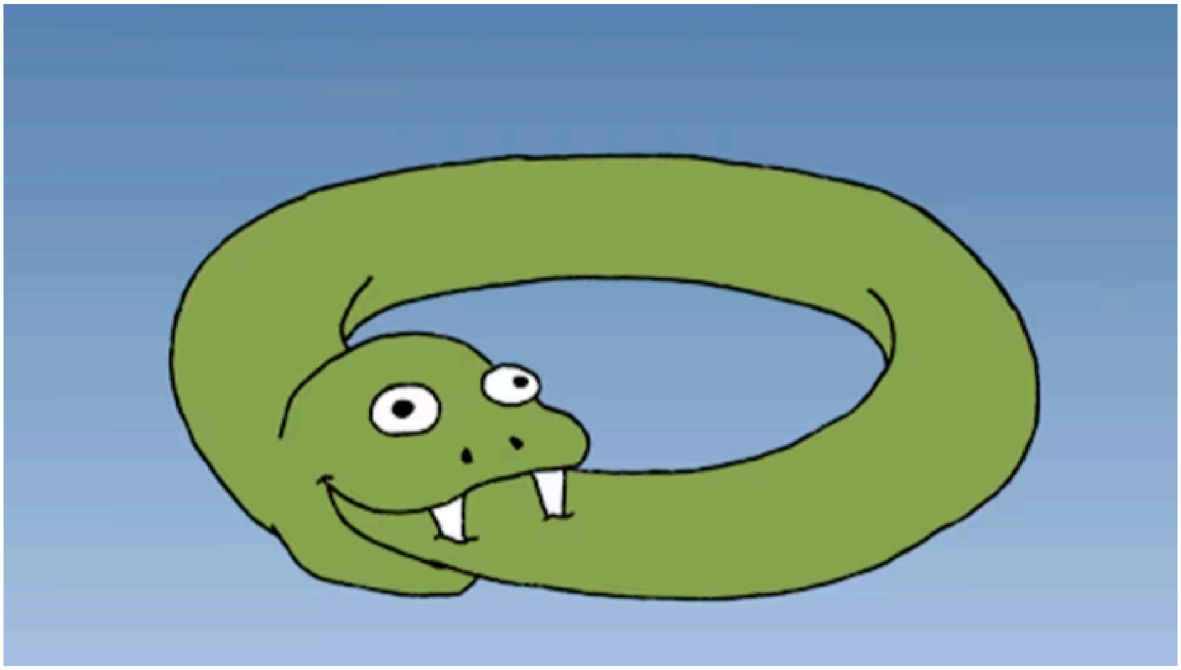
FT Alphaville US banks

The $1tn shadow bank lending boom

‘This is a sensitive trade-off that has not always been well managed in the banking industry’



The American credit system, ca 2025 © Tenor

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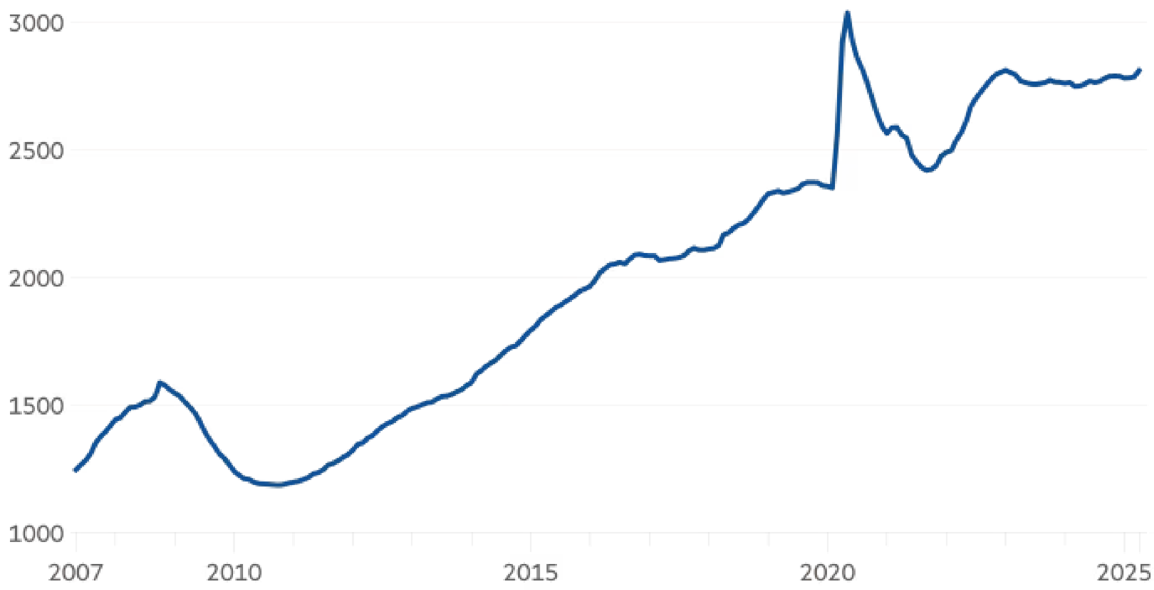
US banks are lending less and less to companies these days. But the business of lending to so-called shadow banks — such as private credit funds, insurers, asset managers and credit hedge funds — is booming.

On the face of it, bank lending to “commercial and industrial” companies (C&I loans) has merely stagnated in recent years, at about $2.8tn at the end of March.

Corporate lending has flatlined in recent years

Commercial and industrial loans by US commercial banks ($bn)



Source: FRED

However, as a percentage of bank assets and relative to the size of the US economy, C&I loans have now been shrinking for half a decade.

That's not because US companies have suddenly discovered the virtues of resilient balance sheets and begun to borrow less. No, it's because banks have begun to lend *indirectly* to many of the same companies by instead making loans to "non-bank financial institutions".

NBFIs is currently preferred if obtuse term for what we used to call shadow banks — a huge and rapidly growing universe of funds, investment firms and financial companies of various shapes and sizes that raise money from other investors and then make loans with them.

According to a new report published by Barclays' macro, credit and bank research analysts, US bank lending to these NBFIs has quintupled over the past decade to well over $1tn, and now accounts for more than 10 per cent of **all** US banking loans (and nearly 5 per cent of all assets)

> In other words, as banks are making fewer direct loans to customers, their indirect lending via NBFIs has grown. Banks are now increasingly "lending to lenders," as they replace C&I loans with NBFI loans. This is indirect lending because the funds provided to NBFIs ultimately flow to the same underlying borrowers (in the aggregate).

This is not a shocking revelation, even if the numbers are eye-popping. The ascendance of NBFIs is one of the most widely talked about subjects in finance, and has been for several years. And although they are often rivals, the fact that conventional banks are deeply enmeshed in the shadow banking ecosystem is well-known.

However, as the Barclays analysts note, it is becoming an ever bigger and broader trend, with no slowdown in sight. The larger US banks have generally been more active in lending to NBFIs, but mid-sized and smaller ones are now also entering the field.

Banks are increasingly lending to NBFIs... © Barclays

...and smaller banks are becoming more active © Barclays

Why are banks suddenly so keen to finance what on the face of it would seem to be competitors? After all, becoming fully or partly cut off from corporate clients could hit a lot of other business areas. As Barclays points out: “Banks sell myriad financial products to their clients; often, a loan is the start of a relationship that can include many other fee-generating services.”

It’s pretty simple really. To paraphrase Method Man, regulations rule everything around us. Or, if you prefer, here is Barclays’ version of the same, with Alphaville’s emphasis in bold:

> Banks are required to risk-weight their assets when calculating their capital requirements. **In the US, risk weights are highly standardized, with most commercial exposures attracting 100% treatment. However, NBFI loans are eligible for much lower risk weights, as low as 20%.** The lower RWA density of NBFI lending reflects a number of factors, including high collateral requirements (ie, low LTVs) and in some cases covenant protections. Many NBFI loans are structured, allowing banks to take senior exposure to a relatively diversified pool of assets. This lending format is similar to the standard in the investment grade securitized credit market. Collateralizing obligations in this fashion ensures that loans to NBFIs have a defined amount of equity beneath them to absorb loss. This generally results in NBFI loans having relatively low loan-to-values (LTVs). These creditor protections support lower risk-weighting of NBFI loans, which makes them less capital-intensive assets in the calculation of regulatory capital ratios (ie, CET1/RWA).

The corporate lending shift from banks to shadow banks might even be understated by the public data, as "synthetic risk transfers" — when a bank buys protection against credit losses from investment funds — are not included in the NBFI lending disclosures, even though they are functionally the same, Barclays notes.

> The increase in these SRTs demonstrates the importance of the capital relief angle for banks. If the NBFI trend was being driven solely by increased competition among lenders, then banks would not be simultaneously executing synthetic versions of the same transaction. It also implies that the trend toward lending to lenders is larger than indicated using the official loan data, because the total volume of SRTs is large and growing globally.

So is Barclays as worried about this as the IMF, FSB, ECB, BoE, Fed, the pre-Trump FSOC and SEC etc etc all are? Kinda, yes!

Jeffrey Meli, Bradley Rogoff and Peter Troisi stress that while there are parallels with the pre-2008 era mortgage boom — when banks gleefully gamed capital rules and ended up ruing it, badly — there are also important differences.

First of all, the underlying corporate loans have historically had much higher recovery values than mortgages. Secondly, the NBFI really does have genuine skin in the game, which shields the bank from losses. Thirdly, capital requirements are higher across the board, so banks have a far bigger cushion to absorb blows than they did in 2007-08.

"That said, there are important concerns to consider as this trend grows," Barclays dourly notes. Alphaville's emphasis below:

> The probability of a correlated and severe shock to borrowers is not a fixed number. It reflects the structure of the economy, including — maybe the most important of all factors — the amount of leverage in the system. **More overall leverage means that less severe shocks can cause greater losses. As NBFI lending grows, so too does leverage.** As stated above, banks are precluded from certain types of leverage; NBFIs are growing in part because they face no such constraints (and the banks are providing additional leverage through the NBFI loans themselves). There is also greater use of off-balance sheet leverage, particularly among investment grade companies.
>
> **Put differently, while the current systemic risks of NBFI lending may be small, they will grow with the size of that lending. Increased use of the leverage provided by NBFIs could eventually increase the probability of a severe shock that causes correlated losses (and corresponding low recovery rates), and thus affects banks, to a point where the capital is no longer sufficient. The capital charge may be adequate now, given the historical experience, but at some point the historical reference points are less useful.** An analogy is that, prior to 2007, mortgage defaults had never caused a vicious cycle of declining home prices, leading banks, regulators, and investors to heavily discount the probability of such an event. But the leverage in the housing system in 2007 exceeded all historical experience and rendered that history irrelevant.

Yup.

Further reading:

— The increasingly blurred lines between banks and NBFIs (FTAV)

— The hedge fund-bank nexus (FTAV)

— Is private credit a systemic risk? (FTAV)

— US banks ❤️ private capital (FTAV)

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