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Private Credit and Financial Stability

Discussion of Chernenko and Scharfstein

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Disclaimer: The views expressed here are my own and not those of the ECB or Eurosystem

The paper

- **Question:** What are the financial stability risks of private credit funds?

- **Data:** 2024Q4 data from SEC filings on the population of business development companies (BDCs), which are a subset of private credit funds involved in direct lending

- **Analysis:** Evaluate the deleveraging risk of BDCs in a severely adverse stress scenario in which the fair value of BDC assets falls, potentially causing a violation in SEC leverage restrictions (A/D>1.5) or loan covenants in bank credit facilities

- **Deleveraging channels:** BDCs may be forced to (a) use loan repayments to pay down debt (instead of making new loans) and (b) sell loans in their portfolios, possible at fire sale prices

Simulation setup

- Adverse shock to the BDC's **portfolio value** consists of the combination of: (a) spike in default rates and (b) increase in yield spreads on BDC portfolio loans.
- Use the **GFC as benchmark** for increase in yield spreads
- Apply rating-specific, GFC (option-adjusted) yield increase on corporate bonds to BDC loans
- Reduce peak increase in yield spreads by about 10 percent on account of higher recovery values for loans as opposed to bonds
- Assume that yield spread captures any fire sale discounts and portfolio holdings are sold at their fair market value
- Assume that debt structure of BDCs remains unchanged
- Assume that BDCs reinvest into existing portfolio (as opposed to new loans)
- **Extensions:** portfolio firms draw down on their credit facilities; equity redemptions by limited partners; correlated default shocks within industry

Main findings

- Median BDC experiences sharp decline in gross assets on account of higher yield spreads, depressing the valuation of portfolio loans
- **Active deleveraging** is relatively modest for the median BDC, but some BDCs in the tails experience substantial deleveraging
- Deleveraging first takes place mostly in the form of **asset sales**, and then increasingly also through **debt repayments**
- **Extensions:** Drawdowns by portfolio firms would substantially increase the deleveraging
- **Case studies from GFC:** Limited deleveraging by BDCs

Some background on the private credit funds landscape

- Private credit in the US totaled around US$1.7 trillion, about a five-fold increase since 2007 (Cai and Haque 2024). **Direct lending** amounts to about half of the total.
- **Private credit** has become a major source of debt financing, similar in size to syndicated loans and close to half that of C&I loans (Fillat et al. 2025). BDCs are a major vehicle in this market (about one quarter), alongside private credit funds (Berrospide et al. 2025).
- Large concentration of **fund managers**, with Ares, Blackstone, and Blue Owl being large players (Chernenko et al. 2025).
- Largest **investors** (limited partners) are pension funds and insurance companies, with Allianz and Metlife alone each holding about US$ 150 billion (Private Debt Investor 2025). Relatively high returns for these investors (compared to bonds).
- **Direct loans** tend to be secured, first lien, floating rate, and target middle market segment in high tech, services, and healthcare sectors (Chernenko et al. 2025). Low default rate (compared to high yield bonds and syndicated loans), but relatively low recovery rate (33%) upon default (Fillat et al. 2025).
- **Bank loans** to BDCs tend to be BBB (65%) or BB (20%) (Fillat et al. 2025)

Comments on the simulation exercise

- It is a **good idea** to model deleveraging originating from a deterioration in asset values due to increases in default risk and yield spreads
- It is not completely clear how well the risk of **fire sales** is incorporated in the analysis, especially the potential for price spirals
- Loans in BDC portfolios are highly illiquid; is such **liquidity risk** properly accounted for?
- What if the **liquidity of banks** themselves is squeezed in a liquidity crisis and they do not stand ready to provide additional liquidity to BDCs?
- When using the GFC as a benchmark, yield increases are mitigated by strong **Federal Reserve support** in the form of liquidity provision in credit markets (for instance, the Commercial Paper Funding Facility (CPFF), while primarily focused on stabilizing the commercial paper market, indirectly supported the corporate bond market).
- Assumption: Fed would (indirectly) support private credit market next time around.

Other financial stability channels

- Paper focuses on deleveraging channel, triggered by decline in the value of assets associated with loan defaults and rising spreads
- **Mitigating factors:** high capitalization; bank loans tend to be secured, first lien; sizeable undrawn credit commitments (“dry powder”)
- **Other possible channels:**
  - Spillovers to banks and other entities that provide capital (loans, bonds, equity) to BDCs – but bank financing tends to be highly collateralized and first-lien senior secured
  - Spillovers to banks from their lending exposures to portfolio firms (Haque et al. 2025 shows that many private debt borrowers also borrow from banks)
  - Erosion in credit standards during the rapid credit expansion, which leaves overleveraged borrowers vulnerable to negative shocks
  - Fire sales spirals
  - Reliance on banks for emerging liquidity could pose systemic liquidity risk in the event of a generalized liquidity crisis, with banks drawing down their credit lines

Policy takeaway and future of private debt

- Scenario analysis in the paper concludes that direct exposure of banks to default risk in private credit seems manageable, but:
  - Private credit funds may not be able to rely on **bank funding** in a systemic crisis
  - Banks are **indirectly** exposed to private credit because many firms borrow from both
  - Several major **insurance companies** have large capital exposures
  - Private credit is heavily concentrated in a **few sectors**
  - Focus of the paper is on BDCs that are regulated (with quarterly reporting) but other private credit funds are only **lightly regulated** with minimal disclosure, and often have less strict leverage constraints, and their closed-end nature makes them highly illiquid
- There are reasons to believe that the **boom in private credit** may slow down:
  - Sizeable “dry power” indicates a lack of investment opportunities
  - Sharp increase in bond yields may make private credit less attractive for debt investors
  - Financial deregulation of banks could revert the retrenchment of banks from middle market deals that was largely induced by regulatory pressure

Thank You !

References

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