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Shadow Banking: Rising opportunities in the private middle market

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Executive Summary

Shadow banking—defined as multiple forms of nonbank lending—grew enormously in the decades leading up to the 2008 credit crisis. Since the crisis, regulators and others continue to tackle the large-scale structure of the shadow banking industry as well as the large nonbank lenders. Banking institutions have, of course, also come under added scrutiny and more stringent regulations.

However, the financial markets continue to evolve and are actively innovating new private financings for middle market companies. These financings are meeting at least some of the real capital requirements in the U.S. economy. This form of private, middle market* lending is a subpart of the whole shadow banking story. These types of private transactions, in fact, constitute one of the more viable and dynamically reemerging elements of the U.S. financial markets where capital finds its way to those commercial enterprises who legitimately need it, but have trouble obtaining it due to structural, regulatory and other impediments.

* Reference to the "middle market," this typically includes financings of between $5 million to $100 million, or, in other contexts, can include loans to issuers with $50 million or less in earnings before interest, taxes, depreciation and amortization (EBITDA).

This trend we believe will have growing implications and challenges for the mainstream banking market:

- As before the credit crisis (but perhaps now in a more sustainable fashion), the mainstream banks will increasingly be missing a significant sector of the lending market. They will be missing opportunities for often perfectly viable credits, but where some element of structural complexity is not consistent with the rigid constraints of mainstream bank underwriting parameters
- A continuation of the ongoing breakdown of established lending relationships between banks and middle market borrowers – the middle market now looks to their banks for say vanilla warehouse lines, but will increasingly look (again) at the non-bank lenders for more high yielding or structurally complex transactions
- On the other hand, there is also an opportunity for those banks who genuinely have the skill sets and the appetite (within prudential bounds) to play in some of these higher yielding / structured transactions. Such banks can compete strongly with the non-bank lenders and potentially out-price them given the cheap deposit funding of the depositary institutions

Shadow banking defined

Although it lacks a universally accepted definition, the term "shadow banking" is used to describe various forms of credit intermediation performed by entities outside of the regular banking system (i.e., not depository financial institutions). The shadow banking sector encompasses a wide array of market participants, including, but not limited to, independent investment banks, financing companies, lessors, money market funds, hedge funds, structured investment vehicles (SIV), and investment companies.

Over the past decade, the shadow banking system (SBS) engineered forms of credit, maturity, and liquidity enhancement, predominantly through structured products such as Collateralized Debt Obligations (CDO), asset-backed securities, and repurchase agreements. Despite the success and long-term utility of these advancements (i.e., new, liquid markets for once opaque/esoteric assets), their excessive reliance on the interconnectedness of the financial system became somewhat circular. This, along with the increasing complexity of products that emerged in the SBS, is often cited by many as the major contributing factor to the financial crisis. It was not until the financial crisis of 2007–2009 that the utility, risk, and regulation—or lack thereof—of the SBS came under increased scrutiny.

Shadow banking sector has become more global

Concurrent with rapid developments in financial innovation and technology in the United States—as well as a favorable financing environment—the global shadow banking market experienced substantial expansion between 2002–2007, increasing from $26 trillion to $67 trillion in size and accounting for roughly 25% of all financial transactions based on Financial Stability Board (FSB) data.[1] As of 2011, the United States had the largest SBS, with $23 trillion in total assets.[2]

The SBS has begun to recover since the global credit crunch, albeit growing at a much slower pace than in the early 2000s. This modest growth has been driven by the expansion of finance companies, hedge funds, and related investment funds; though certain assets of these institutions were impaired and/or written off, they have generally been able to recover with the rest of the economy. This growth has been primarily offset by a reduction in the money market mutual fund and structured finance markets, which contracted at compound annual rates of approximately 4 percent and 6 percent, respectively, from 2007–2011[3]. These sectors were particularly impacted by the failure of several large investment banks, including

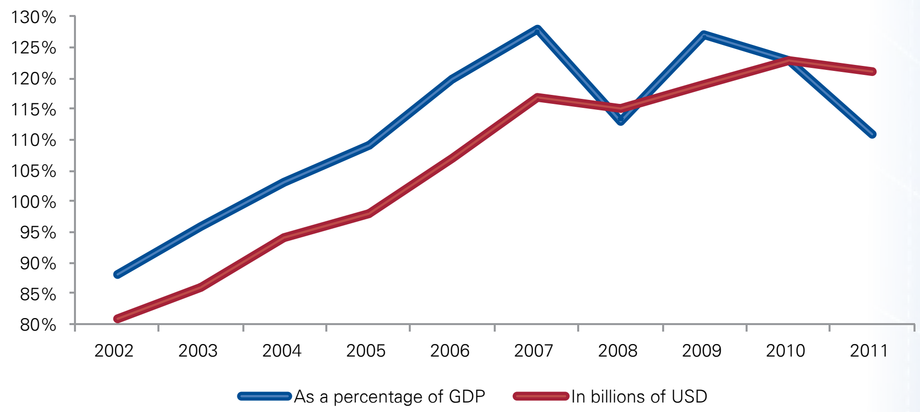
[1] Bockmann, Michele Wiese, Vaughan, Liam, and Moshinsky, Ben. (February 28, 2013). "Blackstone Profits From Regulation With Citigroup Deal," Bloomberg.

[2] Financial Stability Board. (2012). "Global Shadow Banking Monitoring Report 2012," (November 19).

[3] Financial Stability Board, 2012, p. 19.

Merrill Lynch, Lehman Brothers, and Bear Stearns. These failures precipitated the unwinding of large amounts of structured assets/CDOs and the infamous "breaking of the buck" by the Reserve Primary Fund in September 2008. Structured vehicles—which typically pool various types of fixed-income assets (e.g., mortgages, loans, or receivables) and subsequently issue new securities against the consolidated entity—were significantly affected in the crisis due to extensive devaluation of the underlying credits. These events brought to light the systemic risk posed by mass cross-collateralization and hypothecation. Since the onset of the crisis, securitization vehicles have been the subject of various forms of proposed regulatory reforms.

Table 1: Assets of Non-bank Financial Intermediaries



Source: Financial Stability Board

SBS has begun to recover since the global credit crunch, albeit growing at a much slower pace than in the early 2000s.

The United States has the largest shadow banking sector in the world, accounting for approximately 50 percent of all rated, nonbank issuers according to a 2012 study by Standard and Poor's. This compares to the early 1980s, when the United States represented 100 percent of that same market. Recovery in the U.S. SBS has begun, but is still below its previous highs.

Capital finds its way to productive uses: quasimarket efficiency in the middle market

Against this backdrop of the SBS described above, the shadow credit market for ***middle market*** firms stands apart. Similar to the traditional role of commercial banks, middle market shadow lending provides credit and generally increases the liquidity of financial markets. The greater transparency requirements, higher credit standards and more rigid formats of public market securities offerings (itself a consequence of the various abuses of the capital markets leading up to the credit crisis) have meant that ***plenty of otherwise creditworthy entities, have been excluded from the public capital markets***. They can be excluded for numerous reasons that often have little rational economic basis—***due to modest size, or limited stockholders, or being an asset class that is just not familiar to public market institutional investors***. Hence many companies, specialty finance lenders, community banks and asset pools that may have high quality credit features, but are perhaps not quite meeting public market parameters, are therefore ***turning back to private market credit transactions***.

Like the rest of the SBS, middle market shadow lending does not have access to central bank funding (the Fed Window) or the safety nets provided by the government, such as the FDIC. Middle market shadow finance businesses rely instead on: short-term funding underpinned: by asset-backed commercial paper, by the repo market for borrowers able to offer collateral as security against a loan (effectively selling the security to a lender with an agreed-upon repurchase price/date in the future), by private term securitization, or by other private credit/warehouse lines. These shadow credit providers can be involved in the provision of long-term loans, for example, mortgages, facilitating credit across the financial system by matching investors and borrowers individually or by becoming part of a chain involving numerous entities, some of which may include commercial banks. Due in part to their specialized structure, middle market shadow banks can sometimes provide credit more cost-efficiently than traditional banks. In the United States, by the mid-2000s and well before the 2008 financial crisis, the SBS had surpassed the regulated banking system in supplying loans to borrowers, including businesses, home and car buyers, students and credit card users, etc. Shadow banks often assume risk levels higher than commercial banks; for example, lenders may provide loans to borrowers who might otherwise be refused credit by regulated banks. In today's credit environment, this includes many businesses outside the Fortune 100 list.

Certainly for start-ups, "blank-check" proposals or companies that are still nursing wounds from the credit crisis, the private credit markets remain closed. But an increasing number of private, nonrated structured transactions are now being placed domestically in the United States. Such transactions have become the new bread and butter of middle market investment banks and credit investors. These transactions are taking various forms: nonrated, private securitizations of modest-sized mortgage pools; lease and other asset-backed fundings recourse only to the asset pool; subordinated or mezzanine lending to provide first loss protection to senior lenders into various specialty finance companies; and other story credits that have a robust track record and management.

Major U.S. investment banks have recognized the demand for private middle market lending and are taking advantage of the fact that the Volcker Rule has exemptions for lending and small business development[4]. Goldman Sachs group raised up to $600 million to provide loans to midsized companies, the first fund of its kind for Goldman Sachs. The new fund is a Business Development Company (BDC), an investment vehicle that is specifically exempt from the Volcker Rule that limits certain proprietary investment practices by Wall Street investment banks. According to fund documents, it is intended to provide loans to "underserved middle market public and private companies" that commercial banks have largely refrained from lending to since the financial crisis began. The fund enables Goldman Sachs to remain involved in the credit business despite new constraints on trading credit products that are expected once the Volcker Rule takes effect. Other investors are making similar moves, particularly to fill the gap in the 8 percent to 13 percent yield space in the private, middle market including KKR and Carlyle.

[4] Goldstein and Flitter, 2013.

Case study of middle market lending: specialty finance

Recent examples of viable private, middle market, nonbank lending might include funding a specialty finance company in its leasing operations. The credit market provides funding to the lessor (often a small specialty finance company) backed by an assignment of lease rentals and a UCC filing over the equipment. The funding is solely against the leased assets and nonrecourse to the lessor, who might not itself be creditworthy. The leased assets might be a pool of assets or a single lease to a particular lessee (even a rated credit).

This type of asset-backed, private funding allows medium-sized blocks of equipment to find financing outside of the public market. For investors, they are typically getting a 200–300 bps pick-up over, say, BB equivalent bonds—a pick-up earned in exchange for illiquidity and structural complexity. In fact, the investor is usually more than compensated in these types of structures: they are rapidly amortizing and, certainly in the case of FASB 13 operating leased assets, they are protected (if upheld) in a bankruptcy filing.

Cost of capital in the middle market

Yields in the public bond markets continue to be very low, reflecting today's low interest rate environment. Critically, even in the high yield markets (which tend to act as the most useful benchmark for private, unrated transactions), BB 10 year paper was yielding only 7.1 percent (end August 2013) compared to 6.56 percent at the beginning of 2012, which is itself a low rate for this credit level historically. That said, long term U.S. Government Treasury yields have started to creep up. In time, middle market credit pricing will most likely adjust upward since the need for capital creates a modest inelasticity in interest-rate-sensitive financings (exacerbated when commercial banks are lending only to outliers in this niche).

The private, middle market shadow banking sector is priced off the public bond markets, but has its own distinct set of characteristics that drive rates in each transaction. A nonrated entity or asset pool must initially be compared against an analogous rated company or at least against a general rating class. This gives a base pricing, which is then augmented by incremental yield reflecting illiquidity, structural complexity and demand levels.

In practice, pricing in the private banking market tends to fall into three buckets (with the shadow market highlighted in grey) – see below:

Pricing range	Transaction type	Investor type	
2%–7%	Bankable transactions, typically senior debt for established, profitable businesses. Investor may be able to see through (indirectly) to an investment grade rating	"Real" bank market. Commercial banks (community and regional); insurers (for longer tenor transactions)	
8%–13%	**Issuers often with generally good credits or asset pools with limited delinquency; but illiquidity and structural complexity drives up the rate**	**Some banks, but mainly credit hedge funds, BDCs**	**Shadow Market**
14%+	**Speculative, illiquid transactions – story credits**	**Hedge funds, specialist credit funds, private equity**	**Shadow Market**

The biggest gap in available credit in the U.S. market is in the 8 percent to 13 percent type range. These transactions, which often have a fundamentally sound profile and are collateralized, generally have excessive yields for banks (which are typically looking for floating rate yields with a 7 percent maximum). On the other hand, these transactions tend to provide insufficient risk/reward for the more aggressive hedge funds. The transactions may be to good quality rated credits, but where the rating is just below investment grade, or the borrowing entity is not formally guaranteed by the rated parent or there is illiquidity and structural complexity that drives up the yield. Increasingly, private funding solutions are being found via BDCs and other credit funds.

Conclusion

So, here again the private SBS is (slowly) filling the funding gap between lender and borrower needs at this particular yield and risk range. These are exciting and positive developments for the U.S. capital markets generally and for the prospects for U.S. SMEs. It is these, small, private, well-structured financings (away from the exotic CDOs or "too big to fail" nonbanks) that may be the real heart of the recovery in the US financial system.

About the authors

Jeremy M. Josse is managing director and head of the Financial Institutions Group (FIG) KPMG Corporate Finance LLC. He was the former cohead of FIG for Capital Markets, Pierpont Securities, a specialist credit trading firm in New York, and previously cohead of U.S. FIG Rothschild Inc, a senior member of Rothschild's European FIG group, and a board director of N. M. Rothschild (Corporate Finance) Ltd. in London. He was also a member of the U.K. advisory board to the Israeli government committee on the development of the Israeli financial services and banking sector. He has an MA degree in political/economic theory from London University and a BA degree in philosophy, politics and economics from Oxford University. He is also a qualified U.K. banking attorney.

Dr. Craig A. Zabala is founder, chairman of the board of directors, president and chief executive officer of the Concorde Group, Inc., a private merchant bank, and founder, chairman of the board of directors, president and chief executive officer of Blackhawk Capital Group BDC, Inc., a public investment company under the Investments Company Act of 1940, which is a business development company involved in debt and equity investments in the U.S. middle market firms. Dr. Zabala has previously worked at General Motors Corporation. He was an economist at the U.S. Department of Labor and U.S. Department of Commerce in Washington, D.C., has held teaching positions at Rensselaer Polytechnic Institute, University of California, Berkeley, and City University of New York, as well as being a visiting fellow at the University of Warwick in the United Kingdom. Dr. Zabala holds an AB, MA, and PhD degrees from UCLA and is a postdoctoral scholar at UCLA.

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