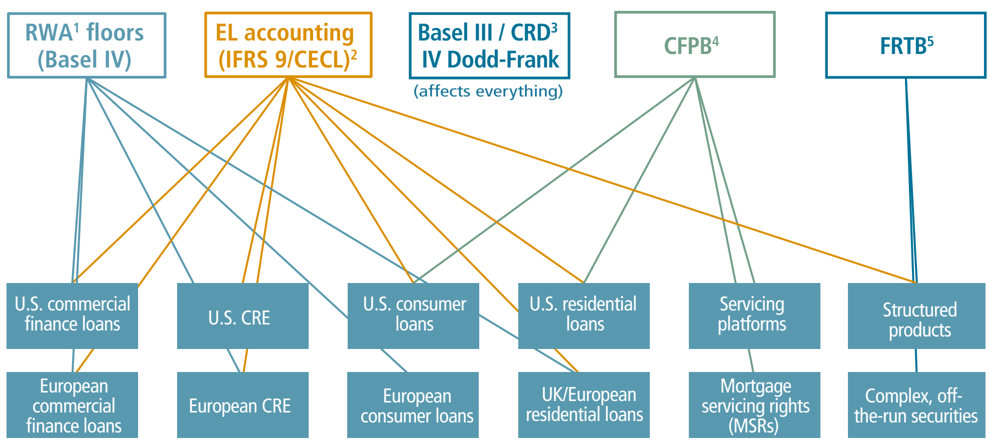
- The Consumer Financial Protection Bureau (CFPB), created by Dodd-Frank in 2010, now employs more than 1,600 employees and has levied fines and consumer relief of more than $11 billion for unfair marketing of financial products.
- The Bureau's Qualified Mortgage and Integrated Mortgage Disclosure Rules impose greater potential liability on lenders.

Although most banks have increased their capital significantly, they face intense shareholder pressure to improve returns on capital. Yet even tighter regulatory capital requirements and mounting compliance costs will continue to pose challenges. Between 2011 and 2015, for instance, JPMorgan Chase nearly doubled its compliance and controls staff to 43,000, or 18% of total staff. Leadership changes at Barclays, Credit Suisse, Deutsche Bank and others underline the pressures these institutions face.

Figure 1 illustrates the complex web of regulation that will create ongoing pressure on banks in the form of

- Higher capital requirements
- Higher loss provisioning
- Higher compliance costs

FIGURE 1: DISRUPTIVE REGULATIONS WILL AFFECT MANY ASSET CLASSES



Source: PIMCO as of 15 May 2016

[1]Risk-weighted assets
[2]Current expected credit losses
[3]Capital requirements directive
[4]Consumer Financial Protection Bureau
[5]Fundamental review of the trading book

SECULAR INVESTMENT OPPORTUNITIES: THREE AREAS

Specific funding gaps. With quantitative easing designed to encourage the supply of credit and some $15 trillion in debt trading at negative yields, it is paradoxical that specific funding gaps persist. However, U.S. and European banks have retrenched from multiple business lines considered non-core. In the U.S. and UK markets, many banks have stepped back from originating non-conforming mortgages due to heightened scrutiny, increased potential liability and tens of billions of dollars in fines in recent years. Mortgage credit has tightened so much, in fact, that PIMCO estimates between 1 million and 1.4 million U.S. citizens who would have been eligible for a mortgage in 2002 (well before the loosening of lending standards that caused the subprime crisis) couldn't get a mortgage today.

Originating mortgage loans to even a subset of these borrowers represents a scalable opportunity to lend at historically wide credit spreads, yet with conservative lending standards. This dynamic epitomizes a true funding gap, one where banks have genuinely retrenched, capital markets are closed to securitization and private capital faces material barriers to entry. Furthermore, a number of factors, alone or together, could result in much tighter spreads and upside convexity. These include consolidation among non-bank lenders, shifts in policy and regulations or the rehabilitation of the securitization market.

Niche lending of this sort has long been the preserve of banks, but there are few credible alternative operators with the ability to underwrite credit risk in compliance with national regulations and, if necessary, work out the local underlying asset. Other examples include land banking, real estate development lending and certain types of consumer lending; the Irish economy is recovering but a single bank dominates the market, creating opportunities for others to win market share. Once again, regulations are a primary force: Under Basel III, for example, High Volatility Commercial Real Estate (HVCRE) rules increase capital charges on construction loans from 100% to 150%.

Identifying investment opportunities is one thing. Seizing them is another. We believe exploiting these opportunities requires a flexible approach to structuring investments, such that potential returns compensate for the degree of risk and economic value created. For example, returns may be generated by lending directly, financing others' loan assets or taking an equity stake in a specialty lending business. Where the provision of capital makes a lending enterprise more valuable, those supplying the capital should share in that value creation.

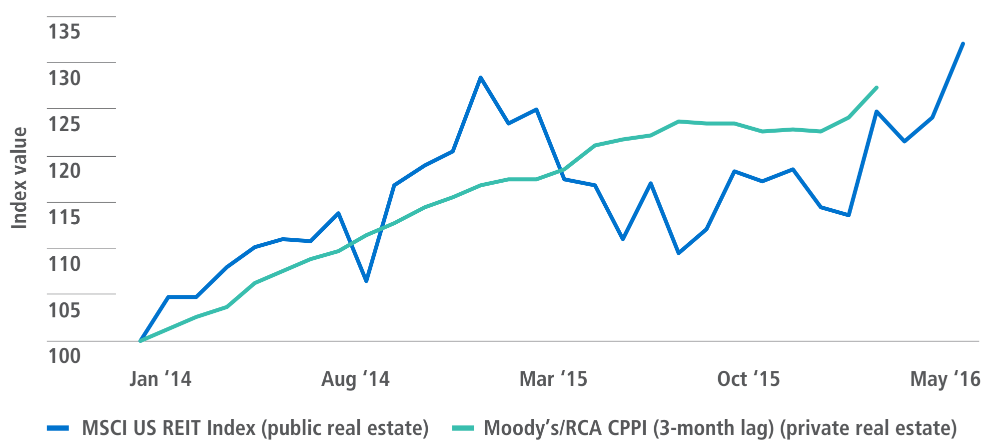
Public-private market dislocations. In contrast to public securities markets, where many investors and all dealing desks have been affected by regulatory reform, many assets in private markets are enjoying historically attractive liquidity conditions. Record sums of private equity and private debt capital are facilitating transactions and supporting valuations, particularly of vanilla corporate and real estate assets. The role of banks as intermediaries in public markets versus the lower velocity transactional nature of private markets can result in dislocations, with pricing of securities versus non-securities implying different valuations for similar underlying assets.

"Dynamics of this sort may create opportunities for investors prepared to engage in hands-on asset management."

For instance, it was notable during both the first and second quarters of 2016 that volatility in public commercial real estate securities, commercial mortgage-backed securities (CMBS) and real estate investment trusts (REITs) was elevated compared to transaction volumes and prices for the underlying physical real estate assets (see Figure 2). The combination of forced selling by certain funds and banks facing prohibitively high capital charges to hold such securities in their trading books meant that the securities implied deep discounts to private transactions.

Dynamics of this sort may present opportunities for investors who can analyze securities and the value of their underlying real estate in a timely and effective manner. This frequently creates potential opportunities for investors prepared to engage in hands-on asset management. Profits may be captured by transitioning risk between public and private markets, typically through some form of active structuring. An example is taking a public real estate investment company private to capture a discount to net asset value. Simplifying or stabilizing cash flows in the process may allow those assets to be sold to a market hungry for the fixed-income-like yield of core real estate.

FIGURE 2: DISLOCATIONS IN COMMERCIAL REAL ESTATE: PUBLIC PRICES VERSUS PRIVATE VALUATIONS



Source: Bloomberg and PIMCO as of 30 June 2016

Structured deleveraging. European banks still have non-performing and sub-performing loans to resolve, but regulations complicate the process. The European Bank Recovery and Resolution Directive (BRRD), for example, prohibits state bailouts. That leaves banks in a bind: They can't afford to sell loan assets at the deep discounts to which they are marked since that would trigger a markdown in their regulatory capital; buyers can't pay more without leverage to enhance returns, but banks are generally retrenching from financing sub-investment-grade assets given higher capital charges.

Structured solutions that are capital-efficient for banks and result in stronger ultimate recoveries may become more prevalent going forward. There is an opportunity for managers with less constrained capital and a more hands-on approach to partner with banks, reducing information asymmetries and infusing necessary asset management expertise.

CAPITALIZING ON DISRUPTIVE REGULATIONS

When prospective returns on capital are lower, focusing on where the supply of capital is impeded by regulation is a logical strategy for seeking excess returns. In that sense, disruptive regulation must rank among the biggest investable themes over the secular horizon. Banks may be ceding economic profits, but to capture them, investors must consider the financial industry relationships, the intensive resources and the regulatory compliance expertise required. Importantly, investors should also have a patient and flexible approach to capital deployment, in order to enable investment in the sectors and assets where risk is most attractively compensated.

These represent material barriers to entry for most investment managers, but ultimately, responsible non-bank capital is essential to plug funding gaps and facilitate transactions, so as to help drive economic recovery. A new market structure is emerging, one needed to fulfill the goal of regulators to create a safer financial system.

BIOGRAPHIES

Christian Stracke

Mr. Stracke is a managing director in the Newport Beach office, a member of the Investment Committee and global head of the credit research group. The group covers all levels of the debt capital structure for targeted industries, including investment grade and high yield bonds, bank debt and convertibles. He also contributes to the analysis, portfolio construction and management of the firm's opportunistic corporate credit and mortgage and real estate-related strategies. Prior to joining PIMCO in 2008, he was a senior credit strategist at CreditSights and held positions as head of Latin America fixed income strategy with Commerzbank Securities and head of Latin America local markets strategy with Deutsche Bank. He has 17 years of investment experience and holds an undergraduate degree from the University of Chicago.

Tom Collier

Mr. Collier is an executive vice president and product manager in the London office, responsible for alternative investment strategies. Prior to joining PIMCO in 2012, he was a director at HSBC, evaluating alternative investment funds and strategies. He performed a similar function at a subsidiary of Bank of New York Mellon, where he was also a member of the investment committee and held responsibility for client reporting. He began his career at Barclays. He has 18 years of investment and financial services experience and holds an undergraduate degree from University College London.

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CMR2016-0823-207048