

CAPITAL PARTNERS

Expanding Horizons in U.S. Nonbank Lending

Why Does the Opportunity Set in Nonbank Lending Persist?

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The U.S. has the most dynamic financial system and capital markets in the developed world. Borrowers and lenders can access and extend credit through plentiful bank and capital market channels. The Global Financial Crisis (GFC) and its legislative repercussions curtailed banks' risk-taking activities. Nonbank lenders (NBL) stepped into the vacuum, growing and evolving to maintain the credit creation vital to consumer and economic health. Yet as its economic importance grows, much of the NBL sector remains poorly understood and sparsely invested, offering investors attractive compensation amidst some unfamiliar risks.

In a series of whitepapers, Partner Neil Hohmann dives into the NBL sector and its opportunities. In prior articles, we dissected the opportunity set in the NBL market. Equipped with a deeper understanding of the landscape, we can now turn to a discussion on why this opportunity set persists, and what makes NBL an attractive — and sometimes misunderstood — sector to investors.

Given the attractive compensation on offer, one would expect nonagency loans to have a wider investor base, but this has not been the case. In many of the sectors discussed – for example, nontraditional asset-backed securities (ABS) – prospective investors are faced with multiple barriers that limit entry to a subset of insurance companies and specialized managers. While

the outstanding debt issuance of nontraditional ABS is large, at nearly \$1 trillion, the sector is fragmented among dozens of loan types originated by small and mid-sized issuers. Each issuer may come to market just a few times a year, and issuance size can be small, typically below \$500 million. All these create challenges to investors large and small.

To start, the breadth of nonagency loan and issuance type requires a larger team of experienced professionals to cover its fullest range of opportunities. Smaller investment managers are typically resource-constrained. Conversely, larger managers are often reluctant to develop specialized teams. The smaller and irregular nonagency issuance common from nontraditional ABS, commercial mortgage-backed securities (CMBS), residential mortgage-backed securities (RMBS), and finance companies isn't material for larger firms requiring substantial issuance size and frequency to invest hundreds of billions or trillions of assets under management.

Other barriers tend to preserve the attractive yield spreads available in the nonagency space to a select investor set. First, issuers understand their target market to be sophisticated investors who are also qualified institutional buyers (QIBs). They typically privately placed their issuance under Rule 144A or Regulation D, forgoing public markets.

Furthermore, many loan-backed issues may carry just one or no credit rating, with that rating from a more specialized nationally recognized statistical rating organization (NRSRO), such as Kroll and Morningstar DBRS, rather than the major companies (Moody's, S&P, and Fitch). Next, given the smaller average issue size, most are excluded from common fixed income benchmarks, absenting them from a growing universe of passive investors.

In addition, even seasoned investors retain concerns about securitized investments, associating them with the poor performance of private-label RMBS during the GFC. (In truth, mortgages aside, there were few impairments in securitizations through the financial crisis. For example, ABS proved a far sounder credit than corporate debt.)

Finally, misperceptions regarding the liquidity of asset-backed investments relative to other credit sectors, particularly corporate debt, discourage some investors. Our research on the contrary confirms that liquidity costs associated with nonagency 144A securitizations are measured and in line with corporate debt. Numerous broker-dealers and banks actively underwrite and support a healthy over-the-counter secondary market.

Conclusion

In sum, the persistence of opportunity in NBL stems not from a lack of investor interest, but from structural barriers that limit broad participation. Fragmented issuance, regulatory constraints, benchmark exclusion, and lingering misperceptions around securitization and liquidity collectively preserve elevated yield spreads for a specialized investor base. For institutional investors equipped with the resources and expertise to navigate this complexity, NBL can offer a compelling and differentiated source of return.

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Risks

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, maturity, call and inflation risk; investments may be worth more or less than the original cost when redeemed. Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices. Mortgage-backed securities have prepayment, extension, and interest rate risks.

Asset-Backed Securities ("ABS") are subject to risks due to defaults by the borrowers; failure of the issuer or servicer to perform; the variability in cash flows due to amortization or acceleration features; changes in interest rates which may influence the prepayments of the underlying securities; misrepresentation of asset quality, value or inadequate controls over disbursements and receipts; and the ABS being structured in ways that give certain investors less credit risk protection than others.



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