Filling the gap

Paul Hatfield, global co-chief investment officer, Alcentra

A perfect storm of tighter regulation and problematic historical loans is putting the crunch on bank lending. This offers an opportunity in 2018 for other non-bank providers to step in, says Alcentra's Paul Hatfield.

One of the many legacies of the global financial crisis is its impact on the supply of credit. In the decade since 2007, the world's central banks have kept interest rates at record lows while at the same time experimenting with ultra-loose monetary policy. Meanwhile, in an effort to shore up the banking system, regulators have added to the rule book on loan provision even as they demand ever higher levels of capital adequacy.

The result is twofold. On the one hand, banks are facing unprecedented pressure to trim their current loan books – especially where they do not foresee them being repaid by the original borrower – but they are also withdrawing from the market, leading to a downturn in the amount of available credit.

On the former point, Pricewaterhouse Coopers (PwC) estimates there are approximately €2.3 trillion of non-core assets on banks' balance sheets (almost equivalent to the GDP of France), close to half of which are highly unlikely ever to be paid back.[1]

For Paul Hatfield, global co-chief investment officer with Alcentra, the outcome is stark. "This is one of the major issues now facing lenders. Regulators are imposing much stricter rules – but banks also face serious problems caused by the poor quality loans they have made in the past – principally in property and corporate lending. We believe the balance sheets of Eurozone banks and their ratio of bad loans to total gross loans is at an unsustainable level.

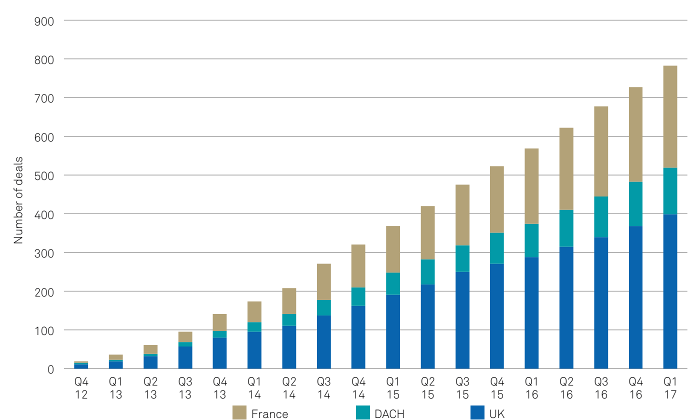
"Banks have struggled to solve this riddle and in response have been disposing of non-core operations, cutting costs and, where possible, issuing new share capital to try to strengthen their financial standing. New European banking regulations are also forcing them to clean-up their balance sheets. These regulations also constrain them from lending to smaller and medium-sized companies."

Part of the issue, according to Hatfield, is the problem of yield. By keeping interest rates to historically low levels, central banks have unwittingly pushed investors further and further up the risk ladder. As a result, and in order to find the kind of returns they would like to achieve, investors have taken on credit that once would have been deemed too risky or too illiquid. "Consequently, we've seen high levels of very poor quality companies being given capital finance in areas like the European high yield bond market," says Hatfield.

With Basel III capital requirements looming, banks now have to address deteriorating returns from these legacy assets and this is adding to pressure to trim loan books. Not only are they selling these loans to other investors, says Hatfield, they are doing so at substantial discounts to the original value: "At a time when investors are hungry for higher returns, this can create opportunities for other lenders to fill the gap left by banks who have stepped back from the arena. There are also opportunities to buy the impaired loans which banks have made in the past at significantly lower prices than their full face value."

Here, he says, the numbers speak for themselves. The UK, France and Germany completed 199 private debt transactions in 2016 compared to 119 in 2013.

NUMBER OF CUMULATIVE DEALS IN CORE JURISDICTIONS



Source: Deloitte, as of April 2017: Deloitte Alternative Lender Deal Tracker Q1 2017. DACH comprises of Germany, Austria and Switzerland. For illustrative purposes only.

Stronger global growth, particularly in Europe and in the US, is adding to the demand. Hatfield notes how smaller and mid-tier companies are keen to tap into the rising economy – as are private equity companies looking to raise finance for acquisitions. Although this is leading to more competition among the more newly established participants in the direct lending market, he says the flow of opportunities "remains strong", meaning larger established managers "can afford to be more selective and discerning in their investments".

Alcentra

[1]*PwC Portfolio Advisory Group:* 'Capitalising on the Acceleration in the Bank Restructuring', 2016.