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Private credit aspirations and realities

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Summary

- Private credit has grown rapidly and spread into new lending sectors
- However, the opportunity may not be as vast as anticipated
- Systemic risks from private credit are low but could rise in a lending boom

Private credit has evolved since the Great Financial Crisis (GFC) from a niche player to one of the five main pillars of corporate debt finance (see Table 1) and is increasingly spreading into asset-based lending (ABL[1]) in consumer and real estate finance as well as hard and financial assets.[2]

Table 1: Debt financing sources of US non-financial corporates

	2010 $ trillion	2024 $ trillion	% change annual rate
Bank loans	1.4	2.6	4.5
High-grade bonds	3.0	5.6	4.5
High-yield bonds	1.0	1.4	2.5
Leveraged loans	0.5	1.4	7.4
Private credit	0.2	1.6	15.3
All	6.2	12.6	5.3

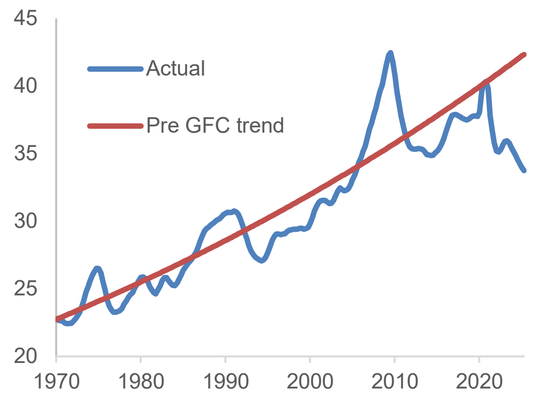
Source: Moody's, Board of Governors of the Federal Reserve, sifma, JPMorgan. [3]

We attribute the rise of private credit to five factors.

- First, the partial withdrawal of banks in the loan market since the GFC due to regulatory changes and new business priorities has created room for non-bank lenders.[4] We estimate that bank lending to businesses and households is 7.5% of GDP (2.6 trillion USD) lower than it would have been if the pre-GFC trend had been sustained (see Chart 1).

Chart 1: Bank lending to businesses and households

% of GDP



Source: Board of Governors of the Federal Reserve, Bureau of Economic Analysis. [5]

- Second, private credit funds seized that opportunity by focusing on smaller borrowers with limited market access and offering faster execution and customized loan terms, which give more flexibility, especially in times of stress.[6]

- Third, private credit has benefitted from the growth of private equity, with some private equity funds establishing their own private credit divisions.[7] In 2022-2023, private credit accounted for more than 80% in LBO financing activity.[8]

- Fourth, the long period of low interest rates between 2010 and 2021 prompted investors to seek higher returns in alternative markets with many institutional investors establishing dedicated private credit investment strategies.[9]

- Fifth, private credit was able to capitalize on heightened financial uncertainty during Covid and the period of Fed tightening in 2022-2023, which made deal execution in bank lending and securitization markets less predictable.[10]

Overall, we think private credit has done well so far in balancing liquidity and valuation problems inherent to private markets with good due-diligence, documentation and credit risk management. In our view, private credit has supported financial intermediation in a changing environment since the GFC and added value to both borrowers and investors.

Aiming for the skies …

As the interest in private credit increases and new avenues within private credit emerge, industry reports predict that private credit will continue to grow at double digit rates in coming years with the addressable market opportunity pinned at 20 to 40 trillion USD.[11]

In the corporate sector, some private credit funds are shifting their focus to the much bigger market for large high-grade issuers.[12] The greater opportunity, however, is seen in the ABL market.[13] In particular banks, which compete with private credit funds in the corporate market, are teaming up with private credit funds in the ABL market.[14]

Institutional investors are also raising their allocations to private credit with more than half indicating in a recent survey that they would prioritize ABL strategies in 2025.[15] Retail investments in private credit account currently for less than 20% of total assets under management but are growing faster than institutional investments and private credit managers are lobbying the government for better access to 401k plans.[16]

... but perhaps settling for less

We agree that private credit will continue to grow but perhaps at a more moderate pace. In the corporate space, we think private credit growth will ease and come closer to the growth of the overall corporate debt market. Similar in size to the high-yield bond and leveraged loan markets (see Table 1 again), private credit is no longer a niche-player and is facing more competition from public markets.

In fact, private credit direct lending to corporates declined in the first half of 2025 by 12% from a year ago to 125 billion USD.[17] Private credit dominated corporate loan refinancing activity 100% in 2022 and 2023, yet in 2024 and in the first half of 2025 roughly as many private credit loans were refinanced by the syndicated loan market as syndicated loans by private credit funds.[18]

We are convinced that private equity will continue to play an important role for private credit but expect private equity growth itself to moderate as hopes for declining interest rates, sustained US growth exceptionalism and deregulation initiatives fade while risks of more disruptive policies materialize.

We also believe that some large high-grade borrowers may value more bespoke debt financing structures, but we are convinced that the majority will not be willing to pay the extra premium that private credit funds need to achieve their return targets. And with interest rates expected to stay higher for longer, we think that many institutional investors will prefer the high-grade corporate bond market, given its size, liquidity, uniformity and transparency.

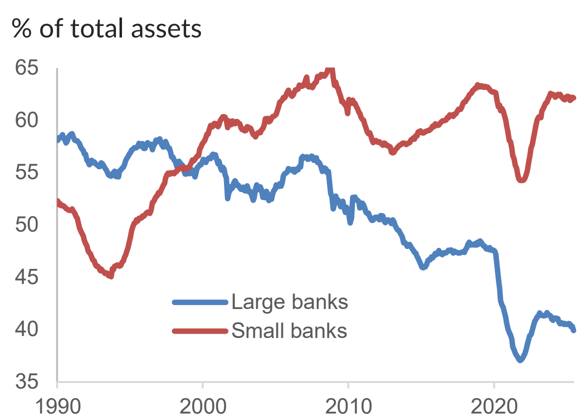
In our view, the growth opportunity is probably larger on the ABL side, as this is a more recent development. However, we don't think the addressable market is as big as the outstanding debt on the public side of the market suggests. Similar to corporate direct lending, we believe the main opportunity for private credit in the ABL market is with smaller and more specialized issuers or loan/asset portfolios, which narrows the opportunity.

We think that the self-amortizing and bankruptcy-remote format reduces the structural risk profile of ABL versus private direct lending to corporates. Yet we view ABL structures as more complex and operationally riskier, requiring more specialized and experienced managers. Given this higher barrier to entry, we expect that a only limited number of mainly large private credit funds will make a successful shift into private credit ABL.

Last but not least, private credit growth projections are predicated on the assumption that banks will continue to retreat from the lending market as rapidly as they have in recent years. In our view, consolidation in the banking system and further optimization of the use of bank capital will create room for nonbanks.

However, the balance-sheet restructuring is already well advanced with the large banks (see Chart 2).

Chart 2: Bank lending to businesses and households by bank size



Source: Board of Governors of the Federal Reserve.[19]

Smaller banks, on the other hand, hold fewer loans in the prime focus areas for private credit and are more exposed to commercial real estate (CRE) loans.[20]

We see private credit making some inroads into CRE via direct lending, notably in short-term bridge financing and with distressed property owners. However, we believe this opportunity is limited, especially if distressed situations in CRE decline; we think that CRE is less suitable for ABL strategies.

Watching mostly from the sidelines

Regulatory and supervisory authorities worry that the spread and growing systemic importance of private credit could become a risk for financial stability, given liquidity, pricing, leverage and transparency concerns.[21]

In the May 2023 Financial Stability Report (FSR), the Fed still stated that "financial stability risks from private credit funds appear limited".[22]

This FSR specifically pointed out that redemption and fire sale risks posed by private credit seem to be low, largely due to long lock-up periods and low leverage or derivative exposures.[23] However, the FSR also noted that the opaque nature of private credit makes the assessment of risks to financial stability extremely difficult.[24]

A Fed study in 2024 found that default rates in private credit have been low compared to the leveraged loan and high yield bond markets, particularly in direct lending.[25] The Fed attributed the low default rates to the periodic monitoring of borrowers through loan covenants as well as the ability to renegotiate flexibly with the borrower and other creditors in stress situations.[26]

Yet, the study also pointed to industry commentary which suggests that recent deals were devoid of financial maintenance covenants as private credit managers increasingly compete with banks over loans to large corporates.[27]

In the latest FSR from April 2025, private credit stress was mentioned for the first time as one of the most cited potential shocks in the survey of salient risks to the financial sector.[28]

Private credit stress ranked far behind risks to global trade, policy uncertainty and US fiscal debt sustainability but ahead of nonbank financial institutions stress, the value of the US dollar and corporate credit stress.[29]

There have been several proposals by US regulators for additional reporting and data collection requirements for private credit funds in 2024, but none has been implemented.[30]

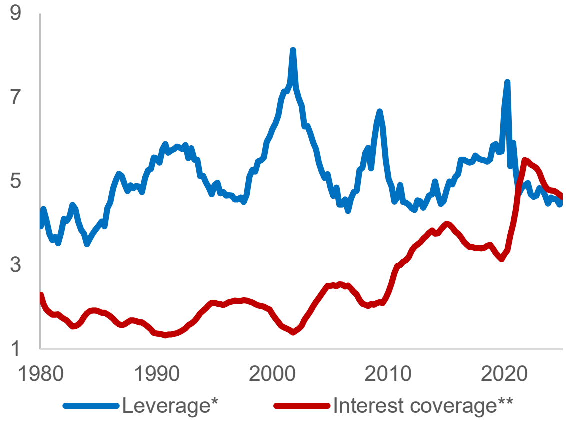
Becoming riskier but not yet systemic

We think that private credit is becoming riskier as more players and money pursue an opportunity that we think is less vast than anticipated.

A concern to us is that rising dry powder[31] and competitive pressures could lead private credit funds to relax their lending and risk management standards.

So far, this has not created an overall lending boom that overstretches debt-servicing capacities, as in the runup to the Dot-Com bubble and the GFC: in the corporate sector, leverage is at the lower end of the historical range and interest coverage is close to the recent high (see Chart 3 on next page), while household debt service payments are at a sustainable level thanks to the declining debt burden (see Chart 4 on next page).

Chart 3: Corporate leverage and interest coverage ratios

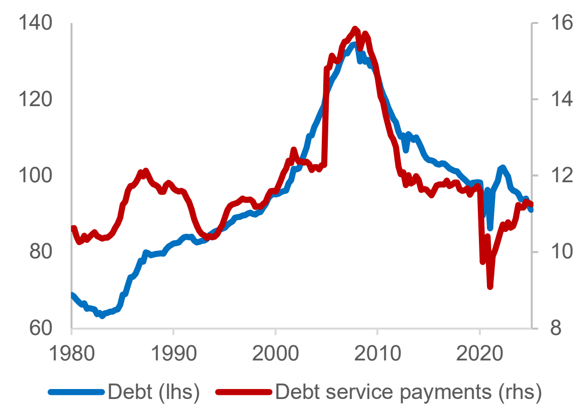


* Debt/EBITDA; ** EBITDA/Interest Payments

Source: Bureau of Economic Analysis [32]

Chart 4: Household debt and debt service payments

% of disposable income



Source: Bureau of Economic Analysis, Board of Governors of the Federal Reserve System [33]

Thus, while becoming riskier, private credit does not yet pose a serious risk to financial stability, in our view. However, that could change if (against our expectations) private credit growth remains higher for longer and fuels an unsustainable lending boom with eroding loan standards.

We believe that, on balance, private credit funds so far have been able to avoid escalating credit risks, but that is no guaranty for the future. We see no inherent structures and risk management processes that make private credit uniquely stress resilient, and are concerned that regulatory and supervisory institutions have insufficient insight and control to prevent lending and leverage excesses.

Periods of general market optimism, as was the case in the runup to the Dot-Com bubble and the GFC, could lead to such a lending boom, which also attracts more funds from nonprofessional sources such as retail investors. A combination of lax fiscal and monetary policies could prepare the stage for a greater risk scenario.

A particular catalyst could be an investment boom in artificial intelligence and related infrastructure such as data centers, that ultimately fails to deliver the expected productivity gains. According to Apollo Global Management, private credit may play a key role in financing the data center boom, which it estimates will require more than 2 trillion USD over the next five years.[34]

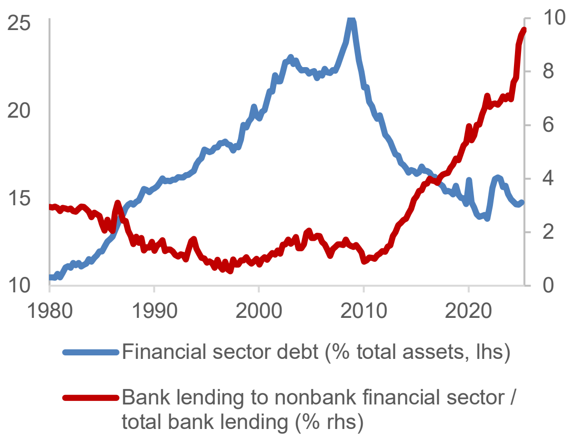
A final concern is interconnectivity and leverage within the financial sector. Overall financial sector leverage has declined significantly since the GFC but lending by banks to nonbank financial institutions, which includes private credit funds, has increased significantly (see Chart 5).

Besides actual lending, the nonbank financial sector also receives support from banks in form of loan commitments. According to a recent analysis by the Fed, credit lines by the largest US banks to private credit funds increased by 145% over the last five years, to 95 billion USD.[35]

In our view, these growing linkages are part of the transformation from bank to nonbank credit and facilitate the operation of the financial system in normal times. Under stress, however, these linkages could backfire and further undermine overall financial stability.

Chart 5: Financial-sector leverage and bank lending to nonbank financial sector

Percent



Source: Board of Governors of the Federal Reserve System [36]

This risk also applies to the insurance sector, which is the largest investor group in private credit.[37] In our view, the longer-dated exposures of private credit align well with insurance companies' long-dated liability profiles, but that is no automatic protection in an economy-wide stress situation and could further undermine financial stability given the size and systemic relevance of the insurance sector.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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[1] ABL is a type of private credit in which the lender's primary source of repayment is a specific pool of contractual cash-flowing assets. The underlying loans are typically consumer and real estate loans as well as hard and financial assets. This borrowing is usually structured in a bankruptcy remote format with the assets as collateral.

Some private credit funds have their own loan origination companies but most private credit managers source the loans for their ABL portfolios in collaboration with banks and finance companies through portfolio sales, origination partnerships or synthetic risk transfers. In most structures, the originating bank or finance company is required to retain a first loss position to ensure risk sharing.

In contrast to the direct-lending market, however, banks and private credit managers are less competitors than partners in the ABL market. For banks, partnering with private credit funds in the loan origination allows them to use their capital more efficiently but keep customer relationships. Furthermore, banks can invest in less-capital-intensive senior tranches from the ABL capital structure to exploit their low-cost funding.

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[37] The estimated share of private credit assets funded by insurance companies ranges between 40% and 70% for the largest private credit funds.

Paul, Weiss, Rifkind, Wharton & Garrison LLP; Private Credit Market Trends: From Originations to Bank Partnerships and Insurance; March 10, 2025.

https://www.paulweiss.com/insights/client-memos/part-i-private-credit-market-trends-from-originations-to-bank-partnerships-and-insurance

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