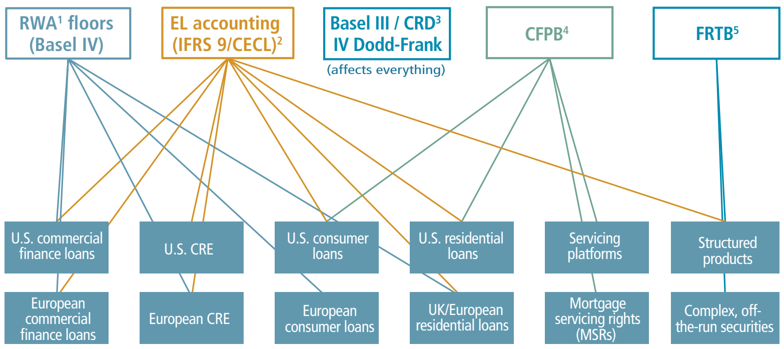
DISRUPTIVE REGULATION:

THREE INVESTMENT OPPORTUNITIES

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. Over this period, 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.

Whether driven by Dodd-Frank, Basel III, Basel IV, or IFRS, banks are facing an increasingly complex web of regulation, as shown in *Figure 1*. This is creating ongoing pressure in the form of higher capital requirements, loss provisioning and 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

1. Specific funding gaps. With quantitative easing designed to encourage the supply of credit, 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 for example, 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.

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 epitomises a true funding gap, one where banks have genuinely retrenched, capital markets are closed to securitisation and private capital faces material barriers to entry. Similar opportunities exist in land banking, real estate development lending and certain types of consumer lending.

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.

2. Public-private market dislocations. In contrast to public securities markets, 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.

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. 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 analyse 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.

3. 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.

CAPITALISING ON DISRUPTIVE REGULATIONS

Disruptive regulation must rank among the biggest investable themes over the secular horizon. But while banks may be ceding economic profits, 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 fulfil the goal of regulators to create a safer financial system.

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