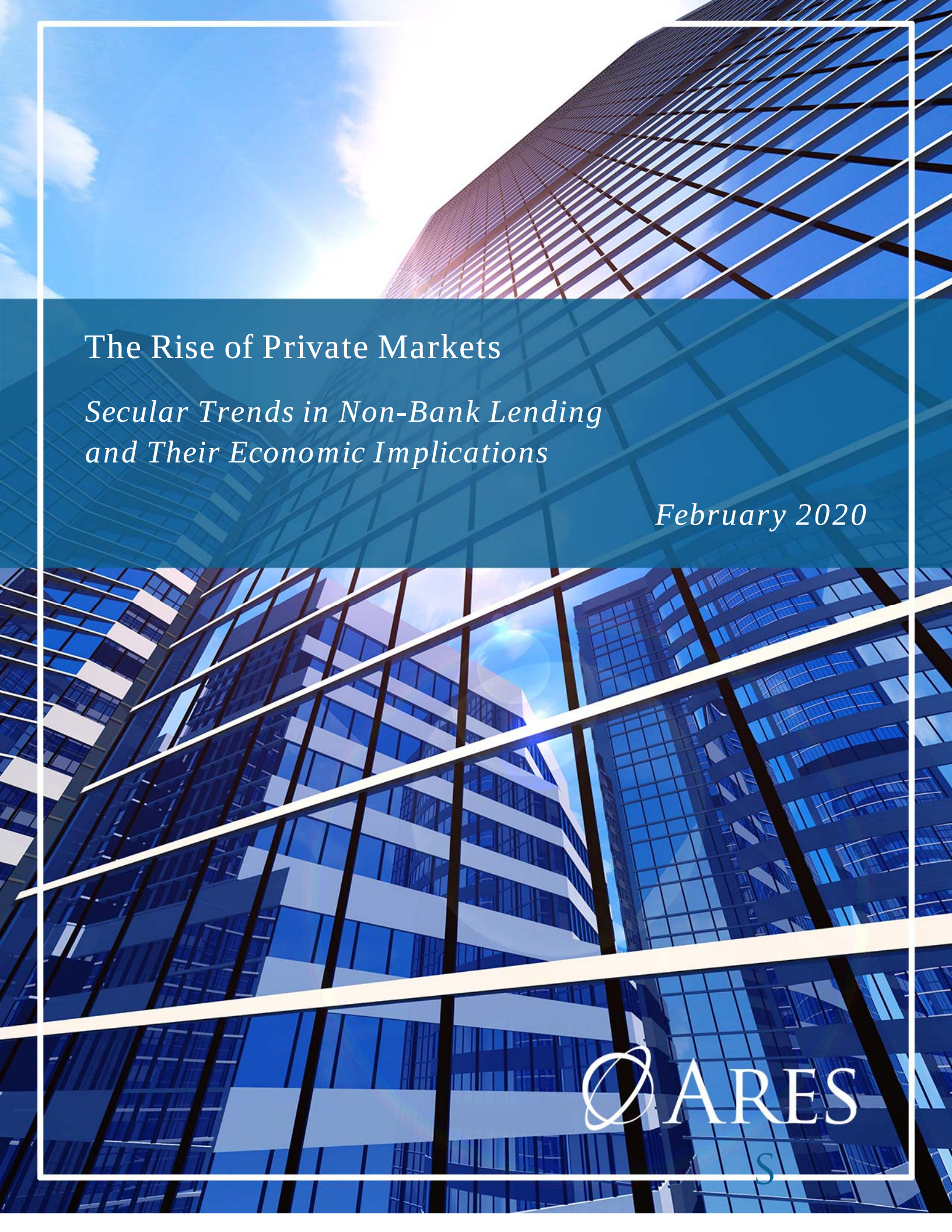

The Rise of Private Markets

Secular Trends in Non-Bank Lending and Their Economic Implications

February 2020

ARES

Contents

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Executive Summary
Section I

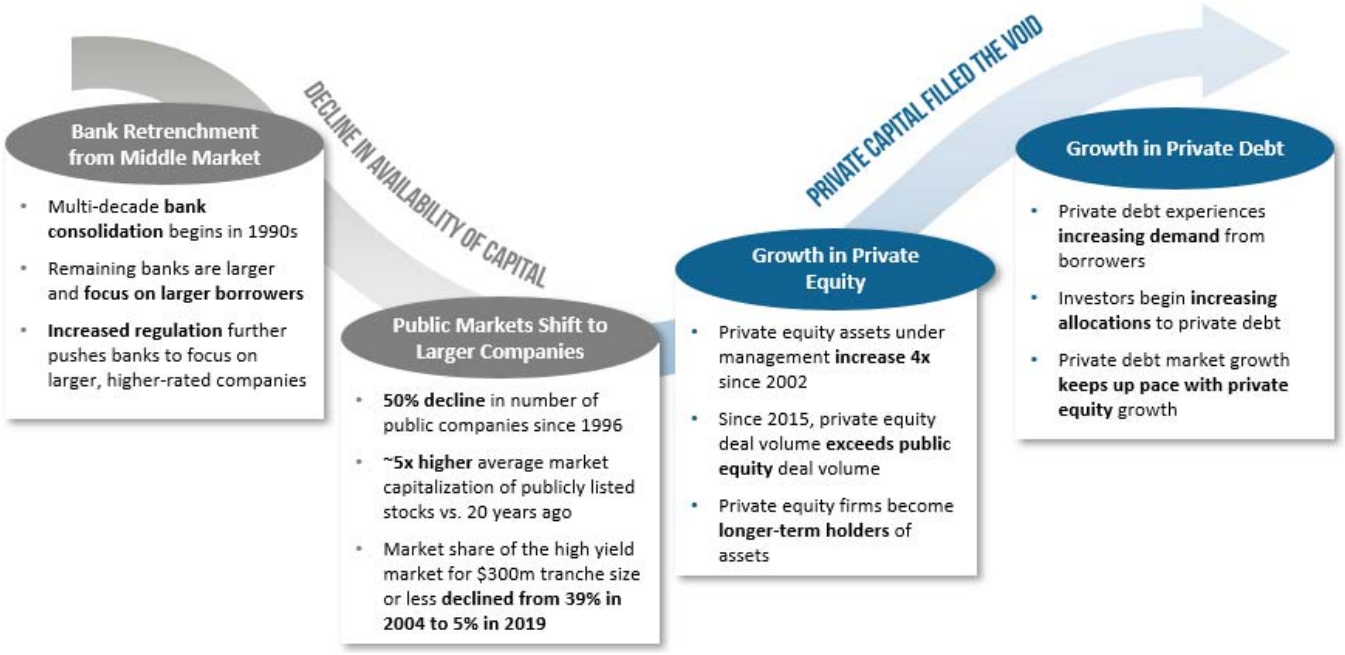
Many financial commentators have recently suggested that the strong growth of the non-bank corporate lending market is a short-term, cyclical trend that could threaten the stability of our financial system. **In our view, the growth of the non-bank market can be explained by a long-term shift toward private capital as banks and public markets have transitioned from serving small and medium-sized companies to larger companies over the past several decades.**

This paper discusses the phases that have led to the evolution of the non-bank corporate market and why we believe it serves a critical function in providing capital to growing middle market companies. We believe that a better understanding of these changes provides context to the growth and market share gains of non-bank corporate lending. Our conclusions are based on proprietary insights that we have gained over the past two decades operating as one of the leading U.S. private credit managers.

Several key events resulted in the rise of U.S. private capital:

- ***Banks shift focus after multi-decade bank consolidation:*** Significant bank consolidation started in the mid-1990s and led to the retrenchment of cash flow lending to small and medium-sized companies. As illustrated by Figure 1, commercial banks have declined in number by 50% since 1998, and **the top 25 banks now hold more than 50% of all bank commercial and industrial (C&I) loans and focus on larger borrowers** (Figure 4). This trend accelerated in response to increased bank regulations following the Great Financial Crisis (GFC), which led to reduced appetite for illiquid assets and accelerated the shift in traditional bank lending to an "originate and distribute" model.
- ***Public markets shift focus to larger companies:*** Public equity and traded debt (high yield and syndicated loan) markets shifted away from smaller borrowers as well. **The number of public companies has declined by nearly 50% since 1996 while the average market capitalization has increased from $1.7 billion in 1998 to more than $8.3 billion in 2019** (Figure 6).[1]
- ***Private capital fills the void:*** As traditional sources of public capital financing became less available and regulatory burdens on public companies made public capital less desirable, private equity and private debt capital filled the void. Along the way, demand naturally increased as investors were attracted to the potentially strong and consistent returns from private equity and private debt investments.
- ***These trends exist far beyond the U.S.:*** European and Asian markets are also experiencing strong demand for private equity and private debt capital as traditional sources focus less on the needs of small and middle market companies.

Structural changes caused a multi-decade shift from traditional providers of capital to the private markets in order to fill the void for small and medium-sized companies[2]



Executive Summary
Section II

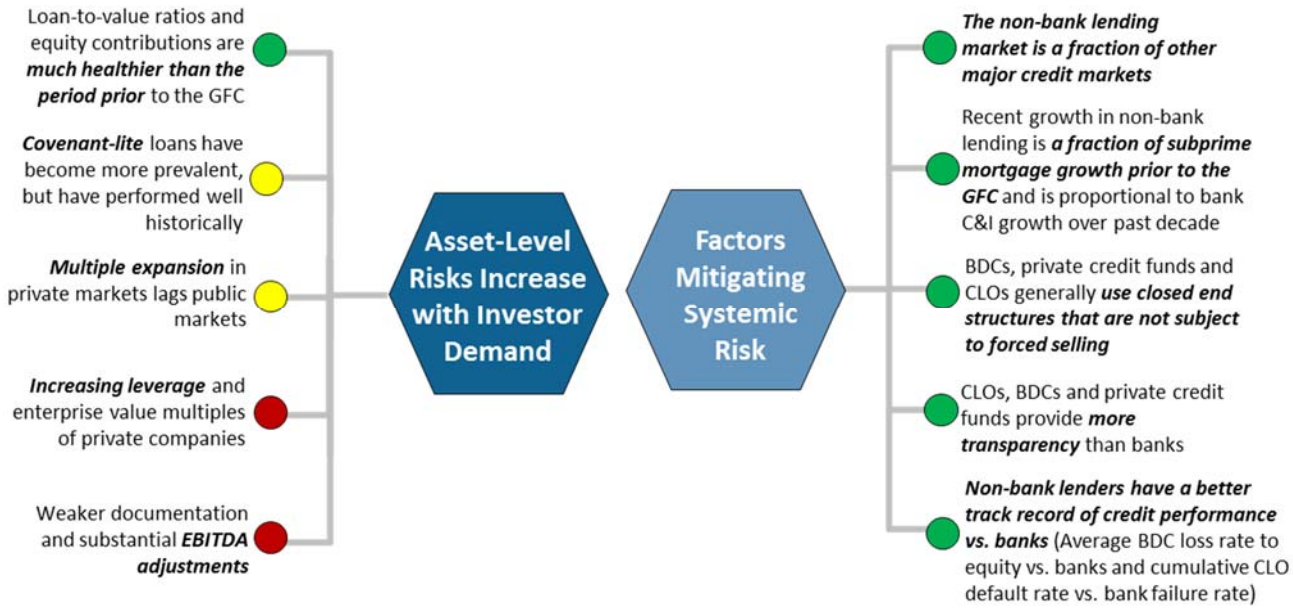
Given the long-term growth of private capital, an important question is: has non-bank lending created asset-level or systemic risks to the U.S. economy? The private markets have not been immune to the forces arising from excess liquidity, such as easy monetary policies and low interest rates, which have resulted in elevated asset pricing in the public markets. However, we believe it is unlikely that the non-bank corporate lending market creates systemic risk due to its relatively small size across credit markets, reporting transparency and strong historical loss performance. **In addition, unlike deposit-funded commercial banks, non-bank lenders generally operate through closed end funds with low leverage, which minimizes forced selling and potential systemic risks.** Non-bank lenders are generally funded by institutional investors, which are arguably more natural owners of this risk than holders of bank deposits.

That being said, due to the increased asset-level risk further discussed in this paper, we believe successful non-bank lenders will need deep sourcing capabilities to originate the highest quality credits, disciplined underwriting processes, extensive portfolio management skills and significant available capital to inject liquidity into potentially troubled companies. We do expect greater dispersion among credit managers lacking these required competencies.

This whitepaper makes the following key assessments of asset-level and systemic risks:

- ***Asset-level risk has increased with investor demand:*** Private equity multiples are elevated and loans contain fewer covenants with weaker documentation, but loan to value ratios have improved compared to the prior credit cycle. To date, long-term recoveries on defaulted covenant-lite ("cov-lite") loans are generally consistent with loans with covenants (Figure 30). **Importantly, it is the large banks that continue to have the most influence over terms and structures in both the middle market and broadly syndicated markets, including cov-lite loans.**[3]
- ***Systemic risk is mitigated by several factors:*** In our view, the long-term structural shifts in the non-bank market have resulted in a de-risking of the U.S. financial system. **While the growth of non-bank lenders has been strong, it is less than one-tenth of the annualized growth of the subprime mortgage market in the decade prior to the GFC** (Figure 33) **and is in line with the growth of bank lending over the last 10 years** (Figure 34). Non-bank lenders arguably provide more asset transparency to their investors compared to commercial banks. **Finally, we believe non-bank lenders have a better track record of credit performance vs. banks, as measured by the average BDC loss rate to equity vs. banks and the cumulative CLO default rate vs. bank failure rate** (Figures 39 and 42).

Due to low interest rates and excess liquidity, asset-level risk has increased for non-bank corporate markets alongside other risk asset classes. However, many factors mitigate "systemic risk," in our view[4]



Defining the non-bank corporate lending markets: *corporate borrowers in the U.S. can seek non-bank sources of debt capital through several markets, including the investment grade bond market, the high yield bond market, the broadly syndicated leveraged loan market and the middle market. In this paper, we will focus on: (1) the broadly syndicated leveraged loan market, where large borrowers generally obtain senior secured, non-investment grade loans from a group of arrangers (often led by commercial or investment banks) who sell the loans to other institutional investors, including CLOs and private funds, and (2) the middle market in which BDCs and direct lending fund managers finance small and medium-sized corporate borrowers.*

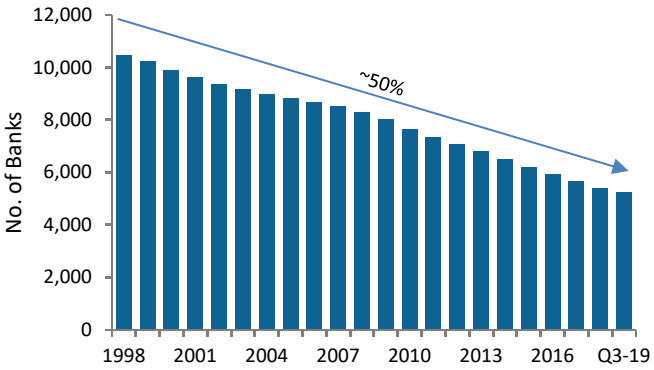
I. Structural Shifts in Public and Private Markets

In this section, we examine the key events that triggered the market transition from traditional sources of capital – banks and public markets – to the private equity and debt markets.

The Growth of U.S. Non-Bank Lending: A Historical Context

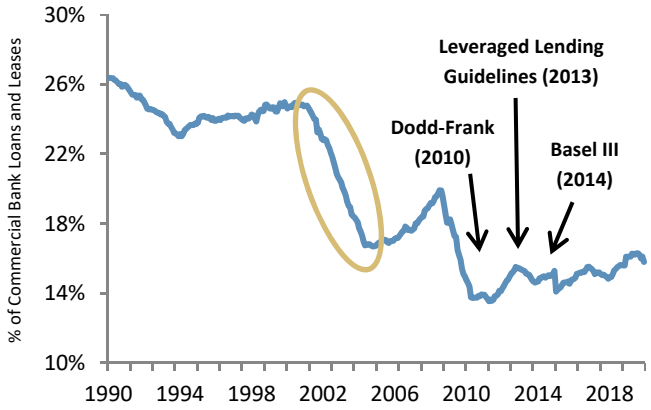
To understand the growth of non-bank corporate lending, it is important to look at the historical trends that preceded today's non-bank lending market. Over the last 20 to 30 years, this has evolved in two stages. Beginning in the early 1990s, **the first stage was significant bank consolidation, which had a profound impact on the supply of capital to small and medium-sized companies.** Bank mergers ultimately led to a decline in the percentage of C&I loans held by banks (Figure 1 and Figure 2). The consolidation of regional banks (that serviced the middle market) into larger, national banks (Figure 3) often resulted in a preference to provide larger facilities to larger customers and, therefore, less capital was allocated to smaller borrowers.

Figure 1: Decline in the Number of Commercial Banks



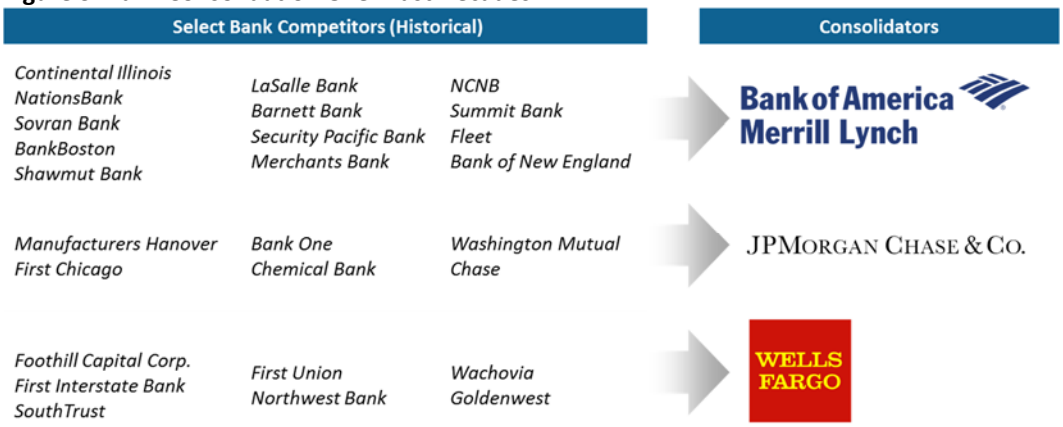
Source: Federal Deposit Insurance Corporation (FDIC), "Statistics at a Glance: Latest Industry Trends," September 30, 2019.

Figure 2: Commercial & Industrial (C&I) Loans as a Percentage of Bank Holdings



Source: Federal Reserve H8 data, December 31, 2019.

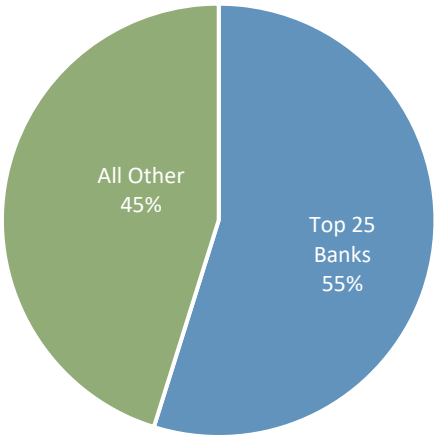
Figure 3: Bank Consolidation Over Past Decades



Source: Ares. For illustrative purposes only.

The primary impact of this bank consolidation was a focus on increasingly larger companies to match the elevated sizes of their balance sheets. As Figure 4 shows, the top 25 banks in the U.S. account for over half of total C&I bank loans, which has caused a shift in focus to larger borrowers. This trend is further evidenced by the fact that the average C&I loan amount has more than doubled since the GFC.[5] This shift to larger borrowers left middle market and non-investment grade borrowers without a steady source of growth debt capital.

Figure 4: Top 25 U.S. Commercial Banks Hold More Than 50% of Total C&I Loans



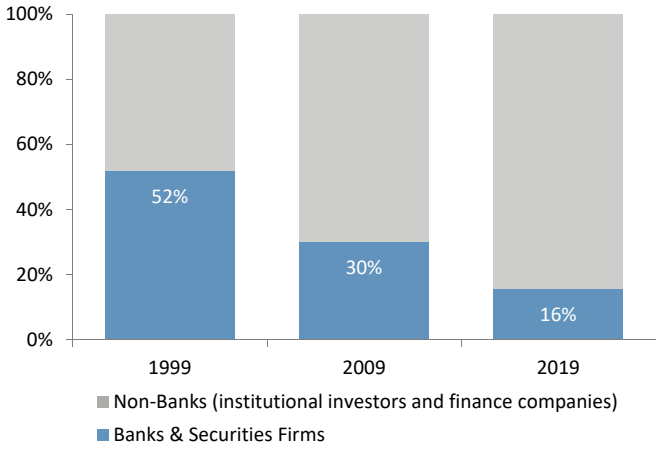
Source: Federal Reserve, December 2019.

The next important event that catalyzed the continued growth of non-bank lending was new bank regulation post-GFC. In the aftermath of the GFC, new regulations, such as Dodd-Frank and Basel III, required banks to increase their capital bases, materially tighten underwriting standards and enhance reporting levels (among other emerging administrative requirements). As a result, coming out of the GFC, banks narrowed their lending products (especially in financing illiquid assets), became more risk averse, shed staff and allowed legacy businesses to run-off or be sold.

The next important event that catalyzed the continued growth of non-bank lending was new bank regulation post-GFC

While banks began transitioning to an "underwrite and distribute" model for non-investment grade credit during the consolidation in the late 1990s, this shift accelerated post the GFC. This approach involved underwriting loans to upper-middle market and larger leveraged companies in the broadly syndicated market, and then syndicating the majority of these loans while collecting fees. Although banks often retained some exposure to larger loan syndications in the form of a low leveraged revolving credit facility or a portion of an amortizing senior term loan A, this strategy allowed banks to offload a significant portion of the credit risk from their balance sheets and earn fee revenue while benefiting from the growing role of private equity sponsors. This trend resulted in a dramatic shift in the holders of leveraged capital over time as banks committed their balance sheet capital to much larger borrowers. As a result, non-banks became increasingly important sources of capital for non-investment grade or leveraged loan borrowers (Figure 5).

Figure 5: Market Share of Primary Investors for U.S. Leveraged Loans



Source: S&P LCD Quarterly Q4-19 Leveraged Lending Review.

Due to banks' reluctance to hold leveraged credit on their balance sheets, non-bank corporate lenders stepped in to fill the void for small and medium-sized companies. For larger corporate borrowers with access to the broadly syndicated loan markets, CLO and loan fund managers have replaced banks as holders of bank-originated products. Similarly, middle market borrowers or private companies that are not serviced by the public financing markets are increasingly seeking the offerings of private credit funds and BDCs that invest in middle market debt.

As non-bank lenders took share of the market and expanded their capabilities, including the ability to hold larger loans, banks have become more aggressive on terms to win new loan mandates.[6]

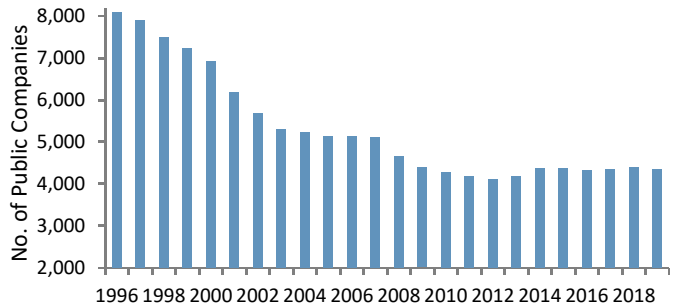
Secular Changes in U.S. Public and Private Capital

As banks consolidated and retrenched, another trend was also occurring: a shift from public equity markets to private equity markets, particularly for small and medium-sized companies. As regulatory requirements for public companies increased and the economy expanded, public markets increasingly focused on larger, more liquid companies. This shift left middle market companies, which account for 200,000 U.S. businesses and one-third of private sector GDP,[7] in need of an equity capital solution and led to the growth and sophistication of the private equity markets. As we discuss later, this ultimately led to the growth in private debt markets as well.

The evolving regulatory environment, including legislation such as the Sarbanes-Oxley Act, created high barriers to entry for small and medium-sized businesses. For example, prior to Sarbanes-Oxley, the median age of a company at the time of its Initial Public Offering (IPO) was about five years. However, by 2019, the time to IPO doubled to 10 years.[8] In addition to increased listing and regulatory costs, companies see more value in partnering with sophisticated private equity investors who understand corporate business models and have a long-term focus. The growing importance of passive investing to the public equity markets further amplifies these issues as private sources of capital often provide advisory, strategic, managerial and operational assistance to support the growth prospects of the business.

The increased regulatory requirements on public companies and the growing sophistication of the private markets led to a decrease of almost 50% in the number of public companies since the mid-1990s (Figure 6). Furthermore, the average market capitalization of listed companies in the U.S. increased from $1.7 billion in 1998 to more than $8.3 billion in 2019.[1]

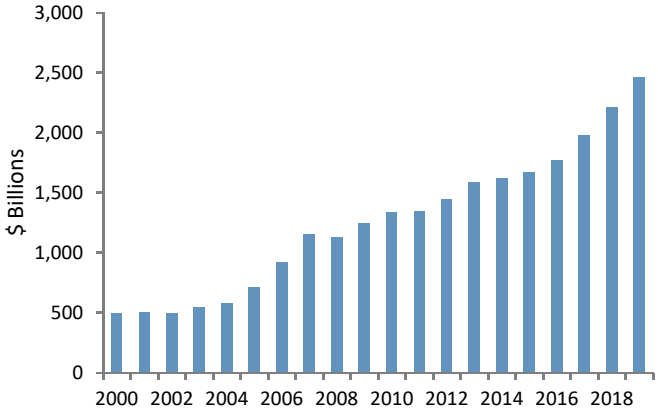
Figure 6: Number of U.S. Public Companies



Source: The World Bank: World Federation of Exchanges Database and FactSet, December 2019.

In response to the decline in public sources of funding to support small and medium-sized businesses in the U.S., institutional capital formed to address the capital needs of U.S. private companies (Figure 7). As a result, private equity capital began to fill the void that was not being serviced by the public equity markets. Private equity firms further adjusted to this structural shift by raising funds that have owned companies for 15 years or longer.[9]

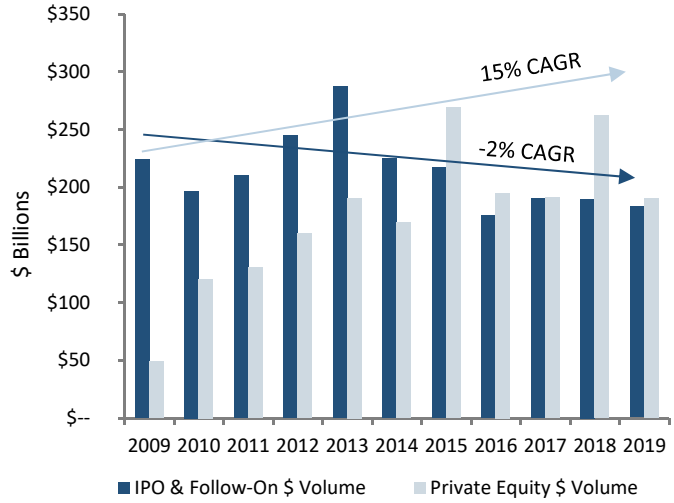
Figure 7: U.S. Private Equity Assets Under Management



Source: Preqin, June 2019.

As a result of the growth in private equity capital to support these companies, the private equity markets have expanded in breadth and sophistication. Since 2009, private equity deal volume has grown approximately 15% per year, while the dollar volume of public equity deals (IPOs and follow-on offerings) has declined 2% per year. **In 2015, more equity capital was raised in the private equity market than in the U.S. IPO and follow-on markets for the first time. Importantly, this trend is continuing**, as shown in Figure 8.

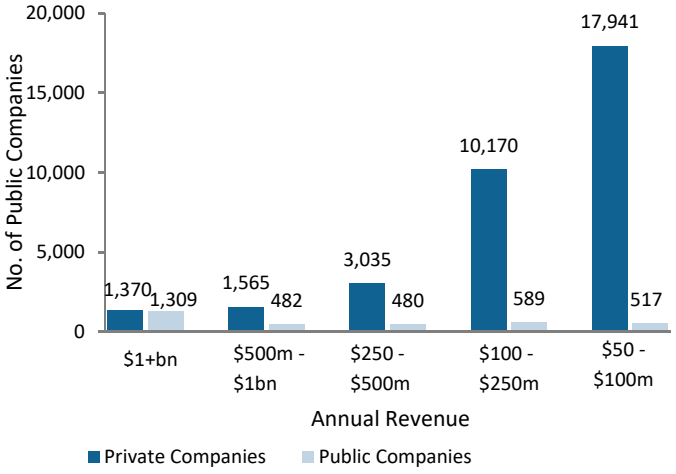
Figure 8: Capital Raised in the U.S. Public vs. Private Markets



Source: Refinitiv, public market follow-on offering and IPO data. Preqin, PE transaction volume data, December 2019.

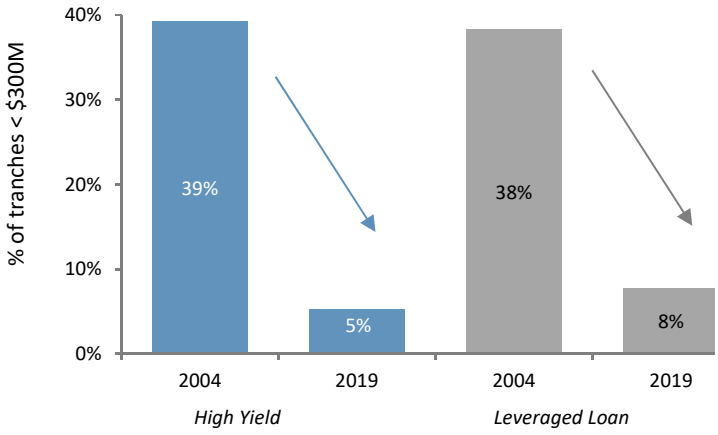
In addition, there are more than 30,000 private companies with between $50 million and $500 million in revenue that may not be large enough to meet the liquidity requirements of the public equity markets (Figure 9). Just as the public equity markets have become a limited source of capital for small and medium-sized businesses, so too have the public and more liquid (high yield and leveraged loan) credit markets. For example, 39% of high yield issuers were in tranche sizes of $300 million or less in 2004. Today, only 5% of high yield market transactions involve borrowers of this size (Figure 10). Similarly, the more liquid leveraged loan market has also shifted toward larger borrowers over the last 15 years (Figure 10).

Figure 9: Number of U.S. Public and Private Companies by Annual Revenue



Source: World Economic Forum, April 2018.

Figure 10: Percentage of High Yield and Leveraged Loan Tranches Below $300M



Source: ICE BofA U.S. High Yield Constrained Index (HUC0) and Credit Suisse Leveraged Loan Index (CSLLI), December 31, 2019.

Institutional Investors Support Scaling of U.S. Non-Bank Lenders

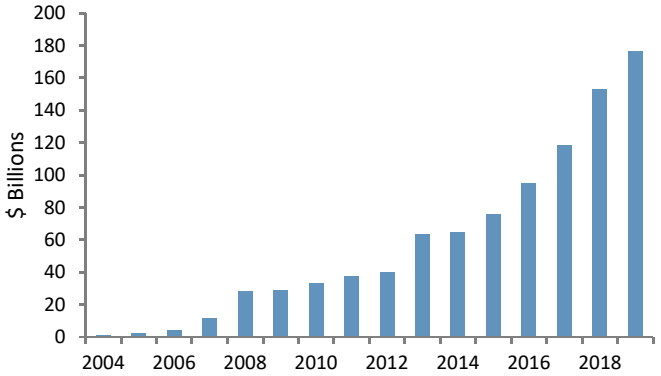
In the previous section, we described the growth of private equity capital. In this section, we describe how private debt/non-bank providers began to scale significantly to support the growth of private equity as institutional investors became increasingly comfortable with the private debt asset class.

Over the past 10 years, institutional investors in search of high, current income with less volatility have increasingly allocated to non-bank capital providers (including alternative asset managers) with alternative liquid/illiquid credit offerings.

This is in stark contrast to the views of institutional investors in the late 1990s through the mid-2000s who considered non-bank assets as inappropriate for liquid credit or traditional private equity asset allocations.[6]

The concurrent growth in demand and supply is illustrated by the increase in direct lending assets under management, as shown in Figure 11. Over time, companies have become increasingly comfortable with the value propositions of non-bank direct lenders, who provide financing solutions to companies without the use of intermediaries such as investment banks or brokers. In contrast to traditional banks, non-bank lenders provide greater flexibility and a partnership-oriented approach.

Figure 11: U.S. Direct Lending Assets Under Management



Source: Preqin, June 2019.

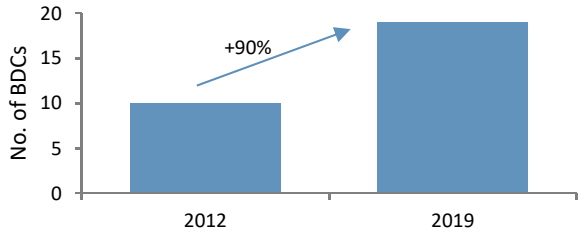
Why has demand grown for private credit assets?

Unlike many traditional asset classes, private credit offers the opportunity to earn less volatile total returns of 5% to 14%, depending on an investor's liquidity/leverage appetite.[10]

According to a 2020 Preqin survey, 89% of surveyed investors believed private debt met or exceeded performance expectations in 2019 and 44% of surveyed investors expect to invest more capital in private debt in the next 12 months compared with the previous 12 months, the largest proportion of any asset class.[11]

As the size and scale of the U.S. private markets have expanded, the ecosystem around private debt markets has also grown with increasing sophistication. For example, since 2012, the number of public Business Development Companies (BDCs) above $1 billion in assets increased by 90% (Figure 12). Borrowers increasingly prefer private markets for several reasons: the speed to execution, the flexibility of capital provided and the willingness of non-bank lenders to hold significant commitments.

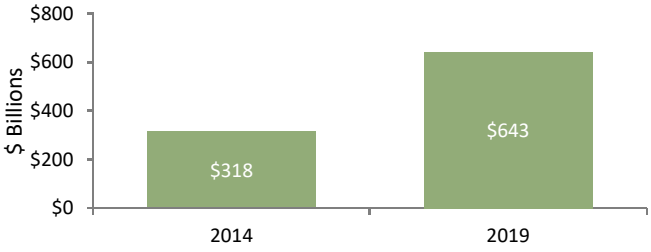
Figure 12: Growth of Public BDCs Above $1 Billion in Assets



Source: S&P, December 31, 2012 and September 30, 2019.

This trend also extends to direct lending fundraising as large firms increasingly gain market share. For example, according to Private Debt Investor, the top 30 fundraisers grew from $318 billion in 2014 to $643 billion in 2019 (Figure 13).

Figure 13: Top 30 Private Debt Fundraisers by Assets Under Management



Source: Private Debt Investor (PDI), December 2019.

In our view, increased scale in private credit provides significant information and product advantages that can lead to better credit investments.

Structural Shifts Extend Far Beyond the U.S.

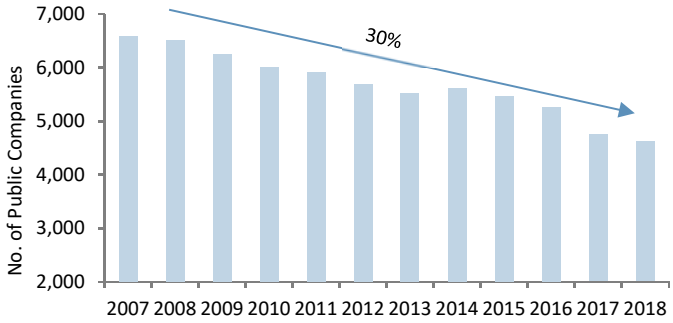
Although this paper is focused on the long-term structural changes in the U.S. capital markets, many of these same trends are occurring in other developed and developing economies.

Trends in European Capital Markets

In Europe, there is also increasing demand for private capital as banks and public equity markets are gradually focusing less on financing small and medium-sized businesses.

As Figure 14 illustrates, the number of public companies in Europe has declined by 30% since 2007, while the average market capitalization of listed companies increased from $800 million in 1998 to $1.2 billion in 2018.[1]

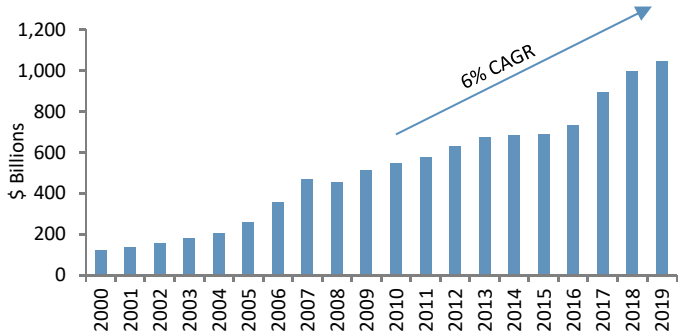
Figure 14: Number of Public Companies in Europe



Source: The World Bank: World Federation of Exchanges Database, December 2018.

As a result of this shift in public capital away from small to medium-sized businesses, institutional private equity is increasingly addressing the needs of these companies. Figure 15 demonstrates this trend as European private equity assets under management have increased 6% annually over the past decade and reached approximately $1 trillion as of June 2019.

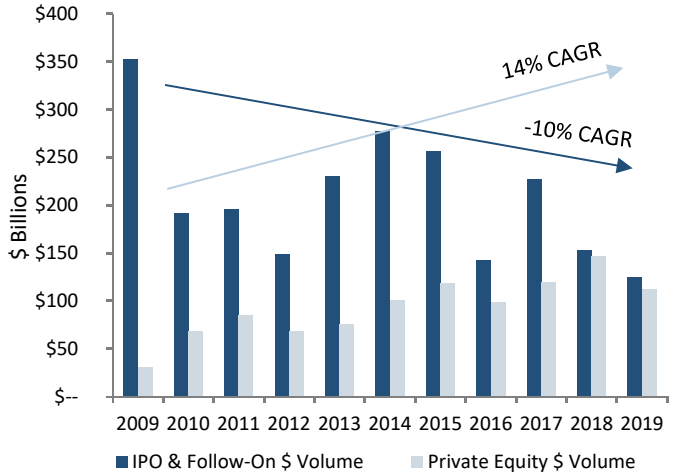
Figure 15: Private Equity Assets Under Management in Europe



Source: Preqin, June 2019.

In addition, as Figure 16 highlights, European private equity volume has increased 14% per annum while European IPO and follow-on volume has declined 10% per annum since 2009. By 2018, private and public equity raised was nearly equivalent for the first time.

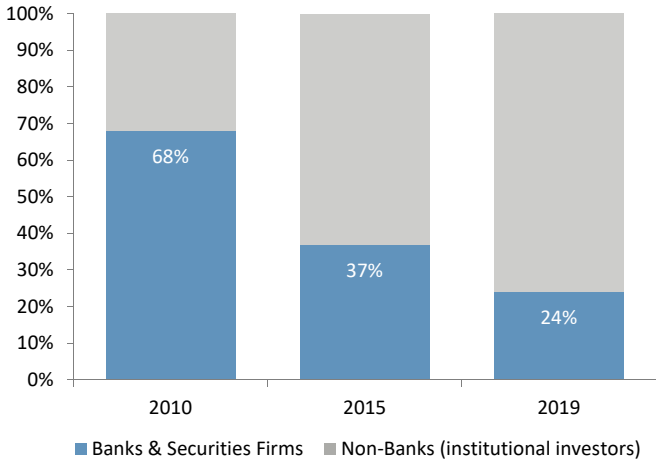
Figure 16: Capital Raised in the European Public vs. Private Markets



Source: Refinitiv, public market follow-on offering and IPO data. Preqin, PE transaction volume data, December 2019.

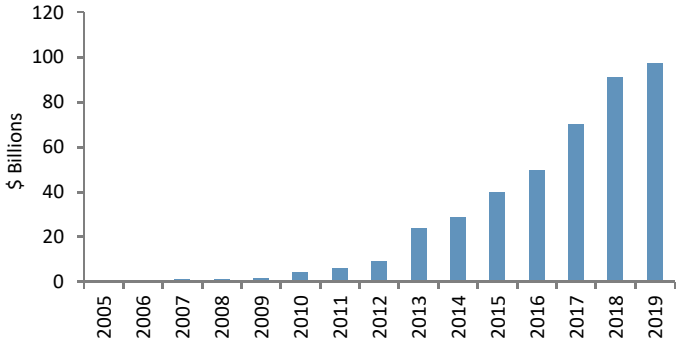
The European demand for private capital has extended to lending as well, and banks have lost share of the leveraged loan market across Europe to non-bank lenders (Figure 17). In this environment, direct lending has expanded as borrowers increasingly seek the stability, speed and execution capabilities offered by direct lenders of scale (Figure 18), who are now positioned to address the needs of companies seeking up to €1 billion in total debt facilities. In our view, this reflects the broader acceptance of non-bank lenders across Europe.

Figure 17: Market Share of Primary Investors for Leveraged Loans in Europe



Source: S&P LCD European Quarterly Q4-19 Leveraged Lending Review.

Figure 18: Direct Lending Assets Under Management in Europe



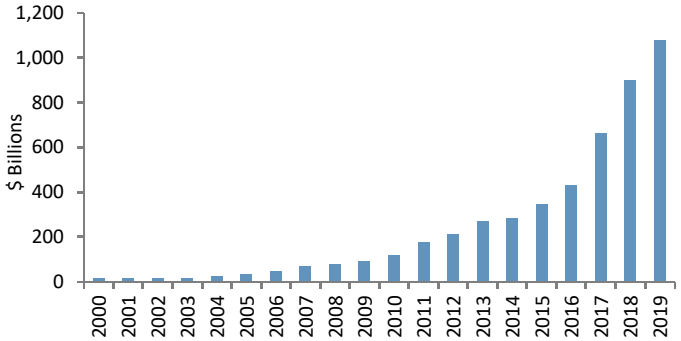
Source: Preqin, June 2019.

In summary, the structural shifts in capital formation from public to private sources for small and medium-sized business is clearly occurring in Europe as well.

Asian Capital Markets Trends

The growth and maturation of the private equity markets in Asia is supported by the increased demand for private capital from both institutional investors and companies that seek the many benefits of private capital. In Asia, private equity assets under management have increased from approximately $90 billion in 2009 to over $1 trillion in 2019 (Figure 19) and now account for approximately one quarter of global private equity assets under management.[12] One of the principal drivers of this growth has been increased acceptance of private equity managers in the region and the recognition that they can support companies in achieving the next phase of their growth plans.[12]

Figure 19: Private Equity Assets Under Management in Asia

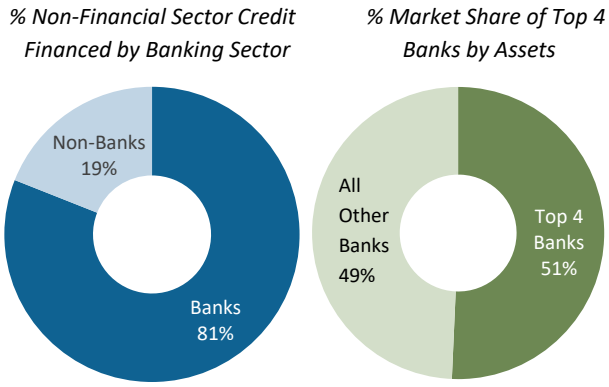


Source: Preqin, June 2019.

The structure of the Asian lending market has also supported growth of private capital via expanding demand for non-bank lending. As illustrated in Figure 20, the Asia banking market is dominated by several large banks. Like the U.S., the large

Asian banks are focused on large enterprises, and as a result of continued consolidation, have not focused on providing capital to Small and Medium Sized Enterprises (SMEs). **According to the Asian Development Bank, although SMEs account for 62% of the labor force and 42% of GDP across the region, SMEs only receive 19% of total bank lending.**[13]

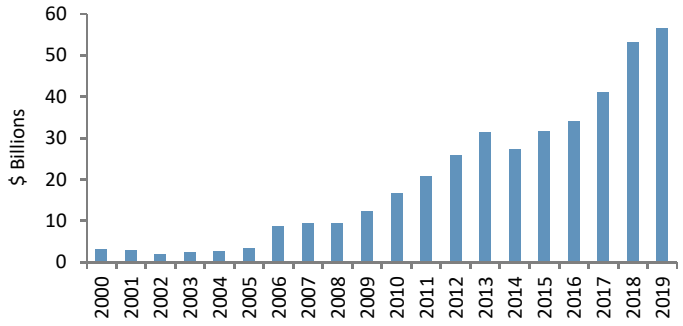
Figure 20: Large Banks Have Dominated Asian Credit Markets



Sources: Bank of International Settlements, June 2018, and McKinsey & Company, December 2018.[14]

In response, capital from non-bank lending managers has been raised to meet the growing demand of this underserved portion of the Asian economy (Figure 21).

Figure 21: Non-Bank/Private Debt Assets Under Management in Asia



Source: Preqin, June 2019.

Additionally, regulations have widened the market opportunity across private debt and private equity in Asia. For example, the implementation of Basel III has led banks to increasingly divest distressed or underperforming assets, which in turn has created a fertile and expanding distressed or opportunistic investing landscape across the region.

As the market opportunity in Asia for private capital has expanded, private equity and private debt managers have raised capital in increasing volumes to address the growing capital needs for Asian companies.

II. Distinguishing Asset-Level and Systemic Risks of U.S. Non-Bank Lending

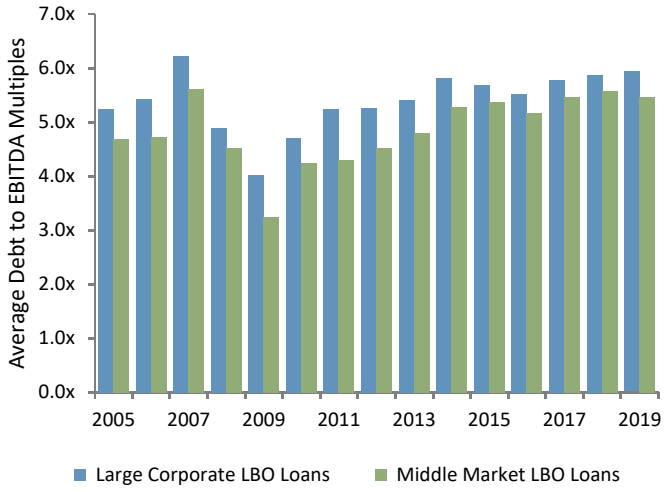
Based on the more mature non-bank lending markets in the U.S., this section analyzes the asset-level risks of U.S. non-bank lending and the potential systemic or contagion risks this presents to the U.S. financial system.

Evaluating Asset-Level Risk

Leverage levels

The financial metric most widely used to measure risk in a debt financing transaction is the level of debt to EBITDA. As Figure 22 illustrates, total debt to EBITDA levels have been in an upward trend as the business cycle has progressed. However, reported leverage levels have not yet surpassed prior cycle peaks in 2007. That being said, we would point out that EBITDA definitions have become more subjective in today's environment given the prevalence of EBITDA add-backs.

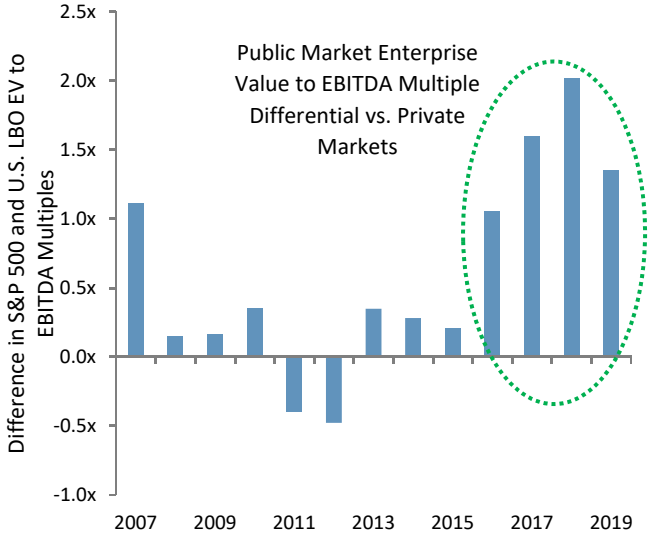
Figure 22: Average Debt to EBITDA Multiples of Large Corporate and Middle Market LBO Loans



Source: S&P LCD, Quarterly Q4-19 Leveraged Lending Review.

While this measure clearly illustrates that debt leverage multiples have expanded, it is important to consider that enterprise value multiples have also expanded. **However, as Figure 23 shows, enterprise value multiples of U.S. leveraged financing transactions have remained 1x – 2x lower than public valuations in recent years**. We believe this is instructive when evaluating the amount of the equity cushion available in private capital structures.

Figure 23: Greater Public vs. Private Market Equity Valuations (Enterprise Value to EBITDA Multiples)

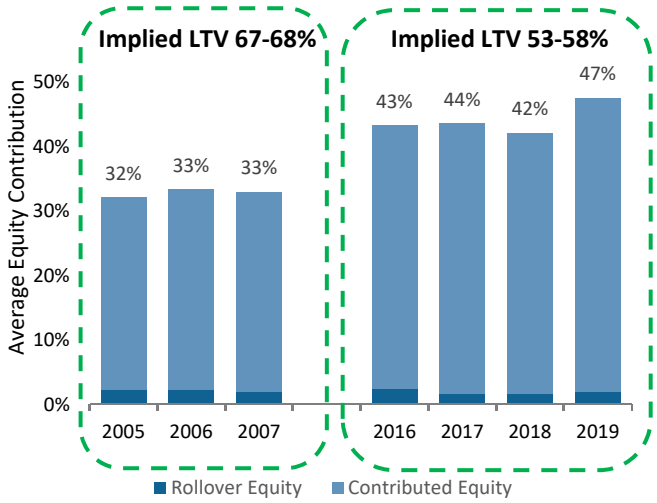


Source: S&P LCD and Capital IQ, December 31, 2019.

Equity contributions/loan to values

Despite rising debt to EBITDA levels, loan to value ratios (a key measure of risk) have not increased because equity contributions have also increased materially during this timeframe. **This means that lenders today have greater amounts of capital junior to them in capital structures, which provides a greater equity cushion and reduces credit risk.** As Figure 24 highlights, prior to the GFC, the average equity cushion was approximately 33%. In recent years, the equity cushion has averaged 44%.

Figure 24: Average Equity Contribution to Leveraged Buyouts and Implied Loan to Value Ratios

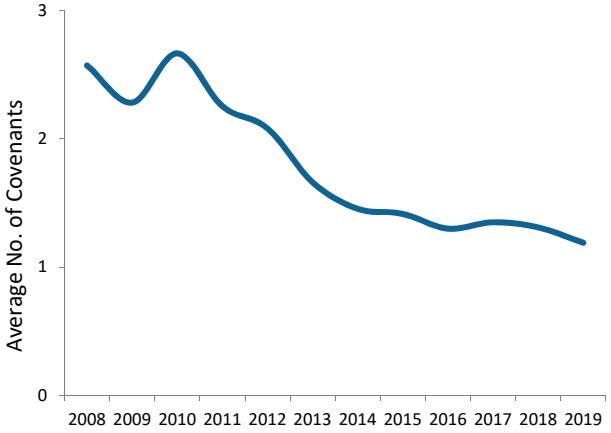


Source: S&P LCD, Q4-19 Leveraged Buyout Review.

Covenant-lite loans

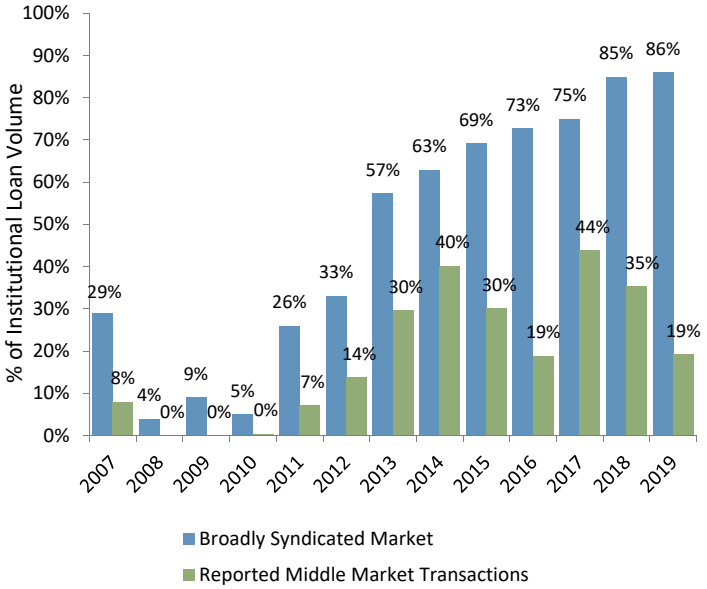
While loan to value ratios and equity contributions today are generally better compared to pre-crisis levels, we would point out that documentation terms have deteriorated. For example, the average number of covenants for leveraged loans has declined (Figure 25), and the prevalence of cov-lite loans has increased. Specifically, cov-lite loans accounted for 86% of new issue volume in the broadly syndicated loan market and 19% of the middle market in 2019 (Figure 26).

Figure 25: Average Number of Covenants for First-Lien Leveraged Loans



Source: S&P LCD, Q4-19 Leveraged Lending Review. Excludes cov-lite.

Figure 26: Cov-Lite Loans as Percentage of New-Issue Volume



Source: S&P LCD, Q4-19 Leveraged Lending Review. Refinitiv Q4-19 Middle Market Review.

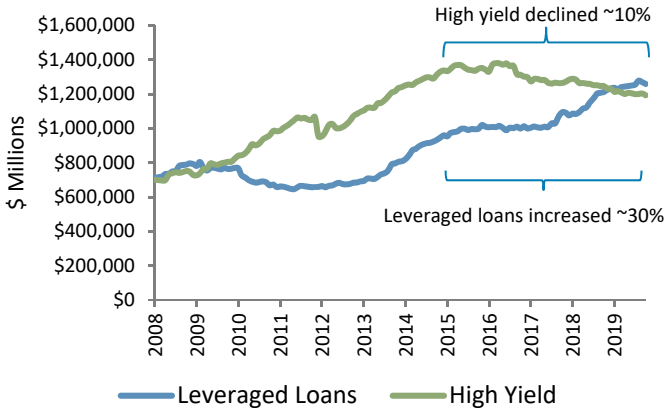
What is a cov-lite loan?

- Cov-lite loans have bond-like incurrence covenants, while covenanted loans have financial maintenance tests. Cov-lite loans still require contractual payments of interest.
- Incurrence covenants enforce financial/operational restrictions only in certain scenarios such as additional debt issuance, dividend payments, share repurchases, mergers and acquisitions, or asset sales.[15] Generally, cov-lite loans, which are secured financings, still carry more restrictions than their high yield bond peers, of which 80% are unsecured.[15]
- A cov-lite loan is not by itself a sign of credit risk. Cov-lite loans are typically made to larger companies compared to those with full covenants, which may imply that cov-lite borrowers have lower inherent risk. In 2019, the average transaction size for a cov-lite loan was $559 million, 53% greater than the $364 million average for full package credits.[16]
- Loans that are deemed to be cov-lite can also benefit from restrictive covenants from revolving credit facilities, often held by banks, that can have springing financial covenants that apply to cov-lite loans. Per Covenant Review, approximately 75% of sponsor-backed loans had springing financial maintenance covenants.[15] In these cases, cov-lite loans would become loans with covenants if the maintenance covenants on the revolving credit facilities were violated.
- In our view, if the underlying credit is healthy and the business model supports the issuer's ability to manage debt, then the existence of maintenance covenants becomes less important.

What drove the growth of cov-lite loans?

One of the structural drivers of the growth in cov-lite loans can be explained by the market share shift from the high yield bond market to the loan market. Since 2015, the loan market has increased approximately 30%, while the high yield bond market has declined approximately 10% (Figure 27). The growth in cov-lite loans coincides with the loan market taking share from the high yield bond market. Of note, the high yield bond market is approximately 80% unsecured, and high yield bonds do not have maintenance covenants.

Figure 27: Growth of Outstanding High Yield and Leveraged Loans - Total Outstanding



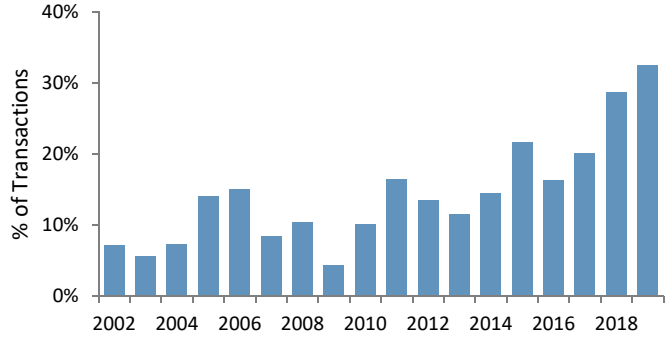
Source: ICE BofA US High Yield Index (H0A0), Credit Suisse Leveraged Loan Index (CSLLI), December 31, 2019.

In our view, this shift in market share to loans has not made the economy riskier. While loan market terms are clearly becoming more bond-like, loans are still senior in priority, typically get a first look at repayments and can have excess cash flow sweeps and improved credit protections compared to high yield bonds.[15]

EBITDA adjustments

The frequency of transactions with EBITDA adjustments has increased significantly since the GFC (Figure 28) while the average adjustment has remained in the 10-13% range during this period.[17] The increased frequency of adjustments is likely the result of growth in the syndicated and direct lending markets as well as the impact of new (and many times inexperienced) entrants to these markets. **Bank syndication efforts have contributed to more borrower-friendly terms in the market.**

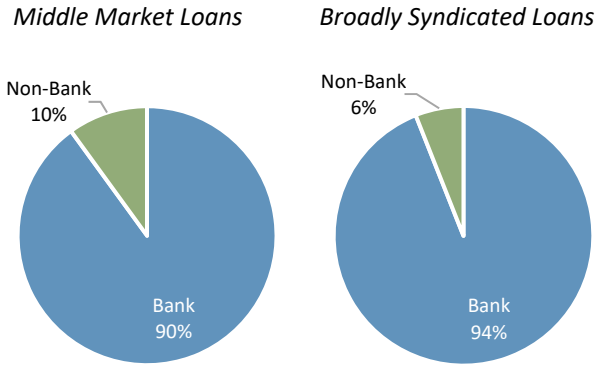
Figure 28: Leveraged Lending – Percentage of transactions with EBITDA Adjustments



Source: S&P LCD, Q4-19 Leveraged Lending Review. Media and telecom loans excluded prior to 2011. EBITDA adjusted for prospective cost savings or synergies.

As Figure 29 illustrates, banks were bookrunners in approximately 90% of reported middle market transactions in 2019. **Although fewer transactions in the middle market are actually reported, as direct lenders take share and often do not report such transactions, banks continue to have more influence over middle market terms, covenants and structures.**

Figure 29: Lead Bookrunner Market Share by Transaction Volume



Source: Refinitiv, Bookrunner League Tables, December 31, 2019.

Will looser loan documentation impact defaults and recoveries in the next credit downturn?

The existence of fewer covenants could provide companies more time and flexibility to act during a period of distress. However, fewer or looser covenants may permit a company's financial condition to deteriorate further. At that point, the owner (potentially a private equity sponsor) may have to decide to financially support the company or risk a recapitalization event, which may result in the lender taking possession of the company's assets.

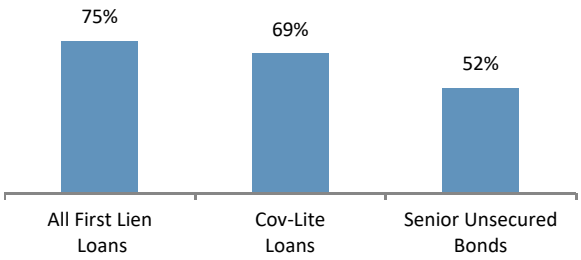
Overall, these factors are likely to decrease the incidence of covenant defaults, while increasing the potential loss rate for a given default. Therefore, the magnitude of the loss after a given default, relative to prior cycles, will largely depend on the depth and duration of the next credit cycle.

In our view, the workout capabilities of lenders will be tested, and those with capital, experience and patience to add value and resolve aggressive capital structures for businesses should outperform.

The existence of covenants does not determine the creditworthiness of a loan. In fact, according to research by Credit Suisse,[18] there is little difference in the secondary market prices of loans with covenants versus cov-lite loans, underscoring the market's view of risk based on this factor alone. In addition, **the historical data shows that recovery rates of cov-lite loans have not differed meaningfully from those with covenants**, as shown in Figure 30. In fact, other factors such as the cyclicality of the business, the loan to value ratio of the loan and the durability of the underlying cash flows are more relevant to the recovery of principal.

Importantly, senior loans will continue to have seniority over the 40-50% of the equity that is typically contributed to leveraged transactions by private equity sponsors.

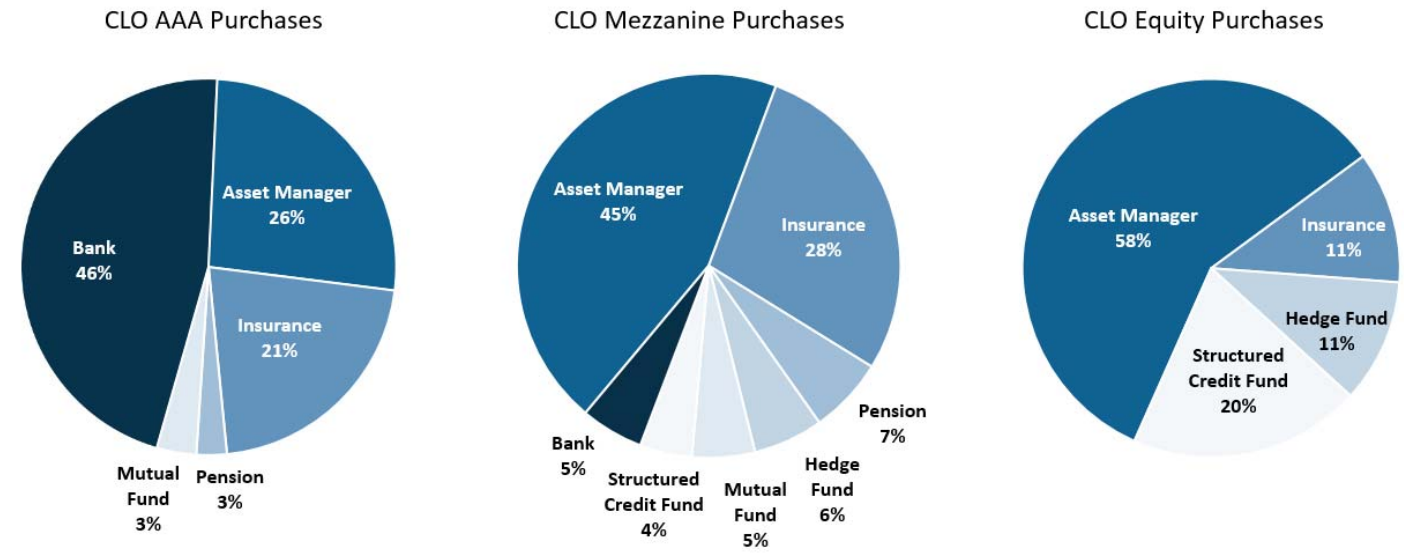
Figure 30: Recovery Rates by Loan Type from 1987 - 2018



Source: S&P LCD.[10]

These secular trends have resulted in the institutionalization of the commercial credit markets. The banks were once the primary investors in loans, but that has shifted to CLOs. Today, investors in CLOs include banks (primarily in AAA tranches), asset managers, insurance companies, hedge funds and others, as shown in Figure 31.

Figure 31: Investor Base by CLO Security



Source: Citi Research. Represents U.S. CLO investor base year-to-date, October 2019. May not foot due to rounding.

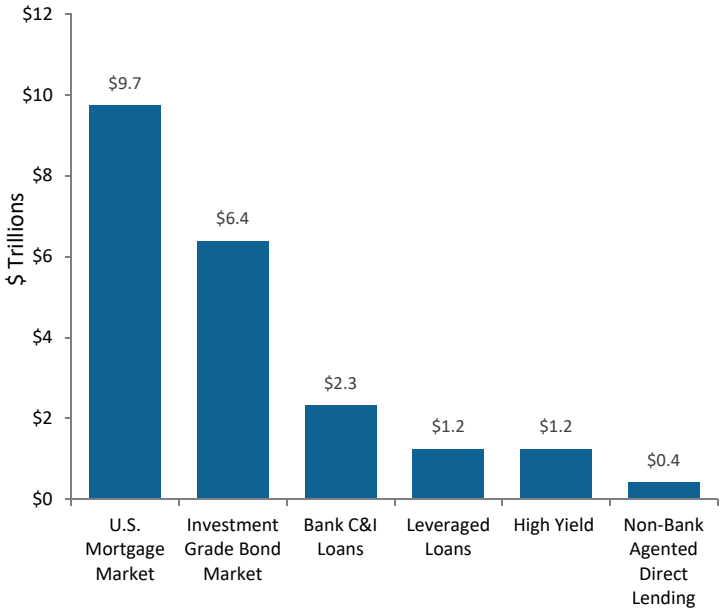
Evaluating Potential Systemic Risks

Let's examine the potential systemic risks of the non-bank market to the economy. In our analysis, we review the size of the market, the stability of non-bank capital structures, the transparency of current non-bank lenders and the lack of interconnectivity to the overall banking system. In addition, we review the historical performance of these non-banks versus banks, and we examine the concern that the growth of non-banks will trigger the next economic crisis. Finally, we ask the question: is this non-bank lending growth a secular or cyclical phenomenon?

Size and respective growth trends of the non-bank corporate lending market

Although it is challenging to size the non-bank corporate lending market due to various criteria and thresholds used by different market participants, it is noteworthy that even a broad definition would result in a market materially smaller than other more systemically important markets, such as the U.S. mortgage market and investment grade bond markets. In our view, the potential for systemic risk is reduced when considering size and materiality alone, as shown in Figure 32.

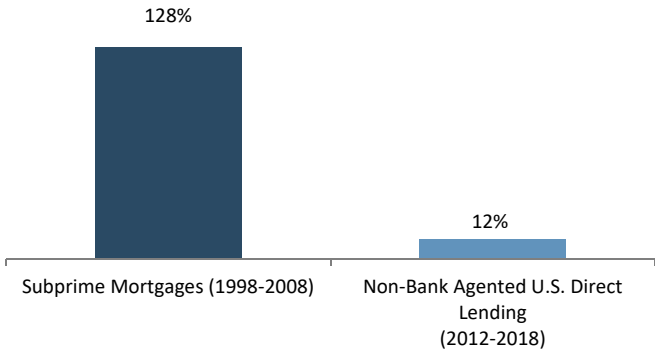
Figure 32: Size of Various Credit Markets (2018)



Source: SIFMA, ICE BofA, St. Louis Federal Reserve, Credit Suisse, Refinitiv, S&P LCD. Note: We estimate the addressable market for U.S. Direct Lending in 2018 is $935 billion, of which $510 billion is underwritten by banks and $412 billion is underwritten by non-bank direct lenders. [19]

Also, to put this in a historical context, the growth in non-bank loans over the past six years of 12% per annum is far less than the growth of the subprime mortgage market, which grew 128% per year in the 10 years leading up to the GFC, as shown in Figure 33.

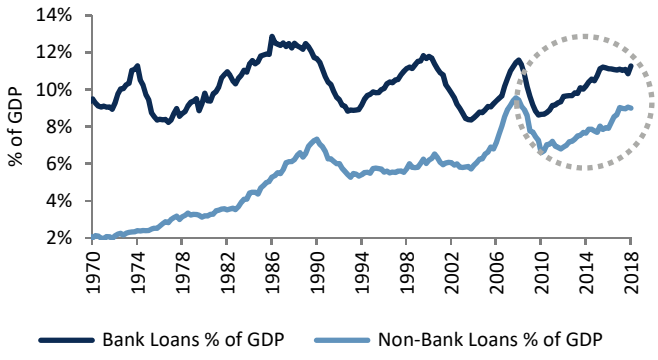
Figure 33: Annualized Growth of the Subprime Mortgage Market vs. the Direct Lending Market



Source: SIFMA, Refinitiv, S&P LCD. Subprime Mortgage based on SIFMA data. Non-Bank Agented U.S. Direct Lending based on Ares' data calculations using information from Refinitiv, S&P and Ares' observations.

Overall, non-bank lending has grown proportionately to the growth of bank C&I loans when measured as a percentage of GDP. As Figure 34 illustrates, the growth in non-bank lending has been a long-term evolution with the fastest wave occurring during 1982-1990 as banks began to consolidate. Figure 34 also highlights that the growth in non-bank lending has been a secular trend over the last three decades. Notably, non-bank loans have not yet reached the prior cycle peak when measured as a percentage of GDP. In addition, the growth over the last 10 years has been largely in line with bank growth.

Figure 34: Bank vs. Non-Bank Loans as a Percentage of GDP



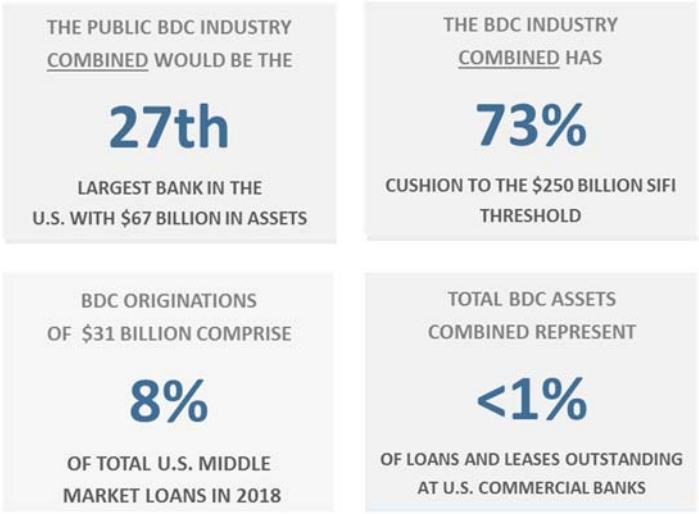
Source: BofA Global Research, Fed Flow of Funds, Preqin.

Following a very strong 2018, middle market fundraising slowed in 2019 and is projected to remain stable or grow modestly in 2020.

Is the size of the BDC industry a potential risk?

When evaluating the size of the BDC industry in comparison to banks, **the entire publicly traded BDC industry combined would be the 27th largest bank in the United States with $67 billion in assets as of December 31, 2018, and, importantly, would be substantially lower than the $250 billion established threshold for a Systemically Important Financial Institution (SIFI)**. In addition, BDCs only account for a fraction of total middle market loans originated in 2018 or total loans and leases outstanding at U.S. commercial banks (Figure 35).

Figure 35: The Public BDC Industry is Small Relative to the U.S. Banking Industry



Source: SNL Financial, Wells Fargo Securities, Federal Reserve, Refinitiv, S&P and Ares' observations, December 31, 2018.[20] Note: includes publicly traded BDCs only.

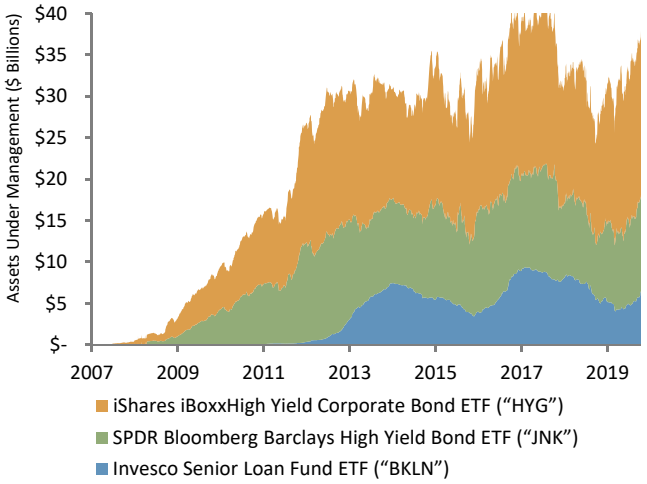
Stability of capital structures and transparency

Capital structures are critically important in assessing the potential risks to the U.S. financial system posed by the growth of corporate non-bank lending. **Regulators and market participants are rightly concerned about "shadow banks" or non-bank funds possessing capital structures with asset/liability funding mismatches and that are subject to a run on their capital. When a run on capital occurs, this causes forced selling, contagion and potential systemic risk.**

The FSB estimates that the size of global non-bank financial intermediation in 2018 was approximately $180 trillion. The FSB narrowed its focus on non-bank financial intermediation to the approximately $51 trillion of the market where non-bank institutions are subject to runs on capital and funding mismatches that make them highly susceptible in volatile market conditions.[21]

For example, in the U.S., the increased demand for passive investing has led to a growth of credit funds (holding loans, high yield and other instruments) with daily liquidity requirements (Figure 36). These funds have created loan price volatility as funds buy or sell to meet redemptions or net subscriptions. This was most recently seen in the volatility of loan and high yield prices in the fourth quarter of 2018 when loan fund redemptions accelerated following the overall "risk-off" market sentiment. In order to meet redemptions, mutual funds and ETFs sold their larger, more liquid loans, resulting in higher-quality "BB" rated loans falling in price by more than the smaller, less liquid and lower rated, "B" loans. This illustrated that the divestitures were driven by forced selling and not by credit concerns.

Figure 36: Growth of Passive Loan and High Yield Funds with Daily Liquidity Requirements



Source: Bloomberg, December 31, 2019.

Further compounding the risks from funds with callable capital, fewer institutions are providing capital to support the market making in the non-investment grade credit markets. Therefore, when these funds with mismatched assets and liabilities need to sell to meet redemptions, there can be runs on liquidity and rapid erosion of value.

According to the Federal Reserve and based on data from Morningstar Direct, $250 billion in net assets or about 20% of the high yield market are tied up in high yield mutual funds with daily liquidity requirements, as of March 2019, which is up from $157 billion in December 2009. Similarly, $112 billion in assets are tied up in bank loan mutual funds, up from $24 billion in December 2009.[22]

U.S. loan funds and ETFs possessing these risks now account for a larger portion of the institutional loan market at 5% in 2007 versus approximately 15% today based on a Barclays annual demand study.[15]

It is important to note that the corporate non-bank lenders that are the subject of this report – BDCs, CLOs and commingled private credit funds – generally hold assets in closed end fund structures that cannot be redeemed or forced to sell. Since these non-bank corporate lenders have long-term, locked up capital structures, they are not subject to forced selling that could trigger contagion, in our view.

Since corporate non-bank lenders, including BDCs, CLOs and commingled private credit funds, have long-term locked up capital structures, they are not subject to forced selling that could trigger contagion, in our view

Non-bank lenders are often labeled as "shadow banks," which was a term that was coined prior to the GFC. Shadow banking was used to characterize financial companies that existed outside of the regulated banking system, were opaque about the risks of underlying assets and posed risks to banks and other financial services companies.

In our view, non-bank corporate lenders, such as CLOs in the leveraged loan market and BDCs in the direct lending market, provide more transparency than banks, as shown in Figure 37. For example, they offer a high degree of transparency by detailing all their investments on a monthly or quarterly basis for their investors. Furthermore, BDCs and CLOs are more transparent than banks in that they provide investors with specific and detailed information on each holding in the portfolio, whereas banks provide fewer details and disclose metrics at a portfolio level.

Figure 37: Capital Structure and Transparency Attributes of BDCs, CLOs and Commercial Banks

Criteria	BDCs	CLOs	Commercial Banks
Loan Disclosures:	Specific Investment	Specific Loan	Aggregated Portfolio
Name/Type	✓	✓	NA
Business Description	✓	✓	NA
Industry	✓	✓	NA
Pricing	✓	✓	NA
Terms	✓	✓	NA
Fair Value	✓	✓	NA
Credit Metrics	Non-Accruing Loans Net Realized Losses	Defaulted Obligors CCC-Basket Detail Maturity/Rating Changes	NPAs/Delinquencies Net Charge-Offs
Reserves	Fair Value Adjustment	Reserve Account	Allowance for Loan Losses
Asset Diversification Requirements	Required	Required	No Specific Rule
Funding:			
Equity	Equity ≥ 33%	Equity ≥ 10%	Equity ≥ 8%
Liabilities	Bank Debt / Notes	Floating Rate Securities	Callable Deposits / Notes

Today's CLOs are collateralized by loans to identifiable companies, where the loans are subject to rating agency review and can be verified on dealer desks. These loan positions are reported monthly to investors. The transparency of CLOs contrasts with subprime CDOs that grew in popularity prior to the GFC. The underlying risks in these CDOs were often opaque as the investments contained correlated to investments in other vehicles (such as the case in CDO squared or cubed structures), held credit default swaps on asset-backed securities, and were hard to understand or value. These factors were especially troublesome given the fact that CDOs could appear in several different structures, further layering the systemic risk.[23] Therefore, we believe CLOs and BDCs do not operate in the shadows; they operate in the daylight.

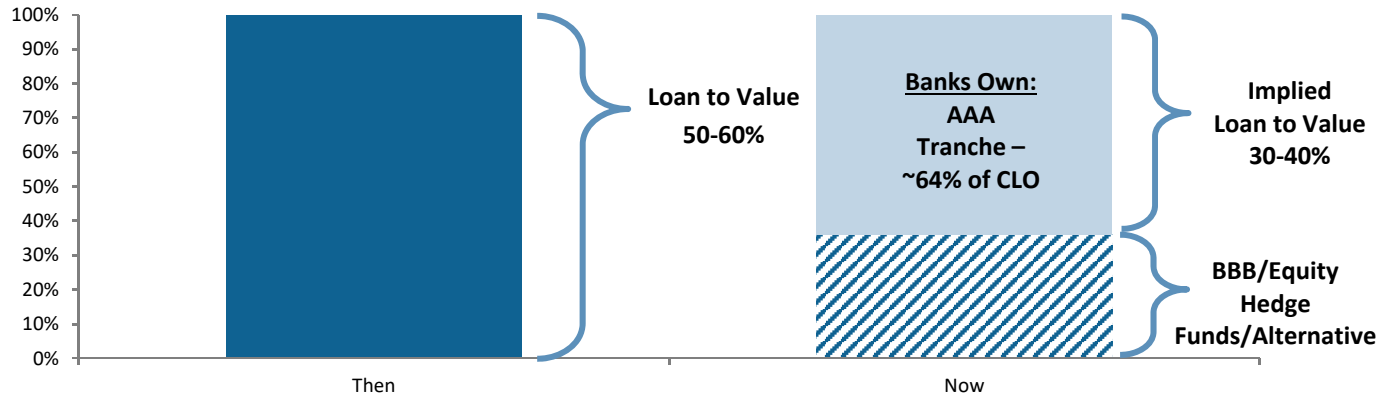
Non-bank corporate lenders, such as CLOs in the leveraged loan market and BDCs in the direct lending market, provide significant transparency. CLOs and BDCs do not operate in the shadows; they operate in the daylight

Lack of systemic connectivity

Undoubtedly, the loosening of terms and other credit protections in the non-bank lending market could result in higher losses. However, as banks have systematically changed their business models from principal investors to syndication agents for broadly syndicated and middle market loans, they have supported the growth of the CLO market. In doing so, banks have transferred most of the risk from their balance sheets backed by federally insured deposits to a diverse group of institutional investors.

As shown in Figure 38, banks would have originally held these loans on their balance sheet (representative $100 senior loan with 50-60% loan to value) and taken 100% of the credit risk associated with the loan. Today, due to the favorable bank capital charges and the deep structural protections offered by lending to pools of loans, banks can syndicate these loans to CLOs, and purchase the AAA tranche of a diversified loan pool. At the AAA layer of the securitization, the CLO structure provides banks with significant structural enhancements as opposed to holding the assets: 64% of a CLO is typically rated AAA with 34% of added structural loss protection below the bank's AAA security. This results in a bank effectively transforming the 50-60% original loan to value to only a 30-40% loan to value. Banks also benefit from lending to a diversified pool of borrowers versus making a discrete investment. Viewed another way, the banks offloaded most of the credit risk onto the CLO market, which in turn is largely owned by institutional investors. The junior tranches of the CLO market are largely held by institutional investors as shown in Figure 31.

Figure 38: Illustrative Risk Transfer from Bank Balance Sheets to CLO Investors



Source: Ares' observations of the market. The sample CLO economics shown are for illustrative purposes only and based on a CLO structure Ares believes is typical of recent primary CLOs.

How have non-bank lenders performed vs. banks?

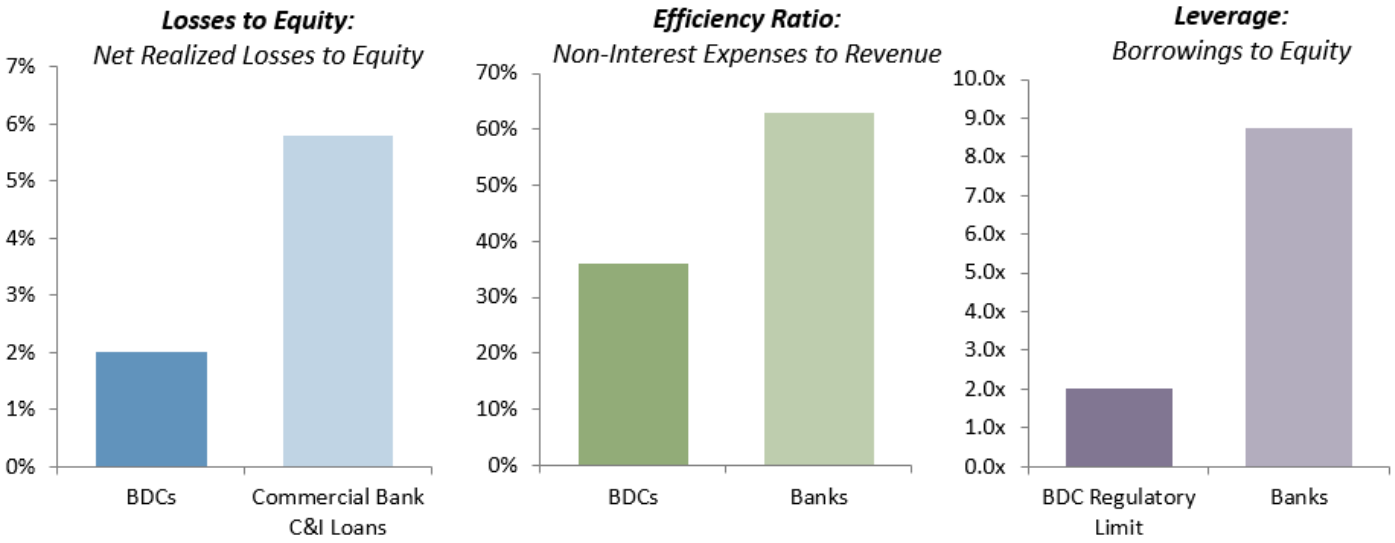
When examining underlying credit metrics in Figure 39, BDCs have lower losses to equity, greater efficiency in generating a profit from the assets and lower leverage compared to banks.[10]

For example, in part due to the low leverage requirement of BDCs (less than 2:1 debt to equity), lenders to BDCs have never lost a dollar on principal assuming they held the loan/bond until maturity or refinancing.[24]

In our view, non-banks, such as CLOs and BDCs, are more natural holders of direct and leveraged loans with better default and risk-to-capital results compared to commercial banks.

When examining the underlying credit metrics, BDCs have lower losses to equity, greater efficiency in holding the assets and lower leverage compared to banks[10]

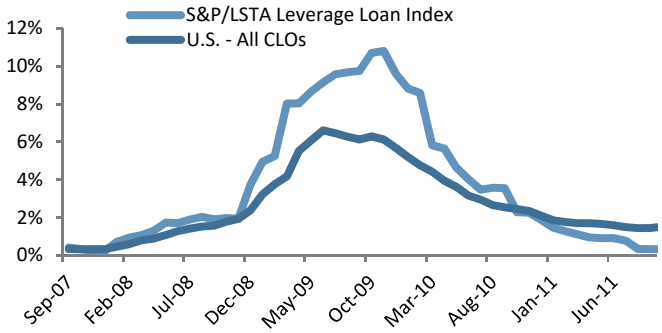
Figure 39: BDC vs. Bank Long-Term Average Net Realized Losses, Efficiency and Leverage



Source: Company filings, Federal Reserve, Federal Financial Institutions Examination Council and S&P. All data from Q4-04 to Q3-19, except for BDC regulatory limit, which is as of March 23, 2018.[25] *Note that a lower efficiency ratio is considered better as it represents a lower level of expenses required to generate revenue.* Past performance is not indicative of future results.

As Figure 40 illustrates, CLOs have an equally strong track record. The historical default experience of CLO securities has been minimal over two decades. While Moody's cites a low historical U.S. CLO default rate of 0.49% over 25 years, we believe the actual default rate is closer to zero, given this data captures a few defaults caused by market value provisions or CLO securities that were not comprised of all loans. **Furthermore, the 0.49% cumulative default rate for U.S. CLOs compares favorably to the nearly 20% cumulative default rate for U.S. CMBS and over 40% cumulative default rate for RMBS Subprime** (Figure 41).

Figure 40: Default Performance Through the Last Credit Cycle – Loans in U.S. CLOs vs. Leveraged Loan Index



Source: S&P LCD, Intex, Ares INsight database.[26]

Figure 41: 10-Year Cumulative Impairment Rate by Original Rating (1993-2018)

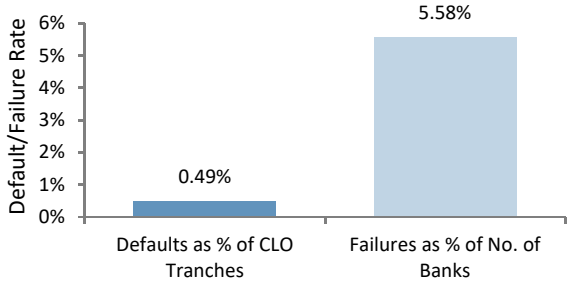
Original Rating	U.S. CLOs	U.S. CMBS	U.S. ABS	U.S. RMBS Subprime
Aaa	0.00%	2.34%	0.70%	22.65%
Aa	0.00%	12.59%	4.23%	51.54%
A	0.06%			
Baa	1.34%	24.11%	6.94%	78.37%
Ba	1.76%			
B	1.12%	62.72%	31.34%	55.08%
All	0.49%	19.78%	2.49%	40.57%

Source: Moody's Investors Service.

In addition, a comparison of the long-term U.S. CLO default rate of 0.49% to the 5.58% cumulative failure rate of banks from 2010-2018 (Figure 42) illustrates that non-bank structures can be more effective holders of direct and leveraged loans than banks.

Past performance is not indicative of future results.

Figure 42: Cumulative CLO Defaults of All Tranches vs. Bank Historical Failure Rate



Source: Moody's Investors Service (1993–2018) and FDIC (2010–2018).

More recently, much has been said about the potential downgrade risk of B3 or lower-rated names and the resulting impact on the ability for CLOs to hold these assets. In short, regardless of downgrades, CLOs will either have the capacity to withstand these downgraded loans or, in more dire situations, redirect investment cash flows to de-lever the CLO structures. **Importantly, under no circumstance will CLOs be forced sellers of these assets, further underscoring the ability of CLOs to hold these assets through cycles.**

Will non-banks trigger the next subprime mortgage crisis?

Some have compared the growth of the non-bank corporate lending sector to the subprime mortgage "bubble" that was a catalyst to the GFC. However, a deeper understanding of the dynamics in today's market demonstrates that there are many important structural differences that do not make this comparison accurate.

As stated, cash flow CLOs have performed remarkably well for over two decades with limited to no defaults, including through the GFC. This stands in stark contrast to subprime CDOs, where more than 90% have experienced an event of default.[27]

We believe the relative stability of the underlying borrower, degree of financial leverage, depth of underwriting, superior performance and the comparatively more conservative loan to values in commercial credit loans are in stark contrast to the subprime loans and the CDOs that financed many of those loans.

Incorrect comparisons between the non-bank lending sector and the subprime mortgage crisis have perpetuated the term "shadow banking" even though today's non-bank lenders and structured financing vehicles operate in a match-funded and more transparent manner with assets that do not have obscured or layered risk.

Is the growth in non-bank lending cyclical or structural?

In our view, the structural tailwinds of private capital and non-bank lending are well-supported. These trends are also evident in other, more developed markets across Asia and Europe, which underscores that the growth in non-bank capital is a global phenomenon.

However, it is hard to ignore the amount of capital that has been raised to address the market opportunity and corresponding changes to underwriting terms or enterprise multiples being paid. As a result, we believe some of the cyclical momentum may slow as investors experience varying rates of success with different private equity and non-bank lenders.

That being said, we believe the structural changes that have occurred in the banking system and the private capital markets are long-lasting. Furthermore, we expect private equity firms and alternative asset managers with scale and competitive advantages to outperform managers that lack these capabilities.

Conclusion

The growth of the non-bank market has been necessary to fill the void created by the retrenchment of the U.S. banking system from small to medium-sized businesses and the shift of public markets toward larger companies. The private markets have developed and become more sophisticated, and borrowers are increasingly favoring the flexibility that non-bank lenders offer. The growth of the non-bank market has also been supported by the backing of sophisticated institutional investors seeking greater investment returns with less perceived risk. This is especially true as investors are increasingly recognizing that structures that hold non-bank direct loans and leveraged loans – BDCs, CLOs and commingled private funds – are more natural holders of these assets than banks, and that they possess capital structures that can better withstand market volatility. As a result, the growth in non-bank lending has performed a critical role in funding the capital needs of small to medium-sized companies in our economy. As highlighted, many of these same trends are driving similar structural changes in capital formation across Europe and Asia as well.

While the institutionalization, sophistication and size of companies that are accessing the non-bank market has matured, terms and pricing have evolved as well. The presence of larger, more established borrowers, with greater equity in capital structures, is offset by growing leverage levels and eroding covenant protections. Risks have changed over time as the market has matured, which will likely result in a wider dispersion of performance among non-bank lenders. As a result of these changes, there are increasing demands on non-bank lenders in terms of sourcing, underwriting and portfolio management capabilities. We believe larger, more established managers with flexible capital, differentiated information and extensive credit experience will outperform.[10] Some investors will experience adverse investment performance as the cycle inevitably turns down, in our view.

The growth of the non-bank market has also been supported by the backing of sophisticated institutional investors seeking greater investment returns with less perceived risk. This is especially true as investors are increasingly recognizing that structures that hold non-bank direct loans and leveraged loans are more natural holders of these assets than banks, and that they possess capital structures that can better withstand market volatility

Often the growth of the private markets and the changes to credit structures (such as the increasing prevalence of cov-lite) is misinterpreted as posing similar risks to those that led to the GFC. Unlike the shadow banks that led up to GFC, we believe most of the non-bank lenders of today are highly transparent in the underlying assets and possess more stable, less leveraged capital structures that have enabled non-banks to be superior holders of these types of assets as compared to banks. Furthermore, the growth of non-bank lending is in line with the growth of banks over the past decade and pales in comparison to the growth of subprime mortgages heading into the GFC. Lastly, the assets held by non-bank lenders are backed by a diverse group of institutional investors versus the balance sheets of banks backed by federally insured deposits.

In our view, the rise of the private markets is a long-running and long-lasting trend. Today's non-bank lending markets provide critical capital to businesses in the U.S., Europe and Asia, and they provide an alternative to public capital markets and bank financing.

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REF: AM-00465

Endnotes

1 Source: The World Bank: World Federation of Exchanges Database. For the U.S., 2019 market capitalization is estimated using the World Bank average market capitalization for 2018 of $6.9 billion and applying the growth of the Wilshire 5000 Price Full Cap Index in 2019 of 28% to support the statement that the average market capitalization of public companies was more than $8.3 billion in 2019.

2 Refer to Figures 1, 6, 7, 8, 10 and Endnote 1 for additional important information.

3 Source: Refinitiv, Bookrunner League Tables for middle market and broadly syndicated loan market originations by banks and non-banks, December 31, 2019.

4 Refer to Figures 22, 23, 24, 26, 28, 30, 32, 33, 34, 37, 39 and 42 for additional important information.

5 Note: Great Financial Crises (GFC) is defined as the period just prior to and following the credit market dislocation of 2008. Source: St. Louis Federal Reserve, Average Loan Size for All Commercial and Industrial Loans, Small Domestic Banks for 2005 vs. 2017.

6 Information based on Ares' observations of market conditions.

7 Source: National Center for the Middle Market, 2018 Annual Report.

8 Source: Ritter, Jay R., Cordell Professor of Finance, University of Florida, "Initial Public Offerings: Updated Statistics," December 24, 2019.

9 Source: Wall Street Journal, "Private Equity Firms are Building Funds to Last," January 1, 2019.

10 There is no guarantee that target returns will be achieved. Past performance is not indicative of future results.

11 Source: Preqin Global Private Debt Report, 2020.

12 Source: Bain & Company, "Asia-Pacific Private Equity Report 2019," March 15, 2019.

13 Source: Asian Development Bank Institute, "The Role of SMEs in Asia and Their Difficulties in Accessing Finance," December 2018.

14 Source: McKinsey & Company, Asian Banking Review, July 2019, reflects the average across the following countries: Australia, Hong Kong, Japan, Singapore, South Korea, Taiwan, Mainland China, India, Indonesia, Malaysia, Philippines, Thailand and Vietnam.

15 Source: Barclays, "Covenant-Lite: An Evolution, Not a Revolution," February 20, 2019.

16 Source: S&P LCD, December 31, 2019.

17 S&P LCD, Q4-19 Leveraged Lending Review. EBITDA adjusted for prospective cost savings or synergies. Media and telecom loans are excluded prior to 2011.

18 Source: Credit Suisse Research according to Nuveen, "The growth of Covenant lite loans doesn't signal the end of the cycle," Fall 2018.

19 U.S. Mortgage Market based on SIFMA data, Investment Grade Bond Market based on ICE BofA Corporate Investment Grade Index (C0A0), Bank C&I Loans based on data from St. Louis Federal Reserve – Federal Reserve Economic Data, Levered Loans based on Credit Suisse Leveraged Loan Index (CSLLI), High Yield based on ICE BofA High Yield Index (H0A0). Direct Lending based on Ares' data calculations using information from Refinitiv, S&P and Ares' own observations.

20 Source: SNL Financial, Wells Fargo Securities, Federal Reserve, Refinitiv, S&P and Ares' observations. BDC industry size relative to bank assets based on information from SNL Financial and Wells Fargo Securities. Ranks total assets by BDCs included within the Wells Fargo BDC Index or the SNL U.S. RIC Index as of December 31, 2018 among all banks included within the SNL U.S. Financial Institutions Index. BDC originations according to Wells Fargo Securities. Includes the following BDCs: ABDC, AINV, ARCC, BBDC, BDCA, BKCC, CGBD, CION, CPTA, FSEP, FSIC II, FSIC III, FSK, GBDC, GLAD, GSBD, HRZN, HTGC, MAIN, MCC, MRCC, NMFC, OCSI, OCSL, OWL, OXSQ, PFLT, PNNT, PSEC, SCM, SLRC, SUNS, TCPC, TCRD, TCW, TPVG, TSLX, WHF. Total U.S. Middle Market originations based on Ares' own data calculations using information from Refinitiv, S&P Global Market Intelligence and Ares' own observations. BDC industry assets relative to loans and leases outstanding at U.S. commercial banks based on information from the Federal Reserve, SNL Financial and Wells Fargo Securities. Represents total assets held by BDCs included within the Wells Fargo BDC Index or the SNL U.S. RIC Index as of December 31, 2018, as a percentage of total loans and leases outstanding at U.S. commercial banks (seasonally adjusted).

21 Source: Financial Stability Board, "Global Monitory Report on Non-Bank Financial Intermediation 2019," January 19, 2020.

22 Source: Anadu, Kenechukwu, and Fang Cai, "Liquidity Transformation Risks in U.S. Bank Loan and High-Yield Mutual Funds," FEDS Notes 2019. Washington: Board of Governors of the Federal Reserve System, August 9, 2019.

23 Source: Michel G. Crouhy, Robert A. Jarrow and Stuart M. Turnbull, "The Subprime Credit Crisis of 07," FDIC, September 12, 2007, Revised July 4, 2008.

24 Source: KBW, "BDC Baby Bond Monitor," December 10, 2019.

25 BDCs includes BDCs with a market capitalization of $450 million or greater as September 30, 2019, who have been public for at least one year, or under common management with a BDC that meets these criteria. This includes: ARCC, AINV, BBDC, BKCC, CGBD, OCSI, OCSL, FSK, GBDC, GSBD, HTGC, MAIN, NMFC, PFLT, PNNT, PSEC, SLRC, SUNS, TCPC and TSLX. Based on data from company filings. Banks includes U.S. banks with a market capitalization of $500 million to $10 billion as of September 30, 2019 based on data from S&P Global Market Intelligence. Commercial Bank C&I Loans based on data from the Federal Reserve's H8 Data Series and Federal Financial Institutions Examination Council Consolidated Reports of Condition and Income. Bank borrowings includes debt and deposits.

26 Source: S&P LCD, Intex. S&P/LSTA Leveraged Loan Index refers to the lagging 12-month loan default rate by principal amount outstanding. "U.S. – All CLOs" refers to the underlying defaults experienced by deals within the broader U.S. CLO universe. Default data for "U.S. – All CLOs" reflects the default rate as reported by trustee reports as of each specified date; includes technical defaults as well as bond defaults, if any bonds were held in the underlying portfolios.

27 Source: Intex, Wachovia, Citi CDO Research, "CLO Equity – A Time-Tested, Well Performing Asset Class," July 2010.