Private Credit: A Safe and Regulated Form of Lending Supporting the Growth of Small Businesses

Private credit is a safe, reliable, regulated form of lending that invests in small and medium-sized businesses across the country. The growing asset class drives economic growth and supports the stability of the United States' financial system:

➢ Private Credit Has Several Risk-Reducing Characteristics Inherent to Its Business Model

The Federal Reserve concluded that private credit is not risky to the U.S. financial system, stating on page 54 of its May 2023 report:

> *"Overall, the financial stability vulnerabilities posed by private credit funds appear limited. Most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress."*

The private credit industry is, in many respects, more stable than bank loans because it does not create a maturity-mismatch from investments into the fund and the loans that the fund provides. Specifically, unlike banks, private credit funds do *not* use on-demand customer cash deposits to offer credit; instead, investors commit funds for extended periods. This also prevents private credit funds from being susceptible to "run risks."

Private credit firms and the funds they advise are not interconnected across markets nor even at the firm level. The unlikely event of a failure of one fund does not impact other funds managed by the firm. Private credit firms have limited derivative exposure beyond hedges and are not subjected to counterparty risk as their investments come from capital committed by limited partner investors for a predetermined period of time. Finally, private credit funds are diverse; their investments tend not to be concentrated in one industry or firm.

➢ Appropriately Regulated by the SEC

The Securities and Exchange Commission (SEC) appropriately regulates private equity advisers that provide private credit. Private credit firms, generally among other requirements, are subject to:

- Registration with the SEC
- On-site SEC examinations
- Regular reporting of asset and business information to the government, including:
  - **Custody Rule, Rule 206(4)-2:** The Advisers Act custody rule requires segregation of client assets to prevent them from risk associated with pooling assets with other advisory clients.
  - **Compliance Program Rule, Rule 206(4)-7:** Private equity firms are required to establish extensive compliance programs to help avoid and identify violations of the U.S. securities laws.
  - **Form PF Reporting Rule 204(b)-1:** Private fund advisers are required to report regulatory assets under management to FSOC on a Form PF, for risk monitoring.

- **Form ADV Reporting, Rules 203-1 and 204-1:** Investment advisers are required to provide extensive information about their businesses and the private funds they manage on Form ADV.

➢ Strong Performance

Private credit has historically had a strong performance. Since the onset of the financial crisis in 2008, direct lending (the most common form of private credit) has consistently outperformed both leveraged loans and high-yield bonds, offering higher returns and lower volatility.

Private credit loans also experience low default rates, with an overall default rate of only 1.41% for the third quarter of 2023.

➢ A Lifeline for Small Businesses

Private credit primarily serves small and mid-size businesses, offering critical financing to companies across the U.S., the majority of which have revenues below $100 million and approximately 150 employees. The returns on private loans to small and midsize businesses are on the rise, with a 6.29% increase reported in 2022, according to the Cliffwater Direct Lending Index.

Private credit addresses a funding gap for businesses unable to secure sufficient funding from traditional lenders. Approximately 70% of U.S. private credit providers surveyed in 2021 reported that businesses turned to private credit because they were "too small for bank syndication."

➢ Private Credit Stabilizes Businesses, Especially During Economic Downturns

Private credit plays a crucial role in stabilizing businesses, particularly during periods of economic uncertainty:

- The industry provides distressed or special situations debt to struggling or complex businesses that traditional lenders may avoid.
- Due to features like lock-up periods and drawdown capabilities in private credit agreements, investors can continue lending money, even when other lenders are forced to pull back.
- Over the past decade, special situations lenders have raised $126.2 billion to support businesses in need.
- Private credit has proven instrumental during recent financial crises, such as the COVID-19 pandemic and the Silicon Valley Bank collapse.

Private credit's strength lies in its flexible, bespoke, and relationship-oriented deals, where investors collaborate closely with businesses for mutual success. Key reasons businesses opt for private credit include certainty and speed (91%), more flexible covenants (77%), and a stable relationship with a lender holding loans until maturity (65%).

To learn more, please visit our website at https://www.investmentcouncil.org/privatecredit/