It Pays To Be Choosy

BY DAVE KUCERA

For nonbank financial institutions, finding the right capital partner is more important than ever.
Lending by nonbank financial institutions has grown dramatically over the last four decades. Today, there are thousands of independent nonbank financial institutions that collectively make up a multi-trillion market in the United States alone and, according to The Economist, over $70 trillion globally. Their specialized knowledge and expanding reach allow them to play an important role in ensuring that credit is allocated to sectors of the economy where it is most needed.

Today, nonbank financial institutions account for a substantial portion of lending in such vital consumer sectors as residential mortgage, student loans, and auto finance as well as lending to small businesses and mid-sized companies. Their presence in these sectors has grown dramatically during the first half of this decade. This is a direct result of the slow recovery of the bank lending market after the financial crisis and the ongoing consolidation in the U.S. banking industry.

The Economist notes that bank lending to businesses in the United States is still 6% below its peak in 2008 and bank lending to consumers has also shrunk. When they do lend, banks have tightened underwriting standards and have shortened the tenor of financing they are willing to provide. At the same time, the number of banks in the U.S. has fallen from more than 10,000 in 1994 to fewer than 6,000 today.

Nonbank financial institutions have stepped in to fill this void. They provide financing in many areas where banks no longer maintain expertise or are effectively restricted by regulation to limited roles. Changes in capital and liquidity rules have accelerated the disaggregation of commercial and consumer lending, reducing banks' presence in such sectors as C&I finance, segments of equipment finance, commercial real estate lending, and certain consumer lending businesses. At the same time, social media and continued acceleration of the digitalization of finance are also enabling newer, nimbler, and more focused lenders to gain market share, or in the case of peer-to-peer, introduce new business models. Finally, nonbank lenders serve investors looking for investment parameters that banks cannot address.

As a result of these trends, nonbank lenders are increasingly taking leadership roles in a number of sectors, including middle-market business lending, residential mortgage finance, and small business finance.

**Lending to the Lenders**

Unlike banks, however, nonbank financial institutions do not rely on
consumer and commercial deposits to fund their lending activities. Instead, they turn to a wide range of investors, each of whom has its preferences for risk, duration and structure. Since the Great Recession, however, the capital flow to some nonbank lenders has become more constrained. This has been particularly true for middle-market and lower middle-market lenders, with AUM of $1 billion and below. Unfortunately for the economy, this is where much of the growth and innovation in the industry is occurring.

This situation has arisen for a number of reasons. For the larger nonbank lenders, the capital markets are still an efficient means of raising capital, but they are often less available, more complicated to access, more regulated, and more expensive for smaller, less frequent issuers. Reporting requirements, for instance, are more extensive, often necessitating costly and time-consuming system development. Some finance companies either lack the capability to create these systems or prefer not to disclose this information for competitive reasons. The rating agencies have also increased their standards, presenting yet another barrier for smaller, less seasoned and, often, less sophisticated companies.

The net result is that capital markets' financing since the recession has been declined sharply, as demonstrated in the Historical Securitization Market chart below.

In addition to the headwinds from the capital markets, many nonbank lenders have also been confronted by the contraction of the so-called lender finance market. Prior to 2007, nonbank lenders received a significant share of their funding from the U.S. asset-backed commercial paper (ABCP) markets, which at their peak stood at $1.3 trillion. A large number of financial institutions, especially European banks, provided hundreds of billions in funding specifically to nonbank lenders.

For a number of reasons, including accounting rule modifications, deleveraging in response to rising capital and liquidity ratio requirements, increased reputation risk, regulatory burden and/or capital requirements, and a trend toward more “parochial” or local business strategies, the ABCP market has fallen to less than $300 billion, a drop of over 70% since 2007. Banks are focusing on businesses where there are better perceived competitive advantages.

Despite the capital markets becoming less accommodating and lender finance institutions retrenching, there remains a great deal of activity in the nonbank market. New nonbank lenders have continued to emerge, existing nonbank lenders are attempting to grow, and a number of former nonbank lenders have “restarted.” The resulting increased competition has also increased the funding gap.
Fortunately for the players in this market, new sources of funding have gradually made themselves felt since the 2000s. Alternative investors such as pension funds, sovereign wealth funds, high net worth individuals, family offices, and insurance companies have established a variety of investment vehicles that can meet the capital needs of nonbank lenders. These new players hope to thereby earn a high risk-adjusted rate of return that provides diversification from existing investment strategies.

As a result, nonbank financial institutions are not feeling a credit crunch. Capital One Bank polled attendees at ABS Vegas in January 2014. Their general sense was that credit is available, though companies might have to work a little harder to get it, and the complexity associated with many financing options has risen significantly. Just 12 percent of the respondents said credit access was the biggest risk facing their companies. This concern was dwarfed by worries about increased regulatory requirements and expenses.

**Finding the Right Partner**

Nonetheless, complexity remains an issue, and nonbank lenders benefit from collaborating with a financing partner who can help them make better choices. What should nonbank lenders and specialty finance companies look for in that partner? The expertise to tailor solutions to the unique needs of lenders and investors and to access to flexible capital.

Ideal leverage partners for nonbank lenders should consist of knowledgeable, innovative professionals who specialize in serving nonbank clients. This is not as easy to come by as one might suspect. Experience counts. It takes years of experience for bankers to understand the unique dynamics of nonbank lending and to compile a track record of successful, tailored financing solutions. This expertise exists on three levels.

A partner should have a deep appreciation of financing alternatives, able to authoritatively evaluate, for instance, the advantages and disadvantages of turning to recourse or non-recourse structures in a specific situation or using special-purpose entities and structured finance techniques to lower risk and reduce funding costs. They should also understand the regulatory issues that nonbank lenders face, a major issue uncovered by the Capital One survey.

A financing partner must have deep industry knowledge. Nonbank lenders often work in highly specialized market niches. They need a counterparty that not only knows their sector, but also has experience structuring financing solutions tailored to these unique needs.

Finally, a financing partner must be willing spend the time necessary to learn the nonbank lender’s underlying business. This means not just getting to know the management team, the organization’s history, and its assets, but also the client’s aspirations and the strategy it intends to pursue to build its business platform.

But having the right people with the right knowledge is only part of the equation. They also must be part of the right institution. Capital is a prime consideration. The ideal finance partner should have sufficient capital to sustain the relationship as the nonbank lender grows. Availability of other services is also an important issue. For instance, having a financing partner with a capital markets affiliate is useful; it potentially provides the nonbank lender with services that can help it underwrite debt, create asset-backed securities, or secure public or private equity financing.

**It’s Time to Be Experimental**

As described above, the current market conditions are favorable for nonbank financial institutions to build their platform, assess different capital structures, review untested financing options, and identify financing institutions who are best suited to become long-term, solution-oriented partners that can assist in a broad range of needs. If a finance company can find a lender with the people and the institutional strength to become a long-term partner, it will have succeeded in putting in place a prerequisite for a more successful future.

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Dave Kucera is managing director and head of the Asset Backed Finance Group at Capital One, which provides recourse and nonrecourse financing and other services to specialty finance companies and asset managers throughout the United States across a broad range of sectors.