A revealing report on the rise and rise of private credit

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The governor of the Bank of England, Andrew Bailey, who is also chair of the Financial Stability Board (FSB), a global watchdog, is worried about the stability of the global financial system because of the explosive growth of private credit. And along with others, he has good reason to be as a report by the FSB released this week makes clear.

It reveals that while private credit, particularly in the US, has come to play an increasingly large role in the global financial system it is shot through with risk factors that could set off a major financial crisis under conditions where regulatory authorities exercise very little control over and in many cases are in the dark about its operations.

Having overseen the preparation of the FSB report, Bailey expressed some of his concerns in a comment piece in the *Financial Times* this week entitled "We must be mindful of the risks of private credit."

According to the report, the private credit market has grown 10-fold since 2009 in the wake of the global financial crisis "with an aggregate size estimated to be between $1.5 trillion and $2 trillion" at the end of 2024. The fact that the FSB makes an "estimate" of the size of this market itself points to one of the risk factors, namely, that its operations are very much out of sight.

Private credit has been undergoing exponential growth. Since 2019 it has experienced a three-fold increase in the US with an estimated size of around $1 trillion. Over the past five years it has expanded at an annual rate of 16 percent in Canada and 17 percent in the United Kingdom. The average annual growth in the euro area over the past decade has been 10 percent. It has also experienced a five-fold increase in emerging markets over the past decade.

Bailey noted at the outset that there was no doubt private credit offered "significant benefits" in that it offered alternative credit solutions to borrowers by providing financing to so-called "underserved sectors"—those unable to obtain credit from banks and other traditional sources—and has diversified lending. But in recognizing these benefits, he continued, "we must be mindful of the potential risks."

One is reminded of a comment made by Karl Marx, that at the beginning the credit system develops as the "humble servant of accumulation," but then intensifies all the contradictions of the profit system.

One of the risks identified by Bailey is that "private credit remains untested in a severe or prolonged economic downturn." He could have added that, having grown by leaps and bounds during the low-interest rate regime which followed the 2008 crash and which continued as a result of the pandemic, it has not experienced the higher inflation and high interest rates now prevailing.

"The current environment," Bailey wrote, "is becoming more challenging: heightened geopolitical risks, a weaker growth outlook and sector-specific issues including AI's potential disruptive impact. Such risks could impact the earnings and values of companies served by private credit. Any sharp or sustained rise in debt-servicing costs, or deteriorating asset quality, could place pressure on private credit funds."

And because of the interconnections of private credit providers with major banks, which provide lines of credit and other financing mechanisms, problems which may start as "borrower specific" could be transmitted more broadly.

In this context one need only recall that the subprime mortgage crisis, which started to emerge in 2007 and was dismissed at the time by the then chairman of the US Federal Reserve Ben Bernanke as having no broader significance because subprime was so small relative to the broader financial market, morphed into the biggest financial crisis since 1929 just 18 months later.

The FSB report identifies a series of potential flashpoints. One of these is that borrowers predominantly

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obtaining finance from private credit "typically lack public ratings." It also noted that some private credit borrowers "also appear to be relying more on payment-in-kind loans, which can also signal deteriorating credit conditions."

Payment in kind refers to a situation where borrowers increase the loan principal or provide the lender with equity in the firm rather than pay the interest bill in cash and is estimated to involve around 12 percent of loans.

Valuation of the assets which private credit finances also poses "challenges." This is because valuations are "often conducted less frequently and may involve significant discretion, which can amplify uncertainty during times of stress."

The phrase "significant discretion" is a euphemistic way of saying that in many cases there is no objective basis for valuations and these are recorded as what the borrowers say they are, according to their own calculations, which are then exposed when they undergo the test of the market.

The FSB report provides numerous examples of major problems. One of these is lack of information leading to a "reliance on private ratings estimates in the market, which are often provided by smaller lesser-known rating agencies. Opacity in credit quality can lead to informational contagion, which in turn can amplify credit related vulnerabilities."

A practice of credit-rating shopping has developed in which borrowers obtain better ratings from smaller agencies, anxious to increase their market share.

It noted that in the changed environment of rising interest rates, "refinancing challenges may become more severe, and persistently negative cash flows often lead to escalating debt and heightened financial stress."

There is also the problem of liquidity mismatches in which investors in private credit want to obtain their money but are unable to do so because it has been invested long term.

"Liquidity mismatches may increase going forward if managers continue offering more flexible redemption terms to attract investors, particularly retail investors."

One of the major sources of contagion is the relationship between the private credit providers and the banks which finance them. These connections often only emerge when there is a crisis or a bankruptcy.

This was the case in the failure last October of two auto-connected private credit-backed firms First Brands and Tricolor. The market reaction to the defaults was short-lived and was "digested by markets without major strains," the FSB report said.

But these events exposed a range of "potential vulnerabilities in corporate credit." In the first instance the use of off-balance sheet financing by the companies involved rendered assessment of overall financial health difficult for lenders.

The report then described the connections of the banks. "In some of these cases, banks lent to private credit funds exposed to the defaulted firms, directly to the failed companies, and to other investors that had exposures to the failed firms."

These events also revealed the globally interconnected character of the financial system "with creditors to the defaulted firms located in 11 different jurisdictions."

One of the most revealing features of Bailey's comment piece—and it is contained in the FSB report itself—is where he addresses the question of what must be done.

Seeking to foster the illusion of a financial cop on the beat maintaining control and regulation in order to prevent the eruption of another financial crisis, he presents a list of tasks which must be undertaken by the FSB.

This guardian and watchdog "will seek to improve cross-sector information sharing between authorities on risk management, strengthening supervisory cooperation. And finally, the data gaps—such as lack of sufficiently granular information of private credit funds' loan exposures, valuation practices, liquidity profiles and on interconnected exposures—must also be addressed."

This "to do" list is revealing because it shows that financial authorities have very little knowledge of the workings of a key part of the system over which they supposedly preside and regulate.

This fact underscores a broader point. At present Wall Street is surging to new record highs. But underneath the surface the conditions are developing for another financial crisis which will suddenly burst over the heads of financial authorities just as happened in 2008, only in a more severe form not least because of the enormous changes in the financial system since then of which the growth of private credit is one.

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