The Bigger Picture for Small Business Loans

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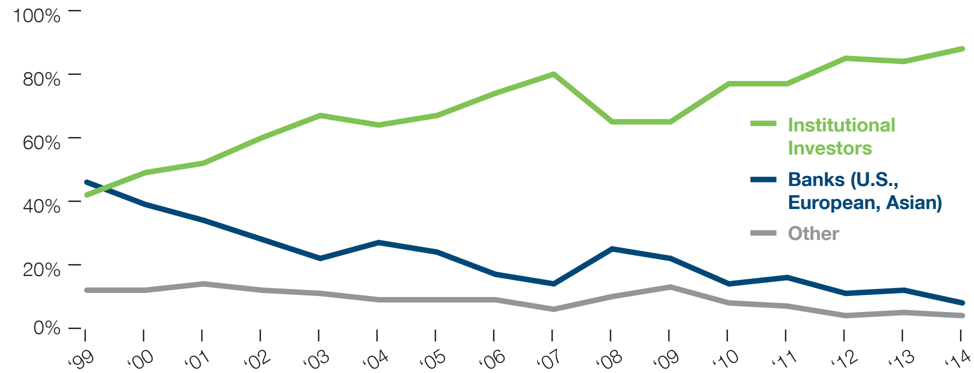
Asset managers once again have an opportunity to invest institutional capital into the SME segment of the U.S. credit market.

As the 1980s drew to a close, the collapse of the commercial real estate market pushed the country into recession. The government was forced to step in and stabilize the financial system as widespread failures of community and regional banks as well as savings and loans impacted the flow of credit to borrowers. While regulators and lawmakers attempted to deal with the crisis and write new rules to prevent a recurrence, the ability of banks to restart certain credit markets was impacted, and a new source of capital was needed.

This lack of available capital through

SHARE OF PRIMARY U.S. LOAN MARKET



Source: S&P LCD.

traditional bank financing extended into the early 1990s, presenting an opportunity for asset managers and institutional investors to replace banks as the primary source of funding for the corporate leveraged loan market, in particular. This market developed alongside the high-yield market in the 1980s, and was critical to sustaining growth in corporate mergers and leveraged buyouts. As asset managers stepped in to fill the void left by banks, the broadly syndicated, leveraged loan asset class emerged as a new capital market and today is primarily funded by institutional investors.

Crisis Rebooted

Fast-forward 25 years, and credit markets are facing many of the same challenges they did in the early '90s—grappling with new post-crisis regulations and dealing with a dearth of lending in parts of the market. Central banks have attempted to solve the problem with quantitative easing (QE), pushing interest rates to record-low levels and leaving institutional investors struggling to find yield.

While the low-rate environment has allowed larger companies to raise capital and build significant cash balances, this has not necessarily been the case for smaller companies. Often referred to as "small and medium-sized enterprises" or SMEs, this sector remains heavily reliant on commercial banks as its primary source of financing. SMEs' access to credit, however, is being affected by the reduced lending appetite of commercial banks brought on by changes in regulations and the passing of Dodd-Frank.

Herein lies the opportunity for some asset managers to once again institutionalize a segment of the U.S. credit markets. The challenge is efficiently investing institutional capital into the broad and fragmented SME sector.

The Way Forward: New Thinking

For asset managers and institutional investors to lend to SMEs on a large scale, they must develop new means of originating, underwriting and monitoring loan portfolios. Building a new system of capital transmission will not be without its challenges, but forward-thinking asset managers are working to overcome them. Among these challenges and possible solutions are:

How can asset managers profitably originate large numbers of smaller loans directly—without bank branches or traditional storefront infrastructure?

To efficiently originate SME transactions at such a large scale, asset managers will need to invest, not only in local teams with on-the-ground credit-underwriting expertise, but in new technologies that will allow them to identify and track small and medium-sized businesses in need of capital. Crowdfunding concepts that have emerged for venture capital and peer-to-peer lending platforms are also likely to play a role in bringing small businesses and institutional lenders together.

How can asset managers underwrite and monitor the credit risk of SME issuers on a large scale?

While large corporate debt transactions are assigned credit ratings and consumer credit risk can be assessed using FICO scores, a vacuum exists for SMEs. The industry must develop a cost-effective way to "risk-rate" SME debt—most likely by leveraging new technologies and "big data." Such methods for assessing and monitoring credit risk must be standardized to facilitate the development of this market and allow for broader inclusion in institutional portfolios.

How can asset managers create investment vehicles that meet the differing needs of institutional investors?

There is no one-size-fits-all approach to delivering returns to institutional investors. Asset managers should create investment solutions that are transparent and cost-effective. These may take the form of closed-end funds, separately managed accounts or even securitizations, such as SME-focused collateralized loan obligations. This customization of solutions segmented by risk-reward profiles will be essential to developing a market with broad investor participation.

Ultimately, the success or failure of bridging the gap in SME lending will depend on asset managers' ability to create scalable and profitable direct-lending operations, as well as investors' willingness to invest in new structures if offered a reasonable return profile. Small business is the core of any economy, and credit must be present to promote sustained economic growth. If modern regulations limit traditional banks from operating profitably in this space, other investors must and will fill the void.