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Värde Views: Private Credit Opportunities in the Wake of Tighter U.S. Banking Regulations

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INTRODUCTION

Brad Bauer (Partner & Co-CIO) and Aneek Mamik (Partner, Global Head of Financial Services & Diversified Private Credit) outline how proposed U.S. banking regulatory requirements may exacerbate the supply and demand imbalance for credit and create opportunities for private credit to fill the void.

Executive Summary

In the wake of U.S. regional bank volatility earlier this year, the sector has come under increasing scrutiny as a potential source of systemic risk and catalyst for an economic downturn.

To curb this sentiment and address the issue, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency recently published a joint proposal aimed at tightening regulation on many banks and bank holding companies, including a new swath of banks of still-substantial size that are currently subject to less stringent capital adequacy requirements than the largest bank institutions.

The proposal, if enacted substantially as proposed, would constitute one of the most significant overhauls of the U.S. banking regulatory system since the one enacted following the Global Financial Crisis (GFC). This would likely result in significant pressure on bank profitability in certain business lines, which could in turn result in a pullback of credit available to many borrowers and sectors.

Private credit firms stand ready to fill this gap, either in place of or in collaboration with traditional bank lenders. These firms could serve as a critical source of lending to provide access where it's needed, as well as become the likely beneficiaries of this supply/demand imbalance in credit.

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2023 in Review

When looking back on 2023, we believe the year will likely be defined by banking turmoil that helped accelerate the largest credit cycle we've seen since the GFC (setting aside an extraordinary 2020). Global banking sector woes, though perhaps just beginning to unfold, in our view will stand at the epicenter of this cycle spurred by unprecedented events already in Europe and the U.S. -- the former marked by hasty changes to Swiss law enabling the state-led takeover of Credit Suisse by UBS, and the latter by an accelerating bank deposit run that resulted in three out of four of the largest bank failures in U.S. history.

The fear of further bank fallout in the wake of these failures seeped quickly into markets, leaving a skittish credit market waiting for the proverbial next shoe to drop. To abate these panicked concerns, we saw swift and extraordinary government intervention in an emergency-like fashion to instill confidence in the stability and resilience of the U.S. banking system.

Proposals for Further Regulatory Change

In the aftermath of the GFC, a set of international banking standards focused on tightening capital requirements for all globally active banks, known as Basel III, was introduced in response to clear regulatory deficiencies in the banking sector. Since these measures were proposed and subsequently approved, the U.S. banking system has been undergoing a near decade-long implementation.

Sentiment around the importance of bank regulation has been revitalized this year and that process is clearly set to extend, and even accelerate, in the wake of U.S. regional bank turmoil.

In July, the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, together released a proposal known as Basel III endgame for a series of rules designed to bring the U.S. banking regulatory regime more closely in-line with international standards.

The goal of this new proposed framework is to ensure banks become better capitalized and more resilient to market shocks by revamping capital requirements and practices around risk modelling. The new standards would apply to any banks and bank holding companies with total assets over $100 billion including those not currently covered by the existing framework that applies to larger U.S. banks.

Under this proposal, covered institutions would no longer be able to use their own internal models, which can often underestimate risk, for most parts of the framework needed to determine regulatory capital requirements. Instead, they would be required to use a standardized, uniform, and transparent framework to be employed by all banking institutions in the covered group.

As a result, required capital levels would be expected to increase by approximately two percentage points, equating, by our estimates, to roughly 20% more capital that banks would need to hold versus current levels, thereby likely impacting significantly the industry's excess capital buffers. For example, and to make a finer point of it, according to Bloomberg Intelligence, the six largest banks in the U.S. currently have an estimated $118+ billion in excess common equity tier 1 capital, which would be virtually eliminated under these new rules. Importantly, while the six largest banks have this buffer (for now), many beyond this group do not have the same luxury.

Given the magnitude of these changes and the time needed for implementation, the proposal would be set to go into effect no earlier than mid-2025, with a three-year phase in period after that for most provisions. If enacted, this overhaul would be one of the most significant reforms to U.S. banking regulations since the GFC.

The Impact of Proposed Regulations

In our view, the adoption of this proposal would have serious implications on the profitability of certain lines of banking business. Impacted banks will likely need to grapple with balancing their volumes of originations against diminished profitability in light of these higher capital requirements. To us, it's not a question whether those banks would reduce lending or seek to increase pricing given higher capital costs but rather how significant would this tightening be and at what speed would it impact the market.

The result, in our view, is certain consequences (both by design and unintended) in a range of markets: these might include lending deserts, i.e., places where banks will leave certain areas of lending entirely barren, especially those that have typically been disproportionately funded by the regional banks. Another consequence may be further failures or significant downsizing of any banks left unviable as standalone institutions in the face of depressed profitability.

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Despite some uncertainty regarding the final form of any new regulation and an undoubtedly lengthy implementation timeline, we are already observing a pervasive anxiety in the market about the future of banking, as well as an inertia taking hold in the provision of capital. We have already seen banks retrenching from providing direct credit to certain borrowers and sectors, reducing capacity, or increasing the cost to end borrowers.

Banks have also been seeking to further raise liquidity by selling assets. This condition of the market has been evident in Q2 and Q3 of this year and marks a trend we expect will continue as banks look to further sell portfolios of assets with higher risk-weights or aggressively sell off non-performing asset portfolios in response to increased provisioning requirements.

Even absent this regulatory backdrop, banks have already been tightening their lending in the face of uncertainty around rate hikes and potential recession. Taken together, a significant pullback in credit availability seems highly likely.

Expanding Opportunities in Private Credit

The trend towards increasing relevance of non-bank capital, and private credit in particular, has already been underway for many years and we believe it will

enjoy a renewed acceleration and greater prominence as the market digests the potential effects of these proposed regulatory changes, and certainly once any such regulatory changes take hold.

While the supply of bank lending appears poised to diminish, demand (and frankly the need) for credit continues unabated, perhaps even growing rapidly driven by the need for financing and refinancing in a higher interest rate environment. This means it will be critical for borrowers previously reliant on bank credit to seek out other avenues of financing.

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These gaps in the supply and demand for credit present an enormous opportunity for non-bank lenders to directly originate into the voids where diminished credit availability is most severe and persistent, either directly in place of traditional bank lenders or in partnership with them. We outline in greater detail below some of the largest opportunities we are seeing today, namely in specialty finance, commercial real estate credit, and fund finance.

Specialty Finance

Heading into this year, the specialty finance markets were already impacted by the tightening credit conditions noted above. Recent events have exacerbated this dynamic amid the pullback of lending from U.S. regional banks, historically a critical source of specialty finance lending into the real economy: individual consumers and small balance commercial businesses.

Add in the pressure of the looming prospect of new regulation, and banks are (quite rationally) pivoting from expansion to retrenchment, responding to uncertainty by shoring up balance sheets and building greater liquidity, often by pulling back from consumer and small business lending and focusing instead on higher quality and greater scale.

This seems a reasonable reaction to the very real impacts tighter regulation would have on banking. Nonetheless, it also constrains credit provision to the real economy which in Värde's view creates a gap that private credit will willingly fill. As this paper discusses, these events appear to be a tailwind, hastening a shift towards non-bank lending that has already been underway.

In our view, there is great opportunity in bringing these loans and loan portfolios into the private credit markets to fill the gap vacated by bank retrenchment. Non-deposit taking lenders, without the benefit of customer deposits, are now motivated to raise capital in private markets, as a means to finance their origination activities. Having traditionally sourced capital from banks in the form of warehouse facilities or capital markets through securitizations, they are increasingly finding strong partners in private credit firms.

This alternate and stable source of funding enables the origination engine to continue, providing valuable credit to the real economy, and preserving long-term enterprise value for the stakeholders. We see strong opportunities to participate in this shift manifesting in many forms, including lending to these platforms directly with multiple sources of collateral, as well as private securitizations that provide security and downside protection directly from the financial assets.

We also continue to find opportunities to participate in the forced sale of loan portfolios from both bank and non-depository lenders. These groups are often motivated sellers looking to free up capital, generate liquidity, and/or continue origination activities. In many cases, firms with asset-specific expertise and deep experience evaluating granular diversified portfolios such as Värde are well-positioned to identify and purchase high-quality assets at attractive discounts that are expected to perform well across a wide range of economic and market scenarios.

Commercial Real Estate Credit

Commercial real estate (CRE) lending is another area we see as offering tremendous opportunity for private credit amid accelerated bank retrenchment. CRE credit represents a $4.5 trillion market in the U.S. and is facing major headwinds as a result of rising rates, declining valuations, and challenging fundamentals. It is also one of the sectors most acutely affected by today's credit cycle given its dependency on financing markets, massive scale, and holdings in many corners across markets.

Banks represent the largest lender group to the CRE market today, holding nearly 40% of total outstanding CRE debt. Of that total, 80%, or just under $1.5 trillion[1], is provided by regional banks. As they continue to reduce lending into the space, they leave in their wake a significant impact on the availability of credit for CRE borrowers. This retrenchment was evidenced by a number of regional banks undergoing massive portfolio sales of commercial real estate at a discount over the last few months in an effort to deleverage their balance sheets.

At the other end of the spectrum, major money center banks have begun curtailing the level of leverage they are willing to provide on balance sheet loans to reduce the sting of punitive capital charges. In lieu of their own direct originations, we see banks favoring arrangements such as loan-on-loan financings to non-bank lenders at the same leverage point they would have otherwise previously found reasonable in direct originations.

This dynamic creates opportunity for non-banks to originate CRE whole loans directly, a place where bank capital has historically dominated. In instances where these banks do deploy balance sheet capacity, it will likely come in the form of lower levered lending against stable property types such as stabilized multifamily, industrial, and self-storage, and perhaps some segments of hospitality.

We expect that the problems of CRE borrowers can only be deferred for so long; a large part of the market is financed with shorter-dated (3-5 years) floating rate loans, meaning a maturity wall is rapidly approaching. Many loans originated with the best intentions in 2020 and 2021 are coming due in 2024 and 2025, in a much tougher refinancing environment with materially higher base rates and spreads.

These factors, taken together with market disruption and more limited capital availability, are highly likely to drive bigger shortfalls in credit markets and thus, an opportunity for private credit firms to structure attractive capital solutions to bridge liquidity gaps for CRE borrowers motivated to transact. For our platform, we are focused on opportunities to originate loans to high-quality borrowers collateralized by strong assets and property types that we believe will remain resilient through a challenging cycle.

Fund Finance

While many of the impacts of the proposed regulations would benefit private credit firms at the expense of traditional banking institutions, there are also emerging and increasing opportunities to partner and collaborate with them.

The largest such opportunity on our radar is in fund finance, a market that has grown substantially over the years in tandem with the growth of the alternative asset management industry. It is also an area that is heavily financed by regional banks and one where the most widely used products come alongside extremely punitive capital charges. So, at a time where demand for this type of credit is already growing, it is concurrently being pushed to a smaller subset of banks with limited capacity available.

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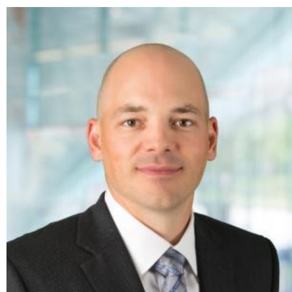
Consequently, we are seeing a large opportunity to partner with banks to structure significant risk transfer (SRT) transactions that provide regulatory capital relief for banks and offer the prospect of strong risk-adjusted returns in what we believe is an attractive asset class with very low default risk.

Conclusion

Potential increased regulation on the banking industry in the fallout of regional bank turmoil may further exacerbate an increasingly widening supply and demand imbalance for credit, creating an extraordinary opportunity for private credit to fill the void, both in the absence of and in partnership with traditional bank lenders. We are seeing this dynamic create the largest opportunities today in the sectors most acutely affected by the pullback in traditional bank capital and most in need of financing to maintain business activities (e.g., specialty finance and commercial real estate lending). Private credit firms with the skills, platform, and expertise to step into these gaps should be well-positioned in our view to capitalize on these dynamics in a market highly favorable to lenders.

1. Source: MBA; Federal Reserve Board of Governors; Trepp LLC; BCA Research. Regional banks defined by <$250 billion of assets.

About the Authors



Brad Bauer
Partner and Co-Chief Investment Officer

Brad Bauer is a Partner and Co-Chief Investment Officer. He oversees private markets investing activity and is a member of the firm's Investment Committee. Based in New York, he joined the firm in Minneapolis in 2007 and was named Partner in 2013.

Brad has held numerous leadership positions throughout his time at Värde, including oversight of all non-investing functions. Prior to that, he was involved in managing the firm's Corporate and Traded Credit team. Brad's experience spans an array of industries and spectrum of credit markets.

Prior to joining Värde, Brad held senior investing and portfolio management roles focused on distressed debt and credit trading at both Deephaven Capital Management and Ameriprise Financial, Inc. Prior to Ameriprise, he worked for U.S. Bancorp Piper Jaffray in the Middle-Market Mergers and Acquisitions group.

Brad received a B.S. in Finance from Iowa State University, where he also competed on the varsity golf team. He earned his Chartered Financial Analyst (CFA) designation.

Aneek Mamik
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Aneek Mamik is a Partner and Global Head of Financial Services & Diversified Private Credit. He oversees credit and equity investments in consumer finance, commercial finance and other areas related to financial services. He also has responsibility for private credit solutions to technology, software and other resilient businesses. Based in New York, he joined the firm in 2016 and was named Partner in 2022.

Aneek previously led Financial Services investing in North America and Asia. Prior to joining Värde, Aneek spent 15 years at General Electric where he most recently served as Head of Mergers and Acquisitions for GE Capital Headquarters. He started as an Associate in GE Capital's Australian consumer finance platform (acquired by Värde in 2015 and re-branded Latitude Financial Services). He subsequently pursued acquisitions globally as part of GE Capital's expansion. Aneek also has senior executive experience in business management, capital allocation, strategy and finance across consumer and commercial lending.

Aneek received a Bachelor's degree in Accounting and Finance as well as a Master's in Business from Monash University in Australia. He qualified as a member of the Institute of Chartered Accountants in Australia.

About Värde Partners

Värde Partners is a leading global alternative investment firm specializing in credit and credit-related assets. Founded in 1993, the firm has invested through multiple credit cycles, building on its roots in special situations and distressed to invest more than $95 billion across the credit quality and liquidity spectrum in both public and private markets. Värde currently manages over $12 billion in assets with teams in North America, Europe, and Asia Pacific focused on Corporate & Traded Credit, Real Estate, and Financial Services & Diversified Private Credit. For more information, please visit www.varde.com.

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