Premium Alternatives News
OPALESQUE

Regulators look more closely at non-bank lending as hedge funds, investors see opportunity

Bailey McCann, Opalesque New York:

Non-bank lending, or shadow banking has been an area of concern for regulators since the crisis. However, allocators, hedge funds and businesses, are looking to the space more and more, as liquidity in more traditional banking spaces dries up. This reality is true worldwide, causing regulators to try and find ways to limit the scope of shadow banking. However, they may find little support for new rules even in the public.

Global demand

Shadow banking has long been a space without much regulation, or even much public awareness of its existence. Since the crisis, shadow banking has taken on a more public profile, and arguably a more significant role in the global financial system. "Capital requirements, regulation, and deal size have made banks not to lend without significant provisioning," said Alfredo González, Co-Fund Manager, LW Short Duration Fund, in an interview with Opalesque. He noted that because of new rules on traditional banks, those banks want bigger deals, with better, creditworthier entities often at the expense of smaller, but still sound ones. LW Asset Management, the firm that manages the LW Short Duration Fund, is focused on Latin America. Middle market Latin American businesses have seen many credit options dry up in the wake of the crisis, creating a significant demand for non-bank lending - an area LW is heavily focused on in the region.

In China, demand for non-bank lending has shot up 34% over the last year, prompting an examination of the country by the Financial Stability Board. Bank Negara Malaysia hosted the fourth meeting of the Financial Stability Board (FSB) Regional Consultative Group for Asia in Kuala Lumpur, Malaysia last week. Its membership discussed a framework for systemically important financial institutions on Asia and possible policy responses, and the structure of shadow banking in Asia.

Following that meeting, credit rating agency Standard & Poor's issued a statement and report, noting that while shadow banking accounts for a considerable amount of all banking activity and GDP in the country, the bigger threat still lies with traditional Chinese banks and their exposure to that country's real estate bubble, and local government financing vehicles.

"The exposure to these segments (local governments and property) by the regular banking sector is already high. When the central government attempted to contain the risk, shadow banking boomed and continued to fuel excessive expansion of the segment," said Liao Qiang, an S&P analyst and co-author of the report. The report also notes that the traditional banking sector, although exposed to risky positions is still stable enough to absorb any fall out from its off balance sheet cohorts.

Outside of emerging markets, shadow banking activity remains equally high. In Europe, where banking rules there have increased constraints on liquidity, and rolling debt crises have pushed more businesses and individuals out of traditional banking channels, non-bank financing is catching on. Irish bank lending to small businesses fell 5% last year according to a report in the *Irish Independent*, despite claims from those same banks that they were "open for business."

As Opalesque reported earlier, Cypriots and other residents of the region are moving into peer-to-peer lending or virtual currencies like BitCoin in an effort to shield cash from new taxes and austerity measures, as part of sovereign debt restructuring.

Regulators, allocators, and funds

Regulators have taken an on again/off again approach to regulating shadow banking. In December, the FSB released 19 documents which effectively provided a framework about how it will understand and approach activity within the sector. At that time, observers noted that under certain circumstances, shadow banking could be a good thing for the global economy. Then in March, following the meeting of the Asia group, the regulator issued a new update to its publication on measuring and controlling large credit exposures. The document is mostly aimed at further providing guidance on capital and credit controls for traditional banks. However, the regulator also noted that some of the information included, "policy measures designed to capture bank- like activities conducted by non-banks that are of concern to supervisors. The Committee has sought to do this through its proposals on large exposures to funds, securitization structures and collective investment undertakings (CIU)."

China too, is getting in on the act. The China Banking Regulatory Commission (CBRC) issued 12 new rules to bring the shadow banking system more closely in line with traditional banking and cap future risk.

Even while regulators try to understand the system, others are trying to get in on the market. Tim Ng, Managing Director and Head of Research at Clearbrook Global Advisors, told Opalesque that the opportunity set for hedge funds to lend to medium and small businesses is appealing. "This is an opportunity set growing out of a lack of bank lending, and can take on a longer duration than what we see traditional credit markets right now," he says. Clearbrook notes that these opportunities - senior secured loans to middle market companies have a tenor of five years, and provide a net yield of 11% to 14%.

The story is compelling, even just for brainstorming. Arena Investors, a new, private investment firm - still in its brainstorming phase, is looking at a variety of options. Arena is the next phase for manager Dan Zwirn, whose previous firm closed following after another staffer made inappropriate fund transfers. (Zwirn was cleared of any wrongdoing in that investigation and subsequent court case.) Zwirn recently brought on Marcel Herbst, formerly of Swiss-based Harcourt Group, where he was most recently COO & Head of Business Development for its US business. At Arena, he will head up Business Development, working with Zwirn to examine a number of opportunities in this space.

"As more people move into what is typically referred to as 'shadow banking', the boom and bust cycles are only going to get more extreme. It's going to look more like when everyone made the initial jump into ABL funds," Zwirn said in an interview with Opalesque.

"Conventional hedge funds often don't want to take on long duration. Duration often gets mistakenly conflated with illiquidity."

He notes an opportunity for returns similar to what Ng sees, or better, based on his experience in the space. For investors seeking returns in specialty finance, he says they would do well to look for an expert, rather than jumping in too quickly. "I don't think people are looking seriously at the blow up risks with shadow banking, few people have the experience to understand all the different forms of non-bank specialty finance businesses."

Article Link (subscription required) :
http://www.opalesque.com/646015/Regulators_look_more_closely_at_lending_as601.html