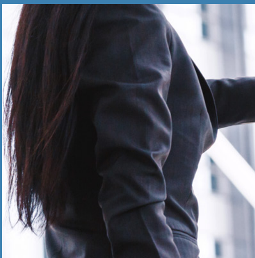
AMERICAN INVESTMENT COUNCIL

Private Credit

Investing in Main Street



March 2021

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Section I. Executive Summary

Policymakers on Capitol Hill and within the regulatory agencies have expressed interest in better understanding the debt market. This interest covers U.S. business debt of all sizes and structures, from investment-grade public companies to non-investment-grade companies, many that are small and medium sized. One area of interest is *nonbank lending*. Nonbank lending has grown in recent years as banks have reduced lending activity and nonbanks have stepped up to fill the void.

Policymakers have expressed particular interest in the *leveraged lending* activities of these nonbank lenders. Although the term has multiple meanings and definitions, policymakers at the Federal Reserve recently described leveraged lending as lending to companies that are considered "non-investment-grade" by credit rating agencies.[1] A recent report from the Government Accountability Office examined these concerns, reporting that there is no systemic risk associated with these activities.[2]

This paper seeks to educate policymakers and the public on a subset of nonbank lending--private credit, a growing and important lender. Although private credit vehicles are structured differently and participate in different areas of the debt market, they have some common characteristics. They are closed-end investment vehicles with assets comprised of debt instruments from a broad array of borrowers. Unlike their open-ended counterparts, such as mutual funds, these closed-end vehicles do not redeem shares on demand and are not exposed to "runs" that could lead to fire sales to meet investor redemptions. These vehicles, for the most part, are actively managed with investor capital "locked up" for a predetermined period, giving managers the ability to manage through risks and avoid forced sales.

In addition to the critical role that these nonbanks play as lenders to businesses, many of which are shut out from capital markets, these vehicles play an important role in ensuring that consumers have access to credit. Regulatory changes in the aftermath of the financial crisis have reduced banks' capacity to lend. Structured credit vehicles, a type of credit fund, allow increased access to credit for consumers to purchase houses and automobiles, among other things, by purchasing this debt, securitizing it, and selling it to investors based on their risk return tolerance. This frees up capital for banks and other finances companies to do more lending. Despite similarities to products that helped to cause the financial crisis, there have been important changes that have significantly reduced risk. These include stricter regulatory requirements, greater credit support, and far more transparency.

Private credit has been scrutinized as part of broader concerns regarding nonbank lending. However, private credit has a number of important characteristics that distinguish it from banks and other nonbank lenders and can contribute to economic stability. Notably, its counter-cyclical investment capability means private credit firms play an important role in stabilizing credit markets and smoothing credit cycles. They do this by investing in companies that would otherwise contract or go bankrupt and by facilitating liquidity in consumer credit markets to ensure credit is available.

Private credit provides:

- Flexible capital solutions to non-investment-grade businesses to drive growth or assist in a restructuring.
- Investors with yield, particularly when traditional fixed income assets have low interest rates.
- Economic stability by providing countercyclical credit when traditional lenders are more likely to reduce activities.

Section II. Coming to a Consensus on the Definition of Leveraged Lending[3]

U.S. Representative Ted Budd (R-NC):

"So, Mr. Chairman, there's been a lot of discussion in recent months about leveraged loans. In fact, you've had a couple of questions on this topic today, but when people discuss the issue, sometimes I think they're referencing different things. So, help us get on the same page here. **In your opinion, how would you define leveraged loans?"**

Federal Reserve Chairman Powell:

"You're right, there are a lot of different ways to think about it. You know, a reasonable ballpark would be something that's rated below triple B, or you could also say it could mean an amount of leverage, typically, they'll have leverage of maybe six times cash flow EBITDA. There are different ways to think about it.

"But I mean I think that the best way to think about it is probably non-investment grade debt."

The term *leveraged lending* has recently received a lot of publicity in Washington. Policymakers want to better understand it. Commentators are providing their opinions about the viability of it. But a threshold problem exists—no one appears to be on the same page about what leveraged lending means.

For instance, one definition focuses on businesses that have borrowed over a certain threshold as measured by their cash flow available to service debt. Another refers to loans sold on the broadly syndicated debt market.

While both types of lending activities could fall into the category of leveraged lending, policymakers are generally referring to the broader non-investment-grade segment of the business debt market. This segment has different characteristics from investment-grade debt. The investment-grade segment of the market is generally made up of publicly traded companies, which are companies with credit ratings above a certain threshold. The non-investment-grade segments of the market are made up of companies that fall below the investment-grade threshold, as well as non-rated small- and medium-sized businesses.

Regulatory agencies, such as the FDIC and the Federal Reserve, have been clarifying that for their purposes leveraged lending refers to the non-investment-grade debt market.[4]

Section III. Why Are Businesses Borrowing Money?

Most business owners choose to start up, purchase, grow, or operate their businesses with the help of money from outside investors. The reasons are many, from a lack of capital to a desire to find others to share in the financial risk and rewards of the business. Capital from outside investors has led to some of the largest success stories and innovations in history, from the Model T to the smartphone. Outside financing supports tens of thousands of middle-market companies located in every community.

Business owners have a choice as to whether to raise capital by equity or debt financing. Some businesses have a choice between the two forms of financing, and they may choose to take on debt. Unlike equity financing, debt financing does not involve transfer of ownership rights. In return for capital, the borrower promises to repay the amount borrowed (the principal), plus interest. The borrower's obligation is fixed and does not increase or decrease, regardless of the performance of the business. Debt can therefore be an attractive form of financing for a growing business. Additionally, interest payments on debt are often tax-deductible (up to a certain amount), which can make debt financing more efficient for the business.

In addition, many small- and medium-sized businesses do not have ready access to equity financing, and debt financing is the only option for these companies. Debt financing enables these companies to grow. Without debt financing, the viability and growth of many small- and medium-sized American businesses would not be possible.

Section IV. The Evolution of the Business Lending Marketplace

Historically, lending was primarily done by banks. When a business or consumer needed financing, a banker and the business would establish lending terms, and the bank would advance the loan, which would be held on the bank's balance sheet. These loans are funded through a combination of customer deposits, repurchase agreements, and other financing arrangements. All of these funding sources are generally short-term. The structure of commercial banks, lending long based off short-term funding, leads to what is known as an asset/liability mismatch, leaving banks leveraged and at-risk in times of economic stress.

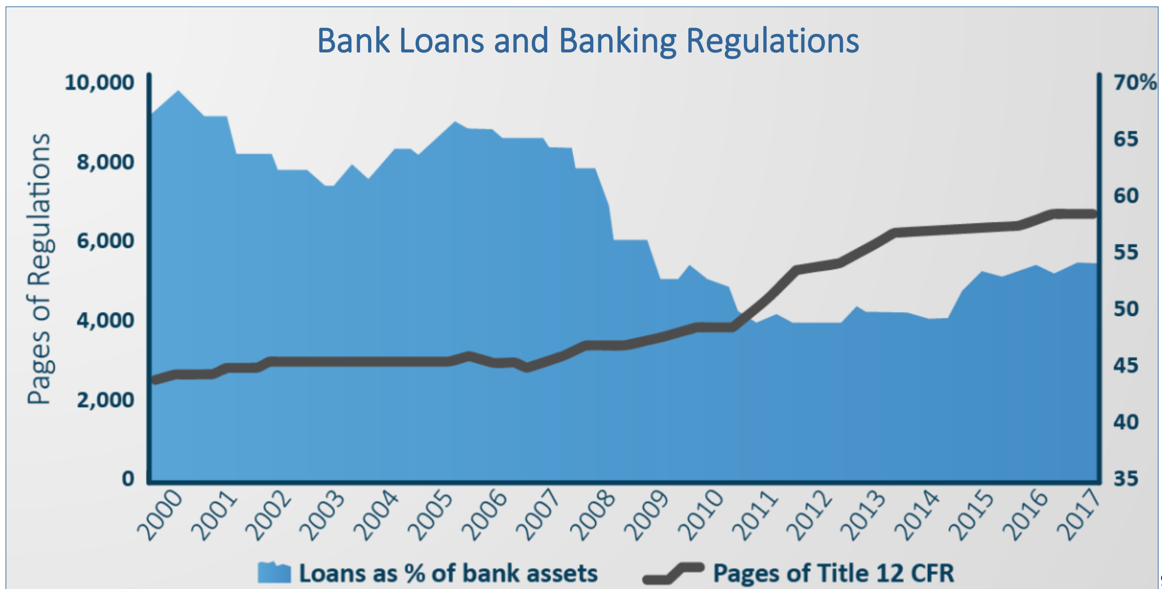
A major contributor to the global financial crisis of 2008-2009 arose from certain concentrations of bank lending activities—specifically residential mortgage loans that were originated by banks, packaged into instruments such as mortgage-backed securities ("MBS"), and sold to government-sponsored enterprises ("GSEs") and other financial institutions.

After the housing bubble burst, it became clear that the interconnected nature of the domestic and international financial institutions involved in these lending activities created increased risk. The mortgage crisis led to a credit crisis, and regulators and policymakers observed that risks undertaken by banks were amplified given their role in providing liquidity throughout the financial system. Financial institutions, such as banks, insurance companies, broker-dealers, and GSEs, had woven such a complex web that the failure of one large bank could have severe consequences on the global financial system.[5] Homeowners, businesses, depositors, investors, and taxpayers were all left exposed in the wake of the credit crisis.

Over the past 30 years, structural and regulatory changes in the credit market have encouraged banking institutions to scale back lending, particularly to lower- and middle-market companies, as well as consumers. This opened the opportunity for nonbanking financial institutions to fill the void in a way that was safer.

Following the Dodd-Frank Act, banks responded to higher capital and liquidity requirements and other de-risking regulations by, among other things, reducing their lending activity.[6] This is particularly apparent when examining loans to below-investment-grade businesses. According to data released by the FDIC in 2019, the percentage of leveraged loans held by banks dropped from 25 percent in 2000 to 3 percent in 2018.[7]

As one academic has observed, "One mystery of the slow recovery is why bank lending failed to respond to expansionary monetary policy. Bank lending declined dramatically during the crisis, and despite the period of very low interest rates since, has failed to recover."[8] The same analysis indicated that bank lending had an inverse relationship to regulations imposed post-crisis, as detailed in the below chart:



[9]

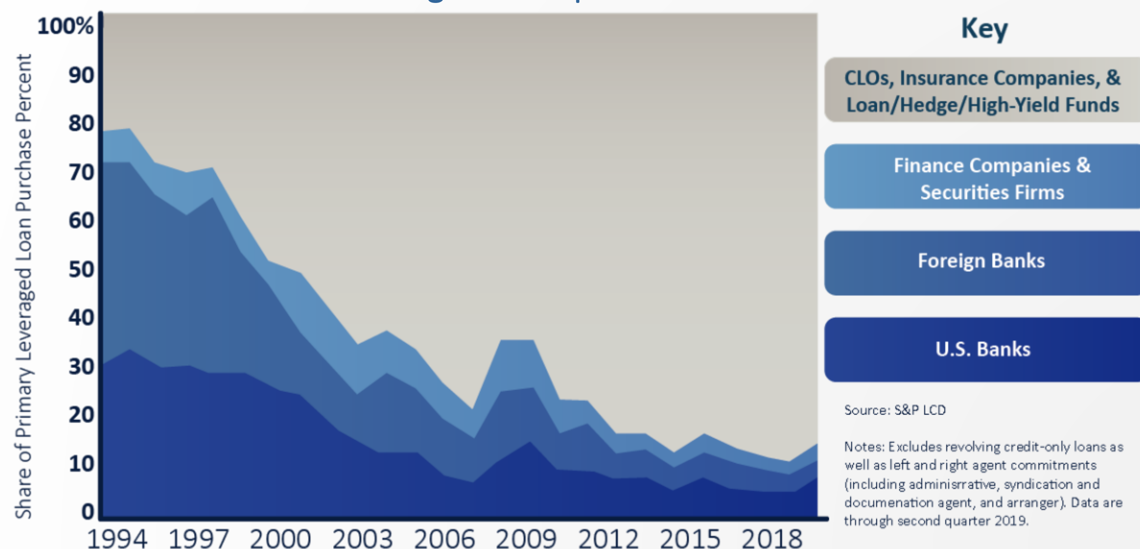
The ability to access credit during varying economic conditions – especially in downturns, when liquidity dries up and needs are the greatest – is critical to financial stability and to business development. Nonbanks have played a critical role in providing credit countercyclically for decades and have stepped in when banks retrenched. Lending in the U.S. has grown substantially since the 1950s, with the bank portion peaking at 62 percent in 1974, and at its lowest point at 32 percent in 2009.

From a regulatory perspective, what sets these "nonbanks" apart from banks is that they do not take traditional demand deposits. For private credit funds, this is an important distinction as it highlights the better asset/liability match between funding from long-term institutional capital and issuance of long-term loans that is absent in bank lending.[10] Additionally, private credit funds do not have deposit insurance or access to the Federal Reserve discount window, further reducing the risk of a government "bailout."

A. Nonbank Lenders Fill the Credit Void

While some policymakers have expressed concern regarding the rise of nonbank lending, such lending has been an important part of the credit markets for decades, as nonbank lenders step in to serve borrowers when banks pull back. A 2019 study by University of Texas professor Maria Loumioti found that direct lending by nonbanks increases by approximately 22 percent when a company's bank faces tighter capital constraints from non-performing loans.[11] The same study found that direct lending by nonbanks is positively correlated with an increase in banks' regulatory capital requirements (which causes banks to de-risk and reduce lending activity) and bank consolidation in a given market (which can result in underserved borrowers).[12] As the study author stated, "[The study] results support the argument that direct lending expands the credit space to companies with fewer external financing options and fills the void in periods of credit contraction."[13]

As regulation on banks has increased, they are unable to hold these credits on their balance sheet. More and more banks have shifted to a business model of originate and distribute, in many cases, to nonbanks who do not pose the same risks to the financial system. These nonbanks have modest if any leverage and are not interconnected in the same manner as banking institutions.



Section V. Nonbanks in the Business Lending Marketplace

A. Broadly Syndicated Market

Syndication of Business Loans. Loans can either be retained on the books of a single lender or syndicated, meaning the loan is funded by more than one lender. Most syndicated loans involve an arranger (the bank that organizes loan terms and identifies partners for syndication), an agent (an institution that acts as an intermediary between the borrower and the lenders), and a trustee (an institution that holds a loan typically for the duration of the term). Syndication can involve a combination of banks, finance companies, and institutional investors that come together to fund the loan.

The bank-syndicated loan and bond markets tend to serve larger companies with EBITDA greater than $50 million and provide loans greater than $250 million. The size of these loans is part of the reason why syndication is required -- a group of banks may need to raise capital to fund the loan through a pool of investors who can trade the loan on secondary markets.

B. Investors in the Broadly Syndicated Loan Market

Collateralized Loan Obligations (CLOs). CLOs are the largest investor in the broadly syndicated loan market. In the United States, CLOs are operated as a type of private credit fund by an asset manager. Outside of the U.S., CLOs are often managed by large foreign banks.

Mutual Funds. Mutual funds are collective-investment pools that are substantively regulated, open-end registered investment companies (“RICs”). Open-end funds, generally speaking, are investment funds that issue new fund shares and redeem existing shares on demand.[14] While mutual funds do not provide direct loans, they are significant holders of loans made to businesses, including companies rated below investment-grade.

Insurance Companies. Insurance companies collect premium dollars and invest through their general accounts to match projected liabilities with assets. Insurers do not lend directly to businesses, but do play an important role in

the credit markets as purchasers of debt. In 2018, corporate debt issues held by life insurers totaled $2.6 trillion, or 21 percent of all U.S. corporate bonds. This represents 34 percent of life insurer assets.[15] Additionally, life insurers held $122 billion in CLOs at the end of 2018.[16]

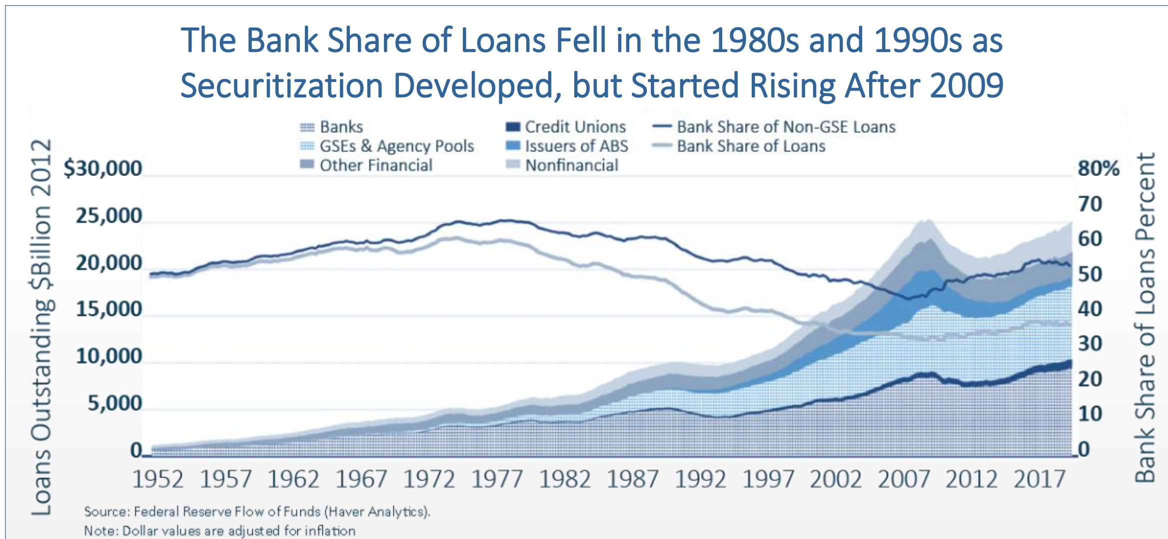
Other participants. Other institutional investors who participate in these transactions include sovereign wealth funds, pension funds, as well as other investors, such as private credit investors. These investors represent a small slice of investment in leveraged loans.

C. Illiquid (Non-tradable) Debt

Direct Lending. Unlike broadly syndicated loans arranged by banks and packaged for sale, direct lenders negotiate the loan with the business, originate the loan, and hold the loan to maturity. In 2019, direct lending funds held $293 billion in assets under management ("AUM"), which represented 36 percent of all private debt strategies.[17]

Direct loans tend to be targeted to lower- and middle-market companies with operating performance in the range of $10 million to $50 million of earnings before interest, tax, depreciation, and amortization (EBITDA). These smaller, non-investment-grade loans are generally for smaller amounts, illiquid, and have higher yields due to their non-tradability and non-investment-grade status. As capital has increasingly been committed to these strategies, the size of these loans has increased.

The below chart from the FDIC demonstrates the overall growth in lending and the relative share of this growth between banks and nonbanks:[18]



Private credit has become an increasingly important part of the business credit market, providing stable investments and expanding access to credit. These investment vehicles can provide businesses with capital when it is otherwise unavailable, stabilizing potential market volatility.[19] During stress in debt markets, private credit vehicles are able to provide liquidity.

Section VI. What is private credit?

Private credit vehicles are typically limited partnership, closed-end structures that invest in debt instruments, in which a manager or general partner manages the investments and investors are limited partners ("LPs") in the fund. The managers are required to have "skin in the game," meaning they are personally invested in the fund and thus their interests are aligned with those of the LP investors. The funds offered by private credit firms typically solicit initial capital commitments and call capital only as investment opportunities within the fund's mandate arise. Investors' capital is "locked up" for the life of the fund (i.e., are not redeemable). Credit funds typically invest for longer terms (six to eight years on average).[20] Additionally, when raising a fund, general partners and limited partners agree to an investment mandate which prevents the general partner from taking on too much risk.

While some general characteristics are uniform across private credit, these vehicles can also offer bespoke financing to enhance flexibility for the borrower and lender. Private credit investments can come in a variety of forms:

- Direct Lending
- Mezzanine financing
- Distressed & Special Situations
- Specialty Finance
- Structured Credit
- Real Estate Credit
- Real Assets Credit

Direct Lending - $293 billion in assets under management

Direct lending funds are typically closed-end funds with limited-partner investors that do not involve a bank intermediary.[21]

A. Business Development Companies

Business Development Companies, or BDCs, are a type of direct lending fund that is a registered investment company under the Investment Company Act of 1940. Unlike many other types of private credit funds, these vehicles, in many cases, have shares traded on public markets which are open for retail investors to invest. These vehicles primarily lend to small- and medium-sized businesses. Additionally, these vehicles are required to provide assistance to their borrowers. These vehicles are the only way that retail investors can gain exposure to private credit.

Mezzanine financing - $159 billion in assets under management

Mezzanine debt is a combination of debt and equity financing, covering the area between high-seniority debt of direct lending and common equity. This type of unsecured debt is generally riskier and requires higher interest as a result.

Distressed and Special Situations- $346 billion in assets under management

Distressed and Special Situations strategies focus on targeting companies that are suddenly faced with a change in either financing or governance. Funds that employ these strategies step in to provide capital at a critical time when companies need access to funds or when other investors wish to exit their investments.

Structured Credit

Structured Credit strategies are financing methods where an institution supplies capital to a business or consumer in the form of a loan. The institution then pools similar loans into tranches based on their credit risk which are resold to investors as bonds. The investors receive returns based on the interest from the underlying loan. These products ensure that capital is available for consumers or businesses by freeing up liquidity in lending markets.

Specialty Finance

Specialty Finance is a type of investing that focuses on specific facets of the marketplace that typically require more specialization and experience to establish and manage credit. Many of these strategies are geared towards smaller enterprises where quick access to capital is critical to success and to capitalizing off of consistent future revenues that can be leveraged for both parties involved.

Real Estate Credit

The real estate credit-lending market focuses on investing in large real estate projects and developments that require significant capital and time. This type of lending focuses primarily on malls, office buildings, and other forms of large commercial real estate. Real-estate credit works like a home loan. An institution will lend a company the funds to buy or build a project and require mortgaging of the asset as a means of collateral. The company will then repay the loan over a long-time horizon of 20 to 30 years.

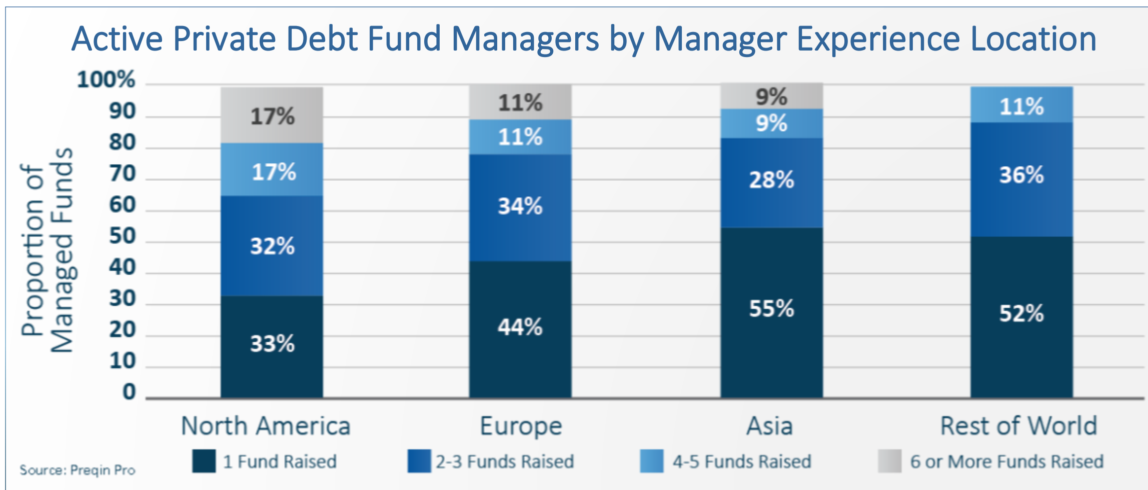
Real Assets Credit

The real asset credit-lending market focuses on investing in large capital projects that require significant upfront costs and assets with complex financing and depreciation schedules. These projects pertain heavily to a company's fixed assets that are vital to their business model, such as manufacturing plants and specialty equipment.

Section VII. The Management of Private Credit Funds

A. Private Credit Managers

Private credit vehicles are primarily run by experienced credit managers who negotiate transactions bilaterally with companies whose debt forms the assets of the fund. Other private-credit managers buy debt on the secondary market. As of January 2020, there were over 1,700 private-credit fund managers in the industry.[22] The U.S. has the most experienced fund managers in the world, with 67 percent having raised two or more funds, and 34 percent having raised four or more funds:



Fund managers conduct extensive due diligence on borrowers to evaluate the credit quality of a company.

Consequently, private credit managers invest significant time to better understand the underlying business they underwrite; with their own firms' capital and reputation at stake, they are strongly incentivized to monitor and work closely with borrowers to resolve problems. Credit managers can also mitigate downside risk by securing access to ongoing financial reporting as part of loan agreements, which allows them to work with company management in advance of significant problems. Overall, the structure of private credit aligns the interests of fund managers and investors through profit-sharing and monetary investments from fund managers, which introduces the "skin in the game" proposition.

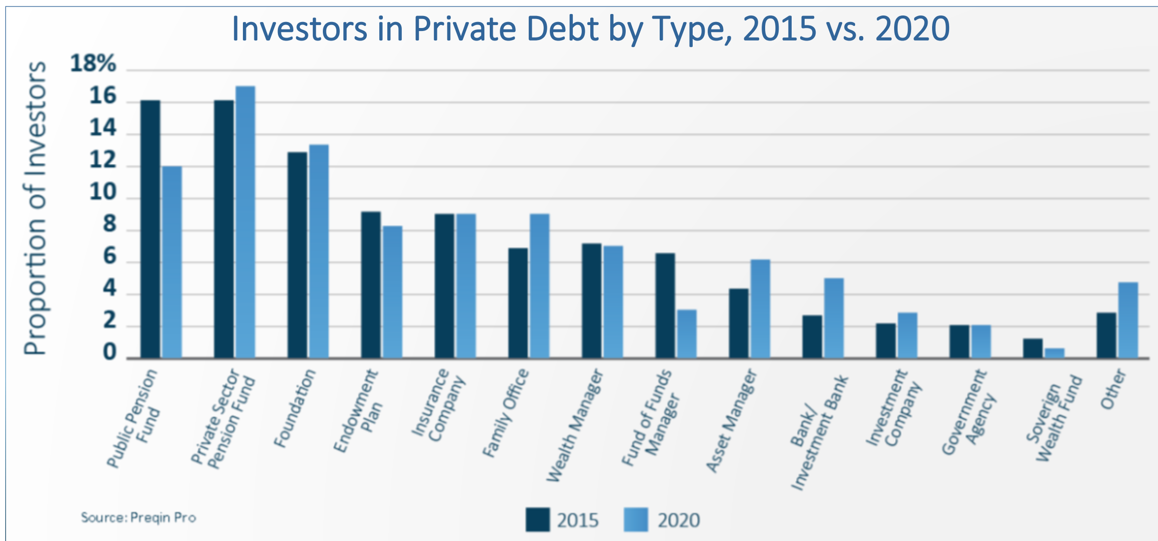
Section VIII. Private Credit Investors

Investors in private credit funds are typically sophisticated institutional investors. With the exception of Business Development Companies, retail investors do not have access to these funds.

For these investors, private credit funds fall within the alternative asset category of their diversified portfolios. Private credit serves a different goal for institutional investors as compared to the private equity funds that invest in the equity portion of a company's capital structure, which promise higher returns.

Private credit funds are attractive because they offer stable returns and risk mitigation to sophisticated investors. According to Preqin, "Investors allocate to private debt for diversification first and foremost – our latest survey reveals 65% of investors are drawn to the asset class for its diversification benefits. As the least correlated asset class to public equity markets, investors look to private debt for protection on the downside as a market correction looms."[23]

The chart below details investors in private debt by type, with public and private pension funds and foundations representing a combined 43 % of investors in private debt in 2020.



Section IX. Historical Performance of Credit Funds

Private credit is an attractive option for sophisticated investors, including pension funds and insurers, in part because of its steady performance. According to research conducted by Hamilton Lane, private credit solidly outperformed public credit offerings in the 10-year period immediately following the financial crisis.[24] According to Preqin data, the IRR for vintage 2006-2016 private credit funds was 9.9 percent.[25]

Private credit funds earn returns by lending directly to companies and buying debt instruments originated by others. According to asset manager Hamilton Lane, private credit investments have outperformed their public market equivalents in almost every year from 1997 to 2019.[26] Over three-year, 10-year, and 15-year time horizons, Hamilton Lane finds private credit investments to have had superior annualized time-weighted returns to both the Credit Suisse ("CS") High-Yield Index and the Barclays Aggregate Bond Index, two bond market indices. From 1995 to 2019, the lowest five-year annualized performance for private credit funds was 5.8 percent, which surpassed returns on such public-market equivalents as the Bank of America-Merrill Lynch High-Yield (non-investment grade bond) Index (-0.9 percent) and the CS Leveraged Loan Index (-2.8 percent).[27]

While their selections of indices and benchmarks in their analyses differ, these commentators agree that private credit has performed well in recent years and is a healthy and vital segment of the capital markets. The strong performance of private credit investments has contributed to the growth of the asset class, with the value of private credit investment funds increasing from around $25 billion in 1999 to almost $800 billion in 2019.[28]

Section X. Policy Questions

A. Private credit assists financial stability

Private credit has been scrutinized as part of broader concerns regarding nonbank lending and leveraged lending. However, credit funds have important characteristics that distinguish them from banks and other nonbank lenders and that can contribute to economic stability. In times of credit dislocation, these investment vehicles identify and purchase debt they think will ultimately be worth more than its market value at the time. This stable, counter-cyclical investment capability means private credit firms play an important role in stabilizing volatile credit markets and smoothing credit cycles by investing in companies that would otherwise contract or go bankrupt. The past decade has proven that private lenders contribute to economic expansion.

Private credit's long-term, private lock-up fund partnership structure is the antidote to the sudden, large withdrawals that are associated with "runs on the bank" and forced "fire sales" of assets, which was distinctive of the financial crisis. The investment banks that financed the sharp increase in mortgage-backed securities during the economic crisis were vulnerable because of a maturity mismatch: the assets they held were mainly long-term, but their liabilities were mostly short-term. This is like commercial banks, which are dependent on deposits and other short-term funding but tend to lend long. By contrast, the long-term liabilities of private credit investors, such as pension funds and insurance companies, match the longer life of credit funds. In addition, private credit lacks two other elements often related to systemic risk and financial instability: high leverage and interconnectedness. As indicated in surveys, private credit managers prefer unlevered credit strategies, and where leverage is employed, it tends to be at low levels.[29] During the financial crisis, banks were at times leveraged nearly 40 to 1 by some metrics.[30] Credit funds and their investments are both stand-alone and independent. Thus, their investments are not cross-collateralized or connected by common debt structures. This means that a loss experienced at one fund, or in one investment, will not enable recourse to other funds or investments.

Credit fund investments provide a natural stabilizing effect because they have access to stable funds, proactive engagement with the lender, and specific strategies tailored to individual investments, such as distressed debt and special situation funds. These traits allow credit funds to provide financing or liquidity in times of economy-wide downturns, as well as industry-specific dislocations, such as the current global pandemic, because of their long-term nature. These more complex strategies often aim at taking advantage of complexity in the market—e.g., pricing distressed debt or converting a debt position into an equity ownership stake—and thus can be more risky, require deep industry knowledge, and more active engagement.

Alternative asset managers, such as Apollo Global Management, Blackstone, and KKR, among others, are able to take advantage of lending origination opportunities and specific sector knowledge of both their credit and equity teams. Often asset managers will raise funds that include multiple strategies, such as private debt and equity, which will provide flexibility as economic conditions and markets evolve.

As of December 2019, there was $292 billion in private debt "dry powder" accessible by private credit managers, representing a substantial cushion for small, medium, and large companies as they face liquidity challenges during the global pandemic.[31]

Private Credit Proves an Important Piece in the Covid-19 Recovery

Private credit has played a pivitol role in the recovery from the fallout of the Covid-19 pandemic. With most firms having to reexamine their business model or transform operations, capital has been needed to fund these changes. In an October 2020 interview, Global Head of Private Credit at Bain Capital Credit Michael Ewald disscusses how the private credit industry has responded to the crisis. He highlights how the industry went to work early in the pandemic when banks and other lenders pulled back on their lending operations, especially with middle market firms.[32] Ewald also cites how covenants and lender protections acted as they were intended during the peak of the economic shutdown, opening the door for conversations with companies and sponsors to decide the best course of action. Pitchbook and Proskauer reported that default rates among US private debt loans was down to 4.2 percent in the third quarter of 2020.[33] This is a drastic reduction from both 8.1 percent at the end of the second quarter and 5.9 percent at the end of the first quarter. Private credit provided a life raft to businesses during a period where many were struggling to stay afloat.

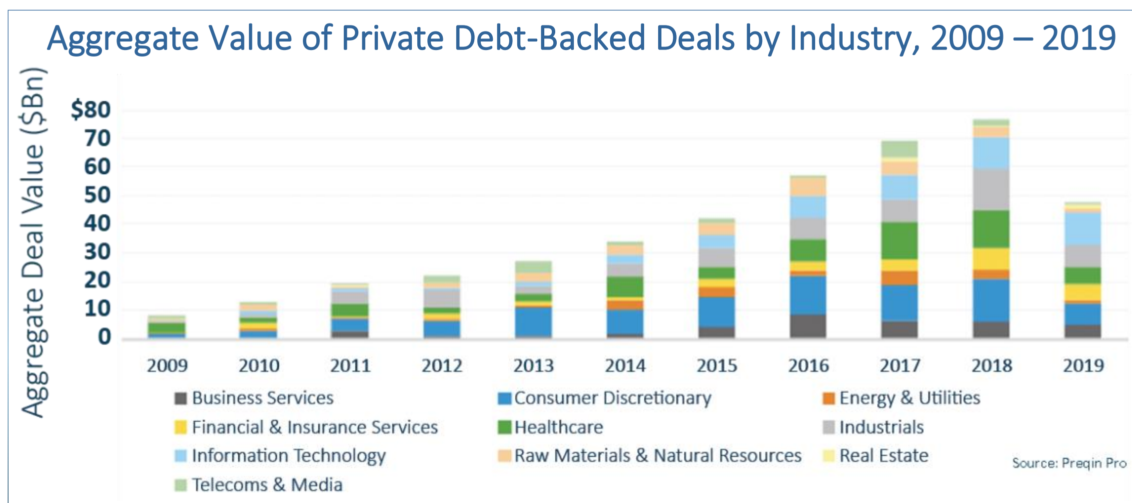
B. Private Credit is not a source of systemic risk

During the economic crisis and the consideration of Dodd-Frank, policymakers identified key characteristics of firms they believed to contribute to systemic risk. These factors were ultimately codified in section 113 of Dodd-Frank and broadly underlie the analysis of systemic risk. These concerns relate to interconnectedness, asset/liability mismatch, counterparty exposure, and risk-amplifying activities, such as hedging. Private credit, simply put, does not create these types of financial risks. In fact, a recent report from the Government Accountability Office confirmed that there is no systemic risk associated with leveraged lending activities or private credit.

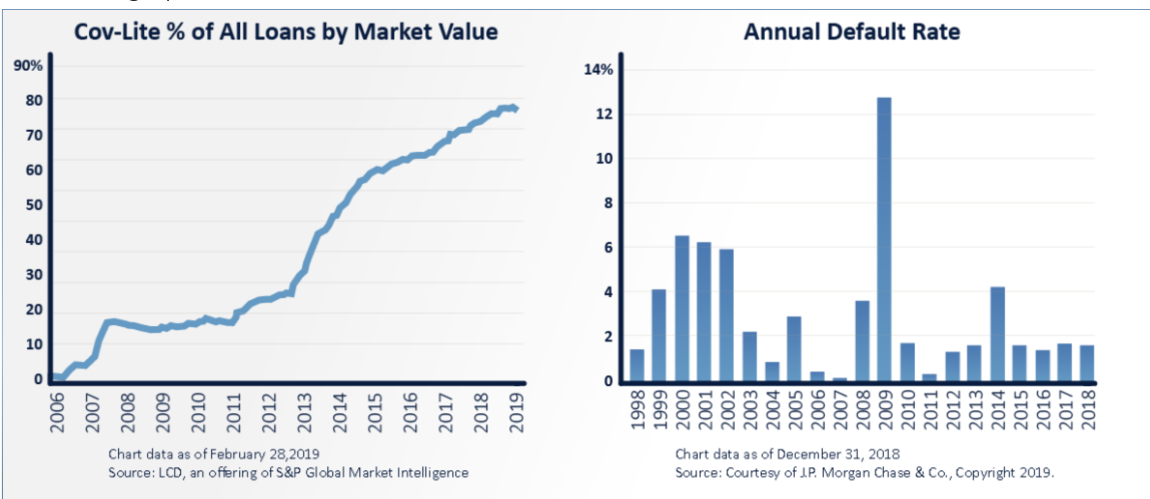
Interconnectedness. The firms that manage credit funds are not interconnected across markets or other types of financial firms. These firms (and funds) do not rely on prime brokers and are not operationally linked to other financial companies. Private equity firms are also not interconnected because funds do not pledge their assets as security for, nor do they guarantee, each other's obligations. And investors in private credit are often sophisticated, diversified, regulated institutions, which typically would invest only a small percentage of their total assets in this asset class. In other words, the failure of loan obligations in a fund would have no knock-on effect on other investments in that fund, or other funds managed by that firm, the firm itself, or on other financial institutions. Lastly, private credit firms do not increase interconnectedness between the portfolio companies within a fund. Credit funds do not pledge the equity or debt of the fund to secure the indebtedness of a borrower company.[34]

Derivative Exposures and Counterparty Risk. Private credit firms do not hold derivative positions (apart from limited hedges). Additionally, such firms are not subject to counterparty exposure arising from swaps or securities lending. They do not rely on short-term credit, nor do they provide short-term liquidity to other financial system participants. Private equity and credit firms invest in illiquid assets and rely on long-term, stable financing in the form of capital commitments from their investors. They don't provide loans to households or governments, and they aren't a material source of liquidity for the financial system overall.[35]

Diversification of Credit Funds. Unlike the financial instruments involved in the financial crisis, credit funds are not concentrated in one sector and are diversified across markets, even within each fund. The table below illustrates the diversification across sectors in private credit:



Covenant-Lite Loans. Covenant-lite, or "cov-lite," loans have received attention among some policymakers and in the media. Prior to the global financial crisis, 80 percent of the loan agreements in the debt market were "covenant heavy," meaning there were restrictions on certain activities carried out by a borrower and stringent requirements that certain repayment thresholds be met at specific times. These "covenant heavy" loans triggered a higher default rate among borrowers. According to a Bain Capital report, "the existence of covenants created multiple near-term triggers that could push a company into a restructuring. Of course, there were myriad factors driving defaults in this time period, but in many instances, a maintenance covenant test was tripped, meaning there were likely some borrowers that could have survived with more runway."[36] The situation today, where cov-lite comprises a significantly higher portion of the overall loan market, tells a starkly different story in terms of defaults, as the graph below shows:



This result is not only the product of the loosening of financial covenants but also of lenders focusing on protective terms that are more closely linked to a borrower's ability to repay. For example, during the recent COVID-19 crisis, we did not see lenders strengthen cov-lite terms, but rather waive financial covenant testing and impose minimum liquidity covenants and reporting obligations instead. Other areas that lenders focused on were the protective terms that regulate when revolvers can be drawn and how long they can remain outstanding. In other words, cov-lite loans often include non-financial terms that work for protecting against borrower defaults.

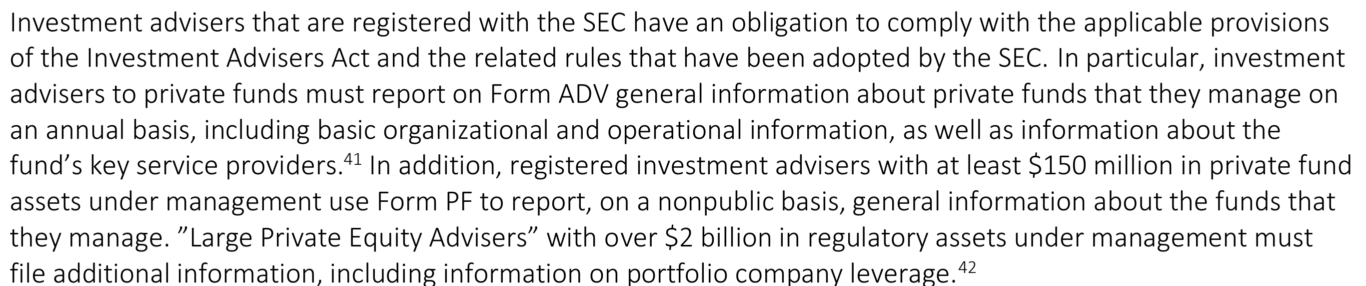
Distinguishing CLOs from Other Subprime Collateralized Debt Obligations (CDOs). As with cov-lite loans, participants in the CLO market have been under recent scrutiny. It is important to note that private credit managers participate at different stages of the CLO process – as the CLO manager who originates the original loans, or as a buyer or seller of individual loans for underlying collateral pool. To match their long-term fund structures, many CLO managers take a buy-and-hold approach to managing collateralized pools. This points to another strength of private credit managers: their proactive role in mitigating default and recovery risk for individual company credits by actively managing a leveraged loan portfolio.

Importantly, CLOs have historically had a low default rate. No AAA-rated CLO bond has ever defaulted, and only one AA-rated one has defaulted. Of the tranches of CLOs rated BB that have defaulted, none were issued since 2010. This is due to a more conservative structure in today's tranches.[37] CLOs are also often conflated with the subprime CDOs that contributed to the financial crisis after the mortgage market collapsed. While both instruments are structured, the similarities end there. The BIS noted the differences in the CLO and CDO markets, noting "There are significant differences between the CLO market today and the CDO market prior to the GFC: CLOs are less complex, avoiding the use of credit default swaps (CDS) and re-securitizations; they are little used as collateral in repo transactions; and they are less commonly funded by short-term borrowing than was the case for CDOs. In addition, there is better information about the direct exposures of banks."[38] Today's CLOs are much simpler structures and they do not mark-to-market their loans, which offers further protection during a downturn.[39]

C. The Regulation of Private Credit Funds

At the federal level, the SEC is charged with regulating investment advisers who run private credit funds and in particular protecting retail investors.[40] As a result of being available to only a limited number of qualified institutional and individual investors, private credit funds themselves are not registered with the SEC. However, the vast majority of investment advisers to private credit funds are registered with and regulated by the SEC and are required to file extensive information with the SEC on their fund activities on at least an annual basis on Form ADV and confidentially on Form PF. That process, as well as other federal requirements for fund managers, is detailed below. The states also have certain authority to enhance investor protection. For example, private funds making offers and sales to U.S. investors must comply with applicable state "blue sky" laws, which regulate the sale of securities. There are also state-specific rules that may require investment advisers of very small funds to register with the state, in the event they do not register with the SEC.

Investment Adviser Registration and Form PF. Generally speaking, investment advisers must register with the SEC and have an obligation to comply with the requirements of the Investment Advisers Act of 1940. Prior to the Dodd-Frank Act, most private fund investment advisers, including advisers to credit funds, had been exempt from registration with the SEC under the "private adviser" exemption. Following the Dodd-Frank Act, which tightened the rules on adviser registration, all investment advisers to private funds must register with the SEC, except some advisers to venture capital funds and advisers to private funds with less than $150 million in assets under management in the U.S.



Investment advisers that are registered with the SEC have an obligation to comply with the applicable provisions of the Investment Advisers Act and the related rules that have been adopted by the SEC. In particular, investment advisers to private funds must report on Form ADV general information about private funds that they manage on an annual basis, including basic organizational and operational information, as well as information about the fund's key service providers.[41] In addition, registered investment advisers with at least $150 million in private fund assets under management use Form PF to report, on a nonpublic basis, general information about the funds that they manage. "Large Private Equity Advisers" with over $2 billion in regulatory assets under management must file additional information, including information on portfolio company leverage.[42]

Other Federal Provisions. The Federal Reserve instituted standards (including Regulation T, Regulation U, and Regulation X) that impose limitations on the amount of leverage banks and nonbanks can extend to investors to purchase securities and U.S. treasuries.[43] The Federal Reserve has also set guidelines on the amount of margin debt and maximum leverage that can be taken on by borrowers and funds.[44] FINRA has a separate regulatory paradigm dealing with margin accounts, among other standards that can impact both investors and borrowers. These leverage restrictions work to safeguard U.S. financial stability during market downturns.

The Financial Stability Oversight Council ("FSOC"), created by Dodd-Frank, also conducts continuous oversight of the impact financial markets have on the stability of the U.S. economy. The FSOC, a collection of U.S. financial regulators, chaired by the Secretary of Treasury, has the authority to designate nonbank financial institutions as systemically important nonbank financial institutions ("nonbank SIFIs"), and also to work with primary regulators (state and federal) to address any activities that pose systemic risk. The Dodd-Frank Act also required the SEC to adopt standards (ultimately manifested in Form PF, explained above) to enable the FSOC to obtain data from private funds to facilitate the monitoring of systemic risk in U.S. financial markets. No private credit or private equity firm has been designated as a nonbank SIFI.

XI. Conclusion

Credit is critical for capital formation and ensuring a dynamic and growing economy. Private credit has become a growing and mainstream source of finance to a broadening array of corporate borrowers, specifically those with the least access to financing. Private credit's growth and success in providing more flexible capital can be attributed to the closed-end limited partnership fund model. Borrowed from private equity, this fund structure successfully accesses stable institutional capital and aligns the incentives of fund managers and investors to create powerful incentives to effectively originate, underwrite, and monitor loans to mitigate defaults and financial distress.

The beneficial and growing impact of private credit continues to be significant and widespread:

- Provides flexible credit for growth and restructuring to a growing number of below investment-grade companies
- Offers investors a way to achieve higher and diversified returns
- Increases the strength and economic resiliency of the U.S. economy to downturns and dislocations

Notes

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[3] "The Semiannual Monetary Policy Report to the Congress." *Board of Governors of the Federal Reserve System.* Feburary 11, 2020. https://www.federalreserve.gov/newsevents/testimony/powell20200211a.htm

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[10] Thus, corporate loans by private credit funds do not put depositors or U.S. taxpayers at risk, but are backed up by the long-term assets of institutional assets of investors such as insurance companies, pension funds, and family offices.

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[12] *Loumioti*. Pp. 28.

[13] *Loumioti*. Pp. 4.

[14] "60th Investment Company Fact Book." *Investment Company Institute.* May 6, 2020. https://www.ici.org/pdf/2020_factbook.pdf

[15] "Life Insurers Fact Book. "*American Council of Life Insurers.* November 24, 2020. https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2020LifeInsurersFactBook.ashx

[16] Financial Stability Oversight Council Annual Report 2019." *U.S. Department of Treasury.* Pp. 34, https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf

[17] 2020 Preqin Global Private Debt Report." *Preqin.* February 2,2020. Pp. 18.

[18] "Bank and Nonbank Lending over the Past 70 Years." *FDIC Quarterly.* December 31, 2020.

[19] Skinner, Cristina Parajon, "Nonbank Credit." *Harvard Business Law Review*, Vol. 9, 2019. https://www.hblr.org/wp-content/uploads/sites/18/2019/11/Final_Skinner.pdf

[20] Munday, Shawn and Hu, Wendy and True, Tobias and Zhang, Jian. Performance of Private Credit Funds." *Kenan Institute of Private Enterprise.* Research Paper. May 7, 2018.

[21] "Closed-end" means that such funds have a fixed fundraising period and a term life. Fundraising periods are usually in the range of 12 to 15 months during which investors make capital commitments to the fund. The investment period usually lasts three to five years and capital is not redeemable during this period.

[22] "2020 Preqin Global Private Debt Report." Pp. 34.

[23] 2020 Preqin Global Private Debt Report." Pp. 54.

[24] *The Beast in the Jungle*, Hamilton Lane Market Overview 2019-2020, Hamilton Lane.

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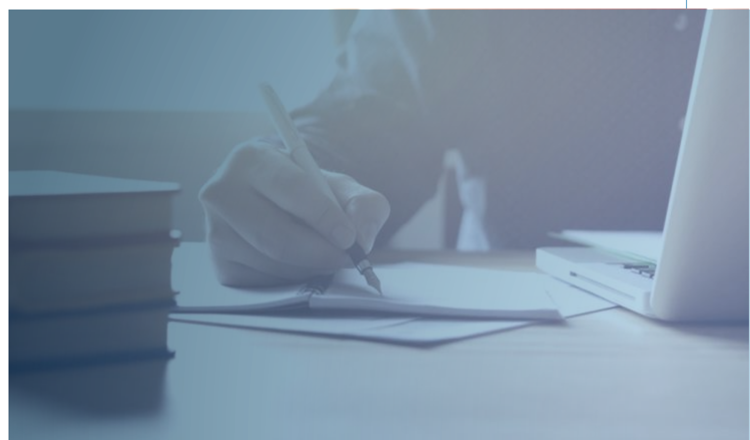

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[28] *The Beast in the Jungle*, Hamilton Lane Market Overview 2019-2020, Hamilton Lane.
[29] Alternative Credit Council, *Financing the Economy 2018*, p. 5.
[30] *The Financial Crisis – Inquiry Report,* The Financial Crisis Inquiry Commission. Janurary 2011. p. xix.
[31] "2020 Preqin Global Private Debt Report." Pp. 52..
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[38] "Structured Finance Then and Now: A Comparison of CDOs and CLOs." *BIS Quarterly Review.* September 2019. https://www.bis.org/publ/qtrpdf/r_qt1909w.htm
[39] "Structured Finance Then and Now: A Comparison of CDOs and CLOs." https://structuredfinance.org/wp-content/uploads/2020/02/SFA-CLO-White-Paper.pdf
[40] The mission of the SEC is to protect investors, maintain fair and orderly markets and to facilitate capital formation. https://www.sec.gov/Article/whatwedo.html. The statutory mandates for the SEC include the prevention of misrepresentation, fraud and deceit, mandating disclosures of risks, and ensuring that investments sold to the public are suitable. See, e.g. Securities Act of 1933,. 15 U.S.C. §§ 77 through 77aa), Securities and Exchange Act of 1934, (15 U.S.C. §§ 78a through 78pp) and the Investment Company Act (15 U.S.C. §80a-1).
[41] 17 CFR 275.204-1 et. seq.
[42] https://www.sec.gov/about/forms/formpf.pdf
[43] These regulations may be found at www.federalreserve.gov.
[44] 12 CFR parts 220 and 221.