CQS Insights

November 2022

Regulatory Capital: Long-Term, Stable Income

Summary

Securities backed by bank loans provide a stable, diversified and attractive income – up to 14% – alternative.

Additionally, these securities' floating-rate nature can help mitigate interest rate and inflation risk.

A wide range of the bank loan universe has been traditionally not available to investors.

Investors may now access the asset class through a Regulatory Capital structure: banks share some of their loan risk and, in exchange, provide investors with stable income.

By sharing risk, banks and investors' interest are aligned.

Bank loans traditionally have a lower default rate than High Yield bonds. Defaults are the strategy's primary risk.

Selection, quality and diversification help mitigate risk.

Reg Cap's main **benefits** include:

1 Stable income

2 High quality collateral

3 Floating-rate

4 Low volatility

5 Low correlation

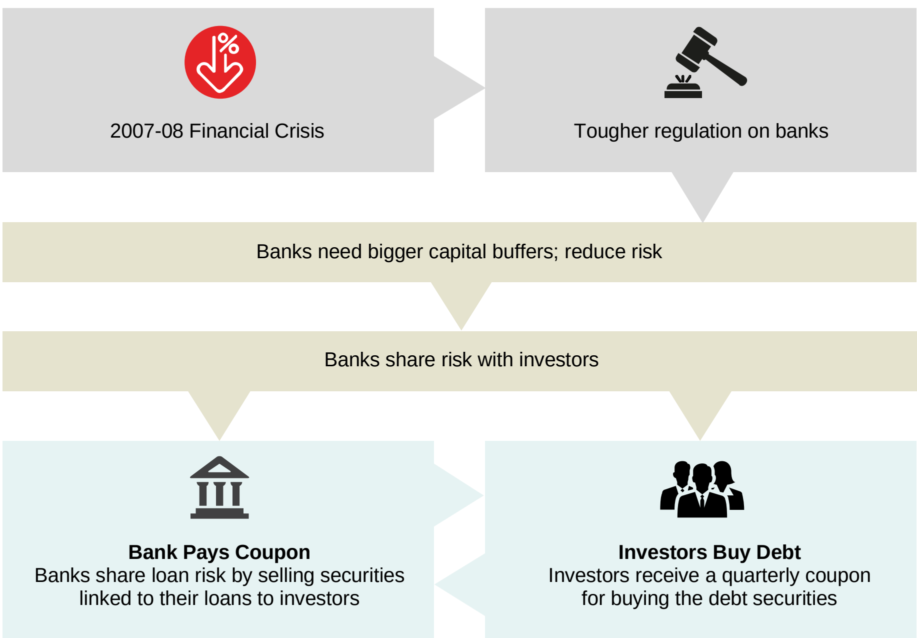
Investors seeking alternative sources of income and a lower correlation to uncertain public markets may consider bank loans.

More stringent bank regulation following the 2007-08 Global Financial Crisis (GFC) requires banks to increase their capital buffers. To free-up capital – and therefore be able to lend more – banks in Europe and North America have partnered with strategic investors to share risk, creating an asset class previously not available to most investors: through a Regulatory Capital (or Reg Cap) structure, investors now have the opportunity to access the bank loan universe, which typically provides high-quality, stable income from a diversified pool of borrowers.

Apart from corporate loans to large, medium and small-sized companies, banks' books also include trade receivables, auto loans, mortgages, housing, farming and infrastructure projects.

As seen in **Figure 1**, the Reg Cap mechanism is simple: banks share loan risk by selling debt securities backed by a pool of their core, high-quality loans. Banks keep the most senior tranches of those loan packages (created through a securitisation process). Investors buy the higher-yielding, more junior tranches of those high-quality loan packages in exchange of regular coupon income. If the loan defaults, investors at the bottom of the capital structure will absorb the first losses. Bank loans, however, have a lower average default rate than publicly traded corporate bonds (more detail in p3).

Figure 1: Reg Cap: Banks and investors swap credit risk for regular coupons



Source: CQS

Reg Cap typically provides quarterly coupons of between 8% and 14% per annum

The structure, also known as Credit Risk Sharing, works for both sides because their interests are aligned: by keeping loan risk, or having *skin in the game*, banks keep the loans on their balance sheet and continue to manage the customer relationship. To mitigate the risk of loan defaults, banks monitor a borrower more closely and also have dedicated workout units that may help, extend or restructure a loan in order to prevent default.

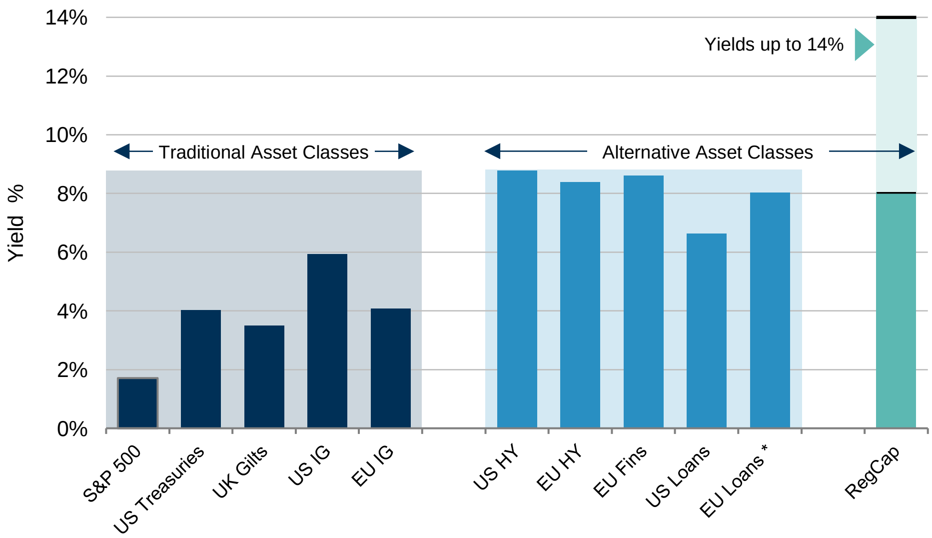
The Regulatory Capital structure is then designed to provide the following benefits:

Benefits for investors:

1. Stable income

Reg Cap typically provides quarterly coupons of between 8%-14% *per annum*, depending on the geography and subsector. Apart from compensation for the risk taken, investors also receive an illiquidity premium, as bank loans typically have a long duration. Combined, and as seen in Figure 2, the asset class provides a high income level relative to mainstream asset classes.

Figure 2: Regulatory Capital provides high, regular income



Source: CQS as 31 October 2022 * EU Loans data as at 30 September 2022.

2. Senior, high-quality collateral

Bank loans tend to be backed by senior, high-quality collateral, leading to superior recoveries in case of defaults. For example, during the 2007-08 Financial Crisis, Moody's corporate losses were in excess of 3%, whereas European Bank Loan charge-offs peaked at around 1%.

Among the pool of loans offered by banks, only the better loans are normally included in Regulatory Capital deals. Reg Cap transactions consist of 100% performing loans at origination (predominantly secured on assets), providing dependable collateral for investors. Also, and because of the alignment of interests between banks and investors, the loans in Reg Cap deals have gone through a rigorous due diligence and underwriting process, and they are also subject to ongoing risk monitoring throughout the life cycle of the loan.

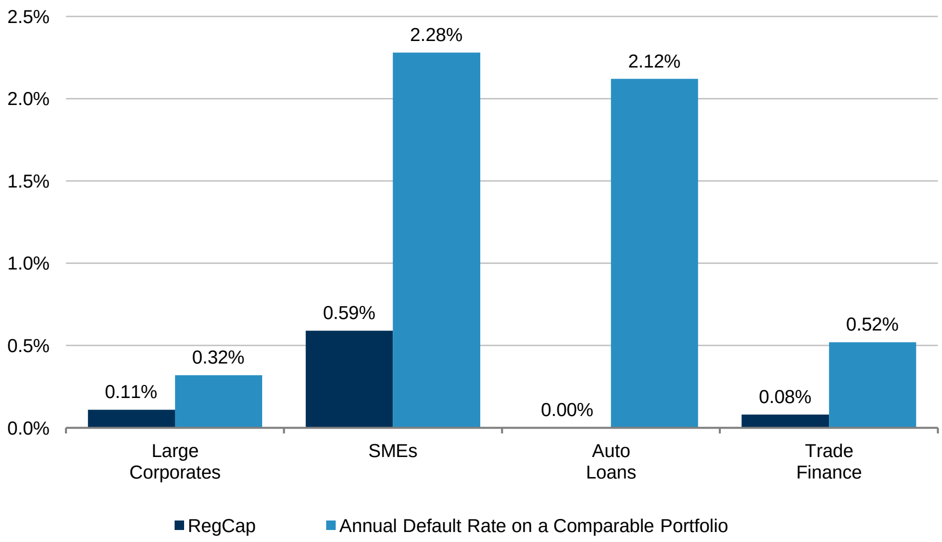
In general, the loans underlying Reg Cap deals have an equivalent credit rating of BBB- (the lowest Investment Grade ranking) or BB+ (the highest non-Investment Grade category). In Europe, underlying Reg Cap loans are typically from European-based, Investment Grade-rated borrowers. This, for example, helped the asset class outperform High Yield and the broad European bank indices during the COVID-19 crisis in 2020/21.

Reg Cap loans have consistently exhibited low default rates

Figure 3 shows that underlying Reg Cap loans have consistently exhibited low default rates.

Figure 3: Reg Cap: lower default rate

(Realised annual default rate and observed annual default rate on a similar but broader portfolio of the bank).



Source: EBA: Report on STS Framework for Synthetic securitisation (6 May 2020).

3. Floating-rate

Most Reg Cap structures have a floating-rate nature, which mitigates interest rate risk – a timely attribute in the present rate-rising environment.

4. Low volatility

Regular high and stable income throughout the market cycle substantially reduces the volatility of the asset class.

5. Low correlation to major asset classes

The regular and diversified cash flow stream makes Reg Cap lowly correlated to volatile public markets.

6. Diversification

Some investors add a Regulatory Capital allocation to a wider portfolio in order to increase diversification and mitigate risk. Some of the assets in Reg Cap structures are hard to source, as they may be originated by banks with a strong expertise or market share in a specific sector (ie. social housing, project finance etc.). This increases the diversification of the asset pool.

Benefits for banks:

Free up capital

- By sharing risk, banks need to hold less capital, freeing resources to lend more. Banks welcomed the Regulatory Capital structure because raising additional equity can be expensive and dilute existing shareholders, while lending less hurts income and market share.

Share risk

- Banks reduce default risk by selling the junior tranches of the Reg Cap structures, while keeping the most senior, which gets paid first in case of default.

Reduce volatility

- By sharing risk, banks have less need to increase provisions and write-downs, reducing earnings volatility.

Strengthen client relationships

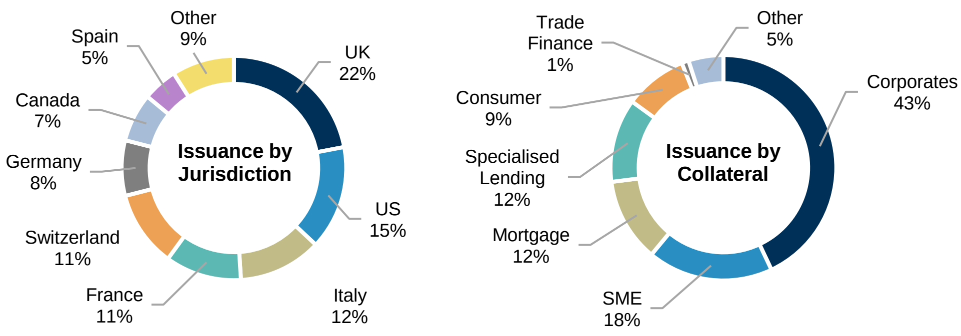
- Sharing risk helps banks support their clients more, potentially extending their relationship.

The opportunity today

Reg Cap has evolved from a niche option to a widely adopted tool for balance sheet optimisation

Banks issue about $12bn worth of Regulatory Capital bonds every year, and the figure keeps climbing as more financial institutions see Reg Cap as an efficient solution to improve capital ratios and lend more. Reg Cap has evolved from a niche option, used by a limited number of primarily European banks, to a widely adopted tool for balance sheet optimisation. The mechanism is now applied by an increasing number of issuers across a widening range of subsectors. The growing number of bank participants, consistent issuance and the wider range of underlying subsectors provide more opportunities and greater diversification benefits.

Figure 4: Reg Cap issuance: Diversified in terms of country and sectors



Source: EBA Report on STS Framework For Synthetic Securitisation, 2021. Chart may not sum to 100 due to rounding.

Mitigating Risk

Like all security investments, Regulatory Capital requires specialised management to minimise risk. In this regard, managers usually implement the following strategies:

Thorough due diligence and selection
In order to mitigate default risk, Reg Cap managers look at bank loans either one by one (for disclosed pools), or as a pool – which is then analysed with statistical tools. Managers may favour loans whose rating has been stable over a 10-year period rather than those with an unstable rating history. For small and medium enterprises (SMEs), where loans are packed together and sometimes the name of the company is not disclosed, managers employ comparative analytical techniques.

Thicker tranches
While still paying attractive coupons, some tranches stretch to a wider part of the capital structure, reducing the potential loss in yield in the case of default.

Diversification
Reg Cap portfolios that hold loans from a variety of industries, credit ratings and countries tend to be more resilient. Managers also favour sectors in which the bank has a strong market share and long-standing strategic relationships with customers.

Quality
The present uncertain environment, with high inflation and rising interest rates, may lead to a rise in defaults. To minimise default risk, Reg Cap managers may be more cautious and choose top-quality assets. In real estate deals, for instance, managers may select transactions where the loan-to-value ratio is about 50%, giving the borrower plenty of margin to absorb market shocks.

Bank relationships
Keeping strong, long-term relationships with banks helps access a wider choice of hard-to-source, high-quality loan options.

Sustainability
Having ample choice increases the opportunity to select sustainable companies and sticking to Responsible Investment guidelines. Over the past few months, there has been more issuance of ESG-related deals coming out of European banks, given the increasing number of underlying loans for social housing, renewable infrastructure and green commercial real estate projects.

Conclusion

Regulatory Capital is a stable, long-term solution that provides investors with a high income, low-volatility and time-tested alternative.

Reg Cap has been a strong source of income and stability over recent major crises (Global Financial Crisis 2008-2009, sovereign crisis 2012-2013, oil crisis 2016, and more recently, Covid-19). By having a low correlation to public markets, the asset class has acted like an income shelter through different market cycles.

Over the past decade, CQS has invested c. $1.4bn in the asset class with consistent performance: our disciplined underwriting process has led to less than 0.1% of cumulative credit losses since 2014 (6.39bps) in the asset class. With a rigorous and selective investment process (we reject 70% of transactions), our scale provides the ability to drive structures, especially within bespoke bilateral deals. Our investment process also incorporates ESG and carbon footprint analysis, including individual borrower screening.

In the present uncertain environment, we believe Reg Cap may offer investors the long-term, quality, stable income they need.

Important Information

This document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the fund will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

This document has not been delivered to, licensed or permitted by the Authority as designated under the Brunei Darussalam Mutual Funds Order 2001. Nor has it been registered with the Registrar of Companies. This document is for informational purposes only and does not constitute an invitation or offer to the public. As such it must not be distributed or redistributed to and may not be relied upon or used by any person in Brunei other than the person to whom it is directly communicated, (i) in accordance with the conditions of section 21(3) of the International Business Companies Order 2000, or (ii) whose business or part of whose business is in the buying and selling of shares within the meaning of section 308(4) of the Companies Act cap 39.

This information does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe for or purchase, any securities or investment products in the UAE (including the Dubai International Financial Centre) and accordingly should not be construed as such.

Furthermore, this information is being made available on the basis that the recipient acknowledges and understands that the entities and securities to which it may relate have not been approved, licensed by or registered with the UAE Central Bank, the Dubai Financial Services Authority or any other relevant licensing authority or governmental agency in the UAE.

This document is provided for information purposes only and does not constitute legal advice. Professional legal advice should be obtained before taking or refraining from any action as a result of the contents of this document.

The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial Companies Law of Oman (Royal Decree 4/74) or the Capital Market Law of Oman (Royal Decree 80/98), nor does it constitute an offer to sell, or the solicitation of any offer to buy Non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market Law (issued by Decision No.1/2009). Additionally, this document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Shares are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Funds. This document does not constitute an offer to the public and is for the use only of the named addressee and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). The fund has not been and will not be registered with the Qatar Central Bank or under any laws of the State of Qatar. No transaction will be concluded in your jurisdiction and any inquiries regarding shares should be made to compliance@cqsm.com

The Funds may only be offered and sold in the Kingdom of Saudi Arabia in accordance with Article 4 of the Investment Funds Regulations issued on December 24, 2006 (the "Regulations"). Article 4(b)[(1)/(4)] of the Regulations states that, if investment fund units are offered to no more than 200 offerees in the Kingdom of Saudi Arabia/certain persons specified in the Regulations and the minimum amount payable per offeree is not less than Saudi Riyals one million or an equivalent amount in another currency, such offer of investment fund units shall be deemed a private placement for purposes of the Regulations. Investors are informed that Article 4(g) of the Regulations places restrictions on secondary market activity with respect to such investment fund units.

This document and the information contained herein, does not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. Funds are only being offered to a limited number of sophisticated investors in the UAE who (a) are willing and able to conduct an independent investigation of the risks involved in an investment in such shares], and (b) upon their specific request. The Funds have not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. The document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee's consideration thereof). No transaction will be concluded in the UAE and any enquiries regarding the Funds should be made to compliance@cqsm.com

This document is not for general circulation to the public in Kuwait nor will the units be sold to the public in Kuwait. The units may only be purchased in Kuwait through a Kuwait local agent that has obtained a licence from the CMA. Prior to purchasing any units, a prospective investor should consult a financial advisor who has been duly licensed by the Kuwait Capital Markets Authority and with his, her or its own legal, business and tax advisors to determine the appropriateness and consequences of an investment in the units for such prospective investor and arrive at an independent assessment of such investment.

This memorandum does not constitute an offer to sell or solicitation of an offer to buy any securities other than the securities offered hereby, nor does it constitute an offer to sell or solicitation of an offer to buy from any person in any state or other jurisdiction in which such offer or solicitation would be unlawful, or in which the person making such offer or solicitation is not qualified to do so, or to a person to whom it is unlawful to make such offer or solicitation.

This document has not been approved by the Israel Securities Authority and will only be distributed to Israeli residents in a manner that will not constitute "an offer to the public" under sections 15 and 15a of the Israel Securities Law, 5728-1968 ("the Securities Law") or section 25 of the Joint Investment Trusts Law, 5754-1994 ("the Joint Investment Trusts Law"), as applicable.

The strategies are being mentioned to a limited number of investors (35 investors or fewer during any given 12 month period) and/or those categories of investors listed in the First Addendum ("the Addendum") to the Securities Law, ("Sophisticated Investors") namely joint investment strategies or mutual trust strategies, provident strategies, insurance companies, banking corporations (purchasing these strategies for themselves or for clients who are Sophisticated Investors), portfolio managers (purchasing these strategies for themselves or for clients who are Sophisticated Investors), investment advisors or investment marketers (purchasing these strategies for themselves), members of the Tel-Aviv Stock Exchange (purchasing these strategies for themselves or for clients who are Sophisticated Investors), underwriters (purchasing these strategies for themselves), venture capital funds engaging mainly in the capital market, an entity which is wholly-owned by Sophisticated Investors, corporations, (other than formed for the specific purpose of an acquisition pursuant to an offer), with a shareholders equity in excess of NIS 50 million, and individuals investing for their own account, in respect of which at least one of the following applies: the total value of their cash, deposits, financial assets (as defined in the Investment Advice Law) and securities traded on a stock exchange licensed under the Securities Law (together, “Liquid Assets”) exceeds NIS 8 million (approximately US$2.1 million); their level of income over each of the preceding two years exceeds NIS 1.2 million (approximately US$300,000), or the level of income of their "family unit" exceeds NIS 1.8 million (approximately US$470,000); or the aggregate value of all their Liquid Assets exceeds NIS 5 million (approximately US$1.3 million) and their level of income over each of the preceding two years exceeds NIS 600,000 (approximately US$160,000), or the level of income of their "family unit" exceeds NIS 900,000 (approximately US$240,000); each as defined in the said Addendum, as amended from time to time, and who in each case have provided written confirmation that they qualify as Sophisticated Investors, and that they are aware of the consequences of such designation and agree thereto; in all cases under circumstances that will fall within the private placement or other exemptions of the Joint Investment Trusts Law, the Securities Law and any applicable guidelines, pronouncements or rulings issued from time to time by the Israel Securities Authority.

This document may not be reproduced or used for any other purpose, nor be furnished to any other person other than those to whom copies have been sent. Any offeree who purchases these strategies is purchasing such strategies for its own benefit and account and not with the aim or intention of distributing or offering such strategies to other parties (other than, in the case of an offeree which is a Sophisticated Investor by virtue of it being a banking corporation, portfolio manager or member of the Tel-Aviv Stock Exchange, as defined in the Addendum, where such offeree is purchasing strategies for another party which is a Sophisticated Investor).

Nothing in this document should be considered investment advice or investment marketing as defined in the Regulation of Investment Counselling, Investment Marketing and Portfolio Management Law, 5755-1995.

Investors are encouraged to seek competent investment counselling from a locally licensed investment counsel prior to making the investment. As a prerequisite to the receipt of a copy of this document a recipient shall/may be required by CQS to provide confirmation that it is a Sophisticated Investor purchasing strategies for its own account or, where applicable, for other Sophisticated Investors.

This presentation is directed only to Egyptian qualified institutional buyers and professional high net worth investors (as defined in the Egyptian Financial Supervisory Authority Directive on the Private Placements of Stocks). The Documents shall not be deemed to be public advertisements or prospectus’s for the purpose of issuing shares in any circumstances. This is not a general solicitation or a general advertising and CQS (UK) LLP has no intention of conducting a public offering of any securities in Egypt. This presentation does not constitute a recommendation, inducement, invitation, offer, or solicitation to purchase or acquire any securities (including shares) or assets in Egypt or North Africa and no legal relations shall be created by this presentation.

This presentation is directed only to Kazakhstan (qualified) institutional buyers and professional high net worth investors (as defined in the English law and supported by the AIFC in Kazakhstan). The Documents shall not be deemed to be public advertisements or prospectus’ for the purpose of issuing shares in any circumstances. This is not a general solicitation or a general advertisement and CQS (UK) LLP has no intention of conducting a public offering of any securities in Kazakhstan. This presentation does not constitute a recommendation, inducement, invitation, offer or solicitation to purchase or acquire any securities (including shares) or assets in Kazakhstan and no legal relations shall be created by this presentation. It is the duty of any Kazakhstan entity or investors to comply with the Kazakhstan qualified investor regulations and to determine the local regulations and any restrictions, and adhere to the local legal and regulatory protocols. The presentation is for information purpose only as directly (unsolicited) requested by the interested party and does not constitute as a public financial promotion.

This document does not constitute an offer to sell or solicitation of an offer to buy any securities other than the strategies offered hereby, nor does it constitute an offer to sell to or solicitation of an offer to buy from any person or persons in any state or other jurisdiction in which such offer or solicitation would be unlawful, or in which the person making such offer or solicitation is not qualified to do so, or to a person or persons to whom it is unlawful to make such offer or solicitation.

This document has been issued by CQS (UK) LLP which is authorised and regulated by the UK Financial Conduct Authority, CQS (US), LLC which is a registered investment adviser with the US Securities and Exchange Commission, and/or CQS (Hong Kong) Limited, which is authorised and regulated by the Hong Kong Securities and Futures Commission. The term “CQS” as used herein may include one or more of CQS (UK) LLP, CQS (US), LLC, and CQS (Hong Kong) Limited or any other affiliated entity. The information is intended solely for sophisticated investors who are (a) professional investors as defined in Article 4 of the European Directive 2011/61/EU or (b) accredited investors (within the meaning given to such term in Regulation D under the U.S. Securities Act of 1933, as amended) and qualified purchasers (within the meaning given to such term in Section 2(a)(51) of the U.S Investment Company Act 1940, as amended). This document is not intended for distribution to, or use by, the public or any person or entity in any jurisdiction where such use is prohibited by law or regulation.

This document is a marketing communication prepared for general information purposes only and has not been delivered for registration in any jurisdiction nor has its content been reviewed by any regulatory authority in any jurisdiction. The information contained herein does not constitute: (i) a binding legal agreement; (ii) legal, regulatory, tax, accounting or other advice; (iii) an offer, recommendation or solicitation to buy or sell shares or interests in any fund or investment vehicle managed or advised by CQS (a “CQS Fund”) or any other security, commodity, financial instrument, or derivative; or (iv) an offer to enter into any other transaction whatsoever (each a “Transaction”). Any decision to enter into a Transaction should be based on your own independent investigation of the Transaction and appraisal of the risks, benefits and appropriateness of such Transaction in light of your circumstances. Any decision to enter into any Transaction should be based on the terms described in the relevant offering memorandum, prospectus or similar offering document, subscription document, key investor information document (where applicable), and constitutional documents and/or any other relevant document as appropriate (together, the “Offering Documents”). Any Transaction will be subject to the terms set out in the Offering Documents and all applicable laws and regulations. The Offering Documents supersede this document and any information contained herein. The Offering Documents for CQS UCITS range of funds is available here (www.cqs.com/ucits-funds#global-convertibles) in English (US persons will not be eligible to invest in CQS managed UCITS funds save to the extent set out in the relevant Offering Document). A copy of CQS’ Complaints Policy, which sets out a summary of investors’ rights, is available here (www.cqs.com/site-services/regulatory-disclosures) in English. CQS may terminate the arrangements for marketing or distribution of any CQS Fund at any time.

Nothing contained herein shall give rise to a partnership, joint venture or any fiduciary or equitable duties. The information contained herein is provided on a non-reliance basis, not warranted as to completeness or accuracy, and is subject to change without notice. Any information contained herein relating to any non-affiliated third party is the sole responsibility of such third party and has not been independently verified by CQS. The accuracy of data from third party vendors is not guaranteed. If such information is not accurate, some of the conclusions reached or statements made may be adversely affected. CQS is not liable for any decisions made or action taken by you or others based on the contents of this document and neither CQS nor any of its directors, officers, employees or representatives accept any liability whatsoever for any errors or omissions or any loss howsoever arising from the use of this document.

Information contained in this document should not be viewed as indicative of future results as past performance of any Transaction is not indicative of future results. Any investment in a CQS Fund or any of its affiliates involves a high degree of risk, including the risk of loss of the entire amount invested. The value of investments can go down as well as up. Future performance is subject to taxation which depends on the personal situation of each investor and which may change in the future. Investments may lead to a financial loss if no guarantee on the capital is in place. An investment in any CQS Fund will involve a number of material risks which include, without limitation, risks associated with adverse market developments, currency and exchange rate risks, risk of counterparty or issuer default, and risk of illiquidity. Any assumptions, assessments, targets (including target returns and volatility targets), statements or other such views expressed herein (collectively "Statements") regarding future events and circumstances or that are forward looking in nature constitute CQS' subjective views or beliefs and involve inherent risk and uncertainties beyond CQS' control. Any indices included in this document are for illustrative purposes only and are not representative of CQS Funds in terms of either composition or risk (including volatility and other risk related factors). Unless stated to the contrary CQS Funds are not managed to a specific index.

The information contained herein is confidential and may be legally privileged and is intended for the exclusive use of the intended recipient(s) to which the document has been provided. In accepting receipt of the information transmitted you agree that you and/or your affiliates, partners, directors, officers and employees, as applicable, will keep all information strictly confidential. Any review, retransmission, dissemination or other use of, or taking of any action in reliance upon, this information is prohibited. Any distribution or reproduction of this document is not authorized and prohibited without the express written consent of CQS, or any of its affiliates. Unless otherwise stated to the contrary herein, CQS owns all intellectual property rights in this document.

CQS is a founder of the Standards Board for Alternative Investments ("SBAI") which was formed to act as custodian of the alternative investment managers' industry best practice standards (the "Standards"). By applying the Standards, managers commit to adopt the "comply or explain" approach described in the Standards. CQS is a signatory of the UN Principles for Responsible Investment and a supporter and participant of certain other responsible investment related industry associations.

PRI Note:
PRI is an investor initiative in partnership with UNEP Finance and the UN Global Compact. MEv10.

3407257502 / G-22-0198 / 11.22

CQS (UK) LLP
4th Floor, One Strand, London WC2N 5HR, United Kingdom
T: +44 (0) 20 7201 6900 | *F*: +44 (0) 20 7201 1200

CQS (US), LLC
152 West 57th Street, 40th Floor, New York, NY 10019, USA
T: +1 212 259 2900 | *F*: +1 212 259 2699

CQS (Hong Kong) Limited
3305 AIA Tower, 183 Electric Road, North Point, Hong Kong, China
T: +852 3920 8600 | *F*: +852 2521 3189

CQSClientService@cqsm.com www.cqs.com Follow us

Signatory of:

PRI Principles for Responsible Investment · UK STEWARDSHIP CODE · TCFD TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES · SBAI SIGNATORY Jan '22 · CDP DISCLOSURE INSIGHT ACTION

A proud participant of Climate Action 100+ · ICGN · IIGCC The Institutional Investors Group on Climate Change · RACE TO ZERO PARTNER