Matt Bass

Episode 178: Opportunities From Bank Dislocation

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. I'm Stewart Foley. I'll be your host. Today's topic is investment opportunities driven by US bank disruption, and we're joined today by Matthew Bass, head of private alternatives at AllianceBernstein. Matt, thanks for joining us. Thanks for taking the time.

Matt: Thanks, Stewart. Great to join you today.

Stewart: So let's start it off like we always do. What town, where'd you grow up? What was your high school mascot? And what makes insurance asset management so cool?

Matt: Great. So I grew up in Great Neck, Long Island, so North Shore of Long Island, not too far from the city. My high school mascot, it was probably, it was pretty boring. So we were the Great Neck North Blazers. I think our mascot was a Griffin. Try to figure out what that actually looks like. So not the most exciting in terms of mascots.

Stewart: Ours was the Owls. If it makes you feel any better.

Matt: The Owls.

Stewart: The Owls.

Matt: Okay. Yeah, I like it. I think what makes insurance asset management interesting. Look, I think in particular, we're going to talk about this I think a lot during the pod. In particular, in the current environment as we're seeing continued secular bank pullback, insurers represent a real complementary source of funding relative to bank deposits, given their liability profile, given their longer-term investment horizon, sourcing capital from premiums versus banks who use customer deposit. So I think as the private credit landscape continues to evolve and additional asset classes move from bank to non-bank lender, insurers are in prime position to benefit from that. I think that's a really exciting current environment.

Stewart: And insurance companies, it makes so much sense, right? Because the ALM match is far better with an insurance company providing that capital than banks that have this huge mismatch with overnight demand deposits and long-term loans. So I love this topic and I'm looking forward to exploring it with you. You've been at AB since 2010 and you were prior overseeing the post-GFC relief programs at the Treasury. And so given your background, it would be interesting from my perspective to hear your take on the evolution of what we've witnessed in the financial markets over the last, call it 15 years.

Matt: Sure, yeah. We could talk about what's happened post-GFC. And I think even stepping back prior to the financial crisis, there's been a long trend of bank consolidation and movement of credit intermediation going from bank to non-bank. And it went from bank to capital markets, bank to insurer. So the global financial crisis was a catalyst for this continued trend of bank at disintermediation. After the GFC, the issues were on the asset side. It resulted in significant re-regulation, Dodd-Frank, et cetera. That resulted in many forms of lending that banks provided moving out of banks to non-bank lenders. So we saw that in particular with corporate private credit, direct lending.

You look at that market corporate private credit, it's experienced significant growth. 15 years ago, it was about $150 million market, compares roughly, similar in size the US leveraged loan market. So significant supply coming out of the banks and at the same time there's significant demand from investors looking for a liquidity premium, diversification, less volatility. So private credit, corporate private credit as an asset class went from what was a niche investment mezzanine loan to an asset class unto itself. It's a piece of an investor's portfolio, defined asset class now. And it's not just corporate credit, and this is what's interesting. You obviously you've got commercial mortgage loans that have historically been financed by insurers. It's only increasing. And it's expanding beyond that. The definition of private credit to include consumer, residential mortgage, transportation, hard assets, asset-based lending broadly defined.

Stewart: That's super helpful. And so from your vantage point, what's the impact of the recent disruption in the bank space? And the obvious example is SVB. Is this cyclical or secular? And what else can you tell us about it?

Matt: Look, I think the secular trend of disintermediation, consolidation remains intact. But if you look at what happened with Silicon Valley Bank, what happened earlier this year, very different than what occurred during the GFC. So the GFC was an asset problem, bank balance sheets. It's more of a liability and liquidity problem now. The assets are in good shape.

So I mean, just kind of talking through it what happened. First, we saw a significant rapid rise in rates. We went from 0% to 5.5% over an 18-month period. That led to significant deposit flight. The banking system's lost about a trillion dollars in deposits given how competitive money markets are. That was exacerbated by Silicon Valley, First Republic's failures. And now you've got more savings draw down post-COVID. And loan officers are obviously conservative given the current environment, what they're seeing in commercial real estate, the uncertainty looking forward. So you have that. You add to it a significant leg in regulation happening, and this is Basel III and specifically a Basel III endgame, which will have the result of increasing capital requirements for US banks. And this is going to be phased in by July 2025.

So it all contributes to this secular theme of bank disintermediation that we've witnessed over the past 15, 25 years. It's going to lead to more consolidation. So we've got, call it 4,100 banks today. I think over the next 20 years, it's conceivable that that shrinks to 1,000, 1,500 driven by this secular theme.

Stewart: I think that's really interesting and I can completely see your logic there. What opportunities is this creating right now and what are some ways that banks are looking to partner with firms like AB?

Matt: The first impact we saw was deposits are out, loan-to-deposit ratios are up. How do you bring that back in balance? You lend less. So that was the first reaction here on part of banks. But going forward, I think banks are going to be utilizing, as they have historically, multiple structures. We as a firm have been involved in all of those historically. So what could banks do? They could sell assets. They could sell loans, portfolios of loans. They could securitize existing loans and sell those off as securities. Again, all to increase their capital, decrease their leverage. They could execute risk transfer transactions, either selling off subordinated positions in loan portfolios, repack in essence, or executing on that risk transfer on a synthetic basis. It's all been done historically. It's all in the toolkit.

What's really interesting to us is buying assets, it's interesting, but it is a point-in-time opportunity. What's really interesting going forward is this notion of future-forward flow and how do we partner with banks? How do asset managers and insurers partner with banks strategically in I think of a non-zero sum relationship?

So if you think about our business, we have a large corporate direct lending business, $17 billion in size. We started that in 2013. We lifted out a team of 5 individuals from Barclays Bank and we turned that business, 5 individuals to 75 people today. That was in direct lending. Going forward, a lot of these lending businesses where banks are constrained have significant infrastructure needs and customer bases that are well-entrenched. So think residential mortgage lending, consumer lending, lender finance. I as an asset manager, I can't just lift out a team and build that business. I don't have a customer base. It's cost-prohibitive.

So I think the future is going to consist of more strategic relationships where banks will partner with asset managers where the asset manager could provide a more diversified source of funding relative to deposits and then source opportunities for its clients.

Stewart: And under that model, which is a really interesting idea, but it's not dissimilar to what they've done with resi mortgages, right? I mean, they're basically, it's a fee generation and then they're selling that loan. And it seems like it would be akin to that because it seems like everybody's incented in the right way with that kind of a relationship. What are some of the key attributes that banks are looking for when you're talking with an asset management/buy-side partner? What are some of the characteristics that would make a manager attractive to a bank?

Matt: Yeah, look, first of all, your point on resi mortgage and incentives is a really good one because you listen to what I'm saying. You think back, "Oh, is this banks looking to move back to a less capital-like business? Does that originate to distribute? Is that what got us into the GFC to begin with?" I think what we're talking about here is fundamentally different. We're not talking about banks selling off 100% of the exposure. We're talking about banks wanting to retain this customer base, wanting to keep this origination infrastructure in the bank, just looking to diversify their funding away from deposits. So these sort of relationships would include banks continuing to maintain meaningful skin in the game as opposed to selling off all the risks. So there's a key difference.

Stewart: Yeah. And I think too, I mean, leading up to the GFC, I think underwriting standards went away. And that's not what we're talking about here at all. This just has to do with partnering with them as where they're doing the origination and then you can be a capital source for them, right?

Matt: We could be a capital source and more than that, right? These are asset classes. It's resi mortgage. It's consumer. If it's a business of financing other lenders, we, AB could bring complementary skills, our knowledge of the underlying industries, our understanding of credit. We could, and we're having discussions around this, partner with banks to create new products for their customer base. So a bank might only be comfortable extending credit to a certain loan-to-value. We may, given our comfort or knowledge of a certain asset class or end market, be comfortable extending a little bit more, taking on a little bit more risk for more return. That might create an attractive product for the bank to offer its customer base that's differentiated. So again, example of these kind of non-zero-sum relationships.

Stewart: That's extremely helpful color. So just kind of going back to where I was, what are the attributes that banks are looking for to partner with an asset manager or buy-side partner? I think that would be helpful for our audience to know.

Matt: Yeah, no, and I think going back to what we talked about, I think having that asset class expertise is important. But in addition to that, first I would say it starts with a demonstrated history of actually partnering with banks. Relationships are important. There's not a one-size-fits-all mentality. I mentioned earlier there are a lot of potential structures that can be used to acquire assets and participate in future origination.

I think with that, the importance of being flexible, ability to offer solutions that meet the bank's needs and having the expertise and, again, track record of having executed before, I think that's important. Servicing is an important point here. Having the ability to service the underlying assets if we're talking about individual loans. Now, some of that might be handled by the bank, but having that expertise and knowledge, workout knowledge is helpful as well.

And I think another important point would be from an asset manager's perspective, having a kind of broad cost of capital to offer the bank. So the example before that I gave around partnering with a bank to create a new credit product that might go deeper into the capital structure. So that would require a different source of capital from the asset manager so that junior tranche, so to speak, could be sourced from a private opportunistic fund targeting double-digit returns. There could be a more senior piece, investment-grade piece that could be relevant to insurance capital. So having that broad cost of capital and client base is an important attribute and partnership as well.

Stewart: That's really helpful. So when we think about private market businesses like AB being accustomed to a direct origination model, how are these bank partnerships different than typical buy-side models and what are the similarities?

Matt: I think some of our business is, if it's corporate direct lending or commercial real estate direct lending, we are originating directly. We have teams of individuals who've got feet on the street, in essence, relationships with borrowers, asset owners. In other cases, we're sourcing opportunities through market participants. Here, we're talking about a more strategic, programmatic sourcing relationship with the bank. But in all cases we are underwriting the risk. We are getting comfortable with the risk as an investor on behalf of our clients. And there is an invest, hold-to-maturity mentality which will include servicing and workouts if necessary.

So I think all of these channels from direct origination through strategic partnership are all similar from a credit underwriting and credit perspective. And that's the common denominator. And I think going forward we're increasingly, well, as the private credit market grows and diversifies from corporate credit, real estate credit to include asset classes that just historically and currently fit more naturally in banks given the large customer base.

So it's one thing for me to have a roster of either private equity firms or real estate developers that I lend to. You maybe count that in the hundreds. You compare that to lending to thousands, tens of thousands of individual consumers. That is a business model that is high-touch, operationally intensive, belongs in a bank. We're not going to lift that out and build that within AB. So again, common denominators, we are understanding and underwriting the risk, but we're kind of optimizing how we originate. I think increasingly going forward as we move into these asset-based end markets, residential, consumer, transportation, banks have the right structure and we just need to figure out how we plug in effectively.

Stewart: And given our audience being overwhelmingly insurance investment professionals, why is this so relevant to AB's insurance clients and what's unique about these opportunities?

Matt: Yeah, I mean, it's what we started, getting back to what we started with. It's exciting in that insurers are at a pretty interesting place given their liability profile, long-term nature of those liabilities, in many cases, if you're from a life insurance perspective, and ability to source capital from longer-term premiums relative to short-term, in some cases, overnight deposits.

So in a world where banks are going to be looking to diversify their source of funding beyond deposits, insurers are really well-positioned. Just a couple examples. We talk a lot about residential mortgages. They have very attractive regulatory treatment from a life insurance perspective, and you have the ability to acquire high-quality performing assets. You generate a yield premium, 100, 200 basis points in the current environment over what you could get by investing in securities. That's attractive, that this market of asset-based finance that we talked about, it's a large addressable market, residential, consumer, transportation, multiples of the size of the private corporate credit market, which is a trillion and a half today. I think many of these asset classes still are underrepresented in insurer portfolios. They're high quality, they're investment grade in nature. And as we know, the vast majority of insurance GAs, we're talking about private, well, investment-grade credit.

So another example, or one specific example on the asset-based side would be the opportunity to provide senior secured loan, senior secured lending to other originators and non-bank lenders. Again, this is a business that historically has sat within banks and it spans multiple collateral types, consumer, residential, credit card, auto. And it's investment grade in nature. It has a public analog. In ABS, we're just talking about the private equivalent, private warehouse financing. So it represents an attractive asset class for an insurer as well.

Stewart: So the last question that is about the future, and I want to ask it with my bias in it, my bias. And what my bias is is that this is not a moment in time, this is momentum, it's a secular trend, the opportunity is there, and it's going to be there. Do you think that I'm right first of all, and secondly, what would have to happen to change this dynamic that would not make this a great opportunity for insurance companies on the next 5 to 10 years?

Matt: Yeah, look, Stewart, I'm like you, I'm biased as well, but we're not the only ones who are biased. I think this is a well-entrenched trend in terms of disintermediation, bank consolidation, movement of assets from bank balance sheet to non-bank insurance, private fund balance sheet. So look, I think it's well entrenched. What would have to happen for this to reverse and therefore pull back the opportunity for non-bank lenders, insurers, private funds would probably be a rollback in regulation, a loosening in regulation. And I think the chances of that are significantly lower than the chances of regulation increasing.

So I think it's fair to say the next five to 10-year trend is pretty clear. So the question is how do you take advantage of it as an insurer? And I would say two things from my perspective. And this is also informed by how we partner on a day-to-day basis with the equitable who has two-thirds ownership in AB and there's a very strategic relationship between our investment teams and equitable on the GA side and the product side as well.

But one would be these notions of investment team silos or the separation between public and private investing needs to go away because if we're right here in over the next 5 to 10 years we see continued growth in private credit really driven by asset-based, consumer, residential, commercial, in addition to corporate credit, there's going to be a much greater opportunity to make relative value investment decisions between, let's say public securitization and a private warehouse facility. It's another way for insurers to generate premium yield in their general account other than just an illiquidity premium, and it necessitates much closer collaboration between public and private investors.

Second would be having a closer connectivity between the asset side and liability side. The asset team and the liability team, so to speak. I think of our relationship with the equitable and many other insurers are liability-driven, asset-focused. Liabilities inform what you can invest in from an asset perspective. But I think these two teams moving closer together. Product teams on the liability side designing product, which then informs assets that can be originated or that the insurer wants to target on the asset side or vice versa, but closer collaboration between those two teams. Again, addition to the first point, will, I believe, be differentiating in the future for insurers.

Stewart: It has been so instructive to have you on. I really appreciate. It's given me a different view here that's moved from the disintermediation and dislocation and moves me to thinking about a new structure basically where there's a collaborative partnership and that the interests of the various parties seem to be better aligned than with banks by themselves. I mean, that's just my opinion of it, but I've learned a lot from the discussion today. Is there anything that you want our audience to take away before I ask you my final fun question on the way out the door?

Matt: Really enjoyed the conversation as well, Stewart, but I'm interested in your final question, so maybe we can move to that.

Stewart: Here we go. So there's some optionality. You can take either one or both. Lots of people take both. No pressure. What's the best piece of advice you've gotten or given? And who would you most like to have lunch with alive or dead?

Matt: Look, I think the most important notable piece of advice, I've been given a lot of good advice, not all of it I've taken initially, but over time, yes. But I think it would be to get comfortable being uncomfortable. I talk about this a lot. It was advice that was given to me very early in my career. Didn't really understand what it meant then. Do now. It's something I've modeled. And it's advice that I often give to individuals starting their career and also to my son who's 14. So I think that's an important bit of advice.

In terms of who I would like to have lunch with and have a real conversation with. This is a good question. I'll give you a couple. I think one end of the spectrum would be Richard Feynman. He was a great scientific mind and had an incredible ability to teach and distill really complex information and make it just really simple and easy to understand. So that would be one. The second, more entertaining end of the spectrum would be Anthony Bourdain. I think for his great ability to tell stories, all the people he's met, places he's traveled, and experiences he's had. Unfortunately, both of those individuals are no longer with us, but I would love to meet with those two individuals over a lengthy meal.

Stewart: That's great. I'm a big Anthony Bourdain guy too. I think that would be a great lunch for sure. Heaven only knows what you'd be having, but would definitely be cool. We've been joined today by Matt Bass, head of private alternatives at AllianceBernstein. Matt, thanks for taking the time.

Matt: Thanks so much, Stewart. It was great to join, enjoyed the conversation.

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