CASTLELAKE

The Perfect Storm

Why we are so Bullish about the Asset-Based Private Credit Opportunity Set

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The implementation of Basel III globally, adoption of new loan loss accounting standards, and material unrealized losses on bank balance sheets have resulted in material bank retrenchment in asset-based lending markets. Castlelake estimates there is a $7T investable global asset-based market opportunity[1] set, of which only 4 – 5% is currently penetrated by private capital[2].

Basel III Endgame

Under Basel III, banks must retain more equity and reserves, known as Tier 1 capital, to create a buffer for performance volatility. Estimates suggest that the largest banks will need to increase their capital reserves by up to 20% in aggregate to meet Basel III requirements[3], but the effects may be more pronounced in specific asset classes, like asset-based lending.

Basel III Endgame is set to take effect on July 1, 2025 with a 3-year phase-in period. We believe these latest changes will make asset-based lending particularly unattractive to banks because of absolute minimum capital requirement levels. Historically, banks were attracted to lending in asset classes with low loss-given-defaults because they could hold relatively small amounts of capital based on internal models. Absolute minimum capital requirements remove this advantage.

The capital reserve requirements under Basel III are also expected to make traditional asset-based lending increasingly inefficient for banks. The increase in regulatory capital means banks will have fewer funds available to write loans and greater equity attribution requirements for the loans they do write. In addition to decreasing supply, this is also expected to increase margin requirements and to tighten lending standards – likely resulting in a significant gap in the capital structure where private capital is needed.

Current Expected Credit Losses ("CECL")

In response to the 2008 financial crisis, the Financial Accounting Standards Board wanted banks to recognize credit losses in a more timely manner and introduced the Current Expected Credit Losses ("CECL") standard in 2016. CECL took effect in 2020 for most categories of SEC filers and 2023 for private entities.

Prior to implementation, lenders were not required to record a loan or lease impairment until an actual loss was deemed likely. CECL requires that banks reserve for potential loan and lease losses on day 1, which creates an immediate income statement loss.

When CECL was implemented in 2020, the allowance for loan and lease losses on bank balance sheets skyrocketed from ~$110B to ~$220B[4]. CECL has a particularly negative impact on lending in asset classes where there are relatively high expected losses over the life of a loan portfolio because a lender needs to take all losses up front as opposed to previously being allowed to amortize those losses over the life of the loan book. Consumer and small business loans are examples of historically cash-profitable loans that are severely impacted by this change.

CECL provisions have resulted in reserving for higher overall loan and lease losses, which ultimately increases the amount of equity required to service a loan. As a result, the overall profitability of banks is suffering, making it more challenging for them to support certain historical lending markets and decreasing overall supply of financing.

Accumulated Other Comprehensive Income ("AOCI")

Accumulated Other Comprehensive Income represents unrealized gains and losses that are netted below retained earnings and reported in balance sheet equity.

AOCI is the difference between market and book value for securities. AOCI decreases (increases) as the market value of securities decreases (increases). AOCI is intended to increase reporting transparency and highlight future potential changes to net income.

During the COVID-19 pandemic, banks experienced a rapid increase in deposits, which were then used to purchase large quantities of fixed rate loans in a low-rate environment. As rates began to rise in 2022, banks accumulated more than $350B in AOCI losses[5].

If banks need to sell securities associated with AOCI losses for liquidity, they would erode net income and Tier 1 capital. As such, banks have generally been forced to hold these loans, limiting their capacity and capital for new lending activities.

Castlelake believes the confluence of continued capital regulation, adoption of new accounting standards, and poor bank risk taking during COVID-19 has created a perfect storm whereby banks are required to hold more equity to service loans under Basel III, the loans they are writing are less profitable due to CECL and their liquidity is meaningfully hampered as a result of AOCI losses. This has created a large, durable opportunity set in which Castlelake is well positioned to execute.

[1] Represents the aggregate size of the markets in which Castlelake seeks to invest in both hard and financial assets. Various sources including, but not limited to: Federal Reserve Z.1 Financial Accounts of the United States Q3 2023, FRB NY Quarterly Report on Household Debt and Credit November 2023, SIFMA statistics Q3 2023, Secured Finance Foundation 2023 Secured Finance Market Sizing and Impact Study, 2022 Equipment Leasing & Finance Industry Horizon Report, CFPB Fact Sheet March 30 2023, Preqin Private Debt 2022 data, S&P Global Credit Trends Report October 2, 2023, and Interval Fund Tracker Most Recent Quarter Data 2023.
[2] Olivery Wyman, "Private Credit's Next Act", April 2024.
[3] Federal Deposit Insurance Corporation. "Memo: Regulatory Capital Rule: Amendments Applicable to Banking Organizations subject to Category I, II, III or IV standards, and to Banking Organizations with Significant Trading Activity." Page 19.
[4] FRED (St. Louis Federal Reserve Economic Data), "Allowance for Loan and Lease Losses, All Commercial Banks". Represents all United States Commercial Banks. Seasonally adjusted. AS of September 2024.
[5] FRED (St. Louis Federal Reserve Economic Data), "Cumulative Other Comprehensive Income". Represents all FDIC-insured institutions. Not seasonally adjusted. As of January 2024.

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