The Remaking of the Lending Market

By William Spiegel,
Managing Director and Head of Financial Services

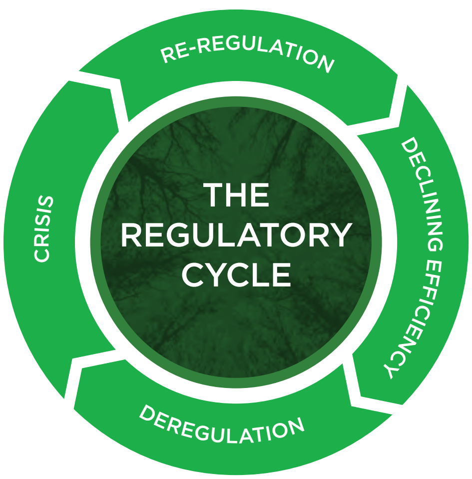
PINE BROOK

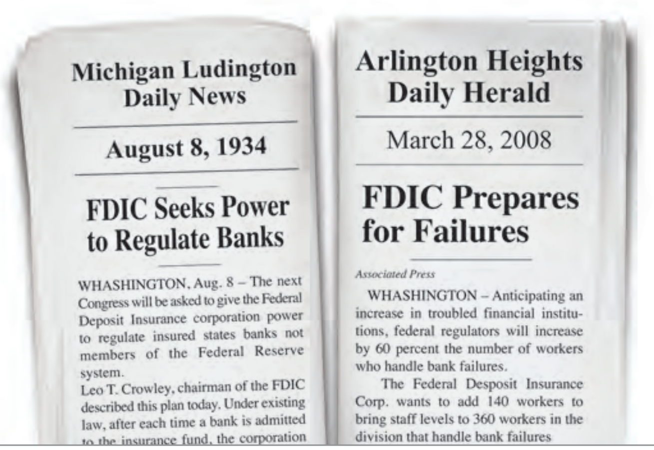
Great Businesses Grow from Great Ideas

The financial services market has changed forever, creating a need for private equity investment to fill the resulting void left in sectors such as consumer and commercial lending. This opportunity has substantial upside for growth equity investors who have the industry knowledge and operational expertise to start these types of specialty businesses.

AS THE CYCLE TURNS

Today there is vast opportunity for both non-bank lenders and the investors who can meet their growing demand for capital. This market transformation is a result of regulatory fluctuation. For example, a financial crisis (such as in 2008) spurs increased **re-regulation** and as the impact of the crisis recedes, a movement toward **deregulation** arises. And then this cycle repeats itself.





Michigan Ludington Daily News

August 8, 1934

FDIC Seeks Power to Regulate Banks

WHASHINGTON, Aug. 8 – The next Congress will be asked to give the Federal Deposit Insurance corporation power to regulate insured states banks not members of the Federal Reserve system.

Leo T. Crowley, chairman of the FDIC described this plan today. Under existing law, after each time a bank is admitted to the insurance fund, the corporation

Arlington Heights Daily Herald

March 28, 2008

FDIC Prepares for Failures

Associated Press

WHASHINGTON – Anticipating an increase in troubled financial institutions, federal regulators will increase by 60 percent the number of workers who handle bank failures.

The Federal Desposit Insurance Corp. wants to add 140 workers to bring staff levels to 360 workers in the division that handle bank failures

To help prove this theory, if you look back 80 years ago will find that newspaper headlines appearing after the financial collapse in the 1930s are eerily similar to those written in the wake of the system's disruption in 2008.

Reeling from Regulation

The current regulatory climate has transformed the community banking landscape. One of the most significant problems community banks face is the sheer volume of banking regulations and the seeming lack of coordination. Dodd-Frank will increase total financial regulatory restrictions by 32 percent over 2010 levels, according to one estimate. Meanwhile, regulators can't seem to even agree on what constitutes a "community bank."

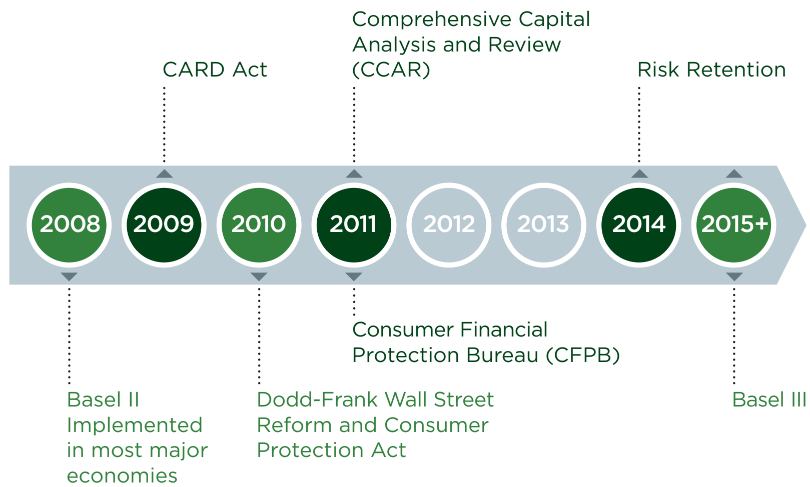
The costs for community banks associated with more regulations are inherently a larger portion of revenue than for larger institutions. For example, one study showed that hiring two additional people to manage compliance reduces median profitability by 45 basis points. This increasingly complex regulatory system has created an uneven playing field that is accelerating consolidation.

Traditionally, community banking has played a vital role to many key lending segments, particularly small businesses. But the regulatory pressures over the past decade have caused these banks to pull back from lending. As they continue to lose market share and volume in the individual, small business and residential lending markets, a void has been created. That's why we will continue to see non-banks enter these traditional lending segments aggressively. There is clearly a substantial amount of unmet demand that shows no signs of abating.

***Marshall Lux**, Senior Advisor to The Program on Capital Markets Regulation and a Senior Fellow at Harvard Law Schools Program on International Financial Systems*

RE-REGULATION AND THE IMPACT ON BANKS

After 2008, the regulatory schemes imposed on the financial services sector read like a menu of alphabet soup. Whether it is Basel II and III, the CARD Act, the CCAR, the CFPB or Dodd-Frank, the intent of all of these has been uniform: reduce bank risk.



As a result of these measures, traditional banks have been forced to reassess and alter their business models when it comes to both consumer and business customers. These banks have reduced their lending to non-prime consumers, who, according to FICO, make up 47% of the total consumer market. On the commercial side, banks have been forced to reduce lending to small businesses, affecting the 99 % of businesses in the U.S. that have fewer than 500 employees.

From these two statistics alone, one can see that the renewed regulatory environment is having a profound impact on the lending environment. With bank lending constrained, alternative lending sources are needed to pick up the slack. This presents a substantial market opportunity for non-bank lenders.

BURGEONING CAPITAL REQUIREMENTS SHIFT

The percentages above are sizable, but they only touch on one aspect of the economic impact this shift to non-bank lending will have. To really scope the challenge, one must look at the sub-sectors affected and the capital that new non-bank lenders need to service this market.

The chart to the right breaks down the size of this market across six different sub-sectors.

Combined, these sectors represent $13 trillion of outstanding loans, which amounts to more than half of the outstanding debt in the U.S. economy.

And this number doesn't even include larger commercial loans, multifamily residential, farm and certain pieces of consumer credit, like auto. Based on research conducted by Goldman Sachs, an estimated $7.8 trillion, or 60 percent, of this lending is taking place within the traditional banking system. While not all of this lending opportunity will transfer to non-banks lenders, Goldman estimates that 20 percent of these loans-- $1.6 trillion—could leave the banking system. By Goldman's calculations, this represents $11 billion of *profit.*

In order to support this volume, new businesses must be formed, and those businesses will require an estimated $150-$300 billion of new equity capital.

Non-Banks Will Require Billions in New Equity Capital...

($ billions)

Sector	Market Size	Est. Amt. in Banking System	Est. Amt. Leaving Banking System	Banking Profit Pool at Risk
Personal Lending (unsecured/credit card)	$843	$683	$209	$4.6
Small Business Lending	$186	$177	$177	$1.6
Student Lending	$1,222	$65	$65	$0.7
Mortgage	$7,758	$5,488	$978	$2.2
Commercial Real Estate	$2,354	$1,322	$118	$0.8
Leverage Lending	$832	$57	$19	$0.9
TOTAL	$13,195	$7,792	$1,566	$10.9

$150 - $300 billion of new equity capital may be required to support non-bank lenders

Source: Goldman Sachs Global Investement Research estimates

A Lender's View

Traditional banks are not equipped to service small business loans because anything under $200,000 isn't profitable for them. These banks classify small business as a company with up to 1,500 employees and revenues of up to $20 million. The average size of our customers is far smaller: entrepreneurs with revenues under $2 million, and fewer than 50 employees. Our average financing is $40,000.

In the past, community banks would service these customers. Relationships and proximity were part of their model, not just five-year revenue projections. But, increased regulation has made that challenging.

The market is large and growing rapidly. When I first got involved with Strategic Funding Source in 2006, the total market was less than $500 million. Today, it's more than $7 billion. I've seen many, many entrants to this market because of the opportunity. But, what's happening now—and what the industry needs to serve businesses efficiently—is consolidation around the leaders. Lenders need to have a strong IT platform and a strong human insight, as well as a platform for syndication that provides the required reach. That's the dynamic that is playing out now and where the winners will be found.

***Andy Reiser**, CEO, Strategic Funding Source*

PRIME OPPORTUNITY FOR PRIVATE EQUITY

Private equity firms are well poised to help fill the void left by traditional banks by serving as a capital and knowledge resource to the new non-bank lenders that will service the displaced customer segments. However, successful investing will require a high degree of specialization and thorough understanding of the market.

Most important, real financial services expertise will be necessary. Whether investing in a business targeting lending to individuals, small businesses, students, or home buyers or commercial real estate, a specialized appreciation of the nuances associated with each is imperative to avoid pitfalls. In addition, the businesses seizing this opportunity are new, so they are not buyout investments, but growth equity commitments.

The reshaped lending market presents one of the most significant investment opportunities in financial services in recent memory. A $300 billion gap means there will be no shortage of deals or private equity firms lining up to provide capital. Investors who know how to work effectively with regulators have experience competing in highly-regulated markets, and have the patience and willingness to build businesses from scratch, will be able to reap the rewards.●

For more information, please visit www.pinebrookpartners.com

The Pine Brook Approach

Since Pine Brook was founded in 2006, we've kept a close eye on the lending market because there will always be a need there. If there's no lending, there's no economy. And we've watched the market change to the point where the only people who have access to credit are those that don't need it.

We identified small business finance as a critical and underserved component of economic growth coming out of the financial crisis. We had been searching for the right partner to combine with our capital to take advantage of the significant market opportunity that exists. We went out and found Andy Reiser and Strategic Funding Source. They were a perfect fit because Andy and his management team have the experience, talent, and the established platform necessary to manage growth while serving more businesses that are underserved by traditional sources of capital.

We think this cycle is in the early innings. More regulation is coming, but it will take years to get implemented. It will be a long time before the banks come back into this market.

There are so many new concepts developing now that we're confident more opportunities will arise in a very fragmented competitive landscape. We're looking at these new entrants every day, and are working to put our line of equity investment approach to work with winners who we believe can be the consolidators.

William Spiegel,
Managing Director and Head of Financial Services

Pine Brook manages more than $6 billion of commitments that makes “business building” and other equity investments, primarily in energy and financial services businesses.

Mr. Spiegel is a founding partner and a managing director responsible for managing Pine Brook’s financial services investing activities. He has 25 years of private equity investment experience. Prior to joining Pine Brook, he was with The Cypress Group from its inception in 1994 until 2006, managing its financial services and healthcare investing activities. Prior to joining the Cypress Group, Mr. Spiegel worked in the Merchant Banking Group at Lehman Brothers. He has served on the board of directors of 17 companies, including seven publicly traded corporations. Mr. Spiegel holds a B.Sc. in Economics from the London School of Economics, an M.A. in Economics from the University of Western Ontario and an M.B.A. from the University of Chicago.

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