CARLYLE

May 2024

2024 Credit Market Outlook

‘Never Let Me Go’: Competition and Opportunity in the Era of Bank Disintermediation

EXECUTIVE SUMMARY

- → Markets rebounded sharply following the November and December 2023 Fed meetings, as the risk of recession receded and rate cuts came into view. Loan and bond issuance set records through the first two months of the year, with credit spreads at their tightest levels since the onset of the pandemic.

- → Much of this activity involved bank-arranged refinancing of loans originated during the period when private credit's market share increased substantially relative to broadly syndicated loans. Bank disintermediation continues to gather pace, but new competitive fault lines have emerged. It is one thing to disintermediate loans from bank balance sheets. It's quite another to disintermediate the banks themselves from their most prized clients and customers.

- → As bank balance sheets become more constrained due to regulation and other factors, their lending decisions will become even more sensitized to relationship considerations, especially for large banks who derive a disproportionate share of their operating earnings from noninterest income. While this may constrain the growth (or expected returns) of direct lenders competing directly with banks for larger borrowers, it should create more opportunities virtually everywhere else, as private funds partner with banks to assume more of their assets in some areas and displace them entirely in many others.

Market narratives can be fickle things. A year ago, as the Fed was taking base rates to levels that were unimaginable just two years' prior (Figure I), market participants prepared for the recession most analysts thought was necessary to extirpate price pressures from the system. It was further assumed that once inflation returned to target, the Fed would swiftly take base rates back down to more "normal" levels, leaving longer-term discount rates largely unaffected. These broadly shared expectations produced a plunge in M&A activity and defensive market positioning, as investors awaited signs of the inevitable downturn and aggressive rate cuts that would soon follow.

The economy proved more resilient than expected. U.S. GDP growth accelerated in the period following the Fed's last rate hike, even as inflation waned. The new narrative, born in the wake of the November 2023 FOMC meeting, was that the risk of recession had dropped materially but the expected rate cuts would arrive just the same (Figure 2, page 4). This set the stage for a remarkable rally in asset prices and market liquidity conditions.

This has, in turn, led to a reconsideration of credit market narratives. A year ago, we warned of the "triumphalism" that characterized discussions of private credit's displacement of more traditional forms of finance. Banks have not only returned to the market in force in 2024, but much of their activity has been concentrated on refinancing borrowers out of the more expensive loans originated during the period when private credit was "the only game in town." A recalibration of expectations seems in order.

Bank disintermediation continues to gather pace, but new competitive fault lines have emerged. It is one thing to disintermediate loans from bank balance sheets. It's quite another to disintermediate the banks themselves from their most prized clients and customers. As more credit market assets inevitably gravitate from banks to private portfolios, expect banks to mount a more vigorous defense of the smaller, but more lucrative, remaining territories; willing to cede assets but not the relationships responsible for their most important income streams.

Figure 1.
Markets Priced 5.3% Base Rates as a 1-in-1 Million Event

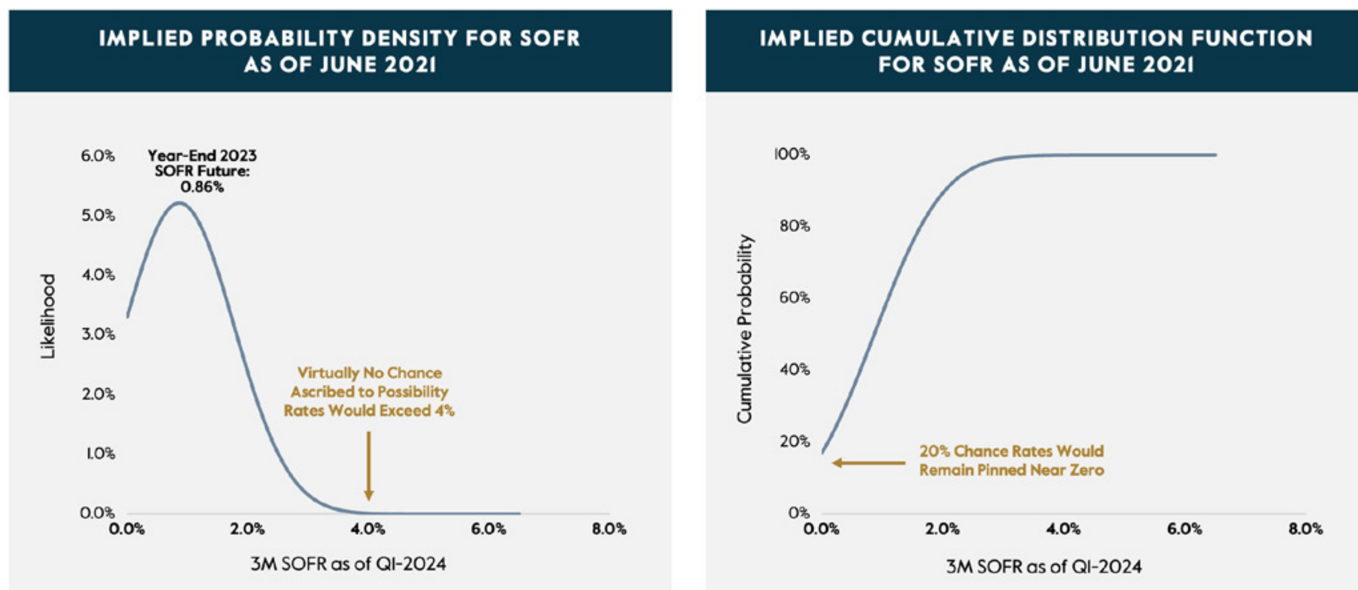
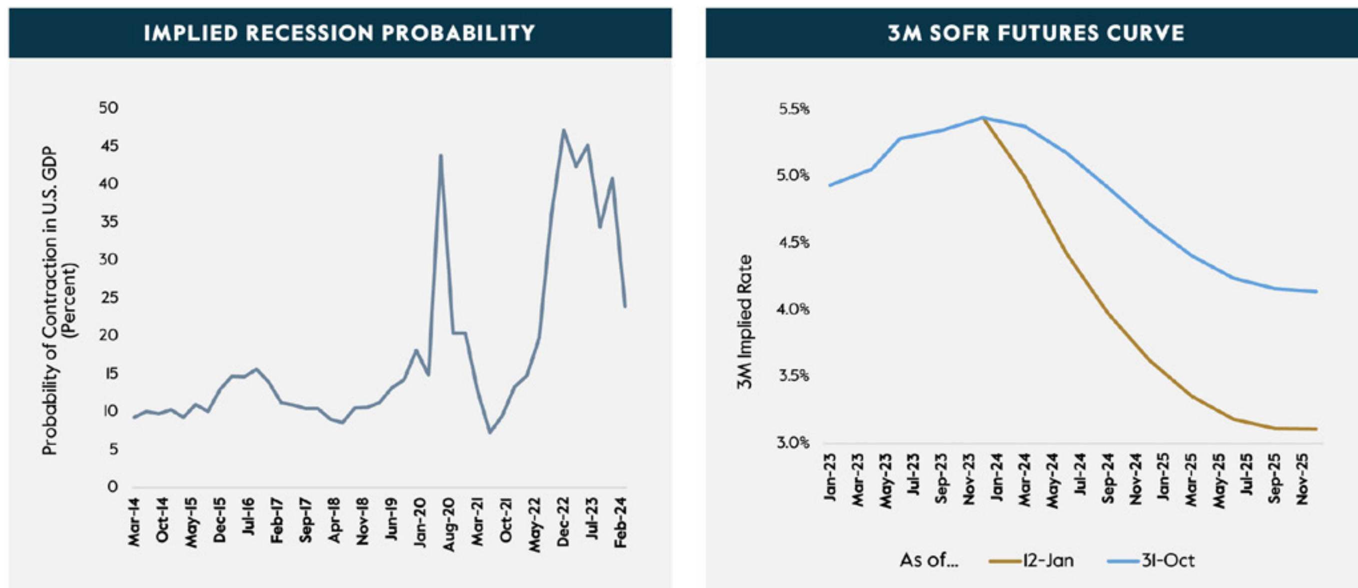


Figure I. Source: Carlyle Analysis of Federal Reserve Data, Bloomberg, November 2023. There is no guarantee any trends will continue.

Figure 2.
Simultaneous Drop in Recession Probabilities & Forward Interest Rates



A MARKET LOOKING MORE LIKE 2021 THAN 2022-23

The proximate spark for the recent rally in asset prices was the strongly hinted conclusion to the Fed's tightening cycle in November 2023, followed by the promise of rate cuts the following month. These announcements were premised on a rate of disinflation (at that time) that would have returned core inflation to the Fed's target by June 2024. Since then, the monthly rate of disinflation has more than halved, which would push the return of "price stability" out to the middle of next year. Futures markets have dialed back rate cut expectations, from nearly seven at the start of the year to just three now (Figure 3, page 5).

This retracement has done little to dent investor enthusiasm. The stock market is up by more than 25% since the Fed signaled base rates had peaked. And, unlike prior rallies, participation has been broad-based, with the 25% gain in the small cap Russell 2000 nearly matching the 30% rise in large-cap tech stocks. Bitcoin has nearly doubled. Meme coins are back in vogue. And credit markets have been red hot, with spreads at the tightest levels since the onset of the pandemic and bond and loan issuance at record levels through the first two months of the year (Figure 4, page 5).

Refinancing has been the main driver of 2024 issuance, accounting for more than 64% of leveraged loans and 88% of high-yield bonds (M&A accounted for a trivial share of year-to-date issuance, though one suspects that's likely to change meaningfully in the months ahead; Figure 5, page 6). And a non-trivial share of that refinancing involves borrowers opportunistically swapping out private credit in favor of cheaper syndicated loans. On average, private lenders charged 650 basis points over SOFR for loans extended in 2022 and 2023 (Figure 6, page 6). With markets wide open and spreads on bank-arranged first lien term loans averaging less 400bps, it's no surprise to see borrowers take advantage, even in cases that involve a 1% or 2% prepayment fee ("call protection").[1]

Figure 2. Source: Carlyle Analysis; FRBP Survey of Professional Forecasters, March 2024; ICE BAML Indices, Bloomberg, March 2024. There is no guarantee any trends will continue.
1. Pitchbook, Weekly Market Wrap, March 2024.

Figure 3.
Stickier Inflation Delays Return to Fed Target

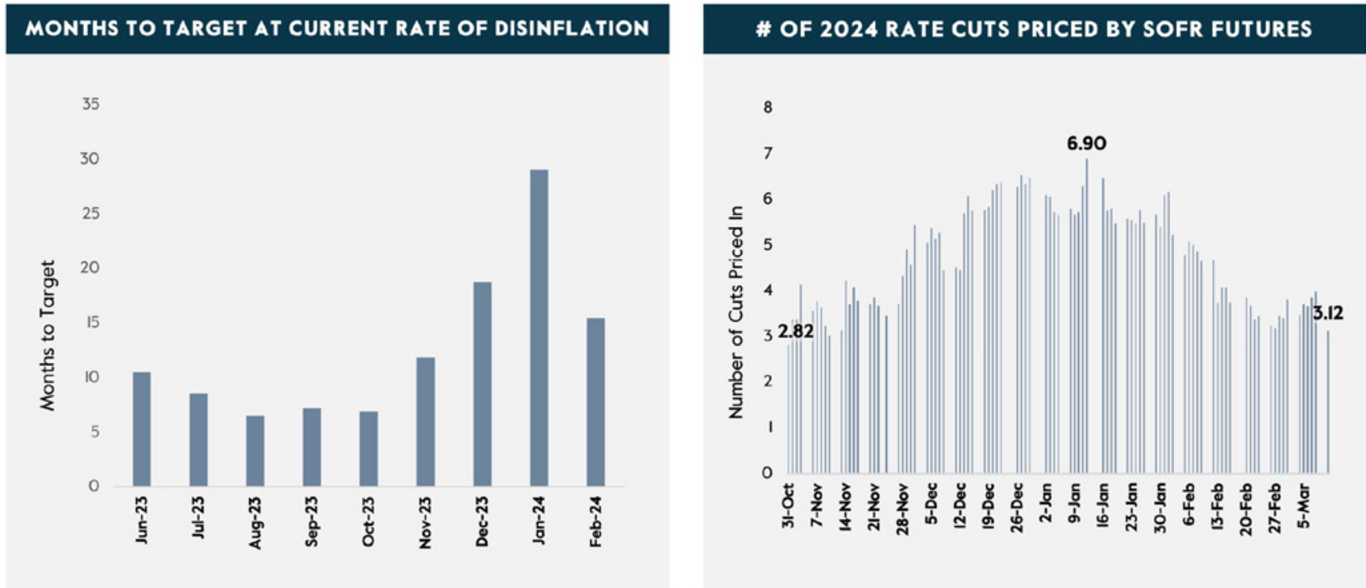


Figure 4.
Declining Risk Premia, Booming Issuance

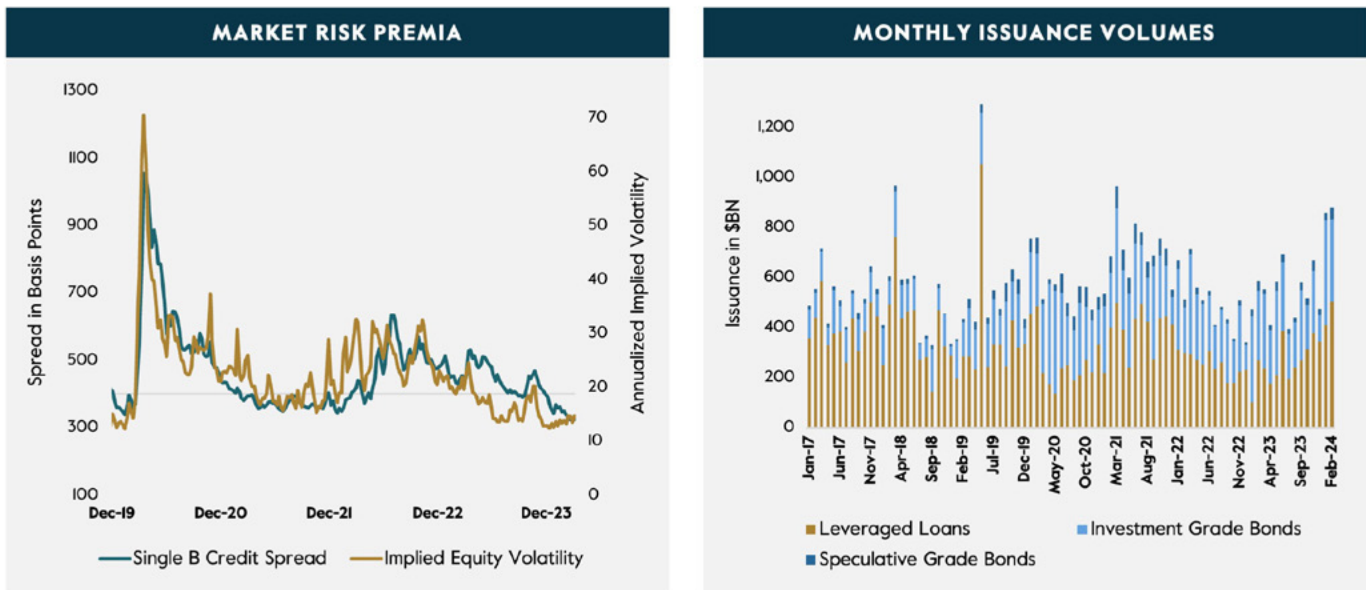


Figure 3. Source: Carlyle Analysis; Bloomberg, March 2024. There is no guarantee any trends will continue.
Figure 4. Source: Carlyle Analysis; Federal Reserve Board of Governors; Bloomberg, March 2024. There is no guarantee any trends will continue.

Figure 5.
Refinancing Main Driver of Issuance

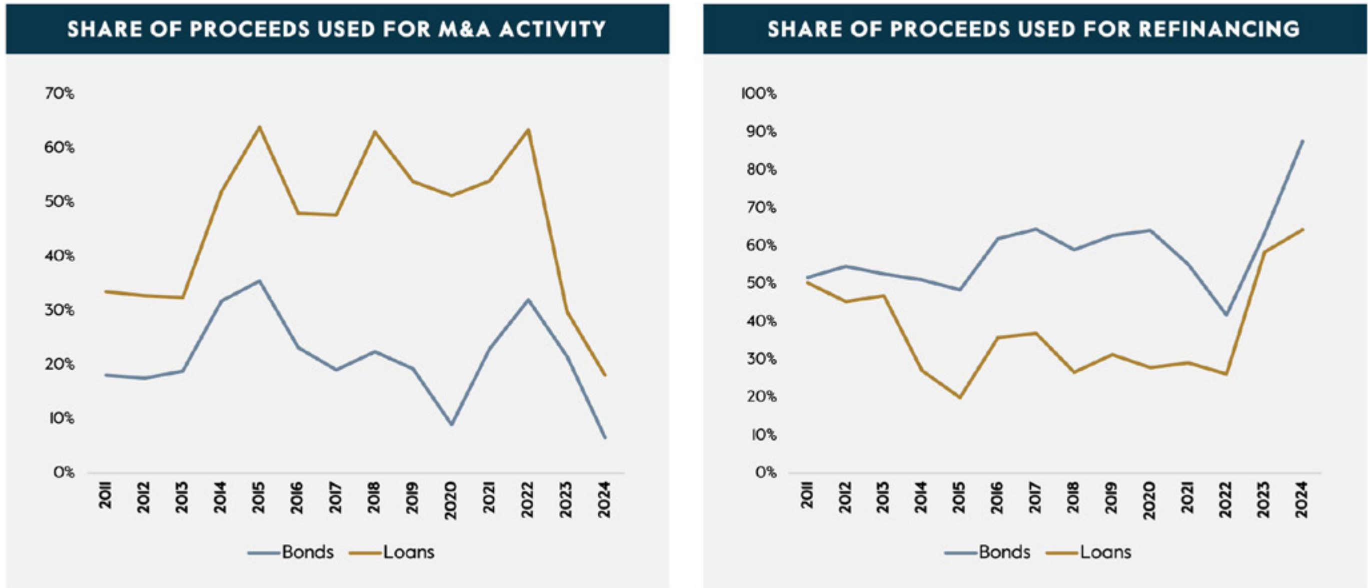


Figure 6.
Differences in Credit Spreads & Lending Activity

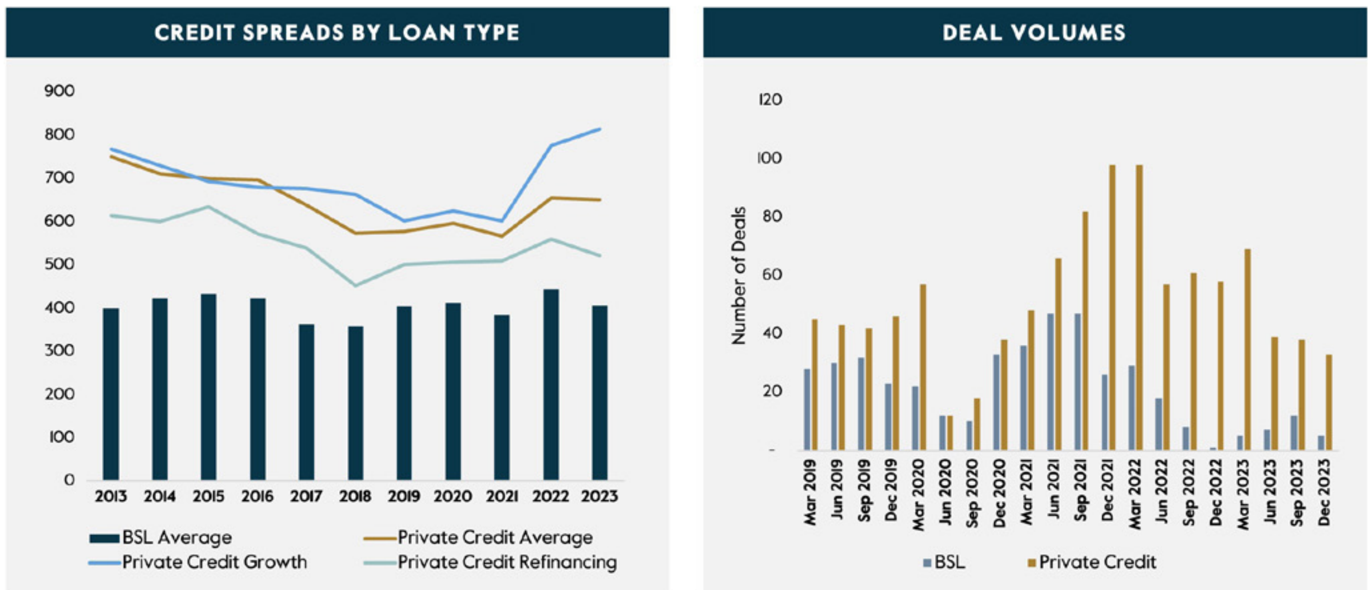


Figure 5. Source: Carlyle Analysis; BAML Credit Market Chartbook, March 2024. There is no guarantee any trends will continue.
Figure 6. Source: Carlyle Analysis; "The U.S. Syndicated Term Loan Market: Who holds what and when?" Fed Notes, November 2019; Pitchbook, LCD Database, March 2024. There is no guarantee any trends will continue.

DOES THIS MEAN BANK DISINTERMEDIATION WAS OVERHYPED?

We warned a year ago that banks had "willingly ceded ground," understandably uneasy about the economy, interest rates, warehousing risk, and increased regulatory scrutiny.[2] Prodigious as private credit's growth has been, it still amounts to just one-third of the credit market (Figure 7), insufficient in itself to meet M&A finance needs or broader corporate loan demand. Banks were always coming back at some point because of their central role as conduits to broader capital markets, and their return has certainly been welcomed by borrowers.

The recent shift in market realities serves more as a clarification rather than refutation of the "bank disintermediation" thesis. The traditional banking business – taking deposits from savers to extend loans to households and businesses – peaked in the mid-1970s and continues to atrophy.[3] Over the years, pressures have mounted on both sides of banks' balance sheet. Funds have become harder to attain – the share of household savings channeled into bank deposits has dropped by half – and more difficult to deploy, as new instruments and lenders emerged to offer credit on terms more tailored to borrowers' needs. At the end of 2023, banks accounted for roughly one-third of the credit owed by the U.S. corporate sector, and that share will almost certainly shrink in the years ahead (Figure 8, page 8).

The fissure cast in greater relief by private credit's dominance in 2022-23 was not between banks and loans, but between banks and their *customers*. Direct lenders disintermediate banks to an extent not observed in the case of investment funds that merely purchase loans or come into new commitments alongside banks; they not only deprive banks of assets and the associated yields, but also the underwriting fees and client relationships that allow banks to cross-sell other services for which much of their income depends.

Figure 7.
Credit Market Size by Instrument

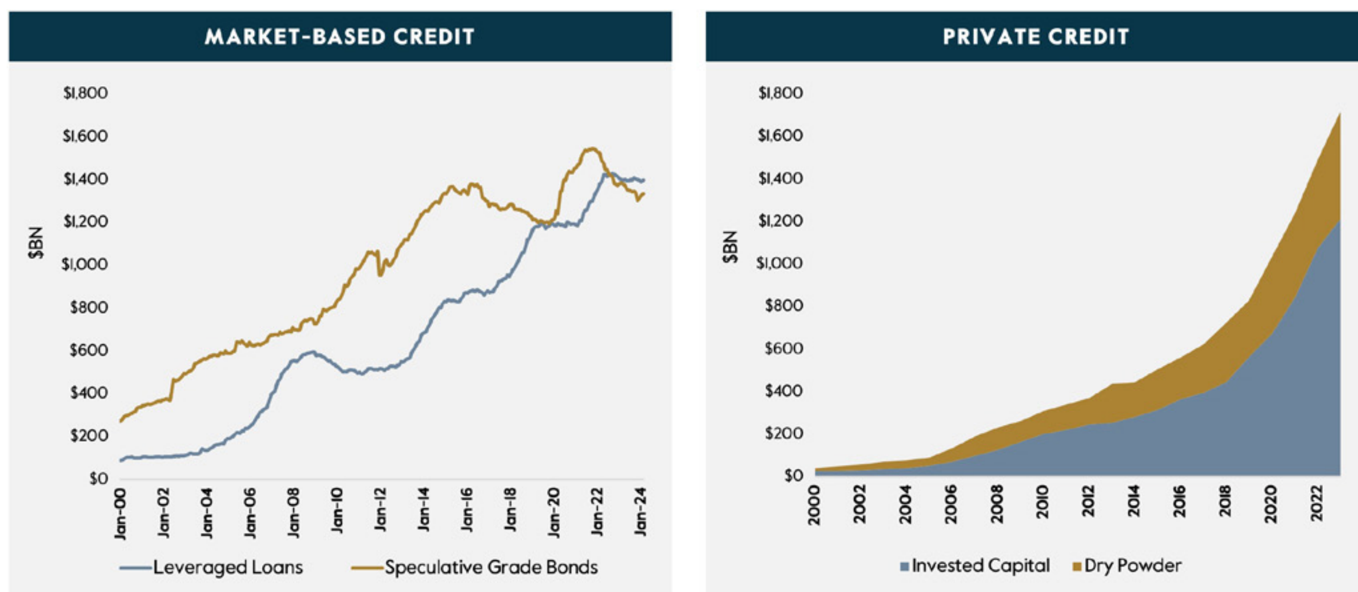
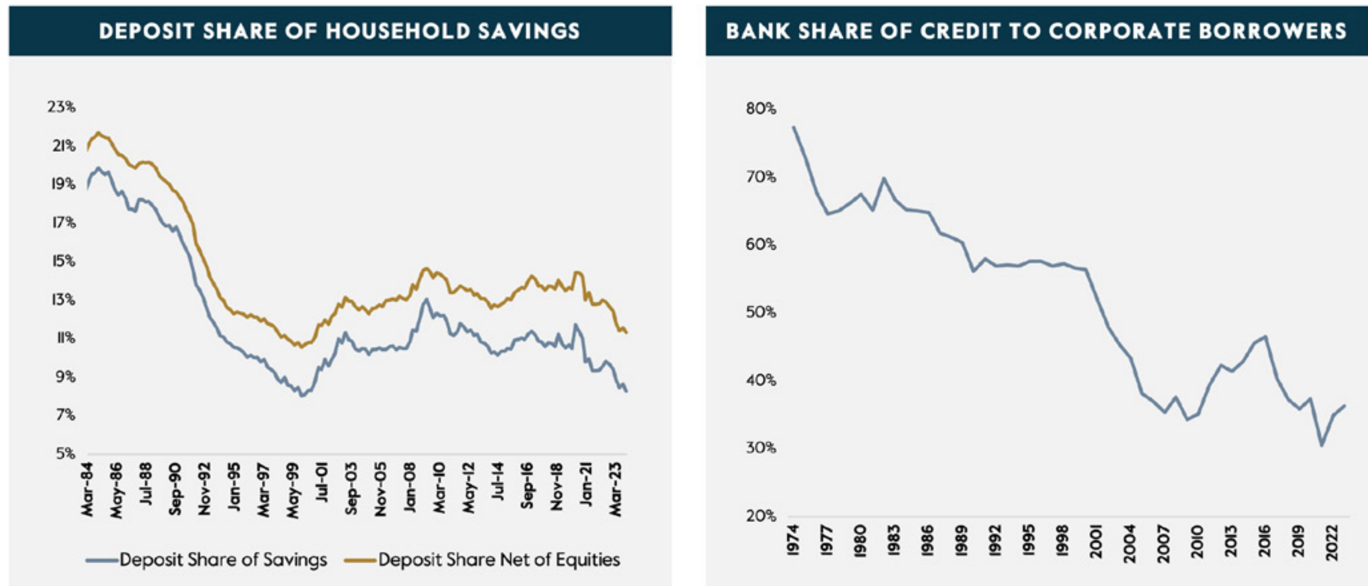


Figure 7. Source: Carlyle Analysis; BAML Credit Market Chartbook, March 2024; "Private Credit: Characteristics and Risks," Fed Notes, February 2024. There is no guarantee any trends will continue.
2. Thomas, J and M. Jenkins (2023), "New Landscapes, New Eyes," Carlyle, April 2023. https://www.carlyle.com/sites/default/files/2023-04/Carlyle-JT-2023-Credit-Whitepaper.pdf
3. FDIC (2019), Quarterly Banking Profile, Q3-2019. Pgs 31-50.

Figure 8.
Banks' Declining Role in Credit Intermediation



LEVERAGED LENDING AS "METERED" DISINTERMEDIATION

Leverage lending perhaps best clarifies this asset-client distinction. Originally conceived to allow one bank to offload credit risk onto others, syndicated lending became a mechanism for the banking sector as a whole to offload credit risk onto nonbanks. In 2000, banks accounted for about 20% of the primary purchases of leveraged term loans. By the onset of the pandemic, that figure had dropped to 3%.[4]

On average, the agent bank responsible for arranging committed credit for its client sells down its share of the term loan balance from 28% at the time of origination to just 1% three months later. Most of the loan ends up in the hands of Collateralized Loan Obligations (CLOs), which today serve as the ultimate home for about 70% of leveraged loans. The ability to distribute loans is key to their origination; CLO issuance explains over 80% of the variation in leveraged loan origination volumes over the past six years (Figure 9, page 9).

In other words, leveraged lending still represents disintermediation – the term loans end up on nonbank balance sheets – but it's of a sort that allows banks to garner underwriting fees, receipts from loan sales, and strengthen relationships with borrowers in ways that can lead to other value-added services, like interest rate and foreign exchange hedging, fiduciary and deposit services, transaction fees, loan sales, and other sources of noninterest income that waned markedly during the time of private credit's ascendence (Figure 10, page 9).

Figure 8. Source: Carlyle Analysis; Federal Reserve Board of Governors. There is no guarantee any trends will continue.
4. FDIC (2019). P. 35.

Figure 9.
Banks Serve as Market Conduits

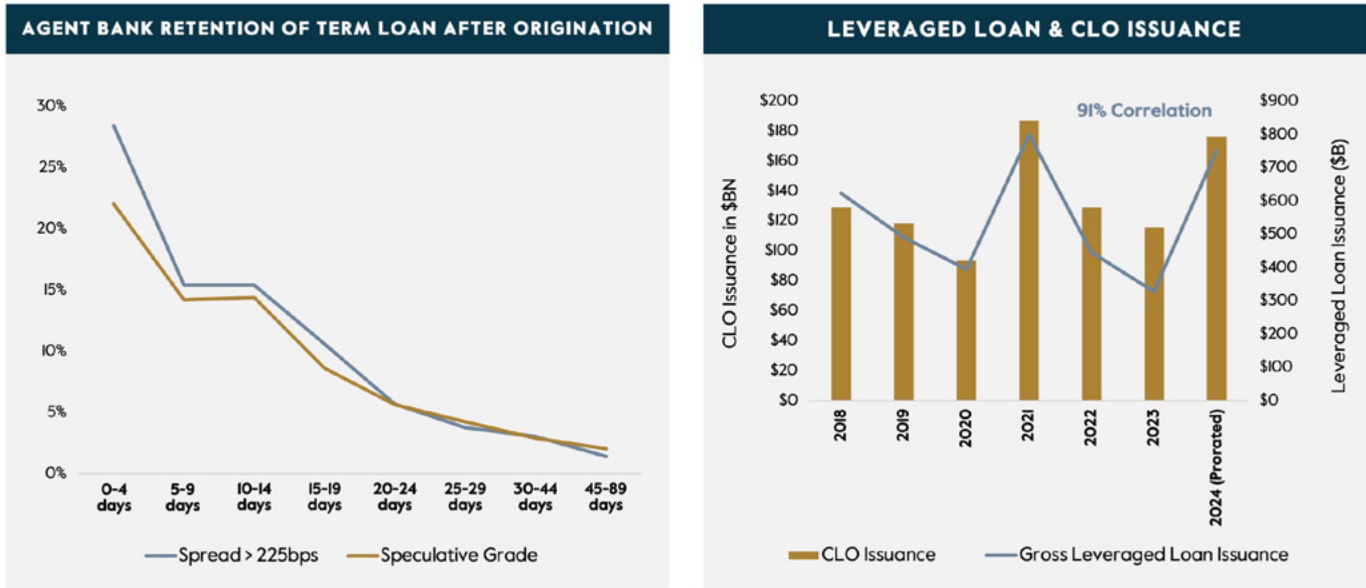


Figure 10.
Recent Trends in Banks' Operating Income

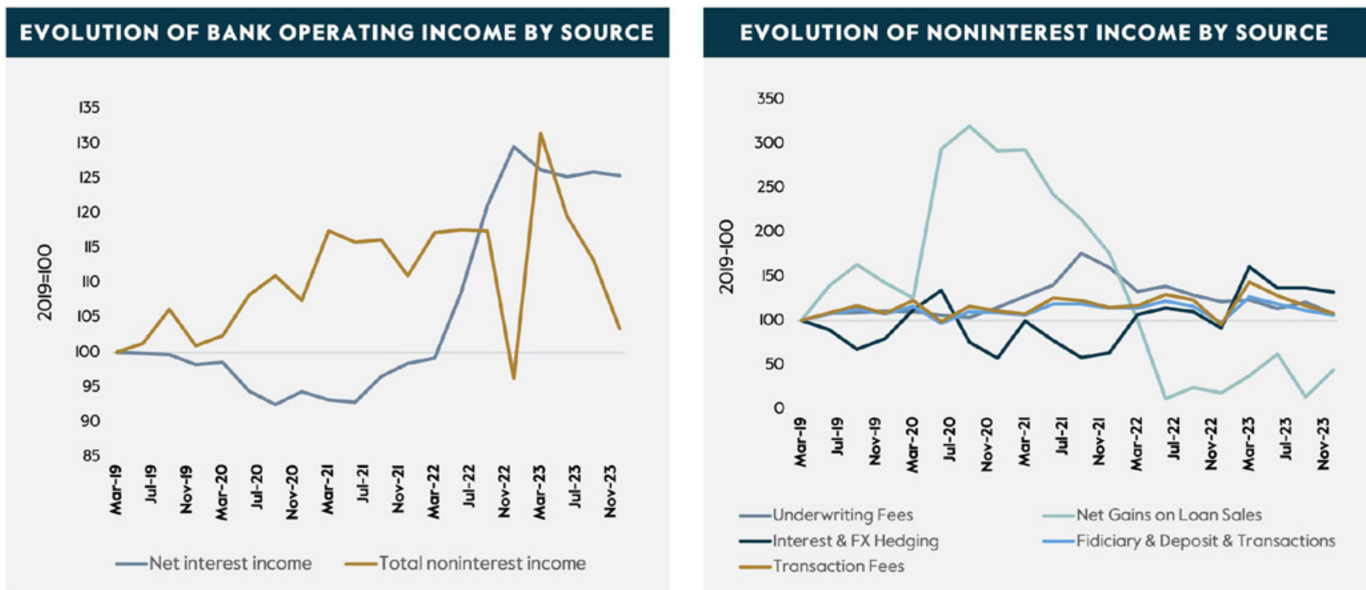


Figure 9. Source: Carlyle Analysis; "The U.S. Syndicated Term Loan Market: Who holds what and when?" Fed Notes, November 2019; Pitchbook, LCD Database, March 2024. There is no guarantee any trends will continue.
Figure 10. Source: Carlyle Analysis; Federal Deposit Insurance Corporation, March 2024. There is no guarantee any trends will continue.

RELATIONSHIPS DETERMINE WHAT ENDS UP ON BANK BALANCE SHEETS

Banks do hold a pro-rata tranche of leveraged loans on balance sheet, which typically consists of a revolving credit facility with tighter spreads and covenants. But this balance sheet capacity tends to be allocated strategically in service of high-value clients. This is evident when examining bank behavior during periods of market stress. When spreads widen (loan prices drop) and leveraged loans cannot be easily distributed to CLOs or other buyers, origination volumes tend to drop, often precipitously, but the pro-rata *share* of loan facilities intentionally retained by banks consistently rises at the same time (Figure 11).

These revolving credit facilities are obviously extended to bolster relationships. For further proof, consider the *inverse* relationship between spreads on newly-issued pro-rata tranches and spreads on secondary market credits (Figure 11). When credit markets froze at the onset of the pandemic in March 2020, leveraged loan issuance dropped by 65% relative to its trailing 12-month average. But the only reason issuance didn't drop 100% was because *all* of the leveraged loan originations that month came in the form of bank-retained revolving credit facilities.[5] And these loans were extended at an especially steep discount: the average spread on revolvers issued in March 2020 was 157bps, which was 220bps below the average spread on the same facilities from the prior month.[6]

Such behavior may appear uneconomic to credit investors focused solely on extending credit at terms that deliver high returns net of any default losses. But it merely reflects the extent to which the economics of banking strays from pure credit intermediation. The implied value of a client relationship to a bank is equal 11.6% of loan principal, on average.[7] And one suspects banks' credit allocation decisions will become even sensitized to the needs of high-value clients in the future, as regulation (Basel III Endgame), further constrains bank risk-taking and the share of balance sheets that can be allocated to capital-intensive loans (Figure 12, page 11).

Figure 11.
Pro-Rata Share of Loans Rises & Spreads Compress During Market Stress

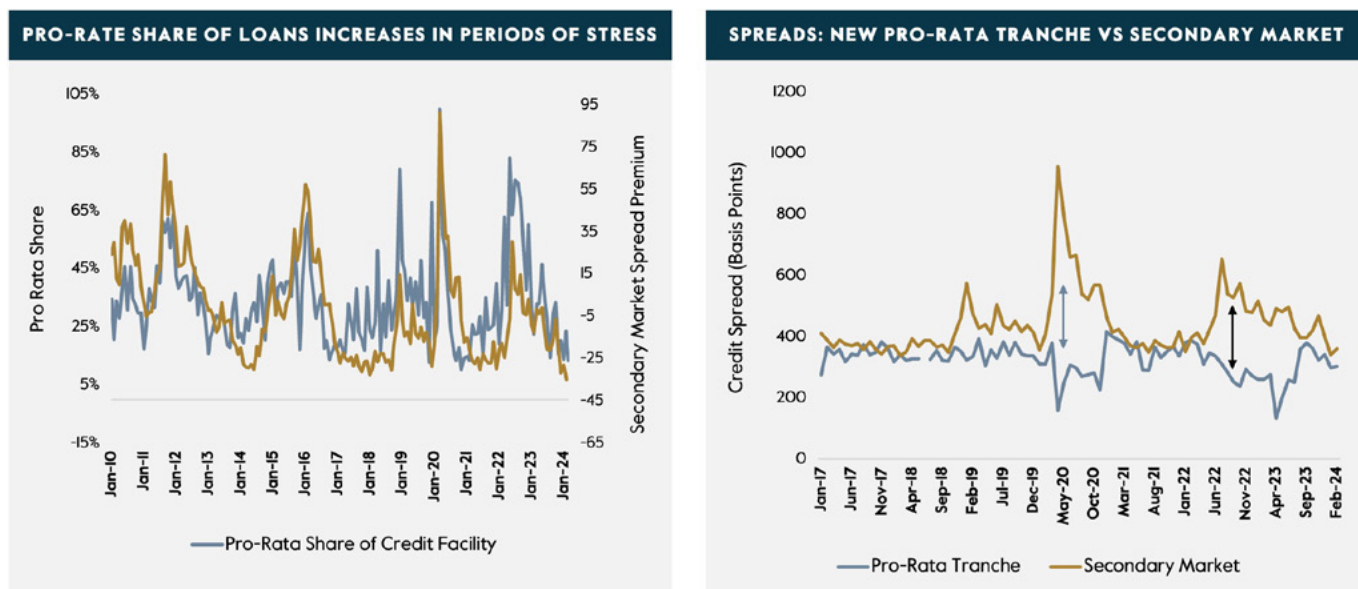
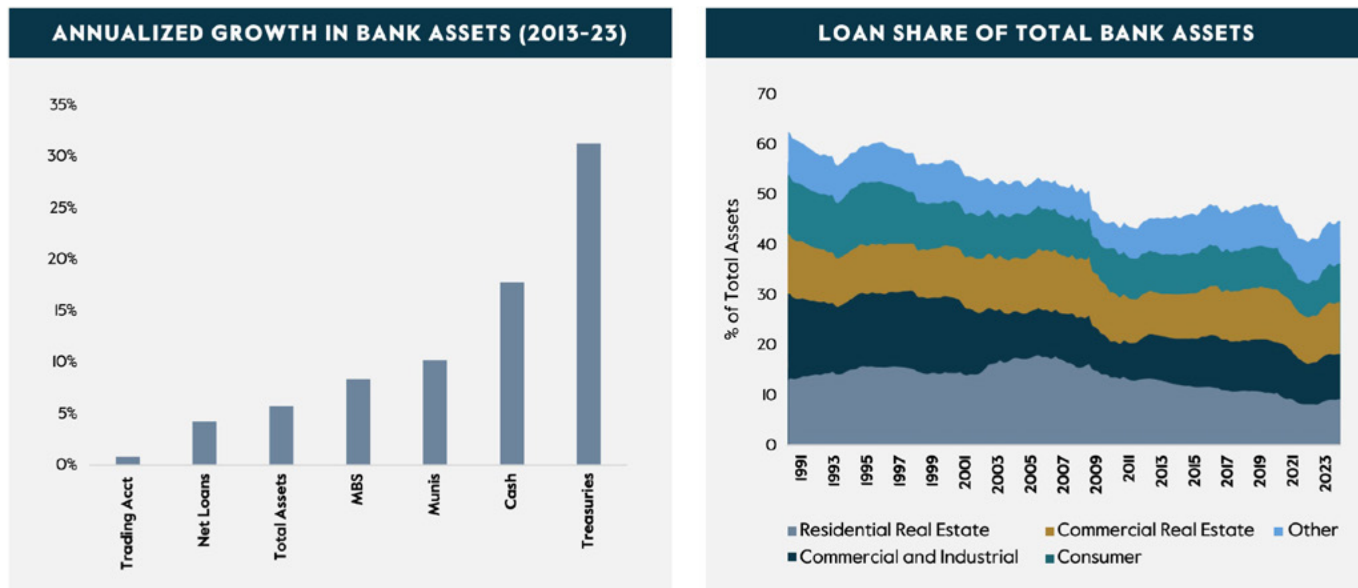


Figure 11. Source: Carlyle Analysis; Pitchbook, LCD Database, March 2024; Bloomberg, March 2024. There is no guarantee any trends will continue.
5. Pitchbook, LCD Database, Accessed March 2024.
6. While some of this inverse relationship could be explained by higher borrower quality during stressed periods (BB rather than B-rated credits, for instance), most of the gap looks like concessionary terms.
7. Ruchti, T. et al. (2024), "The Value of Lending Relationships," Office of Financial Research, U.S. Treasury.

Figure 12.
Change in Bank Balance Sheets Over Time



SIZE MATTERS

For private credit funds, with focused business models that do not take deposits or derive ancillary fees to the same extent as banks, recent developments represent both a warning and opportunity. Direct lenders whose scale pushes them to compete directly for banks' most prized clients may find themselves in a position akin to U.S. steelmakers in the 1960s and 70s: forced to sell their product at market prices (spreads, in this case) that seem to make no sense. But outside of this corner of the market, circumstances are likely to improve materially, as banks disgorge assets and more borrowers seek out alternative sources of credit.

Size matters, both in terms of the banks against which private lenders compete and the borrowers themselves. While all bank holding companies experienced a dip in noninterest income over the past two years, it is the largest banks that derive the greatest share of their operating income from fees and whose lending decisions are likely to be most sensitized to broader strategic calculation. And when looking solely at the largest bank holding companies, dependence on noninterest income appears bimodally distributed, with noninterest income accounting for between 35% and 50% of operating income for a quarter and between 75% and 90% for another fifth (Figure 13, page 12).

This suggests that the clients of a relatively small subset of especially large banks may be able to access credit on more favorable terms because of the fees they generate from potential IPOs, advisory work, acquisitions, and other related needs, including deposit and transaction services. It's impossible to know, analytically, which borrowers fit precisely into this bucket. One suspects that companies above an annual EBITDA threshold between $200 million to $400 million would be prime candidates for precisely the sorts of value-added services for which banks derive so much of their operating income, as would companies affiliated with large financial sponsors with deep and multifaceted banking relationships.

Figure 12. Source: Carlyle Analysis; Federal Deposit Insurance Corporation, March 2024; Federal Reserve Bank of New York, March 2024. There is no guarantee any trends will continue.

Ultimately, spreads on bank-arranged term loans are determined by conditions in the market in which they're distributed. And when added to base rates, the associated cash interest expense limits the leverage (debt/EBITDA) that a first lien loan can accommodate in the current environment. For many capital structures, an increase in bank-intermediated lending necessitates corresponding growth in junior capital. In these cases, private capital will still be central to the transaction, but instead of "unitranche" loans from direct lenders, such participation will come in the form of higher-yielding second liens and preferred securities. This dynamic is a return of sorts to the symbiotic relationship between broadly syndicated and private markets that existed just prior to the pandemic.

Below the $200 million to $400 million annual EBITDA threshold, competition for private lenders is likely to involve more commercially-oriented large banks and regional banks with less fee income to cross-subsidize lending and whose main relationship-based motivation is retaining deposits – which private lenders do not threaten.

The aforementioned trends in balance sheet composition (Figure 12, page 11) should weaken banks' competitive position in this portion of the market. Bank holdings of duration-sensitive Treasuries and mortgage-backed securities (MBS) skyrocketed in the period preceding the rise in interest rates – partly due to regulation – leading to catastrophic fair value losses that have not been recognized for regulatory purposes but reduce earnings capacity and economic capital just the same (Figure 14, page 13). And while the bank share of most types of loans has dropped meaningfully over the years, their share of mortgages collateralized by commercial real estate has remained roughly constant, equal to more than half the market.[8] Given the potential fall-out in the office sector, where the "structural" vacancy rate is nearly 50% due to work-from-home trends,[9] many banks may need to jealously guard capital that they might otherwise have been able to commit to new loans.

Figure 13.
Dispersion in Noninterest Share of Bank Operating Income

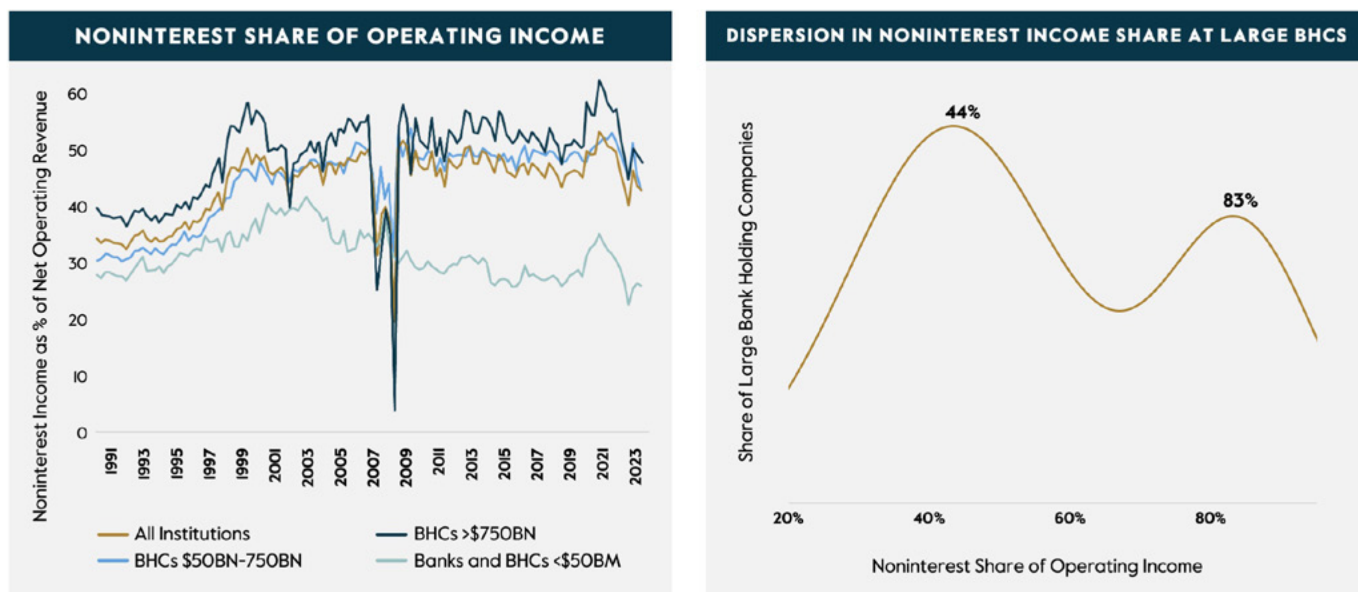
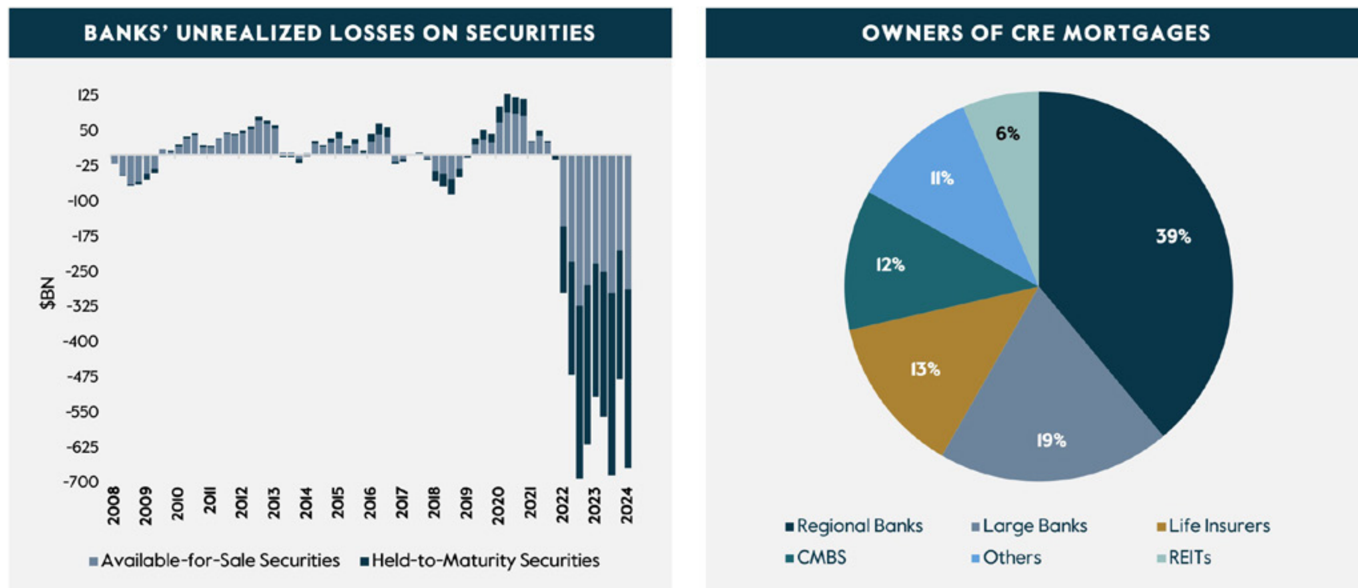


Figure 13. Source: Carlyle Analysis; Federal Reserve Bank of New York, March 2024; S&P Global, June 2022. There is no guarantee any trends will continue.
8. FDIC (2019). P. 33.
9. Doolittle, T. and A. Fliegelman (2023), "Work-from-Home and the Future Consolidation of the U.S. Commercial Real Estate Office Sector: The Decline of Regional Malls May Provide Insight," Office of Financial Research, U.S. Treasury.

Figure 14.
Bank Capital Hit by Bond Losses, Office Exposure



CONCLUSION

Narratives surrounding the disintermediation of banks have not flipped but become more nuanced. The share of total credit market assets on bank balance sheets has dropped materially over the past 50 years and this trend seems certain to continue. As bank balance sheets become more constrained, their lending decisions will become more sensitized to relationship considerations, especially for large banks who derive a disproportionate share of their operating earnings from M&A and IPO underwriting, advisory work, transaction services, and other fees. While direct lenders aspiring to enter this territory may find themselves at a competitive disadvantage, the actionable opportunity set is likely to expand for private lenders in *virtually every other direction.* Appreciation for the asset-client distinction and broader competitive dynamics may be the key to assembling the best-performing credit portfolios in the years ahead.

Figure 14. Source: Carlyle Analysis; Federal Deposit Insurance Corporation, March 2024; Federal Reserve Board of Governors, March 2024. There is no guarantee any trends will continue.

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Prior to joining Carlyle, Mr. Jenkins was a Senior Managing Director at CPPIB and responsible for leading CPPIB's Global Private Investment group. He was Chair of the Credit Investment Committee, Chair of the Private Investments Committee and also managed the portfolio value creation group. While at CPPIB, Mr. Jenkins founded CPPIB Credit Investments, which is a multi-strategy platform making direct principal credit investments. He also led CPPIB's acquisition and oversight of Antares Capital and the subsequent expansion in middle market lending. Prior to CPPIB, he was Managing Director, Co-Head of Leveraged Finance Origination and Execution for Barclays Capital in New York. Before Barclays, Mr. Jenkins worked for 11 years at Goldman Sachs & Co. in senior positions within the Fixed Income and Financing groups in New York.

Mr. Jenkins earned a B.Comm degree from Queen's University. He served on the boards of Wilton Re, Teine Energy, Antares Capital and Merchant Capital Solutions.

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