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Private Capital Practice

# The next era of private credit

A new private credit ecosystem is emerging across asset managers, banks, and insurers. Here's what it means for the industry.

*This article is a collaborative effort by Fuad Faridi, John Spivey, and Ju-Hon Kwek, with Henri Torbey and Luca Bionducci, representing views from McKinsey's Private Capital and Financial Services Practices.*

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2009-2023
10x

**Private credit has been one of the fastest-growing segments** of the financial system over the past 15 years. The asset class, as commonly measured, totaled nearly $2 trillion by the end of 2023, roughly ten times larger than it did in 2009.[1] While that total remains a small fraction of the broader fixed-income landscape, private financing solutions continue to perform well—and win, in many instances—against bank and public alternatives. In fact, our analysis suggests that the size of the addressable market for private credit could be more than $30 trillion in the United States alone (Exhibit 1).

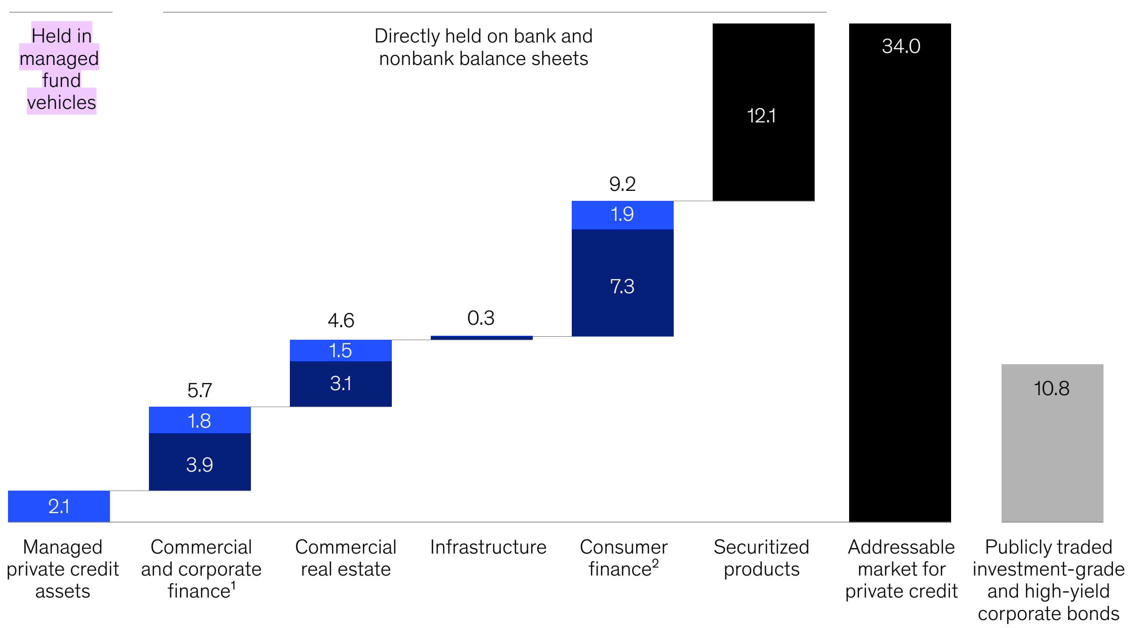
Private credit's growth to date has been largely concentrated in direct lending, a strategy fueled by the twin tailwinds of banks' retrenchment from leveraged lending and private equity's (PE) rapid expansion. But amid the higher rate and slower PE deal environment, the asset class has begun to expand into new areas, including a wide variety of asset-based financing structures.

At the same time, the sources of capital seeking private credit exposure continue to diversify, with significant inflows from retail and insurance capital pools. Additionally, the competitive

Exhibit 1

## Private credit continues to diversify into a broader array of assets.

**US lending balance in 2023,**[1] $ trillion ■ Bank ■ Nonbank




[1]Includes aircraft and railcar leasing, equipment leasing, receivables financing, standard corporate loans, and trade finance.
[2]Includes auto loans, credit card receivables, residential mortgages, student loans, and unsecured personal loans.
Source: Preqin; Securities Industry and Financial Markets Association; Global Banking Pools by McKinsey; McKinsey analysis

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[1] Preqin, accessed August 2024. The cited market size primarily includes capital housed in managed vehicles, mostly closed-end comingled funds, with a stated investment strategy of originating and holding private loans. It doesn't, for the most part, include capital invested in a variety of credit instruments held on insurance and bank balance sheets or in semiliquid fund structures. While these instruments aren't publicly traded, they haven't traditionally been regarded as private credit, either, though that distinction is breaking down as the market ecosystem matures and grows more complex. For more, see "McKinsey Global Private Markets Review 2024: Private markets in a slower era," McKinsey, March 8, 2024.

landscape has become broader and more crowded, with increasing direct participation from insurance companies, traditional asset managers, and even banks.

These changes present both challenges and opportunities for market participants across the lending landscape. Most notably, with banks facing regulatory changes[2] and increased competition from nonbank players, we see the potential for an accelerated transition from bank balance sheets to nonbank entities across a broad range of asset and borrower types.

This transition represents a generational opportunity for existing private-credit funds, other asset managers, and insurance companies that can establish reliable origination in these areas. It also signifies a strategic inflection point for banks, which will need to adapt their business and operating models in the face of "coopetition" from an array of scaled buy-side entities with long-dated sources of capital.

These shifts could lead to significant changes in the industry, such as a decoupling of asset origination from the downstream parts of the value chain. A new breed of partnerships and open-architecture business models could emerge as a result.

To remain competitive in the new landscape, we expect that market participants will need to continue to differentiate themselves in sourcing and fundraising. Scale (as measured by the depth and breadth of capital) and the effective use of technology represent two ways to do this.

While we expect that private credit is here to stay—and indeed, grow—risks need to be carefully monitored. Elevated losses to some companies in a recessionary environment are likely. The credit-investing fundamentals of prudent underwriting, robust portfolio management, and clear communication to investors on the risks they are taking are expected to remain as important as ever.

## Defining the next era of private credit: Four trends

As private credit continues to grow, a new industry ecosystem with more symbiotic linkages across asset managers, banks, and insurance companies is emerging. It will support the origination, syndication, structuring, and distribution of assets at significant scale. We expect four trends to define this new ecosystem: expansion of private credit into a broader array of assets, rise of ecosystem partnerships and open-architecture business models, amplified advantages of scale for competitive differentiation, and increased focus on technology to boost scale and performance.

**Expansion of private credit into a broader array of assets**

Private credit is expanding to include a broader range of asset types and new sets of borrowers. In our view, four asset classes in particular will increasingly shift to nonbank lenders:

— asset-backed finance, particularly segments that feature higher-risk-adjusted yields attractive to institutional investors (for example, aircraft loans and equipment leasing)

— infrastructure and project finance assets with relatively long durations (five years or more)

— jumbo residential mortgages, particularly those with high loan-to-value ratios and, for nonprimary residences, those that are classified as "nonconforming" under bank regulations

— higher-risk commercial real estate, for which banks are increasingly seeking to reduce their exposure

[2] Changes include the Basel Committee on Banking Supervision's finalization of Basel III, often called the "Basel III endgame" proposals, which are expected to take effect next year. They would require banks to increase capital reserves in a range of lending areas. They would also include new rules focused on liquidity that could emerge in the wake of multiple recent bank failures and reduce banks' appetite for longer-duration loans.

Each of these asset types ranks highly against at least one of three criteria that contribute to a propensity to transition off of bank balance sheets (Exhibit 2).

In the United States, we expect that an additional $5 trillion to $6 trillion of such assets could shift into the nonbank ecosystem over the next decade, provided that the following three assumptions hold: interest rates remain elevated above pandemic-level troughs; yield assets continue to perform in line with their historical range (and do not, for instance, experience accelerating credit losses); and the current regulatory environment for banks persists.

**Rise of ecosystem partnerships and open-architecture business models**

This shift in the natural owner of certain credit assets is expected to create opportunities for

Exhibit 2

## Infrastructure, asset-backed finance, and higher-risk commercial real estate are among the asset types most likely to transition to nonbanks.

**Assessment of factors affecting nonbank penetration of US asset classes**

Propensity to transition to nonbanks: High, Medium, Low

| | | Duration mismatch with banking deposits | Ease of origination for nonbanks | Impact to bank ROE after "Basel III endgame" | Total |
|---|---|---|---|---|---|
| **Corporate and commercial finance** | Standard loans[1] | Medium | Low | Medium | Medium |
| | Structured loans[1] | Medium | High | Medium | High |
| | Equipment leasing | Low | Medium | Low | Medium |
| | Aircraft and railcar leasing | High | High | Low | High |
| | Receivables financing | Low | Low | Low | Low |
| | Trade finance | Low | Low | Low | Low |
| **Commercial real estate** | Regulatory <80% LTV[2] ratio | High | High | Medium | Medium |
| | Construction loans and bridge financing | Low | Low | Medium | Low |
| | Regulatory >80% LTV ratio | High | High | High | High |
| | Nonregulatory | High | High | High | High |
| **Infrastructure** | Project finance | High | High | Medium | High |
| **Consumer finance** | Auto loans and leases | Medium | High | Low | Medium |
| | Student loans | High | Medium | Low | Medium |
| | Unsecured personal loans | Low | Medium | Low | Low |
| | Credit card receivables | Low | Low | Medium | Medium |
| | Residential mortgages | High | Medium | Medium | High |

[1]Impact on corporate loans will vary based on the type of borrowers. Examples of structured loans include acquisition finance and leveraged finance.
[2]Loan to value.
Source: Global Banking Pools by McKinsey; McKinsey analysis

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market participants to enter new areas of the value chain, either directly or via partnership. It could lead to the development of open-architecture business models in which different entities originate loans than hold or manage them.

*Banks* could partner with asset managers and institutional investors to sell assets as they selectively shift to more asset-light business models. They could continue to own the last mile to the client, focusing on originating loans and cross-selling fee-based businesses (for example, cash management, foreign exchange, and advisory services). In parallel, they could move the final ownership of those loans through several mechanisms, including expanding traditional syndication capabilities to a broader set of investors, using forward-flow agreements, emphasizing asset sales, pursuing synthetic risk transfer trades, and even creating asset management vehicles in partnership with private credit companies. In doing so, they could become originators and distributors rather than end owners of risk.

*Insurers,* particularly those focused on certain types of liabilities (for example, fixed annuities, fixed indexed annuities, and pension risk transfers) and with offshore balance sheets, could move upstream into origination. For example, some carriers are building or acquiring direct-origination capabilities across private credit asset classes that suit their liability profiles. Others are partnering at scale with banks to acquire assets without having to build their own origination network.

Higher allocations to private credit and, at times, ownership of origination, is likely to improve the yield on the insurer's general account, which can allow more competitive liability pricing and increased ROE. This is especially true when the liabilities are housed in offshore balance sheets, since in offshore jurisdictions, certain types of private credit assets have lower capital charges.

*Asset managers,* particularly those with a first-mover advantage in private credit, could distribute products to new end investors, such as insurance companies and high-net-worth individuals. Alternative-asset managers have also been acquiring insurance carriers and leveraging offshore reinsurance to grow their permanent capital under management and rapidly build their credit capabilities.

When done prudently and effectively, these new business models can match assets with institutions suited to hold them, with potential benefits in financing the real economy.

**Amplified advantages of scale for competitive differentiation**

The bulk of private credit's growth over the past decade has been concentrated in direct lending strategies, which historically have primarily financed highly leveraged midsize companies typically owned by PE. A lender's ability to anchor or lead a given facility through a scaled commitment continues to be advantageous in both access and deal terms in this market.

As private credit's footprint expands into additional, larger subsectors, possessing a certain scale may well be the cost of entry. Only the largest lenders are likely to compete for multibillion-dollar financings of investment-grade companies, major infrastructure projects, and the largest commercial real estate financings.

There are scale advantages on the fundraising side as well. Incremental capabilities across distribution, operations, and technology are needed to raise capital from retail and insurance capital bases. Larger managers are better able to make these investments.

**Increased focus on technology to boost scale and performance**

We expect technology to play a more prominent role in the fundraising, underwriting, and operations of private credit investors in this emerging ecosystem. Machine learning and AI can improve underwriting decisions and support more effective portfolio monitoring, particularly across large pools of assets. Alternative data sources can complement traditional data in pricing and risk algorithms. Automation can standardize and streamline credit processes, reducing the time required to make lending decisions. Design and user experience capabilities can make it easier and more intuitive to apply for a loan, which is especially critical in consumer and commercial lending, in which customers increasingly expect seamless journeys.

Digital-lending platforms are also likely to become more important. As the universe of private credit expands to include smaller loans for consumers as well as small businesses, these borrowers are likely to prefer to access funding digitally at point of sale or through online platforms. These digital channels will allow lenders to originate loans without incurring significant brick-and-mortar investments. They could also serve as marketplaces that connect banks to end investors and facilitate the distribution of loans through forward-flow origination and securitization.

## Preparing for the next era of private credit

Institutions seeking to succeed in this new private credit ecosystem would do well to build additional capabilities to remain relevant and profitable throughout market cycles. As a first step, we believe that there are five questions that all players—incumbents and new entrants—should be asking themselves.

— Which sub-asset classes will be most attractive and scalable, given our risk-return objectives—across asset type, seniority, geography, and other parameters?

— What parts of the private-credit value chain are most attractive for us to participate in, given our client base, risk posture, liability profile, and regulatory setup—for example, origination, distribution, or end ownership?

— How should we access these areas—directly, via partnership, or via a fund manager?

— What targeted investments in supporting analytics, functions, and technology do we need to maximize efficiency and resilience?

— What contingencies—for example, risk monitoring, oversight, and workout capabilities—do we need to ensure resilience in the next credit downturn?

**Institutions seeking to succeed in this new private credit ecosystem would do well to build additional capabilities to remain relevant and profitable throughout market cycles.**

### Implications for banks

As banks formulate their answers to the above questions, we see them taking a few specific actions. To explore new business models, banks could start by building greater insight into the specific types of loans they originate that are most attractive to other investors based on yield, risk, and specific investor preferences. Using these insights, banks could then examine their balance sheets end to end across asset classes, clients, and geographies. This will help them form views on where to continue to hold loans on balance sheets and where to partner or distribute, based on capital treatment, investor appetite, liquidity considerations, the importance of asset ownership to the client relationship, and the overall economics.

After banks determine that partnership or distribution is the right model, they could determine the right transaction structure. This could include fund joint ventures or fully proprietary funds, multitrack syndication, more formal forward-flow agreements, secondary asset sales, and synthetic risk transfer trades. Banks could then revise origination, risk, and operational processes and incentives to accommodate these new transaction structures. Banks could also shift the emphasis of their traditional business model based on balance sheet lending to better weather the threat from new nonbank entrants. They could shift their lending mix to less directly threatened asset classes, such as lower-yielding but lower-risk loans, shorter-duration loans, and highly specialized lending for which nonbanks lack expertise. Banks could also selectively take defensive actions (such as repricing and offering to refinance direct lenders) in threatened asset classes for which they wish to continue to compete on balance sheets.

### Implications for insurers

As traditional insurers formulate their strategic posture within this new private credit ecosystem, they would do well to reexamine how to compete in the market. First, insurers could explore the capital, duration, and risk constraints that are affecting their current allocations to private credit and preventing them from reaching optimal allocation. They could also explore how to optimize the matching of assets and liabilities to the right ownership structures and jurisdictions. Differences across jurisdictions in regulatory capital charges for different asset classes and liability profiles—and the different needs of owned balance sheets, captive reinsurance (onshore or offshore) balance sheets (when available), and third-party reinsurance balance sheets—create the imperative for a more strategic look at capital allocation.

While making allocation decisions, insurers need to assess their conviction in the long-term demand of their general accounts for various subsectors within private credit (for example, consumer-asset-backed finance versus commercial and subasset classes within real estate). This will help them determine where to have long-term exposure. The size of potential deployment over the next three to five years, the duration and liability profiles, and the level of reputational risk and regulatory changes, among other factors, will play a part in the determination. Insurers would also do well to consider if they want to create privileged origination access to scarce, high-quality assets to capture some of the economics that the use of third-party-managed funds cedes. Forward-flow partnerships with banks or originators can be suitable for sectors for which industry participants have limited long-term-demand conviction but would still like to invest for diversification benefits. Direct origination might make more sense for sectors with more demand tailwinds that justify a greater resource commitment.

When insurers decide to participate directly in origination, they could maximize the value of that origination. This happens by syndicating excess commitments to other parties and by creating third-party-fund vehicles that drive additional capital-light earnings. Insurers could also benefit from continuing to invest in robust portfolio management and monitoring.

### Implications for asset managers

For asset managers that already have a foothold in one or more private credit verticals, the expanding footprint of the asset class presents an opportunity to extend their platforms into new asset classes and capital bases, some of which have the potential to be many times larger than the current market. For managers with fledgling or nonexistent private credit programs, establishing a presence in the market is likely to become increasingly important.

We expect leading managers over the next several years to pursue one or more of the following initiatives:

— establishing or acquiring origination and underwriting capabilities beyond sponsor-backed lending, including asset-backed finance, project finance, and real estate debt

— diversifying capital bases to include longer-duration or lower-return threshold capital pools, enabling broader participation across the risk-return spectrum

— driving scale across more and larger vehicles while also developing more sophisticated internal and external syndication capabilities to increase relevance to larger borrowers

— seeking accretive partnerships with other ecosystem players, including banks, insurers, and solution providers

— streamlining and consolidating middle- and back-office loan operation capabilities to enhance flexibility, profitability, and speed to market

— instituting reimagined operating models that reflect a convergence of financing and lending solutions across a full spectrum of credit strategies, fully merging private credit, insurance, and other distribution channels (for example, business development companies, interval funds, and wealth) into a more cohesive whole

The expanding footprint of private credit—and the associated migration of trillions of dollars of assets from bank to nonbank balance sheets—represents a significant opportunity for industry participants. While we believe that private credit is here to stay, careful monitoring of short-term risks is still necessary, particularly in the event of an economic downturn in which a range of loans may become stressed or distressed.

As the market grows, the regulatory paradigm in the industry will also evolve. The insights outlined in this article, along with the foundational tenets of credit investing, including clear investor communication, robust monitoring and workout capabilities, and underwriting discipline can help players succeed in this new private credit ecosystem.

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