Diversifying Growth: Private Credit and the Financial System

Center Forward Basics

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Overview

Private credit, an expanding sector within the financial system, represents a form of lending provided by **non-bank financial institutions (NBFIs)** such as credit funds, hedge funds, and insurance companies. Unlike traditional bank loans, private credit involves direct, privately negotiated contracts between lenders and borrowers. This form of credit has gained prominence due to its flexibility, speed, and ability to meet the specialized needs of companies often overlooked by banks.

As the private credit market has grown to more than $1.7 trillion of **assets under management (AUM)** globally in 2023, it has become an important component of the financial landscape. While private credit offers benefits—including diversification for investors, a source of capital for businesses, and sharing bank credit risk with third-party investors—it has also faced recent regulatory scrutiny regarding the industry's transparency and its potential contribution to systemic risk. This Basic explores the nature of private credit, its various forms, its contributions to the financial system, and the emerging considerations and regulatory responses surrounding its expansion.

What is Private Credit, and Who Does it Serve?

Private credit, also known as private debt, is a broad term referring to funds loaned to businesses by private funds through direct lending or structured finance arrangements. Private credit borrowers negotiate directly with the non-bank lender rather than raising funds in the public markets or by seeking a loan from a bank. Private credit funds tend to extend loans to enterprises of all sizes and across all industries.

Private credit provides an alternative option for businesses to access credit in addition to the traditional banking system or capital markets. Businesses of all sizes use this capital to hire more workers, expand their operations, build new facilities, and develop new products. Institutional investors, including public and private pensions, charitable foundations, and college endowments, use private credit as a critical portfolio diversifier. The loans generate steady returns that institutional investors in private credit funds use to fund retirements, improve communities, and offer scholarships, even during periods of economic volatility.

Private Credit and the Financial System

Private credit plays an important role in the financial system by providing capital to companies across industries. It is also available to companies which may be underserved by traditional banks and fills a gap by serving the middle market and

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Center Forward brings together members of Congress, not-for profits, academic experts, trade associations, corporations and unions to find common ground. Our mission: to give centrist allies the information they need to craft common sense solutions, and provide those allies the support they need to turn those ideas into results.

In order to meet our challenges we need to put aside the partisan bickering that has gridlocked Washington and come together to find common sense solutions.

For more information, please visit www.center-forward.org other niche areas, allowing companies to continue innovating, hiring, and creating economic value. The **International Monetary Fund (IMF)** remarked on this in its Global Financial Stability report. It asserted private credit offers significant benefits to the financial system by providing capital to organizations that banks consider too risky and small for the public market. More non-traditional businesses can utilize this alternative lending to finance their continued growth.

Private credit allows investors, including pensions, foundations, and endowments, to diversify their portfolios. These investments often exhibit a low correlation with public market securities, providing diversification and risk mitigation during periods of market volatility. The federal government does not backstop private credit, so taxpayers assume no liability for such funds during economic instability. If a private credit fund fails, the liability lies with its investors and managers.

By contrast, while banks can rely on stable deposits during times of stress, they tend to withdraw capital or cease lending capital during periods of economic uncertainty and market stress. An August 2024 report from the Federal Reserve Bank of New York suggests growth in bank lending versus non-bank lending does not move hand in hand, with bank lending more sensitive to economic downturns. Furthermore, studies reveal private credit lenders exhibit lower levels of leverage, a risk indicator used to assess a financial entity's capacity to amplify risks and returns while potentially transmitting financial risks elsewhere. Private credit remains in its infancy and has not yet been tested during major economic downturns.

Recent Regulatory Proposals Regarding Systemic Risk

A common criticism of private credit centers around its lack of transparency. Under current law, private credit funds must file Form PF with the **Securities and Exchange Commission (SEC)**. Form PF details a fund's regulatory assets under management. The SEC shares this information with the **Financial Stability Oversight Council (FSOC)**. While comprehensive, this reporting has raised some concerns with regulators as it discloses a different set of factors assessing risk than required for traditional banks, which are prudentially regulated due to their government backstop, acceptance of depositor money, and interconnection with the rest of the financial system.

To address these concerns, the SEC adopted changes to Form PF in February 2024 aimed at improving the reporting of investment exposures, borrowing, risk metrics, and other data by large private fund advisers. Regulators believe these changes will provide better insight into alternative asset managers' operations and strategies while enhancing data quality and comparability. Private credit funds provide other significant data when reporting to Federal and State agencies. This data is suitable and appropriate for understanding the private credit business model, which is distinct from banking.

While some global and domestic regulators worry about the stability risks of the private credit market, a recent report by the **Federal Reserve ("the Fed")** dispels these concerns, finding short-term financial stability risks to be limited. In August 2024, the Fed's Private Credit Growth and Monetary Policy Transmission analysis found private credit returns and capital-raising capabilities remained relatively stable during policy-tightening cycles and market shocks.

Another area of increased regulatory scrutiny is the potential systemic risks posed by NBFIs. FSOC issued guidance on this topic in November of 2023. The guidance aimed to establish a new analytic framework for FSOC to determine whether an NBFI should be designated as a **systemically important financial institution (SIFI)** based on data and market activity. SIFI-designated institutions are under the Fed's supervision and standards established by the Dodd-Frank Act. FSOC's guidance demonstrates regulators' appetite to closely monitor potential threats to financial stability stemming from NBFIs, including private credit funds. Critics of the non-bank designation argue placing one institution under supervision would not reduce real or perceived risks because the activity could simply move to other institutions and won't provide stability to the broader financial system.

Some regulators have also expressed concern private credit funds' use of leverage provided by banks could harm markets if private credit borrower defaults rise. However, private credit funds use very little leverage. The leverage used by private credit funds is reported to the banks' prudential regulators (i.e., the Fed, FDIC, and OCC) through bank call reports. These disclosures enable regulators to monitor in real-time for any potential use of excessive leverage by private credit funds.

Conclusion

Private credit has become a small but increasingly important component of the global financial system and is poised to continue to grow. This growth has attracted scrutiny over the industry's transparency and systemic importance from some policymakers, despite key regulatory leaders supporting its benefits.

Links to Other Resources

- Brookings Institute - What is private credit? Does it pose financial stability risks?
- Congressional Research Service - Private Credit: Trends and Policy Issues
- The Federal Reserve - Private Credit: Characteristics and Risks
- The Federal Reserve - Private Credit Growth and Monetary Policy Transmission
- Federal Reserve Bank of New York - Financing Private Credit
- International Monetary Fund – April 2024 Blog
- International Monetary Fund – October 2024 Report
- KKR - Private Credit Investing: What You Need to Know
- MFA - Private Credit
- Securities and Exchange Commission - SEC Adopts Amendments to Enhance Private Fund Reporting
- U.S. Department of the Treasury - FSOC Approves Analytic Framework for Financial Stability Risks and Guidance on Nonbank Financial Company Determinations