KEEL POINT

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## Shadow Banking: European Direct Lending

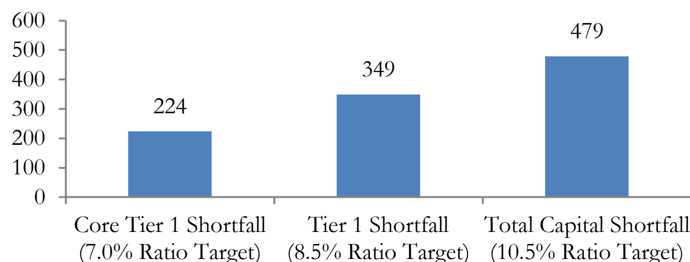
As new financial regulations have taken hold across the globe, the rise of "Shadow Banking" has emerged as a recurring theme in our conversations with existing and prospective managers. From a geographical perspective, nearly every credit focused manager we have spoken with recently has cited the target rich environment offered in Europe, particularly in the area of direct lending to middle market companies. We believe that these opportunities are real and persistent, and wanted to outline our views on their nature, why they exist and how to best access them.

### *The Long, Slow March of the Bureaucrats*

The Third Basel Accord, or Basel III, is a global regulatory standard for financial institutions that was developed in response to the late-2000s financial crisis. Following up on Basel I (1988) and Basel II (2005), it significantly increased the quality and quantity of capital that banks had to hold and added new measures for liquidity and leverage. Implementation is being phased in beginning in 2013, with standards being tightened through 2019. At the end of the day, banks are being forced to deleverage their balance sheets, reducing the absolute amount of lending they will be able to engage in and shifting the lending they do towards larger, more easily valued transactions with more financially stable borrowers.

These new regulations are proving especially problematic for European banks, which exited the financial crisis in significantly worse shape than their American and Asian counterparts. Selling off bad loans would require these lenders to mark their books to market – a circumstance that would no doubt leave many of them technically insolvent. European banks have therefore been slow to deleverage in the hope that an improved economic environment will allow them to sell off their loan books at higher values in the future. Time is running out, however, as current projections show them falling far short of several Basel III requirements (see Figure 1, below).

**Figure 1: Estimated 2019 Basel III Capital Shortfalls (€ bn)**
*Source: EBA Basel III Monitoring Exercise, March 2013*

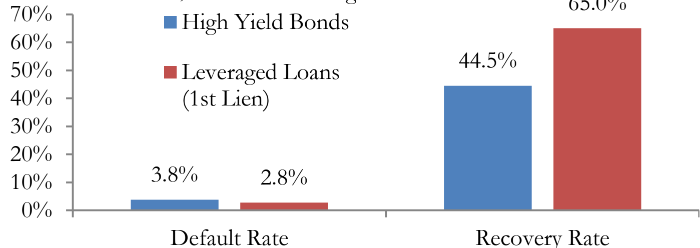



In response to the impending shortfall, many banks have retreated from traditional lending activities and non-bank lenders have moved in to fill the unmet demand, acting as "Shadow Banks." Credit hedge funds, insurance companies, special purpose vehicle and non-bank finance companies are all attempting to capture some of the profits that will now be forbidden to banks. For one example, $163 billion of investor capital has been funneled into distressed debt funds since 2007, looking to profit from a European debt fire sale. While the shadow banking opportunity is manifesting itself in a variety of forms, we believe that European direct lending to the middle-market represents a particularly attractive proposition.

### *To a Regulator's Hammer, All Lending is a Nail*

Since the earliest days of finance, weighing the potential profits of a loan against the risk that a borrower might not pay back what is owed has always depended heavily on the subjective judgment of the lender, a skill which is not easily quantified in the thousands of pages of Basel III regulations. Regulators work with blunt tools and must make wide-ranging assumptions about risk. Among these assumptions are that loans, which trade only rarely on private markets, are riskier than bonds, which are publicly traded and more easily "valued". Thus, under Basel III, loans are accounted for in a way that is more injurious to a bank's capital ratios than are even high-yield bonds. This is despite the fact that lenders a) are generally senior to bond investors and get paid first in the event of default b) have the ability to directly negotiate stronger protections into the loan documents, and c) often have the ability to step in and take corrective actions at earlier signs of distress. Because of these and other factors, leveraged loan default rates have historically been lower and recovery rates higher than those associated with "less-risky" high-yield bonds (see Figure 2, below).

**Figure 2: Default and Recovery Rates**
*Source: Credit Suisse, 1995 - 2012 average*




### *Back to the Future – Direct Lending in Europe*

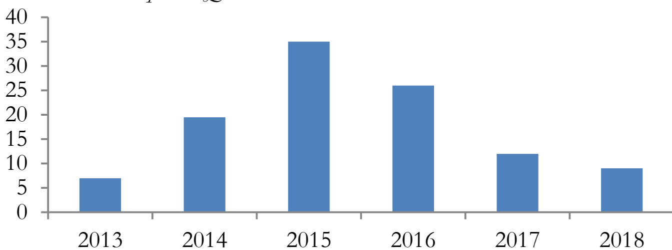
Once upon a time, all lending was done directly and it was taken for granted that a lender should know any potential borrower well and maintain a close relationship over time. With the development of the corporate bond market, first utilized by mining, railroad and canal companies in the 1860s, lenders began to standardize terms, depersonalize the relationship between themselves and the borrower, and allow for the purchase and sale of debt as "securities." Over time, the securitization of lending has grown to encompass other

economic sectors such as real estate, student loans and consumer loans, all of which can now be bought and sold as securities.

Until recently, banks maintained a place for themselves as direct lenders to middle-market borrowers; that is, making one-to-one loans to small and medium sized businesses that lacked the scale to access the corporate bond markets. In the past few decades, however, even this private lending market has seen a creeping degree of securitization with syndicated loans, collateralized loan obligations (CLOs), and business development companies (BDCs) all acting as non-bank lenders. While widespread, the growth of these lenders has been uneven across the world, with Europe proving particularly resistant to the trend. Today, banks' share of private lending in the US comprises only 40-55% of total activity, whereas in Europe, banks still maintain a 60-80% share of this market. These direct loans are among the most problematic for the European banks, as they receive the least favorable regulatory treatment and already represent an outsized proportion of balance sheets. The banks' response has been a wholesale retreat from the middle market.

While the traditional lenders have pulled back, restricting the supply of new loans, demand continues to grow. Lending in support of private equity transactions drives a substantial amount of new loan demand and the amount of capital committed to European private equity funds remains near all-time highs. As funds move closer to the ends of their investment periods, we expect PE activity to increase. Additionally, European borrowers are facing an impending "Maturity Wall" as existing loans come due (see Figure 3, below).

**Figure 3: Institutional Leveraged Loan Maturity Wall (€ bn)**
*Source: S&P Capital IQ LCD, Standard & Poor's, 2012*

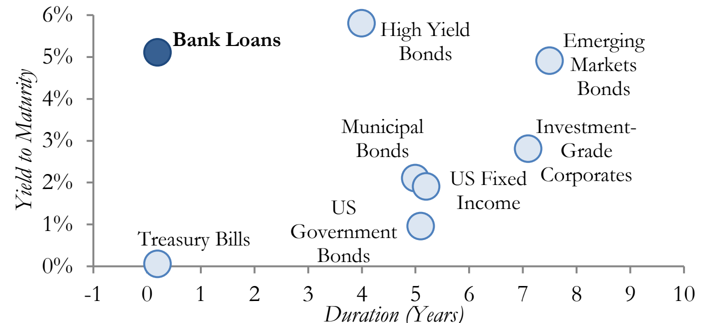



Typically, these obligations would be rolled over and refinanced with the banks, but that demand will now require new providers of capital going forward.

### *Taking the Fixed out of Fixed Income*

As we discussed in our November Investment Bulletin, we continue to believe that Fed tapering, and a resulting rapid rise in interest rates, is one of the top three risks facing investors today. In response, we have been positioning portfolios to reduce the impact of rising interest rates. One of the ways that we can accomplish this is by replacing a portion of traditional fixed income exposure with other strategies and asset classes that offer similar expected return characteristics but have lower "duration," or sensitivity to changes in interest rates. Bank loans (and direct loans) generally pay interest based on floating rates that move in step with interest rates, thereby shielding investors from the interest rate exposure of fixed rate debt (see Figure 4, below). We believe that direct lending offers investors yet another tool with which to address interest rate risk and serves as a natural hedge in a rising interest rate environment.

**Figure 4: Duration and YTM across Fixed Income Investments**
*Source: BlackRock*




Investors should be aware that an allocation to direct lending will result in a decrease in liquidity. Since these loans cannot be bought and sold on an open market, liquidity will usually come when the loans mature after 4-6 years. There is an upside to this illiquidity, however, as investors may see a liquidity premium of at least an extra 1% of return per year relative to the more liquid syndicated bank loan market, as per BNY Mellon estimates.

### *Implementation – The Devil in the Details*

While the investment opportunity is evident, the trick lies in the execution. Much of the expertise needed to source and underwrite deals and navigate the multi-jurisdictional complexities of European lending continues to reside within the banks. Strong managers with dedicated teams of experienced credit analysts and the infrastructure needed to drive these strategies do exist, but substantial work must be done to identify these investments and ultimately deploy capital. For investors that possess a tolerance for the illiquid nature of these investments and have the ability to identify the right managers, compelling macro-economic factors paired with attractive yields and risk mitigants can make private middle market lending in Europe an attractive addition to their portfolios. □

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