WHITE PAPER

Private Credit: Feeling the Pressure & Seizing the Opportunity for Banks

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By Nicole Hildebrandt, Gwenhael Le Boulay, Mark Harris, Johannes Burkhardt, Brad Mayer,
Brian Teixeira, Drew Fleeter, and Sandeep Bahra

Understanding the Rise of Private Credit

Over the past decade, the private credit market's growth trajectory has outpaced most traditional asset classes. In recent years, this growth has accelerated, with 2023 representing an inflection point. Following a sustained period of attractive risk-adjusted returns and relatively low volatility following the global financial crisis, private credit has established itself as a formal asset class commanding a place in most institutional investment portfolios. In a time of higher interest rates, the emergence of private credit has triggered a wave of strategic re-assessments across the spectrum of debt market participants: global banking & capital markets institutions that dominate underwriting and syndication activity, asset managers focused on investment strategy and management, institutional investors searching for yield, and end borrowers in need of capital.

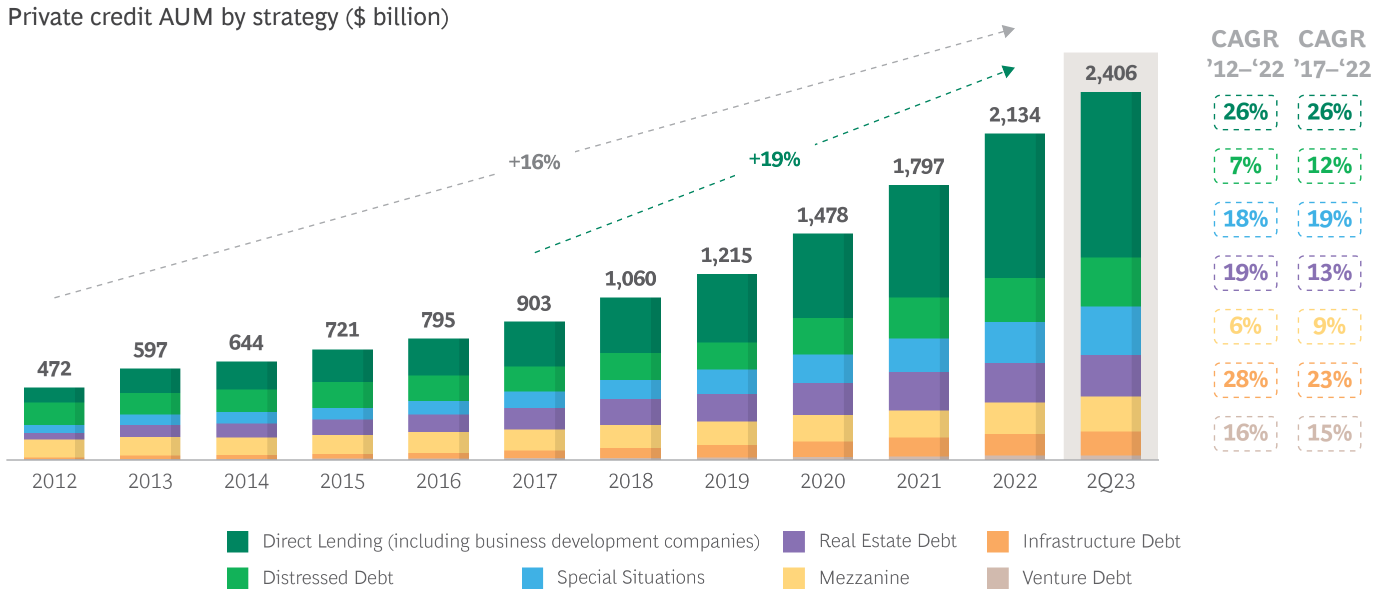
This paper aims to inform and inspire a strategic call-to-action for banking executives by:

1. Explaining the nature of private credit and factors behind its historical and projected growth rates, highlighting key trends and insights
2. Identifying both defensive and offensive strategies for banking institutions to create and protect value
3. Proposing new operating models and implementation considerations focused on partnership opportunities and risk offload via asset distribution, with an appreciation of the evolving regulatory environment (e.g. Basel IV revisions)

What is Private Credit?

Private credit refers primarily to corporate lending by institutions outside of the traditional banking system. Lenders are typically credit fund managers who work directly with borrowers (many of whom are backed by private equity sponsors) to negotiate terms and originate privately held debt not traded in public markets.

Exhibit 1 - Global Private Credit Market by Fund Type



Sources: Preqin, Refinitiv BDC Collateral, KBW

As seen in exhibit 1, the most common types of private credit are:

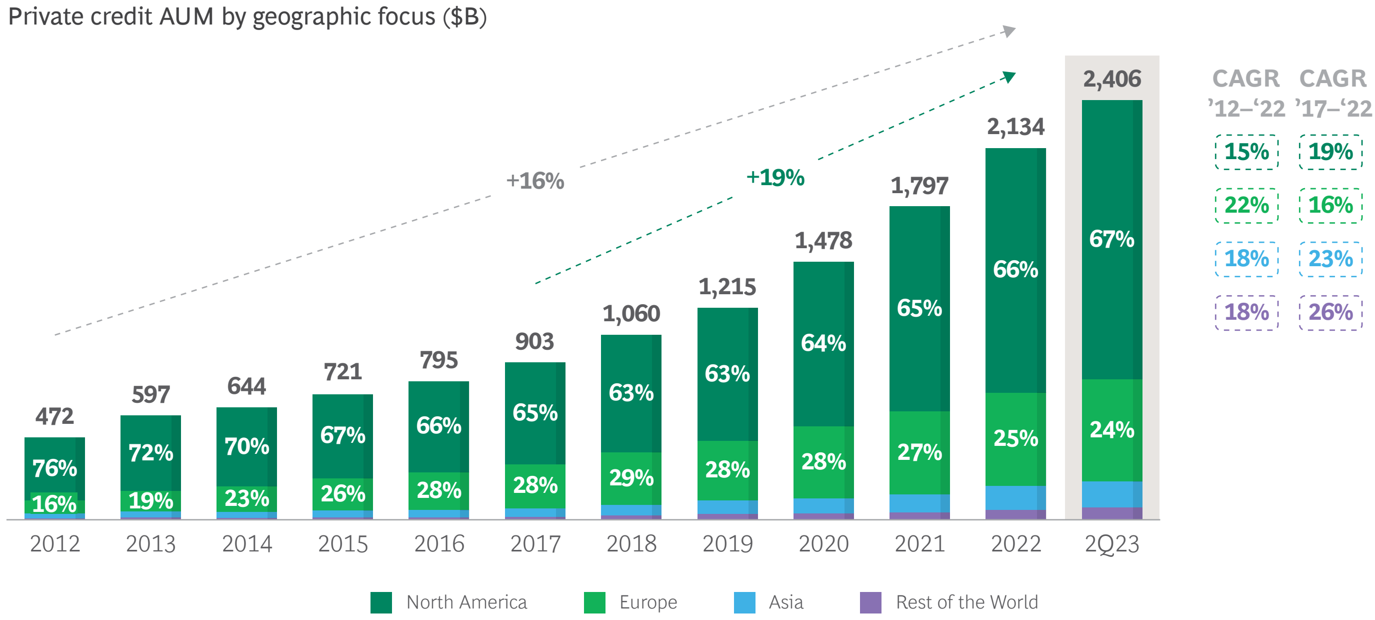
- **Direct lending:** Loans are typically floating rate senior secured and directly originated by non-bank lenders. Borrowers are often small- and medium-sized enterprises that may lack scale and access to public fixed income markets. Debt is higher yielding relative to bank lending with highly tailored yet tighter covenants. Loans are private and there is no developed secondary market for trading, meaning that loans are typically held by the lender until maturity or a refinancing event. Origination is highly relationship-driven, with most deals coming through private equity sponsors who control portfolios of companies that each have individual financing needs.

- **Mezzanine lending:** Loans are in the form of subordinated, junior 'second lien' debt, ranking below senior loans in the event of bankruptcy but still senior to equity positions. Terms are highly negotiated and typically shorter duration. These loans can have fixed or floating rates, and often come with call protection and make-whole provisions. Mezzanine lending often has attractive yields, sometimes offering equity-like returns. In recent years, unitranche[1] loans have grown in popularity, displacing some of the demand for mezzanine capital. However, there is still a clear role for mezzanine to play as a financing bridge between equity and senior debt. Like direct lending, much of origination is sponsor-driven.

- **Distressed:** This type of debt typically occurs when an entity acquires the existing debt of a company in need of urgent debt restructuring to maintain operations. Lenders typically target "good" companies (valuable assets, strong cash flows) with "bad" balance sheets (overleveraged), taking on high levels of risk while aiming for outsized yields or discounted entry prices. Skilled lenders can play a meaningful role in the restructuring process, with returns often generated by short-term price recoveries. Note that hybrid debt/equity solutions also exist and may compete with distressed debt strategies for deal flow.

- **Special situations:** Loans are extended to companies impacted by extenuating circumstances that have little to do with company fundamentals. Debt can be directly originated or acquired in a secondary market, with the expectation that price dislocations are present and that credit worthiness and valuations will significantly rise. This debt typically involves some downside protection and may involve equity conversion or warrants, providing potential for equity upside.

Exhibit 2 - Global Private Credit Market Size by Region



Sources: Preqin, Refinitiv BDC Collateral, KBW, SIFMA

1. "Unitranche" loans contain an "agreement amongst lenders" wherein the economic risk and reward is distributed differently, but there is only one tranche of debt under a single credit agreement from the borrower's perspective.

Market Size and Growth Rates

As seen in exhibit 2, over the last ten years (2012–2022), the private credit market has grown from $0.5 trillion to $2.1 trillion, with a CAGR of 16%, inclusive of all debt strategies. Over the last five years, the growth rate has increased to 19% CAGR, and the most recent data indicates that this trend of high growth persisted through 2023. North America and Europe combined represent approximately 90% of the market, which reflects rapid growth in the two regions, as well as the relative immaturity of leveraged buyout markets in Asia.

As of the second quarter of 2023, AUM in private credit vehicles was $2.4 trillion[2], representing 23.1%[3] of the total corporate bond market and 7.6%[4] of the global fixed income market.

Based on extrapolation of the 2017–2022 historical growth rate (19% CAGR), we expect that between 2022 and 2026, private credit will double in size to greater than $4.2 trillion.

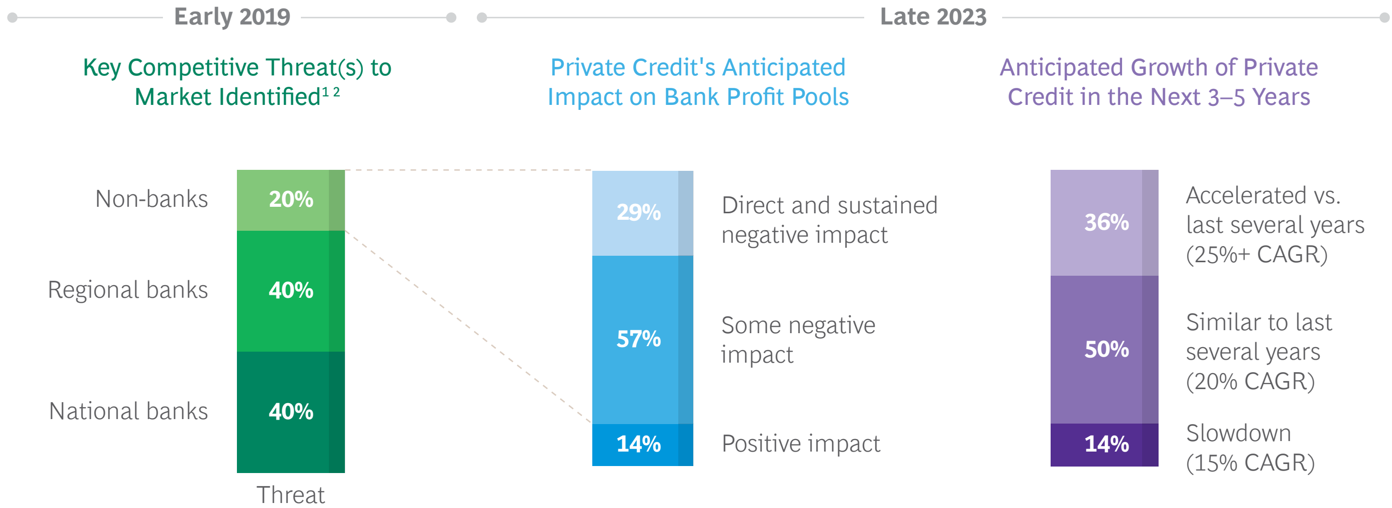
Strategic Considerations for Global Banks

In light of accelerated growth rates in private credit, banking executives must keep a close eye on the asset class's evolution and be open to adapting their growth strategies in response.

For example, BCG's latest US Corporate Banking CEO survey results indicate that 85% of executives anticipate that the growth in private credit markets will have some negative impact on bank profit pools in the next three to five years. That is a notable increase from the market sentiment five years ago, in early 2019, when non-banks were considered at most a minor competitive threat. Furthermore, the private credit market has grown at more than four times the pace of US total commercial lending, which grew 4.6% annually over the same period (2017–2022).[5]

Exhibit 3 - Results from BCG Survey of Corporate Bank CEOs Gauging Attitudes Toward Private Credit

BCG interviews with Corporate/Commercial Banking heads

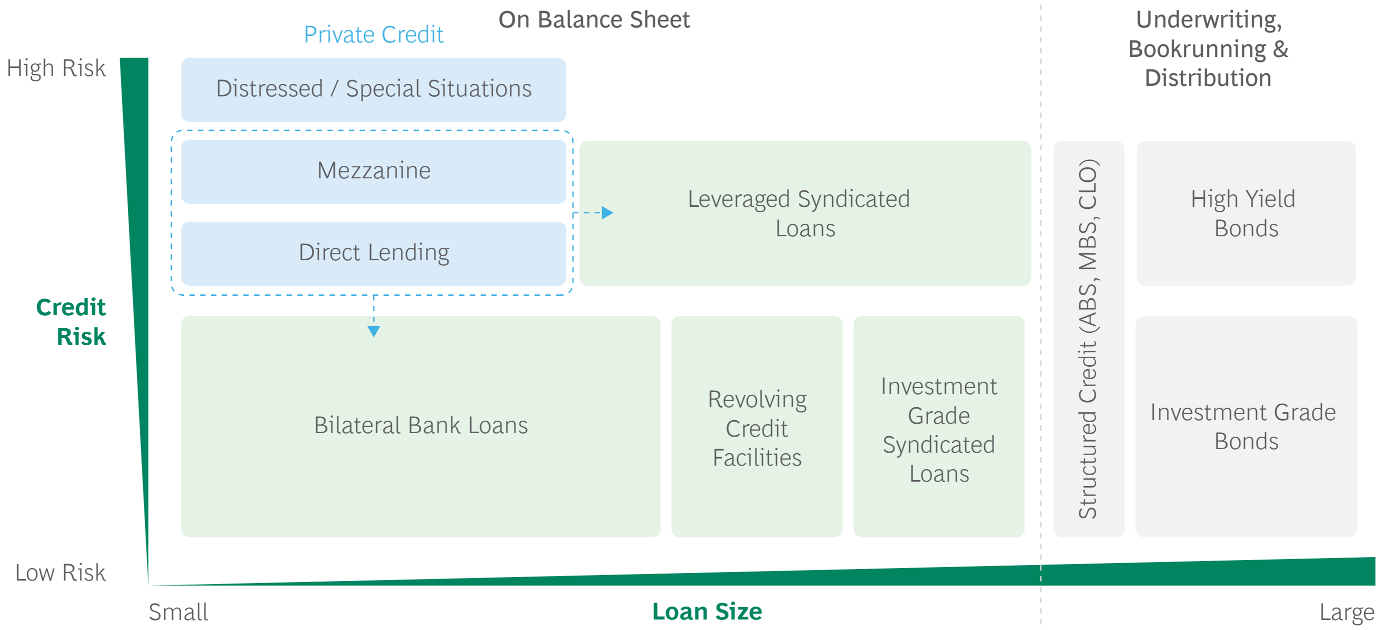


Sources: BCG interviews with Corporate/Commercial Banking heads (May 2019, N=20, October 2023, N=16)

Notes: 1. Respondents could identify multiple threats 2. All respondents included, but each overall bank only counted once for listing an individual threat (when multiple respondents are from the same bank) 3. Non-banks include tech companies, direct lenders, etc.

2. Private credit definition is inclusive of private real estate and infrastructure debt.
3. Source: Bloomberg global corporate bonds outstanding amount including active and matured bonds (as of 09-Jan-2024).
4. Source: Bloomberg global all bonds outstanding amount including active and matured bonds (as of 09-Jan-2024).
5. Source: BCG US commercial banking performance report, US Fed call reports

Exhibit 4 - Direct Lending is increasingly occupying the space of banks



Source: BCG analysis

The trend toward private credit has global implications as well, with impacts varying by market based on regulatory landscape. In continental Europe, regulations make traditional leveraged lending unattractive to non-bank players while real estate, infrastructure, and SME private debt hold large volumes and growth pockets for private debt funds. In the United Kingdom, private credit players have identified and moved into banking coverage gaps such as hospitality and a range of other service industries.

As outlined in exhibit 4, Direct Lending and Mezzanine strategies have begun encroaching on broadly syndicated and bilateral bank loan markets. Given the market context, banking executives have an imperative to understand private credit dynamics and their impacts. In particular, leaders should:

- **Understand why borrowers turn to private markets:** The strong linkage between equity sponsors and lenders has been a key factor in the growth of direct lending and mezzanine strategies, which in recent years have slowly moved up market to compete more with syndicated loans and high yield debt. Private credit has several distinct advantages for borrowers and their equity sponsors. Direct lending funds have capital immediately available. The hold-to-maturity nature of the strategy means there is no need to market or syndicate the debt, and no need to go through a formal ratings process. When private lenders commit to financing, the terms of the debt are certain, whereas syndicated lending typically includes flex provisions that mitigate underwriting risk for the banks but introduce changing terms that may adversely impact borrowers.

  From the borrower's perspective, the result is increased speed and certainty of execution, which is particularly valuable to private equity sponsors. Additionally, direct lending terms are tailored to borrower needs, with confidential processes and bilateral communication that allow borrowers and equity sponsors to negotiate terms directly with investors holding debt. These processes and communication channels often result in strong alignment and high-touch relationships that can be highly beneficial in distressed/workout situations.

- **Understand how private credit may threaten traditional bank lending and broader relationships:** The size of corporate borrowers in private markets is enlarging as the market expands and lenders grow more sophisticated. Banks may be at risk of losing market share in lending to their traditional mid- to large-cap clients if this trend continues as expected. As lending opportunities disappear, so does an important point of leverage for fee-based businesses like treasury management. Banking executives should not underestimate the significant threat relationship disintermediation poses to long-term business viability for commercial and corporate banking segments.

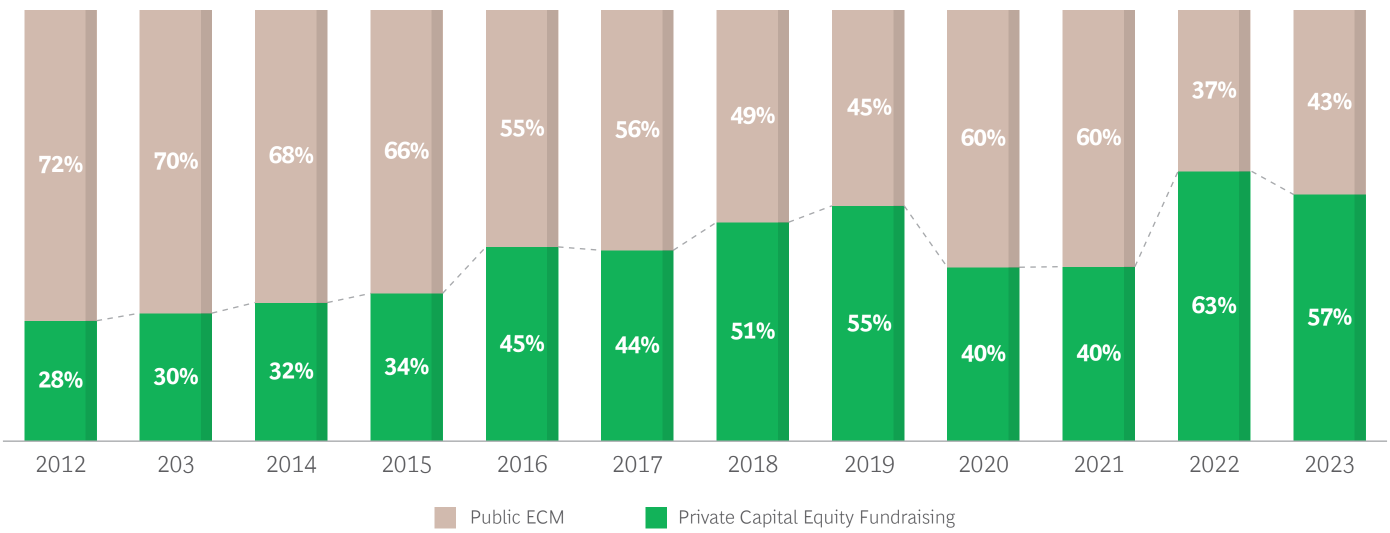
- **Consider the broader financial impact of the shift to private markets, especially business conducted with financial sponsors:** Sponsors are typically a high RoTE client segment for banks. As a result, the relative impact of potential market share losses are higher if private equity firms are increasingly able to fund entire LBOs and refinancings privately. Traditional DCM business, and leveraged finance, could be impacted as approximately 80% of direct and mezzanine private lending is sponsor-backed. Sponsor-owned companies may also elect to stay private for longer, impacting IPO and ECM underwriting deal volumes in the future. Long-term trends indicate an economic shift towards the private economy as indicated in exhibit 5 below. Equity capital raising in private markets has outpaced public equity capital markets volumes over the last decade. This trend marks a shift in ECM activity, which has become increasingly sponsor-backed.

- **Consider how private credit intersects with other strategic priorities for the bank:** For example, most Tier 1 banks have set ambitious sustainable finance goals. Private investors have a high appetite for such projects, and many have the flexibility to provide capital to projects that may not be bankable to a regulated financial institution. Banks can develop strategies to partner with or engage private capital players as a component of their broader sustainable finance strategy.

- **View regulatory challenges as an opportunity to increase risk offload:** As recent Basel revisions propose higher RWAs (see exhibit 8 in our **H1 2023 Investment Banking and Markets Report** for more information), the case for asset distribution of RWA intensive products increases – a trend that is amplified by the phase-in of Basel IV. Private credit represents an opportunity for banks facing rising regulatory costs of holding capital on their balance sheets.

Exhibit 5 - Private Markets Capital Raising has outpaced ECM issuance

Global Equity Capital Raised (2012–2023)



Sources: Preqin; Refinitiv as of 02-FEB-2024; BCG analysis

Note: Private capital fundraising excludes fund of funds & secondaries to avoid double counting; includes buyout, venture capital, growth, real estate and infrastructure strategies

Banks Need to Evolve Their Go-To-Market Strategies

Based on our experience with a wide range of clients, there are two main types of models for banks to consider when determining how best to address this structural market shift: originate-to-distribute models, and private debt fund creation/partnerships.

1. **Originate-to-distribute:** Increase the conversion of illiquid on-balance sheet credit assets into "distributable" assets to address RWA concerns

2. **Private debt fund creation/partnership:** Create and/or manage a private debt fund with loans entered on the books of the fund vehicle rather than the bank

What Could Operating Models or Joint Venture (JV) Partnerships Look Like?

Banks should consider a spectrum of originate-to-distribute strategies

Recently, there have been numerous public announcements of CIB partnerships with fund managers, or CIBs intending to commit capital for in-house private credit fund launches. Based on BCG expert interviews with Tier 1 bank executives, banks appear to be adopting a spectrum of models:

Internal Credit Portfolio Management for Banks with In-House Asset Management Divisions:

Asset management divisions can set up a new fund, raise capital from investors, and leverage sell-side distressed credit/special situations or fixed income trading desks to execute asset transfers from broker dealer entities to asset management entities. For example, a credit desk acquires loans and executes transfers to the asset management division for allocation into relevant private credit fund with strong internal communication and alignment of risk management. This setup also allows for corporate banking divisions to pass clients directly to credit desks or distributed lending teams to keep assets off the banking balance sheet.

Active Credit Portfolio Management (ACPM) for Banks Without Asset Management Divisions:

Banks can set up risk management functions that own originate-to-distribute risks and act as internal intermediaries between loan origination and structuring functions. ACPM departments will ensure loan creation and terms closely align with investor expectations of yield, playing a role in sourcing and warehousing loans. Setup typically involves creating revenue share agreements to align incentives among relationship managers, loan originators, and structured credit teams. Distribution efforts should target private credit funds as ultimate holders of risk and returns. Club deals can also be originated where markets teams organize a club of private funds to which they offload loan assets.

Partnerships and Joint Ventures:

Banks can prospect and invite private credit fund managers to receive loan assets that fit pre-agreed risk and return profiles, targeting origination and private placement distribution. This approach is the most operationally streamlined. Alternatively, banks can act as introductory agents, bringing borrowers and direct lenders together. Benefits include increased deal flow and faster deployment of dry powder for fund managers while banks can maintain borrower relationships by offering avenues to direct lending if traditional bank instruments are less preferred.

Overall, banks need to find the right balance between playing offense or defense. Defensively, banks should strengthen their internal risk management and operating models for credit approvals; anticipate the evolving regulatory landscape around private credit markets and prepare asset management divisions accordingly; and begin informing clients about the risks and opportunities of private credit. Offensively, banks should consider partnerships and white labelling, as well as identify areas in the private credit value chain into which they can insert themselves, like origination, credit assessment, or restructuring advisory. In addition, banks should consider inorganic plays to gain market share via, for example, acquiring targeted direct lending funds with strong records and critical scale. It is important to note that offensive plays for banks may risk damaging big buy-side client relationships if such moves are perceived as direct competition.

Source: BCG/Expand experience

Although they have a firm grasp on originate-to-distribute strategies, banks can consider four main ways to play in the private debt fund space: in-house build, service provision relationship, joint venture, and origination arrangement.

1. **In-house build:** The bank stands up a fully internal private debt fund. This approach enables the institution to maintain full control over the private debt fund and retain all fees. Drawbacks to this approach include slow time to market, high complexity, extensive capability builds across all areas, and high personnel requirements.

2. **Service provision relationship:** The bank selects partners to serve defined roles within the debt fund, like fund administration or placement strategy. In this structure, the bank is still the main driver of the fund and pays fees to the service providers. The bank can leverage partners' specialized knowledge and competencies, and structure the relationships to be demand-driven, achieving higher speed to market and ease of scalability. This approach, however, entails higher service fees and dependencies on external service providers.

3. **Joint venture:** The bank shares profits with other JV parties. Value chain steps are distributed along existing skills and strengths, enabling a positive network effect on deal-inflow and high speed to market with limited change in current bank infrastructure. Compared to the first two options, JVs result in lower margins for the bank and introduce a dependency on other JV member(s). Typical JV structures see banks contributing origination and debt management capabilities, while asset managers provide access to investors through their existing fundraising channels.

4. **Origination arrangement:** In this structure, the bank serves as deal originator, similar to loan syndication, and passes deals directly to a contracted third party. The bank only needs origination capabilities, and fees for the bank are limited to agreed upon origination fees with the third party.

   Given investor appetite and the continued expansion of private credit strategies we see several opportunities for banks to capitalize on relative strengths by acting as origination engines. Both JV and origination arrangement models allow banks to fill clear gaps in private credit manager origination capabilities, creating economic value that can be shared. Areas where bank origination capabilities may be particularly appealing include CRE debt, asset-based lending strategies and non-sponsor backed deal flow for direct and mezzanine lenders.

The Landscape of Private Credit for Asset Managers

It is also important for banking executives to understand how asset managers are approaching the private credit space.

As the macro picture has shifted, appetite for illiquid private credit continues to intensify among institutional investors and a rapidly expanding cohort of private wealth investors, both of whom seek equity-like returns with lower volatility. To meet rising demand from these investor types, asset managers are focusing on where and how to play, optimizing for unique considerations based on existing capabilities, operating models, and firm cultures. Broadly speaking there are three archetypes of asset managers navigating the evolving landscape:

1. **Established private credit managers:** Managers with strong existing capabilities, who have become increasingly focused on identifying the next frontier. In that vein, areas of strategic expansion include asset-based lending, CRE debt, credit secondaries, fund finance, and trade finance. Multi-asset managers with established credit arms may identify potential synergies between debt and equity strategies that can be unlocked via credit expansion. On the originations side, bank partnerships may provide a path for expansion into new strategies and/or geographies. On the product distribution side, newer forms of product packaging – like private BDCs, interval funds, tender offer funds, and long-term asset funds – may allow managers to begin diversifying away from concentrated institutional pools of capital.

2. **Traditional asset managers:** Traditional managers facing steady fee compression may view private markets as a critical source of long-term revenue, with private credit serving as a potential market entry point. Such managers may have a product distribution advantage in the wealth/retail channels if they can establish proper capabilities. First, however, these managers must determine whether to buy, build, or partner with an incumbent to gain a market presence. Established fixed income, structured credit, or bank loan business lines may serve as preliminary building blocks, but the path to an organic build is long and challenging. Alternatively, an inorganic approach is faster but comes with post-merger integration challenges and may occur at a time of heightened valuations. Both approaches require overcoming significant operating and distribution model challenges to maximize capabilities without impairing existing business lines and firm-wide culture.

3. **Principal investors:** This cohort includes long-horizon asset-owners with significant scale, high illiquidity tolerances, and high risk-adjusted return targets that may live on both sides of the General Partner-Limited Partner fence: passively investing in private credit as asset owners while also actively investing their own principal as asset managers. On the passive side, they face difficult asset allocation decisions that require a total portfolio perspective. Should private credit exposure be increased? If so, should an increase come at the expense of traditional fixed income and/or equities allocations? On the active side, should outside leverage be utilized to amplify returns? Should established strategies continue to invest only principal or is third-party capital formation warranted? Such investors face a delicate balancing act; they must harmonize fund investment and direct investment portfolios in a way that leverages strong GP relationships to gain information and deal flow advantages without jeopardizing those same relationships.

Final Remarks

While aided by extraordinary macroeconomic conditions, the expansion of private credit strategies is the result of a broader structural shift in debt markets – and that shift is likely to continue. Heightened regulatory pressure should lead to further contraction of bank-based lending, while private capital managers with stable long-term capital commitments and natural duration matches are well-positioned to meet increased appetite for long duration illiquid credit.

Asset managers should think proactively about the banking sector, seeking opportunities to act as preferred partners with significant expertise, sponsor relationships, stable capital, and suitable investor risk appetites. Global banks seeking to maintain a competitive edge should take a proactive approach, adapting business models and growth strategies to mitigate risks in core business lines while leveraging their strengths to capitalize on opportunities from the continued shift towards private credit and maturation of the asset class.

About the Authors

Nicole Hildebrandt is a Managing Director and Partner and a regional co-lead for the NAMR Corporate, Commercial and Investment Banking practice, based in the New York office. You can reach her at Hildebrandt.Nicole@bcg.com.

Gwenhael Le Boulay is a Managing Director and Senior Partner for the Financial Institutions practice, based in the Paris office. You can reach him at LeBoulay.Gwenhael@bcg.com.

Mark Harris is a Managing Director and Partner for the Principal Investors and Private Equity Practice (PIPE), based in the Toronto office. You can reach him at Harris.Mark@bcg.com.

Johannes Burkhardt is a Partner for the Financial Institutions practice area, specializing in Asset Management, based out of the Munich office. You can reach him at Burkhardt.Johannes@bcg.com.

Brad Mayer is a Knowledge Director specializing in Corporate and Commercial Banking, based in the Raleigh-Durham office. You can reach him at Mayer.Brad@bcg.com.

Brian Teixeira is an Expert Project Leader, based in the Boston office. You can reach him at Teixeira.Brian@bcg.com.

Drew Fleeter is a Project Leader, based in the New York office. You can reach him at Fleeter.Drew@bcg.com.

Sandeep Bahra is a Lead Knowledge Analyst specializing in Capital Markets and Investment Banking, based in the London office. You can reach him at Bahra.Sandeep@bcg.com.

For Further Contact

If you would like to discuss this report, please contact the authors.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