Direct Lenders and Financial Stability

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Abstract

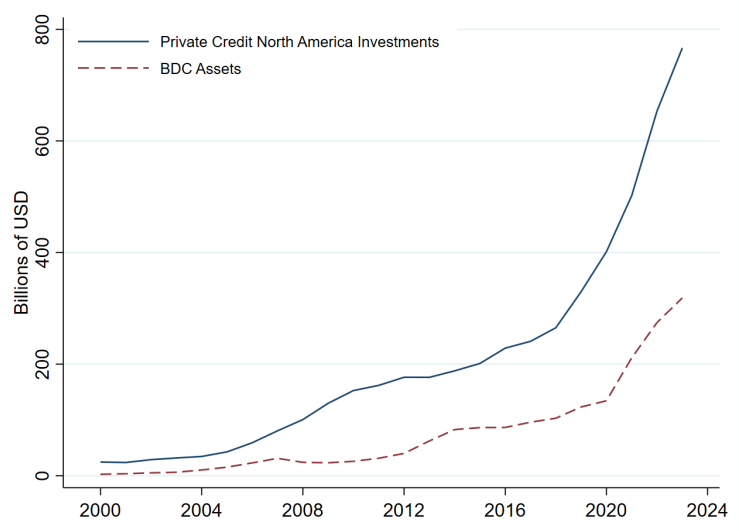
Direct lenders have substantially increased their market share in providing credit to middle-market firms over the past two decades. In this article, we examine the potential implications of this trend for financial stability. We evaluate three channels through which direct lenders may contribute to systemic risk: (1) contagion via funding chains and fire sales, (2) deteriorating credit standards from close ties with private equity (PE) sponsors, and (3) reduced lending following distress. The first risk is largely mitigated by their closed-end fund structures, low credit line exposures to banks, limited secondary market activity, and flexible accounting. The second risk is similarly contained by their repeated interactions with PE sponsors. However, the significance of the third risk – curtailed lending in times of distress – is unclear given the lack of empirical evidence. In summary, we believe that concerns about the growth of direct lenders are unwarranted, as their potential to create financial instability is comparable to or even lower than that of banks. However, this assessment could change as the sector continues to evolve, and we discuss potential future concerns at the conclusion of our article.

Introduction

Since the 2008 Global Financial Crisis (GFC), corporate lending has increasingly migrated away from traditional banks to various nonbank entities (Chernenko et al., 2022; Davydiuk et al., 2024a; Gopal and Schnabl, 2022). Among them, so-called "direct lenders" have grown considerably. Direct lenders raise capital through closed-end funds in both private and public markets. They are "direct" in the sense that they typically originate loans without bank involvement. Shown in Figure 1, the outstanding investments of private credit funds in North America as of December 2023 is $800 billion and $300 billion for business development companies.[1] Taken together, the direct lenders currently stand at around $1.1 trillion. Some in the industry believe the sector to be even larger (see, e.g., Robin Wigglesworth, 2024), but these types of calculations depend on the types of investment funds included. Nonetheless,

[1]The $800 billion in investments by private credit funds is estimated based on the difference between total funds raised and dry powder according to Preqin. This figure does not account for the leverage employed by these funds and is therefore an underestimate. With a median leverage of 25% (Block et al., 2024), the total investments made by private credit funds likely exceed $1 trillion.

Figure 1: Growth in Direct Lenders



Sources: Preqin, Refinitiv, and SNL Financial.

our figures position direct lenders as major players alongside the $1.4 trillion leveraged loan and $1.6 trillion high-yield bond markets.[2]

Due to their rapid expansion and size, regulators and policymakers have initiated efforts to assess the direct lending space (Federal Reserve Board, 2024; International Monetary Fund, 2024; Brookings, 2024). These reports do not express pressing concerns about direct lenders regarding financial stability. Instead, they primarily acknowledge that the general lack of data in this space that makes it difficult to conduct a thorough analysis of potential risks.

In this article, we provide our own assessment of financial stability concerns related to direct lenders. We do so through a combination of literature review and independent analysis. We focus on private credit funds and business development companies given their data availability and that they constitute around 95% of private credit investment vehicles (International Monetary Fund, 2024).[3] Our goal is to provide a comprehensive list of concerns alongside quantitative guidance that will be useful to policymakers. We also tailor our discussion to the unique institutional features of direct lenders and the private credit market. As such, we hope that our insights will help to shape ongoing discussions among industry members and the regulatory community.

Institutional background

Post-GFC Rise of Nonbank Lenders

The 2008 Great Financial Crisis ("GFC") led to the introduction of banking regulations that effectively restricted credit supply from the banking sector (Erel and Inozemtsev, Forthcom-

[2]Sources: LSTA US Leveraged Loan Index and S&P US High Yield Corporate Bond Index (as of December 2023)

[3]CLOs represent nearly all of the remaining share but they are distinct in that they do not originate loans.

ing). On a global scale, "Basel III", implemented by the Bank for International Settlements in 2013, aimed to increase bank capital and liquidity standards. In the U.S., stress tests mandated by the Dodd-Frank Act further raised capital requirements for large bank-holding companies. Additionally, the Office of the Comptroller of the Currency, the Federal Reserve Board of Governors, and the Federal Deposit Insurance Corporation collectively revised the Interagency Guidance on Leveraged Financing in 2013 to tighten banks' underwriting practices and limit their exposure to leveraged lending.

A diverse range of nonbank lenders stepped in to fill the post-GFC lending gaps. In the bank-syndicated loan market, institutional investors such as hedge funds, mutual funds, and particularly collateralized loan obligations (CLOs) became major purchasers of term loans (Irani et al., 2021). The post-GFC shift away from traditional banks has been especially evident among small and mid-sized firms. For middle-market companies – those with annual revenues between $10 million and $1 billion according to the National Center for the Middle Market – research by Chernenko et al. (2022), Davydiuk et al. (2024a), and Jang (2024) shows that nonbank lenders such as finance companies, insurance firms, hedge funds, and direct lenders have increasingly been originating loans without involving bank syndication. Davydiuk et al. (2024a) specifically show that direct lenders stepped in to substitute for middle-market lending done by banks that were effectively hampered by regulatory stress tests and new accounting standards for off-balance sheet assets. In the small business sector, Gopal and Schnabl (2022) report that finance companies and fintech lenders have significantly expanded their lending activities.

The precise causes of the growing market share of direct lenders are still up for debate. For example, Chernenko et al. (2024) argue that it is simply more profitable for banks to lend to direct lenders than to the underlying companies directly. This view aligns with the broader notion that private credit serves as a substitute for bank lending, though it can also be seen as a complement. For example, Haque et al. (2024) document that private credit funds often cater to bank borrowers by providing more junior debt alongside banks' senior secured debt.

Direct Lending Funds

There are two main types of direct lending funds: private credit funds and business development companies (BDCs). Both types are structured as closed-end funds, but they differ in how they raise capital and are regulated.

Similar to private equity and venture capital funds, private credit funds raise capital through a limited partnership structure with a defined lifespan. The investors in these funds, known as limited partners, are typically institutional investors such as pension funds, sovereign wealth funds, insurance companies, endowments, and high-net-worth individuals (Block et al., 2024; Federal Reserve Board, 2023).

Established under the Small Business Investment Incentive Act of 1980, BDCs exist solely in the U.S. and were designed to promote investments in small and mid-sized businesses. Like private credit funds, BDCs operate as closed-end funds. Unlike private credit funds, BDCs are subject to specific SEC regulations, receive special tax treatment, and can raise capital through public equity markets. Non-traded BDCs, similar to private credit funds, primarily raise capital from institutional investors, while traded BDCs, due to their listing status, also

attract capital from retail investors and mutual funds (Davydiuk et al., 2024a,b).

Despite the differences noted above, private credit funds and BDCs share similar key features.

First, both primarily focus on "direct lending", which means that they originate loans directly without involving bank syndication (Block et al., 2024).

Second, there is a significant overlap in deals across private credit funds and BDCs. Not only do they target similar types of borrowers, notably middle-market firms often backed by private equity, but also many asset managers allocate loans belonging to the same deals across both their private credit funds and BDCs. Using Pitchbook data, Jang (2024) shows that, among asset managers with private credit funds and BDCs, 43% of the loans held by their private credit funds also appear in their BDCs.

Third, private credit funds and BDCs rely heavily on "mark-to-model" valuations for their loan assets rather than "mark-to-market" valuations. This aspect differentiates them from CLOs and other credit funds whose assets (e.g., broadly syndicated loans) are relatively more liquid (i.e., they frequently trade on the secondary market). Because model-based valuations inherently rely on subjective inputs, many private credit funds and BDCs also rely on external review provided by third-party appraisal firms (Jang, 2024; Jang and Kim, 2024).

Lastly, because most private credit funds and BDCs are structured as closed-end funds, investors cannot easily withdraw their shares at their net asset value until fund liquidation.[4] As we discuss later in this article, this feature is critical to assess the financial stability concerns regarding direct lenders as it mitigates the possibility of bank-style runs and associated financial fire sales as in CLOs.

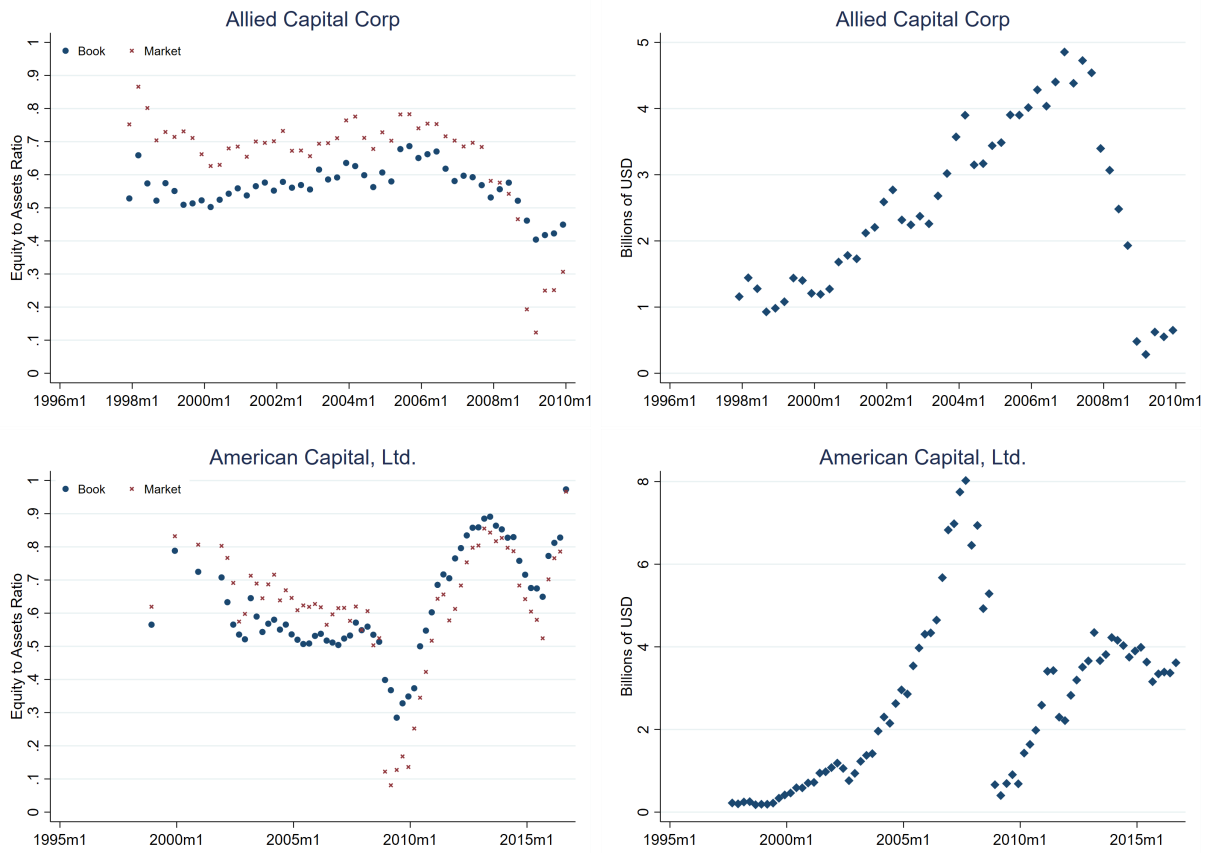
Risks of Individual Institution Failures

Before proceeding to an analysis of financial stability, we must confront the primary question of whether and how individual direct lenders can fail. After all, financial crises typically involve the simultaneous distress and failures of multiple financial institutions. We will explore later the potential channels through which the failure of individual institutions can propagate, but for now, we focus on the primary stage.

It is well known that banks can, and do, fail. Banks are highly-levered financial institutions whose solvency is therefore threatened by seemingly small declines in the values of their assets. This potential instability is further heightened by the fact that banks fund themselves primarily with demandable debt in the form of deposits. For these reasons, banks are heavily monitored and regulated by various federal and state agencies tasked with ensuring the soundness of the banking system. Despite their efforts, however, individual banks still fail due to various reasons ranging from poor risk management to adverse economic conditions. When banks approach insolvency, regulators such as the Federal Reserve and FDIC step in, often providing backstop liquidity and facilitating a takeover by another bank.

[4]Recently, there has been a rise of perpetual-life BDCs, which allows for quarterly investor redemptions capped typically at 5% of net asset value. This strategy made its debut in early 2021 with the introduction of the Blackstone Private Credit Fund (BCRED). As of 2023, perpetual-life BDCs managed around $112 billion, representing around a third of total BDC assets. See, e.g., the LSTA website.

Figure 2: GFC-Induced BDC Failures: Allied Capital Corp and American Capital Ltd



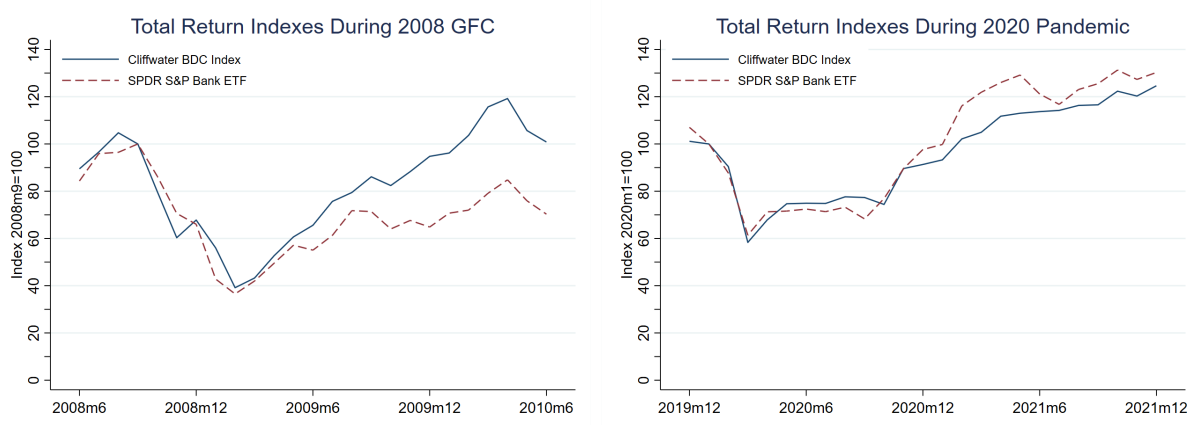
Sources: Refinitiv and SNL Financial.

What about direct lenders? Can they fail and, if so, how? The answer to the first question is, of course, yes. Any institution that is at least partially funded by debt can become insolvent if the value of its assets declines. While it might seem that direct lenders are less likely to fail than banks because they maintain much lower leverage (typically debt-to-asset ratios in the range of 25-50% versus above 90% for banks), their assets are often riskier and less diversified.[5] Therefore, whether banks or direct lenders are more prone to failure remains an empirical question, albeit a challenging one given the opacity of assets and rarity of such events.

Instead of conducting a quantitative analysis using today's markets, we take a different approach. To assess how direct lenders can fail, we consider a few notable historical examples. Specifically, we focus on failures of publicly-traded BDCs and study their market values before collapse. We believe this approach is instructive as the cases we discuss below are relatively unknown compared to those in the banking sector given the historically small size of the direct lending sector.

[5]Block et al. (2024) report an average (median) debt-to-asset ratios of 40% (25%) for private debt funds in the US. In the past, BDCs tended to have ratios between 30-50% (Davydiuk et al., 2024a). However, the Small Business Credit Availability Act of 2018 increased the maximum allowable debt-to-equity ratio for BDCs from 1:1 to 2:1. Since then, the leverage of BDCs have increased to be in the 40-60% range.

Figure 3: Equity Returns During Crises: BDCs vs Banks



Sources: Bloomberg, CRSP, and authors' calculations.

Perhaps the most prominent collapse of a direct lender in recent memory is Allied Capital Corp ("Allied"), one of the largest BDCs operating during the 2000s. Allied's share price declined by over 90% during the GFC amid concerns about its loan portfolio (Figure 2). For several years prior, hedge fund manager David Einhorn had scrutinized Allied and its loan portfolio, suspecting that the BDC was inflating its asset values. Einhron detailed this saga in his book, *Fooling Some People All the Time*. Ultimately, Einhorn's hypothesis was validated as the GFC revealed the true deterioration of Allied's loan assets. In early 2010, Allied was acquired at a steep discount by Ares Capital Corp ("ARCC"), a rival and one of the largest BDCs at the time.

American Capital Ltd ("ACAS") also suffered during the GFC due to the performance of its investments and it actually defaulted on its debt in June 2008. Unlike Allied, however, ACAS managed to survive the GFC. It spent the next several years trying to recover and managed to do so with some success. However, it never quite regained its footing and ultimately sold itself to ARCC in 2016, just like Allied.

Taken together, the Allied and ACAS cases illustrate several points about distress and failure of direct lending funds. Just like banks and other financial institutions, direct lenders can fail due to losses associated with poor investments. In Allied's case, this was arguably due to poor risk management and reluctance to recognize losses. Also just like banks and other financial institutions, direct lending funds are vulnerable to sudden failures during episodes of financial distress. However, unlike banks, large direct lending fund failures – even in the absence of regulatory oversight – appear to be handled smoothly in the private market through M&A transactions without triggering further failures.

As another relevant historical episode, we can consider what happened to direct lending funds during the COVID-19 pandemic in 2020 to 2021. Although not as severe as the GFC, this time period represented significant financial market distress and large declines in valuations. In contrast to the failures of large BDCs during the GFC, we only observed the effective failure of smaller BDCs. HCAP and Garrison were both purchased by Portman Ridge in 2021 while MVC capital was purchased by Barings in December 2020. Other BDCs that experienced stress on their investments were able to weather the market turmoil.

But what about the quantitative risk of failure? So far we have only discussed individual instances of direct lender collapses and distress. Chernenko et al. (2024) attempt to quantify the risk of failures among BDCs. They apply the Federal Reserve's bank stress test methodology to BDCs and find that, even after accounting for the riskiness of BDC assets, BDCs are significantly better capitalized than typical banks. For our purposes, we can also look to the past for guidance. Interestingly, we observe in Figure 3 that the declines in market values of equity in banks and BDCs (i.e., the only publicly traded direct lenders) are relatively similar during periods of crisis. This suggests that, to the extent that BDC assets are riskier is offset by lower leverage. These observations also support the view that market discipline, which Davydiuk et al. (2024b) shows to be important in shaping BDC investments, helps to ensure similar risk-adjusted performance across lender types.

In conclusion, our observations suggest that the sources of distress and failure risk for direct lenders are comparable to those faced by banks. This view differs slightly from the more optimistic tone of Chernenko et al. (2024), who find less risk to solvency among BDCs compared to banks. Our view is in line with the growing consensus that the ultimate cause of bank failures is almost always a deterioration of bank fundamentals (Correia et al., 2024).

Financial Stability Analysis

Now we turn our discussion to the main question at hand: financial stability. When discussing financial stability, we frame our discussion in terms of how individual concerns are magnified or lessened relative to a hypothetical world in which commercial banks, rather than direct lenders, are the primary debt providers. We motivate this framing given the substantial growth of direct lenders over the past decade to replace bank financing. In this sense, we also attempt to compare financial stability in today's environment with that of the pre-GFC era.

Financial fragility extends beyond the distress or failure of individual institutions. Regulators, in particular, focus on the connections between financial institutions to assess "systemic risk" and when designing macroprudential policies.

Leveraging the existing institutional knowledge and academic findings, we assess direct lenders' contribution to systemic risk in the following forms: (1) contagion through funding chains and fire sales, (2) deteriorating credit standards from close ties with the private equity (PE) industry, and (3) reduced lending following financial distress.

Contagion Risk

We examine the extent to which distress or failure in a direct lender could spread to other financial institutions. The concept that the distress or failure of one institution can impact others is broadly known as "contagion." Contagion may occur either directly through funding chains or indirectly via fire sales of assets.

Banks are often seen as having substantial contagion risk due to their funding structure. They frequently lend to each other and depend heavily on short-term debt, such as demandable deposits and commercial paper. This reliance generates significant counterparty, rollover, and run risk, especially when there are concerns about their solvency.

In contrast, we believe that direct contagion risk from the distress of direct lenders via funding channels is relatively limited. Unlike banks, direct lenders seldom lend to one another and raise capital through long-term sources. Their funding generally comes from buy-and-hold investors, such as pension funds and insurance companies, through limited partnership equity commitments and publicly issued bonds, and from banks in the form of revolving loans with typical five-year maturities. While publicly traded BDCs may raise equity from retail investors, their closed-end fund structure inherently protects against redemption risk.

There could be some concern that direct lenders might transmit distress to banks through their credit lines. For instance, during the COVID-19 pandemic, banks experienced significant credit line drawdowns by large firms (Greenwald et al., 2023) and nonbanks such as REITs (Acharya et al., 2024).

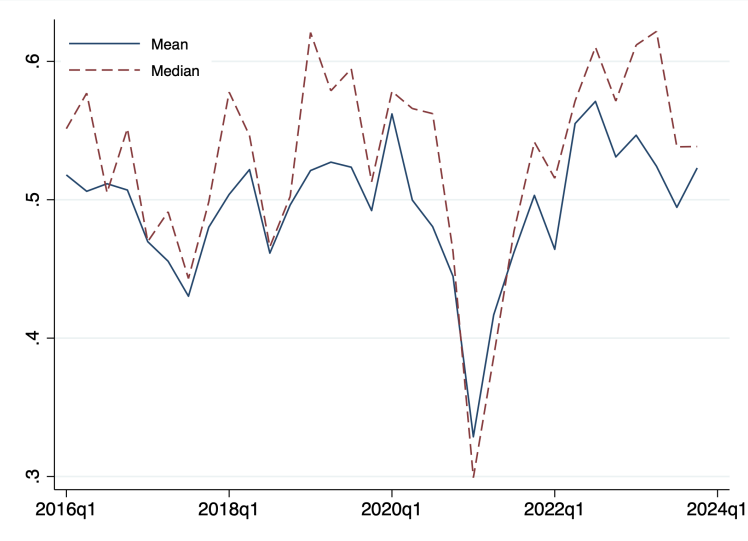
However, we do not believe direct lenders' reliance on bank credit lines poses a significant risk for several reasons. First and foremost, direct lenders likely represent a small share of bank credit line portfolios. Even when using aggressive assumptions in back-of-the-envelope calculations, it is hard to generate meaningful capital losses to banks through their financing to direct lenders.[6] Second, many large direct lending fund managers diversify their funding across multiple private credit funds and BDCs, so unless they all rely on the same bank, credit line drawdown risk is likely spread across several banks. Third, as shown in Figure 4, we did not observe a substantial increase in credit line utilization by BDCs during the pandemic. While BDCs slightly increased drawdowns in the first quarter of 2020, likely as a precaution, they paid them down by early 2021, even below pre-pandemic levels. This suggests that banks actively monitor BDC performance (e.g., through financial covenants) and impose restrictions on debt capacity as needed.

Lastly, financial institutions that invest in illiquid assets while funding themselves with liquid assets, such as deposits or open-end funds, are well-known to face fire sale risk due to strategic complementarities in investor redemptions (Diamond and Dybvig, 1983; Goldstein et al., 2017). While one might assume that closed-end funds are immune to fire sale risk, research on CLOs suggests that this isn't entirely the case; closed-end funds can still be vulnerable depending on the contractual design of their funding structures such as through covenants (Kundu, 2023). Such fire-sale risk has been shown to exist and studied in the leveraged loan market (Elkamhi and Nozawa, 2022).

However, we do not believe indirect contagion via fire sales is a significant risk for direct lenders for two reasons. First, the loan assets of direct lenders infrequently trade unlike, e.g., the broadly syndicated loans of CLOs. Therefore their market values cannot observably decline because they mostly do not exist. Second, even if an individual direct lender sold its loan assets at a deep discount, other direct lenders that hold loans to the same company

[6] We approximate the exposure of banks to direct lenders as of Q4 2023 at $372 billion. BDCs contribute $105 billion through revolving credit facilities and term loans based on data from Capital IQ. The $267 billion contribution from private debt funds assumes that 25% of their assets are financed through bank debt (Block et al., 2024). If we assume a 15% default rate and 20% recovery rate, which roughly capture the performance of junk-rated debt during the GFC, aggregate losses from direct lender leverage would be $45 billion. This amount represents less than 4% of the $1.2 trillion of aggregate equity capital for banks that we observe lending to direct lenders. Further, if we use default and recovery rates consistent the BBB ratings more typical of BDCs, the hypothetical losses from direct lender leverage in a crisis would be less than 1% of bank capital.

Figure 4: BDC Credit Line Utilization/Commitment (2016-2023)



Sources: Capital IQ.

would not be forced to update their fair values accordingly. This is because direct loans are classified as Level 3 assets whose fair valuations are determined using model-based approaches. Without being forced to recognize declines in market value, financial fire sales would not spread or further depress prices. This is not to suggest that investors are incapable of discerning inflated Level 3 asset values – Allied's failure in 2008 serves as a notable counterexample. Instead, the key point is that the primary mechanism by which financial fire sales trigger indirect contagion is absent in the case of direct lenders.

In conclusion, risks of contagion seem to be lower overall in direct lending sector.

Deteriorating Credit Standards from PE Relationships

The private equity (PE) industry has historically been marked by significant cyclicality, exemplified by the junk bond crash of the late 1980s. This event highlighted the dangers of excessive leverage and weak creditor protections (Kaplan and Stein, 1993). In response, stability was fostered by the syndicated loan market. Loan-originating banks, through the use of covenants and the cultivation of long-term relationships with PE sponsors, played a critical role in monitoring credit risk and resolving financial distress (Nini et al., 2012; Ivashina and Kovner, 2011).

Block et al. (2024) report that 78% of US direct lending activity now supports PE buyouts, with leading direct lending funds operated by traditional PE firms such as Blackstone, Carlyle, and KKR. Such close ties between direct lenders and PE sponsors raises a critical question: can direct lenders replicate the stabilizing role that banks historically played in the PE industry? Answering this question is central to understanding financial stability, as PE sponsors inherently strive to maximize returns and benefit their equity stakes by exploiting cheap debt and leveraging their financial sophistication to negotiate looser credit terms (Axelson et al., 2013; Ivashina and Vallee, 2022).

We identify two potential risks that can arise from such close ties between the private

credit and PE industries. First, as direct lenders rely heavily on deal flows coming from PE sponsors, a potential bargaining power imbalance may incentivize direct lenders to act as superchargers for PE sponsors, facilitating riskier deals and contributing to the erosion of credit standards. Second, the growing prevalence of PE-affiliated direct lending introduces concerns about agency conflicts within PE firms. Specifically, PE firms could use their direct lending arms to finance buyout deals, potentially shifting risks from equity investors to debt funds within the same organization. Buchner et al. (2022) emphasize the potential for adverse selection in such "sponsor-levered" deals.

The findings by Jang (2024) suggest that both risks are likely to be low. Examining a large sample of PE-backed firms borrowing from both direct lenders and banks, Jang (2024) finds that direct lenders tend to impose stricter protective covenants than banks. Moreover, during the COVID distress period, direct lenders required more equity injections from PE sponsors during renegotiations, demonstrating their ability to enforce greater "skin-in-the-game" from sponsors. These findings align with survey results from Block et al. (2024), which indicate that direct lenders build stable relationships with PE sponsors without compromising their bargaining power.

Furthermore, using PitchBook data – a leading database on US PE buyouts and private credit deals – Jang (2024) find that "sponsor-levered" deals have become increasingly rare. As of today, they account for less than 10% of loans issued by PE-affiliated lenders. An industry practitioner interviewed on the matter noted that such deals are often stigmatized in the market due to the precise adverse selection dynamics described by Buchner et al. (2022).

Reduced Lending Risk

Thus far we have focused on financial stability concerns from the perspective of distress at financial institutions. However, it is often argued that financial crises are only "bad" if they negatively impact the real economy. The underlying theory is that under-capitalized financial institutions cannot intermediate as well and thus causes real economic activity to decline (Acharya et al., 2016). This perspective underlies well-known systemic risk measures such as $SRISK$, which is publicly available on NYU's V-Lab website.

In short, it is unclear whether direct lenders would cut back lending more so than banks that are similarly distressed. The main reason for our uncertainty is lack of comparable empirical evidence. For example, Davydiuk et al. (2024b) document substantial negative impacts on BDC lending following the exclusion of BDCs from stock indexes in 2014. However, we have not observed a similar natural experiment in the banking sector to which we can compare the magnitudes of the responses.

Even if one studied the lending responses of banks and direct lenders to the same shock (e.g., the GFC), it would be difficult to account for the fact that direct lenders tend to fund riskier borrowers whose demand for credit would differ compared to bank-only borrowers. Chernenko et al. (2024) argue that the reduced lending risks stemming from the deleveraging of BDCs during a stress scenario are substantial. In their analysis of hypothetical stress scenarios, they predict that the assets of BDCs would shrink on the order of 10-20% as they cut lending and pay down debt. They conclude that "[s]uch reductions in lending could adversely affect their middle market borrowers and the broader economy." However, their

analysis does not tell us how banks would cut lending to the same set of borrowers in a hypothetical world without direct lenders. Aramonte and Avalos (2021) find that aggregate private credit flows are equally as procyclical as leveraged loan flows, which would suggest that the lending responses of direct lenders and banks would be similar all else equal.

Taking a step back, the business model of the lending institution (i.e., direct lending fund versus bank) may not even be the most important factor affecting lending in future crises. Rather, we suspect that policy interventions aimed at stimulating lending will be the driving force in shaping such credit decisions. From this perspective, the question of whether direct lenders would reduce their lending more than similarly-distressed banks during a future crisis is a moot one.

Developing Risks into the Future

The direct lending sector continues to grow given the recent outperformance of private credit and corresponding investor optimism (J.P. Morgan Asset Management, 2024).[7] Alongside this growth, the sector continues to evolve. Therefore, it is possible that significant risks will arise in the future that are not as meaningful in today's markets. In this section, we consider such potential risks that will be substantial in the future if current trends continue.

The first potential concern is that resolving the failure of individual direct lenders will be more challenging in future crises. To date, we have not observed a case in which a relatively healthy and large direct lender (e.g., ARCC) was not available to purchase a struggling competitor (e.g., Allied). If such an entity was not available, large direct lending failures could hypothetically be more catastrophic. Then again, we suspect that two relevant factors would assuage such concern. The first is that the funding structure of BDCs (i.e., lack of large-scale demandable equity and debt) would prevent the "forced" sales of assets in the first place. Rather, bankruptcy proceedings should instead lead to an orderly liquidation over time if needed. Second, even if one distressed fund began selling its illiquid loan assets and creating negative price pressure, the ability of direct lending funds to mark their investments to model in times of market distress would prevent indirect contagion as discussed earlier.

Another potentially concerning trend is the increasing complexity of direct lenders. For example, BDCs in the past few years have begun to fund more of their investments through vehicles such as sub-funds and joint ventures. The additional layers created by such investment strategies may make it more difficult for investors to assess the riskiness of private debt investments. As such, excessive risks can build up to a greater extent leading an eventual crisis to be more substantial. This was the case of asset-backed commercial paper conduits created by banks leading up the GFC (Acharya et al., 2013). We cannot point to specific elements of direct lending activity today that would suggest a similar potential for hidden risks. However, we acknowledge that such concerns could become more valid if the complexity of direct lending funds continues to increase.

Related to complexity, one might also be concerned about the increasing opacity of direct lending investments.[8] Much of the post-pandemic growth in BDCs has come from private

[7] Erel et al. (2024) document that this outperformance mostly accrues to the general partners of private credit funds while providing insignificant abnormal returns to the limited partners after accounting for fees and the riskiness of the underlying assets.

[8] While direct lenders are not subject to centralized data collection by regulators and policymakers similar

BDCs, with Blackstone Private Credit Fund (BCRED) managing $53 billion – over one-sixth of all BDC assets – as of Q4 2023. As fewer of these investments are held by publicly traded BDCs, whose equity prices serve as useful benchmarks, the pricing transparency of these investments diminishes. Rintamaki (2024) also finds that private BDCs are more likely to lend to smaller, opaque firms. This decline in publicly traded BDCs raises questions about whether investors, such as limited partners or creditors, can provide adequate oversight over direct lenders' valuation practices. Jang and Kim (2024) find that many direct lenders (e.g. 76% of BDCs) obtain independent valuation opinions from third-party appraisal firms, as frequently required by their own creditors (typically banks). Given the challenges of directly regulating private credit valuation practices, one practical policy approach would be to ensure that banks are effectively monitoring the marks on direct lenders' portfolios that they lend against.

Historically, direct lenders have specialized in cash flow-based financing for middle-market firms (Block et al., 2024). Recent evidence suggests that direct lenders are expanding into asset-based, consumer finance, filling gaps left by regional banks since the collapse of Silicon Valley Bank (Faridi et al., 2024). This shift raises concerns, as diversification away from core business lines has often led to adverse outcomes for financial institutions – e.g. the excessive securitization that contributed to the Global Financial Crisis and Silicon Valley Bank's over-investment in Treasury bonds. Additionally, many private credit fund managers foresee increased consolidation within the industry.[9] For instance, BlackRock acquired HPS for $12 billion in December 2024.[10] If the sector continues to become more concentrated, concerns about institutions being "too big to fail" may extend beyond the banking industry.

Conclusion

This article examines the financial stability risks posed by direct lenders – private credit funds and business development companies (BDCs) – which have significantly expanded over the past two decades, replacing banks as key lenders to middle-market firms. We believe that direct lenders face risks of failure similar to those of banks, which are weak risk management, adverse economic conditions, and declining asset values. Unlike banks, however, direct lender failures have so far been managed through private market mergers and acquisitions. We explore three pathways through which direct lenders might contribute to systemic risk: (1) contagion through funding chains and fire sales, (2) deteriorating credit standards stemming from their ties to private equity (PE) sponsors, and (3) reduced lending during periods of distress.

First, the contagion risk posed by direct lenders appears relatively low compared to banks. Banks face significant contagion risks due to their reliance on short-term debt and interbank lending. In contrast, direct lenders primarily raise capital from long-term investors and avoid

to traditional banks, MFA (2024) details the wealth of information available on private credit from various data sources.

[9] https://www.bloomberg.com/news/articles/2024-02-14/bain-capital-s-lavine-sees-more-consolidation-in-private-credit?sref=lnqdp1gH

[10] https://ir.blackrock.com/news-and-events/press-releases/press-releases-details/2024/BlackRock-to-Acquire-HPS-Investment-Partners-to-Deliver-Integrated-Solutions-Across-Public-and-Private-Markets/default.aspx

heavy dependence on short-term funding or inter-lender borrowing. Although direct lenders' use of credit lines from banks may introduce some vulnerability, this exposure appears small in aggregate. Moreover, direct lenders are not exposed to indirect contagion risk given their illiquid assets and ability to rely on model-based valuations.

Second, while direct lenders' close ties to PE sponsors raise concerns about weakening credit standards, evidence suggests that direct lenders retain significant bargaining power in these relationships. They often impose stricter covenants than banks and require greater equity contributions from PE sponsors during periods of distress. Moreover, concerns about PE sponsors exploiting their affiliated credit arms to favor their equity investments also seem mitigated given the rarity of sponsor-levered deals.

Third, whether direct lenders reduce lending more severely than banks during a crisis remains uncertain. This uncertainty largely reflects a lack of empirical evidence. Direct lenders primarily serve riskier borrowers, and no comparable natural experiments exist to evaluate their behavior alongside banks in a crisis. Ultimately, policy interventions that target lending activity during crises may shape credit decisions more than the differences in business models between banks and direct lenders.

Going forward, new risks may emerge in the direct lending sector. As the sector grows in size and significance, it remains unclear whether large direct lender failures can be as easily absorbed by competitors during a major downturn without central bank support. Additionally, the increasing complexity of direct lending structures – such as sub-funds and joint ventures – may obscure underlying risks, potentially leading to greater instability. Moreover, the decline of publicly traded BDCs raises concerns about pricing opacity and a lack of valuation discipline among direct lenders. Lastly, recent trends toward expanding into non-core businesses such as asset-based, consumer finance and increased consolidation in the sector also warrant close attention. As such, continued research into these directions is essential for informing future policy discussions on financial stability.

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