What does bank retrenchment mean for private credit investors?

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Executive summary

- After the 2008 global financial crisis (GFC), more stringent regulations led to banks cutting lending. Our research indicates that banks have remained the principal providers of debt financing, although over the last ten years alternative lenders have made meaningful advances, particularly in infrastructure.

- 2023 saw a return of bank retrenchment following sharp monetary tightening and the banking crisis in the US. In our view, macroeconomic uncertainty is likely to prolong this situation for some time, meaning private credit could grow significantly as a proportion of the broader capital markets.

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Is bank retrenchment a myth?

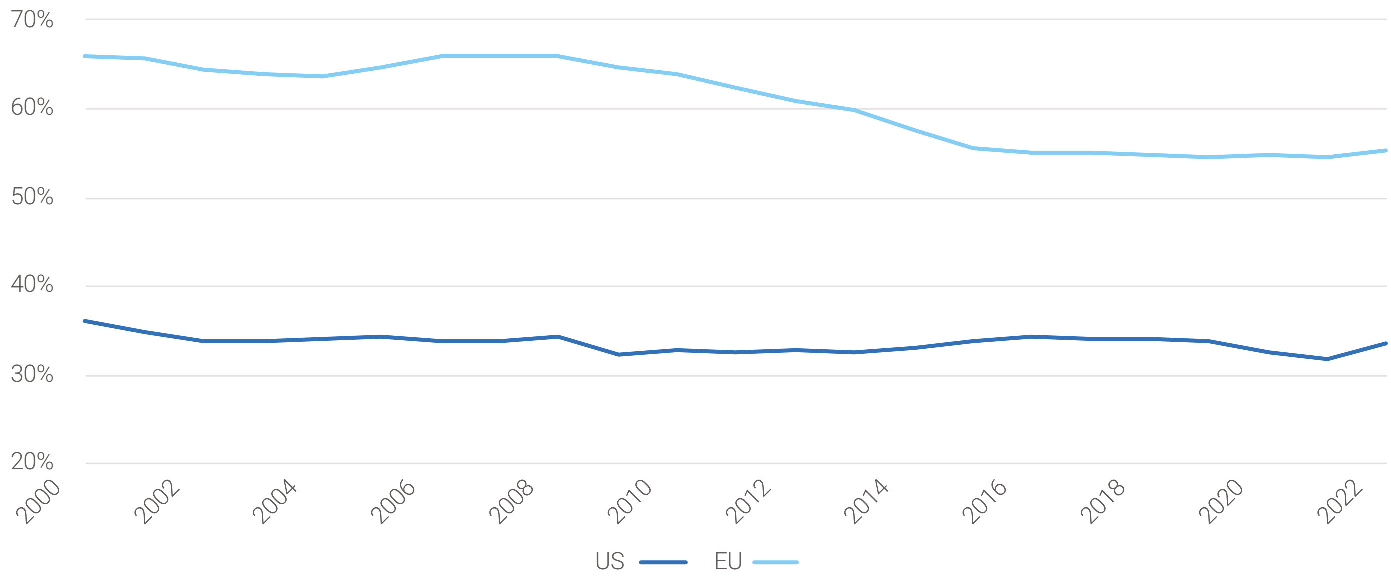
The GFC led to the introduction of Basel III, a set of financial reforms aiming to improve banks' abilities to absorb shocks and increase their resilience against potential future crises. The conventional narrative is that the resulting increase in capital requirements led to banks lending much less than before, creating an opportunity for a growing range of non-bank lenders to fill the gap.

Several academic studies have concluded that although capital requirements do play a role, loan growth is closely linked to macroeconomic conditions.[1] During the period in the immediate aftermath of the GFC when banks were adjusting their balance sheets, their contribution to overall credit provision reduced.

This was far more acute in Europe, where banks' share of the total credit provided to the non-financial sector fell from 65% in 2009 to 55% in 2015, corresponding to a funding gap of around $2 trillion.[2] The reduction was less in the US, which has always been a more disintermediated market.

As the global economy recovered, the supply of bank credit rebounded, supported by ultra-loose monetary policies and stronger demand. However, banks' share of overall credit provision has still not returned to its pre-GFC level.

Bank credit to the private non-financial sector as % of total credit



Source: BIS as at October 2023

1. Source: BIS, Bank of England, ECB
2. Source: BIS

Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

Although banks reverted to growing their loan books, they generally adopted more conservative lending policies and narrowed their focus to core sectors and key clients, preferring those using multiple banking services. Some retreated from overseas markets. Still scarred by the losses they incurred in the GFC, banks have in general become sensitive to market shocks and this caution can lead them to rapidly cut lending in response, as we saw following the SVB bankruptcy.

Strong growth in infrastructure lending

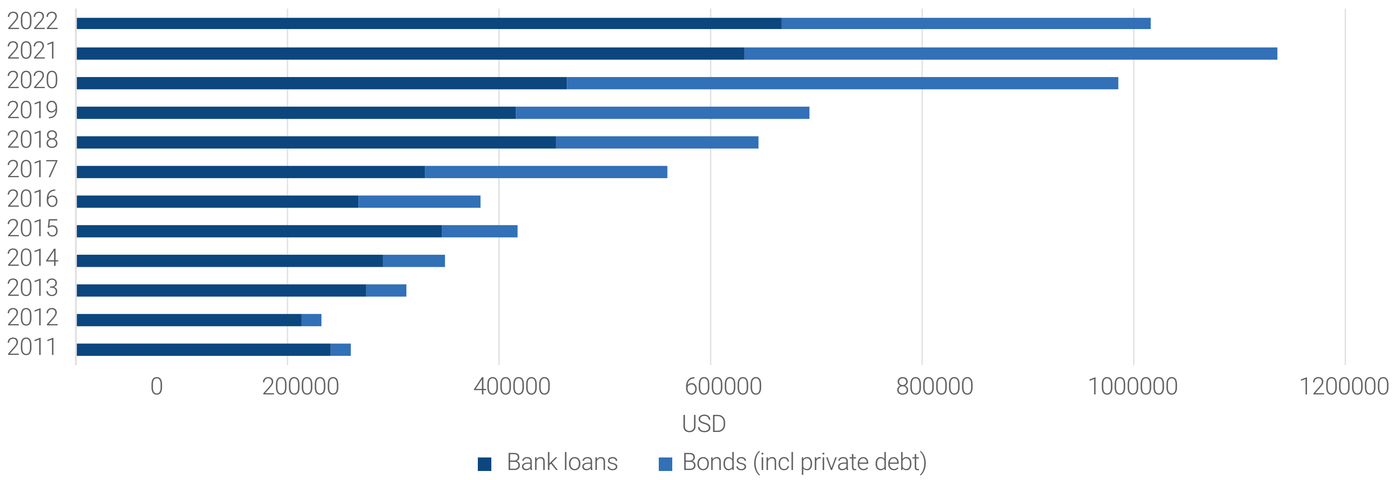
Demand for infrastructure financing has intensified over the last fifteen years, with sponsors replacing equity with debt to lower their cost of capital. Banks and non-bank lenders alike have significantly grown their infrastructure loan volumes, drawn by the assets' stable incomes, strong sponsors, and well-rated jurisdictions.

Loan growth has been particularly strong in renewables and energy transition; banks and other investors have their own sustainability targets and are keen to add 'greener' assets to their books, including sustainability-linked financing. These two sources of capital can be complementary – banks generally prefer shorter maturities and floating rates, while non-bank lenders such as pension funds and insurers tend to favour very long maturities and fixed rates. Their willingness to lend can also fluctuate. Banks are more cyclical, and non-bank lenders' risk appetites tend to be more stable.

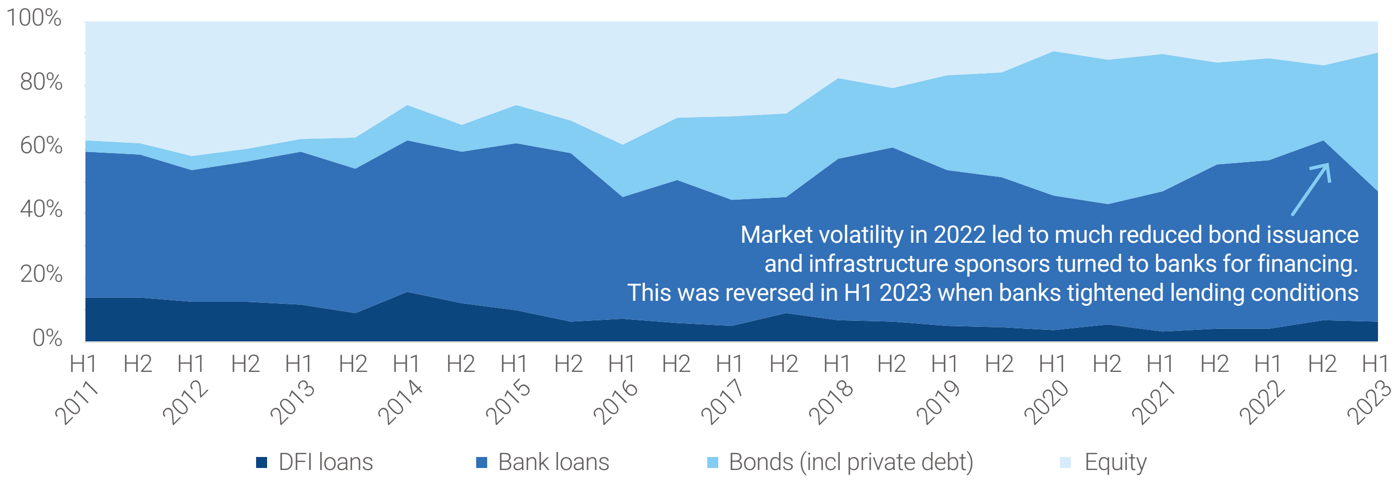
Bloomberg New Energy Finance has estimated that annual investment needs to reach $4.6 trillion per annum by 2030 and $6.9 trillion per annum by 2040 to remain on track to net zero by 2050, versus $1.4 trillion spent in 2022.[3]

A variety of sources of capital will be necessary to plug this enormous funding gap. We expect banks to continue playing a major role, but non-bank lenders such as debt funds and insurance companies are likely to maintain strong growth, driven by institutional investors' desires to increase their allocations to infrastructure.

Strong growth in infrastructure lending volume



Non-bank lenders catching up in market share



Both charts, Source: IJGlobal as at October 2023

3. Source: "Energy Transition Investment Trends", Bloomberg New Energy Finance, January 2023

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Banks still dominate CRE lending – but their share is falling

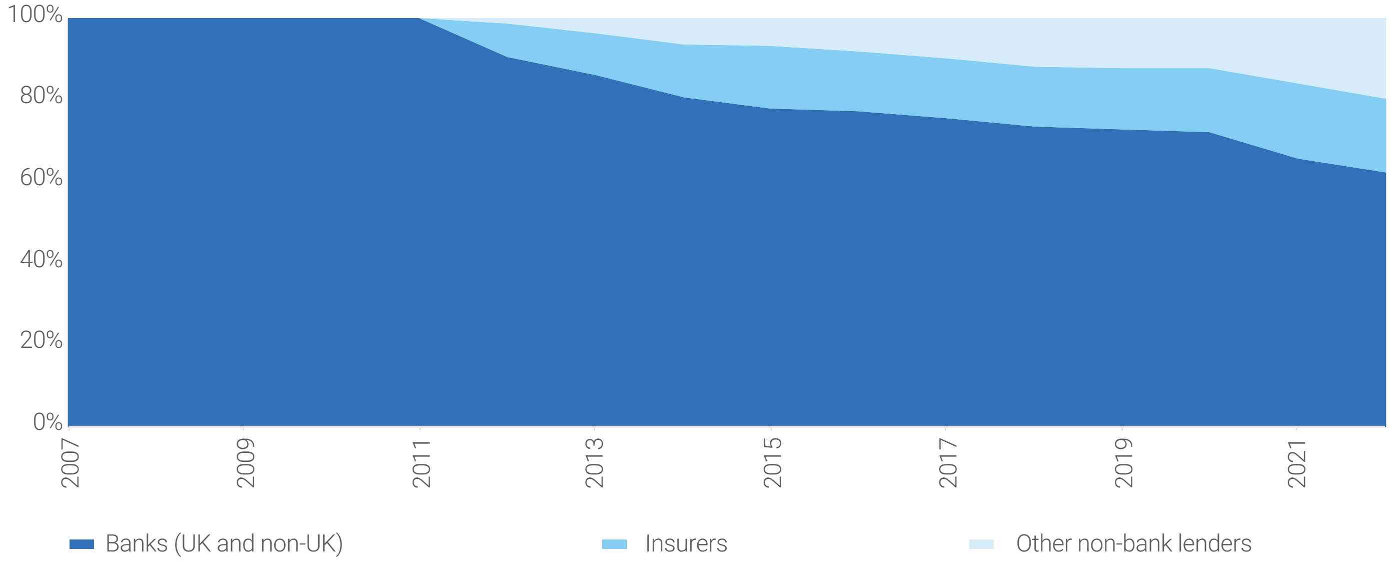
Bank retrenchment has been particularly evident in commercial real estate (CRE) lending, since overleverage in the real estate market is considered by many to have played a direct role in laying the groundwork for the GFC.

Banks have since retreated from riskier transactions such as mezzanine debt and reduced the loan-to-value ratios at which they are willing to provide senior loans from around 80% pre-GFC to 60% now. As a result, debt funds, insurers and other lenders have increased their market share. Nevertheless, banks remain the dominant source of capital.

In addition, CRE loans are generally shorter-maturity (typically five years) and floating rate. CRE borrowers also generally prefer to have prepayment flexibility. These features are not appealing to investors with long-term liability matching needs.

The US CRE lending market is uniquely diversified. Agencies, government-sponsored enterprises (e.g. Freddie Mac* and Fannie Mae*) and the securitised market all play significant roles. Commercial mortgage-backed securities (CMBS) are much more prevalent in the US than Europe –usage is about 17%, compared to only 6% across the Atlantic.[4] We can attribute this to the fragmented nature of the European market, with the multiple jurisdictions and currencies making it hard for CMBS issuers to construct sizeable portfolios of loans with similar characteristics.

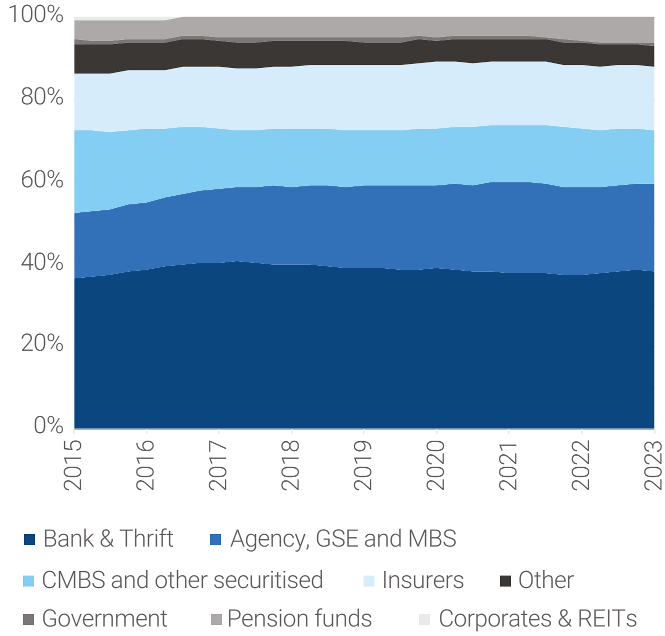
The UK CRE market has evolved from 100% 'banked' in 2009 to 60% today



Source: Bayes Business School as at October 2023

Why is penetration by non-bank lenders lower in the CRE lending market compared to infrastructure? CRE transaction range from less than $5m to more than $1bn, and there is enormous variation in transaction size, complexity, and legal requirements. The scale of banks' portfolios, geographical networks and operational infrastructures enable them to cater to both SMEs and large corporates and diversify the risk of default. Infrastructure projects, although complex, have more standardised funding structures.

The US is more diversified



Source: Mortgage Bankers Association as at October 2023

4. Source: S&P as at October 2023

Key risk: The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the originally invested.

*For illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Retrenchment is back

2023 marked the return of bank retrenchment, led by the US. If we exclude the pandemic, lending conditions are now at their tightest since the GFC.

The Q3 2023 loan officer survey in the US and Europe indicated that banks intend to continue tightening lending standards for the rest of the year, citing the uncertain economic picture and an expected deterioration in collateral value as key reasons. We share the sentiment that banks are likely to keep lending conditions tight until there is greater clarity in the directions of monetary policy and economic growth, and in our view this period of retrenchment could continue for some time. The ultra-low-rate environment after the GFC propelled banks back to increasing lending in the 2010s. We believe this is unlikely to be repeated.

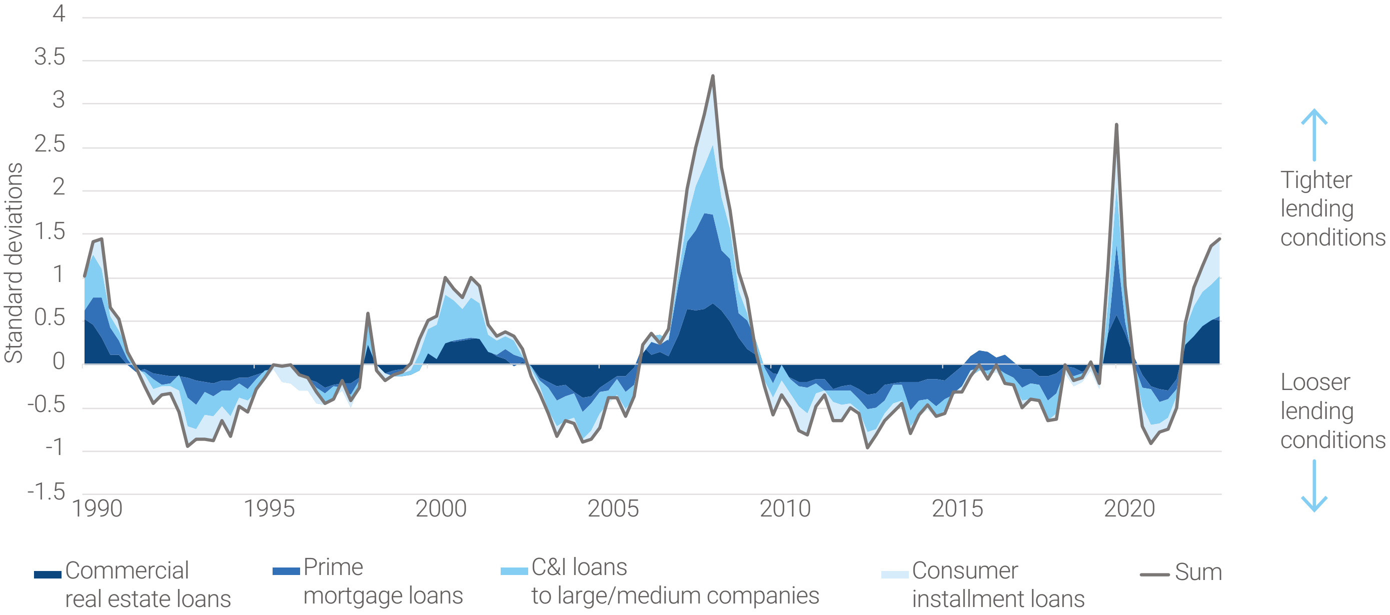
Opportunity for private credit

Banks' willingness to lend is a combination of cyclical risk appetite driven by macroeconomic conditions and corporate strategic direction, which can be influenced by regulatory changes.

Non-bank lenders such as debt funds and insurers can be a more stable sources of capital and take a longer-term views, although they are also subject to financial regulation. It is difficult to predict if the current period of bank retrenchment is just a temporary reduction in risk appetites or if it will lead to further structural retreat from certain areas of credit provision.

What is clear is that there is a window for private credit to take advantage of the reduced competition, although in the current environment it is important that private credit managers remain disciplined and maintain the robustness of their underwriting. From a yield perspective, private credit lenders are currently well rewarded for filling the funding gap. The size of the potential opportunity set is huge – banks account for c. $25 trillion of credit to non-financial sectors in EU and US[5] – so even a small slice of the lending pie can present a big opportunity.

US Senior Loan Officer Opinion Survey, July 2023



Source: Federal Reserve as at 27 September 2023

5. Source: BIS as at October 2023

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Key risks

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