Private credit market under growing stress

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Investigations into private credit have revealed what has been described as "growing strains" in this area of the financial system which may have broader consequences.

Earlier this week, the *Financial Times* (FT) published a major article on the growth of "troubled loans" held by private credit firms. The previous week the *Wall Street Journal* had also reported that despite the industry's "upbeat tone" private credit was "showing increased signs of distress."

The FT article noted that strain was spreading across private credit portfolios "with some of the biggest funds taking write-downs and warning about problem loans as the industry faces its biggest challenges in a decade."

It found that of the loans made by the 20 largest business development companies that invest in private credit, 2.8 percent of the total were placed on a nonaccrual list in the second quarter, up from 2 percent at the end of March.

The nonaccrual designation is given to a loan when borrowers have stopped paying interest or the lender believes the borrower may soon default.

The author of the FT analysis, Eric Platt, elaborated further in a podcast. He said the investigation had found that the number of nonaccrual loans that investors might not get repaid or might lose money on was rising to the levels seen a decade ago "when oil prices had crashed and energy companies that had borrowed were struggling."

But the rise was now taking place against the backdrop of a "resilient US economy." This meant there were "real questions of what this means for the ability of these companies to service their debt if the economy slows or if interest rates continue to … weigh on their balance sheets."

He pointed out that the private credit market operated on a delay and was now starting to run into challenges.

"Loans that private credit funds offer are generally six or seven years long till they mature. And so you go back to the year 2020 and 2021 when there was … boom times in the private equity industry. They were scooping up companies, heaping loads of debt on them, and much of that was financed by the private credit industry."

But conditions had now changed, he continued. Interest rates at that time were near zero. Now interest rates are much higher, and there was a real question about the health of the software industry, which had been financed by private credit.

The market valuations of software companies have been hit by the development of AI because it is feared that it will be utilised to replicate many software functions as a fraction of the cost.

There has been considerable criticism by private equity and private credit chief executives, claiming that the alleged problems in this sector are the creation of a scare-mongering financial press to which Platt responded.

He said that "we are just pointing out the issues that the industry is facing right now, and that's what this data shows."

Asked whether there was a risk that problems in private credit could spread to the rest of the financial market, Platt replied: "That's the real question." At present alarm bells were not being rung but "regulators have been spending a ton of time trying to understand the interlinkages between private credit and the broader financial system."

He did not further elaborate but his response pointed to one of central problems facing would-be regulators. As numerous reports from major institutions, including the US Federal Reserve, the Bank for International Settlements, the International Monetary Fund and the Bank of England, have all indicated the private credit market is very "opaque."

This means that the connections between a company which defaults or goes bankrupt and the major banks and other institutions that have financed it only emerge in the aftermath of a crisis.

The *Wall Street Journal* has presented similar findings to those of the FT. In a report earlier this month it said private credit was "showing increasing signs of distress, despite comments to the contrary by some of the largest fund managers."

It reported that among funds overseen by major firms, Ares Management, Blackstone, Blue Owl Capital and Golub Capital "loan defaults had touched their highest level since at least 2021."

Bad loans so far had been occurring in healthcare companies and firms affected by rising oil prices but the "worry for analysts and fund managers is that defaults might spread to software companies which make up 20 percent or more of the loans in many funds."

It noted that private credit funds managed by Ares, Golub and KKR had all reported increases in the number of borrowers on a watch list for deteriorating performance, and that these lists were at their highest levels in 2022–23 when the Fed started to raise interest rates.

"Longer watchlists suggest more loan defaults could be brewing. The stress among private-credit borrowers is occurring while the US economy is performing well, a possible warning that losses could jump sharply if growth abates."

The response of the chief executives of major investment firms such as Blackstone, Blue Owl and others has been to say that overall, their portfolios are doing well and that the fears are being overblown. According to Craig Packer, the co-president of Blue Owl "credit metrics are healthy and the issues we are managing remain isolated."

But historical experience testifies to the fact that a crisis does not emerge all at once. It begins with problems at the margin which are dismissed as not essential until suddenly it becomes clear that they were the initial expression of deeper processes within the market as a whole.

No one has a crystal ball which can determine when a crisis in the highly leveraged $3 trillion global private credit market might erupt, but the signs are all pointing in the same direction. Last week, analysts at Fitch Ratings warned that private credit defaults in July had hit a new record.