The New Banks – Alternative Lending

With SRZ's leading structured finance lawyers

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Alternative asset managers are increasingly meeting needs for finance that banks, hampered by capital requirements, multiple layers of regulation and gargantuan fines, can no longer fulfil. Indeed, the Basel-based Bank for International Settlements reported that cross-border lending in the first half of 2015 plunged by $910 billion, the largest drop since the crisis-stricken fourth quarter of 2008. Policymakers, including governments and central banks, are acutely aware of the challenges that some firms face in obtaining finance. Though many governments and large companies fundraise at historic lows, palpable gaps are evident in the middle, smaller and retail markets.

In response, the UK Government has become a matchmaker and entitled its consultation 'SME finance: help to match SMEs rejected for finance with alternative lenders' while the Bank of England has a Funding For Lending scheme to encourage more SME lending. The Alternative Investment Management Association (AIMA) has set up an Alternative Credit Council which has launched a social housing development fund, plugging another gap left by governments that have scaled back this type of spending. *The Hedge Fund Journal* has profiled a number of other managers that are active in direct lending strategies.

Diverse investors

The role of alternative lenders has, out of necessity, grown post-crisis – but it is not actually new. Some of the biggest pension funds have been allocating to direct lending for decades. Though it is highly unusual amongst large pension funds in having exited some hedge fund strategies, CalPERS continues to allocate to alternative lending, including in Asia. And it is not only the world's largest investors who are accessing this asset class. In most US states, retail investors can now invest via what is a relatively new phenomenon – peer-to-peer lending platforms – and in the UK these are now eligible for tax-efficient individual savings accounts (ISAs) used by retail investors, as are crowdfunding schemes.

Diverse collateral

THFJ interviewed Boris Ziser, Schulte Roth & Zabel (SRZ) partner and co-head of the firm's Structured Finance & Derivatives Group, who spoke in New York in January 2016 at SRZ's 25th Annual Private Investment Funds Seminar, on a panel entitled 'Private Funds: The New Banks' and Thomas R. Weinberger, an SRZ Partner in the same practice. We asked them how SRZ helps borrowers, lenders, hedge funds, private equity funds and finance companies to structure deals involving a diverse array of collateral. This includes "life settlements, merchant cash advances, cell towers, timeshares, lottery receivables, litigation funding and equipment leasing," enumerates Ziser. He sits on the Esoteric Assets Committee of the Structured Finance Industry Group, and also handles more esoteric collateral such as intellectual property, which involves intangible assets like patents, trademarks and software.

Return targets

High targeted returns, in the mid-to-high teens, are seen in life settlements (here, readers may wish to refer to our separate interview on longevity risk with Ziser and Weinberger). And "in the merchant cash advance space targeted returns are also very high," says Ziser. This segment, which essentially involves buying merchants' receivables at a discount, is similar to 'factoring' on a domestic basis and can be called 'forfaiting' when it entails buying exporters' receivables.

One of the fastest growing areas is marketplace lending online platforms, which can house a wide-range of loan types, from student or consumer loans to SME loans, all with a wide-range of return and risk profiles. A typical yield target could be in the region of 9-10% (after default losses) "but small-dollar consumer loans can pay a lot more," says Ziser.

Types of structures

Fund formation lawyers at SRZ wrap lending strategies in private funds or in public funds, which can include Business Development Companies (BDCs). Ziser instead specialises in secured lending transactions with structures including securitisations, warehouse facilities, secured financings and commercial paper conduits. All of these are backed by assets or by a stream of cash-flows, but after that there is no cookie-cutter model for these deals. Ziser advises on portfolio acquisitions and dispositions, which can be structured as forward purchase arrangements. Some structures can involve a bankruptcy-remote borrower, which might be owned by an operating company parent. Others will vary partly due to tax considerations, which may include tax treaties.

Term securitisations can be a popular structure, which typically involve one or two tiers in a special purpose vehicle. "The motivation for aggregating assets into a securitisation can be to free up borrowing capacity on warehouse lines when coming close to limits," Ziser explains. Another attraction of securitisation can be to reduce funding costs – "if you get the securitisation rated, costs of funding can be lower," Ziser observes. But not every deal will be a good fit for the securitisation markets as "you need a large enough pool of assets to justify a securitisation," says Ziser.

Regulations and risk retention

These deals can be subject to various types of banking regulation. "We try to structure deals in a way that is exempt from Volcker Rule complications but warehouse deals from banks can be subject to some levels of regulation. The granularity varies from deal to deal," says Ziser. Structured credit in Europe is already subject to risk retention rules, and "non-mortgage ABS in the United States will be covered from late 2016," says Ziser who expects many issuers to retain a vertical slice; other SRZ specialists advise on the niceties of the risk retention rules.

Whither usury laws: which state's rules apply?

Usury rules are another type of regulation that are in a state of flux. They are set by the various US states, according to factors including the size of loans and the type of borrower, with interest rate thresholds set for civil usury, and higher thresholds for criminal usury. Most direct lending deals are below usury ceilings or outside the scope of usury laws, but investors should do extra due diligence on those that might be caught in the net.

"When loans are made, usury laws always have to be considered," says Ziser. But risk can be transferred multiple times: first to platforms, then to investors, and subsequently amongst investors. Usury laws in either the borrower's or the lender's state will often need to be observed. The general thinking has been that "if the loan complied at origination, then the transfer of such loans to a non-bank lender was thought to not change that." The Madden decision reached the opposite conclusion. Midland Funding has petitioned the US Supreme Court to hear its complaints about the implications of the Madden decision. "Future legal rulings will determine if state usury laws become a bigger issue in the space," says Ziser. A number of other federal rules can also be relevant.

In the meantime, the most conservative approach to these legal uncertainties could be to follow a 'lowest common denominator' approach and ensure that interest rates are inside the lowest US state usury ceiling, or that loan types are outside the scope of usury laws. A more time-consuming approach could be to check if interest rates on each loan are inside the specific ceilings prevailing in that borrower's state, in order to get comfort in the event of Madden prevailing.

Irrespective of usury laws, alternative lending offers potential for investors to target double-digit yields while supplying finance that some companies, and individuals, apparently cannot obtain anywhere else. **THFJ**