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IN FOCUS

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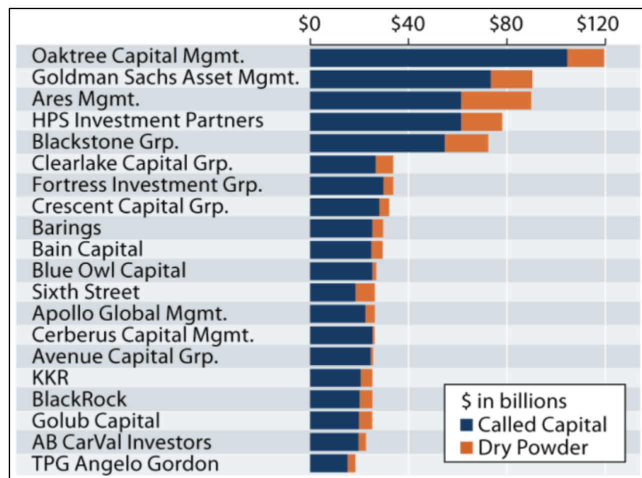
# Private Credit: Trends and Policy Issues

*Private credit* generally refers to a type of lending undertaken by nonbank financial institutions and made to small- and medium-sized private companies that are not publicly traded. As a rapidly growing market that competes with traditional bank loans, but with a different regulatory apparatus, it has drawn financial stability concerns from some observers. This In Focus explains private credit operations, trends, and policy issues.

## What Is Private Credit?

Private credit, also known as private debt, emerged in the 1980s when insurance companies started lending money directly to businesses. Unlike *private equity*, which involves ownership stake in businesses, private credit is a form of business debt. Major private credit investors include pension funds, foundations, endowments, asset managers (including financial firms that also engage in private equity activities), and insurance companies. Because some nonbanks often use asset managers to allocate their money rather than lending directly, industry activities are concentrated among multiple large private credit managers (**Figure 1**).

**Figure 1. Top 20 Private Credit Managers**

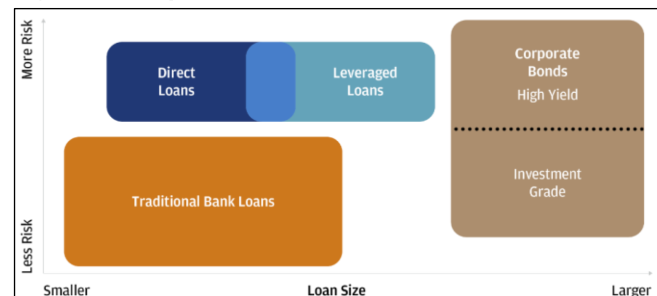



**Source:** Federal Reserve.

**Notes:** *Called capital* refers to invested capital. *Dry powder* refers to committed but not yet deployed capital.

Private credit is one of many *alternative investments*—a broad category of investments that stand in contrast to traditional investments such as holding publicly traded stocks and bonds. Private credit is available in the private market alongside private equity, hedge funds, private real estate, and venture capital. The Securities and Exchange Commission (SEC) has certain authorities that are relevant to private securities markets, which are less regulated than public markets are. The most common type of private credit is **direct lending**, where nonbank investors provide loans with a traditional structure, giving the loans to businesses and holding the loans themselves, typically to maturity. Other types or subcategories of private credit include **distressed debt** (lending to companies in bankruptcy or near-bankruptcy), **special situations debt** (lending in unusual events such as mergers, acquisitions, and changes of control), **bridge financing** (short-term lending intended to sustain a firm while it seeks permanent funding), **venture debt** (lending to early-stage companies that normally receive venture capital backing), and **mezzanine debt** (debt that is subordinate to other debt but senior to equity in bankruptcy repayment orders).

**Figure 2. Corporate Debt Market Instruments**




**Source:** J. P. Morgan.

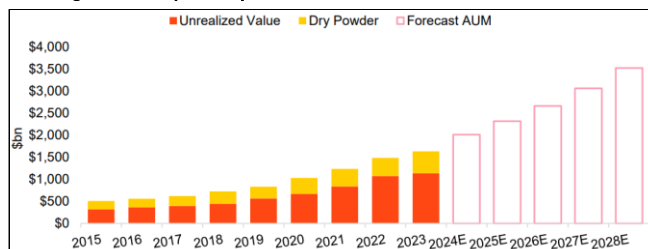
Businesses can borrow money from various lenders and markets. **Figure 2** compares the typical loan size and riskiness of direct loans to other debt instruments. Private credit often involves small and middle-market borrowers that are not large enough to issue bonds. It overlaps with the market for leveraged loans, which are higher-risk loans to businesses with high indebtedness or low credit ratings. Private credit could compete with traditional bank loans but is usually riskier than bank loans.

## Market Trends

Some industry sources estimate the size of the global private credit market to be roughly $1.5 trillion to $2.1 trillion in assets under management (AUM). This is comparable to the size of the $1.7 trillion leveraged loan market and a fraction of the more than $50 trillion U.S. fixed-income market (which largely consists of securities investments paying investors fixed interest payments).

One large asset manager projects the private credit market's global AUM to reach $3.5 trillion by 2028 (**Figure 3**). Around three quarters of the global private credit market focuses its investments in the United States. Like private capital markets more generally, the private credit industry has recently experienced significant growth. Because private credit providers could borrow from or partner with banks, the industry is also somewhat intertwined with banking.

**Figure 3. Private Credit Global Assets under Management (AUM): Actual and Forecasted**




**Source:** BlackRock.

### Private Credit in the Expanding Private Markets

Investment in private credit, like investment in private equity, is generally accessible only to institutional and individual investors who are deemed to have the means to understand and sustain financial risks (i.e., qualified institutions and accredited investors). The market involves limited public transparency, because less disclosure is required than in public markets. Private funds and securities offerings have become increasingly mainstream. For example, private securities offerings have outpaced public securities offerings in recent years and reached a ratio of approximately 4:1 between July 1, 2021, and June 30, 2022. Investors have entered the market in search of investment returns and diversification, leading to increased market size and importance. For example, CalPERS, the largest U.S. public pension plan with around $500 billion in assets under management, announced in March 2024 that it plans to increase its total private market allocation from 33% of plan assets to 40% and its private credit allocation from 5% to 8%. According to CalPERS's performance review, private credit was its best-performing private asset segment, with a 13.3% annual return. Meanwhile, some public fund managers (e.g., Franklin Templeton) have pivoted toward alternative investments by acquiring private credit managers. Other existing private credit managers (e.g., Oaktree Capital Management) have increased the size of their private credit funds.

### Interconnectedness Between Nonbanks and Banks

Although private credit is a form of nonbank lending, asset managers and other private credit lenders often themselves borrow from banks, creating interconnectedness between the industries. According to data from the Federal Reserve, bank loans and leases to non-depository financial institutions (which could include private credit intermediaries) have doubled from $500 billion in January 2019 to $1 trillion in January 2024 and increased more than 10% between January 2023 and January 2024. Other categories of bank loans (e.g., commercial and industrial loans, real estate loans, and consumer loans) saw minor increases or declines. In addition, banks' involvement with private credit could include partnering with private credit funds in *broadly syndicated loans* or offloading higher-risk assets to private credit funds through *synthetic risk transfers*.

## Policy Issues

Private credit provides a source of financing to borrowers including higher risk businesses that are smaller in size. Private credit tends to attract longer-term buy-and-hold investors. The illiquid nature of private credit investments makes them less prone to run-like behaviors commonly seen at banks. Some academic research also finds that private credit funds are more efficient than banks in facilitating credit supply during stress. Additional research indicates that private credit lenders exhibit lower leverage, which is a common risk measure of a financial entity's capability to multiply risks and returns and transmit financial risks elsewhere. Over private credit's relatively short history, it has generated a lower loss ratio than other comparable debt instruments.

Commentators have also identified policy concerns raised by the growth of private credit.

**Market transparency and data availability.** Because private credit transactions normally take place in private markets through bilateral negotiations, it has been difficult to obtain reliable data for market-wide risk assessments and systemic risk monitoring.

**Activity-transition from banks to nonbanks.** Some commentators have attributed the high growth in private credit to the tightening of bank lending standards and the transferring of bank-like activities and risks from banks' portfolios to private credit funds and other nonbanks. Unlike banks, nonbanks typically do not receive taxpayer guarantees or backstop, and investors generally assume all the risk of loss. The "de-banking" trend has prompted discussion about different regulation methods at banks and nonbanks and how that could trigger financial instability.

**Contagion effects.** Given the increased size of private credit and its interconnectedness with banks and other nonbanks, its own risks could spill over to others through channels such as credit losses, capital calls, and leverage. Even private credit funds with modest direct leverage may still experience multiple layers of leverage at borrowers, investors, and special-purpose structures.

**Valuation issues.** Asset valuation for illiquid private fund assets tends not to keep pace with the deterioration of valuation losses during downturns. This could lead to sudden markdowns that may amplify the tightening of credit conditions, especially in stress scenarios.

**Pending cycle-tests.** Private credit's more substantial growth happened after the 2007-2009 global financial crisis. The industry's ability to withstand prolonged recession remains uncertain.

## Regulatory Actions

In 2023, the SEC finalized private fund adviser rules and amended Form PF for private fund reporting. These final rules aim to enhance the regulation of certain private credit fund advisers and provide more visibility into the private fund markets for investor protection and financial stability monitoring purposes. The Financial Stability Oversight Council finalized guidance on nonbank systemically important financial institutions designations in 2023 that outlines procedures for deciding whether a nonbank would be subject to increased supervision and regulation.

**Eva Su**, Specialist in Financial Economics

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