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Managed Funds Association  
The Voice of the Global Alternative Investment Industry

# The Role of Private Credit in U.S. Capital Markets

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## I. Executive Summary

Following the 2008 global financial crisis, many banks “de-risked” and, as a result, decreased lending to many small and mid-size companies. In response, the growth of lending by private credit funds began to accelerate and, in doing so, filled a significant gap in the U.S. credit market. This “private credit”, in turn, has helped facilitate the growth of the companies that serve as the backbone of the U.S. economy.

In this white paper, we discuss how the growth of private credit funds has benefitted the U.S. economy by providing a crucial, alternative source of lending to companies, and does so in a way that does not pose significant financial stability concerns. Among other things, the paper highlights that:

- The U.S. Government Accountability Office’s (“GAO”) recent report regarding leveraged lending confirmed that U.S. financial regulatory agencies have not found leveraged lending to significantly threaten financial stability (although they continue to monitor its risks).
- Even though private credit is not leverage constrained, the evidence shows that private credit lending practices are appropriate and that debt structure, documentation, and underwriting are robust and adequately protective of lenders. These factors have resulted in generally limited default rates for private credit. In addition, business development companies (“BDCs”)—another source of credit for middle-market companies—are subject to significant regulation and disclosure requirements.
- Closed-end private credit funds do not pose financial stability risks because the funding is locked-in with no daily redemptions (there is no risk of “runs” leading to asset fire sales) and the funds and managers are engaged in a limited set of financial activities, are not significantly interconnected with other financial institutions, and are highly diversified so there is little risk of default or contagion from losses.

In light of these findings, this white paper concludes that private credit is distinguishable and poses no significant threat to financial stability, and provides an overall stabilizing effect on the U.S. economy.

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<sup>1</sup> Prepared by Managed Funds Association and The Private Credit Group of Proskauer Rose LLP.

## II. Introduction

On December 17, 2021, the Financial Stability Board (“FSB”) invited submissions of papers for a conference on systemic risks in non-bank financial intermediation and policies to address them. In response to this call for papers, Managed Funds Association (“MFA”) and Proskauer’s Private Credit Group seek to provide more information about the private credit industry, which is sometimes included in discussions of non-bank financial intermediaries (“NBFIs”), and their unique role in capital markets in the United States.

Private credit, as distinguished from bank-intermediated credit, typically refers to credit extended by non-bank investors with limited involvement by banks.<sup>2</sup> In the United States, private credit is extended to non-public middle-market companies that are below investment-grade or not rated and that are typically smaller than those with access to the syndicated leveraged loan market, in which loans are mostly originated by banks.

In its nascent years, the private credit industry was a small segment of the capital landscape, largely confined to mezzanine financing for lower middle-market, non-publicly traded companies. From these early roots, private credit has expanded dramatically over the past 20 years in both scale and diversity although it still is significantly smaller than the banking industry.

Following the 2008 global financial crisis, increased regulation led many banks to reduce their lending activities, particularly to smaller companies, accelerating the growth of private credit. Today, in the United States, the private credit market, consisting of BDCs, collateralized loan obligation (“CLO”) securities, and other closed-end direct lending funds, boasts more than \$1 trillion of assets under management and is expected to grow to \$1.5 trillion over the next five years.<sup>3</sup> In contrast, the institutional syndicated loan market in the United States is currently about \$1.3 trillion.<sup>4</sup> The industry is diverse in terms of the number of asset managers, vehicles, and strategies, and increasingly mature with many of those asset managers establishing long-term track records of performance. As the industry as a whole has grown and individual fund sizes have increased, private credit lenders now are able to serve as an alternative source of lending to larger mid-size companies.

By acting as an alternative lender, private credit is able to stabilize and smooth credit cycles for many small and mid-size companies, which serve as the backbone of the U.S. economy. Private credit is able to provide crucial capital solutions to these companies in a way that does not pose significant financial stability concerns. This is evidenced by both the historically strong performance of private credit and the

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<sup>2</sup> Aramonte S. (Mar. 1, 2020). Private credit: recent developments and long-term trends, BIS Quarterly Review. In this paper, we focus primarily on closed-end vehicles with limited redemption rights as most credit funds have this structure, although we note that open-ended vehicles also participate in the private credit markets. Open-ended vehicles may have a greater need to manage redemption requests from their investors and face more liquidity risks than closed-ended vehicles.

<sup>3</sup> 2022 Preqin Global Private Debt Report, p. 11.

<sup>4</sup> Latour, A. (2021, October 8). Covenant-lite deals exceed 90% of leveraged loan issuance, setting new high. S&P Global Market Intelligence. <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/covenant-lite-deals-exceed-90-of-leveraged-loan-issuance-setting-new-high-66935148>.

GAO recent, detailed report confirming that U.S. financial regulatory agencies have not found leveraged lending to significantly threaten financial stability.<sup>5</sup>

As described in further detail below, private credit lending practices and vehicles differ significantly from those offered by institutional bank lenders. For example, the underwriting, structure, documentation, monitoring, and administration (including following a default by a borrower) of private credit loans are all more robust than institutional loans. As evidenced by Proskauer's annual report entitled Private Credit Insights and the Proskauer Private Credit Default Index, the result is that private credit loans are negotiated to be more protective of lenders with the outcome of fewer defaults on average relative to institutional loans:

- 93% of private credit loans have caps on add-backs to earnings before interest, taxes, depreciation, and amortization ("EBITDA") for run rate synergies.
- For companies with EBITDA greater than \$50 million, 44% of private credit loans had caps for non-recurring expenses.
- The average equity contributions required by private credit lenders was 43% in 2021, providing a substantial cushion to absorb the first losses of any investment.
- Only 1% of all private credit loans in 2021 were without financial maintenance covenants, known as "cov-lite" loans. Rather, 99% of the loans have at least one financial maintenance covenant, typically a total leverage ratio covenant, and 21% have two or more, *i.e.*, a total leverage ratio and fixed charge coverage ratio covenant; by contrast, the share of cov-lite loans in the institutional loan market was 91%, the highest level on record as of Oct. 4, 2021.
- Default rates for private credit loans had fallen to 1.04% by the fourth quarter of 2021.

These data and other structural features of the private credit market that provide stabilizing effects are discussed in more detail in this white paper. Moral hazard is mitigated by the fact that private credit managers typically have "skin in the game" and the absence of a public backstop for private credit funds means there is no risk to FDIC depositors or taxpayers (via a deposit insurance fund or otherwise). Private credit also is not generally impacted by market volatility because loans are funded by illiquid investments vehicles. Moreover, BDCs are subject to robust reporting requirements, which are often more extensive than the information disclosed by commercial banks. While leverage provided by private credit lenders is higher than might be available from highly regulated institutional lenders, structural protections ensure that private credit lenders are no less resilient to losses. All of these factors help mitigate any potential risks posed to the financial system by private credit's leveraged lending activity.

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<sup>5</sup> GAO (Dec. 2020). Financial Stability: Agencies Have Not Found Leveraged Lending to Significantly Threaten Stability but Remain Cautious Amid Pandemic, GAO-21-167 [hereinafter "GAO Report"].

### III. Growth of Private Credit and Its Benefits for the U.S. Economy

The 2008 financial crisis demonstrated the legitimate need to monitor and regulate financial sectors that may present systemic risks.<sup>6</sup> Prior to the 2008 financial crisis, institutional banks were the primary source of leveraged loans. Even though leveraged loans did not play a direct role in the crisis, banks “de-risked” and pulled back from providing loans to small and mid-size companies, in large part due to federal leverage loans guidelines that generally limited leverage levels to 6.0x Total Debt/EBITDA and required additional pipeline management and stress testing.<sup>7</sup>

Private credit lenders filled this void by providing an alternative way for small and mid-size companies to raise capital to grow and operate their businesses. Without private credit loans, these companies would have struggled to find adequate financing to fuel their growth and fund their day-to-day operations. The outstanding amount of private credit grew nearly \$500 billion between 2010 and 2018 while the leveraged loan market grew approximately \$600 billion in the same time period.<sup>8</sup>

To this day, private credit continues to have a stabilizing effect on loan markets because private credit funds are typically relatively insensitive to market volatility.<sup>9</sup> For example, some have reported that private credit lenders helped middle-market companies obtain relief for COVID-19-related challenges.<sup>10</sup> More recently, there are reports that some private credit lenders are providing funding in the wake of market volatility resulting from the Russia/Ukraine war.<sup>11</sup> It has been reported that, when bank financing has not been available, private credit fueled growth in various aspects of the economy, such as medical research, airlines, sports and other industries.<sup>12</sup>

As the private credit industry has matured, established asset managers have been able to raise ever larger private credit funds and deploy that capital to make larger loans.<sup>13</sup> According to Preqin, as of the end of 2021, there were more than 700 funds providing private credit. These funds vary in size and investment strategy, ranging from funds with a few hundred million dollars of assets under management (“AUM”) to up to \$15.7 billion of AUM.<sup>14</sup> In 2021, the median direct lending fund size was \$900 million.<sup>15</sup>

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<sup>6</sup> Bullard, J., Neely C., and Wheelock, D., Systemic Risk and the Financial Crisis: A Primer, Federal Reserve Bank of St. Louis *Review*, Sept./Oct. 2009, 91(5, Part 1), pp. 403-17. One of the key causes of the 2008 financial crisis was the proliferation of unregulated derivatives during that time and the cascading impact of rising interest rates on adjustable rate mortgage loans. This, in turn, led to the secondary market shut-down, investor demand for redemptions, and a concomitant liquidity freeze as more derivatives defaulted. *Id.*

<sup>7</sup> Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency (Mar. 21, 2013). Interagency Guidance on Leveraged Lending.

<sup>8</sup> Aramonte, S. (Mar. 1, 2020). Private credit: recent developments and long-term trends, BIS Quarterly Review.

<sup>9</sup> This is due in part to their “lock up” structure, which is discussed further below.

<sup>10</sup> Latour, A. (Feb. 18, 2022). Private debt structure worked in pandemic, but true test remains, S&P Global Market Intelligence.

<sup>11</sup> Ho, P. (Mar. 15, 2022). Direct Lenders see opportunities amid Ukraine jitters, Credit Connector, Vol. 4, Issue 5.

<sup>12</sup> The Wall Street Journal, Shopping, Planes and Khloe’ Kardashian: How Private Debt Helps Power the Global Economy (Jan 13, 2022).

<sup>13</sup> Preqin Global Private Debt Report.

<sup>14</sup> Pitch Book 2021 Annual Global Private Debt Report 2021, p. 7.

<sup>15</sup> *Id.*, p. 4.

## IV. Private Credit Does Not Pose Systemic Risk Concerns

### A. The 2020 GAO Report Found That Leveraged Lending Activities Have Not Threatened Financial Stability.

In December 2020, the GAO released a report confirming that U.S. financial regulatory agencies have not found leveraged lending to significantly threaten financial stability.<sup>16</sup>

The GAO Report found that even though the leveraged lending and CLO markets<sup>17</sup> were negatively impacted by the economic shocks from the COVID-19 pandemic in late February 2020 and March 2020, markets began to recover in April 2020 and remained largely resilient.<sup>18</sup>

Regulators also did not find that leveraged lending activities posed any significant risks to the stability of the U.S. financial system (although they continue to monitor the risks posed by such activities).<sup>19</sup> As noted above, regulated institutional lenders still comprise a large portion of leveraged lending activities in the United States. Despite this level of activity, the GAO Report found that U.S. banks fared well during the COVID-19 shocks and were able to absorb the increased draws on credit lines.<sup>20</sup> There was also no impact on the banks' creditworthiness or ability to access credit markets. Thanks to the strong capital positions of banks prior to 2020, stress tests showed that the large majority of banks would remain sufficiently capitalized and could continue lending to businesses and households.<sup>21</sup> The GAO Report's findings on U.S. banks' leveraged lending activities is significant to private credit because some private credit funds have subscription credit lines with banks (discussed further below). The GAO Report shows that the potential risk posed to the financial system through this channel was appropriately mitigated by the banks prior to the COVID-19 pandemic and therefore did not have a significant impact during the subsequent period of economic volatility.

Also of relevance to the private credit industry, the GAO Report found that CLO securities have proven to be resilient to sudden increases in the credit risk of underlying collateral and pose less risk to financial stability than collateralized debt obligations ("CDOs") did during the 2008 financial crisis.<sup>22</sup> The GAO Report identified a number of characteristics, including more diversification and transparency, more stable funding, and higher levels of subordination as contributing to this greater resiliency.<sup>23</sup>

Finally, the GAO Report highlighted that because mutual funds offer daily redemptions to investors, they could be forced to sell assets during periods of economic stress, which could have a downward pressure on market prices.<sup>24</sup> In fact, the regulatory agencies found evidence that mutual funds managed their redemptions in the wake of the COVID-19 shock in part by selling leveraged loan holdings, which may

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<sup>16</sup> GAO Report.

<sup>17</sup> CLO securities are backed by leveraged loans.

<sup>18</sup> GAO Report, p. 30.

<sup>19</sup> *Id.*, pp. 29-34.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*, pp. 39-44.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*, pp. 37-38.

have put downward pressure on already distressed prices.<sup>25</sup> However, prices largely stabilized by September 2020, indicating that some market participants may have taken advantage of distressed prices to invest in leveraged loans, thus mitigating the downward pressure on loan prices.<sup>26</sup> As discussed below, unlike many retail products, private credit closed-end funds do not offer daily redemptions to investors and, as a result, lack structural features that would make them subject to similar “runs”. This resiliency permits private credit funds to play a stabilizing role in leveraged loan markets and potentially mitigate the market liquidity risks that banks and some NBFIs pose to financial stability.

## B. Private Credit Leveraged Lending Practices are Appropriate.

Private credit lending practices are complementary to and arguably more robust than those of traditional institutional lenders. Below, we describe how these unique practices help private credit effectively mitigate the risks of leveraged lending while allowing private credit lenders to step in and smooth credit cycles for small and mid-size companies.

### 1. Leverage

Unlike institutional lenders, private credit lenders are not leverage constrained and are able to provide loans based upon higher debt to earnings ratios;<sup>27</sup> however, that does not mean that their lending risks are not otherwise appropriately mitigated.

Based upon Proskauer’s Insights Report, 91% of private credit loans are structurally senior secured loans called unitranche. This was relatively consistent with 2020. One potential criticism of the unitranche loan is that it attaches at a higher leverage point than a traditional bank loan.<sup>28</sup> However, the balance of private credit loans were secured second lien, mezzanine (secured and unsecured), split collateral loans and “debt-like” preferred equity. As a result, most private credit loans are at a balance sheet attachment point whereby any value deterioration is first borne by equity (the sponsor), next by unsecured and junior secured debt, and only then by the senior secured unitranche. Thus, private credit is not significantly riskier than a traditional bank loan because a company has to experience a significant deterioration of value before it compromises the recovery on the senior secured unitranche loan.

Additionally, the component definitions of leverage, debt and EBITDA, are heavily negotiated by private credit lenders. For instance, according to Proskauer’s Insights Report, 93% of private credit loans have caps on add-backs to EBITDA for run rate synergies and, for companies with EBITDA greater than \$50 million, 44% had caps for non-recurring expenses, items that can materially distort actual earnings if not

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<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> Guidance issued by the U.S. federal banking agencies generally limited how much leverage a bank could underwrite in a leverage loan transaction to 6x debt to EBITDA, with EBITDA calculated on the basis of a standard definition. Limiting the amount of leverage that these institutions could underwrite mitigated the risk of their exposure if the company were to underperform.

<sup>28</sup> While a bank may be willing to provide loans based upon 4.5-5.0x EBITDA, a unitranche loan may attach at 6.0x-7.0x of EBITDA. Nevertheless, leverage provided by private credit lenders during 2021 averaged 5.2x total leverage at closing, although leverage for “top tier” sponsors tends to be slightly higher. Notably, during the last 6 years that Proskauer has been collecting data on loans made by its clients, leverage provided by private credit lenders has remained relatively consistent, with average leverage fluctuating by only 0.5x over that period. Average leverage has also correlated with closing EBITDA, with companies with greater than \$30 million of EBITDA obtaining leverage on average 1x higher than companies below the \$30 million EBITDA threshold. In contrast, according to S&P, leverage for B-issues was 7.2x. Leveraged Finance: U.S. Leveraged Finance Q42021 Update: Are ‘B-’ Firms Resilient to Rate Hikes? And Leverage and Recovery Updates | S&P Global Ratings (spglobal.com).

realized. These caps have been relatively consistent over the last five years for private credit loans and, according to Proskauer’s Insights Report, generally range between 20% and 35% depending upon the size of the company. Similarly, private credit lenders have been relatively consistent on the amount of equity that they require in their investments over the past five years, with equity contributions averaging 43% in 2021 according to Proskauer’s Insights Report. This equity requirement provides a substantial cushion to the private lenders’ loan, absorbing the first losses of any investment.

## 2. Documentation

Private credit loans generally have tighter loan documentation and stronger creditor protections than institutional bank loans. Private credit funds are actively managed by managers that typically have skin in the game, mitigating potential moral hazard risks, as the fund managers make decisions for the fund, undertake legal and business due diligence, and arrange financing for individual transactions.

Most private credit loans finance acquisition transactions. In fact, according to Proskauer’s Insights Report, in 2021, 70% of all private credit loans were used to finance acquisition transactions (relatively consistent with 2020 figures). In an acquisition transaction, whether financed by a syndicated loan or a private credit loan, the private equity sponsor typically requires the underwriting bank or private credit lenders to enter into a “SunGuard”-style commitment letter. These types of commitment letters have limited conditionality and are very detailed. Once signed, the private equity sponsor and seller have the certainty of knowing that the sponsor has the financing needed to close the acquisition transaction.

In the syndicated leverage loan market, lead banks will negotiate the terms of the commitment letter and underwrite the loan documentation with the intention of immediately selling down their commitments to a large number of other banks or funds (such as CLOs) which buy small positions in these leveraged loan transactions. In negotiating the commitment papers, the lead bank will look to settle on terms that it believes would be minimally required by the potential syndicate of lenders. To insure a “successful” syndication effort, it will negotiate “market flex” terms, which are key terms pre-agreed to by the lead bank and the private equity sponsor which the lead bank can change to the extent necessary to permit the lead bank to sell down the loan. Market flex terms can include an increase in economics (such as a higher interest rate) or tighter documentation terms. Even with market flex provisions, it is possible that the lead bank has a “busted” syndication (*i.e.*, it is unable to assemble an adequate number of investors willing to buy the loan to satisfy its maximum desired hold size). Thus, prior to closing, the syndication process creates a number of uncertainties for the private equity sponsor and the underwriting bank.

Private credit lenders eliminate this uncertainty. Private credit lenders (or a small club of these lenders) will enter into fully committed SunGuard-style commitment papers and commit to provide the entire loan without the need for syndication or sell-down. In exchange, these lenders are compensated for the additional leverage and certainty of execution that they provide. As a result, “the unitranche structure typically features a higher yield than a syndicated first-lien loan, typically commanding a premium of 50-100 bps over traditional senior financings to compensate lenders for increased risk.”<sup>29</sup>

More importantly, from a structural integrity and creditor rights perspective, because private credit lenders commit fully without market flex, the terms of the loans are more heavily negotiated and require terms that are more restrictive or “tighter” than might be available in the syndicated loan market. For example,

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<sup>29</sup> Gunter, E. (Oct. 12, 2021). Private Debt: A Lesser-Known Corner Of Finance Finds The Spotlight. S&P Global Market Intelligence.

<https://www.spglobal.com/en/research-insights/featured/private-debt>

according to Proskauer’s Insights Report, almost all unitranche loans have at least one financial maintenance covenant (typically a leverage covenant). Loans without financial maintenance covenants are called “cov-lite” loans. Financial maintenance covenants are considered important as they permit lenders to “get to the table” early and proactively address problems with the company before they become a crisis. According to an LCD analysis, cov-lite facilities recover less than traditional term loans with financial maintenance covenants.<sup>30</sup>

According to LCD, as of Oct. 4, 2021, the share of cov-lite loans in the institutional loan market was 91%, the highest level on record.<sup>31</sup> In 2001, cov-lite loans represented only 1% of this market according to LCD.<sup>32</sup> More broadly, some 86% of the \$1.3 trillion in outstanding U.S. leverage loans are cov-lite, according to the S&P/LSTA Leveraged Loan Index.<sup>33</sup>

By comparison, based upon Proskauer’s Insights Report, only 1% of all private credit loans in 2021 were cov-lite loans, with all of them made to companies having at least \$50 million of EBITDA (generally indicating a less “risky” credit). Conversely, according to Proskauer’s Insights Report, 99% of the loans have at least one financial maintenance covenant (typically a total leverage ratio covenant) and 21% have two or more (*i.e.*, a total leverage ratio and fixed charge coverage ratio covenant).

Most syndicated loans are non-amortizing; that is, the borrower is not obligated to make any scheduled principal payments on the loans until the maturity date.<sup>34</sup> In contrast, the majority of the private credit loans tracked by Proskauer amortize at generally the rate of 1% per annum. Other payment terms, such as the mandatory prepayment provisions, are also typically more favorable to the private credit lender. Reductions in the lender’s principal exposure help mitigate the risk to the lender if the borrower’s earnings do not grow at the projected rate or even decline.

Private credit lenders negotiate for other provisions that decrease default risks in their loan documentation. Loan documentation, both in the syndicated and private credit markets, generally permits the borrower to incur additional debt, make investments, pay dividends, and other restricted payments, and otherwise allow the borrower to move cash or assets outside of the loan group. Overall, private credit lenders provide these borrowers with invaluable tools to support their business. These loans provide borrowers with flexibility to re-lever the business, engage in a broad range of asset disposition and investment activities without lender involvement, realize a return on their capital while maintaining control, and manage their lender group during good and bad times.

While there has been a convergence in the upper-middle market with respect to borrower-favorable terms typically available in syndicated loan documentation, private credit loan documentation, even for so-called cov-lite transactions, tend to impose greater limits on the borrower’s ability to engage in these activities, including more restrictive “baskets” and terms under which these baskets can be accessed. Private credit lenders also look to close loopholes for value leakage that often may exist in syndicated loan

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<sup>30</sup> (Latour, 2021).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

documentation known in the financing industry, such as requiring terms that address the “JCrew” and “Chewy”<sup>35</sup> risk or other similar documentary concerns.

### 3. *Underwriting & Administration*

Stronger loan documentation is complimented by more robust underwriting by many private credit lenders. Institutional bank lenders (and the CLOs that invest in loans in the syndicated loan market) are typically “takers of paper”. That is, they are buying loan paper based on a summary of terms in a marketing term sheet and limited information on the company. Private credit lenders by contrast are typically “buy and hold” investors. They invest in the loan with the intention of holding it to maturity, if not refinanced sooner. Therefore, they and their counsel conduct more extensive business and legal diligence before investing in the company. This diligence informs their underwriting, as well as the structuring and terms of the loan documentation.

Private credit lenders also more actively monitor the performance of the company. Private credit loan documentation may provide for more reporting than an institutional loan, including delivery of monthly financial statements and/or delivery of fourth quarter financial statements in advance of the annual audit. Formal reporting is supplemented by active monitoring by the private credit lender. The private credit lender often has informal lines of communication with both the private equity sponsor and company management, and generally monitors the market for any information on the borrower or the industry. Private credit lenders use this information to develop their own internal analysis of the business and its performance and are positioned to identify and react to red flags even before reporting is received from the borrower.

### 4. *Proper Lending Standards Evidenced by Limited Defaults*

The fact that the lending standards and practices of private credit are effective and appropriate is evidenced by the limited default rates of private credit. In addition to collecting data on its private credit transactions, Proskauer tracks the rate of defaults in active deals in its database and publishes its Private Credit Default Index on a quarterly basis. For the fourth quarter of 2021, 867 active deals met the criteria for inclusion in Proskauer’s Default Index. The Default Index includes companies across all major industry groups with EBITDA from \$0 to more than \$1 billion. We believe that Proskauer’s Private Credit Index generally reflects the private credit industry default rate.

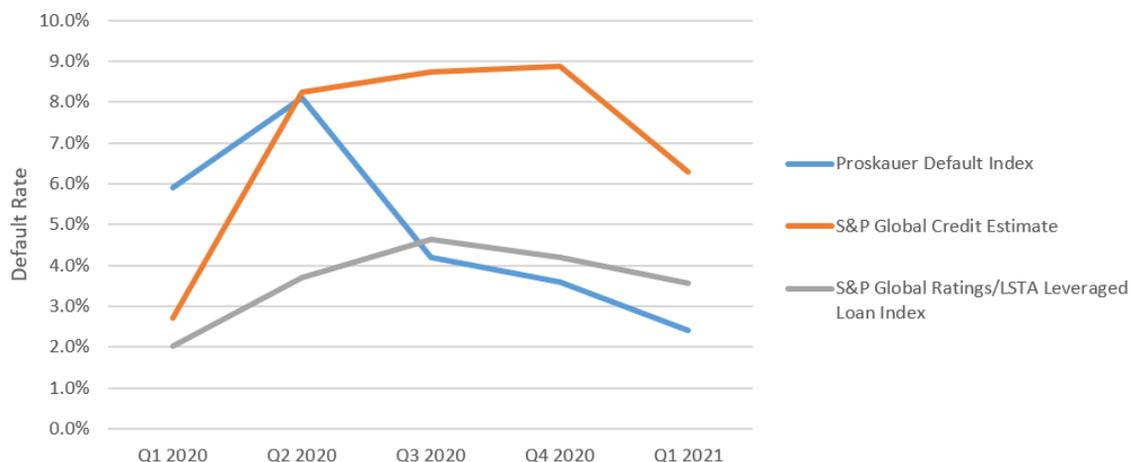
The chart below shows the relative default rates reflected in the Private Credit Default Index during fiscal year 2020 and fiscal year 2021. As the chart reflects, default rates peaked at 8.1% in the second quarter of 2020 but gradually declined to 1.04% by the fourth quarter of 2021.<sup>36</sup> Also as reflected in the chart below, the default rate for private credit compares favorably to the default rate for syndicated institutional loans as reported by S&P for the same period notwithstanding the fact that Proskauer’s definition of a

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<sup>35</sup> “JCrew” and “Chewy” refer to cases in which the private equity sponsor removed valuable intellectual property collateral out of the loan parties and incurred additional debt secured by that intellectual property.

<sup>36</sup> The Proskauer Private Credit Default Index tracks 867 active loans in the United States representing \$141.8 billion in original principal amount.

defaulted loan is significantly broader than the definition of default by S&P.<sup>37</sup> The correlation of the default rate of private credit and institutional syndicated loans has been consistent since Q1 2020.



Not only have default rates for private credit been low, but private credit lenders are uniquely positioned to address problem loans (as opposed to institutional bank lenders) through their relationships with private equity sponsors, their ability to foster consensus, and their ability to take equity and make additional loans in distressed situations.

As noted above, based upon Proskauer’s Insights Report, the vast majority of private credit loans are senior secured unitranche loans made to private equity sponsor backed non-public companies. These sponsors have deep relationships with their private credit lenders. Their private credit lenders may be lenders to a number of their portfolio companies, and for the largest asset managers, relationships may extend beyond private credit. These relationships matter in a troubled loan situation. Moreover, most of these loans are made by a single or small club of one to five like-minded private credit lenders and represent the company’s largest and most senior creditors. These lenders are motivated first and foremost to see the loan repaid, and not to trade the debt or own the company. As a result, parties are motivated to ensure the borrower business thrives.

A workout of a troubled loan can take multiple paths which include amending and extending the loan and investing fresh capital to support the business or to bridge to a sale of the company leveraging the lenders’ “dry powder.” As a last resort, they would effect a change of control transaction whereby the lender ends up owning the company. As of June 30, 2021, there was an estimated \$385 billion of “dry powder” across the asset class.<sup>38</sup> Having all of these tools at their disposal affords private credit lenders

<sup>37</sup> S&P defines a default as a payment or insolvency event of default. By comparison, Proskauer assumes a default to take place on the earliest of the date a debt payment is missed, a distressed restructuring occurs, the borrower files for or is forced into bankruptcy, a financial covenant default occurs, any other default occurs and is expected to continue for more than 30 days (excluding immaterial defaults), or the loan is modified in anticipation of a default.

<sup>38</sup> Prequin.

the ability to avail themselves of the workout and restructuring toolbox to the fullest extent to maximize their recoveries at or near par.<sup>39</sup>

### C. BDCs Are Subject to Significant Regulation.

Regulations governing BDCs mandate these vehicles have investment protocols and conflict guidelines in place to avoid conflicts as they manage common investments across their private credit platform. This included a general prohibition on BDCs engaging in joint transactions with other entities that share the same investment adviser (or an investment adviser controlling, controlled by, or under common control with such adviser). While many BDCs and their investment advisers seek exemptive orders to permit greater flexibility to make co-investments, this exemptive relief must be approved by the SEC. The 1940 Act also contains a 2x debt-to-capital ratio requirement that limits the ability of BDCs to take on leverage secured by their portfolio.<sup>40</sup> Finally, these regulations impose limits on the funds concentrating their loan investments. BDCs cannot hold more than 25% of their assets in a single investment.<sup>41</sup> Thus, BDCs maintain a diverse pool of loan investments, typically in a wide spectrum of companies in diverse industries. According to Proskauer's Insights Report, in 2021, private credit lenders made loans across more than 15 industries with the largest concentration, in business services, making up less than 20% of total deals reported.

### D. Private Credit Funds are Structured to be Resilient and Do Not Pose Financial Stability Risks.

As detailed above, the lending practices of private credit distinguish it from traditional bank leveraged lending and from other sources of public capital. These lending practices make private credit lenders more resilient in the face of disruptions in the financial markets. In this section, we discuss more generally the structural characteristics of private credit funds that help further ensure their resiliency and insulate their lending activities from triggering any cascading effects across the broader financial system. Although we do not discuss CLOs in depth in this paper, we note above that the GAO Report also found that CLOs are generally resilient in the face of economic shocks.

#### 1. Private Credit Funding is Locked In

Private credit asset managers typically deploy capital through closed-end vehicles that do not offer daily redemption to their investors and, therefore, are not susceptible to "runs" from investors that result in asset sales to meet liquidity demands. The "lock-up" periods for private credit closed-end vehicles are typically 7-10 years and may be extended according to the terms of the fund.

Accordingly, private credit vehicles are not exposed to the same liquidity or market risks as certain retail funds that engage in leveraged lending activities and there is no maturity mismatch between their assets and liabilities. Investors in private credit funds themselves are often diversified, institutional, and

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<sup>39</sup> Contrast that with a large syndicate of institutional lenders which may consist of banks, insurance companies, CLOs and other various institutional investors, as well as potentially distressed or special situation investors that trade in below par debt. Each of these investors may have its own investment thesis and motivations which may change as the make-up of the lending syndicate changes or conflict with the motivations of other members of the syndicate. Moreover, banks and CLOs simply may not have the capacity to deploy follow-on capital to support the business in a turnaround, nor may they have the institutional flexibility to consensually convert their debt to equity or take over a business as a path to maximize their recovery. These dynamics makes building consensus in a defaulted syndicated loan without resorting to the coercive tools available under bankruptcy law more challenging.

<sup>40</sup> Investment Company Act of 1940, as amended (the "1940 Act"), and the rules thereunder.

<sup>41</sup> Similarly, closed-end funds typically contain a concentration limit that prevents any single investment from comprising more than 10% of the funds aggregate investments.

sophisticated (e.g., insurers, pensions, endowments, and sovereign wealth funds) and are able to absorb losses from any individual fund.<sup>42</sup> As a result, leveraged lending activities of private credit lenders do not necessitate regulatory limits and stress tests that exist for regulated banks or other similar institutions that provide such products or may be subject to sudden increases in investor redemptions.

## 2. *Limited Activities and Interconnectedness*

Private credit funds are largely managed by companies engaged in a single business line—asset management. Private credit funds themselves are also typically limited in their activities by an investment mandate. Unlike commercial banks and other institutional lenders, private credit funds and fund managers do not provide or underwrite derivatives, credit default swaps, or other speculative hedge products. Private credit funds also do not enjoy the public backstop of commercial banks and, to some extent, money market mutual funds, reducing their interconnectedness with the U.S. economy as losses are entirely borne by long-term and typically institutional and sophisticated investors. This dynamic stands in contrast to bank loans, which are financed by depositors who can generally withdraw their money at any time. Because of this difference, private credit loans pose no risk to depositors or the taxpayers that ultimately backstop deposit insurance guarantees such as the one provided by the Federal Deposit Insurance Corporation.

Private credit funds and fund managers are also not significantly linked to other financial institutions and do not pledge their assets or guaranty other obligations to the same extent as commercial banks and some NBFIs. As noted above, private credit funds may maintain an amount of “dry powder” in the form of bank loans collateralized by committed, but unallocated, capital which can be invested opportunistically or used to ease periods of financial stress.<sup>43</sup> The GAO Report indicated that banks are sufficiently capitalized to withstand drawdowns, even during stress scenarios, and thus such subscription credit lines do not impact banks to any significant amount to raise systemic risks.

Finally, we note that the private credit market, while growing, comprises only a fraction of the financial footprint of banking activities, in which the largest banks have billions of dollars of balance sheet assets.<sup>44</sup>

## 3. *Diversification Contributes to the Resiliency of Private Credit Funds and Fund Managers and There is No Risk of Contagion*

Private credit funds and asset managers are incredibly diversified in terms of their investments and investment strategies and vehicles. Even the largest institutional private credit asset managers have not concentrated their capital in a single BDC or other investment vehicle. Instead, they manage multiple funds each having a unique investor base, strategy and portfolio of loans. While these commonly managed funds allocate loans across multiple private credit funds under the family umbrella of funds, investment decisions are made on a fund-by-fund basis. This diversification within each asset manager and across the industry contributes to its resiliency during times of stress. Specifically, losses from the default of a single loan are not likely to impact the performance of the entire fund or other fund vehicles of the asset manager, even if the manager allocates a loan across several of its managed vehicles.

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<sup>42</sup> Even in open-ended funds, run risks can be managed if sufficient safeguards are in place to prevent investor redemptions from leading to forced sales.

<sup>43</sup> Aramonte, S. and Avalos F. (Dec. 6, 2021). Private markets: a primer, BIS Quarterly Review (describing subscription credit lines).

<sup>44</sup> Federal Reserve Board (Dec. 31, 2021). Insured U.S.-Chartered Commercial Banks That Have Consolidated Assets of \$300 Million or More, Ranked by Consolidated Assets.

Accordingly, leveraged loan defaults are not likely to trigger cascading effects among fund managers or within the private credit industry more broadly, as evidenced by the COVID-19 market disruptions and the findings of the GAO Report.

#### V. Conclusion

Private credit has grown significantly in the past few decades, resulting in benefits to middle-market companies and the U.S. economy as a whole. This white paper concludes that private credit does not pose risks to financial stability as a result of strong lending practices, including debt structuring, documentation and underwriting, and resilient fund structures that are not susceptible to runs or interconnected with other financial institutions. Rather, we find that private credit's distinguishable characteristics allow it to have a stabilizing effect on the financial system.

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## About Proskauer's Private Credit Group and Its Insights Report.

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Proskauer's Private Credit Group has been the leading practice for the private credit industry for the past 19 years. With lawyers located in New York, Boston, Los Angeles, and London, Proskauer's Private Credit Group has over 75 professionals dedicated to representing private credit lenders in their investment transactions. Proskauer's Private Credit Group has consistently closed over 200 transactions a year. In 2021, Proskauer's Private Credit Group represented over 95 private credit lenders in over 400 loan transactions having a transaction value of over \$107 billion dollars. The loan transactions were generally to non-publicly traded, typically private equity sponsor backed middle market companies (with EBITDA between \$10 million and \$775 million) across a wide spectrum of industries. Business services, consumer, health care, manufacturing and software & technology were the five most active industries (consistent with the prior five years). Almost 70% of the deals had more than \$100 million in transaction value. During 2021, we worked with 184 different private equity sponsors.

We continually collect data on our U.S. and European private credit transactions that we close for our clients and compile that data in an annual report entitled Private Credit Insights.<sup>45</sup> Given the sample size, we believe that our data can serve as a good barometer of the private credit industry more broadly from which trends in the industry can be extrapolated. Thus, the views expressed in this paper are informed not only by our knowledge and experience in the industry but also our proprietary data. We also note that while this paper is focused on private credit in the United States, the same trends and mitigants exist in the European market for private credit and the data for our European transactions, while a smaller sample set, is consistent with what our data reflects for private credit transactions in the United States.

## About the Managed Funds Association

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Managed Funds Association (MFA) represents the global hedge fund and alternative investment industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly \$1.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, London, Brussels, and Asia. [www.managedfunds.org](http://www.managedfunds.org).

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<sup>45</sup> Proskauer Private Credit Insights 2021 (the "Insights Report").

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