PRIVATE CREDIT

The issues associated with fractional-reserve banking – the system used by most countries globally to facilitate the extension of credit, creation of monies, and economic growth – have tested regulators for decades. Despite multiple and increasingly stringent iterations of Basel regulation governing liquidity and leverage, and supervisory oversight in the forms of inspection and stress tests, the modern banking system remains susceptible to "moral hazard" – i.e., no modern bank is equipped to absorb fleeting confidence by its depositors. Reinstalling confidence in the global banking system is a priority that far exceeds bank profit margins. And, while the long-term repercussions of recent events remain to be determined, it is likely that regulatory requirements will continue to increase, lending standards will continue to tighten, and access to bank credit will decline.

The combination of market uncertainty and further bank retrenchment is creating an outsized opportunity for alternative lenders to provide liquidity to take market share, drive pricing, and dictate terms. Although most private debt strategies are poised to benefit from higher risk-adjusted returns on a look-forward basis, several strategies look particularly interesting. One such area that is a direct beneficiary of bank regulation is synonymously known as Bank Risk Sharing, Regulatory Capital Relief, or Significant Risk Transfer. These strategies focus on bespoke transactions with banks that synthetically transfer the risk associated with certain assets held on the bank balance sheet to a third party in order to reduce the regulatory risk weighting of the asset and the capital held against it. As banks seek to optimize their balance sheets to preserve gross margins and equity value, these types of transactions provide a supportive solution.

One area of the banks' balance sheet that has become increasingly scrutinized as of late is their commercial real estate (CRE) portfolios. This is particularly true for commercial and regional banks given their ability to assume concentrated asset portfolios and avoid certain regulations governing the systemically important institutions. In addition to the uncertainty in the outlook of entire property types in the post-covid era (e.g., office, hospitality, retail), higher cap rates and lower valuations have caused banks to sell off assets that may often still be performing and to reduce their CRE lending activities. This has created the opportunity to acquire loans backing fundamentally healthy assets at a discount given that the banks have become non-economic, forced sellers. At the same time, higher interest rates have made existing debt more difficult to service. As there are few options to support a refinance, borrowers are being faced with the predicament of having to pay down an existing loan to accommodate an extension or hand the keys to the lender. The current supply-demand imbalance is creating significant opportunities to originate new CRE-backed loans and generate a better risk-adjusted return than has been achievable in the past.