Disruptive Investments Within Disruptive Regulations

Disruptive Forces in Investing July 9, 2024

Anu Rajakumar: With a whirlwind of banking volatility in the last few years coupled with crises such as with Silicon Valley Bank, regulators have been increasing scrutiny across the sector. There are many disruptive forces at play from higher interest rates to the supply of capital markets, and as a result, banks are adjusting to the new regime, but what impact could increased regulation have on the finance industry, and what opportunities could evolve as a result? My name is Anu Rajakumar and joining me today is Ian Haas, portfolio manager on our NB Alternative Investment Management team to delve into the complex world of banking regulations, and the unique investment landscape that comes with it. Ian, welcome to the show.

Ian Haas: Thanks for having me.

Anu: Now, Ian, as I alluded to in the opening, there are many disruptive forces to discuss. Which ones are most prevalent, and how are they impacting what you do today?

Ian: So, the biggest one certainly, and it's been in the press a lot recently, you can't get away from it, is the so-called Basel III Endgame proposal, which was released last year by US regulators. It's a thousand-page-plus proposal.

Anu: So, just some light reading-

Ian: Just some li-

Anu: -for dinner time.

Ian: -light reading, and it'll-it'll put you to sleep certainly, but very important. So, in some ways, this is new, and in other ways, it's nothing new. So, Basel III first came about post the financial crisis in 2008 as a response to what happened during the GFC. And the first iteration of Basel III was released in 2010 and so here we sit, a decade and a half later without a final set of rules and regulations. But the so-called Basel III Endgame proposal ventures to get us a bit closer to the finish line. And so we're in a, comment period right now. Predictably, there's been a lot of pushback from the banking sector. The proposal really aims to further strengthen bank capital adequacy and to increase transparency.

I think regulators, you know, are aided certainly from a timing perspective post the events of the spring of 2023 with the Silicon Valley Bank issues and other bank failures to really, you know, get this out, get it finalized and there are a lot of impacts that the proposal would place onto the banking sector. In looking at the proposal, there's a few takeaways that we have, and they'll have a big impact on how banks do business, but also an impact on private markets investors such as ourselves in terms of creating opportunities.

So, to summarize our key takeaways, one big one is an increase in risk-weighted assets or RWAs. So, every asset a bank holds on its balance sheet has some RWA charge associated with it, meaning some amount of capital has to be held against that asset. Under the Basel III Endgame proposals, and this is just a bit of a, you know, to simplify, RWAs could increase by about 20% across the industry. Now, each bank would be affected in a different way depending upon its mix of assets and their perceived riskiness, but that's a big increase in RWAs. All else equal, that would lead to an increase in required capital levels. So, that's one.

A second big thing, and this sort of speaks directly to some of the issues we saw in the spring of last year, is that unrealized gains and losses from various investments would be better reflected in bank capital levels. And this is one of the issues we saw with a bank like SVB that had big market-to-market losses from its fixed-income holdings that weren't reflected in a market-to-market manner in its equity capital level. So, that would be a second kind of big sea change.

And then a third, is that the proposed regulation really expands the universe of banks that are affected by the Basel III provision. So, this would include banks with total assets of 100 billion and up, not just the mega-large systemically important banks. In the US, that's a universe of about three dozen affected banks, and this would have covered many of the banks that failed in the spring of last year. Not saying it would have changed the end result. Perhaps, it would have, but, you know, it's-it's a much bigger universe, of included banks.

So, from a regulatory standpoint, that's really the biggest sea change that we're seeing. The rules have not been finalized yet, and once they are, it will take some number of years to be phased in, but all this is pushing in the same direction of increased bank capital strength, increased transparency, and that will have implications for bank lending activities as well as what private markets investors like, us are able to do.

Anu: That's a terrific background. So, just to recap, you sort of said three big changes because of this Basel III Endgame, increase in required capital levels, change in how unrealized gains and losses are reflected, and a wider range of banks that are affected. So, with all that being said, Ian, what opportunities do you think that you're going to be seeing as a result of those changes?

Ian: So, I break this into two categories thinking about that question. So, I think there are direct impacts and then more indirect impacts as well. So, on the direct side, we're seeing a big increase in so-called significant risk transfer, or SRT transactions. I think next to Basel III Endgame, SRT is the latest buzzword that you can't get away from if you read the financial press these days. So, what an SRT deal is, is it's essentially a risk-sharing transaction that helps a bank free up capital or increase its capital position in the eyes of a regulator.

Now, theoretically, any asset on the bank's balance sheet can be put into an SRT deal, and typically it looks like a synthetic securitization. So, you'll have a pool of assets. The bank puts them into an SRT transaction. They retain a senior slice of the deal and sell off a junior position to private markets investors. In an exchange for that, you'll receive a coupon for taking that risk, providing the bank the insurance policy, and the bank, from a regulatory capital perspective, will free up a lot of capital.

So, we're seeing more of these deals come to the market in the US banking sector as a result of better guidance from US banking regulators last year as part of the proposals to allow these transactions. This is nothing new in the European banking side. So, these deals have been active in Europe for the better part of the past two decades given more clear regulatory guidance. So, there is precedent, there is a big market that exists, but just given the sheer size of the US banking sector, the SRT space is a chance to double or triple in size, we think, over the next number of years.

So, that's kind of a direct impact as banks seek to respond to higher capital requirements. A more indirect ramification is, in our view, banks pulling away from lending activities, which is nothing new. This has been a feature of markets really post-2008, but we think it can accelerate as a result of the fact of, you know, the cost of doing business essentially becoming more expensive for banks. So, they can either look to do these SRT deals, they could look to raise equity or debt capital, or they could simply pull away from certain lending businesses. And we think that will create additional opportunities for direct lending, for asset-based lending, for private market credit.

Anu: Great and on that note, you know, you mentioned more SRT deals, these indirect opportunities. How does all that fit into the narrative that we've been hearing for the last year plus about the private credit story?

Ian: So, I think it continues to help the private credit story, the market from an opportunity set standpoint. And I break the market, you know, broadly speaking into two categories. And, you know, what gets more of the press, and what's a bigger part of the private credit market is what I would call, you know, more traditional direct lending. And direct lenders have taken a lot of bank lending market share over the past decade as banks have pulled back.

And today, you know, we have a $2 trillion private credit/direct lending, business, which is here to stay and will only continue to grow. We focus on our strategy on a subset of that market, which is more asset-based lending focused, which we think will also benefit from a bank pullback in risk appetite and response to higher equity capital requirements. Furthermore, in a typical asset-based lending transaction, that we see, that we find attractive, they're essentially liquidity solutions.

So, there's a borrower that's undergoing some form of stress. They have some liquidity need. They may have an existing bank in their capital structure that isn't willing to, or can't for risk reasons, put up additional capital to support the borrower. That oftentimes leads to an asset-based lending opportunity for us whereby we can structure a loan which mitigates business risk because we're lending against a specific asset.

And we'll often do that in an off-balance sheet, bankruptcy remote structure to further divorce ourselves from, you know, taking a view on the business or, being exposed to a restructuring or a default. So, what we like to see in those cases are you could have, again, a business undergoing some form of stress. You may not want to be an on-balance sheet lender to them, but they might have a valuable asset on their balance sheet.

It could be investment grade accounts receivable, valuable hard assets or real estate, valuable royalty streams. If we can lend into those in a first lien senior secured way off balance sheet, we find that attractive on a case-by-case basis. And we think, you know, with this further theme of bank retrenchment, more of those opportunities should present themselves to us.

Anu: And maybe, Ian, could you speak a little bit about the sort of competitive field that you and your peers are competing in? What sets Neuberger Berman apart when it comes to being, a partner to these banks?

Ian: I think it's two things. So, one is sourcing. So, within our strategy, we rely upon a diverse and broad sourcing network, which today spans about 400 different GP partners who we source and underwrite deals with. So, our flow is fantastic. We maintain a very conservative funded rate, which is averaged about 5% historically, so we're very selective. So, I think sourcing is one. And I think the second thing which can differentiate us is speed of execution. So, as I mentioned for a typical asset-based lending transaction that we look at, you know, there's some element of stress or a near-term liquidity need that a borrower has.

And if you can structure a solution over a shorter period of time than your competitors that works for the borrower, that's a competitive advantage. And so again, for us that also does two things. It can de-risk these situations because we're lending against valuable assets at conservative advance rates, while not sacrificing return because our capital is needed.

Anu: Yeah, absolutely. So clearly opportunities abound in this space but what would you say are some of the main challenges and risks associated with a strategy like this?

Ian: You know, the space we're talking about now, the kind of asset-based lending market where oftentimes there's a near-term liquidity need, there are a couple of practical risks that are away from a credit risk that we have to wrestle with. So, one I just alluded to it, we're an expensive source of capital and so what that leads to is a risk of early refinancing. You know, so a lot of our deals tend to be two to three-year duration and maturity. You know, frankly we'd love for them to be four, five, six years, but it's a push and pull, a give and take with the borrower who wants to maintain some flexibility, or if it's a longer-term deal, they want to negotiate the call protection.

So, we are expensive, so there's a risk of early refinancing. Also, in situations where we're lending to a stressed borrower, there is a risk of a default or a restructuring. We've been in situations before where that's happened, which has taken us out of transactions sooner than we'd like. So, I think the one practical risk is we can't always control the exit.

Anu: And, Ian, how do you mitigate some of those risks that you just mentioned?

Ian: In terms of, you know, the main risk mitigations that we seek to, to address those issues, I think, you know, it kind of comes back to the importance of sourcing.

You know, if we're in a-- what's we hope to be a three to four-year term loan and, you know, we're taken out after 12 to 18 months, we need to recycle that capital. So, this puts an emphasis on sourcing, on pipeline, on maintaining those relationships and that deal flow so we can replenish and reinvest during our reinvestment period. In terms of credit risk, which of course, you know, is present to a degree in all of these transactions, we try to mitigate that by focusing on, you know, in the SRT space, either high-quality banks and high-quality reference portfolios, or in the asset-based lending space by lending to high-quality assets at conservative advance rates.

Anu: Terrific. Thank you very much, Ian. I guess looking ahead, what are some of your views on the outlook for the landscape going forward?

Ian: There's two things that come to mind. And so, one is the interest rate environment, and this notion that we're in a higher for longer rate environment, which is a notion that we subscribe to within our business. Ultimately, that's a good thing for our opportunity set because what this rate environment does is it serves to put further stress on business' balance sheets, especially those with floating rate debt and what that leads to is liquidity needs, and the need for creative financing solutions like some of the ABL solutions that we discuss.

So, I think net-net it's a positive thing for the opportunity set for what we do and that's more of a cyclical factor that won't persist forever, but there's good runway we think for the next 12 to 18 months that will drive deal flow for us. Second point, and this one we think is a bit more secular as opposed to cyclical is the part of the private credit space, we operate in. We do see an ongoing, imbalance of capital, the supply of capital, and the demand for it.

So, if we're in a space where the average maturity or holding period of one of our deals is two to three years, if you think about who we're competing with for that flow, that is generally a little bit too illiquid for hedge fund capital who may have quarterly or annual redemptions. It's a little bit too short for a traditional private credit or direct lending player who wants to underwrite five to seven-year term cashflow base loans and so what that leads to for us is just better opportunity given that part of the market that duration of capital that we have. I don't think that changes at least over, you know, the investment horizon of the strategies that we manage. So, I think those two things are, what come to mind, and I think they're both positive for our opportunity set and our competitive position as we look ahead.

Anu: Yep, definitely. Well, Ian, those are my prepared questions for today, but I can't let you go without a quick bonus question. Now you've been with the firm since the year 2000, so I believe that means that you are just a year away from a 25-year tenure here which is really a huge milestone. So, Ian, reflecting on your career, I'd like to know what are you most proud of professionally and also personally?

Ian: I think, it's amazing 25 years, next year, I think- I think professionally, I think that's sort of a-- becoming more of a rare thing, you know, and not just our industry but broadly any industry to be at a firm for that long. And for me, it just speaks to the quality of the organization, the people, the business that we've built which has only continued to strengthen from my seat. Certainly, post the events of '07 and '08. So, I think I'm just proud to have been at the same firm for 24, nearly 25, years now and we've grown together as a business and a team. Yeah, and hopefully there's another 24, 25 after this that are just as, just as rosy.

Anu: Yep. And what about any personal, accomplishments that you're really proud of?

Ian: I think, I'd leverage the statements I just made, I guess, kind of being a part of the same business. I've done a few things at the firm over 24, 25 years, but I've been in my current business for two decades now and we've seen a lot of changes to the industry, a lot of, evolution in terms of what clients are looking for and what they value. And I think, and this is kind of borders on professional, but just being able to, you know, continue to grow, and evolve the business in a way that meets the unique needs of our clients is something that I and my colleagues are very proud of.

Anu: Absolutely. Lots-lots to be very proud of. So, we're glad to have you here, Ian. Thank you again for being here for this conversation. We talked about the Basel III implications and the bank retrenchment that we've seen over the last number of months and the opportunity that that creates for asset-based lending but of course, you also highlighted some of the risks, early refinancing default. We also touched on how your team mitigates some of those risks, both from a sourcing perspective and focus on high-quality assets.

And finally appreciated your thoughts on the outlook, that you think there's still opportunities abound in this space and, there's still going to be a need for creative asset-based financing solutions. So, Ian, we really appreciate you being here. Thank you again.

Ian: Thank you.

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