POLICY SPOTLIGHT

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BlackRock

Non-Bank Lending: A Primer

Non-bank lending is an important source of capital for small- and medium-sized companies. Recently, policy makers have begun to raise questions about the resilience of this market, particularly as signs of later stages of the credit cycle emerge and increasing leverage due to borrowing in the financial system may foreshadow economic vulnerabilities. As policy makers consider the non-bank lending market, it is critical to distinguish **broadly syndicated loans** (also known as leveraged loans or bank loans) from **private direct loans**. In addition, it is important to understand what types of investors and investment vehicles hold each. Notably, most loan products are not held in open-end funds.

Exhibit 1: Overview of Non-Bank Lending Markets

	Broadly Syndicated Loans	Private Direct Loans
Description	Loans that are underwritten by banks acting as agent lenders, who then distribute the loans to a range of investors	Loans made directly to borrowers by one or more institutional investors
Market Size[1]	• US market: USD 1.17 trillion • European market: EUR 0.20 trillion	• US market: Approx. USD 910 billion • European market: Approx. EUR 120 billion
Liquidity Profile	Trades daily in high volumes in a normal, functioning market; longer, non-standardized settlement times	Limited liquidity, although able to find secondary buyers in normal market conditions
Investment Vehicles	Separately managed accounts (SMAs), mutual funds, exchange traded funds (ETFs), collateralized loan obligations (CLOs)	Closed-end funds, business development companies (BDCs)
Also Known As…	Leveraged loans, bank loans	Private credit, middle market investing

Overview of broadly syndicated loan market

Bank loans are senior secured, floating rate instruments issued by companies that are below investment grade. Typically when we describe the 'bank loan' market, we refer to 'broadly syndicated loans', which are the portion of the market arranged and distributed by large sell-side institutions. Borrowers are generally limited to medium and large companies in the US and Europe. Over the last 25 years, this asset class has evolved from a market dominated by banks to one with increasing participation from a diverse range of investors. Today, the US broadly syndicated loan market has surpassed USD 1 trillion in par amount outstanding.[2] The size of the borrower companies, and the fact that these loans are originated by banks and syndicated to investors, distinguishes this asset class from private direct loans, which generally focus on smaller companies.

Broadly syndicated loans can be found in different investment vehicles, including: separate accounts, mutual funds (both dedicated bank loan funds and diversified fixed income funds), ETFs, and CLOs. Retail investors can access the broadly syndicated loan market through registered investment funds. Exhibit 2 on the following page shows some of the largest US bank loan open-end mutual funds and US bank loan ETFs by AUM. In Europe, banks loans are not permitted investments for UCITS, though in many European Union member states, Alternative Investment Funds (AIFs) are permitted to invest in bank loans. Globally, the investor base is dominated by institutional investors who invest in broadly syndicated loans as part of a diversified portfolio, holding primarily CLOs and direct investments via separate accounts. As shown in Exhibit 3 on the following page, in the US, CLOs hold 60% and loan mutual funds (open-end, closed-end, ETFs) hold 16% of the market.[3]

Exhibit 2: Largest US Open-End Bank Loan Mutual Funds and US Bank Loan ETFs (by AUM)

US Open-end Bank Loan Mutual Funds	Total Net Assets (USD MM)
Invesco Oppenheimer Senior Fl Rate	11,241
Lord Abbett Floating Rate Fund	10,870
Fidelity Advisor® Floating Rt Hi Inc Fd	10,290
Eaton Vance Floating-Rate Advantage Fund	8,129
Eaton Vance Floating Rate Fund	7,658
Virtus Seix Floating Rate High Inc Fund	4,098
T. Rowe Price Instl Floating Rate Fund	3,725
Loomis Sayles Sr FloatingRate and F/I Fd	3,197
Hartford Floating Rate Fund	3,157
BlackRock Floating Rate Income Fund	3,127

US Bank Loan ETFs	Total Net Assets (USD MM)
Invesco Senior Loan ETF	4,507
SPDR® Blackstone / GSO Senior Loan ETF	2,232
First Trust Senior Loan Fund	1,624
Highland/iBoxx Senior Loan ETF	324
Franklin Liberty Senior Loan ETF	57
AdvisorShares Pacific Asst Enh Fl Rt ETF	29
Virtus Seix Senior Loan ETF	6
Eaton Vance Floating-Rate NextShares	5

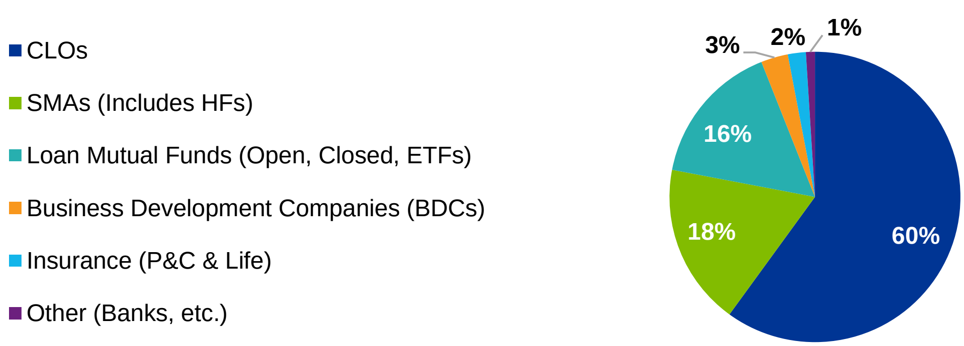
These lists are being provided for illustrative purposes only to demonstrate a segment of the syndicated loan mutual fund market in the US, focusing on the 10 largest open-end bank loan mutual funds in terms of AUM, as well as all 8 bank loan ETFs in the US, as sourced by Morningstar as of July 31, 2019. BlackRock does not offer or distribute any of the third party funds. This is not intended to be sales material and, importantly, these funds may not be available in certain jurisdictions.

Loans are contracts, not securities, and thus the settlement process is not as efficient as for fixed income securities. Settlement periods for bank loans are approximately 10 to 12 days, which is longer than for fixed income securities, which usually settle in 1-3 days. Open-end broadly syndicated loan mutual funds are subject to liquidity risk given the potential mismatch between the daily liquidity of the fund and the delayed settlement period for the loans. Due to this potential settlement mismatch, managing broadly syndicated loan mutual funds requires more robust liquidity risk management procedures than a typical daily liquidity fund. Managers of bank loan mutual funds have several tools available to manage fund liquidity risk. For example, portfolio managers can maintain a slice of the portfolio in liquid assets, invest in more liquid bank loans and larger bank loan deals, establish a dedicated bank loan facility, and limit the use of permissible leverage during normal market conditions. BlackRock has long been a proponent of standardization of the settlement cycle for bank loans. We welcome efforts by bank regulators to address bank loan settlement.

While bank loan mutual funds and ETFs are often a focus of policy maker concern due to the extended settlement times for bank loans, these products have proven to be resilient during recent market stress events. The fourth quarter of 2018 was a real-world stress test for bank loan mutual funds and ETFs, with widening spreads and deteriorating liquidity conditions across the fixed income market and significantly elevated outflows during a period of seasonally low liquidity. Nonetheless, bank loan mutual funds (including ETFs) effectively managed approximately USD 15 billion in net outflows, more than double the largest monthly outflow ever experienced by the broadly syndicated loan mutual fund sector.[4]

Other bank loan vehicles, including closed-end funds, separate accounts, and CLOs, are not exposed to liquidity risk because they do not have pre-specified redemption time frames. While CLOs often conjure images of pre-crisis collateralized debt obligations (CDOs), salient differences distinguish the CLO market of today from the CDO market pre-crisis. Specifically, CLOs lack ‘leverage on leverage’, and the collateral for CLOs are the loans themselves, not the most subordinate tranche of pools of loans. Another significant difference is that today, leverage is not concentrated in the banking industry since loans are dispersed broadly across a wide range of end-investors.[5]

Exhibit 3: US Broadly Syndicated Loan Market Breakdown



Source: Barclays Research, S&P LCD, Lipper, Bloomberg, EPFR, HFR, Credit Flux, Federal Reserve, Refinitiv, Kaneri, Bloomberg Barclays Indices. As of October 31, 2018.

Exhibit 4: Overview of Redemption Features of Bank Loan Investment Vehicles

	Separately Managed Account (SMA)	Collateralized Loan Obligation (CLO)	Closed-End Fund	Open-End Fund	Exchange Traded Fund (ETF)
Description	Portfolios of individual securities managed by a professional investment firm	Portfolios of bank loans that are securitized and managed as a fund and structured as a series of tranches and a small portion of equity	Investment structures that issue a fixed number of shares that trade on an exchange	Bank loan mutual funds are only allowed in the US and governed by the Investment Company Act of 1940; in Europe, UCITS does not permit inclusion of bank loans in portfolios	Open-end mutual fund with shares created by primary market Authorized Participants (APs) that trade intraday on an exchange
Details	The assets are owned directly by a single asset owner	Investors are paid back on a long-term schedule coinciding with collateral amortization	Capital is locked in with either perpetual or term trust structure	Settlement periods for loans are much longer than fixed income securities, resulting in settlement mismatch	Retail investors cannot redeem shares directly from the ETF, as with traditional mutual funds
Liquidity Terms	Investor has direct ownership and control over assets and the ability to redeem as desired	No ability to redeem outside the specified payment schedule	No redemptions offered except at the fund's maturity or closure	Daily liquidity for fund investors	Redemptions in the primary market by APs only
Liquidity risk	No	No	No	Yes; Requires a more robust process than a typical mutual fund	Yes; Mitigated by "in-kind" versus cash redemptions by APs

Overview of the private direct loan market

Private direct lending (also known as middle market investing) is a form of corporate debt financing in which non-banks make loans directly to borrowers. The borrowers are typically mid-sized companies. The loans are originated without intermediaries like broker-dealers facilitating the transaction, hence the term private *direct* lending. Private direct loans tend to be floating rate loans and are often secured, meaning the lender has a claim over collateral in the case of borrower default.

As banks have pulled back their lending to middle market corporates, there has been an increase in non-bank lenders providing capital to middle market companies. In recent years, this market has been funded primarily by institutional investors, such as insurance companies, pension funds, endowments, and sovereign wealth funds. When asset managers are hired by institutions to invest in private direct loans on their behalf, a number of investment vehicles are typically used, including: institutional funds, separate accounts, CLOs, and BDCs.

Exhibit 5: Top 10 Direct Lending Managers by Capital Raised

Manager	Total Funds Raised in the Last 10 Years (USD MM)
Oaktree Capital Management	38,878
Goldman Sachs Merchant Banking Division	37,070
GSO Capital Partners	33,263
Intermediate Capital Group	28,417
Ares Management	27,565
Apollo Global Management	21,272
HPS Investment Partners	20,606
Fortress Investment Group	14,527
BluBay Asset Management	14,413
KKR	13,164

Source: Prequin. All data self-reported. Data as of 2019.

The private direct loan market is generally not available to retail investors, and open-end mutual funds do not participate in this space given the liquidity profile of these assets. Instead, the investor base is primarily institutional investors who invest via a separate account or a privately offered fund. These funds are structured with limited redemption features and may use a modest amount of leverage. Any losses in the fund reduce expected returns to the fund's investors. Since these loans are made directly from a fund and not from the manager's balance sheet, the fund manager is not exposed to losses.

BlackRock's broadly syndicated loan business

BlackRock is a manager of broadly syndicated assets on behalf of clients, with USD 23 billion of broadly syndicated loans under management across separate accounts, mutual funds, and CLOs.

BlackRock's private direct loan business

BlackRock sources, structures, and manages private direct loans on behalf of clients, with USD 10.9 billion in middle market private loans under management. We manage USD 8.7 billion in US middle market lending strategies (which includes two BDCs) and USD 2.2 billion in European middle market lending strategies. BlackRock does not have substantial balance sheet exposure to the loans and BlackRock's business model is based on compensation through management and performance fees, unlike a bank, which earns its returns from the spread between funding costs and the interest rate at which loans are made.

Notes

1. For Broadly Syndicated Loans: S&P Global Market Intelligence. Data as of August 22, 2019. For Private Direct Loans: Ares Management, "Opportunities in Global Direct Lending" (April 2018). Data as of December 31, 2017.
2. S&P Global Market Intelligence. Data as of August 22, 2019.
3. Barclays Research, S&P LCD, Lipper, Bloomberg, EPFR, HFR, Credit Flux, Federal Reserve, Refinitiv, Kaneri, Bloomberg Barclays Indices. As of October 31, 2018.
4. JP Morgan based on data from Lipper FMI. As of February 1, 2019.
5. BlackRock, Commentary from Systematic Fixed Income: "How I Learned to Stop Worrying and Love the Bond…" (Q2 2019), available at https://www.blackrockblog.com/2019/04/16/stop-worrying-and-love-bonds/

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