News & Views

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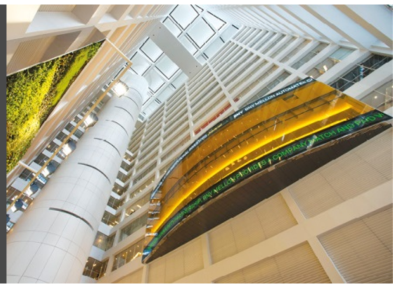

Turning the tide

Incoming Basel III capital adequacy requirements are driving major shifts in European bank lending trends and the types of institutions providing loans, says Alcentra chief investment officer Paul Hatfield.

Basel III capital adequacy rules, introduced in the wake of the 2008 global financial crisis, have had a dramatic impact on the European banking sector, prompting major banks to raise hundreds of billions of euros[1], hire new regulatory and compliance staff to help meet the latest requirements and, in some cases, jettison riskier business divisions.

According to the European Banking Authority, the main purpose of the Basel III agreement and its implementing act in Europe, the so-called Capital Requirements Directive (CRD IV) package, is to strengthen the resilience of the banking sector in the European Union (EU) so it will be better placed to absorb economic shocks, while ensuring banks continue to finance economic activity and growth.[2]

But while improving banking resilience in a post financial crisis world might seem a practical, even necessary goal, its phased introduction has already triggered a range of unintended consequences of concern to the wider European business and investment community.

Among these, small and medium-sized businesses (SMEs) - often cited as the engine room of economic growth[3] in markets such as the UK and who previously relied heavily on banks for loans -have found many banking institutions increasingly unwilling or unable to lend to them.

Lending constraints

Paul Hatfield, chief investment officer at specialist investment manager Alcentra, says: “Because of the regulatory capital implications of Basel III, banks can’t do as much lending to SMEs as they used to because it takes too much regulatory capital. That’s why we have seen more corporate rights issues, with banks pulling back from lending in many cases.”

Despite some modest increases in UK bank lending to SMEs over the past 18 months, driven partly by government pressure on financial institutions to support business – the ongoing credit squeeze in this sector has prompted the development of a number of alternative lending sources. Among these, investment managers like Alcentra have been increasingly active in the alternative lending space – moving into a space increasingly vacated by many banks.

Lending in the SME sector requires stringent checks and due diligence - to eliminate the selection of potentially risky or unviable deals – and this can prove extremely time and labour intensive. However, Hatfield believes the private loans business can deliver positive gains to both investors and dedicated specialist lenders in an environment where bank lending capital has become an increasingly scarce commodity.

Describing the current environment, Hatfield says: “We have been one of the beneficiaries of recent regulatory change and market growth in this sector has recently been keeping our direct lending teams very busy. While the banks haven’t withdrawn totally from the lending market, they no longer write many of the big ticket items they used to and have increasingly limited their corporate lending at the smaller end of the market.”

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[1]FT. Basel IV spectre looms for battle-worn bankers. 14 March 2016.

[2]Implementing Basel III in Europe: CRD IV package. European Banking Authority. 03 March 2015.

[3]Grant Thornton. Agents of growth: the MSB agenda. 12 June 2015.

Commenting on the wider picture for both loans and the capital adequacy of banks, Hatfield notes a sharp contrast between the US and Europe, with a rise in non-performing loans (NPLs) a recent feature of the European landscape since the Global Financial Crisis.

“The number of NPLs in the US has declined steadily since the height of the financial crisis as the US took radical action through the introduction of the Troubled Asset Relief Program (TARP) and other measures. In Europe the picture is markedly different. In fact, the level of non-performing loans within the eurozone has actually gone up since the crisis and some banks have tended to fudge the issue rather than addressing it head on. That is unsustainable in the longer term.

“Whatever the broader impact of Basel III and other capital adequacy measures, European banks are going to have to be more transparent about their non-performing loans and take requisite action to fully repair their balance sheets where necessary,” he says.

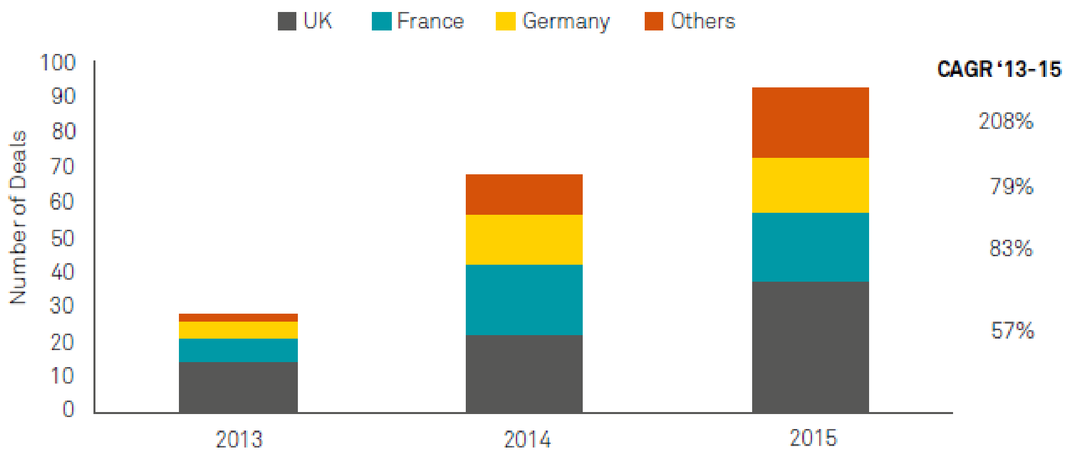
European challenge

As this process evolves and the growth in alternative lending continues (see chart), Hatfield sees key lending opportunities emerging in continental European markets, though he adds that the UK has already done much to tackle its own banking sector concerns.

“Most UK banks are in reasonable shape now, having have done a decent job of sorting out problems with their balance sheets. But some of the continental European banks still have a way to go; we expect to see a significant increase in European banking sector deleveraging in the months ahead,” he says

Commenting on the business potential for lenders in continental Europe he says: “In terms of business opportunities France, Germany and parts of Scandinavia all look strong and Spain and Ireland could also provide significant opportunities in distressed and direct lending as the market evolves.”

DIRECT LENDING GROWTH IN EUROPE (BY DEAL COUNT AND JURISDICTION)



CAGR = Compound annual growth on debt
Source, Altium Mid-Market Monitor Report, Q4 2015

Hatfield adds that while the market has seen some resistance to Basel III, the sheer volume of non- performing loans on European bank balances means change - and further bank deleveraging - now appear inevitable.

"In terms of unwinding NPLs, the European banking sector has only scratched the surface. We believe there is a lot more deleveraging to come to come," he adds.

The evolving landscape poses a range of threats and opportunities to the various market players. While full implementation of Basel III regulations is unlikely to be concluded until 2019[4], there are already some concerns in the wider banking community that these could evolve into a more wide- reaching Basel IV initiative. This might include an extensive overhaul of the capital treatment of banks' trading books and perhaps restrictions on the way they calculate their risk weighted assets.[5] Others, including Bank of England governor Mark Carney, believe market concerns about a new wave of regulation are being exaggerated and banks have little to fear from evolving capital adequacy regulation.[6]

Whatever the changes ahead for the European banking sector, the SME lending market looks set to offer growing opportunities for specialist asset managers who can help support companies and support the increasing need for reliable sources of new funding.

RULES OF THE GAME: BASEL III IN FOCUS

Basel III is a set of international banking regulations developed by the Bank for International Settlements (BIS) in order to promote stability in the international financial system. Following on from earlier Basel I and II capital requirement measures its purpose is to reduce the ability of banks to damage the economy by taking on excess risk. According to BIS[7] the measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures.

Under Basel III BIS works closely with banks to implement reforms that target:

- bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress.
- macroprudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time

Basel III requires banks to maintain higher levels of capital than they did previously, with minimum common equity holdings at banks increasing from 2% to 7% of risk weighted assets. According to BIS, full Basel III implementation is expected by 2019.

[4]FT. Basel IV spectre looms for battle-worn bankers. 14 March 2016.

[5]Ibid.

[6]Bloomberg. Carney says news of Basel's next big wave not fit to print. 01 December 2015.

[7]The Bank for International Settlements (BIS) as at 17 June 2016.

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