The Rise and Risks of Private Credit

Private credit has grown rapidly to provide long-term financing to middle market firms. Private credit offers borrowers a value proposition through strong relationships and customized lending terms. While banks appear to have become less willing to lend to middle-market, or medium-sized, firms, private credit has emerged as a key lender. Credit migrating from regulated banks and relatively transparent markets—such as syndicated loans or corporate bond markets—to the opaque world of private credit creates potential risks. **While immediate risks may seem contained, the sector has meaningful vulnerabilities.**

The sector could experience large, unexpected losses in a downturn. Private credit is typically floating rate and caters to relatively small borrowers with high leverage. Such borrowers could face rising financing costs and perform poorly in a downturn.

Liquidity risk could rise with the growth of retail funds. The great majority of private credit funds poses little maturity transformation risk. However, the growth of semiliquid funds could increase first-mover advantages and run risks. Increasing retail participation in private credit markets raises conduct concerns as retail investors may not fully understand the investment risks or the restrictions on redemptions from an illiquid asset class.

Multiple layers of leverage create interconnectedness concerns. While private credit funds appear to use limited amounts of leverage, they are also often part of complex network that include leveraged players ranging from borrowers to funds to end investors. These multiple layers of leverage, often hidden by reporting gaps, could magnify losses. In addition, funds may still face significant capital calls, with potential transmission to their leverage providers.

Uncertainty about valuations could lead to a loss of confidence. The opacity of borrowing firms and the fact that the sector has never experienced a severe economic downturn at its current scope and size make prompt assessment challenging for outsiders. Fund managers may be incentivized to delay the realization of losses as they raise new funds and collect performance fees based on their existing track records.

Risks to financial stability may also stem from entities with particularly high exposure to private credit markets, such as insurers influenced by private equity firms and certain groups of pension funds. The assets of private-equity-controlled insurers have grown significantly in recent years, with these entities owning significantly more exposure to less-liquid investments than other insurers.

Assessing overall financial stability risks of this asset class is challenging because of the data limitation. If the asset class remains opaque and continues to grow exponentially under limited prudential oversight, the vulnerabilities of the private credit industry could become systemic.

Authorities should consider a more intrusive supervisory and regulatory approach to private credit funds, their institutional investors, and leverage providers. Authorities should enhance cross border and cross sectoral cooperation to address data gaps and make risk assessments more consistent across financial sectors.

Authorities should prioritize the closing of data gaps so that supervisors and regulators may more comprehensively assess risks, including leverage, interconnectedness, and the buildup of investor concentration. Authorities should enhance reporting requirements for private credit funds and their investors, and leverage providers to allow for improved monitoring and risk management.

Authorities should monitor closely and address liquidity and conduct risks in funds—especially retail—that may be faced with higher redemption risks. Securities regulators should implement relevant product design and liquidity management recommendations from the Financial Stability Board and the International Organization of Securities Commissions.

To see the full report, please refer to the English version here: http://IMF.org/GFSR-April2024