Why The Surge In Loans To Nonbank Financial Institutions Is Unlikely To Spell Major Trouble For U.S. Banks

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Key Takeaways

- We believe banks that have rapidly increased their exposure to nonbank financial institutions (NBFI), particularly banks lacking experience in this area or those lending to borrowers with weak creditworthiness, could suffer credit losses, particularly when the cycle turns.
- Still, we don't see NBFI loan exposures as a threat to many ratings, in large part because they make up a small portion of most banks' loan portfolios, with the exception of few, and likely well less than 10% of loans in the banking system.
- Furthermore, banks structure most of their exposures to NBFI to cushion themselves against losses, and loans to subprime consumer lenders make up a minority of the NBFI portfolios of most banks we rate.

Banks in the U.S. since 2011 have more than tripled their loans to other types of financial institutions--such as finance companies, insurance companies, private equity funds, and others that use bank financing to fund their own loans and investments. (We refer to these institutions collectively as "nonbank financial institutions," or NBFI, for the purpose of this article). That trend has raised questions about whether some banks have built large indirect exposures to risky asset classes, such as subprime auto loans and unsecured consumer loans, which some NBFI hold.

Banks that have sharply increased their loans to NBFI, particularly those banks with limited experience in this asset class or those with material exposure to lowly rated or unrated borrowers, could ultimately experience credit problems in this area, in our view. That said, we see NBFI exposure as a manageable risk for the banking sector as a whole, one unlikely to cause us to lower our ratings on many banks.

In our view, the key factors that ameliorate banks' NBFI risks are:

- NBFI loans account for a small percentage of overall loans in the banking system--likely well under 10%.
- Loans made to subprime consumer finance companies, which we view as one of the riskier

areas of NBFI exposures, likely make up the minority of this exposure. Loans to originators of prime mortgages, real estate investment trusts (REITs), investment funds, and other borrowers likely account for the majority.

- Banks mostly structure loans to NBFIs as secured asset-based revolving facilities with significant collateral haircuts or as secured term loans.
- NBFI loans are concentrated particularly at the large banks, with Wells Fargo & Co., Citigroup Inc., Bank of America Corp., The Goldman Sachs Group Inc., JPMorgan Chase & Co., and Morgan Stanley likely accounting for roughly two-thirds of the industry exposure. Most other banks have little exposure. The greater diversification of the large banks compared with the smaller peers should enable them to better withstand any NBFI losses that materialize.

The Increase In Bank Loans To Other Types Of Financial Institutions

Federal Deposit Insurance Corp. (FDIC)-insured commercial banks and savings institutions reported on their regulatory filings that "loans to nondepository financial institutions" increased to $375 billion as of second-quarter 2018 from only $79 billion in 2011, a compounded annual growth of 27% (see chart 1). (This figure does not capture loans held by banking groups outside of their FDIC-insured subsidiaries, meaning it somewhat understates the total amount of nondepository loans in the overall banking system). Banks also have a material amount of unfunded commitments to NBFI on lending facilities. The amount of those commitments is not publicly available but probably adds materially to $375 billion of outstanding exposure. The term "nondepository financial institution" essentially overlaps with the "NBFI" term we use. Regulators define nondepository financial institutions mostly as REITs, mortgage and other types of finance companies, holding companies of other depository institutions, insurance companies, federally sponsored lending agencies, investment banks, and small business investment companies. Such loans rose to almost 4% of the total loans of FDIC-insured commercial banks and savings institutions from about 1% in 2011.

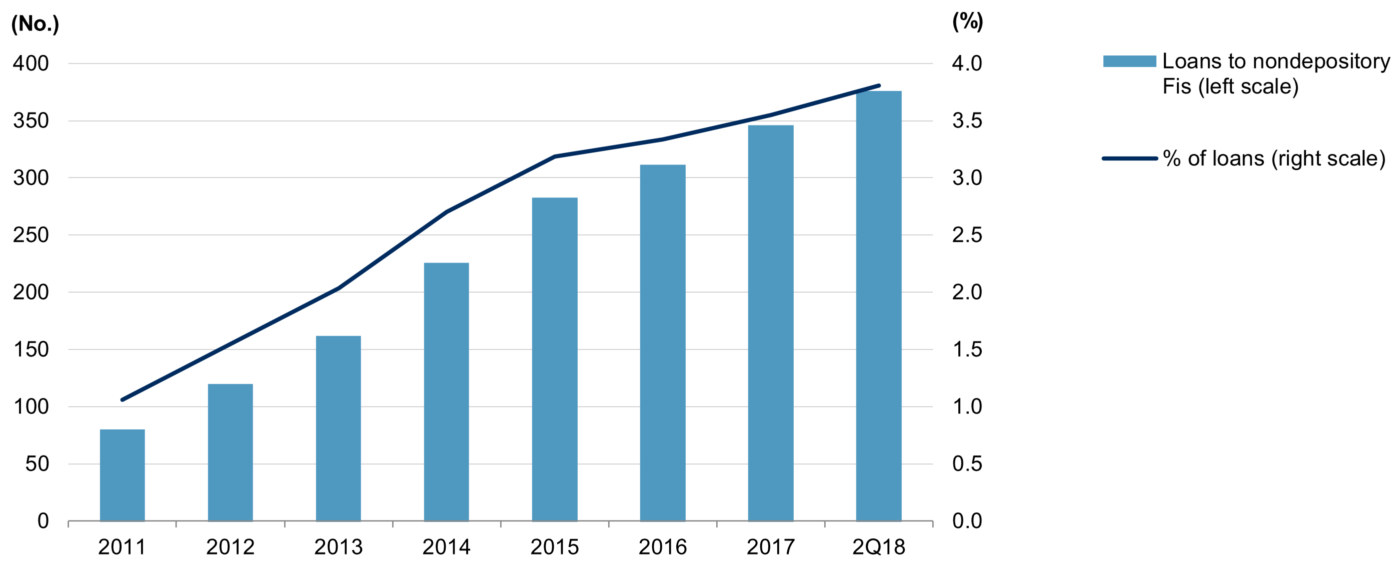
Banks have sometimes chosen to lend to NBFI, instead of directly to consumers or businesses in certain sectors.

Table 1

Common Examples Of NBFI Borrowers

Residential mortgage originators and servicers
Real estate investment trusts
Asset managers (e.g., private equity funds)
Originators of commercial loans
Prime and subprime auto finance companies
Unsecured consumer finance companies
Aircraft leasing companies
Equipment leasing companies
Insurance companies

Bank Loans To Nondepository Financial Institutions



On top of those loans, some banks may also have additional exposure to NBFI that they may not count in the category of nondepository financial institutions. For instance, we believe that a minority of banks count capital call lines or subscription facilities--a type of exposure largely to private equity and venture capital funds (which we discuss in detail later in the article) in the line item "loans for purchasing or carrying securities." That category also includes other types of loans to asset managers, as well as loans made to individuals collateralized by securities. (Although most banks seem to count capital call lines in loans to nondepository financial institutions).

We believe the rapid growth in NBFI lending relates in part to a change in banks' risk appetites following the financial crisis and the implementation of new regulation, heightened competition, sometimes-sluggish demand in more traditional lending strategies, and robust growth in certain areas of the shadow banking system. Rather than sharply expanding loans directly to consumers and businesses in certain areas, some banks have chosen to lend to a variety of NBFI, which in turn lend to the end borrowers. Banks, for instance, have provided an increased amount of warehouse financing to NBFI that originate residential and commercial mortgages, as well as other types of consumer and commercial loans. The banks help NBFI by pooling and securitizing such loans through their capital markets units. The strategy creates a buffer of protection against the credit risk associated with direct consumer and commercial loans and also allows the banks to win capital markets business.

Furthermore, low interest rates and a sharp increase in asset prices have fueled an expansion in many NBFI segments. This has created opportunities for banks to lend to NBFI that have experienced expansions in their business such as REITS, a variety of types of asset managers, collateralized loan obligation managers, and others.

Banks With Significant Exposures To Nondepository Financial Institutions

As of June 30, 2018, Wells Fargo--by a wide margin---had the largest holdings of loans to nondepository financial institutions, followed by a number of the largest banks in the country (see table 2). Certain regional banks also had significant holdings of these loans, especially as a percent of their total loans. For instance, they made up one-third of Texas Capital Bancshares Inc.'s loans, reflecting its large residential mortgage finance business in which it purchases and warehouses mortgages originated by NBFI.

The large banks had the overwhelming majority of loans for purchasing or carrying securities, likely largely including loans originated through their prime brokerage and wealth management units. However, SVB Financial Group appears to count its capital call lines, or its lending facilities backed by investor commitments to a fund, in this regulatory line item, which accounted for a very high 47% of its total loans. (As discussed above, some other banks count capital call lines in loans to nondepository financial institutions).

Table 2

Loans To Nondepository Financial Institutions, Q218

(Banks with nondepository FI loans >$3 billion or >5% of loans)

	--Total--		
Bank	**Total (bil. $)**	**CAGR since 2011 (%)**	**% of loans**
MEDIAN	**8.4**	**21.4**	**8.6**
Wells Fargo & Co.	94.3	41.3	9.8
Citigroup Inc.	59.5	14.3	8.6
Bank of America Corp.	45.2	43.7	4.6
JPMorgan Chase & Co.	38.4	2.4	4.0
The Goldman Sachs Group Inc.	33.7	25.8	25.6
Morgan Stanley	26.5	32.1	17.2
Capital One Financial Corp.	11.6	35.3	4.6
SVB Financial Group*	11.6	49.3	46.8
PNC Financial Services Group Inc.	11.1	21.4	5.0
BMO Financial Corp.	9.7	23.2	13.2
Texas Capital Bancshares Inc.	7.2	16.5	33.1
HSBC North America Holdings Inc.	6.7	4.5	10.1
Comerica Inc.	6.0	15.4	12.2
Regions Financial Corp.	5.5	21.3	6.9
TD Group US Holdings LLC	5.5	N/A	3.6
MUFG Americas Holdings Corp.	5.4	31.7	6.6
BB&T Corp.	5.2	15.5	3.6
CIBC Bancorp USA Inc.	4.4	N/A	17.4
SunTrust Banks Inc.	3.4	32.3	2.4

Table 2

Loans To Nondepository Financial Institutions, Q218 (cont.)

(Banks with nondepository FI loans >$3 billion or >5% of loans)

	--Total--		
Bank	**Total (bil. $)**	**CAGR since 2011 (%)**	**% of loans**
MEDIAN	**8.4**	**21.4**	**8.6**
First Horizon National Corp.	3.4	12.9	12.2

*SVB Financial's numbers reflect the loans for purchasing or carrying securities that it reports in its regulatory filings. We believe these are capital call lines, which most banks appear to report as loans to nondepository financial institutions. Note: We do not rate HSBC North America Holdings Inc., TD Group US Holding LLC, or CIBC Bancorp USA Inc., although we rate their parent organizations. N/A--Not applicable.

Factors That Contribute To Risk On NBFI Exposure

The rapid rise in loans to NBFI raises questions about whether banks' credit standards have been conservative enough in this area and whether they have sufficient expertise to manage the credit risk. While a number of factors appear to lessen the risk of these loans, some banks probably will eventually experience losses on loans to NBFI, perhaps because of a lack of sufficient understanding of borrowers' operations, the underlying collateral, or how best to structure their exposures. While many NBFI borrowers tend to be fairly small in size, their operations can be complex, opaque, and difficult to analyze. Often speculative-grade or unrated, these borrowers can be unable to withstand difficult economic conditions. In the event of default, even if a bank ultimately receives full repayment on a well-collateralized NBFI loan, it could be forced to work through a foreclosure or another recovery process.

Factors That Ameliorate Risk On NBFI Exposures

With the exception of a handful of banks, NBFI loans generally make up a small portion of overall bank loans, making widespread problems unlikely. On top of that, banks ameliorate the risk through underwriting strategies, collateral requirements, client selection, and diversification. For instance, while public disclosure is limited on these types of loans, based on data we have gathered from a number of banks we rate, we believe that secured asset-based revolving loan facilities often make up the largest portion of NBFI exposures.

For instance, a bank may lend to an NBFI that originates residential mortgages. (NBFI that originate and securitize residential mortgage in pools guaranteed by Fannie Mae or Freddie Mac are some of the most common bank borrowers.) The bank typically would extend a facility collateralized by such mortgages with a significant haircut applied on the collateral. The bank often would require the borrower to meet certain financial and qualitative covenants to maintain access to the facility, allowing the bank to reduce its exposure if the NBFI has difficulties.

Underwriting, collateral requirements, client selection, and diversification all help to cushion banks from NBFI loan losses.

Wells Fargo, the largest holder of loans to nondepository financial institutions, earlier this year publicly underscored such points. It said that asset-based revolvers accounted for about 80% of its nondepository exposure and that it applies significant haircuts on underlying collateral. The company also noted that it lends to a very diversified set of borrowers, with exposure to consumer subprime lenders making up less than 15% of its total exposure. Likewise, we believe loans to subprime lenders constitute a minority portion of the NBFI portfolios of most of the other rated banks with significant overall exposures. Furthermore, certain NBFI loans are to higher-rated financial institutions such as insurance companies and asset managers, reducing the probability of losses.

Managing Risk On Capital Call Lines

Some banks in recent years have sharply increased loans and lending facilities known as capital call lines or subscription facilities to private equity and venture capital funds. For instance, SVB Financial's outstanding capital call lines have risen to more than $12 billion as of June 30, 2018, from about $1 billion in 2011. A number of other banks have also grown their capital call lines, although such exposures tend to make up a smaller percentage of their overall loans than for SVB.

In these funds, investors (or limited partners) commit to send capital to the fund's sponsor (or general partner) when the sponsor calls on that capital in order to finance investments. The sponsor initially leaves such capital commitments undrawn as it seeks investment opportunities and subsequently calls on the capital as it makes investments into the fund.

Private equity and venture capital funds sometimes borrow from banks via capital call lines to bridge the timing difference between when the sponsor makes an investment and when the limited partners investor send it capital. However, we believe the nature of capital call lending has changed to a degree, spurring some of the rapid growth in this area. Sponsors now seem to be borrowing for longer periods in order to fund their investments rather than immediately calling on capital from their investors. We believe that this practice could allow them to improve the return on their funds, particularly early in the life of the fund.

Undrawn capital commitments from a fund's investors serve as the primary source of collateral for capital call lines, allowing the bank to exercise capital calls from the fund's investors if the fund defaults on the capital call line. We believe bank lenders also often have recourse to the underlying investments in the fund, which they would take possession of if the sponsor fails to meet repayment and the fund's investors default on their capital commitments.

We believe banks have experienced very low defaults on such exposures historically for several reasons. Most notably, these funds have relatively creditworthy institutional investors that rarely default on capital commitments, allowing the sponsor to use the funds advanced from the investors to repay the capital call lines. Furthermore, if an investor fails to meet a capital commitment, it could lose the ability to invest in successor funds of that particular asset manager and, in some cases, any capital it previously invested in the fund.

In addition, the sponsor can take steps to meet repayment on capital call lines even if an investor fails to meet a capital commitment. For instance, it may sell the commitment of the defaulted investor to another investor or sell assets in the fund. Sponsors are typically incentivized to meet repayment on capital call lines not only for reputational reasons, but also because the recourse banks often have to the investments of the fund.

On top of requiring the collateral of capital commitments, banks use other measures to manage risk on these exposures, including structuring capital call lines to have maturities of a year or less. The strength of the sponsor and its investors is also crucial. A sponsor with a well-known reputation, an ability to raise capital from a variety of investors, and a good investment track record is probably less likely to default on a capital call line. In the event that one of its investors fails to meet a capital commitment, it may be able to fund the investment or find another investor to step in. A sponsor with capital commitments from large institutional investors, such as pension funds and insurance companies, is also probably less likely to default on a capital call line.

Economic Performance And Experience In Underwriting Will Determine Performance In NBFI Lending

We expect credit losses on banks' NBFI exposures to depend both on economic factors and underwriting. A turn in the economy could lead to deterioration in the portfolios of various types of NBFI, probably also weighing on these firms' profitability and access to capital and liquidity, and increasing the likelihood that they would default on bank loans and facilities.

At that point, the quality of bank underwriting and client selection on NBFI exposures will become clear. For instance, in capital call lending, the banks that lack experience with the intricacies of the legal agreements governing limited partnerships, or banks that have exposure to smaller funds with a prevalence of individual investors will likely suffer losses. Likewise, in lending to consumer or commercial finance companies, the banks that fail to understand the lending strategies and operations of their NBFI borrowers will likely be those that perform the worst.

Related Criteria And Research

- Still Casting A Long Shadow, The Risks Of U.S. Nonbank Credit Intermediaries Have Changed, May 16, 2018
- Could Banks, Asset Managers, Or Nonbanks End Up Holding The Bag In The Leveraged Loan Market?, Nov. 29, 2017

This report does not constitute a rating action.