# Private Credit: The Risks and Rewards

12 June 2024

Private credit has seen remarkable growth, with global assets skyrocketing from $310 billion in 2010 to $1.52 trillion in 2024. This sector's resilience and steady returns have attracted investors amid economic uncertainties. As private credit continues to expand, it brings new opportunities and challenges. This article delves into the IMF's concerns about this shift from traditional banking, the impact on ESG-driven building renovations, and the transition from private equity to private credit.

## Regulation

The International Monetary Fund (IMF) has raised concerns about the shift from regulated banks to private credit markets. Private credit borrowers can be smaller companies, making them vulnerable to economic downturns and rising interest rates. The IMF's analysis shows that one-third of these borrowers now face interest costs exceeding their current earnings.

Unlike leveraged loans that trade in transparent markets, private credit loans see smaller valuation markdowns during stress, despite lower credit quality, due to the lighter regulatory regime in which they operate. Institutional investors' exposure to private credit is growing and therefore this interconnectedness with other financial sectors could pose future systemic risks. A severe downturn could erode credit quality, causing defaults and significant losses.

This could in turn impact public markets, forcing institutional investors such as insurance companies and pension funds to sell more liquid assets. These concerns have prompted calls for stricter regulatory oversight and supervision of the private credit market. Ensuring adequate monitoring and assessment of risks is crucial for maintaining financial stability.

Recent amendments to the alternative investment fund managers directive (AIFMD) have mitigated the potential risks of this growing space. The new rules seek to improve the liquidity management tools available to fund managers and provide an EU framework for loan-origination funds. Data sharing and cooperation between authorities are improved under the rules. These changes collectively address the need to alleviate risks posed by private credit to the financial system and introduce additional investor protection.

## ESG

In a recent article, we discussed how the fast-approaching maturity wall for commercial real estate (CRE) loans coupled with the regulatory restraints placed on traditional lenders following the 2008 financial crisis have created a debt funding gap in the sector. This debt funding gap presents an opportunity for alternative lenders in the form of increased demand for private credit finance.

Through a combination of regulatory requirements and increased tenant and investor demand, the green transition to more energy-efficient buildings is well underway. Under the Energy Performance of Buildings Directive, Member States are required to renovate the 16% worst-performing buildings by 2030. By 2033, the 26% worst-performing buildings must meet certain energy performance standards.

According to Lisney, this will result in a quarter of commercial buildings in Ireland needing upgrades over the next ten years. Funding this green transition, whether through new developments or refurbishments, will be a huge challenge for the financial sector but also a great opportunity for private credit.

Private credit can take a forward-looking approach and invest in retrofitting and refurbishing older assets. Pillar banks are often prevented from doing this due to minimum loan to value (LTV) or capital adequacy requirements. This gives private credit an edge in supporting the green transition.

## Shift from private equity to private credit

Private credit has delivered consistent and reliable returns to investors through the current interest rate cycle. This is in contrast to the volatility of the private equity market, which is highly reliant on the performance of portfolio companies. Private equity has long relied on low borrowing costs and consistent asset appreciation.

Uncertain global economic conditions have led investors to pivot towards private credit. This period of turbulence has forced private equity funds to keep their chips off the table, resulting in a record accumulation of dry powder in the sector. By December 2023, this dry powder totalled $2.5 trillion.

The post-financial crisis regulatory restraints introduced for traditional lenders have created a lending vacuum. Private credit has flourished in this environment, becoming the natural home for investor capital that previously would have gone to private equity.

## Conclusion

Both opportunities and challenges have emerged as a result of the rapid growth of private credit. Regulatory scrutiny is essential to mitigate potential systemic risks. ESG initiatives offer a chance for private credit to support sustainable development. The shift from private equity to private credit reflects investors' search for stable returns in uncertain times. Ensuring economic stability amid the rise, and maturing, of private credit is crucial. Private credit's impact on the broader financial sector cannot be underestimated. It is a force that demands careful oversight and strategic management to ensure its continued success.

For more information and expert advice on matters related to private credit, contact a member of our Banking team.

*The content of this article is provided for information purposes only and does not constitute legal or other advice.*