Baker McKenzie.

FINDING BALANCE

THE POST-COVID LANDSCAPE FOR FINANCIAL INSTITUTIONS

The Phenomena of Rising Global Indebtedness and Alternative Financing

Part 8

Renew & Reinvent
Own the Future

INTRODUCTION

Welcome to our eighth briefing on how COVID-19 has affected financial institutions and its impact on current industry trends. In this edition, we focus on the related phenomena of rising global indebtedness and alternative financing (non-bank financial intermediation), also known as shadow banking, whose vulnerabilities have concerned the authorities and regulators for many years. Not only are these issues critical to financial and market stability, but they also go to the prudential soundness and businesses models of financial institutions. They also have special relevance to private equity, funds and banks. As always, in addition to sharing our own opinions, we reference the views of external commentators. Please bear in mind that our opinions are based on hypotheses that may change in a rapidly developing situation, and there are doubtless other perspectives.

Takeaways

- Global indebtedness has continued to increase since the 2008 financial crisis and, with it, concerns over the vulnerabilities posed to both individual corporates and economies by this growing burden. Despite the initial shock to markets and economies globally from COVID-19, given the scale of government and central bank support and the stronger-than-expected economic recovery, these risks have yet to come to fruition. However, the withdrawal of this policy support and potentially higher interest rates may lead to more corporate defaults affecting financial institutions.

- Similarly, the alternative financing (shadow banking) sector has grown since 2008 with non-bank financial intermediation, such as pension funds, insurance corporations and other financial intermediaries now making up around half of the global financial system. Despite financial stability vulnerabilities, many shared with global indebtedness, the sector has come through the pandemic well positioned to further increase its market share compared to more heavily regulated banks that are subject to costlier prudential requirements.

- The risks arising from unsustainable indebtedness to which both the traditional banking and alternative financing sectors have exposure are higher in emerging economies, where the debt burden is more elevated generally and whose borrowers are more susceptible to default if (as is expected) US dollar interest rates rise. Emerging economies with less policy intervention, monitoring and regulation are more vulnerable than advanced economies.

Rising Global Indebtedness

A global investment surge

In recent years, a global investment surge has driven a rising debt burden, which, combined with ongoing economic disruption, has created the conditions for rising debt defaults. Total global debt as a percentage of GDP — public, household and corporate together — is now higher than ever; at USD 281 trillion it is over 75% more than in 2008, despite one of the causes of the global financial crisis being over-leverage. With COVID-19, the global debt burden rose by an additional USD 24 trillion in 2020.

Loose monetary policy has accentuated the issue of debt. Low interest rates have encouraged investors into higher risk assets acting as "jet fuel" for private equity acquisitions, making financing cheaper and easier. Higher risk issuers have been able to raise debt at progressively cheaper rates as investors seeking income buy into bonds. In 2019, "riskier" companies issued leverage loans of USD 500 billion, whose value has the potential to drop sharply should investors need to seek safety and liquidity. [2]

Special vulnerabilities in emerging economies

Emerging economies such as India, Brazil and China have seen a marked growth in indebtedness reaching unprecedented levels. For example, China's debt to GDP increased dramatically from 150% in 2008 to 250% in 2016. With COVID-19, it soared to 317% in Q1 2020 according to the Institute of International Finance although it had decreased to 279.4% at the end of 2020. While the prospect of sharply reduced economic growth during the early stages of the pandemic has receded, the level of China's debt means that a slowdown has the potential for distress. There have also been issues with bank asset quality leading to concern that their capital ratios could fall to dangerous levels. Additionally, in recent years there have been warnings about systemic risk from China's USD 1.09 trillion money market fund industry, where funds have bought up bank credit despite an increase in bank bad debt, although regulators have imposed tighter regulations.

For the moment, due to resilient bond markets, private debt investors have largely avoided the risk of defaults that would see painful debt restructurings. This better-than-expected resilience in emerging markets is due to more diversification in the sense that foreign creditors' exposures are now spread across more economies than previously and are limited to around 20% in each. Instead, increased domestic ownership of debt limits contagion in the case of distress. One question to be answered is whether emerging economies can benefit from the rising demand for environmental, social and governance finance products. It currently accounts for only 4% of total funds under management in emerging economies. Such markets may be disadvantaged by less-developed social and governance structures and the quality of due diligence. [6]

The impact of COVID-19

The International Monetary Fund considers that government and central bank support during the pandemic may have unintended consequences, such as "stretched" valuations and rising financial vulnerabilities. It also expects that the recovery is likely to be "asynchronous and divergent" between advanced and emerging markets. In particular, because of their large external financing needs, a number of emerging markets face stress should US interest rates rise leading to a repricing of risk and tighter financial conditions. Moreover, corporates in many countries are emerging from the pandemic over-indebted, although there is a large variation depending on the size of the business (small and medium-sized businesses being more affected) and the specific sector. In case of those businesses in hospitality, travel and retail which have been most affected by COVID-19 lockdowns and social distancing, to date, a combination of employee retention schemes, loans, tax holidays and stays on litigation together with new insolvency procedures have kept many businesses on life support. As public support measures are withdrawn levels of delinquency will rise. Concerns about the credit quality of hard-hit borrowers and profitability are likely to weigh on the risk appetite of banks. Similar concerns have been voiced by the European Securities and Market Authority that higher levels of sovereign and corporate debt raise the risk of future debt sustainability issues, potentially requiring a reappraisal of credit risk in the future. [9]

Private equity may be more exposed through portfolio companies than banks, which are more constrained in their lending by regulation. For corporates with weak balance sheets, additional borrowing is unlikely to be sustainable despite the spring 2020 reductions in central bank base rates. To survive, new equity is likely to be required. To give a sense of the level of debt in advanced economies, a survey by TheCityUK in July 2020 estimated that by March 2021, the level of "unsustainable debt" owed by UK private corporates would amount to between GBP 90 to GBP 105 billion. Substantial amounts of new capital would therefore be required, whether via new equity and/or restructured debt. Fortunately, the economic impact has been less pronounced — with a lower expected take-up of government lending schemes, so estimates of unsustainable debt have since been very significantly revised down. On the other hand, in terms of new finance, private equity groups have taken the opportunity to invest in affected sectors such as travel and hospitality on the assumption that demand will quickly bounce back following successful vaccination programs. For businesses that are judged to remain viable, private equity through credit funds should be well placed to intervene, and should benefit from being less expensive than traditional lenders and able to act more quickly. Successful fund raising means that equity and credit funds have no shortage of capital available for the right transaction.

Managing non-performing loans (NPLs)

Although a global issue, NPLs are a particular problem for banks in the EU originating from the 2008 financial crisis. NLPs require banks to set aside capital affecting their ability to lend, reducing their liquidity and ultimately their profitability. The extent to which individual financial institutions are affected by the COVID-19 pandemic and, for example, their lending books and portfolios by restructuring & insolvency activity, will depend on their exposure to different sectors of the economy and in which regions. Corporate restructurings have become increasingly common and more investments may become distressed. This will inevitably impact financial institutions and their portfolios of NPLs, which, prior to the pandemic, had been gradually reducing. Most large lenders should be able to manage the deterioration of asset quality because of high capital buffers and provisions, though regional differences remain. [13]

With a substantial rise in NPLs, we should see an increase in NPL portfolio sales, as well as restructuring of loan portfolios, with investors continuing to purchase to obtain higher yield income-producing investments. COVID-19 has significantly changed debt capital markets in light of near-zero interest rates and higher levels of defaults. Given the nature of the market, banks, sellers and issuers will find the process challenging as regards identifying suitable investments, marketing and due diligence through to post-sale activities. To prevent NPLs building up on bank balance sheets, the EU is proposing further reforms to support the market and its liquidity, by improving the quantity, quality and comparability of NPL data available to participants. These measures are in addition to the EU's Credit Servicing Directive, which was approved by the EU Council in November 2021 and is intended to both regulate and facilitate the secondary market. There remain, however, EU capital rules such as "calendar provisioning" which make NPLs not only expensive to hold in capital terms for sellers but also buyers. China is gradually opening its NPLs markets for foreign investors to facilitate high-quality development of the banking and insurance markets. The China Banking and Insurance Regulatory Commission (CBIRC) issued guiding opinions in 2019 to attract foreign financial institutions specializing in wealth management, NPL disposal, factoring, consumer finance, pension insurance and health insurance services to the Chinese market. Moreover, under the phase one trade agreement between China and the US, China will allow US financial services companies to apply for AMC licenses, which will permit them to acquire NPLs from Chinese banks.

Alternative Financing

What's in a name?

The related expression "shadow banking" was first used in 2007.[17] As the saying goes — if it looks like a duck, quacks like a duck and acts like a duck, then it is a duck. In this context, it applies to institutions that look like banks and act like banks, but are not banks.[18] There is no precise definition of shadow banking, but it generally involves credit intermediation outside the regular banking system, including capital markets and, in particular, through financial intermediaries such as investment funds, captive financial institutions and money lenders, central counterparties, broker-dealers, finance companies, trust companies and structured finance vehicles,[19] as well as credit funds and in some emerging markets like China, financial leasing companies, commercial factoring companies and online peer-to-peer lending companies etc.

How shadow banking works is constantly changing and evolving, and therefore presents challenges to regulators' attempts to identify and manage the systemic risks it can (as it has in the past) pose to the financial system. Shadow banking in the form of products such as credit default swaps, collateralized debt obligations and securitizations more generally was blamed for the 2008 financial crisis. Much of the damage arose in the US, with securitized mortgages and money market funds, but in an illustration of the potential for risk to become systemic it also affected non-US banks that bought and traded these instruments.

The financial assets of the non-bank financial intermediation sector made up of pension funds, insurance corporations and other financial intermediaries amounted to 49.5% of the global financial system in 2019, up from 42% in 2008.[20] According to the Financial Stability Board, non-bank financial entities are playing an ever-more important role in financing the real economy, including managing the savings of households and corporates. In the context of the sector's growth, relative to size, shadow banks have grown faster in emerging markets (e.g., Brazil, China, India and Russia) than in advanced economies, reflecting the less-developed nature of traditional financial infrastructure. For example, as of the end of 2019, the financial assets of the broad measure of China's shadow banking (as defined by CBIRC) reached 84.80 trillion CNY (the historical peak was 100.4 trillion CNY), accounting for 86% of China's GDP in 2019 (the historical peak was 123%).[21] Although growth has been broad based, in recent years it has been driven predominantly by increases in the financial assets of investment funds, pension funds and insurance corporations, rather than hedge funds and money market funds. The drivers of this growth include higher non-financial corporate debt issuance in a low-interest rate environment.

The challenge of monitoring shadow banking

Financial intermediation connects the wider economy, namely, those with funds to save or invest with, say, prospective homeowners or businesses that need capital. Traditionally, banks as intermediaries match shorter-term liabilities with longer held assets — providing maturity transformation and leverage (their lending representing a multiple of their available equity). While, for example, single name corporate bonds pose less risk to financial stability because maturity transformation and leverage are avoided, the collaterized debt traded and held by financial institutions in 2008 was far more complex and less transparent, thereby reintroducing maturity transformation and leverage with disastrous consequences. These issues were largely resolved thanks to subsequent regulatory reforms and the role of the Financial Stability Board today in monitoring non-bank financial intermediation.

Nonetheless, the difficulty for financial supervisors remains the relative absence of (or the fact of lighter) regulation to which shadow banking is subject. Unlike banks, there is little prudential supervision with minimum capital requirements, no lender of last resort, nor the ability for retail customers and small businesses to resort to deposit protection insurance. As referred to already, the reforms put in place since the financial crisis of 2008 have addressed some risks by imposing controls over the quality of collateralized debt, strengthening valuations, maturities and risk management standards for money market funds, and for securities lending and repo, the introduction of reporting to increase transparency. Moreover, the Basel rules as well as nearly doubling bank capital ratios have tightened up on bank exposures to non-banks, although this remains a real vulnerability in some emerging markets in APAC.[23]

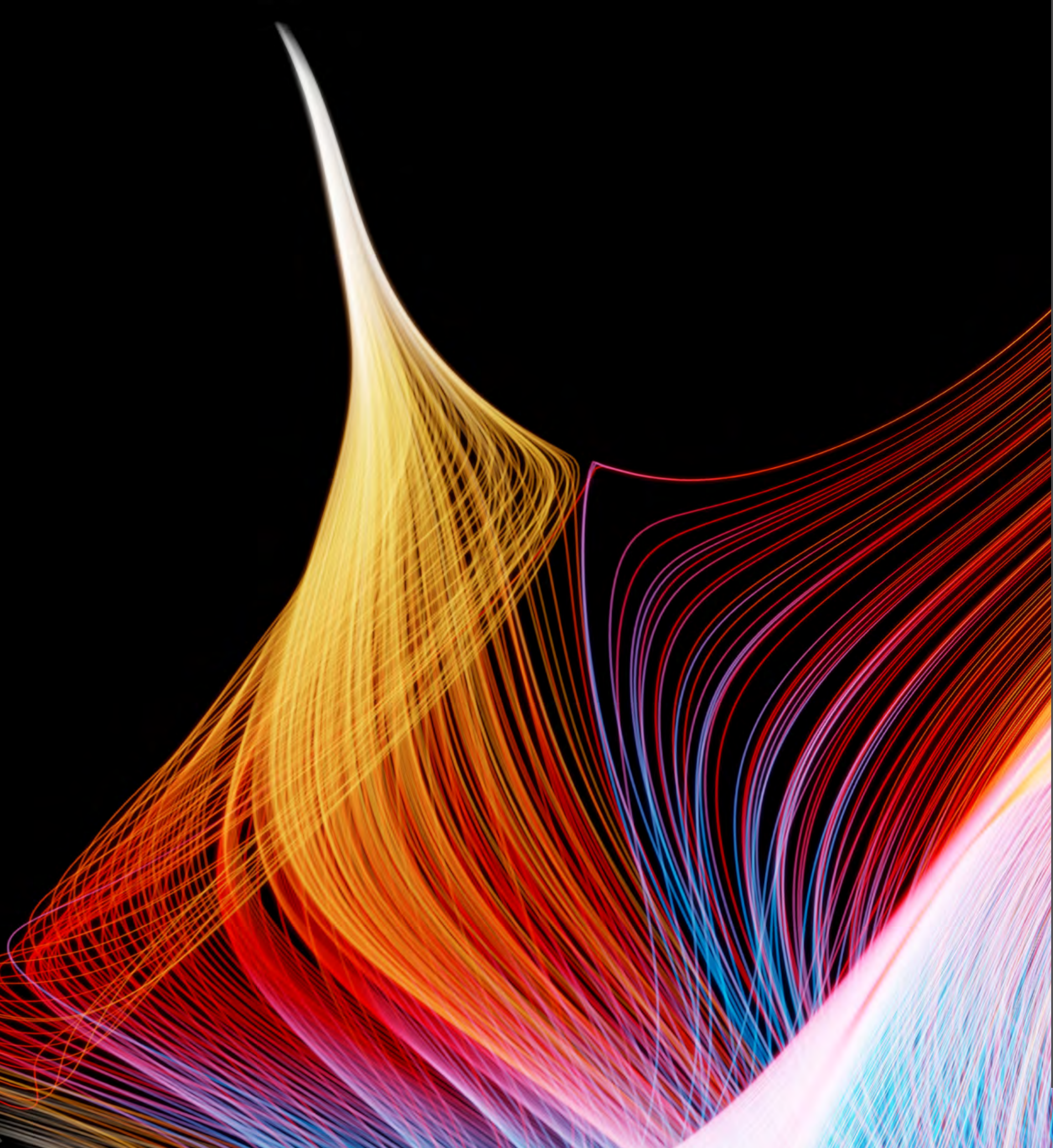
The evolving nature of shadow banking and risk

In line with its evolving nature, new risks have emerged over the last decade that have the potential to affect financial stability. The sector has benefitted from over 10 years of ultra-low interest rates, leading institutional investors to search for higher yield and, as a result, accept more risk. Its rapid growth, demonstrated by increasingly competitive lending, can tempt participants to engage in excessive risk-taking (e.g. covenant-lite) or write business outside their core markets. As discussed in respect of rising global indebtedness, there is the sheer increase in and scale of corporate debt, especially in emerging economies, and the growing use of leveraged and complex products. While this indebtedness may be sustainable in a benign economic environment, should the value of the US dollar appreciate, the burden of this debt will increase and, equally, if US dollar interest rates were to increase in response to post-COVID inflationary growth, then the costs of servicing may put entities in distress.

The degree of interconnectedness between banks and non-bank financial institutions has largely remained stable over recent years. Banks regularly extend credit to (or invest in) insurers and pension funds as examples, while these in turn provide funding to banks.

The impact of COVID-19

In the initial stages of the pandemic, in March 2020, when the scale of the crisis first became apparent, investors and corporates alike sought safety and liquidity in a "dash for cash." Elements of the non-banking system such as money market funds (MMFs) saw significant outflows while some open-ended funds experienced large redemptions. Consequently, some funds saw significant liquidity stress receiving large redemption requests at the same time as a fast deterioration in liquidity of money market instruments. These weaknesses exacerbated fears over the ability to redeem funds — in other words, liquidity mismatches — and threatened to spread elsewhere, for example, to bond markets creating the equivalent of a bank run.[24] During the first quarter of 2020, non-bank financial assets decreased slightly when compared to asset growth of banks and central banks. These pressures reduced after central bank monetary interventions, which stabilized markets and restored confidence — preserving the supply of credit to the economy. The "waterbed effect" is a useful analogy here, where pressing down on one end of the financial system (i.e., after 2008 with bank reforms) can cause risks to pop up elsewhere.[25] By way of illustration, the Financial Stability Board has proposed measures to improve the resilience of MMFs and reduce the risk of associated system-wide vulnerabilities.[26]



Outlook for alternative financing after COVID-19

In 2020, there was naturally concern that if economies went into a protracted recession, credit quality would deteriorate and defaults would increase.[27] In the event, this has not happened, as economies have adjusted to lockdowns. With the rollout of vaccine programs in the advanced economies, growth has quickly rebounded. However, it is likely that exposures to those sectors most affected, such as travel, tourism and real estate, will affect shadow banking entities as government support measures are withdrawn.

While banks may be stronger than in 2008, many are still anxious to protect their balance sheets and will be unable to match the speed and flexibility of the non-bank finance providers. Moreover, post-financial crisis banking regulation will continue to limit banks' access to leveraged finance markets. Institutions such as debt funds do not operate under the same restrictions and capital requirements as regulated banks and, as such, are in a better position to continue to grow their market share. As the sector is not a quasi-utility, unlike banks whose activities must be supervised and are not readily allowed to fail, it should be better placed to invest the record amounts of available cash in the best investment opportunities arising from the COVID-19 crisis.

Reflecting how non-bank financial intermediation is constantly evolving is the growth of cryptoassets and stablecoins. In the last 18 months market capitalization of cryptoassets has gone from less than USD 200 billion to USD 2.4 trillion and in stablecoin from below USD 10 billion to more than USD 130 billion in value.[28] This brings new financial stability (and other) risks which regulators are monitoring and which they will wish to control or prohibit some activities.

1 IIF, Global Debt Monitor: COVID Drives Debt Surge—Stabilization Ahead, 17 February 2021.

2 IMF, Global Financial Stability Report, October 2019.

3 People's Bank of China, China Financial Stability Report, 1 September 2021.

4 FT, China money market funds' rush into bank credit worries investors, 16 July 2018.

5 FT, Private lenders to emerging markets face threat, 13 April 2021.

6 IMF, Emerging Markets in Flux, summer 2021.

7 IMF, A COVID-19 Tantrum?, summer 2021.

8 IMF, Global Financial Stability Report, 6 April 2021.

9 ESMA, Risk Dashboard, 3 June 2021.

10 TheCityUK, Recapitalising the post-Covid-19 economy, 11 May 2020.

11 The CityUK, The Demand for Recapitalisation: Updated Estimates of UK Unsustainable Debt, September 2020.

12 FT, Private equity groups on diverging paths with post-pandemic bets, 2 June 2021.

13 S&P Global Ratings, European banks' loan loss provisions set to decline in 2021 after 2020 peak, 12 April 2021.

14 ECB, Non-performing loans, [site visited 7 June 2021].

15 European Commission, Improving Transparency and Efficiency in Secondary Markets for NPLs, June 2021

16 European Central Bank, Speech, Andrea Enria, Exchange of views at the Italian Senate, 6 July 2021.

17 The Economist, How Shadow Banking Works, February 2016 [no link].

18 IMF, What Is Shadow Banking?, Finance & Development, June 2013, Vol. 50, No. 2.

19 FSB, Global Monitoring Report on Non-Bank Financial Intermediation, December 2020.

20 FSB, Global Monitoring Report on Non-Bank Financial Intermediation, December 2020.

21 China Banking and Insurance Regulatory Commission, Report on China's Shadow Banking, December 2020.

22 For example, the Basel IV revisions to the securitization framework, FSB recommendations for Money Market Funds and the EU Securities Financing Transaction Regulation.

23 Harvard Law School Forum, Shadow Banking and Financial Instability, 16 April 2012.

24 FSB, Speech Randal K Quarles, Financial Stability and Coordination in Times of Crisis, 18 October 2021.

25 FSB, Klaas Knot, Speech, Rebuilding resilience: the financial system after the Covid crisis, 11 May 2021.

26 FSB, Policy Proposals to Enhance Money Market Resilience, 30 June 2021.

27 Bank of England, Speech, Seven Moments in Spring, 4 June 2020.

28 FSB, Speech Randal K Quarles, Financial Stability and Coordination in Times of Crisis, 18 October 2021.

The Resilience, Recovery & Renewal Model

Our Resilience, Recovery & Renewal model is helping organizations navigate the business and legal impact of the COVID-19 pandemic. While most businesses will pass through all three phases of the model, the phases themselves are non-linear and may recur or overlap, particularly for those with global operations. Wherever you are in your response to the pandemic, we will help you with the services and resources you need. Visit our Resilience, Recovery & Renewal Roadmap to Stability hub for more information. Also, visit our 3R Resource Center for the latest legal and regulatory updates from around the world.

Baker McKenzie helps clients overcome the challenges of competing in the global economy.

We solve complex legal problems across borders and practice areas. Our unique culture, developed over 70 years, enables our 13,000 people to understand local markets and navigate multiple jurisdictions, working together as trusted colleagues and friends toinstill confidence in our clients.

Baker McKenzie.

bakermckenzie.com

© 2021 Baker McKenzie. All rights reserved. Baker & McKenzie International is a global law firm with member law firms around the world. In accordance with the common terminology used in professional service organizations, reference to a "partner" means a person who is a partner or equivalent in such a law firm. Similarly, reference to an "office" means an office of any such law firm. This may qualify as "Attorney Advertising" requiring notice in some jurisdictions. Prior results do not guarantee a similar outcome.