Financial Stability Reports Explore Private Credit

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Private credit has grown markedly in recent years and now collectively maintains over $1.7 trillion in assets under management. This development has recently caught the attention of the Federal Reserve (2023) and International Monetary Fund (2024) in their roles as financial stability overseers. After describing the private credit market, this post summarizes the analyses and conclusions presented in recent financial stability reports prepared by the two agencies, as well as the initial regulatory steps being taken to assess potential concerns.

Background

Data from Preqin indicates that private credit assets under management (invested and uninvested) exceeded $1.7 trillion as of year-end 2023, an increase of 137% since 2018. In the U.S., most of this intermediation activity is conducted by private credit funds and business development companies (BDCs).[1] Both types of investment vehicles are typically structured as closed-end funds with a capital call option, long-term capital lockups, and a fixed lifespan. Private credit funds do not typically use debt financing, although leverage is a standard feature of BDCs and is permissible up to 50% of total assets. Private credit funds are limited to institutional investors (often pension funds and insurance companies) and high net worth individuals, while BDCs are open to the full range of investors.

Cai and Harque (2024) use data from Pitchbook to characterize the nature of lending by private credit funds and BDCs over the past decade. The authors find that borrowers are typically middle-market companies (i.e., those with $10 million to $1 billion in total revenues), which use the loan proceeds for working capital, private equity buyouts, and refinancing of existing debt. The loans are generally senior secured liabilities with floating rates and an average maturity of five years. The nonprice terms of private

[1] BDCs are investment companies created pursuant to the Small Business Investment Incentive Act of 1980 that are required to target at least 70% of their investment to private companies or public firms with equity values below $250 million. BDCs are pass-through entities for tax purposes that are required to payout at least 90% of their income as dividends, which are then taxed as ordinary income by their shareholders.

credit, including covenants, are often negotiated and can be tailored to meet the circumstances of the borrower and needs of the lender. Private credit borrowers tend to be observably riskier, which coupled with the flexible loan contract terms, results in private credit borrowers paying higher interest rates than observed in other corporate lending market segments.

In terms of performance, Cai and Harque (2024) find that private credit loans have lower default rates than substitute markets, such as high yield bonds and leveraged loans, which likely reflects greater workout flexibility. However, these loans also have higher loss given default (i.e., lower recovery rates), which the authors attribute to the popularity of private credit with sectors like financial services and healthcare which have fewer collateralizable or tangible assets.

Block et. al (2023) present survey data from the general partners of private credit funds in the U.S. and Europe that indicates that they lend to firms that banks would not. Consistent with this, some recent academic research suggests that the growth in nonbank lending to middle-market firms is directly related to tighter post-crisis bank regulations that created a pool of underserved borrowers. Chernenko, Erel, and Prilmeier (2022) study loans to publicly traded middle market firms and find that nonbanks are much likelier to lend to the riskiest borrowers as measured in terms of earnings and interest coverage, a propensity that increased following 2013 bank regulatory guidance on leveraged lending.[2] Davydiuk, Marchuk, and Rosen (2024) examine investment-level data for BDCs and find that it increased in geographic areas more exposed to regulation-related bank credit supply shocks (the introduction of the Federal Reserve's stress testing program and changes to accounting rules related to the consolidation of variable interest entities).

While these studies help to explain the emergence of private credit a decade ago, the rapid growth of this market segment is more recent. Chernenko, Ialenti, and Scharfstein (2024) suggest that it may be more profitable for banks to lend to BDCs rather than to middle-market firms directly for two reasons. First, such lending is typically in the form of warehouse lending to securitization special purpose entities, which provides more favorable regulatory capital treatment than loans to corporate entities. Second, by lending to a nonbank intermediary rather than many individual firms, a bank can substantially reduce its fixed

[2] See: <https://www.federalreserve.gov/supervisionreg/srletters/sr1303a1.pdf>.

costs of loan origination and servicing. Beyond competition with banks, Degerli and Monin (2024) show that as private credit has expanded, the outstanding stock of leveraged loans and high-yield bonds has remained relatively flat. This suggests that there has been some substitution across products by riskier middle market firms.

Federal Reserve: Financial Stability Risks from Private Credit Funds Appear Limited

The Federal Reserve's May 2023 Financial Stability Report includes a "box" that evaluates financial stability risks posed by private credit funds through the lens of its standard financial stability assessment framework.[3,4] The analysis is based on data from the Securities and Exchange Commission's Form PF and focused on the use of financial leverage and liquidity transformation by these investment vehicles.[5]

The Federal Reserve finds that most private credit funds are unlevered, although some use modest amounts of financial or synthetic leverage provided by banks. Thus, the risk to bank lenders is viewed as moderate given the scale of borrowing and its secured nature. The agency also points out that private credit funds closed-end structure and long-term capital lockups imply that these intermediaries engage in limited liquidity and maturity transformation. However, the discussion does note that private credit funds can pose liquidity demands on their investors through capital calls that could be met by liquidating other assets.

Given the limited use of financial leverage and liquidity transformation, the Federal Reserve concludes that the financial stability vulnerabilities posed by private credit funds appear to be limited. The report cautions, however, that this sector "remains opaque and that it is difficult to assess the default risk in private credit portfolios."

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[3] The report is available at: <https://www.federalreserve.gov/publications/files/financial-stability-report-20230508.pdf>.

[4] The framework regularly monitors four broad sets of vulnerabilities to the financial system that could amplify shocks: (1) household and business leverage, (2) financial institution leverage, (3) the extent of maturity and liquidity transformation in the system, and (4) asset valuations.

[5] The analysis required isolating private credit funds in the Form PF data from other reporters, including BDCs, collateralized loan obligations, and collateralized debt obligations.

International Monetary Fund Calls for More Intrusive Oversight of Private Credit

The International Monetary Fund's (IMF's) April 2024 Financial Stability report includes a chapter devoted to the "Rise and Risks of Private Credit".[6] The analysis focuses on risks arising from borrowers, liquidity mismatches, leverage, asset valuations, and interconnectedness. The IMF identifies a host of potential vulnerabilities associated with private credit funds and calls for a "more intrusive supervisory and regulatory approach" and new data collections relating to these entities, their investors, and leverage providers.

The IMF is concerned that private credit loans to risky corporate borrowers would result in elevated default rates during a recession (especially one coupled with inflation and high interest rates) and result in investor losses. While almost certainly correct, the risk of loss is priced into loans at origination (reflecting expected losses and a return on equity for unexpected losses). More important is whether and how losses to private credit investors would transmit to the broader financial system.

The IMF discusses the opacity of private credit loans and their valuations in the event of a recession. Two possible issues are raised by the agency, although no connections are made to financial stability. The first is that leveraged end-investors and their regulators may be caught unaware of mounting risk as disclosed loan values based on models may be slow to adjust downward. While this could happen, the risk is understood as a feature of private credit investment. The second seems to be about the distribution of losses for semi-liquid funds. The IMF suggests that informed investors may have a first-mover advantage in exiting their positions due to stale valuations and irregular appraisals of fund assets. This is unlikely to be an issue for private credit funds, which have lockup provisions and are limited to institutional investors, although BDCs have some retail investment and limited redemption options.

A natural place to look for financial stability risks emanating from private credit is fund leverage. Bank lending to funds often have loan-to-value triggers, which could trigger collateral calls during times of stress. However, as mentioned above, private credit funds are typically unlevered and BDCs have low

[6] The report is available at: <https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024>.

leverage. This suggests that fund losses during an economic downturn is unlikely to flow back to banks in a material way. Nonetheless, the IMF has some residual concern that bank lending to private credit may be concentrated in a handful of institutions.

The IMF recognizes that the structure of private credit funds is designed to minimize liquidity and maturity transformation risk through long-term lockups and other structural constraints. However, the agency notes that liquidity stress could arise from revolving credit facilities often provided to borrowing firms. The risk is that the firms could simultaneously and unexpectedly draw on the facilities in a downturn, which would suddenly increase private credit funds' need for cash. Such liquidity demands could be transmitted to fund investors through a call on their committed capital that results in significant selling of liquid assets that, in turn, disrupts markets more broadly.

Overall, the IMF says that the "immediate financial stability risks from private credit appear to be limited," but expresses concern that the "rapid growth of this opaque and highly interconnected segment of the financial system could heighten financial vulnerabilities given its limited oversight."

Regulatory Agencies Seek Additional Data

While the two financial stability reports do not identify any immediate concerns posed by the growth of private credit, both cite limited data availability as hindering their assessment. U.S. federal banking agencies have subsequently sought additional insight into the role of banks in the private credit ecosystem.

In May 2024, U.S federal banking regulators finalized new reporting requirements for bank loans and commitments to nonbank financial institutions.[7] These entries will be added to the consolidated reports of income and condition ("call reports") and apply to all insured depository institutions with more than $10 billion in assets and take effect for the 2024:Q4 reporting cycle. While aggregate exposure to nonbanks has been reported since 2010, the new disclosure will break this down by institution type: (1) mortgage credit intermediaries, (2) business credit intermediaries; (3) private equity funds; (4) consumer

[7] The final rule can be found at: <https://www.govinfo.gov/content/pkg/FR-2024-05-22/pdf/2024-11221.pdf>.

credit intermediaries, and (5) other nonbank institutions. Bank lending to private credit funds and BDCs would be considered obligations of "business credit intermediaries."

In June 2024, the Federal Reserve proposed revisions to its stress testing-related data reporting requirements for subject banking organizations.[8,9] The proposal includes, among other things, updates to loan-level data collections for wholesale lending exposures. This includes loans and loan commitments to nonbanks, including private credit funds and BDCs. The stated motivation for the proposal is that bank lending to non-bank financial institutions has grown rapidly and that current reporting of the financial condition of these obligors has been lacking relative to that for other corporate borrowers. Consistent with the recent call report changes, the Federal Reserve is also asking for information about the type of nonbank borrower. The proposal would also require covered banks to provide information about financial sponsors, collateral types and values, and covenants and any related breaches.

Closing

The private credit market has expanded significantly in recent years. Recent analysis provided by the Federal Reserve and IMF generally found that financial stability risks emanating from this sector are currently low, while identifying data gaps. In response, the Federal Reserve is asking large banks subject to stress testing to provide additional data on their lending to nonbank financial institutions. Future research exploring this data should further enlighten policymakers and the public about the risks of private credit.

[8] The proposed rule can be found at: <https://www.federalregister.gov/documents/2024/06/21/2024-13798/proposed-agency-information-collection-activities-comment-request>.

[9] Bank holding companies, savings and loan holding companies, and intermediate holding companies with $100 billion or more in total consolidated assets are subject to stress testing and related capital requirements. However, those institutions with total consolidated assets above the threshold but below $250 billion participate in the stress in even years (i.e., bi-annually).

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