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As private credit goes more mainstream, some CFOs may have questions

With US markets rallying and many investors anticipating a more deregulation-friendly administration, some CFOs may seek to borrow new funds or look to shed their company's high-priced debt in favor of less costly borrowing options.

Historically, such alternatives would have involved securing loans from banks (or, in the case of syndicated lending, loans intermediated by banks) or issuing bonds. However, in recent years, an increasing number of investment funds and other nonbanks have begun deploying another strategy: private credit. While the phrase can be applied to several diverse subsegments, including mezzanine financing and opportunistic credit, private credit is a blanket term for a negotiated loan between a borrower and a private provider of debt. For example, a nonbank lender could be an alternative asset manager or an insurance firm.

Private credit funds have climbed in recent years. Last year, assets under management hit an estimated $1.7 trillion globally.[1] One projection predicts that by 2028, the private credit market will skyrocket to $3.5 trillion globally.[2] That's more than the current US leveraged loan market and high-yield market combined.

What makes these types of loans appealing to both borrowers and lenders? Lenders, as well as others who may have supplied them with capital, could be enticed partly by the possibility of healthier returns than those typically offered by more common fixed-income instruments, a function of underlying volatility or high leverage. Also, nonbank lenders' typical one-on-one relationship with borrowers may make it easier for them to customize the terms of deals. In addition to tailored term sheets, borrowers may expect quicker decisions, greater certainty of execution, and higher leverage available than through traditional lending. But for CFOs, how does the burgeoning realm of private credit fit into the broader landscape of financing options?

In this edition of *CFO Insights*, we'll explore the private credit phenomenon—how it works, whom it best serves, and why its fast growth may yet accelerate more.

Bank shot

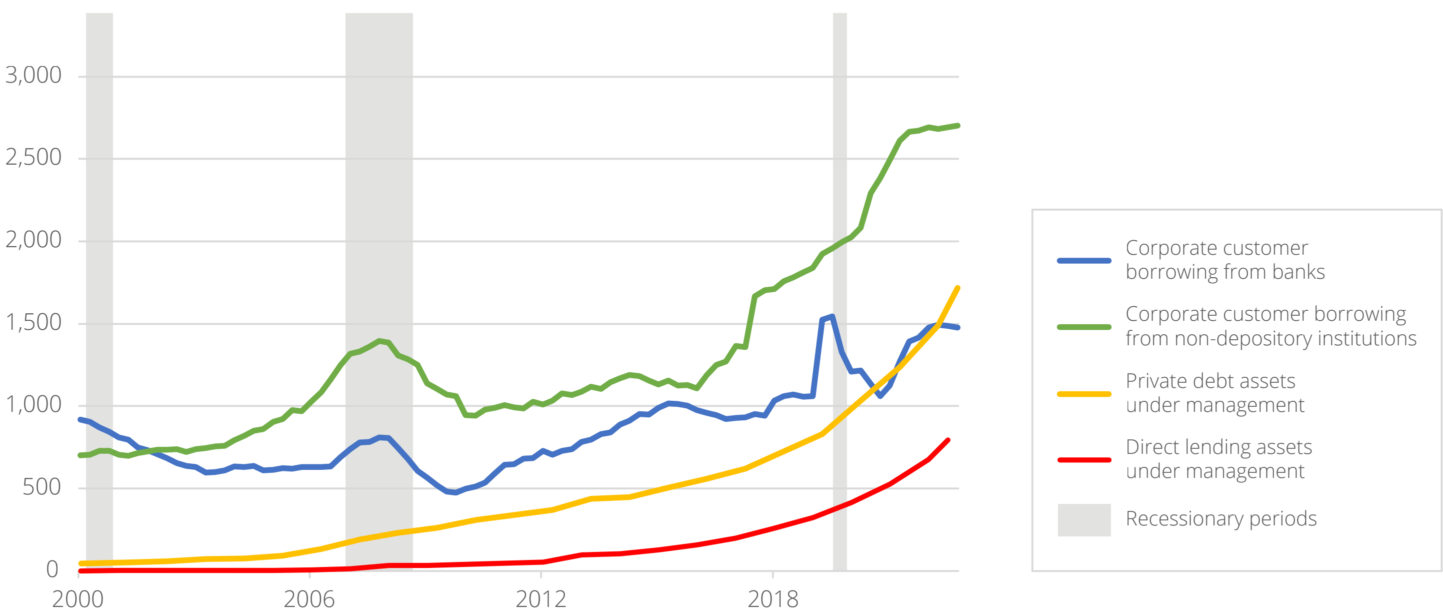
The rise of private credit in the United States has fundamentally altered the corporate lending ecosystem, challenging traditional sources of capital. Are banks competitors or partners to private credit firms? That can depend on the specific circumstances (see accompanying story, "Adapting to the rise of private credit: How banks are making change").

In other cases, banks may partner with private credit firms, with the former originating the assets while the latter provides the capital. Overall, bank lending as a proportion of all corporate borrowing amounted to 35% in 2023, dropping from 44% in 2020. In contrast, nonbank lending experienced tremendous growth (see Figure 1).[3] By collaborating with private credit firms, banks can maintain client relationships while also limiting their exposure to potentially riskier investments.

Private credit isn't new, by any means. In the wake of the 2008 global financial crisis, with regulators requiring banks to de-risk their balance sheets, private credit stepped in to take on the kind of deals that might have otherwise been financed by conventional bank loans and public market offerings. Lured by an appealing risk/reward profile—with a potential internal rate of return of 15%[4]—a range of institutional investors stepped up despite the additional risk that could be driven by the loan terms. Such terms can include payments-in-kind or giving lenders lower priority in the capital structure.

The more recent rise of private credit has in part been powered by the vast amount of dry powder—uninvested capital—among private equity (PE) firms, an estimated $2.49 trillion globally.[5] In recent years, as high interest rates contributed to slowed dealmaking activity, PE firms supplied funds to support PE-backed transactions. Private credit loans tend to be structured around floating rates. In early 2023, troubles at some regional banks[6] enabled private credit firms to further expand, taking on bigger deals of $2 billion and up.[7]

Figure 1. Partial eclipse: Corporate borrowing from nonbanks, compared to banks
Borrowing from banks and nonbanks, 2000-2023 (US$ billion)



Source: Deloitte Center for Financial Services analysis.

In fact, the average private credit loan is now much larger than the average bank loan.[8] What was once mainly considered a high-yield instrument for distressed debt has now evolved to serve more creditworthy borrowers—which is why some CFOs, likely already aware of private credit, may want to know more about the benefits and the unforeseen risks.

Custom built

Given that private credit funds invest for the long term (five to seven years) and tend to work closely with borrowers, their participation can conjure a kind of one-to-one relationship that used to be common between the CFOs of corporate borrowers and their bankers. Unlike syndicated debt, where the risk is spread among investors far and wide, private credit firms tend to hold the debt in their funds or with a small number of other private credit funds.

This model can foster trust and cooperation between the private credit firm and its borrowers. Other mechanisms, such as the floating price—when interest is re-priced regularly—give lenders a reason to keep in close touch on an ongoing basis, taking the company's pulse to gauge its financial health. Their unique debt covenants, sometimes "covenant-lite," may also include provisions for consistent check-ins. Private funds may also negotiate a seat on the board, giving them visibility into management.

More broadly, however, the appeal of private credit funds may have less to do with the more traditional lender-CFO working relationship and more to do with flexibility. That flexibility comes in many forms, such as the following:

- **The absence of a one-size-fits-all deal structure.** Private credit funds can work with borrowers directly to customize the terms of a loan, depending on how much the borrower is seeking and the level of risk involved. Unlike asset-based firms, which typically require collateral, direct lenders can base loans on the overall assets of the business, including goodwill. Firms can also quickly adapt lending terms when necessary. Banks, owing to regulatory limits and the structure of their balance sheets, have constraints on how creative they can get. Risk management is also evolving within banks to add veto points and increase scrutiny of non-traditional deal structures.
- **The presence of speed.** Private credit firms can move quickly to provide financing, given that they don't depend on sprawling investment committees whose approval can take more time. A commercial banker needs to assess a borrower's creditworthiness and decide the size of the loan and maximum leverage the bank is willing to extend. Bank lenders must also decide where the funds will come from—their own balance sheets, third parties, or via syndication.
- **The absence of voluminous red tape.** Private funds are currently not subject to the same regulation as banks, although their growth may draw the attention of regulators.[9] Nonbanks are not regulated as entities, and any additional regulation will likely be imposed at the fund level rather than at the firm level. As long as banks continue operating in a more regulated environment, they are increasingly likely to seek additional capital partners and prioritize non-balance-sheet lending alternatives.
- **The presence of an evolving "user experience."** Private credit firms are typically in the business of originating loans and holding them to maturity, a duration match that aligns the borrower with the source of funds. Moreover, private credit firms compete against each other by showing themselves to be the better partners—which may mean extending a business borrower a longer runway, for example, to turn the fortunes of the business around.

On borrowed time?

Periodic disruption and ongoing disintermediation of the banking industry has helped fuel private credit growth so far. As some banks' lending habits have grown more cautious, private credit has expanded to fill the gap.

Beyond creating more private credit funds, that opportunity has led some alternative asset managers to acquire or partner with insurance firms. The arrangement can help private lenders build their balance sheets and obtain employees who have deal-making skills and relationships with potential borrowers. In the past, banks dominated origination, finding end-borrowers via their investment banking or corporate or retail arms. As these relationships become increasingly democratized, providers of private credit could grow into larger sources of debt, further displacing banks.

Still, there are uncertainties regarding the future growth of private credit. Newly resurgent global M&A activities, particularly in North America, could slow down depending on interest rates. Or a broad decline in borrowing, caused by any number of external factors, could change the outlook for the asset class.

For that matter, a high-profile default could propel more private credit investors to shift into high-yield bond funds or collateralized loan obligations. While hedge funds typically have sizeable divisions focused on managing distressed companies, some private lenders may prove ill-prepared for turning a business around. That, too, could lead to a pullback as funds start underperforming.

For now, however, private lenders seem poised to grow and innovate. Some may diversify to accommodate a broader array of debt. Others may look to add more features, trying to simulate bank offerings, such as revolving lines of credit. For those CFOs who take an interest, the intensifying competition could pay off.

Adapting to the rise of private credit: How banks are making change

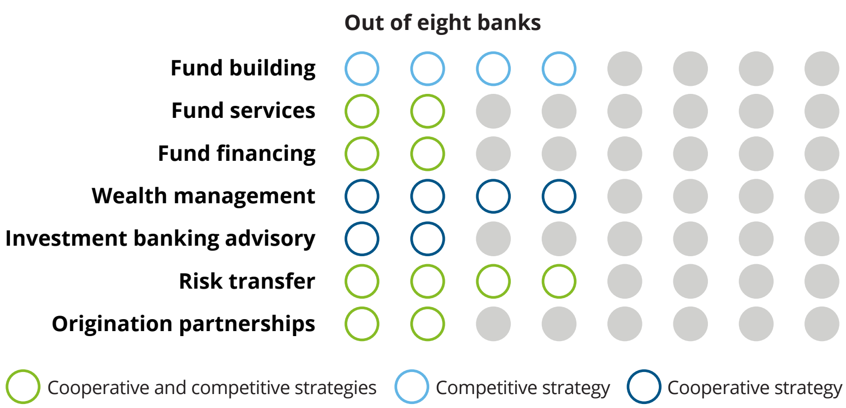
A surge in private credit raises an obvious question: How are more traditional financial institutions—banks, specifically—competing with these new rivals?

Some banks compete head-to-head, building their own funds to complement existing investment banking services and wealth management products, while others see opportunities to cooperate with private credit firms. The decision to choose one path or the other may depend on such factors as the strategic position of a bank, its size, and its product offerings.[10] Many regional banks, for example, have yet to respond with a clear strategy.

No matter how (or whether) they choose to respond, most banks are likely feeling the heat from their private credit competitors. For the largest banks, the leveraged lending market represents a multibillion-dollar revenue stream. On average, banks collect a 1% fee each time they syndicate debt. By displacing this market, private credit funds could take billions of dollars of potential revenue away from banks.[11]

Historically, a third of investment banking fees have come from underwriting and syndication. However, in terms of the sheer number of deals, the private credit market has outpaced the syndicated market in recent years, financing more leveraged buyouts.

Figure 2. How banks are responding to the growth of private credit
Actions taken by global systemically important banks in the US



Sources: Deloitte Center for Financial Services analysis, based on research of the 50 largest banks in the United States during the second quarter of 2024.

Limited partners
Conversely, some banks seek ways to partner with their private debt competitors. Banks can play the role of facilitator by creating connections between their corporate clients and private credit firms. Corporate clients may benefit from faster and more flexible lending terms, while private credit firms benefit from the bank's relationships.

For banks, one advantage of working with private credit firms is retaining less credit risk. But as nonbanks, private credit firms typically face fewer regulations. Working in partnership may also help banks provide better service to their corporate borrowers.

By adopting this strategy, banks could relinquish their traditional lender role and become middlemen, reducing overall revenue. However, some banks are developing units to lend directly to credit funds, aligning the success of a private credit fund with the bank.

Some banks are responding to the rise of private credit by building their own private credit capabilities to compete directly with nonbanks. Large banks can combine their balance sheet, wealth management, and investment banking groups to help develop their own funds. They can raise money from wealth management clients and find deals through their leveraged lending and advisory teams.

As private credit plays a more prominent role in the lending market, banks' responses vary widely; they have announced a range of strategic initiatives to compete and/or cooperate with private credit firms (see Figure 2).

The largest banks seem to have a sense of urgency in their efforts to scale capabilities to increase lending revenue and fee income. Is there room in the lending market for both banks and private credit firms? Ultimately, it will be up to borrowers to decide which system best suits their needs.

End notes

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Contacts

Mark Brindisi
Senior Manager
Deloitte Consulting LLP
mbrindisi@deloitte.com

Josh Henderson
Research Manager, Banking & Capital Markets
Deloitte Center for Financial Services
Deloitte Services LP
johenderson@deloitte.com

Jeff Levi
Principal, Casey Quirk
Head of Strategy Offering for Financial Services
Deloitte Consulting LLP
jalevi@deloitte.com

Tim Partridge
Principal, US Commercial Banking Leader
Deloitte Consulting LLP
tpartridge@deloitte.com

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Deloitte CFO Insights are developed by Josh Hyatt, Editor, CFO Insights, CFO Program; and John Goff, Senior Manager, CFO Program, both Deloitte LLP.