On The Growth of Non-Bank Lending

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HARVARD | BUSINESS | SCHOOL

Agenda

1. Topology of the non-bank lenders
2. Drivers of their growth
3. Should we worry about it and why
4. Lessons from 2020

1. Non-bank lenders:

- The non-bank credit market is clearly segmented
- Is it helpful to think of these lenders as one big group: “non-banks”?
- Let’s organize our thoughts:

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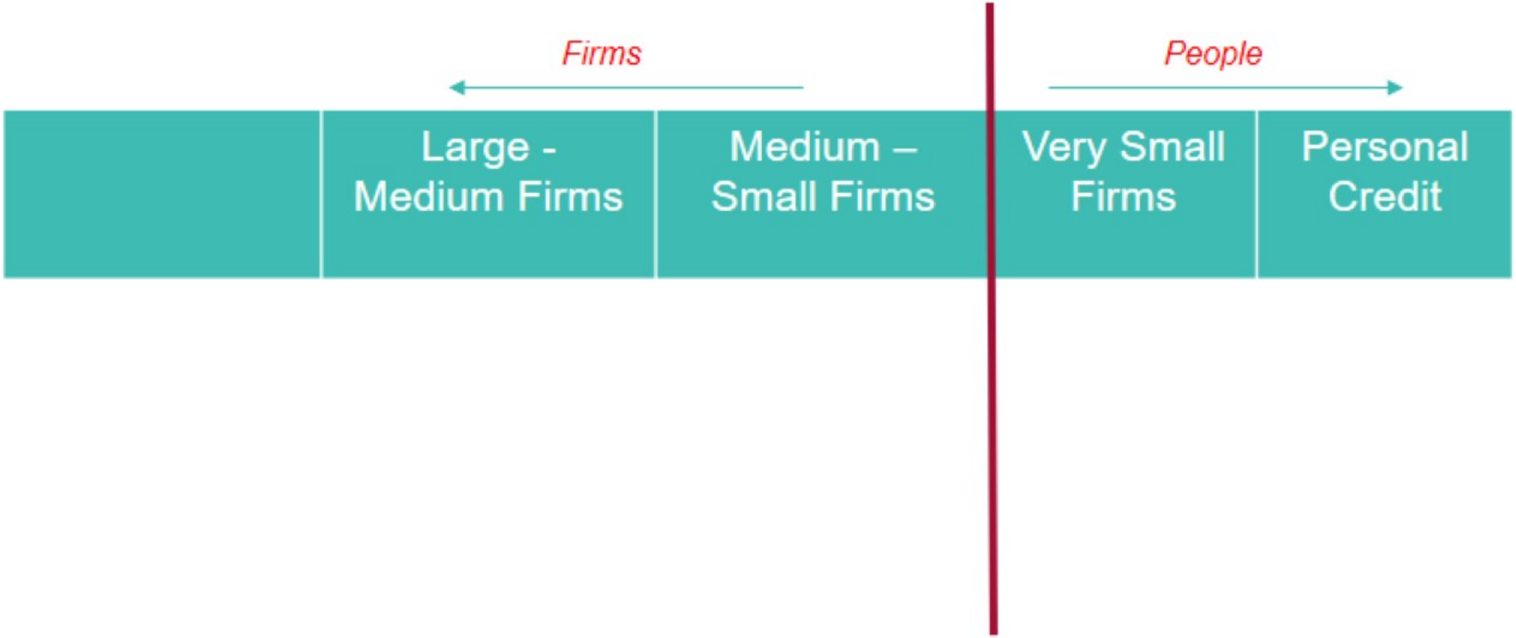

1. Non-bank lenders:

- The non-bank credit market is clearly segmented
- Is it helpful to think of these lenders as one big group: “non-banks”?

Firms ← | → *People*

	Large - Medium Firms	Medium – Small Firms	Very Small Firms	Personal Credit
Asset-based				
Secured				
Unsecured				

Significantly different risk

1. Non-bank lenders:

- Alternative/non-banks credit segments that have experienced significant growth post 2008:

	Firms		*People*	
	Large - Medium Firms	Medium – Small Firms	Very Small Firms	Personal Credit
Asset-based				FinTech
Secured	Leveraged Loan Market	Private Debt	FinTech	FinTech
Unsecured	High-Yield Bonds	Private Debt		FinTech

2. Drivers of the growth:

- What is the role of regulation? Unclear; there are at least two other major forces at play

Regulation

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Low interest rate environment

Data and analytics revolution

Non-bank lenders in the corporate space:

This is what "private debt" is

<u>Directly originated debt</u>

Traditional fund structure:
(think PE-like structure & investors)

Direct lending
Mezzanine lending
Special situation/Rescue financing
Distress
etc.

"BDC"
Business Development Companies
(think REIT-like structure & investors)

<u>Bank originated non-bank debt</u>

"CLO"
Collateralized Loan Obligations
(securitized structure/ABS)

Loan Mutual Funds

- I.e., each of these broader segments has layers that have different mechanism at play, a point that is relevant to understand when thinking about financial fragility

3. What are the implications for financial fragility?

This paper highlights:

1. Funding Fragility:
    - Is the funding structure short-term or runnable?
2. Amplification mechanism:
    - Interconnection with banks (i.e., connection to potentially fragile institutions)
    - Dealer’s balance sheet constraints

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This paper highlights:

1. Funding Fragility:
   - Is the funding structure short-term or runnable?
2. Amplification mechanism:
   - Interconnection with banks (i.e., connection to potentially fragile institutions)
   - Dealer's balance sheet constraints
   - Borrower's defaults—we are dealing with much higher leverage (e.g., Greenwood, Iverson and Thesmar, 2020; Group of Thirty, 2020; Ellias, Iverson and Roe (2021), Braeuning, Ivashina, Ozdagli, 2021)
     - How non-bank lenders behave beyond their liability structure (and firesale effect) -- are they "patient"? do they mark to market? can they renegotiate? are they in a position to deal with distress?– becomes crucial for understanding amplification

3. What are the implications for financial fragility?

- Separately, one has to look within broad market segments outlined earlier to understand fragility pressures

Directly originated debt

Don't freeze, don't run

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Loan Mutual Funds

Runable → firesales

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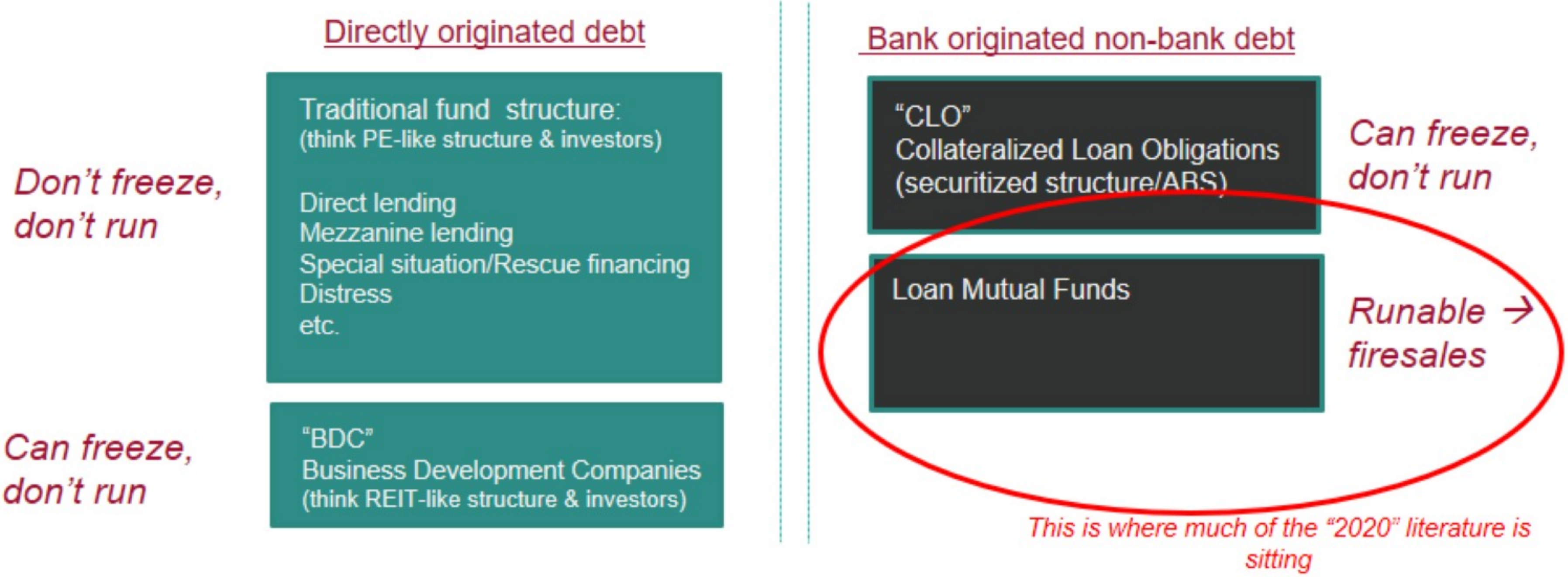

- Current emphasis (here and in the literature) is on the March 2020 run, i.e., on the liability structure

3. What are the implications for financial fragility?

3. Balance sheet constraints of non-bank structures (e.g., Harmon and Ivashina, 2020; Kundu, 2020)

- At least CLOs can precipitate financial distress

3. What are the implications for financial fragility?

- Can this come back to the balance sheet of the banks in a benign way? – I just don't see how; this is not something a bank has "edge" in (on a significant scale) however you look at it, and there are many examples from 2008

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Low interest rate environment ***Data and analytics revolution***

3. What are the implications for financial fragility?

- Can it come into to the balance sheet of the banks in a hidden way? – With the information that we have, it is hard to rule out; more research on the backstop leverage provided by banks for securitization (for example) would be helpful

- Relatedly, revolving lines can be another mechanism for indirect, hidden source of bank exposure (and 2020 gave us an insight on it)

- Who holds the risk is not fully clear either, for example, it appears that foreign global banks might be holding a significant fraction of top-rated CLO tranches

4. 2020 Lessons (Missed?)

- Coming back to amplification mechanism: Borrower's defaults—we are dealing with much higher leverage (e.g., Greenwood, Iverson and Thesmar, 2020; Group of Thirty, 2020; Ellias, Iverson and Roe (2021), Braeuning, Ivashina, Ozdagli, 2021)
- And credit market (and, relatedly, public market) frothiness has escalated farther since 2020

Open topics:

- As I already pointed out, micro studies of the non-bank lenders and structured way of thinking about non-bank lending growth is key
- To what degree did 2020 intervention inject moral hazard into already unhinged debt market?