

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 Size¹	<ul style="list-style-type: none"> US market: USD 1.17 trillion European market: EUR 0.20 trillion 	<ul style="list-style-type: none"> 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, bank 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)	US Bank Loan ETFs	Total Net Assets (USD MM)
Invesco Oppenheimer Senior FI Rate	11,241	Invesco Senior Loan ETF	4,507
Lord Abbett Floating Rate Fund	10,870	SPDR® Blackstone / GSO Senior Loan ETF	2,232
Fidelity Advisor® Floating Rt Hi Inc Fd	10,290	First Trust Senior Loan Fund	1,624
Eaton Vance Floating-Rate Advantage Fund	8,129	Highland/iBoxx Senior Loan ETF	324
Eaton Vance Floating Rate Fund	7,658	Franklin Liberty Senior Loan ETF	57
Virtus Seix Floating Rate High Inc Fund	4,098	AdvisorShares Pacific Asst Enh FI Rt ETF	29
T. Rowe Price Instl Floating Rate Fund	3,725	Virtus Seix Senior Loan ETF	6
Loomis Sayles Sr FloatingRate and F/I Fd	3,197	Eaton Vance Floating-Rate NextShares	5
Hartford Floating Rate Fund	3,157		
BlackRock Floating Rate Income Fund	3,127		

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/>

This publication represents the regulatory and public policy views of BlackRock. The opinions expressed herein are as of August 2019 and are subject to change at any time due to changes in the market, the economic or regulatory environment or for other reasons. The information herein should not be construed as sales material, research or relied upon in making investment decisions with respect to a specific company or security. Any reference to a specific company or security is for illustrative purposes and does not constitute a recommendation to buy, sell, hold or directly invest in the company or its securities, or an offer or invitation to anyone to invest in any funds, BlackRock or otherwise, in any jurisdiction. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

In the U.S., this material is available for public distribution. **In the EU**, issued by BlackRock Investment Management (UK) Limited (authorised and regulated by the Financial Conduct Authority). Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Registered in England No. 2020394. Tel: 020 7743 3000. For your protection, telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment Management (UK) Limited. This material is for distribution to Professional Clients (as defined by the FCA Rules) and Qualified Investors and should not be relied upon by any other persons. For qualified investors **in Switzerland**, this material shall be exclusively made available to, and directed at, qualified investors as defined in the Swiss Collective Investment Schemes Act of 23 June 2006, as amended. Issued **in the Netherlands** by the Amsterdam branch office of BlackRock Investment Management (UK) Limited: Amstelplein 1, 1096 HA Amsterdam, Tel: 020 - 549 5200.

In Australia, issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975, AFSL 230 523 (BIMAL). This material is not a securities recommendation or an offer or solicitation with respect to the purchase or sale of any securities in any jurisdiction. The material provides general information only and does not take into account your individual objectives, financial situation, needs or circumstances. Before making any investment decision, you should therefore assess whether the material is appropriate for you and obtain financial advice tailored to you having regard to your individual objectives, financial situation, needs and circumstances. BIMAL, its officers, employees and agents believe that the information in this material and the sources on which it is based (which may be sourced from third parties) are correct as at the date of publication. While every care has been taken in the preparation of this material, no warranty of accuracy or reliability is given and no responsibility for the information is accepted by BIMAL, its officers, employees or agents. Any investment is subject to investment risk, including delays on the payment of withdrawal proceeds and the loss of income or the principal invested. While any forecasts, estimates and opinions in this material are made on a reasonable basis, actual future results and operations may differ materially from the forecasts, estimates and opinions set out in this material. No guarantee as to the repayment of capital or the performance of any product or rate of return referred to in this material is made by BIMAL or any entity in the BlackRock group of companies. **In Singapore**, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). **In Hong Kong**, this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. **In South Korea**, this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations). **In Taiwan**, independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In Japan**, this is issued by BlackRock Japan Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In China**, this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. For Other APAC Countries, this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions) and does not constitute investment advice or an offer or solicitation to purchase or sell in any securities, BlackRock funds or any investment strategy nor shall any securities be offered or sold to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. **In Latin America**, for institutional investors and financial intermediaries only (not for public distribution). This material is for educational purposes only and does not constitute investment advice or an offer or solicitation to sell or a solicitation of an offer to buy any shares of any fund or security and it is your responsibility to inform yourself of, and to observe, all applicable laws and regulations of your relevant jurisdiction. If any funds are mentioned or inferred in this material, such funds may not be registered with the securities regulators in any Latin American country and thus, may not be publicly offered in any such countries. The securities regulators of any country within Latin America have not confirmed the accuracy of any information contained herein. Investing involves risk, including possible loss of principal. The contents of this material are strictly confidential and must not be passed to any third party. Mexico. If any funds, securities or investment strategies are mentioned or inferred in this material, such funds, securities or strategies have not been registered with the National Banking and Securities Commission (Comisión Nacional Bancaria y de Valores, the "CNBV") and thus, may not be publicly offered in Mexico. The CNBV has not confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico, subject to strict rules, and performed under the supervision of the CNBV. BlackRock Mexico, S.A. de C.V., Asesor en Inversiones Independiente ("BLKMX") is a Mexican subsidiary of BlackRock, Inc., registered with the CNBV as an independent investment advisor under registration number 30088-001-(14085)-20/04/17, and as such, authorized to provide Investment Advisory Services. BlackRock México Operadora, S.A. de C.V., Sociedad Operadora de Fondos de Inversión ("BlackRock MX Operadora" and together with BLKMX, "BlackRock México") are Mexican subsidiaries of BlackRock, Inc., authorized by the CNBV. For more information on the investment services offered by BlackRock Mexico, please review our Investment Services Guide available in www.BlackRock.com/mx. Reliance upon information in this material is at your sole discretion. BlackRock México is not authorized to receive deposits, carry out intermediation activities, or act as a broker dealer, or bank in Mexico. Further, BlackRock receives revenue in the form of advisory fees for our mutual funds and exchange traded funds and management fees for our collective investment trusts.

©2019 BlackRock, Inc. All Rights Reserved. BLACKROCK is a registered trademark of BlackRock, Inc. All other trademarks are those of their respective owners.