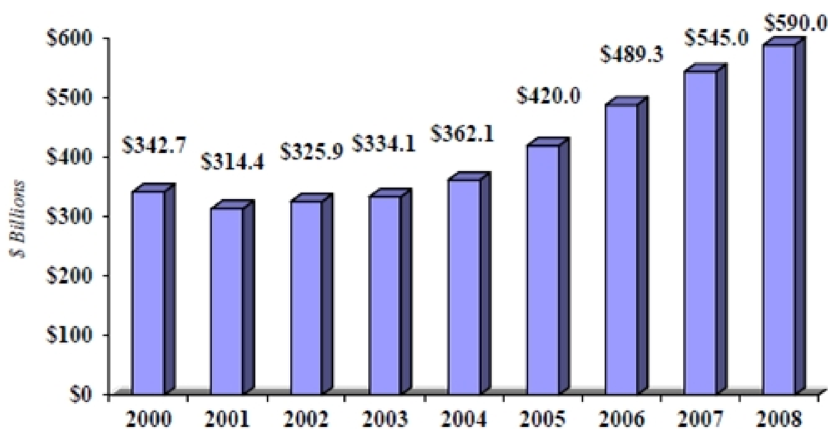
One of the few areas of commercial lending that has managed to generate growth over the past 12 months is Asset Based Lending (ABL). During the recent economic downturn, banks scrambled to tighten their lending policies and started to review their loan portfolios. The resultant contraction in the number of outstanding lines of credit and the loss of liquidity helped to deepen the crisis. The only bright spot in this dreary landscape was the ongoing success of the ABL sector. The table below shows the growth trend in ABL volumes to the end of 2008. Data for the first quarter of 2009 indicates this pattern remains intact.



The economic contraction saw banks with commercial loan portfolios become re-focused on risk measurement and management. Loans that generated high interest revenues and fees were attractive in times of economic expansion because the growing economy tended to offset the higher risks that had to be assumed in order to earn those higher returns. The current recession has brought risk management back into vogue and loan portfolios are being purged of unused standby lines, under-priced credit risk and non-compliant facilities. The lack of liquidity in the financial markets has also drawn attention to capital adequacy.

Under the Basel II rules, banks must calculate capital adequacy by referencing the risk in every loan (not just classes of loans). If a bank wishes to lower the amount of capital that must be set aside to support a loan, then it must lower the measured risk of that loan. ABL allows banks to do just that. By taking sufficient, liquid collateral (normally in the form of accounts receivable and Inventory) the risk of a loan is significantly reduced and the required capital reserve is also

lowered. In addition to the quality of the collateral, ABL facilities typically require frequent reports from the borrower to the lender and allow the lender to take dominion over cash.

ABL has enjoyed ongoing growth while other forms of lending have declined in volume. Banks have converted several commercial lines of credit into ABL facilities in order to reduce balance sheet risk and capital requirements. Borrowers have also turned to ABL because in times of tight credit, these facilities open access to capital that would otherwise be denied.

What is surprising is that the growth in ABL has occurred while prices rise and the risk that banks are willing to take has declined. The recent attention to risk has improved the risk/return ratio for ABL lines. Pricing has been increased slightly and many loans that were made based exclusively on the available collateral are no longer being provided by the mainstream banks. The banks are looking for adequate profitability and cash flows to provide assurance of the borrower's future survival.

The higher risk ABL loans have migrated to non-bank funds and smaller firms that have the resources to customize facilities and the flexibility to price the risk appropriately. This tier of financial entities has enjoyed new growth recently as the banks turn away from risks they would have assumed a few months ago and open the door to their more aggressive competitors.

From the borrowers' point of view, ABL is often the only way capital can be raised. The economic slowdown has undermined financial performance of many companies. This has caused banks to call loans, remove unused lines of credit, increase pricing and ask for additional collateral. By unlocking the value of selected assets on the balance sheet, borrowers can gain access to working capital at rates that are appropriate for the risk they represent.

For the borrowers that cannot meet the minimum requirements of the banks, the non-bank sector is an alternative. While these lenders are more comfortable with their heavy reliance on collateral, they still impose minimal performance standards on their borrowers. If a borrower meets these requirements, the cost of the credit facility can be much higher than those charged by the banks. The combination of interest rates and fees can be onerous enough to make the cost of borrowing more expensive than the cost to issue equity. At that point, the borrower must either consider an equity issue or re-evaluate the ongoing business model.