Assessing the Decline in Bank Lending to Businesses

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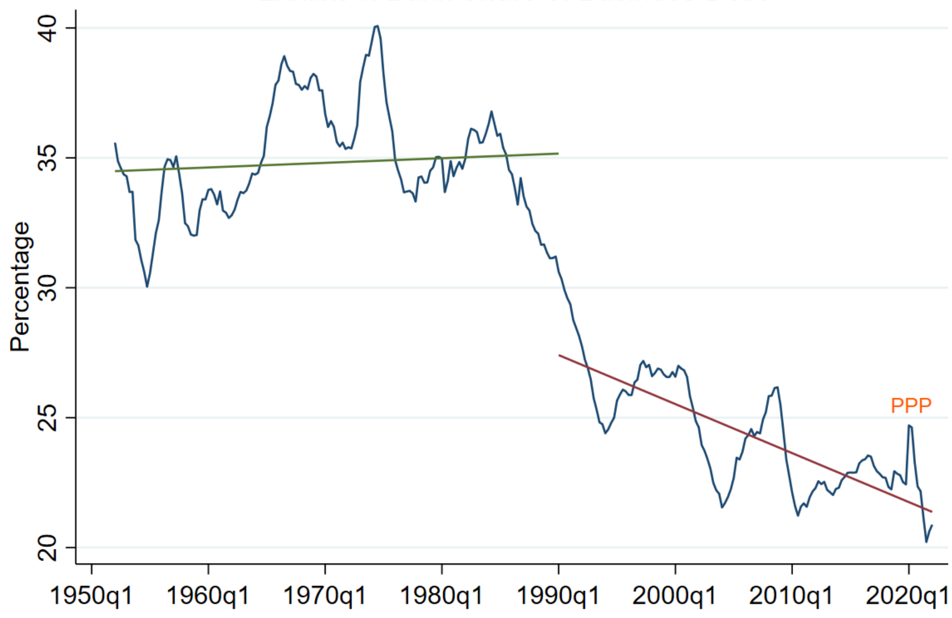
Much commentary has focused on a major shift of mortgage origination and servicing from the banking to the non-banking sector. But less attention has been paid to an equally significant trend: a shift in business lending to nonbanks. Here, private capital markets—private equity, hedge funds, loan mutual funds, finance companies and business development companies (BDCs)—have dramatically increased their market share. And since these lenders are generally not publicly traded companies, and therefore lack transparency into the size and scope of their operations, their role has been more difficult for the public and policymakers to observe. This post documents the decline in the bank share of business debt; explains how high capital requirements imposed by banking regulators have driven that decline; and identifies implications for financial stability (including potential future extraordinary Fed interventions in financial markets), given the increasing reliance by businesses on nonbank lenders to meet their funding needs.

As shown in Exhibit 1, the bank share of business debt has been declining since the mid-1980s. This trend started in the 1980s with the rise of the high-yield corporate bond market (also known as "junk bonds") as an alternative means of financing. Before that, the bank share of business debt was stable going back at least to the early 1950s.

Exhibit 1: Bank Share of Business Debt



Source: Federal Reserve Board, Financial Accounts of the United States.

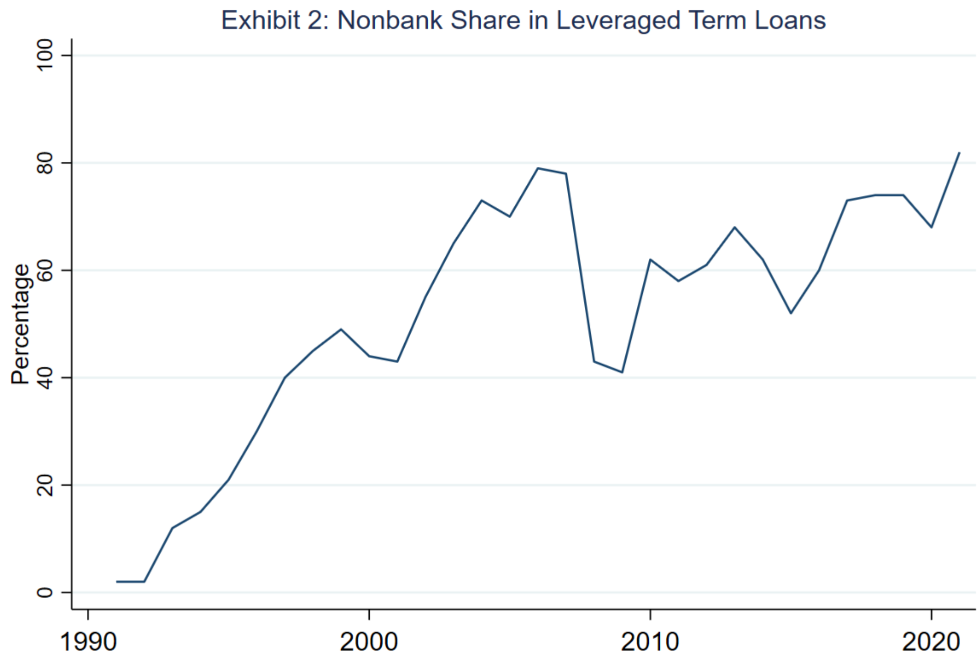
Since the 1980s, the decline in the bank share of business debt has been gradual. It dropped from about 30 percent in the early 1990s to 20 percent in 2021, with some oscillations based on business cycles. Typically, corporate bonds increase their market share during economic recessions because some of the largest businesses—those that can access public debt markets—take advantage of low interest rates. This effect is reversed during the economic expansion that follows. The Paycheck Protection Program (PPP) created by the U.S. government to incentivize small businesses to retain their employees during the COVID-19 pandemic caused a spike in the bank share of business debt, but that was temporary.

Some academic studies find that borrowers are generally worse off borrowing from nonbanks than from banks, because nonbanks charge significantly higher interest rates than banks do, controlling for observable borrower and loan characteristics.[1] Banks also offer other benefits to businesses relative to nonbanks that help borrowers. These include providing liquidity during a crisis, offering deep experience in monitoring informationally opaque firms, and being staffed and ready to work out problem loans well before a default is likely to occur. Some of these advantages translate to lower borrowing costs to businesses of all sizes, whereas others allow firms to better support employment during a crisis. For example, lower bankruptcy costs ex-post result in tighter loan spreads and reduced costs to businesses ex-ante. Also, during the earliest stages of the COVID-19 crisis, nonfinancial firms drew funds from their bank credit lines as other funding sources dried up. As documented by Li, Strahan, and Zhang (2020), commercial and industrial loans on the books of banks expanded by nearly $500 billion, or about 20 percent, in the second half of March 2020.[2]

As outlined in the next sections, the decline in bank share of business debt is evident in all main business loan markets after 1990: syndicated corporate loans, loans to middle-market firms and loans to small businesses.

Syndicated Corporate Loans. Most bank loans to large corporations are syndicated. In a loan syndicate, a group of lenders pool resources to offer funds to the borrower. Initially, the lenders offering the funds to borrowers were mostly commercial banks. Over time, the share of nonbank lenders in loan syndicates has been rising. According to Irani, Iyer, Meisenzahl, and Peydró (2021), nonbank participation in syndicated loans increased from about 20 percent in 1993 to 70 percent in 2014. The rise in the nonbank market share has been driven by increased loan participation by collateralized loan obligations (CLOs), hedge funds, private equity and loan mutual funds. For leveraged loans—those to firms that have no rating or are rated below investment grade—the nonbank share of the market is even higher. As shown in Exhibit 2, the nonbank share in leveraged loans rose from nearly zero in 1990 to over 80 percent in 2021.

[1] See Chernenko, Sergey, Isil Erel, and Robert Prilmeier; "Why Do Firms Borrow Directly from Nonbanks?", *Review of Financial Studies*, forthcoming.
[2] Banks also offer credit lines to nonbank financial institutions, which these borrowers rely on primarily to meet unexpected credit needs.



Source: Thomson Reuters, Loan Pricing Corporation.

Most syndicated loans include both a term loan and a line of credit or revolver loan. Banks still have comparative advantage in managing the liquidity risk associated with holding the lines in their balance sheets, especially in times of stress. Therefore, banks still hold almost all the lines of credit that are part of a syndicated loan.

Middle-market Lending. Middle-market firms have revenues between $10 million and $1 billion. The sources of funding in this market are still relatively understudied. But a few papers have recently shown that the nonbank share has also been increasing, especially since the 2008 financial crisis. Banks are probably still the main provider of funds to mid-sized firms, but they have been rapidly losing market share to nonbank financial institutions.

- Chernenko, Erel, and Prilmeier (2022) report that one-third of direct loans to middle-market publicly traded firms were funded by nonbank financial intermediaries between 2010 and 2015. Those include finance companies, private equity firms, hedge funds, insurance companies and BDCs. They also show that compared with bank borrowers, middle-market firms funded by nonbanks are less profitable and have higher leverage. For instance, they find that having a negative EBITDA or a ratio of debt/EBITDA greater than 6 is an important determinant in a middle-market firm's decision to borrow from a nonbank.
- Davydiuk, Marchuk, and Rosen (2020) show that funding to middle-market private firms by BDCs, a special type of closed-end fund, has more than quadrupled since 2008.

Small Business Lending. Definitions of what constitutes a loan to a small business vary, but the most-referenced definition would be loans to businesses with less than $1 million in revenues or sales. Due to lack of data on the size of small businesses, bank Call Reports define a loan to a small business as a loan of $1 million or less. This loan-size proxy is not a good one, because it may reflect a small loan to a large firm. The loan size threshold should also be adjusted higher now due to inflation and economic growth since this definition was first adopted in 1990. Despite the challenges in defining a bank loan to a small business, several academic papers have documented a significant decline in the share of lending to small businesses by banks after the 2008 financial crisis.

- Chen, Hanson, and Stein (2017) examine trends since the 2008 financial crisis. In 2010, at its lowest level, loan originations to small businesses by the largest banks had declined 60 percent relative to 2006. After large banks recovered from the crisis, smaller banks and nonbank lenders started gaining market share. Using data from a small business credit registry maintained by PayNet Inc., the authors show that small business borrowers shifted to nonbanks beginning in 2008, but they had to pay higher interest rates and received loans with shorter maturities.

- Gopal and Schnabl (2021) report on growth in lending to small businesses by finance companies and FinTech lenders after the 2008 financial crisis. Using data on secured bank loans, they show that bank loan originations fell by nearly one-third between 2007 and 2010. After reaching the trough in 2010, bank lending slowly recovered from 2010 to 2016 but remained sluggish. At the same time, nonbank lenders expanded lending by 70 percent, significantly more than banks. By the end of 2016, nonbank lenders had a market share of nearly 60 percent in small business lending.

Reasons for the Declining Bank Share of Business Debt

A common explanation across the papers that have studied the decline in bank lending, especially since the 2008 financial crisis, focuses on tighter regulatory constraints applied only to banks. For instance, Irani et al. (2021) examine a tight relationship between bank capital requirements and trading of syndicated loans in the secondary market. More specifically, they find that banks with lower buffers above regulatory capital requirements sell their syndicated loans with higher capital requirements to nonbanks. Similarly, the 2013 Interagency Guidance on Leveraged Lending, which increased the stringency of supervisory expectations with respect to leveraged lending standards, caused a further reduction in the share of leveraged loans originated by banks, as shown by Kim, Plosser, and Santos (2016). Chernenko, Erel, and Prilmeier (2022) report that the increase in nonbank lending to middle-market firms is being driven by bank regulation. This makes it costly to lend to firms with negative earnings, consistent with the Interagency Guidance on Leveraged Lending.

Several academic papers have also concluded that higher capital requirements have driven the decline in small business lending by banks. Cortés et al. (2020) show banks subject to the stress tests reduced their originations of small business loans relative to smaller banks and charged higher interest rates on small business loans. Banks not subject to the stress tests fill in the gap, leaving credit to businesses essentially unchanged. According to Chen, Hanson, and Stein (2017), the four largest U.S. banks cut back significantly on small business loan originations relative to the rest of the banking sector. In contrast to Cortés et al. (2020), the authors find that the decline in small business loan originations at those banks contracted credit supply and slowed economic growth. They associate the contraction in credit supply to post-crisis changes in financial regulation, including the U.S. capital stress tests and the capital surcharges for systemically important institutions.

Consequences of Reliance of Businesses on Nonbank Lenders

The growth in the share of business lending by unregulated nonbank financial intermediaries implies that stress in the financial system will likely worsen during future recessions.

First, the migration of business lending toward nonbanks has increased the leverage of nonfinancial business firms, especially in the riskiest segment of this market. Therefore, a negative demand shock can impair a firm's ability to repay its debt. The increase in financial distress will reduce capital expenditures at these business firms well before defaults and bankruptcy occur, because the breach of covenants would result in an immediate reduction in investment. This channel for the transmission of shocks generates an amplification mechanism, as noted by Bräuning, Ivashina, and Ozdagli (2022), and intensifies the initial impact of the shock.

Second, nonbank lenders will lose some access to funding and therefore retreat from lending. For example, leverage loan issuance dropped to almost zero in March 2020 and only bounced back quickly following the massive intervention by the Federal Reserve and Congress. For small business loans, Ben-David, Johnson, and Stulz (2021) reported that lending through fintech lenders collapsed during the COVID-19 crisis, because those nonbank lenders could not fund loans due to rising financing constraints.

Third, as noted above, although banks have the capacity and incentive to engage in workouts, many nonbank lenders lack the funding or the expertise to conduct workouts. This may result in higher bankruptcy costs due to a potential concentration of bankruptcies, as shown by Greenwood, Iverson, and Theismar (2020) and Iverson, Ellias, and Roe (2021).

Fourth, further increases in capital requirements will constrain banks from offering credit lines to some firms, thereby limiting the provision of liquidity by banks during stress events.

In summary, a future crisis or recession will have higher losses on loans to businesses because of greater leverage. Stricter regulations are more likely to make it uneconomical for banks to offer lines of credit to firms. Furthermore, businesses could expect a procyclical drop in credit availability, as nonbank lenders lose funding and retreat from the market. As a result, the need for the Federal Reserve to intervene in credit markets, as seen in March 2020, will likely be more common.

Conclusion

Heightened capital requirements on banks pushed intermediation into unregulated financial institutions after the 2008 financial crisis. As regulators assess implementation of the so-called “Basel III Endgame” in the United States, they must consider that a further increase in bank capital requirements will further boost the migration of business debt and other types of lending to nonbanks. The continued rise in nonbank market share of business lending is weakening financial stability through the role corporate leverage plays in propagating negative shocks throughout the economy, and by constraining how banks supply liquidity during a crisis.

This note does not take a position whether capital requirements on loans to businesses are too high, too low or about right. But the fact that nonbanks have increased their market share at the expense of banks across all main loan markets and continue to do so indicates that capital requirements are significantly mispricing the risk of bank loans to businesses. We leave this question for further study.
