Private Credit: The Original Impact Investment?

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Prior to 2010, allocations to private credit in endowment or high worth client portfolios were rare. Today, strategies under this umbrella exceed $1.2 trillion in assets under management (AUM). Many average investors now have exposure through Business Development Companies, 1940 Act interval funds, and or recently developed private vehicles managed by Wall Street firms such as the Blackstone Group and Starwood Capital Group.

Rapid AUM growth in recent years suggests the embrace of private credit is in its early chapters. AUM expansion in Europe and Asia, for example, is now outpacing North America. Given over half of current AUM is based in North America, the potential globally is substantial.

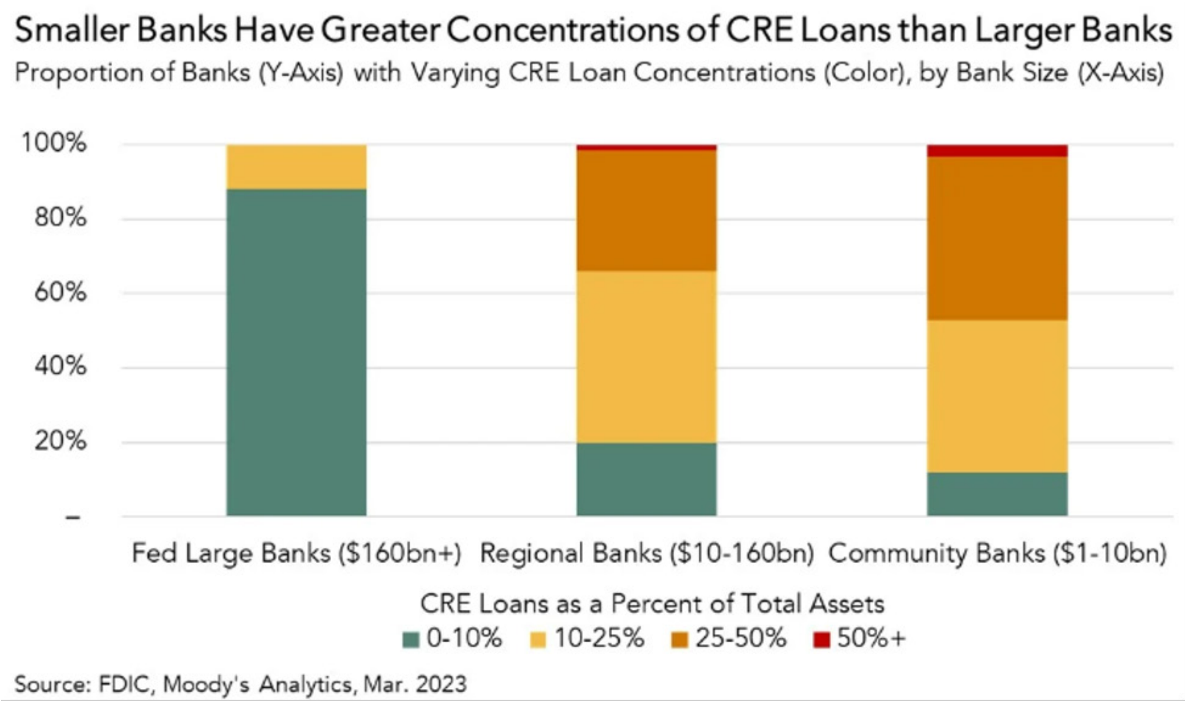
Private credit's formal inception is widely considered to be the creation of the U.S. high-yield market in the late 1970s and early 1980s. What is less known, however, is that there was simultaneously a very different origin story developing in private credit on the other side of the world.

In both cases, private credit was formed to solve problems traditional banking couldn't, which includes giving greater access to people and businesses that are overlooked or underbanked. Powerful actors in financial systems often have internal and external incentives to reduce credit exposure to individuals, small businesses, and private companies. In the U.S. and other nations, historical analysis shows this trend accelerates during crises. One could argue that crises are when a functioning financial system for the average citizen is needed most.

Within Impact Investing, expanding financial access is often referred to as Financial Inclusion. According to the World Bank, Financial Inclusion means that individuals and businesses have access to useful and affordable financial products and services to meet their needs. This includes financial transactions between people and entities, low-cost payment systems, savings vehicles, attainable credit, and various forms of insurance. This functions differently based on the size and needs of economies and includes traditional microfinance, small to medium enterprise lending (SME), and targeted lending to minority-owned businesses.

From a top-down perspective, one could argue that private credit embodies the core elements of Impact Investing: Financial returns, Intentionality of Impact, and Measurement/Reporting of goals, all of which improve transparency and accountability. Contrary to charity, Impact Investing must attract more capital by satisfying the objectives of capital providers and demonstrating concrete results for the individuals, small businesses, and private corporations that capital is directed toward. This is integral to healthy capital markets, which has been and remains a challenge for developed and developing economies alike.

According to the National Bureau of Economic Research (NBER), in 2010, the year the Dodd-Frank Act passed, large banks originated 26% of smaller commercial and industrial loans. In 2018, Large banks originated 17% of the market, or a 38.5% decline in six years. NBER research states the main factor was reduced incentives by government for banks to make small loans. Many believe this cycle is currently repeating with the degradation and consolidation of regional banks. As of July 2023, hundreds of billions in assets have transferred from the more small business friendly regional banks to larger banks. We can only assume this will magnify the lack of credit available to individuals and SMEs in the U.S.



Smaller banks hold 4.4 times more exposure to U.S. commercial real estate than big banks as a percentage of assets. Regional banks in the U.S. are responsible for an outsized portion of commercial and real estate loans, which serve a greater percentage of small and medium-sized enterprises compared to other types of lending.

This isn't unique to the U.S. or modern times. For political and practical reasons, financial systems favor large transactions. Banks frequently absorb similar costs underwriting a $500,000 loan as a $5 million loan. Regulators would rather oversee five mega-banks, all with the capacity to pay large fines and better digest sweeping regulatory changes, than 1,000 community banks of varying scale and capitalizations. A single bank with a trillion dollars in deposits is more effective from a lobbying perspective than a collective of hundreds of lenders that see each other primarily as competition.

The first casualties of this system are individuals and small businesses perceived as less credit worthy. The less sophisticated and capitalized the borrower, the greater the disadvantage. Since the 1970s, private credit has expanded to fill many gaps in financial systems in the U.S. and globally. Its growth both domestically and internationally and consistent financial performance suggests the business rests on a strong foundation.

Most investing in Private Credit is for favorable potential total returns, above-average distribution yields, and enhanced portfolio diversification, but it's worth considering the function and Impact that private credit plays in capital markets, SMEs, and the lives of individuals.

The focus of this paper is first to analyze private credit's inception, including its integral ties to modern-day impact investing. Second, it is to evaluate private credit's performance during the pandemic and any lasting repercussions. Lastly, it is to assess private credit's role and responsibility in improving financial inclusion and access to credit globally.

Micro Finance

Micro finance has been existence for centuries, if not millennia. Friedrich Wilhelm Raiffeisen's village bank movement began in 1864 and reached two million rural farmers in Germany by 1901. An important step in its formalization occurred in 1974 by the Self-Employed Women's Association (SEWA) in Gujarat, India.

Organizations, including Grameen Bank of Bangladesh, expanded credit into rural areas where the financial and social impact on individuals and communities is typically most dramatic. Economics professor Mohammad Yunus founded Grameen Bank and won the Noble Prize in 2006 for his contributions to microfinance. The disproportionate benefit of giving rural areas access to finance has been well studied and remains true today in many parts of the world. Africa, for example, is consistently the fastest growing market for microfinance with financial inclusion currently estimated at 45%. That compares to mobile phone penetration of approximately 90%. Kenya's embrace of mobile financial services contributed to financial inclusion increasing from 26.7% in 2006 to 82.9% in 2019. Private credit managers and their portfolio companies are working hard to duplicate that success in other parts of the continent.

A functioning microfinance system has ramifications far beyond financial inclusion. The economies of developing countries generally lack a traditional job market capable of employing all citizens looking for work. This is especially the case in countries with rapid population growth.

As a result, a large portion of society becomes entrepreneurs by necessity. This is evident to anyone who spends time exploring a developing country. The reach of banking systems in these same nations are usually limited, as is the capacity for regular citizens to become credit worthy. This results in wide swaths of the population operating small businesses with little formal training and even less access to capital.

Grameen Bank's original thesis was simple and illustrates the development of modern microfinance. The bank made affordable loans to impoverished but hard-working entrepreneurs. In Grameen's case, that was almost exclusively women. A seemingly trivial $40 loan may be enough to double the produce a family can sell daily at the local market. As their credit profile improves, that same family may expand from one to half a dozen stalls and be able to provide employment opportunities to family members that would otherwise have no income.

While entities like Grameen were exploring microfinance in Asia, Shorebank was founded in 1974 in Chicago. It was among the first microfinance and community development banks in North America. What started as a humble industry fifty years ago has grown globally to serve approximately 140 million borrowers through an aggregate loan portfolio exceeding $124 billion. In recent years, Green Microfinance has emerged as one of the most successful and fastest growing elements of microfinance.

At its core, microlending is trusting capital with people the formal financial system excludes. That may be due to lenders' decisions or incentive structures created by regulatory systems. Provided all major components are executed correctly, the sustainable reduction in poverty is striking.

According to studies published in the 1980s by the Bangladesh Institution for Development Studies and later the International Food Policy Research Institute, Grameen borrowers' incomes were 43 percent higher than comparable women in villages without access to microfinance. Extreme poverty for the same populations was reduced from 75 percent to 48 percent over the period. Another evaluation of Grameen was published in 1993 and reached similar conclusions.

A study by the World Bank in 1998 by Shahid Khandker found positive correlations between female borrowing via microlending and school enrollment by borrowers' daughters, improved nutrition, and increased spending on food and essential nonfood items. The main author and several other key contributors continued to publish research reaching similar conclusions through at least 2016. More recently, the World Bank concluded the reduction in absolute poverty from 44.2% in 1991 to 24.3% in 2016 was in part due to the widespread adoption of microfinance.

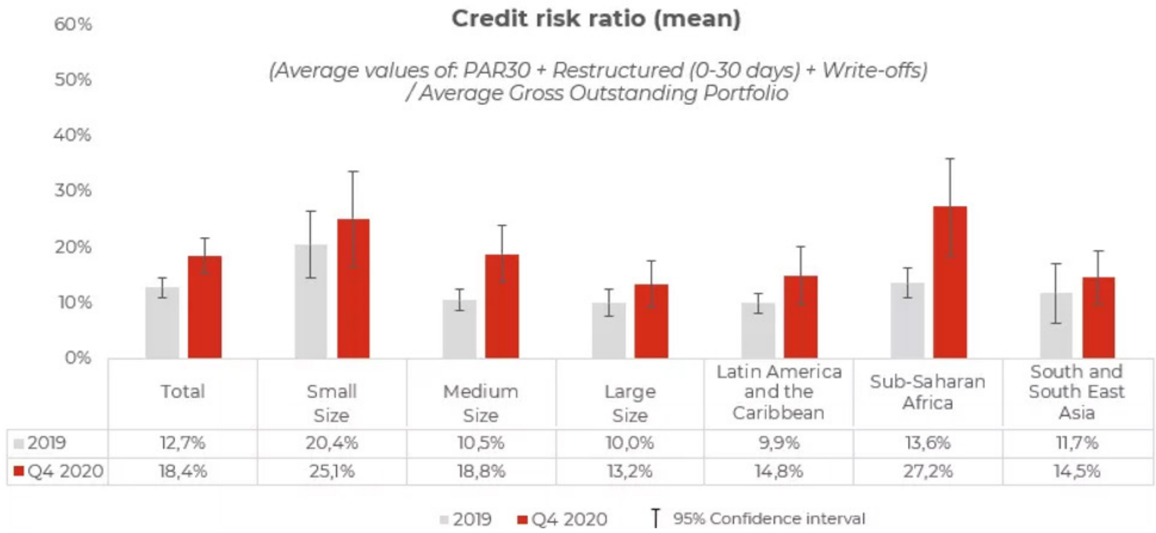
Grameen Bank and its founder Muhammad Yunus are not without controversy. The bulk of the criticism is derived from domestic politics in Bangladesh. Independent of one's view of Grameen Bank or its founder, their contribution to the early stages of expanding flexible credit to impoverished regions is undeniable. India and neighboring Bangladesh continue to have among the most vibrant microlending industries globally with numerous successful private credit managers active in one or both nations.

Recent Statistics

By 2018, 139.9 million people worldwide were served by microfinance institutions. That is 43% growth over the previous 10 years. To gauge the long-term potential of microfinance, understanding the health of borrowers and lenders is critical.

Over that same decade, the loan cost per borrower absorbed by the lender increased significantly from $68.4 in 2009 to $106.7 in 2018. During the life of the loan, however, operating expenses for the lender declined by 2.7%. Overall lender returns improved by 1.3% on assets and 2.9% on equity. From a risk perspective, the percentage of loans past due by at least 30 days rose marginally from 6.4% in 2009 to 7% in 2018. In aggregate, this data suggests a sustainable business model with the capacity to serve greater populations.

For comparison, the default rate on loans issued by the U.S. Small Business Administration ("SBA") was 9.04% in 2018. SBA borrowers generally face much stricter underwriting standards than those receiving microloans, which makes the outperformance of the latter notable.



https://www.cgap.org/blog/covid-19-and-microfinance-what-data-says-about-risk-in-sector

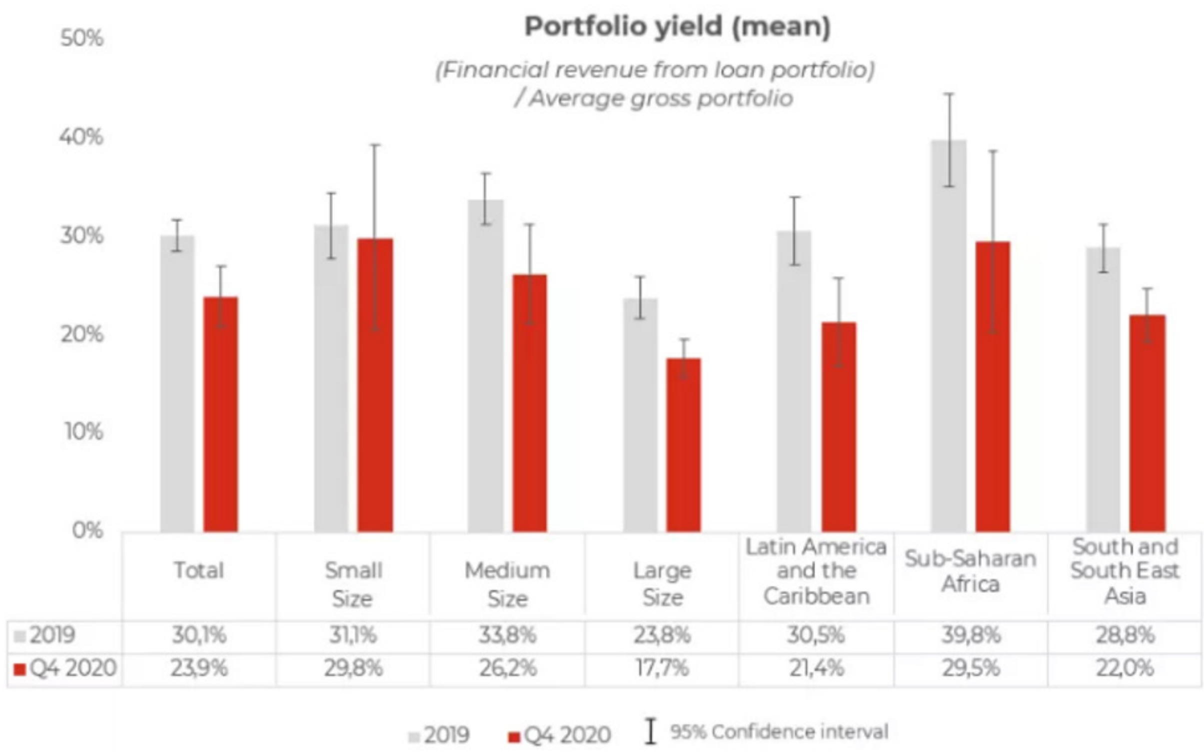
To analyze microloan metrics effectively, it is necessary to divide the discussion into pre and post-pandemic periods. During 2020, the deterioration in credit risk was the industry's and non-governmental organizations' (NGOs) major concern.

Microfinance institutions' (MFIs) credit risk ratio, which combines loans past 30 days due, the write-off ratio, and the restructured ratio, is a popular tool to measure loan health. This metric rose from 12.7% to 18.4% between 2019 and Q4 2020. These statistics, as well as 2021's, were significantly influenced by temporary loan deferrals. Based on comprehensive data from multiple nations, non-payment by borrowers spiked alongside the announcement of loan deferrals. While some governments were successful in at least partially supporting the balance sheet of lenders during this time, many were not.

This factor, among others, caused experts to worry that the microfinance industry could collapse. With the pandemic and vast majority of deferral programs behind us, we can confirm that the industry survived. Substantial loan degradation, however, did occur. Understanding the drivers of what is likely the worst performing period for microfinance is an opportunity to build a more durable system going forward.

The largest delta in pandemic loan performance occurred in Sub-Saharan Africa. Troubled loans doubled from 13.6% to 27.2%. India's data was also troubling with a large spike in non-payment occurring in April 2020. From a statistical perspective, the timing and duration of stay-at-home orders had the greatest impact on loan repayments. Based on corporate solvency and other relevant economic data, it appears stay-at-home orders have an outsized effect on microloans and the parties involved. Within days of the orders being announced, repayments eroded.

At least 115 governments announced forms of debt deferral alongside stay-at-home orders, which makes reliable statistical analysis of individual variables difficult. When debt deferrals occurred, policies often left the balance sheets of at least one part of the financial system vulnerable. Money allotted to support financial institutions and intermediaries did not necessarily reach these firms before the sharp decrease in repayments negatively impacting their balance sheets. As liquidity declined, so did lenders' capacity to loan. This caused a sharp decline in lending despite influxes of capital in certain layers of the financial system.



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Lower yields for microlending in Q4 2020 are another indicator of higher levels of nonpayment. Across all categories, microloan portfolios generated 20.6% less yield in Q4 2020 compared to full-year 2019. Based on data from various institutions, including VisionFund, loan performance stabilized in 2021 and improved in 2022.

In the year 2020, it is estimated that 88 to 115 million people globally moved into extreme poverty. Economic repercussions were especially evident in poorer nations. As one example, when polled shortly after stay-at-home orders were announced and enforced in March 2020, those reporting no income peaked at 40% in Uganda. Another 47% reported significantly reduced income compared to the prior year. The unemployment rate remains elevated compared to all pre-pandemic years going back to at least 1991 but has improved since 2020 highs.

In future crises, governments may more effectively assist all socioeconomic levels by better integrating support of the microfinance industry. In both developed and developing nations, there is a tendency to direct emergency resources toward the largest financial institutions. The same incentive structure is at work that favors fewer large transactions among established parties as opposed to a more distributed approach involving all levels of society. Given the increasingly critical role of microfinance and private credit more generally in supporting lower and medium income citizens and organizations, funds and policies aiding the nontraditional banking system are key to equitable responses to crises and the development of an effective financial system long-term.

Looking Forward

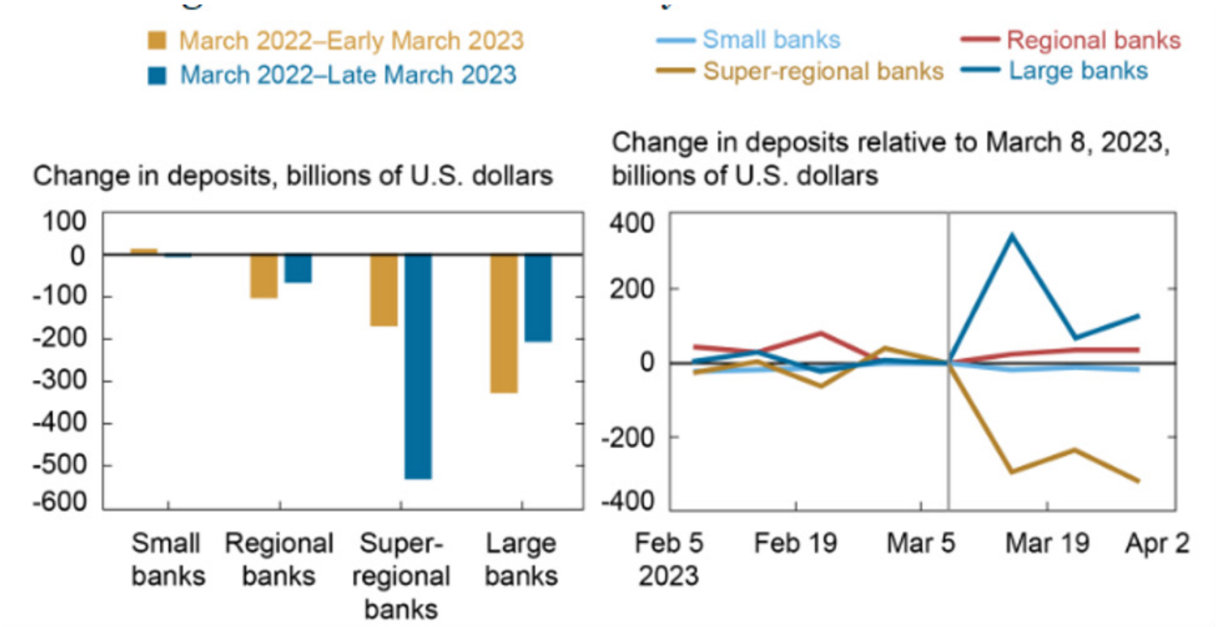
Almost exactly three years after the pandemic shook global markets, on March 10, 2023, Silicon Valley Bank (SVB) failed and went into receivership with the Federal Deposit Insurance Corporation (FDIC). Sixteen days later, the FDIC entered into a purchase and assumption agreement with First-Citizens Bank & Trust Company to take over most loans and deposits of the failed institution. On May 1st, First Republic Bank failed with JP Morgan receiving $92 billion in deposits in the process. The Federal Deposit Insurance Corporation (FDIC) agreed to absorb most of the losses on First Republic Bank's mortgages and commercial loans that were now part of JP Morgan's balance sheet. The FDIC also gave JP Morgan a $50 billion credit line. JP Morgan expects a one-time accounting gain of $2.6 billion and $500 million in annual profits due to the deal. Shares of JP Morgan rose 3.3% on the news. While JP Morgan's financial situation appears as solid as ever, the financial outlook for the tens of thousands of individuals and SMEs that relied on First Republic Bank is far less certain.

In the U.S., regional banks represent approximately one-third of all small business bank lending. Without these institutions, the effectiveness and reach of the Paycheck Protection Program (PPP) would have been reduced by approximately one fourth. Roughly 55% of these loans were made to small businesses with less than five employees and nearly three-fourths to those with less than 10. Regional bank originations of PPP loans to professional and administrative services were particularly high at $33.5 billion. During the pandemic and in normal environments, regional banks play a critical role in serving small businesses. These same small businesses generate approximately two out of every three new jobs in the U.S.

The impact of regional banks is pronounced in the Northeast, South, West, and certain regions of the Midwest. In these areas, regional banks originate the greatest number of small business loans per capita compared to other financial institutions.

The fate of the regional banking model is uncertain, but the cost of the ongoing bank crisis is clear.

Deposits Flowed from Super-Regional Banks to Large Banks following the Run on Silicon Valley Bank



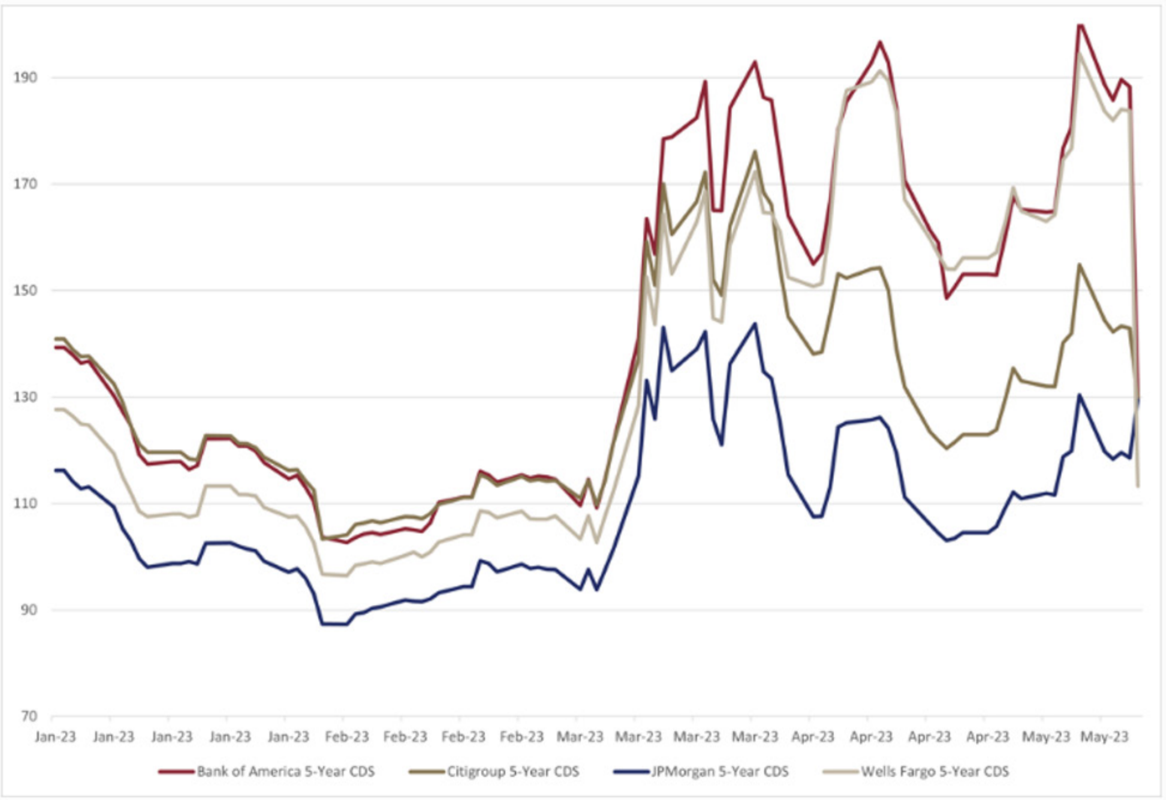
Source: Board of Governors of the Federal Reserve System, H.8 microdata. Notes: Banks are categorized by the size of their domestic assets: small banks—less than $5 billion; regional banks—$5 to $50 billion; super-regional banks—$50 to $250 billion; large banks—greater than $250 billion.

New York Federal Reserve bank researchers concluded that the initial outflows from regional banks totaled at least $550 billion. The new home for the deposits was almost exclusively large banks. This data was prior to the May 1, 2023 failure of First Republic Bank. As of April 2023, the San Francisco based bank had total assets of approximately $229.1 billion and total deposits exceeding $103 billion.

Those totals are net of approximately $100 billion of deposits that were withdrawn following the failure of SVB. Equity valuations on several regional banks, such as PacWest Bankcorp (PACW), suggest additional bank failures are probable. The valuations and equity prices of even the highest quality regional banks remain significantly below pre-crisis levels.

The situation for the major banks is very different. The iShares U.S. Financials ETF's (IYF) top 10 holdings include every U.S. mega bank. The ETF gained 6.6% in the past 12 months ended Q2 2023. That compares to a -31.3% return over the same period for the iShares U.S. Regional Banks ETF (IAT). Notably, many of IYF's holdings, including Truist Financial (TFC), are classified as regional banks. Without this exposure, IYF's outperformance would exceed IAT's by an even greater degree.

G-SIB Mega Bank CDS Pricing



SOURCE: GLENVIEW TRUST, BLOOMBERG

Credit default swap (CDS) pricing of the four U.S. mega banks – JP Morgan (JPM), Wells Fargo (WFC), Bank of America (BAC), and Citigroup (C) – have all returned to pre-crisis levels. The general consensus is that the flows of deposits from regional banks to the largest institutions has de-risked the latter to potentially lower levels than before the failure of SVB and crisis among regional banks.

This historic movement of capital is expected to create a deficit in small business lending and aggravate the already challenging lending market in U.S. commercial real estate. The exact outcomes of pending legislative efforts are uncertain, but the direction is clear: increased capital requirements and rules and regulations. Just as the Dodd-Frank Act did following the Great Recession, these legislative actions are likely to disincentivize lending to small businesses and private companies deemed to be riskier than large and often publicly traded corporations.

This illustrates the centralization of banking in response to crises. Private credit, from senior secured loans to middle-market private companies to microlending to individuals, will once again be looked upon to fill the space.

Conclusion

From its inception, private credit has been synonymous with financial inclusion. As is often the case with impact investing, solving societal and economic challenges often go hand in hand. The breadth of private credit has changed. It still starts with microloans in developing nations in increments of less than $100. The difference is it has grown to include $5 billion direct loans.

Other changes bode well for private credit and improved access to credit. Approximately 5.2 billion people, or two thirds of the global population, regularly access the internet. Over 7 billion people use mobile phones. This has led to exponential growth in digital financial activity in developing markets.

Never has the world been more ready and capable of embracing an expansion in lending to individuals and small businesses. Traditional banking systems, their regulators, and the priorities of many governments continue to favor the largest players in the economy. That long-term trend, congruent with the ongoing regional banking crisis in the U.S., reinforces the need for private credit to step in where traditional lenders are unable or unwilling to operate.

Additional Sources

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