DISCUSSION OF “BANK CAPITAL AND THE GROWTH OF PRIVATE CREDIT”

Karen Pence

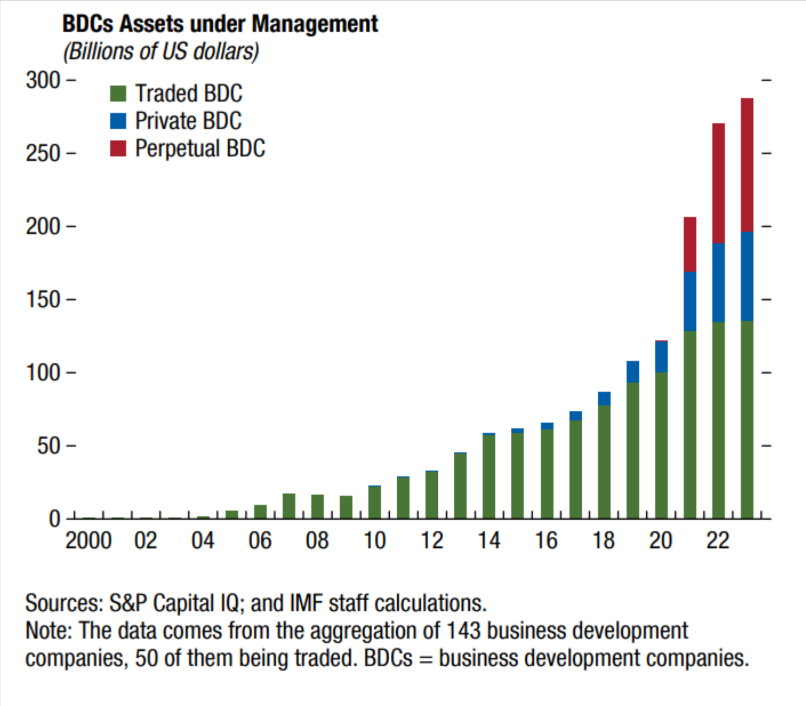
Stanford “Banks and Beyond” Conference

April 2025

Note. The views in this presentation are mine and not necessarily those of the Federal Reserve Board or its staff.

BUSINESS DEVELOPMENT COMPANIES

- Business development companies (BDCs) extend loans to and invest in the equity of middle-market companies
- Represent a small but growing share of loans originated to businesses
- Since many types of BDCs are open to retail investors, detailed data on their balance sheets are publicly available
- BDCs are thus a good laboratory to examine
  - Why is activity shifting to the nonbank sector?
  - Does it matter?



Source. International Monetary Fund.

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

WHY (NOT): SUPERVISION AND REGULATION

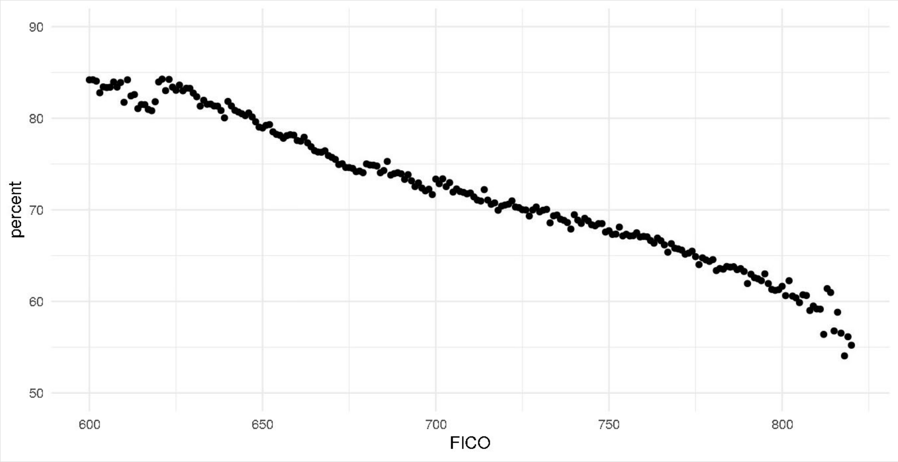
- Authors show that capital requirements can't explain why BDCs are increasing
  - BDCs are hold more capital than banks
  - In some ways not a surprising finding -- SEC regulatory leverage limits
  - But the authors go through all the bells and whistles (risk weights, stress tests) to demonstrate this point
- Authors attribute BDC growth instead to:
  - Banks facing more supervisory scrutiny (2013 leveraged loan guidance)
  - Banks obtaining better ROE on other products (such as lending to BDCs)

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

MORTGAGE MARKET ANALOG

- Nonbanks now originate and service the majority of US mortgages, partly because of changes to capital requirements
  - "Mortgage servicing right" capital requirements became more stringent
- But if capital was the only reason, banks would specialize in mortgages extended to low credit score borrowers
  - Mortgage servicing rights have less value for borrowers who are more likely to default
- Answer could be greater supervisory scrutiny for lending to riskier borrowers

Share of mortgages originated by a nonbank by credit score



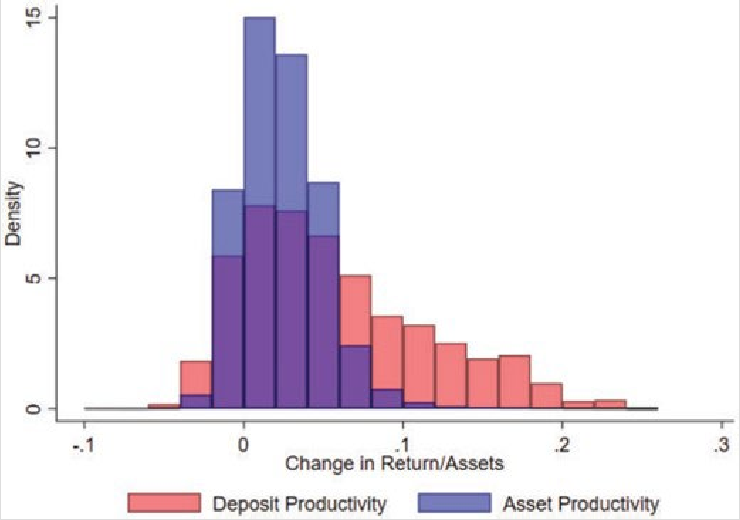
Source. HMDA (2021)

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

BANKS HAVE MULTIPLE PRODUCT LINES

- Banks prioritize customers that they can cross-sell more profitable products to
- Profitable products exploit bank comparative advantages
  - Banks can offer government-insured deposit accounts
  - Banks are integrally connected to the payment system
  - Banks have cheaper sources of funding

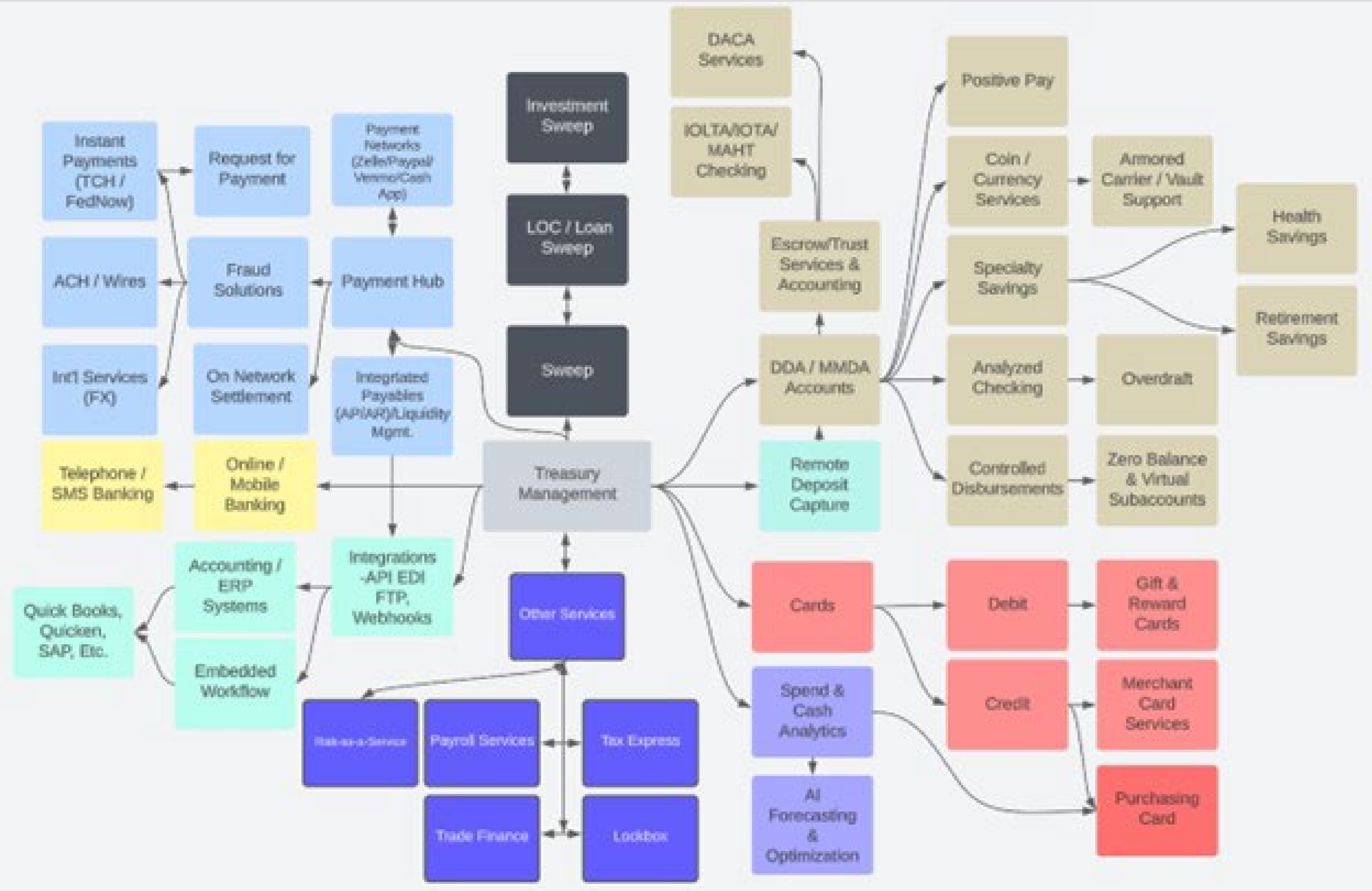
Bank profitability from deposits relative to loans



Source. Egan, Lewellan, and Sunderam (2022)

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

Treasury Management Functions Provided by Banks



https://southstatecorrespondent.com/banker-to-banker/treasury-cash-management/5-steps-to-better-treasury-management/

PRODUCT LINES AND RISKIER BORROWERS

- Certain types of borrowers are more profitable for banks than nonbanks because of cross-selling opportunities
  - Banks are less likely to be able to sell wealth management services to riskier borrowers, or earn lots of interchange fees from their credit-card purchases
- Conversely, banks don't want to take risks that will imperil their ability to cross-sell products (e.g., reputational risks from mortgage foreclosure)
- While monoline nonbanks can shed outsized losses from a particular business line by declaring bankruptcy, banks cannot follow the same strategy without sacrificing their other business lines

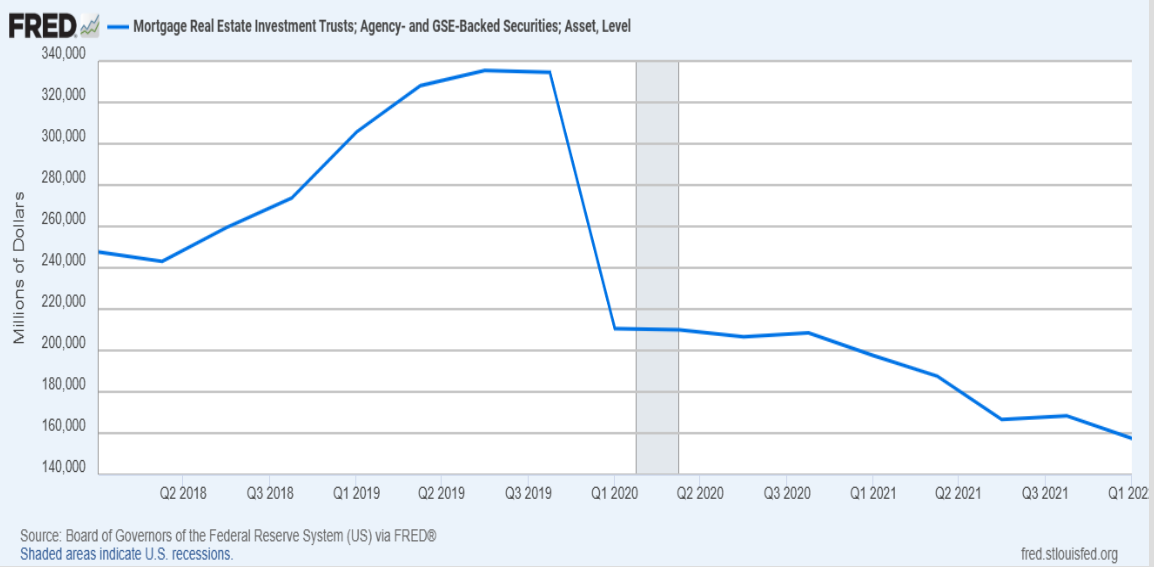
The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

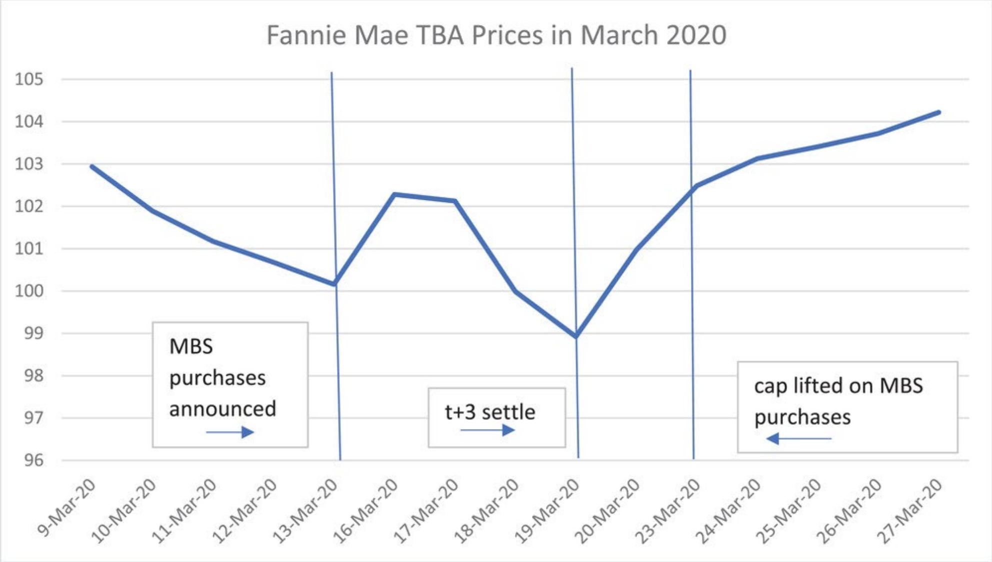
WHY DOES IT MATTER? DELEVERAGING

- BDCs have to maintain certain asset coverage ratios to comply with SEC regulations and to remain in good standing with the covenants on their bank credit lines
- If asset values fall sufficiently, BDCs may need to sell assets to stay in compliance
- If these fire sale prices become embedded in broader market prices, other market participants may face margin calls or otherwise experience losses
- BDCs likely do not take these broader externalities into account in making their investment and financing decisions

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

MORTGAGE REIT DELEVERAGING IN MARCH 2020





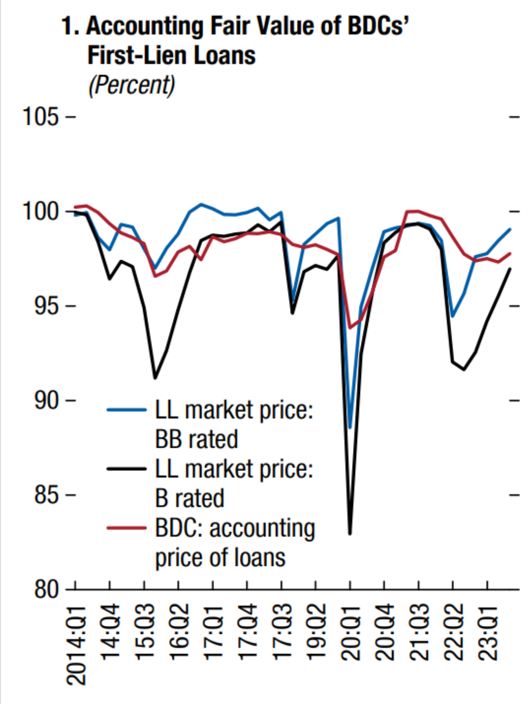
Source. Financial Accounts of the United States

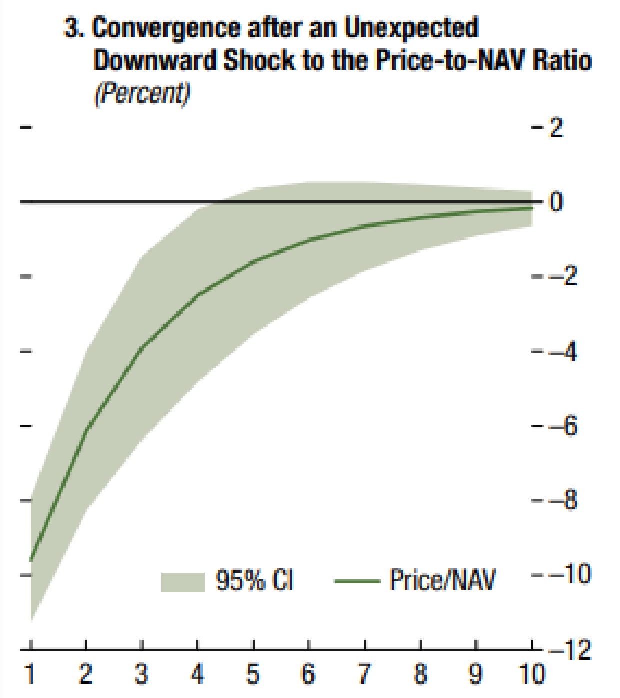
Source. Pence (2022)

The views in this presentation are not necessarily those of the Federal Reserve Board or its staff.

BDC DELEVERAGING IS UNLIKELY TO BE AS DRAMATIC

- Loans held by BDCs are valued quarterly
- Loans held by BDCs are illiquid and valued using models
- Changes take a considerable time to be reflected in asset valuations

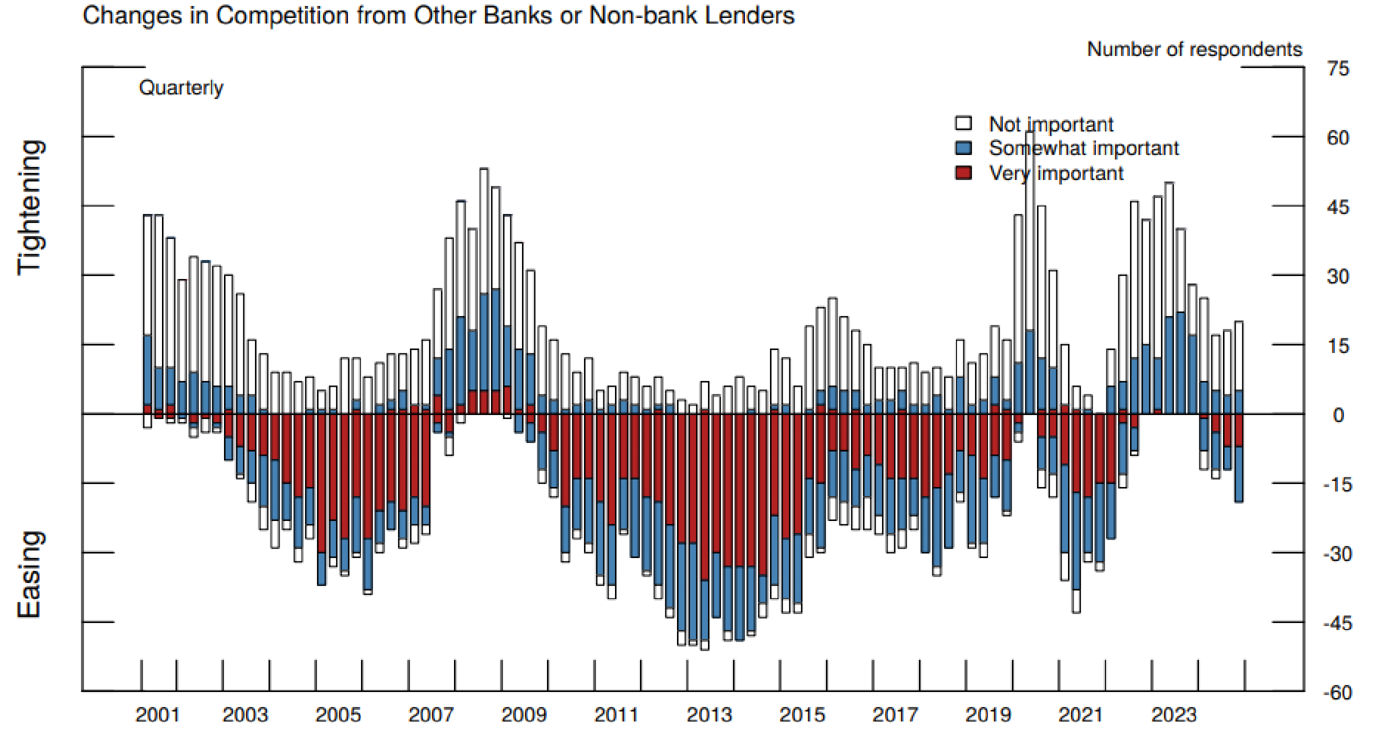




Source. International Monetary Fund.

LARGER WORRY: CONTRIBUTE TO AN OVERLEVERAGED BUSINESS SECTOR?

Banks report that competition from other lenders is a "very important" reason for easing standards on C&I loans



Positive values represent those banks that tightened their standards that quarter. Negative values represent those banks that eased their standards that quarter.

Source: Senior Loan Officer Opinion Survey.

CONCLUDING THOUGHTS

- Authors conclude "It may be worth considering whether a policy of very high capital requirements combined with lighter touch regulation and supervision could meet financial stability and bank profitability objectives"
- Since risk weights are crude measures, an increase in capital requirements may also increase risk-taking within a risk-weight category because banks need to clear a higher ROE hurdle
- If the financial stability concern is an over-levered corporate sector, does it help or hurt if banks ease their standards?