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PRIVATE CREDIT – THE DE-BANKING OF LENDING

Security through stability.

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Private credit – the de-banking of lending

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- *Nonbank lenders are increasingly providing loans directly to companies. This type of nonbank lending is referred to as private credit. Private credit has been the fastest growing segment in alternative markets and credit markets in the past years. This rapid growth has the potential to significantly affect financial intermediation, the corporate landscape and the economy as a whole.*
- *The private credit market is dominated by private equity firms and large asset managers. The main investors in private credit are institutional investors such as pension funds, insurance companies, endowment funds, foundations and sovereign wealth funds.*
- *Private credit has typically been offered to mid-market companies with an above-average risk profile. In the past few years, average deal sizes have increased, and private credit now also serves as a substitute for syndicated loans.*
- *The private credit market is currently worth USD 1.7 trillion and rapidly gaining market share. After 2008, the market grew significantly as banks – also driven by stricter post-crisis regulation – became more risk averse, and private credit funds filled the gap for loan demand. Another boost for the private credit market came from the low interest rate environment and the search for yield by investors. Finally, in the recent rate hike cycle, private credit funds started buying loan portfolios from banks.*
- *From the borrowers' perspective, private credit offers highly flexible credit terms, fast execution and a high level of confidentiality with regard to financial information. Borrowers are willing to pay a significant premium, which is typically in the range of 2–3 percentage points above that in a traditional loan. From the investors' perspective, private credit has provided high returns and outperformed most other asset classes (even after adjusting for risk) in the past few years.*
- *Private credit is seen as a threat to the traditional business model of banks, especially as private credit funds are less regulated. This allows them to provide financing in a faster, flexible and less bureaucratic way, thereby earning a significant spread. Another competitive advantage of private credit funds is that they are not subject to restrictions on holding both equity and debt in a company.*
- *Banks are exposed to the private credit industry by providing funding to various players on the market (private credit funds, asset managers and investors) and by acting as counterparties for foreign currency (FX) and/or interest rate risk (IR) hedges.*
- *The lack of transparency in private credit reduces the information about firms or even entire industries; they are shielded from the discipline and scrutiny provided by markets and the public. This could lead to a misallocation of capital. While publicly traded debt instruments provide early warning signals when companies suffer financial stress, this is not the case for private credit. This may lead to sudden, unexpected shocks, as financial distress only becomes publicly visible when firms go bankrupt.*
- *Another critical issue is systemic risk. Large investment funds and asset managers are dominating the private credit market and might become even larger, owning large parts of both the equity and debt of companies. This further raises questions with regard to the market power of large asset managers.*
- *Furthermore, private credit funds might be reluctant to take – avoid or postpone the recognition of – credit losses ("zombification"). On the one hand, unlike banks, private credit funds are not subject to strict provisioning rules, on the other hand, private equity investors in a company are often willing to inject capital.*

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- *From a supervisor's perspective, the links and interconnectedness between the private credit market and the banking sector should be analyzed and closely monitored to identify potential risks and spillover effects. As a first step, the data quality must be improved to allow an informed debate about the inherent risks and opportunities of private credit and the respective exposure of banks.*

1 Private credit – an overview

In recent years, nonbank lenders have been increasingly providing loans directly to companies. This type of nonbank lending is referred to as private credit. Private credit, therefore, can simply be defined as debt financing provided by nonbanks and without intermediation by banks. It can be seen as a third way of debt financing in addition to traditional bank loans and publicly traded debt (bonds).

While alternative markets such as private equity have been extensively studied by scholars and market analysts, research on the impact of private credit is rather scarce. This is also due to limited data availability.

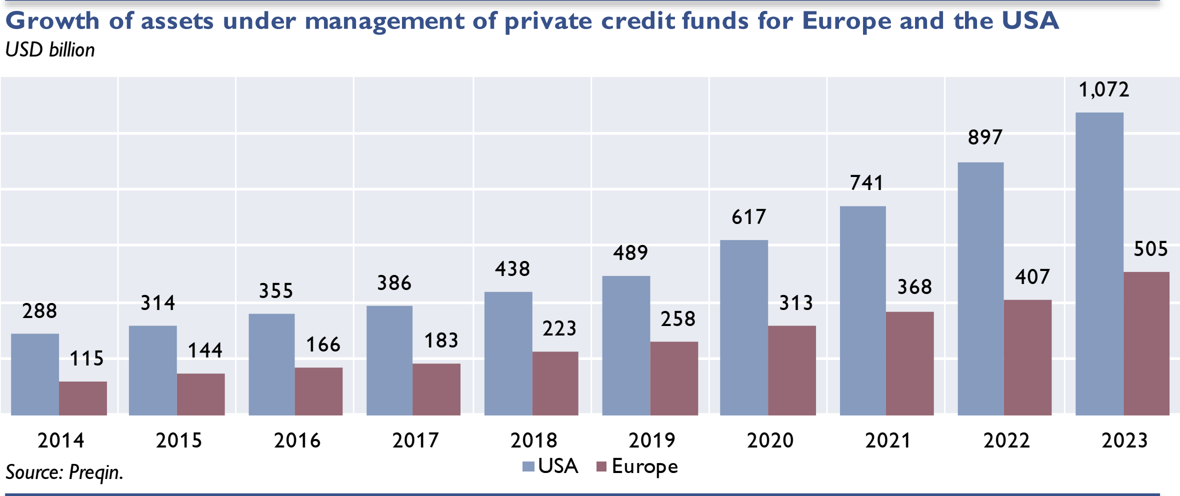
1.1 The rise of private credit

Private credit has been the fastest growing segment in alternative markets and the fastest growing credit market segment in the past few years. Companies – especially in the USA – are increasingly borrowing from private credit funds. Recent research suggests that the rapid growth of the private credit market has the potential to significantly alter financial intermediation, the corporate landscape and the economy as a whole (Ellias and de Fontenay, 2024). It is expected that the structural shift from bank-intermediated finance to private credit will transform corporate finance, firm behavior and economic activity.

Assets under management of private credit funds located in the USA grew at an average annual rate of 20% over the past five years, and private credit accounts for more than 7% of all loans granted to nonfinancial corporations. The private credit market in the USA has reached the size of the syndicated loan and high-yield bond markets. In Europe, the private credit market is smaller but also grew rapidly at an average annual rate of 17% (IMF, 2024).

Chart 1 shows the growth in assets under management of private credit funds in the USA and Europe between 2014 and 2023.

Chart 1



Market analysts and researchers expect the private credit market to further gain market share in the coming years. Blair Jacobson, a senior manager of Ares Management (one of the leading alternative investment managers), even expects private credit funds to become the "new banks."[2] However, there are also prominent voices, such as UBS chair Colm Kelleher, warning that a credit bubble is forming in the private credit market.[3] Analysts are worried that the private credit market is under-regulated (especially compared to the heavily regulated banking industry), lacks transparency and thereby disguises material risks.

1.2 Characteristics of the private credit market

The typical private credit structure involves a private credit fund collecting capital from institutional investors and lending directly to companies. The private credit borrowers are usually mid-market companies with an above-average risk profile, high levels of leverage and an often volatile or short cash flow history.

Private credit funds are usually structured as closed-end funds, and investors cannot withdraw capital during the initial lockup period, which is typically three to four years.

The interest rate on private credit is almost always floating and linked to an interbank rate. Therefore, yields increased significantly in the recent rate hike cycle, leading to high returns for private credit investors. Of course, higher interest rates correspond to a higher default risk for the borrower, and there is a critical trade-off between short-term profits due to higher interest payments and long-term credit risk due to increased borrowing costs. Despite higher funding costs, defaults in the private credit market have been only moderate so far. One reason might be the relatively high flexibility of private credit with regard to loan restructurings and forbearance measures – this will be discussed in more detail later.

When multiple private credit funds join together to fund particularly large transactions, this is called "club deal." Typically, however, private credit is granted by sole lenders, meaning that loans are not syndicated. A key feature of private credit is that the original lender (the private credit fund) holds the loan until maturity, so that the loan is not traded. This is a critical difference to the securitization market and has important implications for risks related to moral hazard and asymmetric information, which appear rather contained for private credit.

The private credit market is dominated by private equity firms and large asset managers, which are controlling around 80% of the overall market (Loumioti, 2024). The most important players in the private credit market are Apollo (which had raised USD 268 billion in private credit by end-2023), Ares (USD 241 billion) and Blackstone (USD 206 billion). The main investors in private credit are institutional investors with long time horizons and a high risk tolerance, such as pension funds, insurance companies, endowment funds, foundations and sovereign wealth funds.

While private credit has typically been offered to mid-market companies[4] with a rather high-risk profile and high leverage, average deal sizes have increased in the past few years, and private credit now also serves as a substitution for syndicated loans.[5] Recently, large corporate transactions have been financed via private credit, and private credit funds are increasingly targeting larger companies.

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[2] Bloomberg, "Private Credit Funds Are the New Banks, Says Ares' Jacobson", July 2024.

[3] Bloomberg, "UBS Chair Kelleher Warns Bubble Is Forming in Private Credit," November 2023.

[4] The definition of mid-sized or middle-market companies varies. In the USA, they are typically classified as companies with annual revenues of up to USD 1 billion. In Europe, the thresholds for mid-sized companies are lower.

[5] A syndicated loan is funded by a group of lenders.

1.3 Private credit, private equity and collateralized loan obligations

While private credit is defined as private investments in a company's debt, private equity refers to investments in the equity of private (e.g. not listed) companies. Private credit strategies have an average duration of three to four years, and the principal is returned faster than under private equity strategies (typically more than ten years). Both markets, private credit and private equity, grew significantly over the past few years. Especially during the low interest rate environment, both markets provided attractive returns to investors searching for yield. Furthermore, both markets provide diversification benefits to portfolios consisting of traditional asset classes. With regard to size, the private equity market (USD 9 trillion) is considerably larger than the private credit market (USD 1.7 trillion), although private credit is rapidly gaining market share.

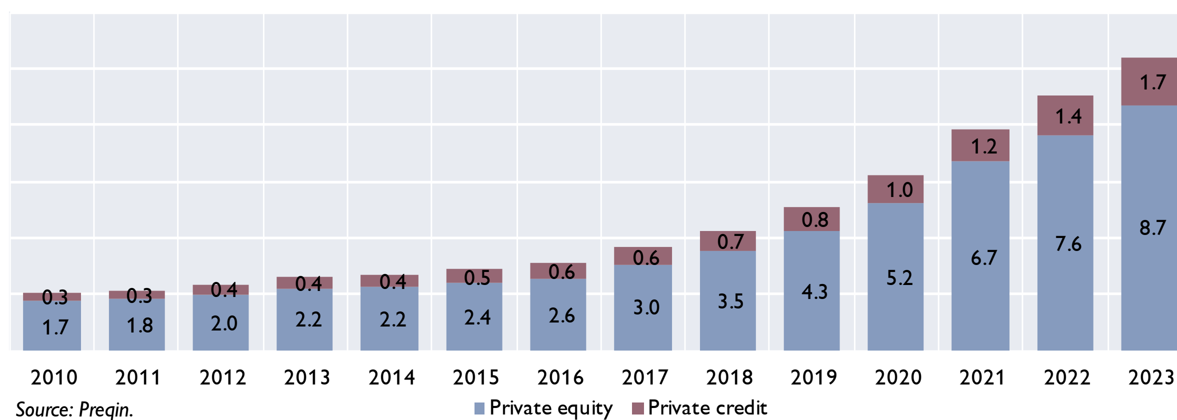
There are strong interlinkages between the private credit and the private equity market. Private credit is predominantly used to finance companies backed by private equity (although private credit has expanded to a broader range of companies and asset types). Private equity firms not only have considerable expertise in investing in risky and distressed businesses, but they also have long-term relationships with potential private credit borrowers. Hence, there are strong links and collaborations between private equity and private credit firms. That is also the reason why a lot of private equity managers entered the private credit market and now manage private credit funds. Funds holding both, equity and debt positions in the respective industries, have better insight into the market but this could also lead to potential conflicts of interest (Aramonte, 2020).

Charts 2 and 3, respectively, show the rapid growth of assets under management of private equity and private credit funds and the assets under management of private credit funds by region.

Chart 2

Global assets under management of private equity and private credit funds from 2010 to 2023

USD trillion

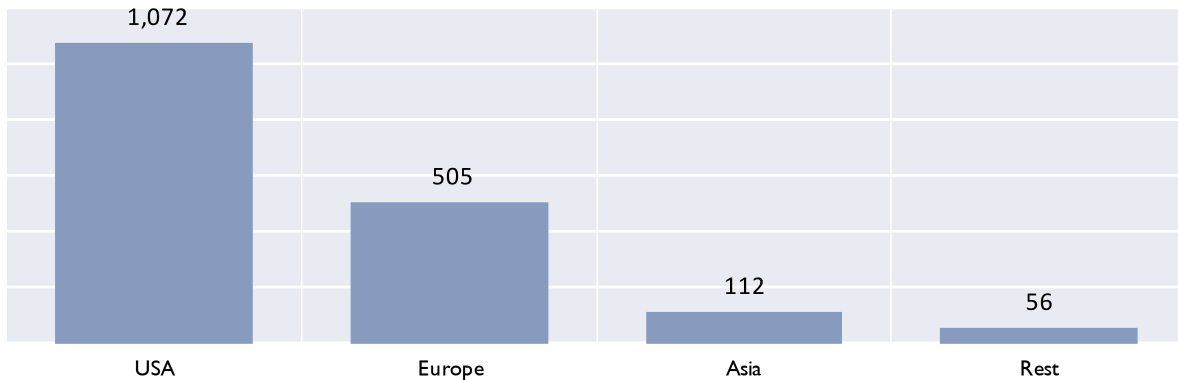


Source: Preqin.

Chart 3

Assets under management of private credit funds by region in 2023

USD billion



Source: Preqin.

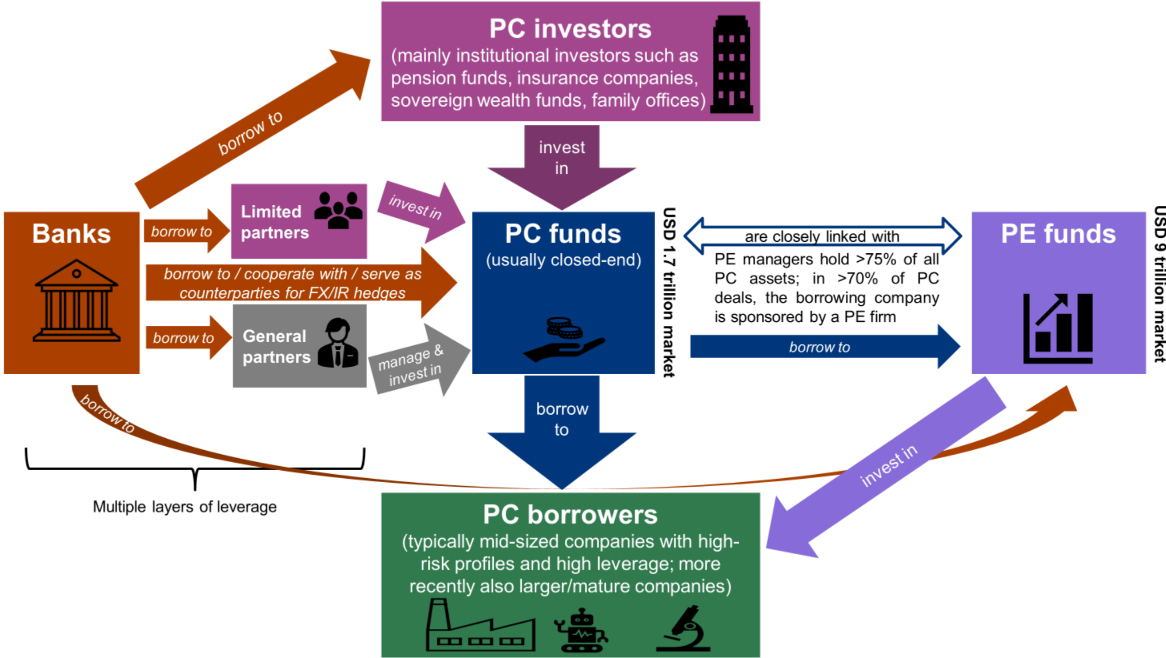
There are also important links between the private credit and the securitization market. Private credit fund managers often also manage collateralized loan obligations (CLOs) (Aramonte, 2020). However, private credit and CLOs are structurally different markets. In the securitization market, commercial banks play an active role in the origination of loans. In the private credit market, on the other hand, banks typically are not involved in the intermediation process (shadow banking). Empirically, there are substitution effects between private credit and CLO volumes: when the growth of the CLO market slows down, private credit substitutes the volumes and vice versa (Loumioti, 2022). It is possible that CLOs invest in private credit, but the market is rather small (only 5% of the overall private credit market) while the most common private credit vehicle is a closed-end fund (IMF, 2024).

1.4 Stylized illustration of the private credit market

Figure 1 shows the most important players in private credit lending and their linkages.

Figure 1

The most important players in private credit lending and their linkages



As illustrated above, private credit investors (such as pension funds, insurance companies and other institutional investors) invest in a private credit fund, which is typically set up as a closed-end fund with a lockup period of three to four years. The investors usually have a long-term investment horizon and a high risk tolerance. The private credit fund is managed by the general partner and receives capital from both the general and the limited partners. The fund then lends to companies, which typically have been mid-sized companies with a high-risk profile.

There are multiple links between the banking and the private credit industries: banks lend to private credit investors, the partners and directly to private credit funds. Banks also serve as counterparties for hedges, cooperate with private credit funds and sometimes set up their own funds. Furthermore, banks have exposures to the private equity industry, which is closely linked to the private credit market: private equity funds not only invest in private credit funds and borrow from them, but they often hold capital in companies funded by a private credit fund.

Box 1

The history of private credit

The private credit market grew significantly over the past few years. It is currently worth USD 1.7 trillion and still rapidly gaining market share.

Historically, three events and periods (the global financial crisis (GFC) of 2007–08, the low interest rate environment until mid-2022 and the recent rate hike) are key to explaining the rise of private credit:

Before the GFC, private credit used to be a niche market where primarily large insurance companies lent directly to selected companies. After 2008, the private credit market started to expand rapidly as banks became more risk averse with regard to lending to small and mid-sized companies and bank loan growth generally stagnated. Some also cite stricter post-crisis regulation as the main driver of private credit growth, as private credit funds filled the gap in loan supply (Buchak et al., 2024). At least for the USA, the growth of the private credit market is strongly associated with stricter bank regulation after the financial crisis (Erel and Inozemtsev, 2022; Irani et al., 2020).

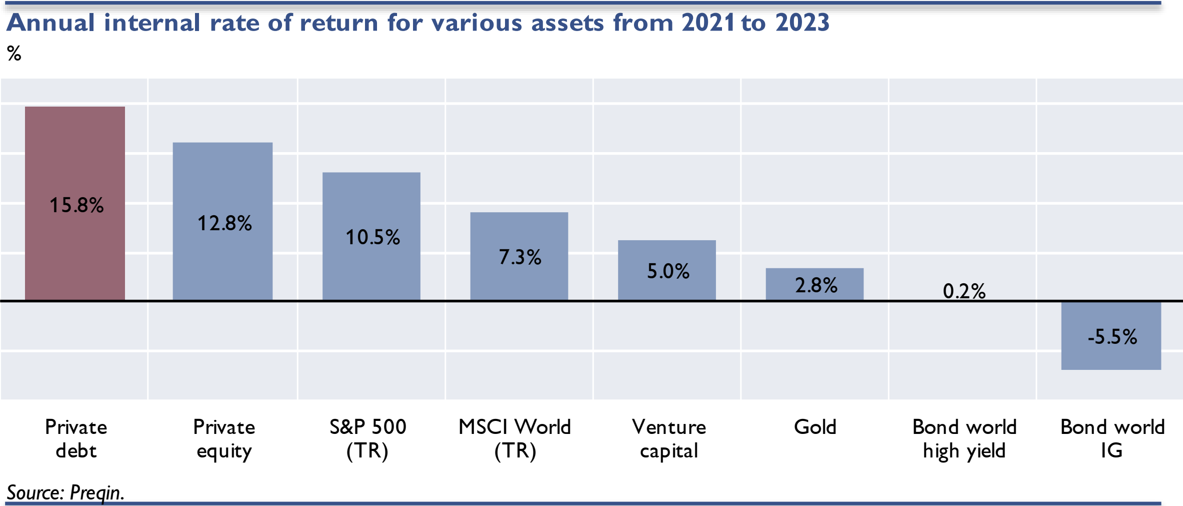
In addition, after the GFC, it became more difficult for mid-market companies to issue public debt as the average transaction size had increased significantly since then. Consequently, private credit became an important funding source for companies that banks would not fund any longer (Block et al., 2023). That is why direct lending by nonbanks became common for smaller and less profitable borrowers with a limited credit and cash flow history (Loumioti, 2022). Private credit fund managers often argue that they predominantly provide financing to companies that banks would not fund (Block et al., 2023).
Another important reason for the fast growth of the private credit market was the low interest environment until 2022, when loan demand was high (borrower-driven demand) and investors were looking for high-yield investments (investor-driven demand).
Finally, the rate hike cycle that started in mid-2022 boosted the growth of the private credit market. Many banks ended up with a large share of unprofitable loans in their portfolio which they had granted in the years before, when rates were low. Private credit funds stepped in and started to buy these loan portfolios.
After the US regional bank crisis of 2023, private credit funds increased their market share in financing tech companies, which have previously been funded by specialized regional banks.
While private credit used to be a complement to bank loans und public debt, it has now become a substitute for them (Ellias and de Fontenay, 2024).

1.5 Opportunities and benefits of private credit for borrowers and investors

From the borrowers' point of view, private credit provides several advantages. First, private credit is more flexible (less standardized) with regard to credit terms, repayment plans and collateral structures. This is especially attractive to innovative, fast-growing companies with cash flows which are hard to predict (e.g. in the tech sector).
Another advantage of private credit for borrowers is the certainty and speed of execution. The pricing of private credit deals usually happens up front, while the price of syndicated loans fluctuates before the closing of the deal, leaving the company with a degree of uncertainty about the execution price. Compared to traditional bank loans and bonds, the lending process usually takes less time. Private credit funds can deploy – significant – capital quickly, which is especially attractive to companies with unexpected or urgent financing needs. This is possible because private credit funds are subject to less regulation and do not rely on other parties (such as rating agencies or investment banks) to close a deal.
Private credit offers a high degree of confidentiality to the borrowing company, as financial information must only be shared with the private credit lender. By contrast, bond placements on public markets or syndicated loans require the borrowing company to provide an audited financial statement and to obtain external ratings. This financial information is disclosed to a relatively large group of (potential) creditors and becomes available to the market through the pricing of debt. In traditional bank lending, the borrower's financial information might become available to the bank regulator. In the case of private credit, no external ratings are necessary, and no information must be disclosed to other stakeholders than the private credit lender.
Finally, certain private credit strategies are highly complex and require specialized knowledge to adequately price and monitor transactions (e.g. distressed lending). The expertise of specialized private credit lenders in certain industries can provide additional value for borrowers.
This high degree of flexibility, certainty and confidentiality is attractive to borrowers who are willing to pay a significant premium, which tends to be in the range of 2–3 percentage points above that in a traditional loan. Empirical evidence shows that nonbank lenders charge significantly higher interest rates compared to banks, even after controlling for borrowers' risk (Erel and Inozemtsev, 2022).
Private credit also offers several advantages from the investors' point of view. Empirically, private credit funds provided high returns to investors and outperformed most other asset classes by a significant margin (including stocks and high-yield bonds), even after adjusting for risk. An

important reason for this excess return is the illiquidity premium which investors expect as compensation for the lack of liquidity of private investments.
In addition to historically high returns, private credit provides diversification benefits due to a low correlation of returns with traditional asset classes like stocks and bonds. Importantly, however, this low correlation is also driven by stale and infrequent valuations based on model (and not market) values. That said, infrequent valuations can also be advantageous for the private credit fund, as it makes market-driven fire sales less likely. Private credit asset managers usually have significant discretion over loan valuations, and a valuation review by an external auditor is typically conducted only once a year. This makes it less likely that private credit funds are forced into selling their loans at depressed prices during volatile markets (Ellias and de Fontenay, 2024). So far, the earnings projections of private credit funds have been relatively stable, and volatility has been low. Chart 4 shows the superior performance of private debt investments from 2021 to 2023.

Chart 4



Source: Preqin.

Overall, private credit is currently seen as a very attractive asset class by the market due to a historically superior risk-adjusted performance and potential diversification benefits. However, due to inherent liquidity and valuation risks, private debt investments should be seen as riskier than traditional bonds in the long term.

1.6 Specific risks of private credit

While private credit provides unique benefits to borrowers and investors, the private credit market is also exposed to specific risks. Due to the heterogeneity of private credit strategies, the risk profile of private credit is highly dependent on the characteristics of the specific transactions. Generally speaking, capital preservation strategies (e.g. investments in senior debt) are less risky than return maximization strategies (e.g. distressed debt). Independent of the specific strategy, private credit loans share the following characteristics: they are usually not rated by an external agency, not traded on public markets (therefore highly dependent on model valuations) and not standardized.
Market analysts and researchers are currently worried how the private credit market will perform in a higher-for-longer rate environment and how it will cope in times of increased market stress. Unexpected losses might adversely affect major private credit lenders, especially as the strong

demand for private credit by investors seen in the past few years has been accompanied by a deterioration in covenant protection (Aramonte, 2020).

It is important to highlight that private credit offers advantages when credit risk materializes, offering more flexibility with regard to loan restructurings. In the case of publicly placed syndicated loans, by contrast, different stakeholders might have quite different or even opposite interests, which, in the past, led to "creditor-on-creditor violence." Private credit investors usually do not have to monitor the behavior of other creditors to protect their interests. In a typical private credit investment, the asset manager of the private credit fund has a governance function and makes sure that creditors do not harm each other. Furthermore, the typically close relationship between the private credit lender and the borrowing firm helps to mitigate some of the credit and liquidity risks. Another mitigating factor is that private credit borrowers usually have private equity investors who are often willing to inject additional capital in times of stress to secure their investment.

A systematically important risk factor is the opaqueness of the private credit market. Data are scarce and the transparency of data on borrowers, credit risk and the industry in general is much lower than in the public debt market and the highly regulated banking sector. Private credit funds are dependent on often infrequent model valuations. On the one hand, this leads to a negative bias when measuring the volatility and diversification benefits of private credit. On the other hand, in times of market stress, this could lead to cliff effects driven by valuation adjustments.

From the borrowers' point of view, funding risk is important, as most private credit loans have floating interest rates. Furthermore, borrowers might become overly dependent on private credit lenders, who often not only control the complete debt of the company but are also heavily invested in the firm's equity. Because investments in private credit funds are characterized by long lockup periods with limited redemption rights, liquidity and maturity transformation risk can be expected to be rather low. Recently, private credit funds (especially in Europe) have introduced more frequent (sometimes even monthly) redemption opportunities, which may potentially increase liquidity risk (IMF, 2024).

Private credit might lead to an increase in corporate leverage and defaults in times of crisis. As already discussed, private credit serves more and more as a substitute for bank loans and public debt. This allows many borrowers to get financing they would not have obtained otherwise. This leads to relatively high levels of leverage as well as low collateralizable assets and higher spreads in private credit compared to syndicated loans. As a result, private credit increases overall corporate leverage, which might make the sector more vulnerable to financial shocks. In an economic downturn, higher interest payments on floating-rate debt could lead to a substantial increase in defaults in the private credit market.

What is more, the significant increase in dry powder (cash that has not yet been invested by private credit funds) and ongoing competition with banks may undermine underwriting standards and lead to a deterioration in credit quality. Due to the expectation to deliver high returns to the limited partners within a set timeframe, private credit managers may opt for riskier investments, provide more covenant-lite loans or generally lower underwriting standards. A decline in deal quality due to high competition, pressure from investors and declining investment opportunities can lead to higher future defaults, negatively impacting fund performance and investors' returns (Cai and Haque, 2024).

2 Private credit and banks

Traditionally, banks were at the center of commercial lending either as a direct source of capital (loans granted by commercial banks) or as intermediaries between companies and investors in bond issuances coordinated by investment banks. Companies could either borrow from banks or issue bonds, which are typically underwritten by investment banks. In the past few years – especially in the USA – investment firms have increasingly been replacing traditional banks as the originators of corporate loans (Ellias and de Fontenay, 2024).

2.1 Private credit and the business model of banks

Private credit is a potential threat to the business model of banks. Compared to traditional banks, private credit funds are subject to less regulation as they do not collect insured retail deposits. This leads to important competitive advantages: Private credit funds can provide financing to companies in a much faster, flexible and less bureaucratic way and thereby earn a significant spread. Recent research shows that especially in Europe, private credit funds are competing with banks (Block et al., 2023). Private credit funds have cost advantages over traditional banks as they are subject to less regulation and compliance costs. Empirical evidence shows that direct lending by nonbanks is positively associated with stricter bank regulation, and direct lenders tend to be more active when banks face greater regulatory constraints (Loumioti, 2022). The contrast between relatively heavily regulated banks and less regulated private credit funds will likely accelerate the movement from traditional bank to private credit lending (Cai and Haque, 2024).

As mentioned above, the growing importance of private credit has been going hand in hand with stricter post-crisis regulation and more risk-averse bank lending practices. As private credit funds focused on loans to mid-sized companies with an above-average risk profile in the years after the GFC, the average deal size of private credit transactions increased rapidly; meanwhile, the private credit market has become a substitute for the syndicated loan market as well. Hence, in the years after the GFC, private credit funds were not directly competing with banks, as they basically granted loans to those companies which would not qualify for a traditional bank loan. As private credit funds became larger and as they have increasingly been targeting larger firms, competition with banks is becoming more of an issue.

One specific competitive advantage of private credit funds is that they are not subject to restrictions on holding both equity and debt in a target company. A private equity company, for example, which has been investing in a company's equity for several years, has superior knowledge about risks and opportunities of this company and may decide to also invest in the company's debt (which, in fact, is quite common). The main competitive advantage of banks, of course, is their ability to create new money, which private credit lenders cannot do. Furthermore, banks have access to central bank liquidity, which has important implications, e.g. for funding costs.

Currently, banks are trying to benefit from the growth opportunities and potentially high profits in the private credit market. Société Générale and JP Morgan, for example, have established their own private credit funds, while other banks have started to cooperate with existing private credit funds.

2.2 Exposure of banks to the private credit market

Even though banks are not directly involved in the origination of private credit loans, they are exposed to the private credit market through various channels. First, banks have exposures to private credit funds, asset managers and private credit investors, such as insurance companies,

pension funds, sovereign wealth funds and family offices. Private credit fund managers often borrow directly against the fund assets, which leads to "back leverage." Second, banks are exposed to the private credit market through counterparty risk via foreign currency (FX) and interest rate (IR) hedges. Finally, banks which are part of larger groups are also exposed to private credit investments via their insurance arm. Insurance companies have significantly increased their private credit exposure in the past few years.
Due to the low transparency of the private credit market, it is difficult or even impossible for banks to quantify their overall exposure to private credit.

Banks exposed to private credit through one of the channels mentioned above are subject to various risks. First, private credit investors might default, which, however, is rather unlikely as the most important private credit investors are large asset managers, pension funds and insurance companies with high credit ratings, a long-term investment horizon and adequate risk-bearing capacities.

Furthermore, banks are exposed to valuation risk. Loan valuation in private credit funds is heavily based on infrequent model valuations, which could lead to cliff effects in times of market stress. Because information about companies and even industries financed via private credit is not publicly available, there is an increased risk of fraud, market distortions and severe market corrections. A delayed realization of losses in times of market stress could potentially lead to a sudden spike in defaults and subsequent severe valuation losses in the private credit market.

2.3 Private credit and financial stability

A comprehensive assessment of the financial stability risk of private credit is difficult due to the inherent opaqueness of the market and the lack of data. Recent studies have raised the question if the growth of private credit potentially exacerbates financial stability risk and have also provided several affirmative arguments.

The high level of confidentiality and the lack of transparency in private credit reduces the information about firms or even entire industries available to the market, regulators and the general public. As a consequence, these private credit firms are shielded from the discipline and scrutiny provided by markets and the public, which could lead to the misallocation of capital. Publicly traded debt instruments, such as bonds, show early warning signals when companies suffer financial stress (e.g. increasing spreads), thereby providing timely and useful information to investors and regulators. This is not the case for private credit, where data are scarce and valuations infrequent and opaque. If financial distress becomes only visible when firms go bankrupt, this may lead to sudden, unexpected market-wide shocks. Furthermore, companies relying on public debt traded on the secondary market are closely followed by financial analysts, which improves information efficiency.

Another argument refers to the market dominance of asset managers such as BlackRock, which can be expected to become even larger. This might be problematic from a systemic risk and political point of view, as a recent study concludes: "Private credit represents perhaps the final major step toward investment funds owning US firms' entire capital structure – both the equity and the debt. [...] A large private company, for example, may have all its equity in the hands of a

single private equity fund, while all of its debt is held by a single private credit fund. As a result, we are now close to a world in which most firms' capital structure – both the equity and the debt – will be funded and held entirely by investment funds. This is a radically different way of owning companies" (Ellias and de Fontenay, 2024).

Private credit may increase the phenomenon of "zombification," which happens when private credit funds are reluctant to take credit losses and forebear defaults; they can do this easily due to flexible credit terms and light regulation. While bonds are priced on public markets and bank regulation requires banks to (pre)book potential credit losses, private credit lenders often can choose when and if they take a loss.

However, there are also voices on the market stating that private credit has the potential to reduce financial stability risk. Most importantly, there is evidence suggesting that private credit is less cyclical than other types of borrowing, which would be positive from a systemic risk point of view. In the beginning of the COVID-19 pandemic, private credit did not contract as strongly as the high-yield bond and the leveraged-loan markets and proved more stable. Private credit seems to be less responsive to sudden credit shocks (IMF, 2024).

Until now, the private credit market has not experienced a severe downturn, and it may even provide benefits to the economy. Based on recent research, we would conclude, nevertheless, that nonbank lending potentially exacerbates financial stability risk (Erel and Inozemtsev, 2022).

2.4 Overview of opportunities and risk of the private credit market

Table 1 summarizes the risks and opportunities of the private credit (PC) market from different perspectives.

Table 1

Risks and opportunities of the private credit (PC) market from different perspectives

Perspective	Opportunities	Risks
Borrowers	▪ Flexible, nonstandardized credit terms ▪ Fast execution and fixed pricing of loans ▪ No external ratings necessary ▪ High confidentiality ▪ Specialized knowledge of PC lenders ▪ Close relationship with PC lenders	▪ Relatively high loan rates (2–3 percentage points spread to comparable bank loans) ▪ High dependence on PC lenders ▪ Higher interest rate risk (hedging costs) as PC loans are floating
Investors	▪ Historically high returns ▪ Historically low volatility and low correlation with traditional asset classes ▪ Lower risk of abrupt price movements due to nonexistent market prices ▪ Lower risk of investor flight as investors typically have long time horizons	▪ Infrequent and stale model valuations increase price uncertainty ▪ Low liquidity due to lockup periods (limited redemption rights) ▪ PC is still a high-risk asset class despite superior performance in the past
Financial stability	▪ PC seems to be less cyclical than other types of lending. During the pandemic, the PC market did not contract as strongly as the high-yield bond and the leveraged-loan market ▪ PC seems to be less responsive to sudden credit shocks ▪ PC may lead to economic benefits by providing long-term financing to innovative firms too risky to obtain traditional bank funding	▪ Competition with banks may lead to a deterioration of asset quality ▪ Infrequent model valuations may lead to cliff effects in times of stress ▪ Low transparency leads to increased risk of fraud and market corrections ▪ PC borrowers are shielded from the discipline provided by markets ▪ Zombification: opaqueness and high flexibility of PC lenders could lead to a delayed realization of losses ▪ Market concentration: already large asset managers are dominating the PC market
Banks	▪ Banks might benefit from exposure to the highly profitable PC market (either indirectly via borrowing to private credit funds and private credit investors or directly via establishing their own PC funds)	▪ PC funds are a potential threat to banks' business models ▪ PC funds are subject to less regulation (cost advantage) and can also hold equity in the borrowing firm (information advantage) ▪ Banks are exposed to valuation risk due to stale model valuations ▪ Banks have problems estimating their exposure to the PC market

Source: Authors' compilation.

3 Conclusion and policy recommendations

Private credit – a market currently worth USD 1.7 trillion – has been the fastest growing segment in alternative markets and credit markets in the past few years; it can be expected to further gain market share in the coming years. While private credit has typically been offered to mid-market companies, average deal sizes have increased, and private credit now also serves as a substitution for the syndicated loans. In the past few years – especially in the USA – investment firms have increasingly been replacing traditional banks as the originators of corporate loans.

From the borrowers' perspective, private credit offers highly flexible credit terms, fast execution and a high level of confidentiality. From the investors' perspective, private credit has so far provided high returns and outperformed most other asset classes, even after adjusting for risk.

However, the private credit market is relatively intransparent due to its light regulation, low disclosure requirements and the absence of market prices. The lack of transparency reduces the amount of available information about firms or even entire industries.

Because private credit funds are less regulated than banks, they can provide financing in a much faster, flexible and less bureaucratic way. Banks are exposed to the private credit market mainly through their exposure to private credit funds, asset managers and investors but also as counterparties in FX and IR hedges. Important risks of banks exposed to the private credit market include credit risk, valuation/model risk and liquidity risk.

Banks often cannot identify their overall epxposure to the private credit market. Data gaps should be closed and reporting requirements should be enhanced to comprehensively assess risks with regard to leverage, interconnectedness and market concentration. The Chairman of the European Banking Authority (EBA), José Manuel Campa, said that in order to combat the lack of transparency in the market "some kind of reporting requirements" on shadow banks and private credit funds should be the next step. The Financial Stability Board (FSB) is planning to publish the findings of an exercise at the end of 2024 that had the goal of gathering data on nonbanks including their ties to traditional banks. Policy proposals by the FSB should follow at the beginning of 2025.[6] Furthermore, authorities should strengthen cross-border regulatory cooperation.

From a bank supervisor's perspective, the links and interconnectedness between the private credit market and banks should be analyzed and closely monitored, especially with regard to bank exposures to private credit asset management firms and private credit investors. As a first step, data quality must be improved to allow an informed debate about inherent risks (but also opportunities) of private credit and the respective exposure of banks. The potential deterioration of lending standards fueled by the increased competition between banks and private credit funds should be carefully monitored. Box 2 summarizes our policy recommendations for bank supervisors.

Box 2

Policy recommendations for bank supervisors

In response to the increasing role of private credit, supervisors should

- ***improve*** *the* ***data quality*** *with a special focus on banks' exposure to the private credit market;*
- ***analyze*** *the interlinkages between private credit and the banking sector, thereby* ***identifying*** *potential risks and spillover effects for banks;*
- ***closely monitor*** *the private credit market and the risks identified for the banking sector;*
- ***strengthen*** *cooperation with other relevant authorities (including financial market supervisors and insurance supervisors).*

[6] Reuters, "EU watchdog warns of data 'black holes' amid efforts to uncover shadow bank risk," July 2024.

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