Spotlight on Shadow Banking: an INSEAD Alumni Live Event Report

INSEAD alums and guests gathered in October 2016 to learn how private credit funds, peer to peer lending and other forms of private lending are revolutionizing the credit markets. The event was organized by the Geneva Chapter of IPEC (Roman Pelka, MBA 00J, Montfort Capital; Pan Pan, MBA 03J, Pantèra Ventures), with participants from banking, consulting, family offices and institutions.

IPEC hosted practitioners from the various private debt categories whose business activities are filling the void left by banks. While there has always been a need for alternative finance to fund M&A activity or business expansion (e.g. private placements and mezzanine finance), there is now more demand as banks withdraw from several segments of lending due to increased regulation and capital requirements. The opportunity for special lenders and peer to peer lending platforms is quickly growing.

The panel discussion covered drivers, key success factors and pitfalls in a fascinating and rapidly evolving market. Here below are excerpts from the discussion, which was moderated by Roman Pelka.

Private Credit Market Insights

What is shadow banking and how is it financed?

To finance their direct lending practices, non-banks typically raise funds that have a pre-defined lifecycle of 3 to 10 years. Capital is raised from traditional private fund investors such as pension funds, insurance and family offices. Private debt is a particularly popular asset class currently because of its yield component. Target returns range from 5 to nearly 20%. Of course, the higher yield, the higher risk. Increasingly the allocations come from the fixed income “bucket”, and other times it might come from the “hedge fund” allocation.

What is the view on the US?

The US private debt market is highly developed and specialised. About 80% of the credit for SMEs is provided by non-banks. The loans are often special situations or complex, involving different tranches with differing grades of risk. Banks are prohibited in many cases by regulation from doing these kinds of loans.

Fundraising is easy but what about being able to deploy the capital?

It is clear that raising large amounts of capital for private debt is currently not a problem. But what about dealflow? Origination is difficult and competitive. Healthy small and medium sized businesses still have a lot of choice to finance growth. Some banks are working as partners to provide deal flow to private debt funds, some are competing for the same business. Panelists have seen some very large pension funds enter the private debt market directly because of fee pressure and because they could not find enough quality fund managers to invest in. Due diligence takes anywhere from 3 to 6 months, which slows down the pace of deploying capital. Stringent credit approval means that for every debt package approved, there are many other borrowers that are rejected. The duration of the loans is also challenging for alternative financiers, because of the need to match them with fund cycles and institutional investors' portfolio allocation strategies.

How will Europe evolve?

Alternative financing is growing in Europe but will probably never reach the penetration seen in the US. Banks still provide over 80% of SME finance (versus 20% in the US) but the banks' share is falling. Private debt is expected to become one of the mainstream options offered to corporates and private equity firms to access long-term and short term debt financing. Europe may not reach the US figure of 80% of all loans but could go to 30% in 3 to 5 years. For example, banks no longer control the USD 300 bn leasing business. It is now in the hands of non-banks. Currently pegged at around USD 60 bn per annum, European lending could grow to USD 450 bn with insurance and pension funds driving the supply of capital. The regulators are working to put into place a regulatory framework.

Why is the Swiss SME factoring market so small compared to Germany and the UK?

Factoring provides liquidity to manufacturers and other types of businesses who borrow against their accounts receivables. The receivables are sold to factoring companies who verify the information and insure the credit. They are not collateralized loans. Very large companies and international traders can

use banks for factoring but small and medium-sized companies or SMEs (which are known as KMU in Swiss German) typically turn to specialist lenders. The UK factoring market as expressed in percentage of GDP is 20 times the size of the Swiss market. Germany's is 6 times the size. The Swiss market could be a lot bigger. There are at least 500 SMEs using factoring and that number is growing at 10% a year. Panelists attributed Switzerland's small factoring market to the difficulty of due diligence. Some large financial institutions who were early entrants were burned and they retreated from the market. Less stringent accounting practices and legal systems (compared to UK and Germany), as well as cultural differences, are some of the reasons given for Switzerland's lagging in factoring.

Panelists

Neil Fillary
Partner, Blu Family Office
Mr. Fillary is a founding partner of Blu Family Office and is responsible for business development and deal origination. He has more than 15 years' experience in capital markets and asset management, having worked at J.P. Morgan in asset management, as well as listed & OTC derivatives hedge fund sales. Before that he worked at RBS and Deutsche Bank. He has a wealth diploma (2013) from the Securities Institute and holds a BSc in Business Economics and Finance from Loughborough University.

Dr Teddy Amberg
Partner, CreditGate24 AG
Dr. Teddy Amberg is responsible for business development at CreditGate24. Before he was senior manager in the global marketing and sales department at Partners Group. He holds a MA in Banking and Finance from the University of St. Gallen (HSG) and a PhD in Sociology from the University of Zurich.

Urs Van Stiphout, MBA'00
CEO and Executive Board Member, KMU Factoring AG
Mr. Van Stiphout is CEO and shareholder of KMU Factoring AG and serves on the Executive Management Board of the Austrian bank A.B.S. Factoring AG (formerly VB Factoring Bank AG). Before acquiring KMU Factor in 2009, he worked at Lehman Brothers as an advisor to technology enterprises and later as an advisor to banks in Europe. He studied law and business at the University of Geneva.

Peter Rosenbauer
Managing Director, HPS Investment Partners
Mr. Rosenbauer is a Managing Director at HPS Investment Partners. Prior to joining HPS in 2016, Mr. Rosenbauer was a Managing Partner and Head of Business Development at Renshaw Bay LLP and before that he was Managing Director at BlackRock Inc., responsible for product strategy and fundraising. Mr. Rosenbauer began his at Chemical Securities (now a part of J.P. Morgan). Mr. Rosenbauer received a BA in Philosophy from Gettysburg College.

Threats to Growth in Alternative Lending

What are the hurdles to growth of peer to peer platforms?

Demand for credit online is strong. There is clearly a financing gap for small businesses but there are hurdles to overcome. The financing gap cannot be filled quickly. The challenges facing alternative lenders are due diligence, fraud checking and risks due to incomplete data or insufficient credit records. Despite being online, a peer to peer lending platform typically makes its decisions based on "old school" style underwriting. Assessing this type of credit risk is an "art not a science" and it cannot and should not be automated.

Will private finance still be a good investment if interest rates go up?

If rates go up, there will still be a case for private credit. Startups and small companies will always have to turn to alternative lenders rather than banks because of the size of the loans and because banks' approval processes tend to be longer. Fast growing companies also need alternative finance.

From the investor perspective, fixed income is underperforming, equities and private equity returns are also far below the historical norm. The advent of zero interest rates is not the primary driver of growth of non-banks. It is the regulatory environment. Banks are being increasingly unable to lend to SMEs profitably.

What if the regulators clamp down on shadow banking?

The economics of shadow banking will not be affected by more stringent regulation. Non-bank credit is already regulated. All the panelists reported that they are already regulated by multiple financial authorities.

What is the likelihood of another credit market meltdown?

Growth is based on a need and the utility of alternative finance. Some panelists thought illiquid credit risk is better housed outside the banking system. One reason is that private lending funds should be better at matching asset and liability maturities. Money in these funds is not necessarily coming from the public; rather it is sophisticated investors who are putting their money at risk. If wealthy institutions or families become slightly less wealthy it does not incur the same damage as bank depositors losing their savings. The risk for peer to peer lending is a reputation risk. Should one of the online platforms make a series of bad loans and fail, it will have a negative impact on all the other online platforms, regardless if they have been diligent and careful.

IPEC Event Organizers

Roman Pelka, MBA'00J, CEO, Montfort Capital

Roman Pelka has been active in the alternative investment industry for over 17 years. He is the founder and CEO of Montfort, a FINMA regulated provider of Swiss fund representation to the hedge fund and private equity industry. Before founding Montfort in 2009, Roman was Managing Director at The Carlyle Group. Prior to that Roman held positions with Aspect Capital, HgCapital and EBRD. He received his MBA from INSEAD (France) and is a Chartered Alternative Investment Analyst (CAIA).

Pan Pan, MBA'03J, CAIA

Pan Pan is founder and managing partner at Pantèra Ventures, a Swiss investment advisory and family office consulting boutique. She was with Bunge Investment Management before that as head of China and deputy head of investment development. Prior to that, she worked in the consulting, investment banking and consumer goods industry in the US and Europe. Pan holds an BA in Economics from Northwestern University (USA), an MBA form INSEAD (France) and is a Chartered Alternative Investment Analyst (CAIA).---ENDS