Episode 107

FireSide: What's next for banks?

[00:00:05] Lara Rhame: Welcome back to Fireside, a podcast from FS Investments. I'm Lara Rhame, Chief U.S. Economist, and I'm joined today by my partner on the research team, Andrew Korz. Andrew, welcome.

[00:00:15] Andrew Korz: Thanks, Lara. Excited to be here.

[00:00:16] Lara Rhame: Today's conversation is going to focus on the banking sector, the rise of private lending and what's next for banks.

We've written a great piece called "Playbook for the Great Lending Evolution." Advertisement in advance: Look at the show notes and download it. It's really a terrific narrative and discussion of this critical topic. But I love the title because, you know, the difference between the words evolution and revolution is so powerful.

A lot of money and a lot of interest and attention has surged into private lending and private credit. But it's not a revolution, right. It's been a multi-decade evolution. And to us, this fundamentally changes the way financial markets, the economy, investors and interest rates all interact.

[00:01:07] Andrew Korz: Yeah, Lara, our reason for writing this chartbook and for this podcast is really to track that evolution over time, because to your point, it really has been a slow burn, right. You look at what the banking sector looked like 60 years ago versus today. It's completely different, but it's been a slow pace of change, over time.

So I'll throw it to you first. Can you give us an understanding of the core drivers of this change over time—regulation, consolidation of the banking market, innovation and other parts of the market? What are, in your view, the core economic drivers of what's gone on in the banking sector?

[00:01:41] Lara Rhame: I feel like the banking sector really piqued in importance for our economy in the mid-seventies, early seventies. And just through multiple phases of added regulation. We all really think of the financial crisis and Dodd-Frank regulation that came in and have seen business debt fall from 40% in the early 70s, only 20% today.

When you think about the bank share of household lending or to household debt, it has really plunged. It was over 70% in the mid-70s to now only 20% of mortgages. Even you look at consumer debt—which is your autos, your credit cards—it has gone from 60% down to 40%. A lot of numbers there, but it's been a long, slow decline.

And we've had regulation that has radically increased transparency, limited the sphere of banking investment opportunities, raised their capital requirements. And that has also pushed this massive consolidation from over 14,000 banks. Today we have just 4,000 banks. And I think maybe the last observation I'll make is this winner take all—now landscape within the banking sector.

Today, the four largest banks hold over 40%, about 43% of total deposits. That's versus, in 2020, as recently as then, we had the largest banks holding only 18%. So, it's been a huge change and really, during that time, of course, the economy's grown a lot. So while we've had this slow shrink in the banking sector, we've seen the economy just chug along.

[00:03:27] Andrew Korz: And if I may take those great points and put a narrative around it. And I think this is really the core of what we're trying to get to in this chartbook.

[00:03:35] Lara Rhame: Is this your three phases of the bank? I love this. I love this. Take us through it.

[00:03:38] Andrew Korz: Yeah. So maybe to get to the conclusion up front.

[00:03:41] Lara Rhame: I love your three phases of the banking narrative.

[00:03:44] Andrew Korz: Not to bury the lead. So when I think about how the banking sector plays within our broader financial system, I do think there are three very broad phases of that.

And of course, we're grossly oversimplifying this, but the way I see it is phase one was the pre-1970s, to your point. Where, banking was very simply the bank takes in deposits. They hold deposits. They make loans. They hold those loans in their balance sheet.

Simple Banking 101, if you will. I think phase two sort of began to develop in the 1970s and the early '80s. When you really saw this explosion in the leveraged buyout market, LBOs really demanded these larger financing packages, right. That maybe one bank alone couldn't meet that need.

So you started to get the growth of the high yield bond market, the syndicated loan market to meet these larger financing needs for these LBOs. And at first, it was multiple banks coming in and arranging these financing agreements, and then over time, it's developed into banks arranging these financings and then syndicating off the risk to other investors. So you have this transition from banks—as our Head of Private Credit, Brian Gerson, likes to say—being in the storage business to the moving business.

[00:04:57] Lara Rhame: Love that analogy.

[00:04:58] Andrew Korz: And I think we're now entering, maybe over the past five years or so, we're entering into the third phase.

Phase two isn't going away. The syndicated loan market is still growing. But I think now banks are faced with the growth of the private credit market, right. And I think banks are finally understanding that this isn't going away. Private credit is sourcing the largest share of loan growth in the market.

So they're trying to understand, how do we take part in this? How do we combat this, if you will. And I think what you're seeing is they're doing this in two ways. Number one, they're entering into partnerships with private credit firms, right. So…

[00:05:34] Lara Rhame: …can't beat 'em, join them.

[00:05:35] Andrew Korz: Precisely, precisely. We've seen almost 20 of these partnerships from major banks partnering with private credit firms. Generally speaking, both firms can benefit—private credit firms get banks, broad-based relationships, and banks can reduce the amount of capital they need for these new loans, while giving clients, access to private credits, structuring and origination, heft.

And then the second thing they're doing is lending to private credit firms, right. So private credit generally has a pretty modest leverage profile. Just as an example, if you've got a $100 million loan that a bank may have done wholly, call it 20, 30 years ago, today you've got a private credit fund that's doing that $100 million loan, and maybe the bank is lending them $25 million of that $100 million.

So banks are really understanding where the puck is going. They're starting to partner with and finance these private credit firms. And I think that's the third phase that we're just starting today. Lara, we've talked a lot about big picture things, decades long trends. Let's really focus it on today and what's going on because there's a lot of interesting things going on in the banking sector today.

Clearly the industry has been under pressure, especially following the bank failures of spring 2023. Yield curve that's been inverted. I know we've steepened more recently, but a yield curve that's been inverted for more than two years now…you've touched on a lot of the secular headwinds facing banks.

Can you walk us through where some of the more cyclical challenges sit today?

[00:06:57] Lara Rhame: Yeah, and this is something we cover in this piece of research because there's a big cyclical piece to this as well. Fed rate hikes to combat inflation really did a couple of things. You mentioned yield curve inversion, and you think about that kind of simple banking model, right.

You pay interest on short-term deposits, you take interest on your loans, and ideally there's a positive spread there that gives you a profit, or a net positive net interest margin. And when the yield curve is inverted, that just becomes a lot more challenged. It also created a huge flight of deposits into money market funds.

So banks have had to really battle each other for deposits. It just meant that they're paying even more for these deposits after 15 years of paying nothing for deposits. And then, finally, when the Fed raised rates, they really decreased or brought down the value of Treasuries. And these Treasuries are cash-adjacent bonds, and held by every bank out there in the U.S. They're really on every bank balance sheet. And these unrealized losses…it's a direct result of the regulation that we saw in the wake of the financial crisis, but it's clogging the gears of banks. And as a result, we've had bank lending really flatline since June 2022, between 2.2, 2.3 trillion.

And the good news, credit quality has stayed strong. I think that's been the savior here against the backdrop of…

[00:08:40] Andrew Korz: What about consumer delinquencies, though? I know we've seen an uptick. I think we have a chart in here on consumer delinquencies. How concerned are you about that trend?

[00:08:47] Lara Rhame: I think this is not good news. I think it's not good news for the economy because the economy has been relatively strong. So we are worried that this rise in consumer

delinquencies we usually see during recessions is notable. I think, for banks, a fewer share of their assets are held in credit card debt, in auto loans.

I don't think it's a systemic risk to the banking sector in the way that mortgage-backed securities were. And yet, we do see banks also continuing to take loan loss reserves. Again, it's grit in the flywheel of lending.

[00:09:24] Andrew Korz: It's another incremental driver of lower lending capacity.

[00:09:26] Lara Rhame: Lower lending capacity, caution, tighter lending standards, all of the things that have caused bank lending to tread water at a time when economic growth has been strong. And one place that really stands out that we didn't talk about off the top is commercial real estate lending, because that's one place where—in contrast to these other sectors where bank lending has fallen as a share of the overall debt shape in the economy—commercial real estate lending has stayed very strong on bank balance sheets.

[00:10:02] Andrew Korz: Yeah, I know. Banks have held their market share within commercial real estate lending pretty impressively. It's been really 50-ish percent for decades now.

[00:10:11] Lara Rhame: And this has caused a lot of concern and headlines at a time when CRE has gone through a pretty notable correction. There's been concern that banks are going to fail. They haven't, again, credit quality stayed good. It's kind of in the shining grace, but why is that against this correction?

[00:10:29] Andrew Korz: Yeah.

[00:10:29] Lara Rhame: That we've seen that.

[00:10:30] Andrew Korz: So I think there's nuance that's needed here. Obviously, there's a lot of commercial real estate headlines out there, specifically around the office sector.

And it's…folks, look at some of the regional bank balance sheets and look at some of the exposures and get concerned. And look, there's questions that need to be asked, understandably so. Our team did some really good work here. Again, banks are a core part of the commercial real estate debt market and the commercial real estate market relies on banking pretty heavily.

[00:10:56] Andrew Korz: Our team did some really good work on this, pulled some really good data, and we looked at it from banks perspectives, right. And when you look at the top 150, 160 banks, the exposure to commercial real estate really does depend on the size of those banks, right.

I think most of us know this, who have been following the headlines. But the smaller regional banks tend to have a higher CRE exposure, close to 30% of their assets. Larger regional banks may have 20% of their assets. The biggest banks, it's only like 5% of their assets. But this is not the whole story.

And this is really important. This is what doesn't get covered. When we think about trouble in the CRE market right now, the concern really is the office sector, right. There are spotty one-off issues in other sectors, but systemically, it really is the office sector and then everything else.

And if we just look at the CRE loan books of banks—just the CRE loan books—the smaller banks actually have much less office exposure as a percentage of CRE.

[00:11:52] Lara Rhame: Sure. They're mostly one- to four-family homes. Even the community banks are one- to four-family homes.

[00:11:56] Andrew Korz: Small, retail, maybe—they're not doing as many office loans. It's 10% to 12% of their CRE loan books. It's going to be 10% to 12%. Whereas the big banks, if you carve out their CRE loan books, closer to 20% is Office. And you take that a step further, Office is the most problematic. It's the big downtown, older, high-rise, central business district office buildings.

Now who's doing an $800 million loan on a big downtown Manhattan office building? It's not Ocean First Bank, who's headquartered in Toms River, New Jersey. It's one of the largest banks, one of the Big Four that you mentioned. So, I think ultimately, the smaller banks may have more CRE, but they have less of the very problematic CRE.

And I think we can take some comfort in that systemically. It doesn't mean that it's not going to curtail their ability to go make new loans. To me, it's another sort of incremental driver of slower loan growth over time. So that's how I see it. I think the commercial real estate exposure is going to take a while to play out, but it's nuanced.

[00:13:01] Lara Rhame: I don't think anybody does better CRE research than you and the team.

[00:13:06] Andrew Korz: Oh, thank you.

[00:13:07] Lara Rhame: This is certainly a piece of the cyclical story and it's an important one because it has gotten so many headlines and I think that extra layer of data was a big data dive.

[00:13:24] Andrew Korz: It was a big data dive and I will say the data I just referenced, all of that is in a chart in the chartbook.

[00:13:29] Lara Rhame: Yeah, a big piece of the story. Alright, so the reason that we're having this discussion around the traditional banking sector is because there is this counter side of this evolution of a decreased and receding footprint of the traditional banking sector is the rise of private markets, private equity, private lending; private credit has been a slower moving increase, but has been one that has recently felt new.

And I wanted you to frame out that for us because banks aren't going away. That is one of our core takeaways today. But this new private capital markets landscape has also been evolving right along with the receding banking footprint. And, while it's felt sort of like a rush of money has gone into these markets, I want you to frame out the evolution and the rise of these private markets.

[00:14:36] Andrew Korz: And those two trends, to your point, they go hand in hand, right. You don't have one without the other. So if you can bear with me for a second, I'll provide some data here and I want to just home in on the U.S. just to simplify this analysis, but we look at private credit today.

Private credit, which, by way of definition is broadly just a private investment firm doing a bilateral loan with a company going directly to the company, not going through a bank. So private credit today is about a trillion dollars in AUM in the U.S.

Some of that's dry powder, it's uninvested, but just for sake of argument, we're going to call it a trillion dollars in the U.S. That's up from about $250 billion about a decade ago. So that's a fourfold increase in a decade. To your point, pretty impressive growth, over a fairly short period of time. How does that compare with the size of other lending markets that tend to serve as similar borrowers? So you look at the high yield bond market, right. That is about $1.3 trillion. That's about flat from a decade ago. Hasn't grown at all.

Yeah. Banks, C&I loans (commercial and industrial) loans, it's about $2.5 trillion right there. That's up only about 40% over that time. Nominal GDP of the economy is up well over 60% over the past decade. So to your point, banks' C&I loans have grown at a much slower pace than the economy has. And the syndicated leveraged loan market, it's about one, one-and-a-half trillion dollars. It's up about 75%, but it's flat over the past three years. So more recently, the growth in that market has been stagnated. You put all that together. You take banks, you take public capital markets, you take private credit. You've got a little more than $6 trillion in outstanding corporate debt, right, when you put all those together. And that's grown consistently with nominal GDP as a whole. But if you look at where the growth has come from, it hasn't been even across those different lender types. More than half of the growth in that entire cohort of lenders has come from private credit. So more than half the growth, but private credit is still only 17% of the overall debt load of…we would call it the leveraged finance market.

[00:16:47] Lara Rhame: So it's gotten a ton of inflows, a ton of investor interest, but it still needs to be put in this context of a much larger private capital markets evolving backdrop.

[00:16:59] Andrew Korz: I think there's really two takeaways. I think number one, it's growth in private credit is not necessarily driving the U.S. economy to take on more debt overall. It's just a question of share. And number two, private credit is still only 17% of this overall market, right. So folks who ask: Is there room to grow? Is private credit reaching its ceiling in terms of its addressable market? No, this financing demand is going to track nominal GDP over time, generally speaking, and private credit currently only has a 17% share of that. So those are the two takeaways that I'd like folks to have from that data.

[00:17:36] Lara Rhame: This is really important. And I want to address something else that has come up because as we've seen so much investor interest, you did mention a fourfold increase in this space. Something which even comes up in policy circles is any kind of structural problem with the rise in private credit, because we know that banks, because they're hyperregulated, because they're very transparent, there's an idea that somehow they're structurally more sound than the private credit space. And one of my favorite slides in the chartbook is slide number 10, where we break down the balance sheet and talk about where there's vulnerabilities in these structures. Take us through that.

[00:18:26] Andrew Korz: First of all, it's a very logical question. When you're quickly moving or relatively quickly moving financing into the economy from one balance sheet to another balance sheet, and one of those balance sheets is highly regulated, to your point, and the other one less so, it's a logical question as to what are the implications of that, right.

[00:18:46] Lara Rhame: And I think it scares people. Hey, we had a big problem based in banks, we've regulated banks, and guess what? People have moved away from banks. Are we going to now have a whole new problem? And I think one of the big issues is that banks have deposit, they have overnight deposits, which is the big difference here.

[00:19:05] Andrew Korz: I think that's absolutely right. And I think that brings up the question, why are banks so regulated, right. And I think the answer is that they provide a mission critical public service. Public service probably isn't the right term, but you know what I mean. They give people and firms a safe place to park their money. Where they're confident that they can go there tomorrow, a week, a month from now, and the money is going to be there. And then they utilize that financing to go create credit for the economy. That's a core sort of function of any civilization, really. I think the cost to banks of getting access to deposits, only they can take deposits, the cost of that is higher regulation, right.

That's just quid pro quo, if you will, with the government. Private credit investors are generally sophisticated institutions, high net worth individuals, et cetera, who understand that they're taking risk in pursuit of return, right. That's not what bank depositors are doing.

Nobody thinks these investors are just putting this money in there for safekeeping. That's not the idea. So I think this notion that there should be concern just because banks face a tougher regulatory regime than do private credit firms, it's not immediately obvious to me that that should be in itself a concern because many of the reasons that banks are more highly regulated are just not present in private credit, right.

[00:20:23] Lara Rhame: And we talk a lot about the illiquidity premium and investment return. You know, depositors aren't getting double-digit returns on their deposits. Whereas private credit investors, that's a much longer lock-up, they're not withdrawing $100 to buy food. You know, it's just a completely different liability side.

[00:20:39] Andrew Korz: It's a different operation, absolutely.

[00:20:40] Lara Rhame: Yeah, of the balance sheet there.

[00:20:41] Andrew Korz: And the liability side...look, the structure of banks versus the structure of private credit vehicles are completely different, right. Completely different. If banks are very highly levered, they generally hold equity of 10% to 14%.

So, call it around nine-to-one debt to equity. They also have this liability asset mismatch that you mentioned. Many deposits can be redeemed at any time where loans can be three to 10 years in maturity. If you look at private credit and in the chartbook, we utilize publicly traded BDCs because that's where we have the best data. On average, they're levered one-to-one debt to equity; the liability side of their balance sheet tends to be maturity matched with the asset side. It tends to be three-and-a-half, four years, you know, average maturity on both sides of the balance sheet. So, structurally, I think housing, at least a good portion of middle market corporate loans we're talking about here within structures that are less levered have better asset liability management, and are funded by risk aware investors. It's not clear to me that that makes the financial system any riskier.

[00:21:43] Lara Rhame: I think that's such an important point about this whole evolution.

[00:21:49] Andrew Korz: We're talking about the differences between different lender types. I mean, every lender cares about the outlook for the economy. That's the most important thing. I would agree. I feel like we're kind of whistling past that right now.

What is your view for the economic fundamentals and ultimately the lending backdrop for the next, call it, six to 12 months?

[00:22:05] Lara Rhame: Because cyclical challenges are inevitable. I mean, unfortunately, that's just the nature of life and investing. I think, importantly, over the next six to 12 months, I do not expect a recession. My forecast has been for an incremental slowdown in growth. And I think it's certainly a great outcome for U.S. businesses, U.S. middle market companies, and is supportive and resilient of credit quality. At the end of the day, the reason recessions are so painful is because they impact credit quality and that's a problem for everybody.

[00:22:37] Andrew Korz: Yeah, absolutely. So what I'm watching is regulation and specifically, Basel III endgame.

[00:22:44] Lara Rhame: We've been waiting for that for a long time.

[00:22:47] Andrew Korz: You know, you're going to turn on a college football game this fall. You're going to see commercials, from groups supporting banks, speaking out against this potential regulation.

So I think people more and more understand what this is. I think banks have done a good job throwing sand in the gears of this actually getting implemented. It's still in the works. The Fed's saying they're going to re-architect it and take out some provisions.

It's a very complicated proposal. But ultimately, what it does is it's going to raise capital requirements for a lot of banks. It's going to make calculating risk weights for loans on bank balance sheets more complicated. And I think ultimately, all else equal, reduce the lending capacity of banks.

I think so, in stalling this, I think it's going to go past the election and ultimately be decided by the next president as to what parts of this move forward, what doesn't and even if it moves forward at all. So I think that does put the election on the table as really important—and of course, the election is important for a million reasons. But for financial regulation here specifically, I think the election sort of takes on increased importance just given the stalling in Basel III endgame.

But I think, regardless of who wins, regardless of whether this becomes new policy, the long trend arc, which is really what we're focused on in this chartbook, it's not…

[00:24:03] Lara Rhame: That's the evolution.

[00:24:04] Andrew Korz: It's a multi-decade process and the long arc is toward more regulation, toward more stringent rules to protect consumers, to protect depositors, and ultimately that means that banks are probably going to continue to be hampered in growing their loan base.

The economy is going to continue to grow, as you tell us, and with it, demand for debt financing. Ultimately, I think our view is that the lenders that are best equipped to handle that growth are probably private credit lenders.

[00:24:34] Lara Rhame: And I think this is where we can bring it back to the investor. Because private investments in private credit, it's not a flash in the pan. When I talked to our investment team, they hang their head that this is considered a hot new area, quote unquote, because to them it should be a real cornerstone of an investment portfolio. And it's something that should be set it and forget it for years. It's a long-run investment. It's a great investment with significantly enhanced yield income. But it's an investment that should not be considered new or cool. It's something that's been around for a long time. And, when we think about what's

next for banks, we inevitably ask what's next for private credit, and growth and depth and complexity in that area will only continue to expand. And as investors, we need to participate in that.

[00:25:30] Andrew Korz: There is a structural change in the economy, and I think slowly, but surely, investors are starting to understand it's not going away.

[00:25:35] Lara Rhame: Right, and you didn't miss it. I think that's the other thing. It's not, look, you've missed this opportunity. It's only going to grow and become more, more interesting.

[00:25:43] Andrew Korz: I think that's well said.

[00:25:44] Lara Rhame: More compelling. Well, Andrew, thank you so much. You know, this is a phenomenal piece of research, "Playbook for the Great Lending Evolution," and I think this is something that is going to continue to come up again. I hope everybody can give it a read. And thank you so much for joining today.

[00:26:01] Andrew Korz: Great discussion, Lara. Thanks.