# Bank Mini-Crisis Creates Opportunities for Non-Bank Lenders to Grab Market Share

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The history of the Banking Industry has proven that when banks see other banks failing, their boards, management, and stakeholders all ask the same question – could our bank have similar issues? This questioning forces banks to take the time to evaluate their investments, loan portfolios, and capital adequacy ratios to ensure whatever problems other banks may be facing do not extend to their own balance sheets. Furthermore, when the government intervenes to rescue depository institutions, this results in the FDIC, OCC, Treasury and Congress evaluating new bank regulations to minimize further failures and limit exposure to taxpayers. As a result, banks embrace a risk-off mentality, slow down decisions, and tighten lending. When banks begin to tighten, this presents non-bank institutions with the opportunity to capture market share by financing the commercial borrowers who fall outside these banks new risk-off lending guidelines.

Silicon Valley Bank's collapse was the canary in the coal mine, but as we quickly learned last week, it is not where the problems stopped. Unfortunately, even after Signature Bank failed, and both First Republic and CSFB required additional capital and new ownership, it still isn't clear how many banks will have similar capital deficiencies and how far the potential contagion spreads.

A direct effect of these incidents is potential tightening of lending standards and capital standards for banks which could lead to a significant credit crunch in the market. BlackRock's Chief Executive Larry Fink predicts that "It does seem inevitable that some banks will now need to pull back on lending to shore up their balance sheets, and we're likely to see stricter capital standards for banks." Additionally, Jim Caron, head of macro strategy for global fixed income at Morgan Stanley Investment Management agrees, "We're going to see tighter lending standards, whether it's in the US for small- and mid-sized banks. Even the larger banks are going to tighten lending standards more."

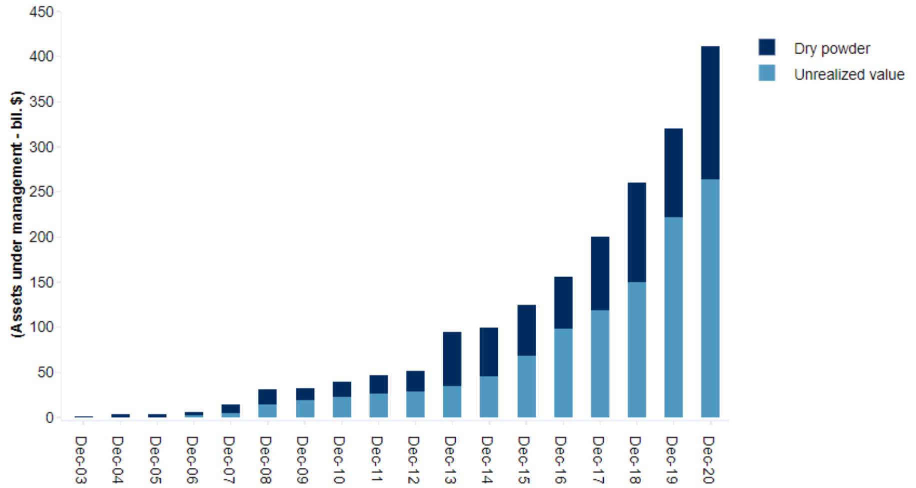
We agree with these experts and anticipate that banks will need the next six to twelve months to both evaluate their balance sheets and take the necessary steps to raise capital ratios and meet potentially new capital guidelines. Thereafter, banks will tread carefully before loosening their investment and lending criteria to previous levels. Such a backdrop will create the environment for non-bank lenders to further accelerate their market share gains that grew after the 2008-2009 Great Financial Crisis. This is because such lenders are not subject to the same capital adequacy requirements as deposit-taking institutions and can be more agile than traditional banks, allowing them to respond quickly to changing market conditions.

In the US, funds primarily involved in Private Debt, specifically Direct Lending, grew AUM ~4x in the decade following the 2008-09 financial crisis. By 2020, AUM of such funds surged to $412bn, and it included nearly $150bn in dry powder to buy additional private debt assets[1]. Total Private Debt AUM swelled to more than $850bn by 2019[2], owing to a declining presence of banks in middle market lending – a trend which began in the 1980s, but was accelerated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010, which introduced

[1] S&P, Preqin
[2] Preqin

enhanced rules and regulatory requirements that intensified underwriting standards and mandated that banks hold additional capital against assets.

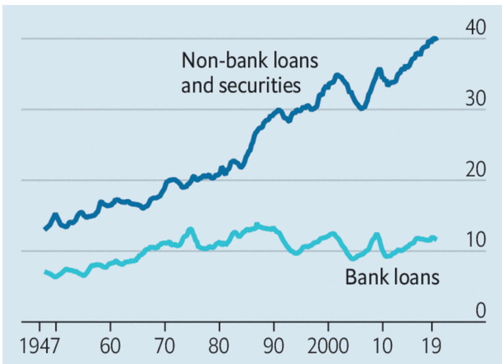
**AUM of Funds Primarily Involved in Private Debt (Direct Lending)**




*Source: S&P, Preqin*

A direct result of all this capital deployed into private credit was significant growth in business loans in the US by non-banks: from ~20% of GDP in 1980 to ~40% by 2019[3]. While there were short-term gains for banks for a brief period between 2007-2008, the Great Financial Crisis accelerated this lending transition to non-bank lenders. As US GDP grew over time, businesses continued to look at non-banks for financing, which is a trend we do not expect to reverse but only to continue.

**US Non-Financial Business Debt (% of GDP)**




*Source: The Economist*

We anticipate this mini-crisis will be yet another catalyst for non-bank lenders to accelerate stealing market share from banks, and non-banks need to prepare themselves to do so. A survey by Cerebro Capital at the end of 2020 suggests that more 60% non-bank lenders view a

[3] The Economist

weakening economy as an opportunity to grow their loan books, as their competitors are disadvantaged.

The recent collapse of several US Banks, combined with the possibility of stricter banking regulations will slow down lending to many businesses that rely on banks for liquidity. However, this creates an opportunity for non-bank lenders, that are more flexible and don't have the same capital restrictions as banks, to further capture market share. To do so, requires these non-bank lenders to tailor customer acquisition, underwriting, and the financing solutions they offer these once "bankable" businesses. Furthermore, they must enhance their collections capacity to address the higher volume of loans and to service these higher quality borrowers.

Lastly, to grow their portfolios and capture market share, these non-bank lenders must shore up their balance sheet capacity to ensure their own capital providers are not at risk of tightening. This means looking beyond banks to provide the lending capacity but instead, targeting insurance companies, credit funds, and other investors that do not have the same regulatory constraints as depository institutions.

Banks are likely to cede an important part of their current franchise to non-bank lenders. These lenders have been building capabilities for the last 25 years and now represent very strong entities that are well positioned to pick up these volumes. This shift from banks to non-bank lenders may tip the balance of power even more to the non-banks. What is becoming increasingly clear is that as this mini-banking crisis continues to unfold, non-bank lenders will have an opportunity to take share and lend to more "bankable" clients while banks take the time to convince their stakeholders that they are not at risk of becoming the next headline.

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