September 12, 2024

Global Credit Weekly:

The drivers behind private debt's growth

BlackRock.

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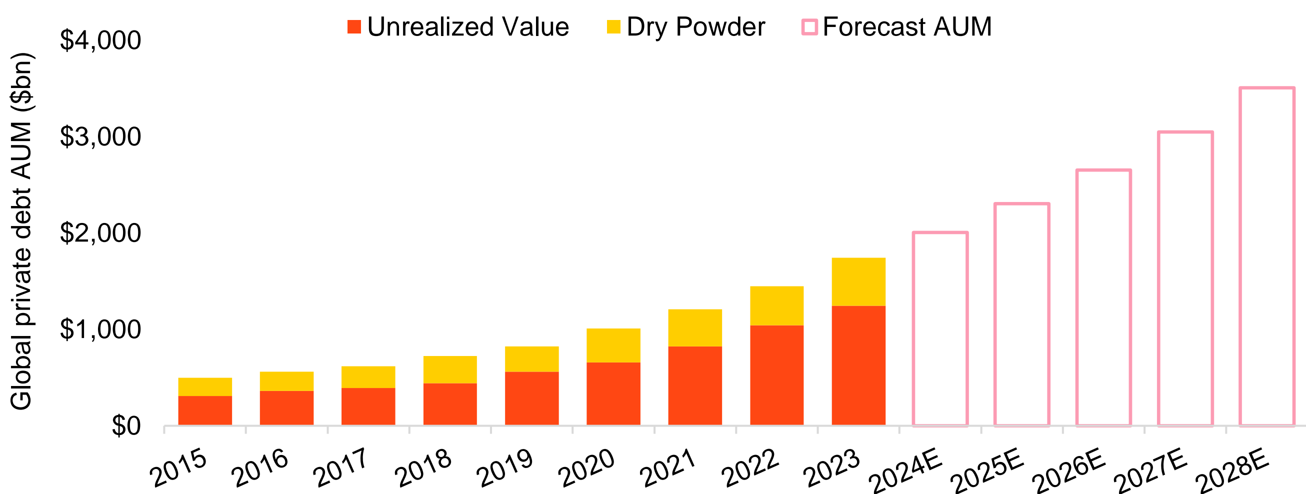
Key takeaways

- In our latest in-depth report on the asset class of private debt (please see: *Private Debt: The multi-faceted growth drivers, Sept. 2024*), we reiterated our forecast for global private debt assets under management (AUM) to reach $3.5 trillion by year-end 2028 (Exhibit 1). *Note: this forecast is specific to the various strategies of middle market corporate lending and excludes areas such as private asset-backed finance, which we have discussed separately.*
- In the report, we also explored four multi-faceted growth drivers behind private debt: (1) borrower preferences for certainty of execution, flexibility and clarity on pricing – and an expanding addressable market; (2) investor desires for portfolio diversification and increased comfort with private debt; (3) evolution in the public debt markets (which now serve much larger borrowers) and equity markets (as companies stay private for longer); and (4) shifts in bank lending.
- Related to the factors above, this past week provided some incremental data on growth driver #4: shifts in the bank lending system. In a speech at the Brookings Institution on September 10th, Federal Reserve (Fed) Vice Chair for Supervision Michael Barr addressed the potential for "broad and material" changes to the "Basel III endgame" 2023 proposal, among other items. While Vice Chair Barr's speech was consistent with remarks from Fed Chair Powell (earlier this year) that changes were likely, it was nonetheless notable as it appeared to quantify (at least preliminarily) the (revised) amount of additional capital certain U.S. banks would be required to hold.
- Vice Chair Barr's comments pointed to potential for a less onerous capital increase for certain subsets of the U.S. banking system, relative to the 2023 proposal. That said, the directional trend remains for higher capital charges relative to the status quo, on top of current bank lending standards which are not especially "easy" by historical standards (Exhibit 6). This should continue the trend of private debt establishing itself as a third and viable funding option, alongside bank lending and the public debt markets – which we view as a positive for financial stability.

Exhibit 1: We expect global private debt AUM to reach $3.5 trillion by year-end 2028
Private debt global assets under management (unrealized value and dry powder), and AUM forecasts



Source: BlackRock, Preqin. Historical (actual) data from Preqin, as of each calendar year-end. 2024E to 2028E are BlackRock estimates. **There is no guarantee any forecasts may come to pass.** As of August 28, 2024.

The multi-faceted growth drivers behind private debt

In our latest in-depth report on the asset class of private debt (see: *Private Debt: The multi-faceted growth drivers, Sept. 2024*), we reiterated our forecast for global private debt AUM to reach $3.5 trillion by year-end 2028 (Exhibit 1). *Note: this forecast is specific to the various strategies of middle market corporate lending and excludes areas such as private asset-backed finance, which we have discussed separately*.

In the report, we also explored four multi-faceted growth drivers behind private debt in detail:

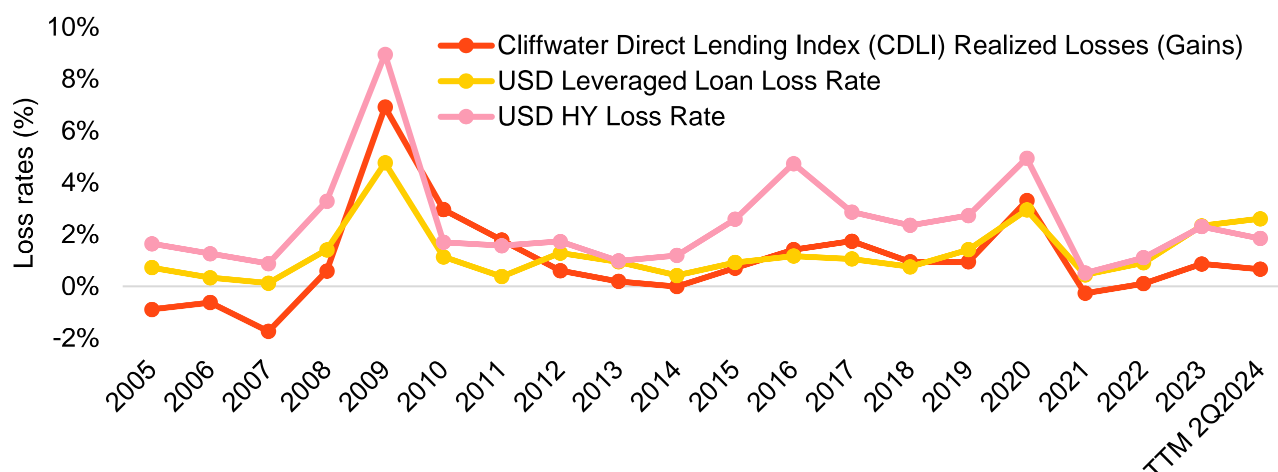
(1) Borrower preferences and an expanding addressable market. Many corporates – especially those at inflection points in their growth – desire customized funding solutions and value the certainty of execution and flexibility inherent in a long-term borrower/lender relationship. As the size of the private debt asset class has grown, it is no longer reserved for "niche" financing solutions. Rather, it can now compete in areas where it previously could not – such as the syndicated debt markets. As a result, the "addressable market" of private debt borrowers has expanded.

(2) Investor desires for portfolio diversification and increased comfort with private debt. In its earlier years, some investors were concerned about the potential for "adverse selection" in private debt. Over time, that theory has been somewhat disproven, as (1) companies with demonstrated access to the public markets have chosen the path of private debt, and (2) losses (for the Cliffwater Direct Lending Index (CDLI); Exhibit 2) have compared favorably to the USD HY and leveraged loan markets. With a "whole portfolio" view, more investors are turning to private debt for diversification, reliable income, and opportunities to introduce structural protections, depending on the strategy.

(3) Evolution in the public debt *and equity* markets. The public debt markets now serve larger borrowers, as evidenced by average new issue deal sizes that are prohibitively large for most middle market firms. Companies are also staying private for longer, as seen by a long-term decline in new equity listings and longer private equity "hold times". This provides an opportunity for private financing to play a larger role in the growth journeys of many companies.

(4) Shifts in the bank lending ecosystem. Since the global financial crisis, the share of bank lending to U.S. GDP has declined. And regulatory considerations have driven banks to reassess the most capital efficient use of their balance sheet. Private debt is well positioned to fill any potential "financing voids," and having a third and viable funding option for a range of companies – alongside the public debt and the banking channels – is a *positive* for financial stability, in our view.

Exhibit 2: Direct lending losses have compared favorably vs. public markets in recent years
Realized annual and trailing 12-month loss rates for the CDLI and BlackRock estimate of loss rates (using actual defaults and average recoveries) for the USD leveraged loans and HY bonds tracked by Moody's



Source: BlackRock, Moody's, Cliffwater. As of 2Q2024 (most recent). We assume a 40% recovery rate for HY and a 60% recovery rate for leveraged loans (in line with historical averages), to arrive at estimated loss rates given the Moody's issuer-weighted, trailing 12-month (TTM) default data. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future result.** Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Realized gains can be driven by equity stubs, warrants, and gains on exited investments. These were more common in 2005-2007, when second lien and mezzanine loans were a greater portion of the CDLI.

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A recommended re-proposal for "Basel III endgame"

Related to the aforementioned factors, this past week provided some incremental data on growth driver #4: shifts in the bank lending ecosystem.

In a speech at the Brookings Institution on September 10th, Federal Reserve Vice Chair for Supervision Michael Barr addressed two topics related to U.S. bank capital requirements: (1) the 2023 "Basel III endgame" proposal, and (2) the proposal to adjust the capital surcharge for global systemically important banks ("G-SIBs").

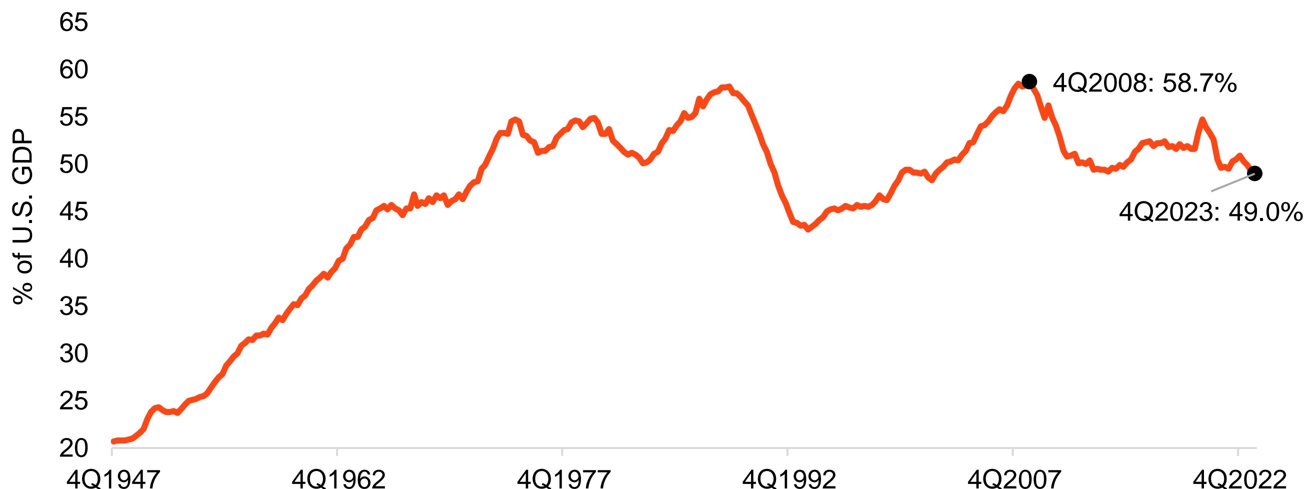
In his remarks, the Vice Chair Barr spoke about an important "balance between resiliency and efficiency," as higher capital requirements raise U.S. banks' cost of funding (which can then be passed on to households, businesses and clients).

After an extensive public comment period on both proposals, Vice Chair Barr said the Federal Reserve Board – alongside the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) – concluded that "broad and material changes to the proposals are warranted." This echoed remarks earlier in the year (i.e., March and July testimonies to Congress) from Federal Reserve Chair Jerome Powell, where he suggested that changes to Basel III endgame would be forthcoming, following the receipt of comments from a wide range of stakeholders.

We noted the following key takeaways from Vice Chair Barr's remarks:

- **Timing:** The recommended re-proposal of the Basel III endgame and G-SIB surcharge rules would include another public comment period. Similar to the previous proposal, there will be 1-year between finalization and implementation, with a phase-in period afterwards.
- **Capital charges:** The recommended changes to the proposal (as they stand currently and subject to finalization) would increase aggregate common equity tier 1 capital requirements for G-SIBs (i.e., the largest and most complex banks), by 9%. This is roughly half the 19% increase estimated in the 2023 proposal. For other large banks that are not classified as G-SIBs (i.e., those with $250 to $700 billion in assets), the estimated, combined longer-run increase to regulatory capital requirements is 3.5-4.5%. Banks with assets between $100 and $250 billion would no longer be subject to the Basel III endgame changes, other than the requirement to recognize unrealized gains and losses of their securities in regulatory capital.
- **Diversity of funding sources:** During the Q&A, Vice Chair Barr noted that the diversity of the U.S. financial system – with various sizes of banks, and non-bank institutions – was a positive. As Exhibit 3 illustrates, the share of U.S. GDP financed by the U.S. banking system has declined vs. the 2008 peak.

Exhibit 3: The share of bank lending to overall U.S. economic activity has declined post-GFC
U.S. bank lending to the domestic private non-financial sector (at market value), as a percentage of U.S. GDP



Source: BlackRock, Bank for International Settlements. As of 4Q2023 (most recent as of August 22, 2024)

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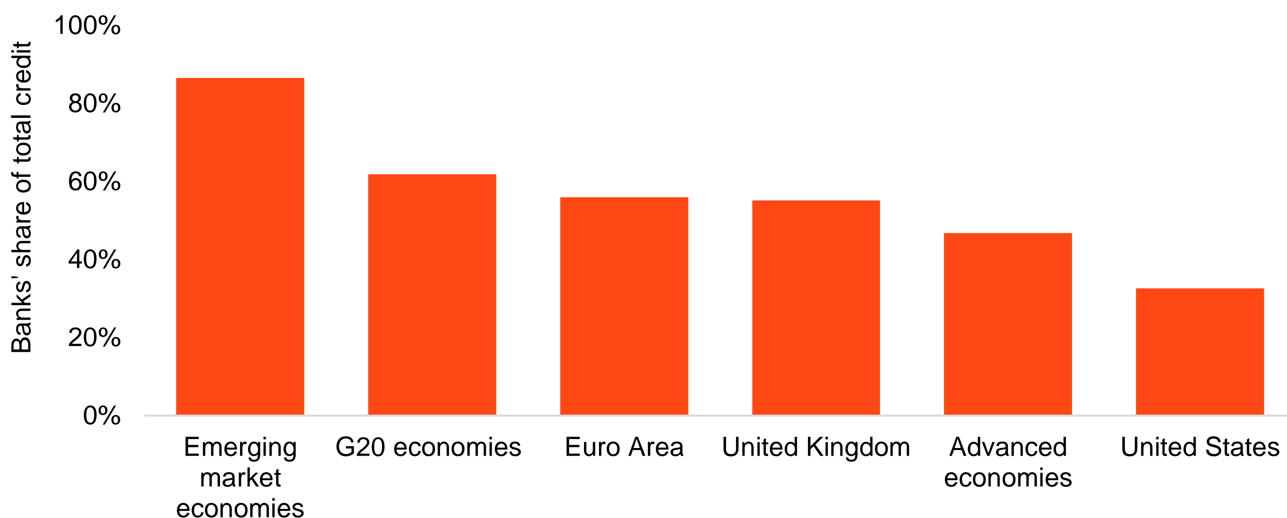
As shown in Exhibit 4, the U.S. is less reliant upon banks to finance the private sector than other developed market peers such as the Euro Area and the United Kingdom.

We believe this is a direct reflection of the growth of the private debt market: North America represented the largest regional share, by far, of private debt AUM, at 61% as of year-end 2023 (per Preqin; Exhibit 5). That said, while Europe is smaller than the U.S., it *is* growing – and we believe the region's focus on establishing a Capital Markets Union is a longer-term structural tailwind behind the role of non-bank financing in supporting the European economy.

Vice Chair Barr's comments this week pointed to potential for a less onerous capital increase for certain subsets of the U.S. banking system, relative to the 2023 proposal. That said, the directional trend remains for higher capital charges relative to the status quo, on top of current bank lending standards which are not especially "easy" by historical standards (Exhibit 6). This should continue the trend of private debt establishing itself as a third and viable funding option, alongside bank lending and the public debt markets – which we view as a positive for financial stability.

Exhibit 4: Relative to many other regions, the U.S. is somewhat less reliant upon the banking system for financing the private sector

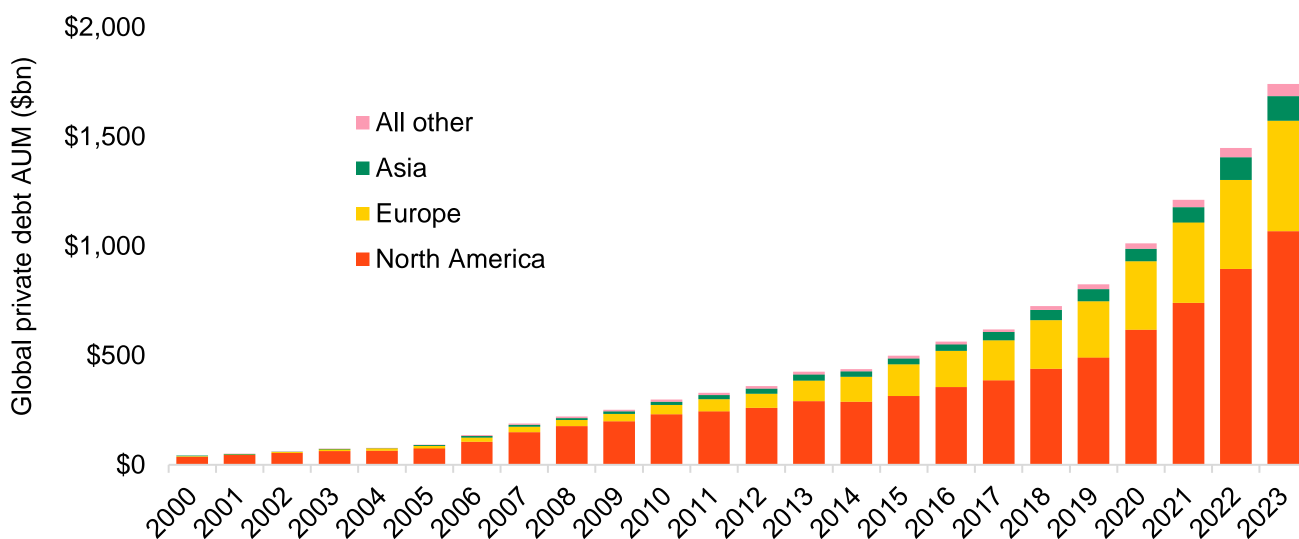
Banks' share of total credit provided to the private non-financial sector - select regions



Source: Bank for International Settlements, BlackRock. As of December 31, 2023 (most recent available).

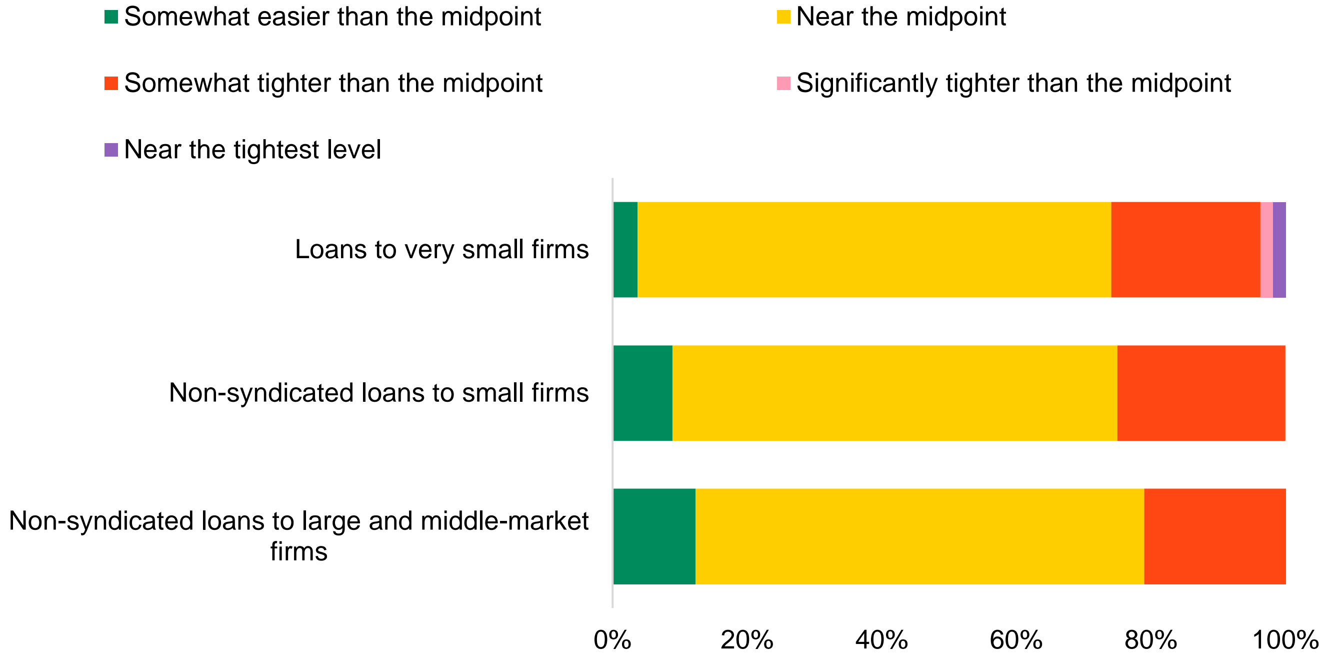
Exhibit 5: North America represents 61% of global private debt assets under management

Total global private debt assets under management, by region



Source: BlackRock, Preqin. As of December 31, 2023 (most recent available as of September 1, 2024). Excludes Real Estate and Infrastructure lending.

Exhibit 6: Over a longer-term history, bank lending standards are not "easy"
Respondents to the July 2024 Senior Loan Officer Opinion Survey were asked: For each loan category, describe the current level of lending standards for commercial & industrial (C&I) loans and/or credit lines, relative to the range of 2005 – present.



Source: Federal Reserve Board July 2024 Senior Loan Officer Opinion Survey (released August 5, 2024), BlackRock. "Large and middle-market firms" are defined as those with annual sales of $50 million or more. "Small firms" are defined as those with less than $50 million of annual sales. "Very small firms" are defined as those with annual sales of less than $5 million.

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