Bank Lending to Nonbanks: A Robust Channel Fueled by Constrained Capital?

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Abstract

This paper documents the way banks are increasingly directing their lending portfolio to nonbanks, fueling recent growth in nonbank assets. Importantly, the shift in lending towards nonbanks is accelerated following unexpected shocks to banks' core capital positions, such as the Basel III regulatory shock, the Oil Shock of 2014, and the COVID-19 crisis. Nonbanks with credit arrangements from bank lenders, in turn, lend more to corporate borrowers, participate more in syndicated loan deals with their bank lenders, and are less likely to sell their shares. These findings highlight a salient channel of banks' lending to nonbanks, driven by banks' constrained capital.

Introduction

Non-Bank Financial Institutions (NBFIs) are playing an increasingly pivotal role in the global financial system, holding 49.5% of total global financial assets by the end of 2019. Bank lending to these entities, including private equity firms, FinTech companies, and Business Development Companies (BDCs), has also grown significantly over the past decade. This paper examines the upward trend in bank lending to NBFIs, suggesting that the post-GFC surge in nonbank assets has been fueled partly by banks increasing their lending to nonbanks.

Banks, with their access to deposits and liquidity backstops, are uniquely equipped to channel funds to nonbanks and provide liquidity. We argue that the shift toward lending to NBFIs is motivated by the lower capital requirements compared to traditional lending, enabling banks to respond to heightened capital requirements efficiently.

Research Questions: 1- Is bank lending to nonbanks motivated by heightened cost of regulatory capital? 2- What are the implications for the real economy?

Methods and Materials

Data Sources: Primary data come from the **Shared National Credit (SNC)** database, covering syndicated loans from 1990 to the present. Additional data include **FFIEC Call Reports** for bank financial information.

Methodology: We use three exogeneous shocks to banks core capital and analyze lending patterns pre- and post-shock. First, we investigate the regulatory capital shock resulting from the U.S. implementation of Basel III, using cross-sectional variation in banks' exposure to this change within a DID framework. This allows us to examine how capital constraints influence the distribution of bank loans between corporate borrowers and non-banks. Second, we consider two economic shocks impacting banks' core capital—the 2015 Oil & Gas crisis and the COVID-19 pandemic—to assess the resilience of bank lending to NBFIs during periods of economic stress. Finally, we explore the broader impact of this lending channel on the real economy.

Key variables: include Tier 1 capital ratios, bank exposure to economic shocks, and banks credit commitments to nonbank and corporate borrowers.

Results

Shift in Lending Patterns: Results indicate a clear shift in lending from corporates to nonbanks, particularly after regulatory or economic shocks. Banks with lower capital buffers displayed a greater tendency to direct lending toward nonbank borrowers, enabling nonbanks to step in and continue lending to other borrowers.

Impact of Regulatory Capital Constraints: Economic shocks did not curtail credit availability to nonbank borrowers; instead, banks affected by these shocks adjusted their portfolios by increasing lending to nonbanks. This tendency was especially pronounced among banks facing capital constraints. Lending to NBFIs allowed banks to optimize capital usage by utilizing structures that require lower capital reserves than traditional corporate loans.

Implications for the real economy: Nonbanks with access to bank funding were able to sustain credit flows more effectively during economic downturns, leveraging this capital-efficient funding source to support broader credit availability.

Discussion

Banks and Nonbanks Relationship: Our paper offers a new perspective on this relationship, shifting from the traditional view of substitution to one that emphasizes their direct linkages and connections. Banks are repositories of liquidity which positions them as a crucial component in nonbank activities through liquidity provision.

Implications for Stability of Nonbank Credit Provision: Although tighter interconnections may facilitate the propagation of shocks from nonbanks to banks, our paper demonstrates that banks serve as shock absorbers by providing liquidity to nonbanks. This support reinforces the role of nonbanks as credit intermediaries for the real economy. Our results indicate that during the oil and COVID-19 shocks, banks, despite facing capital constraints, adjusted their lending portfolios toward nonbank borrowers, enabling these nonbanks to better support the economy

Conclusions

- Bank funding has been a major driving force behind the growth of nonbank sector. Banks response to capital shocks was to lend more to nonbanks.
- Bank funding plays a crucial role in the resilience of nonbanks as reliable financial intermediaries. Findings generate optimism about the resilience of nonbank funding and credit provision during periods of economic downturns.
- **Broader Implications**: As nonbanks grow in importance, ensuring stability within this sector and its connections to the banking system will be crucial for financial resilience. The resilience of bank lending to nonbanks supports optimism about the stability of nonbank credit provisioning to the real economy.