Haris Muminović[*]

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The Rise and Risk of Private Credit

Private credit creates significant economic benefits by providing long-term financing to firms too large or risky for banks and too small for public markets. However, credit migrating from regulated banks and relatively transparent public markets to the more opaque world of private credit creates potential risks. Firms borrowing private credit tend to be smaller and riskier than their public market counterparts, and the sector has never experienced a severe economic downturn at its current size and scope. Such an adverse scenario could see a delayed realisation of losses followed by a spike in defaults and large valuation markdowns. The chapter identifies vulnerabilities arising from relatively fragile borrowers, increased exposure of pensions and insurers to the asset class, a growing share of semiliquid investment vehicles, multiple layers of leverage, stale valuations, and unclear interconnections between participants. Assessing this asset class's overall financial stability risks is challenging because the data needed to analyse these risks fully are unavailable. Despite these limitations, such risks appear contained at present. However, given private credit's size and role in credit creation—now large enough to compete directly with public markets—it may become macro-critical and amplify negative shocks to the economy. The rapid growth of private credit, coupled with increasing competition from banks on large deals and pressure to deploy capital, may lead to a deterioration in pricing and non-pricing terms, including lower underwriting standards and weakened covenants, raising the risk of credit losses in the future. If the asset class remains opaque and continues to grow exponentially under limited prudential oversight, the vulnerabilities of the private credit industry could become systemic.

Key words: private credit, stale valuations, risk of credit, credit industry, financial stability

Introduction

This chapter evaluates how financial stability is affected by the recent evolution of private credit into a major asset class. Private credit has grown exponentially and is becoming an increasingly important and interconnected part of the financial system. The sector predominantly involves alternative asset managers who raise capital from institutional investors using closed-end funds and lend directly to predominantly middle-market firms. This chapter focuses

[*] Docent na Fakultetu pravnih nauka Univerziteta Donja Gorica, *e-mail*: haris.muminovic@udg.edu.me.

on performing corporate credit rather than distressed assets, infrastructure, and real estate. Private credit has provided significant economic benefits during its approximately 30-year existence. It developed as a lending solution for middle-market companies deemed too risky or large for commercial banks and too small for public markets. Loans are typically negotiated directly between borrowers and one or more alternative asset managers. Although usually more expensive than bank loans, private credit offers borrowers a value proposition through strong relationships and customised lending terms designed to provide flexibility in times of stress.[1]

In contrast with most broadly syndicated loans, private credit offers terms that include enhanced covenants, providing lenders with downside protection.[2] Private credit managers also claim to have much greater resources to deal with problem loans than either banks or public markets, thereby enabling fewer sudden defaults, smoother restructurings, and lower costs of financial distress. Lenders typically rely on long-term pools of locked-up capital for financing because private credit deals are idiosyncratic and difficult for outside parties to value or trade. Private credit has grown rapidly since the global financial crisis, taking market share from bank lending and public markets.

Private credit benefitted from the long period of low interest rates that saw a huge expansion of attention to alternative investment strategies. In this context, private credit has appeared attractive, with some of the highest historical returns across debt markets and appears to be relatively low volatility. At the same time, post-crisis regulatory reforms raised capital requirements for banks and made regulation more risk-sensitive, incentivising banks to hold safer assets. Some end investors (notably insurance companies) were also incentivised to move into private credit because the capital charges are lower and less risk-sensitive than those applicable to commercial banks.[3] There is a concern that tighter bank regulation will continue to encourage credit migration from banks to private credit lenders.[4] As banks appear to have become less willing to lend to middle-market firms with riskier profiles in the United States and Europe, private credit has emerged as a key lender. Private credit assets grew to

[1] Customized lending terms can include, for example, the option to capitalize interest payments (that is, pay in kind) in times of poor liquidity.

[2] Covenants can vary depending on the transaction and can include, for example, limits for leverage and interest coverage ratios, restrictions on capital expenditures and dividend distributions, restrictions on additional debt, and limitations on asset sales.

[3] Cortes, Fabio, Mohamed Diaby, and Peter Windsor, *Private Equity and Life Insurers,* IMF Global Financial Stability Note 2023/001, International Monetary Fund, Washington, DC, 2023.

[4] Cai, Fang, and Sharjil Haque, *Private Credit: Characteristics and Risks,* FEDS Notes, Board of Governors of the Federal Reserve System, Washington, DC, 2024.

approximately $2.1 trillion globally in combined assets and undeployed capital commitments in 2023, with a focus on North America and Europe.[5]

For context, such assets are comparable to about three-quarters of the global high-yield market, a more mature but similarly risky market. Although still focused on middle-market lending, private credit has expanded its remit significantly over the last 20 years, particularly over the last 5. As a result, private credit firms in the United States and Europe can now provide loans to much larger corporate borrowers that would previously fund themselves through broadly syndicated loans or even corporate bonds. Such borrowers may now prefer the customised arrangement of private credit that avoids the disclosures and costs associated with public markets. Private credit remains focused on North America, but other regions, including Europe and Asia, are experiencing similar growth dynamics. As of June 2023, assets under the management (deployed and committed) of private credit managers in the United States reached $1.6 trillion, growing at an average annual rate of 20 per cent over the last five years.

Private credit now accounts for 7 per cent of the credit to nonfinancial corporations in North America, comparable with the shares of broadly syndicated loans and high-yield corporate bonds. In Europe, private credit also increased rapidly at an average rate of 17 per cent per year over the same period, although it has a smaller footprint of 1.6 per cent of corporate credit. There is evidence of cross-regional investments, with North American managers financing a significant portion of the private credit funds focused on Europe and Asia. Asian private credit accounts for about 0.2 per cent of the credit to nonfinancial corporations, although it has grown by 20 per cent annually over the last five years. Private credit in Asia finances mostly smaller deals, targeting high-yield and distressed segments with limited financing options in emerging market economies. Given the low liquidity, higher credit risk, and lack of transparency of private credit, the space is dominated by institutional investors. The most common private credit investment vehicle, accounting for approximately 81 per cent of the total market, is a closed-end fund with a capital call structure and limited life cycle, similar to funds used for private equity. An additional 5 per cent of the market consists of specialised collateralised loan obligations (CLOs) that invest in middle-market private credit.[6] Typical investors in these two vehicles are pension funds, insurance companies, sovereign wealth funds, and family offices. A rapidly growing segment in the United States is known as

[5] This estimate of the growth in private credit assets includes the assets of private credit funds ($1.7 trillion globally, as of 2023), business development companies, and private collateralised loan obligations. Therefore, it underestimates the overall size of private credit globally. This is because some end investors also lend directly to middle-market firms.

[6] Sources: Preqin, S&P Capital IQ, and PitchBook LCD.

business development companies (BDCs), which account for 14 per cent of the market. BDCs (covered in greater detail later in the chapter) are often public and open to retail investors. In Europe, some funds have adopted more frequent redemption periods (for instance, monthly or even more often) to appeal to a wider investment base. The growth in private credit has followed the rise in private equity, which is closely linked. Managers whose umbrella firm is also active in private equity hold more than three-quarters of private credit assets. For about 70 per cent of private credit deals, the borrowing company is sponsored by a private equity firm.

1. *How Private Credit Could Threaten Financial Stability*

This chapter assesses private credit vulnerabilities and risks to financial stability and focuses on macro-financial imbalances that might amplify negative shocks to the real economy.[7] Specifically, this chapter analyses the risks from borrowers, liquidity mismatches, leverage, asset valuations, and interconnectedness. The migration of credit provisions from regulated banks and relatively transparent public markets to more opaque private credit firms raises several potential vulnerabilities. Whereas bank loans are subject to strong prudential regulation and supervisory oversight, bond markets and broadly syndicated loans to comprehensive disclosure requirements that foster market discipline and price discovery, private markets are comparatively lightly regulated and more opaque. Furthermore, private credit loans are unrated, rarely traded, typically „marked to model" by third-party pricing services, and without standardised contract terms. Rising risks and their potential implications may, therefore, be difficult to detect in advance. Severe data gaps prevent a comprehensive assessment of how private credit affects financial stability. The interconnections and potential contagion risks many large financial institutions face from exposures to the asset class are poorly understood and highly opaque. Because the private credit sector has rapidly grown, it has never experienced a severe downturn at its current size and scope, and many features designed to mitigate risks have not yet been tested. At present, the financial stability risks posed by private credit appear contained. Private credit loans are funded largely with long-term capital, mitigating maturity transformation risks. The use of leverage appears modest, as do liquidity and interconnectedness risks. The rapid growth of the asset class requires careful monitoring. As private credit assets under management grow rapidly and competition with investment banks on larger deals intensifies,

[7] Adrian, Tobias, Dong He, Nellie Liang, and Fabio Natalucci, *A Monitoring Framework for Global Financial Stability*, IMF Staff Discussion Note 2019/006, International Monetary Fund, Washington, DC, 2019.

supply-and-demand dynamics may shift, thereby lowering underwriting standards, raising the chance of credit losses in the asset class, and rendering risk management models obsolete.

The private credit sector may also eventually experience falling risk premiums and weakening covenants as assets under management rise rapidly and the pressure to deploy capital increases. Immediate risks may seem contained, but the sector has meaningful vulnerabilities, is opaque to stakeholders, and is growing rapidly under limited prudential oversight. If these trends continue, private credit vulnerabilities may become systemic:

— Borrowers' vulnerabilities could generate large, unexpected losses in a downturn. Private credit is typically a floating rate and caters to relatively small borrowers with high leverage. Such borrowers could face rising financing costs and perform poorly in a downturn, particularly in a stagflation scenario, which could generate a surge in defaults and a corresponding spike in financing costs.

— These credit losses could create significant capital losses for some end investors. Some insurance and pension companies have significantly expanded their investments in private credit and other illiquid investments. Without better insight into underlying credit performance, these firms and their regulators could be caught unaware by a dramatic rerating of credit risks across the asset class.

— Although currently low, liquidity risks could rise with the growth of retail funds. The great majority of private credit funds pose little maturity transformation risk, yet the growth of semiliquid funds could increase first-mover advantages and run risks.

— Multiple layers of leverage create interconnectedness concerns. Leverage deployed by private credit funds is typically limited, but the private credit value chain is a complex network that includes leveraged players ranging from borrowers to funds to end investors. Funds that use only modest amounts of leverage may still face significant capital calls in a downside scenario, with potential transmission to their leverage providers. Such a scenario could also force the entire network to simultaneously reduce exposures, triggering spillovers to other markets and the broad economy.

— Uncertainty about valuations could lead to a loss of confidence in the asset class. The private credit sector has neither price discovery nor supervisory oversight to facilitate asset performance monitoring, and the opacity of borrowing firms makes prompt assessment of potential losses challenging for outsiders. Fund managers may be incentivised to delay the realisation of losses as they raise new funds and collect performance fees based on their existing track records. In a downside scenario, the lack of transparency of the asset class could lead to a deferred realisation of losses followed by a spike in defaults. Resulting changes in the modelling assumptions that drive valuations could also cause dramatic markdowns.

— Risks to financial stability may also stem from interconnections with other financial sector segments. Prime candidates for risk are

entities with particularly high exposure to private credit markets, such as insurers influenced by private equity firms and certain groups of pension funds. The assets of private-equity-influenced insurers have grown significantly in recent years, with these entities owning significantly more exposure to less liquid investments than other insurers. Data constraints make it challenging for supervisors to evaluate exposures across financial sector segments and assess potential spillovers.

— Increasing retail participation in private credit markets raises conduct concerns. Given the specialised nature of the asset class, the risks involved may be misrepresented. Retail investors may not fully understand the investment risks or the restrictions on redemptions from an illiquid asset class.

2. Characteristics of Private Credit Borrowers

Private credit borrowers tend to be riskier than their traded counterparts, such as high-yield bonds and leveraged-loan issuers. Borrowers in private credit are also relatively vulnerable to interest rates, as loans have floating rates. However, the support of private equity sponsors and the relatively close and flexible relationship between lender and borrower partially mitigate liquidity and solvency risks. Collateralisation and the greater use of covenants provide additional protection for investors.

A key reason driving firms to private credit markets is the challenges of accessing traditional funding sources. Evidence suggests that weaker firms with low or negative earnings and high leverage are less likely to secure bank loans and are more inclined to borrow from nonbank sources.[8] Private debt fund managers also believe that they finance companies and leverage levels that banks would not fund.[9] In addition, borrowers in the private credit market may be excluded from the syndicated loan market because of their size or lack of high-quality collateral for bank lenders. Private credit can also offer benefits in flexibility, speed of execution, and confidentiality. Aspects of each transaction, such as the repayment schedule and collateral requirements, can be tailored to the parties involved. Compared with traditional bank loans and public debt offerings, private credit transactions are often executed more quickly and provide confidentiality. These characteristics have recently attracted larger borrowers who have traditionally accessed other funding sources. This alternative and flexible funding source for riskier borrowers involves a higher cost; as a result, interest rates on private credit loans tend to exceed yields for market-based alternatives.

[8] Chernenko, Sergey, Isil Erel, and Robert Prilmeier, Why Do Firms Borrow Directly from Nonbanks?, *Review of Financial Studies* 35 (11): 4902–947, 2022.

[9] Block, Joern, Young Soo Jang, Steven N. Kaplan, and Anna Schulze, *A Survey of Private Debt Funds*, NBER Working Paper 30868, National Bureau of Economic Research, Cambridge, MA, 2023.

3. *Characteristics and Vulnerabilities of Private Credit Borrowers*

Tracking the financial characteristics of private credit borrowers is challenging because of their private nature, resulting in limited availability of their financial statements. To address this challenge, a sample of private credit borrowers was constructed by cross-referencing data from Preqin with corporate fundamentals sourced from S&P Capital IQ. Private credit borrowers are typically highly leveraged middle-market companies. These firms are significantly smaller than broadly syndicated loans or high-yield bond-issuing firms. Private credit borrowers have higher debt-to-earnings ratios but better asset coverage than their syndicated loan counterparts. For all these asset classes, high debt levels are often driven by private equity sponsors that enhance returns for their investors by increasing debt on the balance sheets of the firms they acquire.[10] Private credit borrowers operate across various economic sectors and are overrepresented in the information technology and healthcare sectors.[11] Private credit borrowers are vulnerable to interest rate shocks. Private credit borrowers almost exclusively use floating-rate loans. By contrast, only about 29 percent of high-yield corporate bond issuers' total debt is a variable rate.[12] Panel 1 of Figure 2.4 highlights the swifter transmission of interest rates to the cost of debt for firms with a higher share of variable-rate debt. Rising interest rates could ultimately lead to a deterioration in credit quality. The rise in benchmark rates has increased the interest burden for private credit borrowers, prompting some firms to resort to payment-in-kind interest. This flexibility may help borrowers withstand temporary stress but can lead to compounding losses if a firm's underperformance cannot be reversed. The share of payment-in-kind interest in BDC interest income has doubled since 2019. In addition, the proportion of firms with unsustainable interest coverage ratios has increased to over one-third among firms with size and leverage characteristics similar to those of private credit borrowers.

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[10] Haque, Sharjil M, *Does Private Equity Over-Lever Portfolio Companies*? Finance and Economics Discussion Series 2023–009, Board of Governors of the Federal Reserve System, Washington, DC, 2023.

[11] For comparison, the weights of the technology and health care sectors in the S&P 500 Index are 30 percent and 12 percent, respectively, whereas these shares are 24 percent and 11 percent for the Bloomberg World Large and Mid Cap Index.

[12] For a sample of 518 North American and 157 European high-yield corporate bond issuers, the average share of variable rate debt is 29.4 percent, at the end of 2022. Sources: S&P Capital IQ; and IMF staff calculations.

3.1. Mitigating Factors of Credit Risk

Despite the risky profile of private credit borrowers, their credit losses have not historically exceeded losses in high-yield bonds and are comparable to leveraged loans. Headline default rates for private credit indices tend to be relatively high, but these include covenant defaults, which often lead to renegotiated terms rather than a true payment default. Sponsorship by private equity firms also mitigates private credit risks. Private equity sponsors want to preserve the long-term value of their investments and may inject additional capital into their portfolio firms if they believe that stress will be transient. Evidence from the leveraged loan market illustrates that firms sponsored by private equity have lower default rates during periods of stress than other firms. This strategy may lessen defaults in a short-lived downturn. Most private credit loans are secured to help boost recovery rates in case of liquidation, which mitigates credit losses. Collateralisation can be lower in some sectors, such as the software industry, where unitranche and mezzanine loans are more common.

3.2. Private Credit Cyclicality

There is mixed evidence regarding the cyclicality of private credit lending. Private credit managers argue that private credit remains accessible during economic downturns, whereas traditional funding sources often contract. Evidence suggests that private credit's relationship with private equity sponsors facilitated lending during the COVID-19 pandemic.[13] In March 2020, private credit lending did not „dry up," while high-yield bond and leveraged-loan issuance contracted strongly. Private credit lending subsequently proved more stable than similarly floating-rate leveraged loans. A structural analysis shows that private credit market activity is less responsive to a sudden credit shock than the high-yield bond and leveraged-loan markets. However, there is also evidence of procyclical behaviour. The Bank for International Settlements found that capital deployment in private equity and private credit positively correlates with stock market returns.[14] In addition, data from the BDC markets indicate that new private credit loans contract when banks tighten their lending standards. New lending by private credit funds seems to be less procyclical than BDC lending.

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[13] Young Soo, Are Direct Lenders More Like Banks or Arm's-Length Investors? SSRN, January 24, 2024.

[14] Aramonte, Sirio, and Fernando Avalos, The Rise of Private Markets. *BIS Quarterly Review*, December, 2021.

Conclusion

Current reporting requirements are insufficient and prevent a comprehensive assessment of the leverage used in private credit. At present, the potential transmission of funding shortfalls from leverage providers cannot be fully evaluated. Fund-level reporting requirements to securities, insurance, or pension fund supervisors may not capture the complex and multilayered sources of leverage, including the subscription lines and leverages special-purpose vehicles or feeder funds deployed. Reporting is also fragmented across borders and sectors. These data gaps and the lack of a comprehensive overview prevent supervisors from monitoring leverage at the macro level. When banks or other supervised institutions provide private credit firms with leverage, regulators should enhance risk management practices regarding potential funding needs. This will likely require the private credit funds borrowing from supervised institutions to engage in some thematic reviews of liquidity management practices. Such exercises should incorporate stress scenarios featuring tightening of funding availability, markdowns of levered portfolios, and sudden and significant drawdowns of credit facilities by private credit funds' corporate borrowers.

Regulators should fill data gaps by enhancing comprehensive reporting of leverage across the value chain, with close cooperation domestically and internationally. Insurance and pension supervisors should address excessive risk-taking by adjusting prudential requirements under the principle of „same activity, same risk, same regulation." In the event that such monitoring finds excessive leverage that may have systemic implications, securities regulators should consider suitable regulatory tools such as leverage caps.

Regulatory requirements for private credit funds currently focus on policy documentation, governance, and investor disclosures but do not specify how assets should be valued. The overall regulatory framework for private funds tends to have a light touch, including on valuation, because the institutional investors are sophisticated, the primary expectation being that investors have the capacity and incentive to seek relevant information from asset managers and adjust their valuations. Unlike other aspects of a private credit fund, however, the main investors (insurance companies and pension funds) may not have an incentive to challenge fund managers' valuations because they desire to maintain the stability of their investments. The managers' significant discretion also results in wide variations in valuation for the same asset across funds and entities. An IOSCO survey also found that the approach to valuation varies significantly by country. IOSCO's agreement with the International Valuation Standards Council to identify potential approaches to enhance the quality of valuations is welcome in this context. Supervisors should closely monitor the valuation approaches and procedures of private credit funds, insurers, and pension funds and, in case of heightened valuation risks,

strengthen regulation on valuation independence, governance, and frequency. To address these concerns, some regulators have already strengthened regulation concerning independent audits (for example, the US SEC) and intensified supervision (for example, US SEC, UK Financial Conduct Authority, European Securities and Markets Authority) relating to the valuation of private funds.

Supervisors should continue to thoroughly assess valuation governance and control through intrusive supervision, including on-site inspection, of the valuation practices of private credit funds. Timely and strict actions, including enforcement, should follow improper or fraudulent valuation. Proper and timely loss recognition will become even more important for private credit funds with semiliquid structures and funds after the expiration of lock-up periods. If such supervisory efforts indicate heightened valuation risks, regulators should consider mandating independent external valuations and audits while strengthening the managers' internal governance mechanisms on valuation procedures. Regulators may also consider increasing the frequency of external valuations and audits if necessary.

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Dr Haris Muminović

Uspon i rizici privatnog kredita

Privatni kredit stvara značajne ekonomske koristi pružanjem dugoročnog finansiranja kompanijama koje su prevelike ili rizične za banke i premalene za javna tržišta. Međutim, migracija kredita iz reguliranih banaka i relativno transparentnih javnih tržišta u neprozirniji svijet privatnih kredita stvara potencijalne rizike. Kompanije koje posuđuju privatne kredite obično su manje i rizičnije od svojih kolega na javnom tržištu, a sektor nikada nije doživio ozbiljan ekonomski pad u svojoj trenutnoj veličini i opsegu. Takav nepovoljan scenarij mogao bi dovesti do odgođene realizacije gubitaka praćene naglim porastom neispunjavanja obaveza i velikim smanjenjem vrijednosti. U poglavlju se identificiraju ranjivosti koje proizlaze iz relativno krhkih zajmoprimaca, povećane izloženosti mirovina i osiguravatelja klasi imovine, sve većeg udjela polulikvidnih investicijskih sredstava, višestrukih slojeva financijske poluge, zastarjelih procjena vrijednosti i nejasnih međupovezanosti između sudionika. Procjena ukupnih rizika finansijske stabilnosti ove klase imovine je izazovna jer su podaci potrebni za potpunu analizu tih rizika nedostupni. Unatoč ovim ograničenjima, čini se da su ti rizici trenutačno obuzdani. Međutim, s obzirom na veličinu i ulogu privatnih kredita u stvaranju kredita — koji su sada dovoljno veliki da se izravno natječu s javnim tržištima — oni mogu postati makrokritični i pojačati negativne šokove za ekonomiju. Brzi rast privatnih kredita, zajedno sa sve većom konkurencijom banaka u velikim poslovima i pritiskom za raspoređivanjem kapitala, može dovesti do pogoršanja cjenovnih i necjenovnih uvjeta, uključujući niže standarde preuzimanja i slabije obveze, povećavajući rizik od kreditnih gubitaka u budućnosti. Ako klasa imovine ostane neprozirna i nastavi eksponencijalno rasti pod ograničenim bonitetnim nadzorom, ranjivosti privatne kreditne industrije mogle bi postati sustavne.

Ključne riječi: privatni kredit, zastarjele procjene, kreditni rizik, kreditna industrija, financijska stabilnost