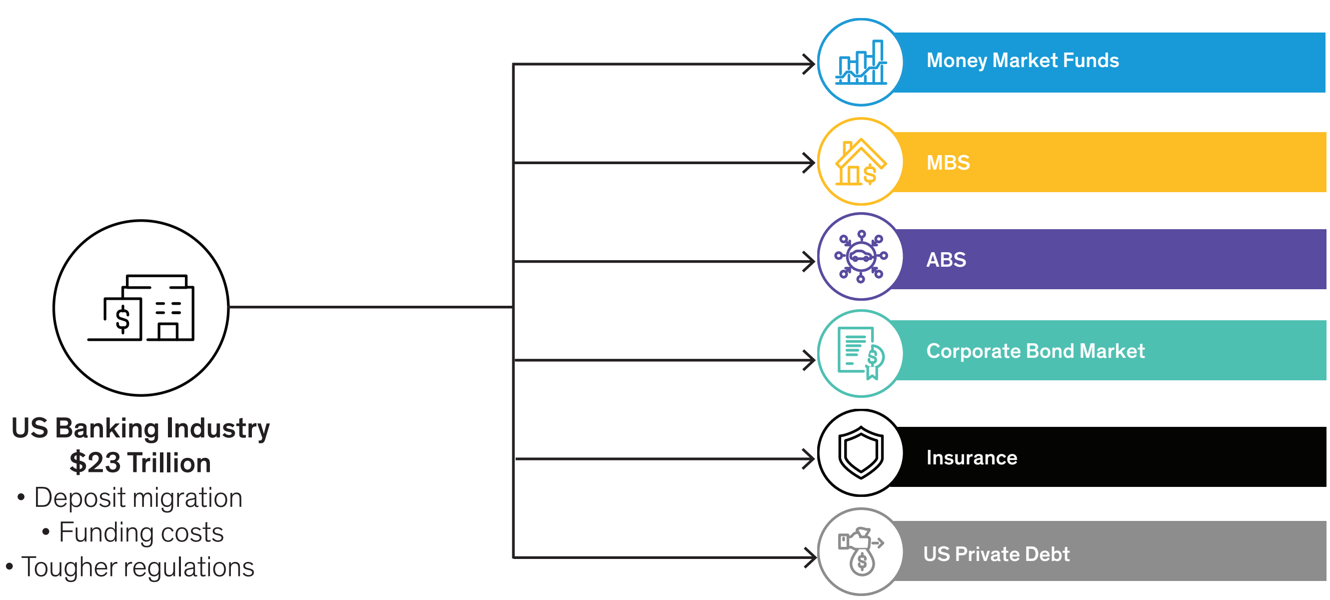
Stress in the US banking system: Overview & Opportunities

2023 saw a return of bank retrenchment following dramatic monetary tightening and a banking crisis in the US. Rising rates, regulation and the prospect of a recession put increasing pressure on banks, and we saw the sector face challenges. At AB CarVal, we believe private credit investment opportunities will grow significantly as a result of this set of events and the accompanying uncertainty. These issues are chronic and will take time to resolve as banks rationalize and adjust to today's new operating environment. This paper will examine this damage in more detail and will highlight the investment opportunities we are seeing.

The US banking system is a massive ecosystem worth $23 trillion , with the top 28 banks categorized as systemically important accounting for $16 trillion. Regional banks are 40% of the U.S. commercial credit market[2] and are facing multiple challenges: capital constraints, increased funding costs, and credit quality concerns. As a result, loan growth is slowing and banks—especially regionals—are retrenching from the secured financing markets. The proposed Basel III Endgame regulation aims to improve the strength and resilience of the banking system, impacting all banks in the US with total assets greater than $100 billion[3] , and likely increasing risk-weighted assets, resulting in an increase in capital requirements for the banks .

These chronic challenges are expected to take time to solve as these banks have to rationalize and live in the new world of today's cost of capital. In 2024, we believe banks' reluctance to lend will widen the opportunity set for investors across the risk-return spectrum in multiple private credit asset classes, including corporate lending, commercial real estate, energy transition, and consumer finance.

ASSETS ARE EXPECTED TO MOVE OUT OF THE US BANKING INDUSTRY



Source: Federal Reserve November 2023

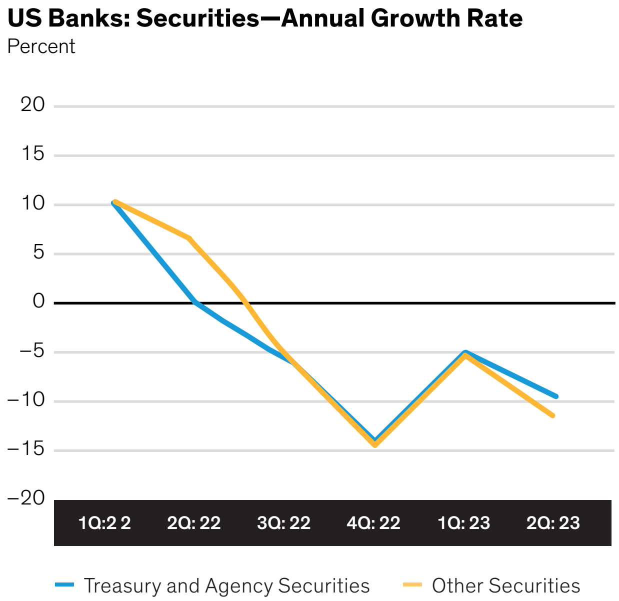
1 US Federal Reserve—November 2023.
2 Fitch Ratings—April 2023.
3 The proposal can be found in the Federal Register, 88 Fed. Reg. 64028 (Sept. 18, 2023).

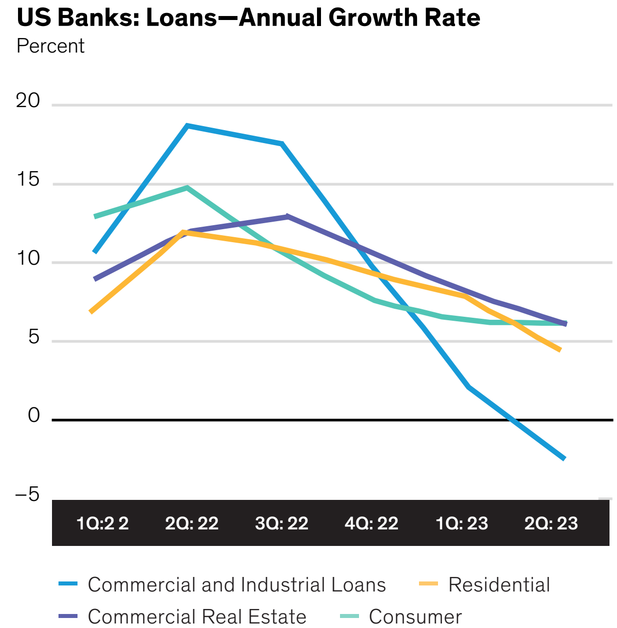
Key challenges in the US Banking System

Deposit Flight

Banks have sharply reduced lending as they shed deposits and took mark-to-market losses on assets as interest rates soared (*Display 1*). More than $1 trillion of household deposits have left the US banking system since interest rates started their rapid rise in 2022, adding momentum to the trend of bank retrenchment that began after the global financial crisis.

DISPLAY 1: BANKS IN DEFENSIVE MODE AFTER THE DEPOSIT OUTFLOWS





Past performance does not guarantee future results.

As of June 30, 2023

Source: US Federal Reserve Board

To manage through this situation, one of the easiest things a bank can do to either manage its growth or shrink its balance sheet is to reduce lending. The annual growth rate has tapered off as the banks take down their loan originations. We do not expect that banks are going to raise additional capital to restore the excess or comply with the requirements. Instead, we expect a lot of shaping and pruning to optimize their capital.

Most banks seem relatively stable now due to intervention, but problems persist (as seen in the example of New York Community Bancorp). Excluding the pandemic, lending conditions are now at their tightest since the Global Financial Crisis.

Regulatory Burden

Banks also may be on the clock for complying with updated global Basel III regulations, which if implemented as proposed, could start to come into effect in 2025 and could include a rewrite of the risk-weighted asset framework. What the regulators want to see here is more consistency, more specificity, more transparency, and less of the internal model, “black box” kind of approach that’s used by some of the large banks under the current regime. This could force many banks to reduce lending further and shed some of the loans—residential, commercial, corporate—already on their balance sheets.

Put another way: banks today increasingly want to be in the moving business, not the storage business. That will create opportunities for private capital to partner with banks across market areas and geographies in 2024 and beyond. For example, private investors may step in and purchase pools of seasoned loans from banks at a discount or enter into forward flow agreements to acquire new ones that meet pre-determined credit requirements.

Banks, meanwhile, will likely benefit from maintaining customer relationships and generating fees without incurring the high regulatory capital charges that would come with keeping these loans on their books in a Basel III regime.

Constructive Backdrop

The systemic shift of global banks away from long-term lending has created a large credit vacuum, leaving opportunities for more specialized non-bank lenders. The progress and pace of this evolution in the lending market differs across geographies, with the US leading the way and Europe following the path. Specialized non-bank lenders can fill the credit vacuum left by global banks and provide financing for businesses and individuals that may not meet the strict lending criteria of regulated banks.

Filling the Gap

So where should investors set their sight as 2024 continues to unfold? We think there are several areas that deserve attention. But 2024 may turn out to be the year in which asset-backed lending strategies—also known as "specialty finance"—start to take up more space in private asset allocations.

Specialty finance encompasses niche strategies that involve non-bank lending against pools of cash-flowing assets or receivables—often consumer- or small-business-related—such as auto and equipment loans or esoteric assets such as the revenue streams generated by royalty payments.

Turning a Corner?

Activity in the commercial real estate market was restrained in 2023. But signs that interest rates in the US and Europe may have peaked suggest that could change. We expect greater rate stability to result in higher transaction volumes and increased price discovery across property types.

A wave of maturing loans that banks hold but may be reluctant to extend may create opportunities for private lenders who have remained patient and well-capitalized. As always, the risk-reward calculus varies by property type.

The Global Energy Transition

We expect private lenders rather than banks to continue to drive financing for renewable energy projects in the year ahead, and we see a number of attractive opportunities today. Many stem from the repricing of long-dated public and private infrastructure assets—the result of sharp rate spikes in the third quarter of 2023.

Summary

For investors who can take a highly opportunistic approach, the current market backdrop looks appealing. Developer demand for capital remains robust and stress in the banking sector means negotiating leverage has shifted to private capital providers, who can demand credit enhancements and other protective provisions. We see opportunities across the US and European markets.

Even if the pace of economic growth slows, yields are likely to remain above pre-pandemic-era lows. And we expect deal terms across asset classes to remain favorable, with low loan-to-value ratios and attractive asset values that were reset over the last 18 months as rates rose. In our view, 2024 will be a good time to put capital to work.

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> Slower growth and rising interest rates have tapped the brakes on private deal activity this year. But as banks continue to retreat from lending, we see plenty of opportunity for investors to pick their spots across the broad private credit universe."
>
> —Matt Bass, AllianceBernstein

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