CAPITAL PARTNERS

Expanding Horizons in U.S. Nonbank Lending

The Anatomy of the Nonbank Ecosystem

By: Neil Hohmann, Ph.D., with Thomas Brennan, CFA; John Ackler, CFA; Timothy Rourke, CFA, CAIA; Chris Ling; Vaidas Nutautas; and Anthony Sylvester, CFA

The U.S. has the most dynamic financial system and capital markets in the developed world. Borrowers and lenders can access and extend credit through plentiful bank and capital market channels. The Global Financial Crisis (GFC) and its legislative repercussions curtailed banks' risk-taking activities. Nonbank lenders (NBL) stepped into the vacuum, growing and evolving to maintain the credit creation vital to consumer and economic health. Yet as its economic importance grows, much of the NBL sector remains poorly understood and sparsely invested, offering investors attractive compensation amidst some unfamiliar risks.

In a series of whitepapers, Partner Neil Hohmann dives into the NBL sector and its opportunities. Here, we start by looking at the bigger picture of U.S. lending. This provides useful context for understanding the NBL sector and its variances and complexities.

The U.S. loan landscape

There are about $31 trillion in loans outstanding in the U.S., based on the U.S. Financial Accounts kept by the Fed.[1] For perspective, there are $28 trillion of U.S. Treasuries and $11 trillion of U.S. corporate bonds outstanding.

U.S. loans – defined by their holder at risk – can be split into U.S. depositories (banks) and NBL. NBL, in turn, is split between government-sponsored enterprises (GSEs, or agencies) and securitization trusts, financial companies, and funds that hold the rest (nonagency, collectively). Exhibit 1 reveals that the $17 trillion in outstanding NBL today (agency and nonagency) eclipses the $14 trillion in loans held by U.S. banks.

Another way to segment U.S. lending is by loan type. Residential and commercial mortgages (i.e., loans secured by real estate) are the largest, amounting to

[1] As of 12/31/2023. Excludes U.S. government loans, interbank lending, broker-dealer financing, and offshore loans.

Breaking down the different types of nonagency lenders and investment vehicles

- **Commercial mortgages** (commercial mortgage-backed securities, or CMBS) are the largest nonagency loan type ($2.2 trillion). They're held in roughly even measure by insurers; CMBS vehicles; and real estate investment trusts (REITs), finance companies, and others. Nonagency residential mortgage-backed securities (RMBS) ($1.2 trillion) are held rather evenly among nonagency RMBS trusts; REITs and finance companies; and other holders.

- **Nonbank commercial loans** ($2 trillion) fall into two types:

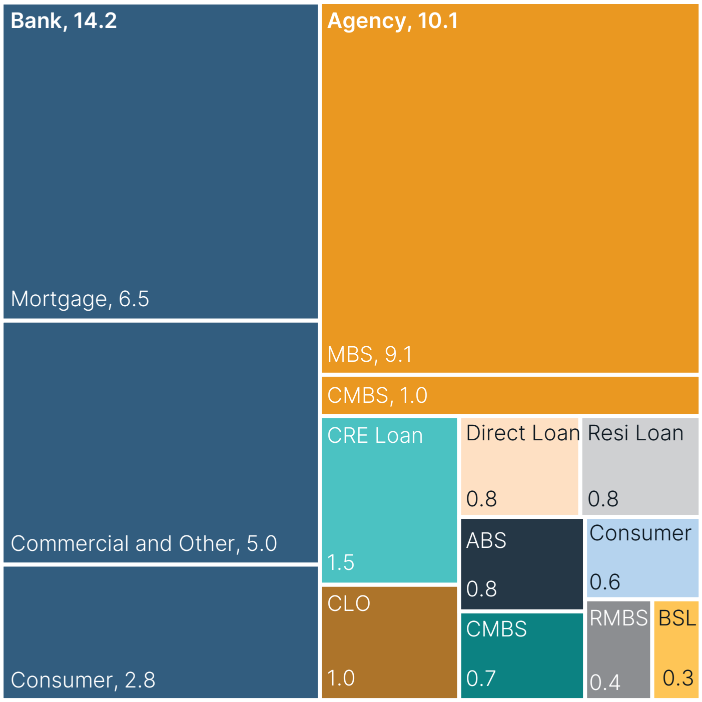
  - **Bank-syndicated loans (BSL)**, or leveraged loans, are agented by large commercial banks to high-yield borrowers that typically have $100 million or greater EBITDA. BSL are rated and generally liquid. BSL are held evenly by banks (~$1 trillion) and nonbanks (~1.2 trillion), with the latter predominantly in collateralized loan obligations (CLOs) but also in mutual funds and other investment vehicles.

  - **Direct loans**, by contrast, are not publicly rated and mostly by contrast, are not publicly rated and mostly illiquid. They are originated mostly to firms below $100 million EBITDA. Direct loan holdings have accumulated quickly in business development companies (BDCs), which now hold as much as private funds and other financial companies, with the remainder held in CLO and asset-backed securities (ABS) securitization trusts.

- **Consumer and other loans** are the most fragmented of NBL types. More than 30 different varieties of specialized lending are held across thousands of ABS vehicles. Loans are held on balance sheets of a dizzying array of financial companies (with the captive lenders of the large auto manufacturers prominent among them).

A top-down view like this of nonagency loan types and holders provides clarity to what can otherwise seem like a daunting collection of acronyms and strange vehicles that deter participation.

Exhibit 1: U.S. loans by holder ($ trillion) – total $31 trillion



Source: Federal Reserve, SIFMA, J.P. Morgan
Data as of December 31, 2023
* Excludes government, interbank, and broker/dealer lending.

$20 trillion. Commercial lending (i.e., recourse loans to U.S. companies) is $7.5 trillion. Consumer and other lending sums to $3.5 trillion.

Bank and agency lending are public, prominent in markets, and familiar. By contrast, the $7 trillion piece of nonagency lending – represented by the boxes in the lower right of Exhibit 1 – are the opposite. Nonagency lending encompasses a complex mix of lenders, is largely private, and is mostly absent from the major bond and equity indices. This massive, unfamiliar, and convoluted nonagency loan market is home to some of the best value in investing, in our opinion.

The entire NBL sector makes more sense when it's seen as a natural sorting of $17 trillion in nonbank loans into the various types of holders and vehicles that can provide their borrowers with a swift, efficient, and low-cost solution.

Conclusion

The U.S. NBL sector has grown significantly, filling the gap left by traditional banks post-GFC. This diverse and complex ecosystem, encompassing various loan types and holders, offers substantial investment opportunities. Understanding the segmentation and dynamics of NBL is crucial for navigating this evolving landscape.

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Risks

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, maturity, call and inflation risk; investments may be worth more or less than the original cost when redeemed. Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. Mortgage-backed securities have prepayment, extension, and interest rate risks.

Asset-Backed Securities ("ABS") are subject to risks due to defaults by the borrowers; failure of the issuer or servicer to perform; the variability in cash flows due to amortization or acceleration features; changes in interest rates which may influence the prepayments of the underlying securities; misrepresentation of asset quality, value or inadequate controls over disbursements and receipts; and the ABS being structured in ways that give certain investors less credit risk protection than others.

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