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The NAIC's Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Please see the Capital Markets Bureau website at INDEX.

Private Credit Primer

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Executive Summary

- Private credit refers to debt, or debt-like, securities that are not publicly issued or traded and are primarily extended to middle-market firms.
- Private credit lenders benefit from stronger control over documentation and are able to customize terms of the transaction given their direct relationship with borrowers.
- To compensate for the illiquidity and lack of a secondary market, private credit offers higher spreads and yields than traditional, public corporate bonds and loans.
- Private credit has a variety of strategies that include direct lending, distressed debt, venture debt, mezzanine finance, and special situations.
- Direct lending is the largest segment and accounts for about 40% of the U.S. private credit market.
- The largest investors in private credit are typically pension funds, insurance companies, and sovereign wealth funds.
- As the private credit market scales up to a larger and broader base of investments, its historical performance may not translate to comparable performance in the future.
- Private credit has recently evolved from the more traditional issuer obligation transactions to more complicated structured finance type structures.
- The private credit market is estimated to range between $1.3 trillion and $1.7 trillion, dominated by the U.S., and about 4.5% of the overall U.S. credit market.

Private credit is an evolving, alternative funding source. In recent times, rather than obtaining funding through broadly syndicated loans (BSLs), an increasing proportion of middle-market funding has come from private credit. It has also grown from mostly being utilized by middle-market firms to now also serving as a funding source for larger companies that had primarily utilized BSLs and the high-yield bond market for capital financing. In addition, private credit has evolved into many types of assets, such as infrastructure projects, real estate, and asset-based lending.

Although the inception of private credit dates back to the 1980s, when insurance companies served as direct lenders to companies with strong historical borrowing standards, private credit gained broader popularity after the 2008 financial crisis. At that time, private credit represented an alternative to traditional bank lending, as regulators began imposing lending restrictions on certain financial institutions. Over time, private credit has become a competitor to traditional bank lending for all types of businesses. This includes expanding into asset-based financing, which historically has been a product of bank lending, where loans are secured by collateral, such as inventory, receivables, equipment, or property.

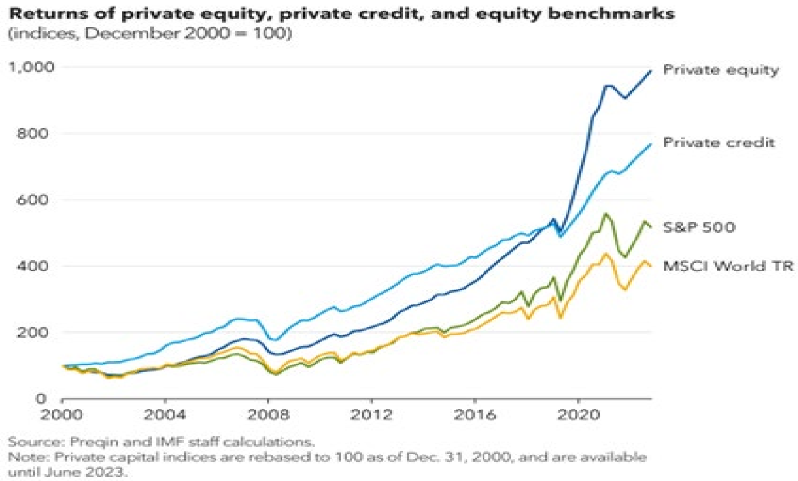
What is Private Credit?

Private credit refers to debt, or debt-like, securities that are not publicly issued or traded. Non-bank lenders, including insurance companies, private debt funds, and business development companies, issue private loans directly to mostly small and middle-market companies that do not have—or have limited—access to the public corporate bond and loan markets. These small middle-market companies often have more debt than larger companies that access capital via leveraged loans and public bonds and, therefore, they are more susceptible to economic downturns and the impact of rising interest rates.

The direct nature of the transaction allows for terms and conditions to be negotiated to meet the specific needs and objectives of the individual borrower as well as the lender. Private credit lenders benefit from stronger control over documentation and are able to derive customized terms and more flexible solutions. Working directly with borrowers generally results in faster and greater execution certainty, among other factors, than working with BSL lenders.

Private debt generally offers higher spreads and yields than public corporate bonds and loans to compensate investors for the relative market illiquidity. It also has the potential to provide greater investment returns as well as a broader pool of debt issuers that results in portfolio diversification. In addition, private credit has historically (pre-2020) outperformed private equity (PE) and equity benchmarks, as shown in Graph 1.

Graph 1:



For investors, an allocation to private debt and ensuing diversification can result in protection from general market volatility. Private debt typically prices at a floating rate, which benefits investors in a high interest rate environment.

On the other hand, private credit can create potential risks. The lack of liquidity limits investors' ability to trade private debt securities if desired, as there is a limited secondary market. As a result, valuation tends to be infrequent, and credit quality is not always easy to ascertain. However, in the event of stress, lenders and investors should be able to work directly with the borrower to modify the transaction terms or add investor safeguards. In addition, there is little to no transparency in private credit transactions for market participants who are not directly involved. It can, therefore, be challenging for outside investors and other market participants to determine and price risk. Because of minimal regulation and the opaque nature, or lack of transparency, with private credit lending, the U.S. Securities and Exchange Commission (SEC) established a rule requiring private credit fund managers to disclose more information regarding fees and certain activities.

Private credit lenders have been able to grow their investor base and diversify lending across various investor types. The largest investors in private credit typically include pension funds, insurance companies, and sovereign wealth funds, but many other types of investors are participating as well, following the significant growth in the market.

Depending on the definitional source, private credit is considered to have a variety of strategies. According to Preqin, there are five key strategies for private credit[1]:

1. *Direct lending*: Companies borrow directly from a non-bank lender acting alone or as part of a small group. The lender typically holds the loans to maturity.
2. *Distressed debt*: Private credit funds buy corporate debt trading significantly below its original value or provide new financing to a distressed company, hoping to turn a profit as the business restructures or liquidates.
3. *Venture debt*: Financing is provided to startups that have yet to make a profit. The loan size is typically based on a multiple of a firm's recurring revenue.
4. *Mezzanine finance*: Investments in higher-risk debt that sits between other loans and equity in the queue for repayment when a borrower cannot meet its obligations.
5. *Special situations*: Loans are extended to take advantage of a particular event or situation, and where lending decisions are often not related to a company's fundamental metrics, such as profitability or growth.

In addition, a sixth strategy has recently emerged:

6. *Fund financing*: The financing of funds through vehicles like net asset value loans, collateralized fund obligations, and rated feed fund notes.

Direct lending is the largest segment of the private credit market, accounting for approximately 40%, and the transaction structure typically includes senior debt, junior/subordinated debt, and unitranche debt (i.e., a tranche that combines senior and subordinated debt). Direct lending tends to have more robust covenants than BSLs and is typically cash-flow based, floating rate, and senior secured.

What Does the Private Credit Market Look Like?

The early days of private credit were evidenced by direct lending to mostly middle-market corporate companies. Larger companies also increasingly turned to the private placement debt market as it provided an alternative and dependable financing source to the public corporate debt market. These companies tended to be primarily investment-grade corporate issuers. Insurance companies, particularly large life insurers, have been active investors in such traditional private placement debt transactions for several decades.

The private debt market grew significantly following regulatory changes after the 2008 global financial crisis. Banks reduced their middle-market lending because of increased capital requirements and guidelines relative to leveraged lending. Other direct lenders entered the market to fill the void, offering

[1] Bloomberg, *Why Private Credit Is Booming and Banks Are Fighting Back*, March 2024.

attractive features to borrowers such as faster execution and greater pricing certainty. Some of these lenders have included alternative asset managers and PE firms, to name a few.

Alternative asset managers, in particular, have been seeking opportunities in private credit by aligning with insurance companies (mostly life insurance companies) through acquisitions and joint ventures and, in turn, building long-term capital. This is particularly true with respect to asset-based financing[2], as long-term assets match well with life insurers' long-term liabilities and tend to offer higher credit quality than other alternative asset types.

The lower-for-longer interest rate environment has also spurred private credit growth. Among many other investors, insurers have been attracted to the private credit market because of the higher yields and promises of enhanced returns.

Currently, Preqin estimates the size of the private credit market ranges between $1.3 trillion and $1.7 trillion. The U.S. dominates the market, with Preqin estimating that private debt represents approximately 4.5% of the overall U.S. credit market. According to Preqin, substantial growth in private credit assets under management (AUM) is due to an increase in both supply and demand, and "private credit AUM has grown 16% annually since 2006, with most of that growth having been realized in the post-financial-crisis period."[3]

Growth in private credit is expected to continue due to the attractive returns compared to other investment types, which in turn increases demand for private credit. Growth forecasts vary but are likely attributed to the particular assets included in projections. For example, Moody's Ratings (Moody's) estimates the private credit market will reach approximately $2 trillion by 2027, while Preqin and BlackRock project the market will grow to $2.7 trillion and $3.5 trillion, respectively, by 2028.

The expansion into private credit has resulted in growth in the amount of "dry powder," or uninvested capital associated with private lending; this implies the supply for funding via private credit may outweigh the demand. The Federal Reserve Board (FRB) has expressed concerns surrounding the growing risks associated with a high concentration of dry powder among a few large asset managers, in particular, Oaktree Capital Management, Ares Management, Goldman Sachs, HPS Investment Partners, and Blackstone, as it implies higher demand for these managers. In addition, the FRB estimates that the top 10 U.S. private debt fund managers account for about 40–45% of all dry powder relative to private credit strategies.

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[2] Moody's Investors Service, *Private Credit Insights: Escalating Private Credit Competition Will Increase Risk and Scrutiny,* March 2024.
[3] Institute of Private Capital, *Performance of Private Credit Funds: A First Look*, July 2018.

What are the Risks?

In addition to the aforementioned illiquidity, lack of pricing, and credit transparency, there are additional risks that can potentially arise as the private credit market has evolved in recent years and continues to evolve in the coming years. With the entrance of other market participants into the private credit market that have typically focused on non-traditional, alternative assets, it is possible that the nature and risks of private credit will change if it has not already begun to do so. It may transition to include transactions that are more esoteric, have lower credit quality, and perhaps are more structured than previously seen (i.e., asset-based lending).

Thus far, private credit has generated attractive returns due to higher yields, but the solid performance has been generated in a relatively benign credit environment. However, as the nature of private credit evolves and expands, there is no assurance that this trend will continue. The solid historical performance of private lending may not translate to comparable performance in the future as the market scales up to a larger and broader base of investments. In addition, performance may differ in a more challenging and stressed credit environment, particularly in the midst of higher interest rates.

While risks relative to illiquidity and infrequent valuation will continue to be prevalent in private credit transactions, there is also the possibility of new risks, such as performance scaling (i.e., past performance not dictating future performance as the market grows and changes form) and the evolving nature and riskiness of transactions. In turn, depending on various factors, including economic trends, the performance of private credit, as it morphs into another form, is not predictable.

The NAIC Capital Markets Bureau (CMB) will continue to monitor trends and developments with private credit and report as appropriate.

Questions and comments are always welcome. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org.