February 2024

THE BIG OPPORTUNITY IN BANK DE-RISKING

Banks' Need to De-Risk Can Benefit Investors in Specialty Private Credit

TPG

EXECUTIVE SUMMARY

U.S. banks are between a rock and a hard place. On the one hand, disruptive change – primarily driven by higher interest rates – has raised borrowing costs, discouraged lending, depressed asset prices, and contributed to the collapse of several regional banks in early 2023. On the other hand, tight regulatory scrutiny and the upcoming Basel III Endgame regulations may force a growing number of banks to raise additional capital and further de-risk their balance sheets.

The message for banks is loud and clear: Something has to give.

Many market observers believe that banks will have to exit certain lending areas where they've long dominated, and that non-banks – particularly private credit funds – will step in to fill the resulting financing gaps. Importantly, banks' lending is largely centered on non-corporate credit backed by collateral that typically generates predictable cash flows. As such, we are especially optimistic about the prospects for specialty private credit – also known as asset-based private credit – which is most aligned with those areas from which banks may retreat in the face of these pressures.

We believe this creates a big opportunity for investors. Not only is the addressable market for specialty private credit huge, but it also offers an expansive universe of instruments from which to choose, provided a manager has the specialized infrastructure and experience to successfully participate.

For a deeper dive on the merits of and implementation considerations for adding specialty private credit to investment portfolios, please see our recent paper, "Find the Gap: The Case for Specialty Private Credit."

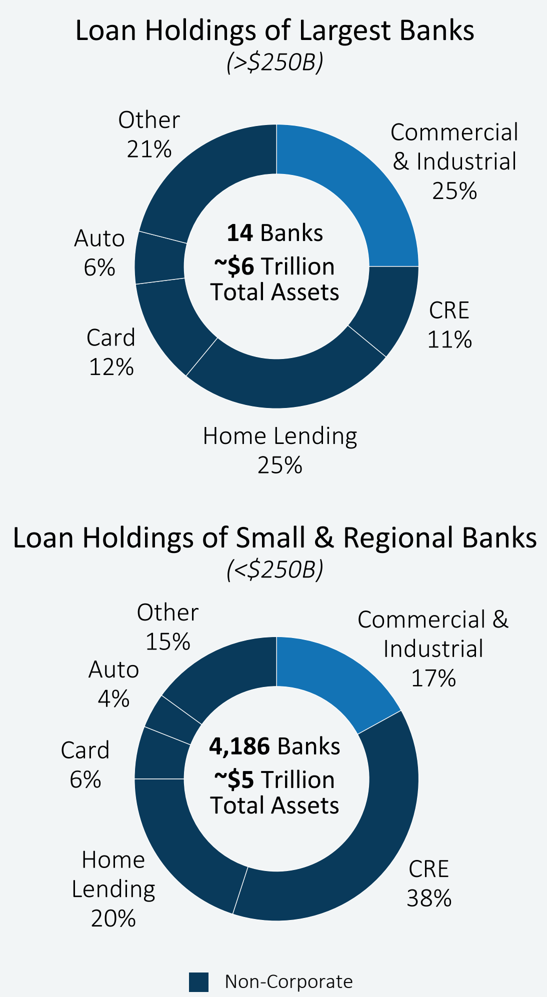
SETTING THE STAGE: DISRUPTIVE CHANGE FOR U.S. BANKS IN 2022 AND 2023

The U.S. banking sector has experienced significant disruption over the past two years. A potent mix of rising inflation, aggressive interest-rate hiking by the Federal Reserve, and fears of recession sent financial asset prices plunging and led many banks to curtail their lending activities. The pullback in lending was most pronounced among regional (i.e., small and mid-sized) banks, whose role in non-corporate lending markets is notable. As shown in Figure 1, the 14 largest U.S. banks hold approximately $6 trillion in assets, and nearly 4,200 regional banks hold approximately $5 trillion. Notably, the vast majority of banks' loan holdings, at over 80%, are comprised of non-corporate credit – a point we will explore in greater detail in this paper.

In just 16 months between March 2022 and July 2023, the Fed raised its benchmark fed funds rate from nearly zero to a range of 5.25%-5.50% – the highest level since 2007. Combined with recession fears and higher inflation, we believe this has had negative consequences for the banking system:

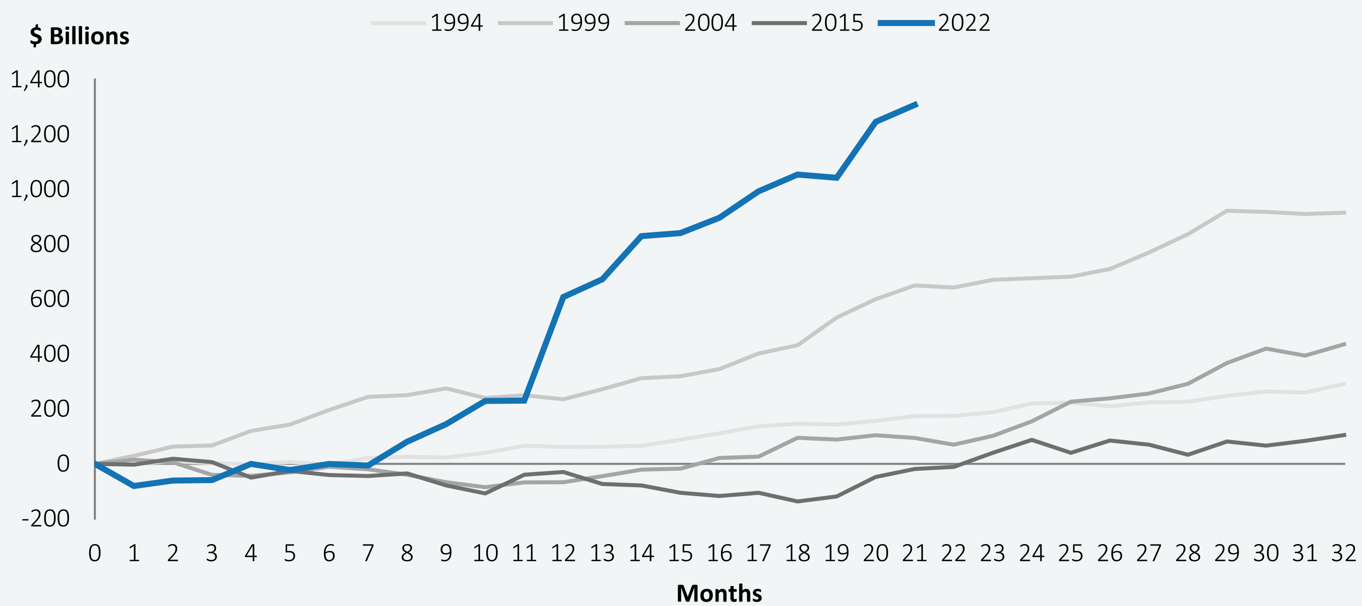
- **Deposit rates** became more expensive, leading many customers to move savings to higher-yielding money market funds (Figure 2).
- The **value of securities** that banks held on their books – especially high-quality fixed-income assets such as U.S. Treasury bonds and Agency RMBS – plummeted (Figure 3). This was a two-fold blow for banks: The securities were less valuable as lending collateral, and selling them would force the banks to realize large losses.
- The **value of loans** held by banks declined as well, which further exacerbated the adverse impact outlined above.
- **Loan growth fell** to anemic levels as banks struggled to reduce their losses and credit risk.
- Overall **credit related loss provisions rose**.

Figure 1: U.S. Banks Largely Own **Non-Corporate** Credit



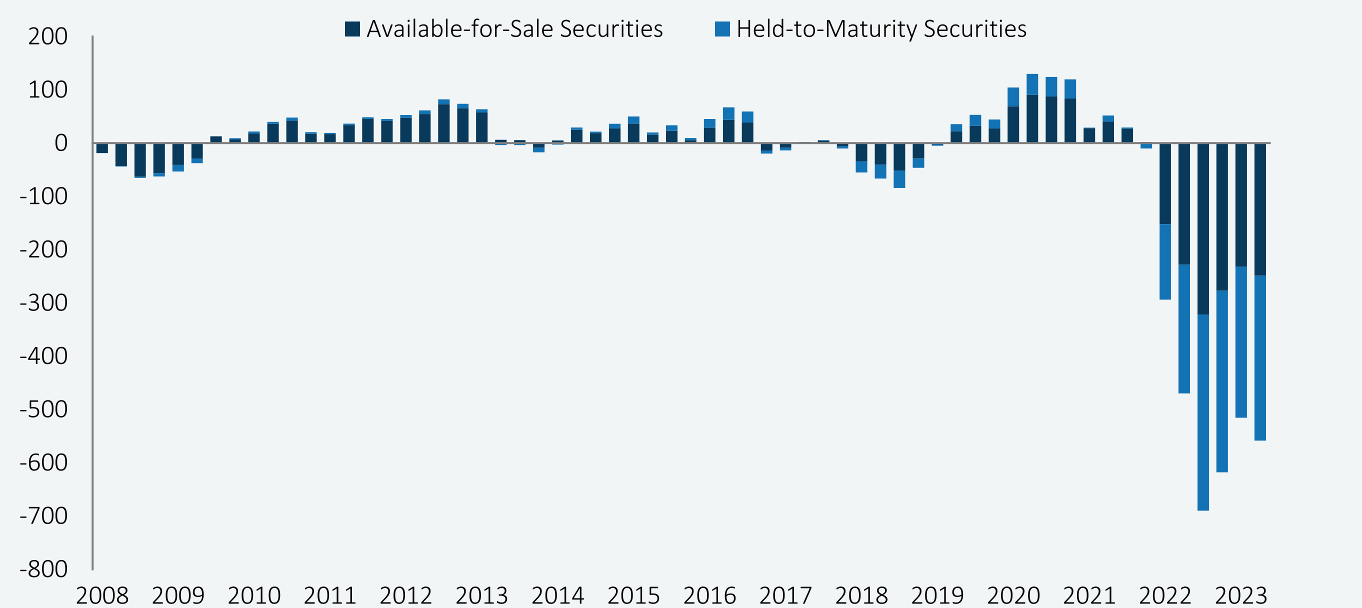
Source: SNL Financial. As of September 30, 2023.

Figure 2: Nearly $1 Trillion Has Flowed Into Money Market Funds Since the Fed Started to Raise Interest Rates



Source: ICI. As of December 2023.

Figure 3: Banks' Unrealized Losses on Investment Securities Have Surged Since 2022



Source: Federal Deposit Insurance Corporation. As of June 30, 2023.

While the aggregate effect of these consequences was unfavorable for most banks, it was particularly disastrous for a small group of niche regional lenders that were overexposed to interest-rate risk and an asset-liability mismatch. Three of these banks – Silicon Valley Bank, Signature Bank, and First Republic Bank – collapsed, and a crisis of confidence in banks of all sizes ensued. The resulting stress remains evident, to varying degrees by institution, across much of the U.S. banking system today.

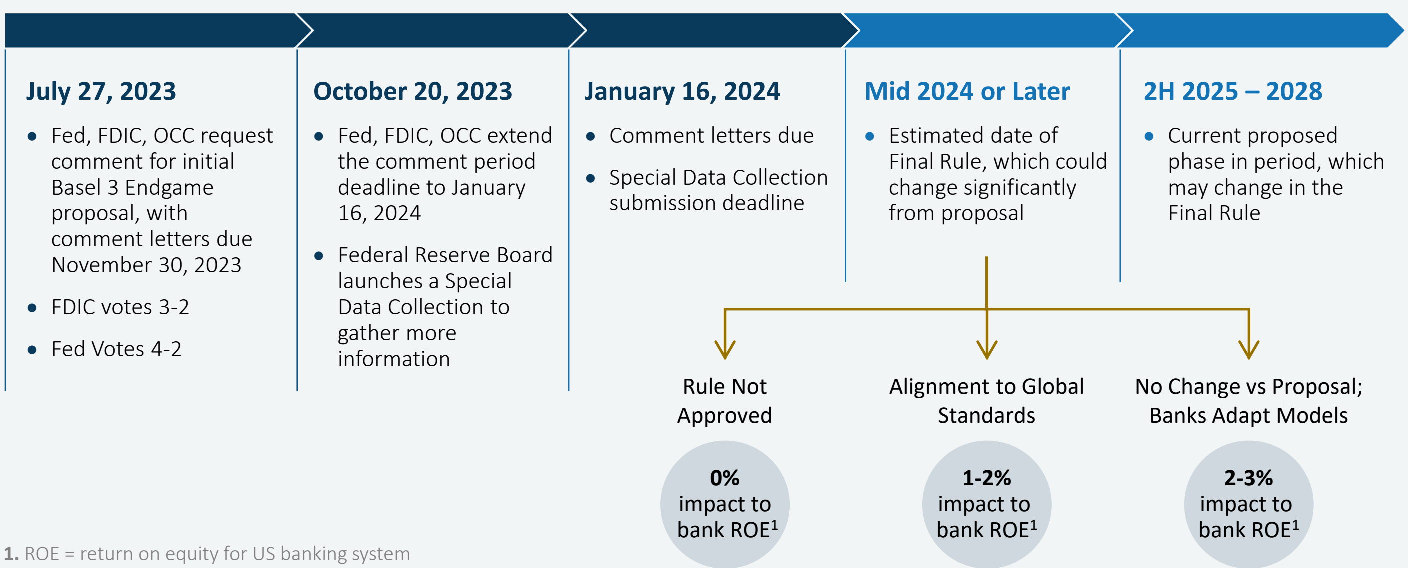
MORE TO COME: BASEL III ENDGAME = MORE PRESSURE TO DE-LEVER

As if the developments of 2022 and 2023 weren't disruptive enough, a new regulatory regime with enormous implications for U.S. banks is on the way. These proposed regulations – known as the "Basel III Endgame" – are part of a process of regulatory reform that began in 2009 and, once finalized, will transform American bank risk profiles.

A brief history lesson is in order here. "Basel" is short for the Basel Accords, named for the Basel Committee on Banking Supervision, whose members include central banks and banking supervisory authorities in 28 countries and other jurisdictions. Basel I was issued in 1988 and set minimum bank capital requirements to promote systemic stability and reduce risk for the largest banks in the world. Basel II, issued in 2004, built on Basel I and provided a framework for national regulatory bodies to deal with systemic, liquidity and legal risks, among others.

The Basel III Endgame is a highly complex update to existing U.S. bank regulations and was authored with the goal of meeting Basel III global standards, which were proposed in 2009 in response to the Global Financial Crisis ("GFC"). Following 10+ years of back and forth developments, three U.S. agencies with banking regulatory authority – the Fed, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation – proposed the final, enhanced U.S. regulatory framework for Basel III (i.e., the "Basel III Endgame") in July 2023. The public comment period for the proposed regulation ended in mid-January 2024, suggesting that the proposal could become final later this year (Figure 4).

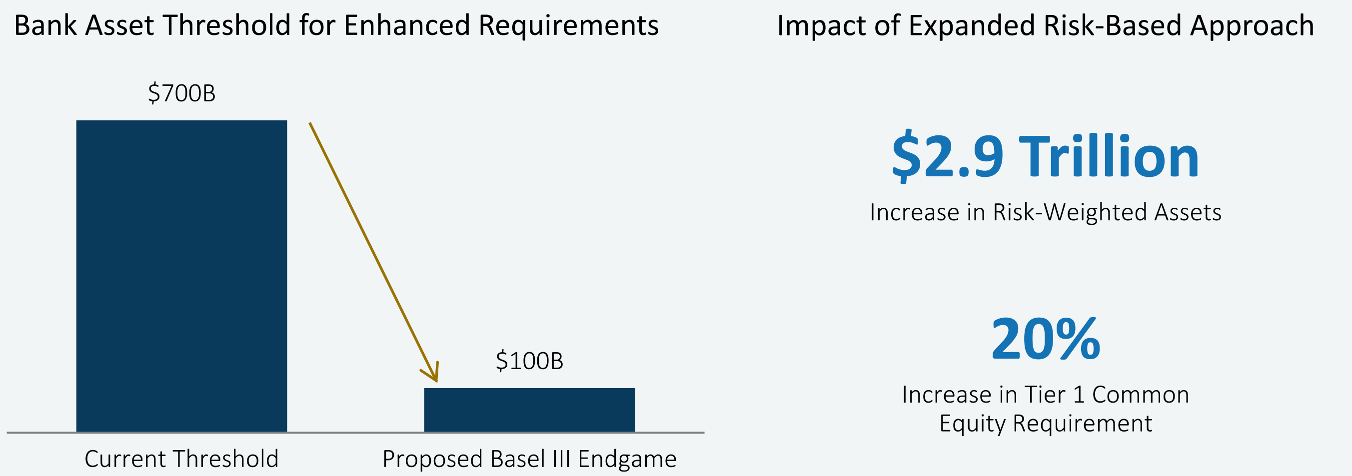
Figure 4: Basel III Endgame Timeline – A Wide Range of Potential Outcomes



1. ROE = return on equity for US banking system
Source: Morgan Stanley Research. As of November 19, 2023.

Ultimately, the proposed rules would require U.S. banks to reserve much more capital to offset the risk of certain loans and securities that they hold. As illustrated in Figure 5, for example, market observers estimate that these new regulations, in their current proposed form as of this paper's authoring, would increase risk-weighted assets by almost $3 trillion and require an increase of 20% in Tier 1 common equity across the overall U.S. banking system. **In other words: These are very large increases in regulatory capital requirements!**

Figure 5: Basel III Endgame Would Add Significantly to U.S. Banks' Risk-Weighted Assets



Note: The above chart illustrates the revised expanded RWA requirements under the Federal Reserve rule proposed in 2H 2023, which would be phased-in over three years starting July 1, 2025. For Category III and IV banks, the requirement to reflect AOCI in regulatory capital would also be phased-in over three years starting July 1, 2025. The rules would be fully phased in on July 1, 2028. Still, it is unclear if the market, or the banks, will fully utilize this phase-in or instead accelerate capital building by tempering share repurchases or shedding assets.
Sources: Company data, Basel Pillar 3 Disclosures, Morgan Stanley Research estimates.

The Basel III Endgame's impact on regional banks would be meaningful as well: It would lower the threshold for compliance to banks with at least $100 billion in assets, which is significantly lower than the current minimum threshold of $700 billion. This is a major concern for investors, whether they own bank stocks or are participants in markets supported by such banks.

While the new regulations would apply to all banks above the $100 billion minimum compliance threshold, the effects would be most acute for institutions with $700 billion or less of assets, which previously weren't covered by Basel requirements. Pressure on these banks to reduce balance-sheet risk and cut expenses – which already was high – could soar.

While we expect significant modifications to the currently proposed Basel III Endgame rules before final implementation, **we believe it is reasonable to assume that the new regulatory framework will force banks to offload significant amounts of risk-weighted assets to non-banks and other parties and/or to raise expensive equity capital. In other words:**

> ***U.S. banks' misfortune may present specialty private credit investors with a big opportunity.***

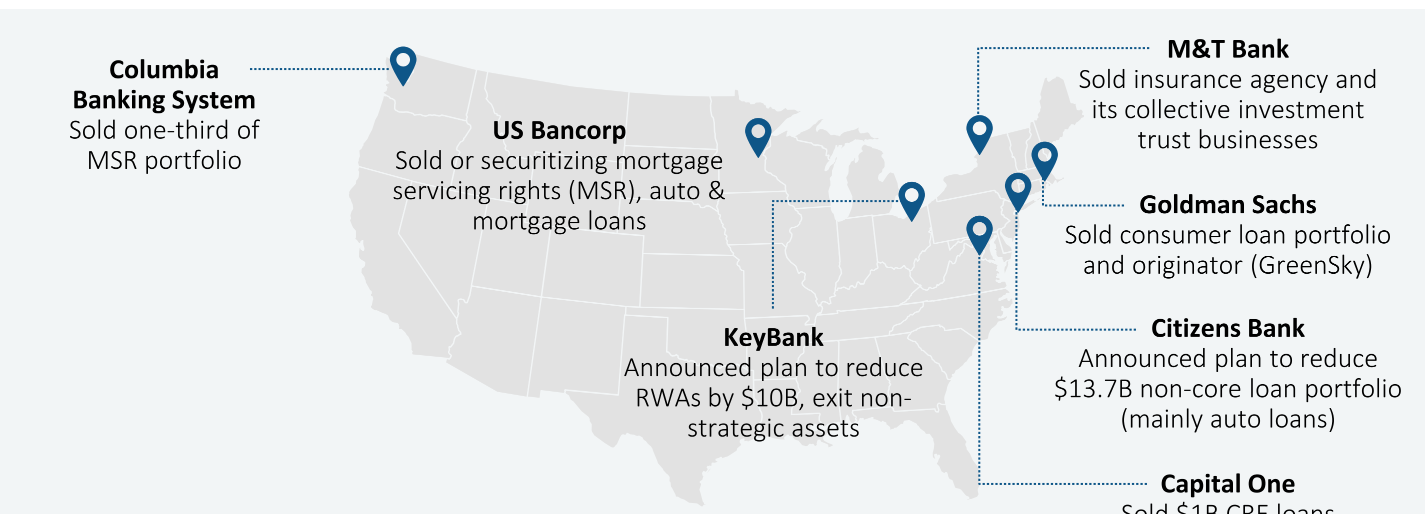
OPPORTUNITY IS KNOCKING FOR INVESTORS

Specialty private credit investors' big opportunity is that banks, effectively, will likely have to shrink in order to meet these new capital requirements. Banks can do this in a variety of ways:

1. **Asset Sales:** The simplest way to de-risk is to sell assets – typically loans, securities, and business units – to other parties. See Figure 6 for some recent examples of this.
2. **Securitizations:** Securitization is a process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. Residential mortgage-backed securities are perhaps the best-known type of securitization.
3. **Flow Partners:** "Flow" arrangements involve a capital owner agreeing to buy loans from an originator on a programmatic basis, often subject to certain criteria (e.g., FICO, LTV, etc.). These arrangements allow an originator – whether a bank or a non-bank – with a limited balance sheet to continue to create new loans without needing all the capital required to retain those loans, while the purchaser obtains desired credit exposure.
4. **Synthetic Risk Transfers (SRTs):** SRTs are complex contracts that allow banks to transfer the risk of certain credit assets to another party in exchange for payments. Essentially, SRTs are a form of insurance in which the bank continues to own the assets but with better capital treatment. Readers may also encounter the term "credit linked note," or "CLN," which is a substantially similar concept.
5. **Bilateral Credit Default Swaps (CDSs):** CDSs are bilateral over-the-counter contracts that transfer the risk of a credit exposure – such as a bond or loan – for a specific borrower from one party to another, again affording better capital treatment. Typically, the buyer of a CDS makes periodic payments to the seller in exchange for a payout when a credit event (i.e., a negative change in a borrower's ability to make an interest payment) is deemed to have occurred.
6. **Raising Equity:** Adding new equity is a straightforward de-risking method. It strengthens a bank's capital structure by reducing the proportion of risk-weighted assets on the bank's balance sheet.

For bank management and shareholders, raising equity is the most costly option. As such, market observers broadly expect to see an increased volume of asset sales and risk transfer-related transactions in the coming years, as bank management will presumably seek to avoid that costly last-resort option.

Figure 6: Banks Are Selling Assets to De-Risk



Sources: Public company filings/press releases as of December 2023.

HOW CAN SPECIALTY PRIVATE CREDIT INVESTORS BENEFIT?

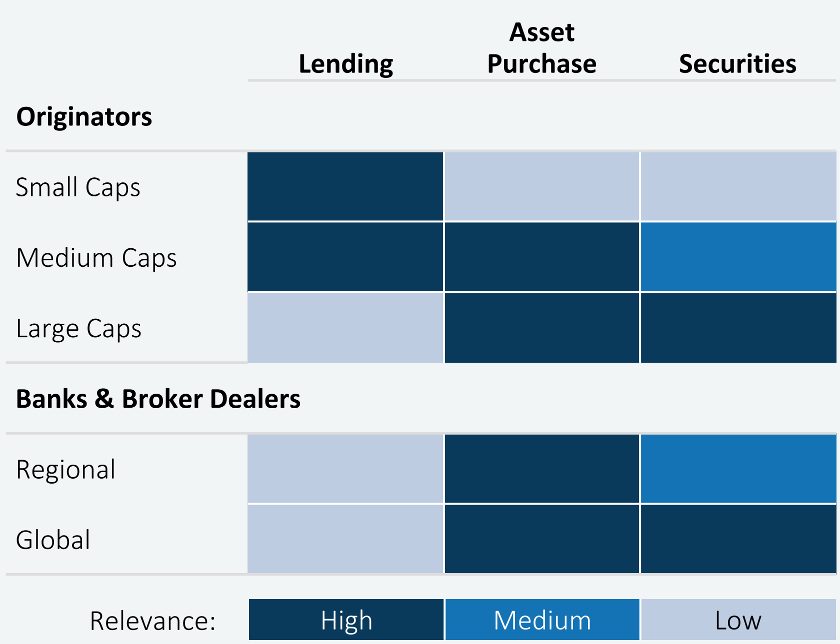
We mentioned earlier that nearly 80% of the credit currently held by banks is non-corporate credit. Meanwhile, to date, private credit strategies have largely been focused on corporate credit. This is where alternative asset managers and other non-banks with established asset-based or specialty private credit expertise and capabilities come in. Needless to say, given the $10+ trillion aggregate size of bank balance sheets impacted by these developments, we believe that investors with sufficient size, expertise and flexibility will have a large, highly varied universe of potential opportunity resulting from banks' need to de-risk.

In our view, there are several ways in which alternative credit funds can capitalize on this market dynamic. They can:

- ✓ **Purchase assets** sold directly by banks as investments
- ✓ **Assume the role of originating** many of the forms of lending that banks previously dominated
- ✓ **Provide capital and liquidity to banks** as a means for them to de-leverage
- ✓ **Provide capital and liquidity to non-banks or "specialty finance" originators** that have traditionally borrowed from banks but will now need other sources of debt and channels for placing their originations

In Figure 7, we illustrate these high-level mechanisms to deploy capital into this dislocation, which we believe are relevant across both banks and originators that are being impacted.

Figure 7: Capital Solutions Mechanisms in Specialty Private Credit



AND THE WINNERS ARE…

Not all credit investors will be able to take advantage of this bank de-risking opportunity. We believe that specialty private credit asset managers will need to have deep expertise in these non-corporate credit sectors. This, of course, requires **proficiency in those underlying collateral types**; however, for many types of lending, it will also require **specialized infrastructure,** such as data and analytics for both underwriting and portfolio management, the operational infrastructure for servicing and underlying asset management, as well as financing and capital markets (i.e., securitization) capabilities. Furthermore, given the varied nature of opportunities that may arise due to this ongoing dislocation, we believe mangers with the highest probability of success will have a **broad, flexible investment approach and capabilities spanning both asset types and the liquidity spectrum**. Finally, we also expect that banks will focus heavily on the quality and credibility of their counterparties. As such, we expect that managers who are already well-known in the ecosystem of banks and specialty finance firms will be most likely to be involved in these strategically important trades for financial institutions.

PUTTING IT ALL TOGETHER

We believe the collective impact of two powerful forces – high interest rates and the Basel III Endgame rules – should compel U.S. banks to de-risk in coming years. In particular, banks may need to reduce the risks posed by certain loans and securities on their books by shedding risk-weighted assets and raising fresh equity capital.

We further believe that this trend will present investors with a major opportunity. Specialty private credit managers should be able to help banks de-risk by buying assets that banks want to sell, stepping into the loan origination role previously dominated by banks, providing capital and liquidity to banks to help them get better capital treatment, and providing credit to non-bank, specialty finance originators that formerly borrowed from banks.

In our view, the investors likely to benefit from this de-risking will be those that engage with managers that have a broad, flexible approach across asset types and the liquidity spectrum, the appropriate specialty private credit infrastructure to implement these trades, and deep relationships with originators and banks across the ecosystem of impacted market participants.

DISCLOSURES

For more information on TPG AG Structured
Credit & Specialty Finance, visit www.tpg.com
or contact InvestorRelations@tpg.com

TPG