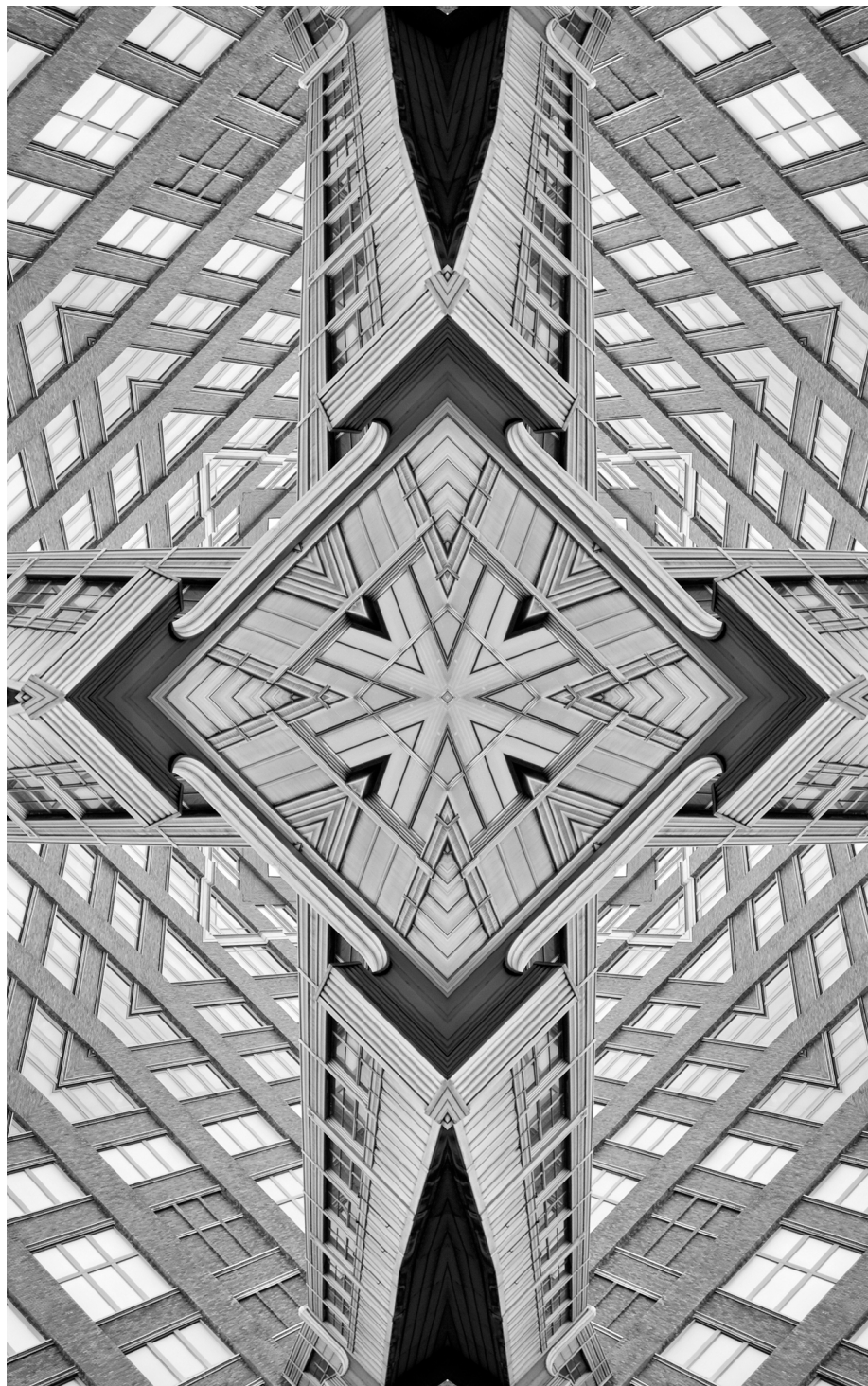


Issue Brief

ISSUE NO. 783
FEBRUARY 2025



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The Changing Contours of Private Credit: The Market Implications of a Seemingly Endless Stream of Supply and Demand

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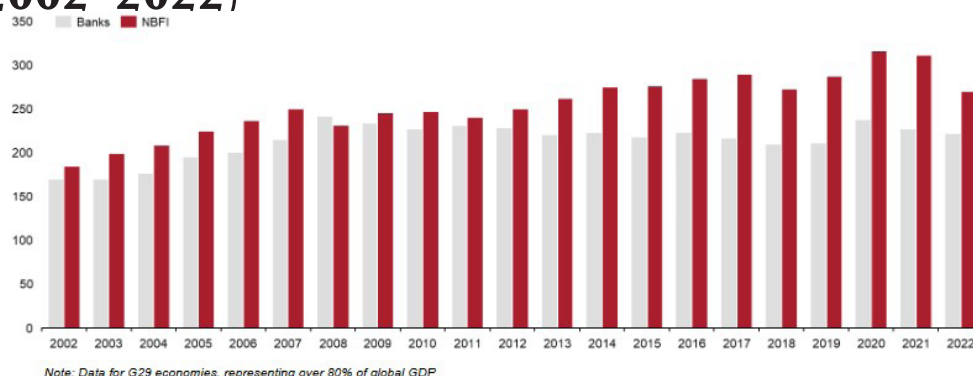
Abstract

Despite a seemingly endless supply of and demand for private credit, the rapid expansion of the market has been a cause of concern for some regulators and executives. Should investors be worried? This brief explores certain aspects of private credit that warrant a close look—including the retailisation of the market and the current interest rate environment. It highlights the implications for financial stability, including the potential for finance to be rendered a disservice to the real economy.

The financial cycle is never eradicated, nor is financial instability ever really extinguished. On the contrary, financial risk moves like liquid mercury out of certain entities and into others. And increasingly credit-fuelled economies are especially prone toward credit crises. In many ways, regulation can be backward-looking, and thus can often be directed toward the last crisis. Over 17 years since the Global Financial Crisis (GFC), regulators maintain a keen focus containing banking crises;¹ justifiably so, as the recent banking wobbles in the United States (US) in March 2023—and those which rippled across the Atlantic—demonstrate that risks are still inherent (and perhaps contagious) within the global financial system.

And yet, looking beyond the traditional banking system, potential vulnerabilities lurk within certain elements of the system of non-bank financial institutions (NBFIs).² The late American economist, Hyman Minsky observed that strong medicine can have strong side effects.³ And one side effect of the regulation imposed upon globally systemic important banks (GSIBs) in the wake of the GFC has been for a swelling of assets under management (AUM) held by the NBFIs. As shown in Figure 1, since the GFC, the spread between the global AUM held by the shadow banks (NBFIs) and those held by the traditional banks has widened considerably. Accordingly, the Financial Stability Board (FSB) has been focused on ‘strengthening the resilience’ of the NBFIs on a global basis,⁴ given the lack of transparency and systemic stress testing within the industry.

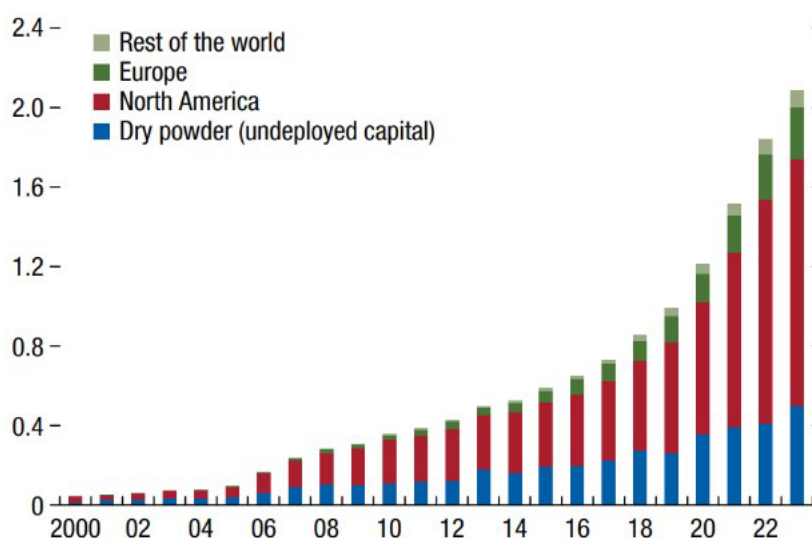
Figure 1: Assets of Global Bank and Non-Bank Financial Institutions (% of GDP, 2002–2022)



Source: Financial Stability Board⁵

One area under acute focus beneath the NBFI umbrella is the explosive growth of the private credit (PC) market. Expanding at an annual rate of 20 percent in the US and in Asia over the past five years—and by 17 percent over the same period in Europe—PC assets (invested and undeployed capital) have grown to an estimated US\$2.3 trillion globally⁶ (see Figure 2).

Figure 2: Private Credit Assets Under Management by Region (in US\$ trillion, 2000–2023)



Source: International Monetary Fund⁷

Private credit emerged as a bespoke form of typically first-lien financing provided by asset managers to middle-market firms, usually designated as ‘too risky’ for large banks and ‘too small’ for public markets.⁸ In the corporate space, a bulk of these PC borrowers are within the technology and healthcare sectors. PC managers—the majority of which are private equity houses—construct loans on a bilateral basis, which are then funded by end investors, such as institutional investors, including pension funds and insurance companies. As private credit has become an institutionalised source of capital, traditional banks are rethinking their role in lending and increasingly working with PC managers for mutually beneficial access to the market. Although PC

managers initially focused on the provision of financing to the non-financial corporate space, it now also has the potential to extend deeper into the real asset landscape, as a preferential form of lending for asset-based finance in infrastructure.⁹

While some regulators, investors, and industry bodies have expressed concern regarding potential risks to financial stability that could emanate from PC,¹⁰ such anxiety has yet to translate into far-reaching regulation. And yet, two aspects of the PC market warrant a clear-eyed look from executives, investors, and policymakers. First, the emerging trend of retailisation of the PC market may invite more scrutiny from regulators.¹¹ As private credit invites more public participation, the combination of inherently illiquid assets with an open-ended structure could result in forced asset sales to meet lender demands or redemption requests. This would likely not only increase losses to the fund's investors, but create broader investor concerns and instability which could have a ripple effect across financial markets. While the participation of retail investors in private markets is a welcome opportunity—insofar as it democratises access to differentiated asset classes—fund managers will need to implement sufficient mechanisms to manage elevated liquidity risk. Thus, the ability to impose significant redemption controls is likely to gain importance.

Second, this growing trend of retailisation—combined with the current interest rate environment—also raises alarm bells. As many regulators concede, private credit has never experienced a downturn. Moreover, a rapid acceleration of the PC market unfolded within a low interest rate environment. The bulk of PC loans are floating rate, and borrowers may come under duress in a higher-for-longer interest rate environment (or even just a prolonged relatively higher rate environment). As will be discussed later in this brief, early signs of stress for borrowers are evident in an increase in the use of the 'payment in kind' (PIK) instrument, according to which PC borrowers—faced with higher or seemingly unaffordable debt service costs—pay interest 'in kind' via adding another layer of interest to their principal loan.¹² Borrowers are increasing in propensity to defer interest (and increase leverage), the longer the duration of the higher interest rate environment. One can see how troublesome the use of such 'IOU' payments might be in the event of a downturn within the private credit market, or credit markets, more broadly.

Introduction

In the heady craze of “animal spirits” within financial markets—as equity indices in the US continue to reach historic highs—it might ring of Cassandra or Eeyore to highlight potential vulnerabilities lurking beneath the surface. However, the confluence of several factors—namely, the potential for an increase in retailisation, and the use of open-ended structures, as well as the timing of the cycle in the US—raises some concerns. While the provision of credit to the real economy (the supply side) and the democratisation of private markets (the demand side) can be beneficial developments for growth and wealth—the current lack of substantial controls tailored to the risks inherent in PC structures underpins an environment of potential ‘accidents waiting to happen’.¹³ As the contours of the private market continue to shift and expand, investors and policymakers will need to work collaboratively to prevent a scenario that could undermine confidence in markets, potentially harming the very growth it is meant to finance.

Private Credit: A Seemingly Endless Stream of Supply and Demand?

From a supply and demand standpoint—for creditors as well as borrowers—the private credit universe seems to be expanding along an unstoppable trajectory with some investors estimating a total addressable market as large as US\$40 trillion or more. For end investors, years of sky-high equity markets have prompted institutional (and retail) investors to hunt for yield elsewhere—and high yield debt has provided relatively tantalising yields.

While elements of the junk bond sector came under pressure during the initial waves of the COVID-19 pandemic in the US¹⁴ (prompting intervention by the US Federal Reserve in order to stabilise the market), returns from the private credit space have been comparatively resilient (partly due to being mostly floating rate assets). By some estimates, private credit assets have provided an average return of 11.6 percent between 2008 and 2023.¹⁵ In 2023—described as the ‘golden age’ of private credit¹⁶—many investors were pleased with the performance of private credit over other alternative assets, including private equity and infrastructure.¹⁷

Accordingly, institutional investors have poured into the private credit market. On the hunt for yield, pension funds in the US alone have invested over US\$100 billion in the asset class,¹⁸ with allocations set to significantly rise in 2025.¹⁹ Insurance companies are also major (and growing) end investors in private credit, in part, because they need to hold long-term assets on their balance sheets, and can thus incur an ‘illiquidity premium’. In turn, private equity companies, who act as sponsors and managers for the bulk of private credit deals, have increasingly shifted into acquiring insurance companies outright.²⁰ These ‘private-equity-influenced life insurers’ have a growing exposure to illiquid assets, which includes private credit.²¹ Traditional banks, too, have been getting in on the private credit game. On a regional basis, banks are playing a larger role within PC in the US market, followed by Asia-Pacific and Europe.²²

On the demand side, PC borrowers—often too small for recourse to debt from public markets, or too levered for traditional lenders—favour the bespoke terms for financing offered by PC managers. In turn, PC managers work collaboratively with private equity sponsors, who can infuse their own capital into their own portfolio companies in order to bolster financing needs, thus, potentially providing stabilisation in a moment of distress.²³ PC borrowers might also favour the bespoke terms of financing written by private equity managers, and value the discreet nature that such private structuring might offer.

What Are the Principal Risks Lurking Beneath the Surface?

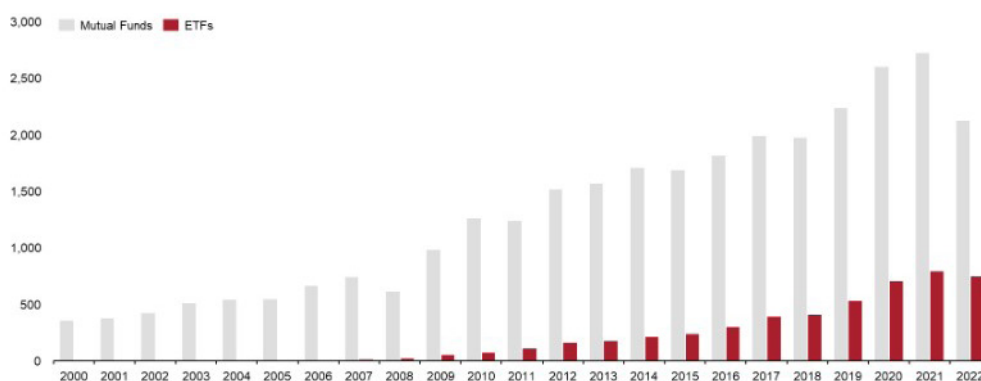
Growing Trend of Retailisation

As previously indicated, one clear concern regarding the sweeping proliferation of PC emanates from the retailisation of the market and the potential combination of illiquid assets with open-ended structures. In this regard, it is important to view this development within the context of the broader trend of the retailisation of credit.

Consider again the supply and demand dynamics of credit provision: On the supply side for investors and for credit managers, one side effect of tighter regulation on the banks in the wake of the GFC has been for non-bank lenders to take on a growing share of corporate debt.²⁴ Beneath that umbrella, asset management firms have taken a larger market share of bonds, whose share of the total bond market has increased from about 5 percent in 1990 to 37 percent in 2022.²⁵

As a subset of asset management, retail funds in the US—in the form of mutual funds (MFs) and exchange traded funds (ETFs)—have also steadily increased their bond holdings over time (see Figure 3).

Figure 3. Bond Holdings of US Mutual Funds and ETFs (US\$ billion, 2000–2022)



Source: National Bureau of Economic Research²⁶

What Are the Principal Risks Lurking Beneath the Surface?

And, seeking higher returns (and a diversification away from sky-high US equity markets), many of these investors have accordingly moved into riskier debt classes over time.²⁷ The experience of corporate bond market fallout during March 2020 has not dissuaded investors from moving into riskier debt (perhaps, in part, because of the Fed's intervention to stabilise the market).²⁸

Thus, private credit has proliferated within this backdrop of asset managers of ETFs and MFs expanding their exposure to riskier debt. The potential problem is that the retailisation of PC involves combining illiquid assets with semi-liquid structures (the latter of which appeal to a broader investor base). Given that the PC market has yet to experience a real 'downcycle',²⁹ the kind of liquidity management controls PC managers might have instilled is still unknown; and so is the adequacy or performance of those mechanisms in a truly distressed scenario. As some sponsors look to raise new open-ended funds within private credit, regulators and industry bodies may have such 'known unknowns' on their mind.³⁰

This also raises the issue of valuation risk: because of the inherently private nature of PC, these assets have not been subject to the price discovery often found within secondary or public markets, and as a result, commonly rely on a combination of internal models and third-party estimates of value. Further, historical PC funds were typically marked quarterly, and at most monthly, with only a few providing a limited level of redemptions. When considering the opacity of PC valuations within the context of an emerging set of open-ended retail funds, PC managers will need to establish a new set of processes and controls to provide accurate and timely valuations—and also, to adapt these valuations in response to an ever-changing business and economic environment.

Furthermore, consistent with an emphasis on liquidity risk management, managers should evaluate scenario analysis that simulates broader systemic stress (or artificial volatility) in order to test their liquidity management capabilities—and perhaps take on board suggestions from cross-border regulators and industry bodies as to how best to carry out such stress tests in an evolving market.

What Are the Principal Risks Lurking Beneath the Surface?

Cycle Risk

The second key risk related to the expansion of the PC market is where we are in the current cycle. As previously discussed, PC proliferated during a period of low interest rates within the US, Europe, and pockets of Asia. Assuming a higher-for-longer interest rate environment within the US—and recognising that the bulk of these loans are floating rate³¹—borrowers could come under duress in a prolonged higher rate environment. As mentioned earlier, the increase in the use of the PIK instrument is potentially an early warning of signs of distress. Data shows that the share of PIK interest within BDC interest income has doubled since 2019.³² Borrowers are thus increasing in propensity to defer interest payments, thereby increasing their leverage, the longer we advance in a higher interest rate environment.

In 2024, and looking out to 2025, a multitude of managers from different parts of the financial system have signalled their expectation of focusing on growing AUM through private credit. Yields have compressed, and spreads have tightened. Given the market expansion, PC managers are rapidly identifying new sources of credit origination to meet the growing investor demand. This pressure to secure more origination could lead to even more competitive pricing, or drive deterioration of underwriting quality, as the pressure to deploy dry powder begins to mount. As one author concedes, within the rapidly swelling PC market, credit sponsors may look afield to lend to even riskier borrowers in order to provide juicy returns.³³ Therefore, a higher-for-longer interest rate environment may not only place existing PC borrowers under added strain, but it might also naturally create more demand for borrowers in a riskier segment. Imbalances may continue to build up and deepen from the pressure to deploy amidst swelling investor demand.

A potential scenario to consider is one where the tide goes out on one segment of the corporate debt market (as it did in the high-yield space in the US in March 2020). Investor confidence could then swiftly dissipate within other elements of the credit market (including PC). Such a loss of confidence could also come from a seemingly uncorrelated sector shock: for example, a loss in faith within the oil and gas industry,³⁴ or from within the tech sector. In such a scenario, cross-border linkages might also become problematic: for example, even though regulators have conceded that the PC market within the Asia-Pacific region remains slender (currently standing at 0.2 percent of credit to the non-financial sector),³⁵ the majority of PC managers hail from North America.³⁶ Should any instability erupt within credit markets within the US, this could quickly cascade as a contagion risk across borders, or from within markets, by a potential loss of confidence in foreign managers.

Finance in the Service of the Real Economy?³⁷

The financial cycle remains an inescapable facet of our global economy. In the heady days of animal spirits in financial markets—with US equity indices hitting historic highs—the discussion of the eternal presence of gravity may be perturbing for some. Nevertheless, as economic history shows, imbalances build up—and in recent decades, this is often a facet of the trend of hyperfinancialisation of economies—as well as that of unchecked exuberance.

As the traditional banking sector has adapted to the ‘strong medicine’ of regulation in the wake of the GFC, the non-bank financial institutions have assumed a greater share of global AUM, and have spurred additional forms of lending. Additionally, the NBFIs continue to innovate in generating retail products, inviting more and more public participation into private markets. Certainly, both provide an important role in our economy in the potential to generate growth and wealth. First, the provision of credit is a beneficial cog in the wheel of the real economy. For example, the stunning growth of the venture capital industry in the United States has spurred significant innovation as well as job creation over decades,³⁸ and has even magnetised tech unicorns to relocate from Europe.³⁹ Second, the democratisation of capital markets, and the opportunity for retail investors to participate in yields generated from private markets, can be inherently beneficial. Mario Draghi,^a former European Central Bank President, has recently highlighted the ways in which a comparative lack of exposure to capital markets and ‘productive investments’ within Europe has undermined the transformation of household savings into wealth (relative to the US).⁴⁰

As a subset of NBFIs—and indeed, even extending beyond, given the traditional banks’ expansion into the space—the private credit market exemplifies both of these opportunities, but it also makes apparent certain risks. First, given the seemingly endless supply of and demand for PC, underwriting quality may deteriorate, the longer we go in this cycle. Added to that, in a higher-for-longer environment, borrowers are increasingly resorting to the use of the PIK instrument.⁴¹ This use of interest to make interest payments illustrates

a Mario Draghi—one of Europe’s foremost economists-- was tasked by the European Commission to prepare a report of his personal vision on the future of European competitiveness. It was published in September 2024.

Conclusion

an element of distress, which might be exacerbated in a higher-for-longer interest rate environment.

Second, the potential expansion of retail participation within PC, and the design of structures catered to meet some demand, also merits close examination. The marriage of illiquid assets with open-ended structures may be problematic, especially within a ‘downcycle’ scenario. This, of course, raises the challenge of valuations within the PC market, given its inherently private nature. Perhaps in this regard, acting as stewards of capital, the most sagacious PC managers will proactively collaborate with regulators and industry bodies in order to instill substantive liquidity controls. Such sponsors would regard implementing these guardrails not as a hindrance to their fiduciary duty, but rather, as an extension of it—and hence, an expression of prudence and investor protections.

Yet, as one regulator points out, even strong individual fund management may not be sufficient if the tide goes out,⁴² and thus, if the PC market meets its ‘Minsky moment.’ In such an event, given the interconnectedness of markets—and the cross-border and active role of PC managers in the Asian and European markets⁴³)—certain geographies are not immune to problems shaking out, for example, in the US. Looking beyond geographies, and into sectors, the expansion of PC beyond corporate paper into new frontiers, including infrastructure and asset-based finance,⁴⁴ might also warrant a closer look.

In sum, while some observers have conceded that the PC may not currently present a systemic risk,⁴⁵ as economic history and a study of financial cycles clearly evidences, tremors in one part of a market (such as a pocket of the credit market) can have a ripple effect into other asset classes. Should such instability emanate from PC, it may indeed render finance a disservice to the real economy, thus unravelling the very growth that it was meant to spur. 

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The views expressed here are entirely those of the author, and not necessarily those of PwC or of ORF.

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