Out of the

VALUATION IN THE GLOBAL SHADOW BANKING MARKET

Shadows

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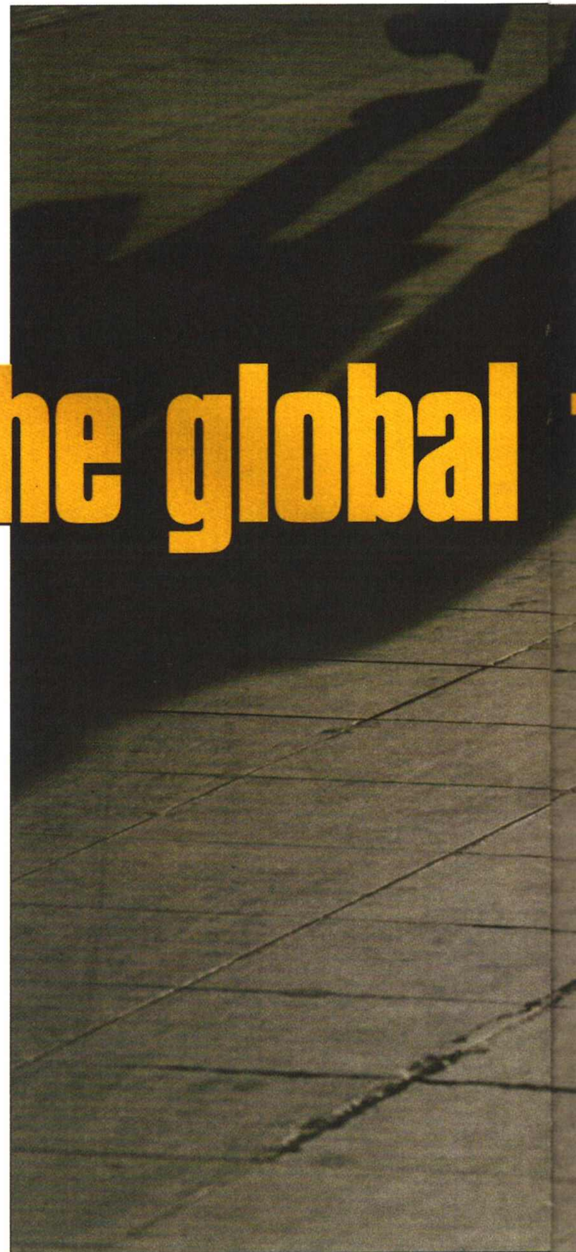
WHILE THE GROWTH OF SHADOW BANKING INSTITUTIONS HAS CREATED OPPORTUNITIES FOR INVESTORS, ENTITIES LARGELY OPERATE OUTSIDE OF THE REGULATED BANK FRAMEWORK AND PRESENT COMPLEX VALUATION CHALLENGES.

In the wake of the global



traditional lending and banking institutions are under pressure as never before. Increased liquidity requirements posed by the Third Basel Accord, the Federal Reserve's imposition of new leverage ratio requirements, and key risk-mitigation provisions of the Dodd-Frank legislation have contributed to slow traditional lending activity, depriving many companies of much-needed capital for growth and investment. Further, historically low interest rates incentivize investors to seek higher returns, creating opportunities for entrepreneurs.

The global recession also caused major credit market disruptions due to large and small banks facing larger than expected and highly correlated losses on their portfolios of assets, including previously "safe" sovereign debt and mortgage-backed securities. These losses put pressure on the banks' balance sheets and reserves, resulting in over 450 U.S. financial institutions failing since 2007 as compared to only 32 failures from 2000 through 2007.[1] The decline in the value of mortgage-backed securities and other safe debt have left many traditional lenders in a bind, balancing solvency and realizing losses on their portfolios, and thus making new originations a second priority. One data point tells the story: as of 3/31/2013, commercial banks held $584 billion in small-business loans, compared with $713 billion in 2008.[2]

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Enter the rise of the shadow banking industry, which can be loosely defined as non-bank financial institutions that fulfill some of the functions of traditional banks. This broad definition could include hedge funds, business development companies, other alternative lenders (e.g. pawn shops), and even the friendly neighborhood loan shark (although it is unlikely that any central bank is concerned about systematic risk relating to loan sharks). How big is the shadow banking system globally? According to the *Financial Times,*[3] at the end of 2011, the global shadow banking system had over $60 trillion of assets. During Q1 2013, the hedge fund portion alone grew by over $122 billion. Publicly traded business development companies, U.S.-focused shadow entities that generally focus on providing credit to middle market companies, have grown from $16 billion in total assets in 2005 to over $37 billion at the end of 2012. Given the size of the global shadow banking system, it is easy to see why central banks and regulators have an interest in its evolution and its direct or indirect effects on the overall monetary system and risk management.

From investors' perspective, shadow banking entities have recently provided them with the opportunity to earn higher yields on their money while mitigating risk. Downside risk is minimized by investing high in capital structure, where recovery rates in times of distress are more favorable. In an increasingly competitive (and challenging) investing environment, this is precisely the kind of differentiated strategy that investors are seeking.

The New Normal (or Lack Thereof)

Shadow banking entities largely operate outside of the regulated bank framework. As such, capital regulatory and leverage requirements are often limited, but some entities that are registered with a regulator do have structural requirements, such as business development companies. Business development companies are registered with the Securities and Exchange Commission (SEC) and have rules to follow that primarily are intended to mitigate the risk of their portfolios (e.g., asset concentration and asset types). Hedge funds have been required to register with the SEC if their assets under management

exceed $150 million, to help the SEC identify systematic risks but not to impose capital requirements or strategy limitations. Overall, regulations that govern sectors of the shadow banking system are not well-coordinated across one country's regulators, to say nothing of international regulatory coordination.

The lack of consistency in the various regulatory regimes that touch the shadow banking system contributes to the difficulty in understanding the breadth of the system, as does the wide variety of assets involved and, in certain cases, underlying collateral. Money market funds are very different from business development companies which, in turn, are very different from hedge funds. Even within these broad categories there are significant differences—some business development companies lend to established companies while others lend to early-stage companies; some hedge funds invest in only publicly traded equities while others invest in only illiquid distressed assets.

The Valuation Conundrum

While the shadow banking system will continue to "shadow" and fill in the lending void where the traditional banking system leaves off, the industry as a whole is not quite as opaque as the anecdotal evidence would suggest. For example, many of the shadow lenders (such as hedge funds and other alternative investment vehicles) are beholden to investors/limited partners (LPs), who demand transparent, timely, and accurate reporting. As these investors in shadow banking entities perform their due diligence (initial or ongoing), they are asking increasingly sophisticated questions concerning the investment strategy and operational aspects of alternative investments in shadow banking entities. Many of these questions concern the complex valuation issues that

abound due to the disparate assets within the shadow banking system. These valuation challenges take on many forms, as discussed below.

Credit Considerations. First, at the highest level, loans to small to mid-sized businesses are distinctly different from publicly traded bonds. Few of these companies are publicly traded, followed by analysts, or rated by ratings agencies. Credit extended to small to middle market companies is typically held by a small number of holders. By comparison, the syndicated loan market appears quite deep and liquid. In valuing loans to small to mid-sized businesses, assessing the credit quality (a key input to determine the appropriate discount rate/yield) of a company may be significantly harder than for a more established company. Considerations such as customer concentration, business/technology risk, and depth and experience of management are highly subjective, qualitative assessments that significantly affect the final determination of the yield required by an investor. As noted above, shadow entities hold differing assets, not only individual, performing loans. The assessment of a pool of acquired non-performing assets will incorporate many qualitative considerations that are implicit in a "comparable" performing asset in a more favorable jurisdiction.

Second, many of the established entities that make up the shadow banking system may well be valued as typical *going concern* financial institutions. Some newer or more novel companies, however, may require discounted cash flow analysis or an analysis based on rounds of financing. The underlying assets may have descriptions that are similar to well-known credit instruments, but many of the individual attributes of the assets make valuation challenging. There are entities that fall in between—for example, an established hedge fund that creates a fund specifically to acquire portfolios of assets from distressed banks and governments (a newer asset class).

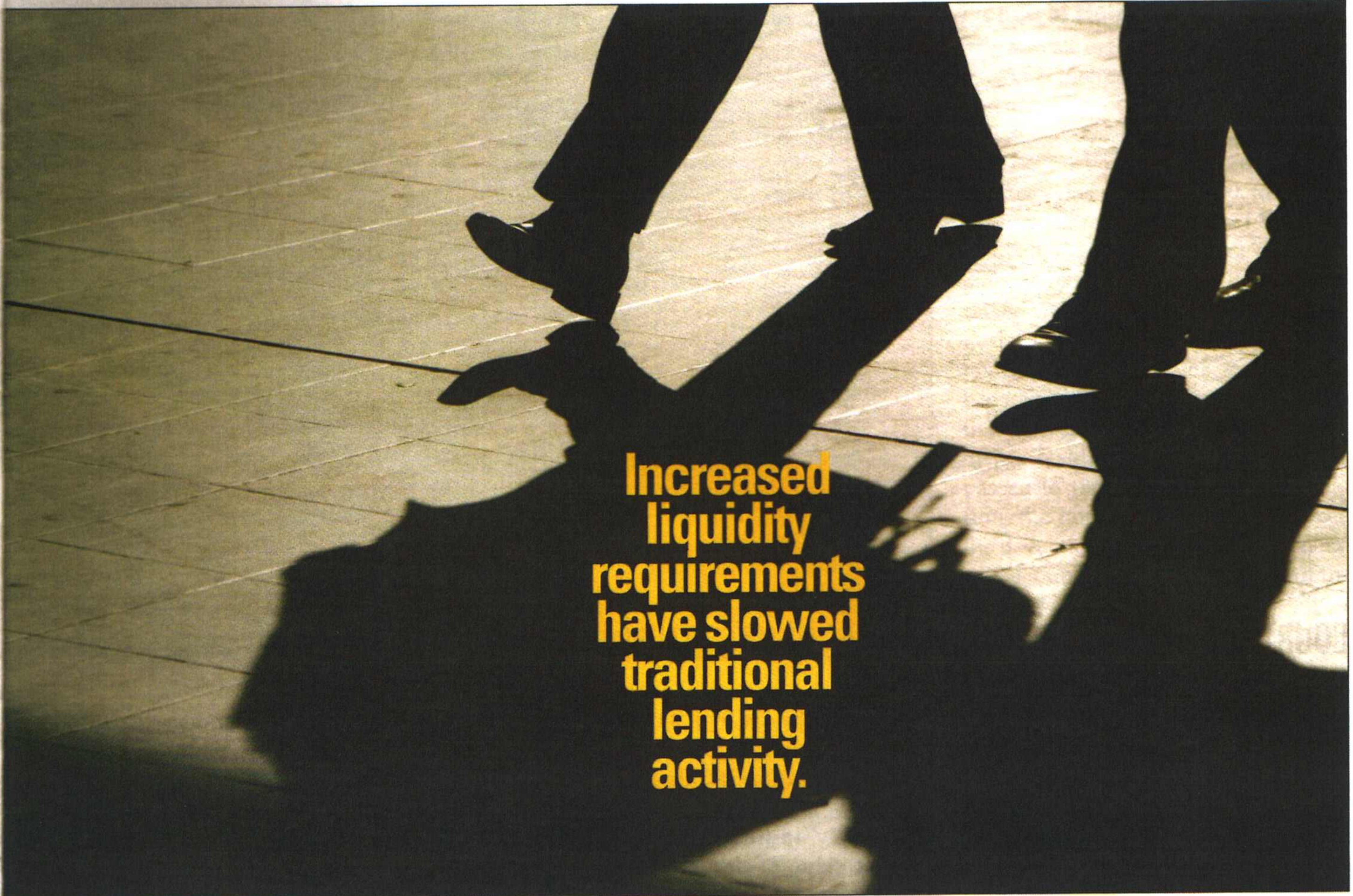
Narrowing the Spread. The bottom line in this respect is that the bespoke nature of the acquired portfolios and the varying circumstances under which the assets were acquired likely generates a wider spread between the respective purchase price and objective fair value. The resulting valuation challenge therefore falls to a relatively small universe of valuation professionals or auditors, possessing adequate experience to understand the issues with adequate fluency to narrow the spread if and when appropriate.

Valuation policies generally have some similarities when discussing the valuation of an asset class, but are definitely not similar across all organizations. When considering distressed or non-performing credits, valuation methodologies bring into consideration the underlying collateral. Consider, for example, that credit issued to small and mid-sized companies through the shadow banking system typically has tighter covenants as well as pledged collateral. Given the smaller sizes of the companies or individuals approaching a shadow banking entity, the form of collateral will vary more widely than for larger, established companies. Primary assets held by smaller companies or individual borrowers are increasingly likely to fall into nontraditional categories such as personal assets (e.g., homes, cars, aircraft, etc.) or intellectual property, including patents. Rates on such loans typically exceed those made by banks, but the borrowers typically have exhausted traditional lending options when they approach nontraditional lenders. While some will view shadow lending practices as unscrupulous, these lenders fill a need in the market not met by traditional banks. And, like banks, there are stories of borrowers whose experience with a shadow lender results in restructuring, bankruptcy, or foreclosure, but there are also success stories.

Mortgage-Backed Securities. The mortgage-backed securities market provides a compelling look at how the underlying collateral can profoundly affect valuation challenges. Values for mortgage-backed securities peaked prior to the financial crisis. At the time, the market for mortgage-backed securities was very liquid with most assets being classified as FASB Topic 820 (ASC 820) Level 1 or Level 2 assets. When the bubble burst, the value of previously "low risk" securities declined as the price for the underlying collateral collapsed, resulting in the drying up of liquidity in the market and leaving certain mortgage-backed securities reclassified from Level 1 to Level 3 assets. If, when, and how different institutions reflected this reduction in value and liquidity varied, making comparisons across a peer group difficult. Annual audits did not (and still do not) necessarily ensure a level playing field as significant latitude exists within an individual organization's valuation policy, accounting rules across industries, and variability in capabilities across audit firms (and across individual auditors). Further, where an active broker market existed and ten quotes may have been readily available pre-crisis, it was not uncommon to see most brokers ceasing the provision of "indicative" quotes to clients. As a result, where a firm historically had three to five broker quotes in the past—some or all of which may have undergone some level of back testing to test reliability—during and after the crisis, it is not unusual to see one quote, which is often fewer than is required by a valuation policy to deem the asset as a Level 1 or Level 2 asset. Slowly, the investment, investor, and auditor worlds are taking notice that all broker quotes are not created equally, but there is still a reliance on quotes that are stale, or otherwise cannot be acted on.

Conclusion

The growth of the shadow banking system has been nothing if not global in nature. With the international credit crunch caused by the economic downturn, shadow banking entities became a source of capital for individuals and small and mid-sized companies around the globe. Implementation of easy monetary policies to stimulate economic growth has helped increase asset prices, but has kept interest rates at historic lows, forcing investors to seek yield, helping the shadow banking industry grow. In Europe where capital markets are most similar to the United States, non-bank lending to small to middle



market companies has increased as investment funds have migrated east to take advantage of good credits and banks struggling with balance sheets overloaded with non-core and non-performing assets. The growing gap in valuation and risk between blue chip properties and all peripheral outliers has caused a surge in shadow lending from insurance companies and North American pension funds to these higher risk investments, primarily in the real estate sector.[4]

In Asia, tight credit is compounded by tighter government controls and emerging capital liberalization. A prime example is how China's recent jump in lending rates has generated increased returns on wealth management products offered through the shadow banking system, attracting funds from retail investors seeking better returns, while at the same time, banks and traditional fund managers have been forced to liquidate equity to raise cash as the country's central bank has placed increased pressure on commercial banks to correct their balance sheets. Small and midsized lenders are heavily reliant on wholesale markets for funding and are exposed to the country's shadow financing system, which the authorities are keen to bring under control by forcing banks to match assets and liabilities.

Loose monetary policies are not expected to continue forever. As the U.S. Federal Reserve has debated the duration of its quantitative easing program, equity markets have become attuned to listening to every word spoken, and bond markets have also begun to react. As of late July 2013, the yield on the ten-year U.S. Treasury note has risen, pushing mortgage rates to recent highs (which are still historically low in the grand scheme). Concurrently, China has removed rate caps. With equity markets at all-time highs and bond prices falling, investors are seeking stable yield. The shadow banking system may meet some of these needs, however if rates continue to rise, spreads for these organizations may be squeezed—some more than others.

The ultimate outcome has yet to be determined, but the shadow banking system has proven to be resilient and will likely continue to adapt to provide capital to those in need when traditional capital markets are inaccessible. This evolution coupled with interesting economic times will undoubtedly continue to pose challenges for valuation practitioners as well as investors, auditors, and other market participants. One thing is for certain, it may not be easy, but it will be thought provoking and interesting. As the Chinese proverb says, "May you live in interesting times"; those working in and around the shadow banking system definitely do. ●

1 The FDIC has compiled information on failed banks at http://www.fdic.gov/bank/individual/failed/banklist.html.

2 "As Banks Retreat, Hedge Funds Smell Profit," Wall Street Journal, 7/22/2013.

3 "Shadow Banking Surpasses Pre-Crisis Level," Financial Times, 10/27/2011.

4 "Time Arrives for Different Finance Mix," Financial Times, 3/11/2013.