United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

December 20, 2024

The Honorable Jerome Powell
Chair
Board of Governors of the Federal Reserve System
Constitution Avenue & 20th Street NW
Washington, DC 20551

The Honorable Michael Barr
Vice Chair for Supervision
Board of Governors of the Federal Reserve System
Constitution Avenue & 20th Street NW
Washington, DC 20551

Dear Chair Powell and Vice Chair Barr:

We write to express our concerns regarding the growing risks in the private credit market. In November 2023, we wrote to you and the other federal banking regulators[1] noting the rapid growth in the private credit market and drawing your attention to hazards created by the unusual characteristics of the market—such as its minimal oversight from regulators, lack of transparency, and significant interconnectedness with the banking system. These concerns have only intensified over the last year as the private credit market has grown both in size and complexity. There is no doubt that the risks in the market continue to build up.

As you know, U.S. and foreign regulators continue to analyze private credit markets and identify emerging vulnerabilities and potential risks to financial stability and the banking system.[2] Their work points to mounting threats, including that companies borrowing in the private credit market tend to be smaller and carry more debt than companies with traditional capital structures.[3] In addition, private loan valuations are more opaque, and often more generous, than valuations set by public markets.[4] Furthermore, private credit investors, funds, and borrowers often employ multiple layers of leverage to enhance returns, and these layers of interconnected debt are typically not visible to regulators because of gaps in reporting.[5]

The lack of information about these transactions harms other market participants, as the broader market loses insight into the condition of troubled companies or industries. As firms or industries turn exclusively to private credit, a limited group of asset managers will have a view into

[1] https://www.banking.senate.gov/newsroom/majority/brown-reed-warn-regulators-of-risks-posed-by-private-credit-market.
[2] https://www.bankofengland.co.uk/financial-stability-report/2024/november-2024.
[3] https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024.
[4] https://www.bloomberg.com/news/articles/2024-02-28/how-private-credit-market-boom-is-hiding-potential-valuation-problems.
[5] https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024.

changes in the outlook for both individual companies and broad parts of the economy that would previously have been widely available to market observers. Researchers have raised concerns that this lack of information may make it more difficult for markets to price in business conditions, potentially leading to an increase in sudden, unexpected shocks. [6]

We are also concerned by the industry's desire to achieve continued growth by relying on increasingly complex structures and soliciting new investors to deliver additional capital. Private credit fund managers and industry consultants expect future growth in areas where traditional banks are projected to reduce their activity, such as asset-backed finance. As one fund sponsor notes, "we believe the next chapter in the private credit story is the migration of asset-backed finance (ABF) toward alternative capital providers."[7] In other words, private credit funds see an opportunity to take share from banks' traditional business, while avoiding traditional regulatory oversight.

As private credit funds compete on banks' turf, banks have increasingly engaged with the funds to improve their financial metrics so they can target other risky lines of business. For example, researchers have found that banks prefer lending to business development companies (BDCs), a type of private credit fund that lends to private, midsized businesses, rather than lending to those businesses directly, due to the preferential regulatory capital treatment of loans to BDCs.[8] Private credit funds have also become key buyers of instruments issued by banks, referred to as synthetic risk transfers (SRTs).[9] All bank loans face some level of risk that the corporate or individual borrower may default on repaying the debt. On paper, SRTs shift this default risk away from banks' balance sheets to private credit funds. By using SRTs, banks can reduce the amount of capital they are required to hold for a specified set of loans, allowing them to increase their profitability ratios and engage in additional high-risk transactions. Meanwhile, private credit funds that invest in SRTs take on the risk of those loans, hoping to profit as the loans are paid back. But, if credit conditions deteriorate and bank loan borrowers begin to default, these private credit funds will be called upon to support bank balance sheets, and therefore the stability of the financial system. SRTs also add to the complexity of banks' financial statements due to the possibility that risk purportedly laid off to third parties will boomerang back to the bank during a crisis.

Banks' use of SRTs is growing – in October, it was reported that $1 trillion in loans globally are now tied to SRTs.[10] Neither private credit funds, nor banks, nor regulators have experience

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[6] Jared Ellias & Elisabeth de Fontenay, *The Credit Markets Go Dark* (Oct. 23, 2024). 134 Yale Law Journal ___ (2024), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4879742.

[7] https://www.oaktreecapital.com/insights/insight-commentary/market-commentary/performing-credit-quarterly-3q2024-who-are-the-lenders-now.

[8] Sergey Chernenko, Robert Ialenti, and David Scharfstein, *Bank Capital and the Growth of Private Credit* (Sept. 30, 2024), https://www.hks.harvard.edu/centers/mrcbg/programs/growthpolicy/bank-capital-and-growth-private-credit.

[9] https://www.wsj.com/finance/banking/bank-synthetic-risk-transfers-basel-endgame-62410f6c.

[10] https://www.bloomberg.com/news/articles/2024-10-21/loans-tied-to-srts-reach-1-trillion-as-sales-run-at-record-pace.

effectively managing this level of interconnectedness during times of stress. For example, private credit funds may borrow from one bank to buy SRTs issued by a different bank. Both of the banks and the private credit fund could have exposure to some of the same risky loans, and significant loan defaults could ripple through the different connections, potentially amplifying any losses. But none of these links and layers of interconnected leverage are required to be reported to regulators.

Another example of novel ties between banks and private credit funds was reported in October, when a bank offered bonds backed by loans to private fund managers. The bonds are to be repaid when investors fulfill their investment commitments to the funds (loans known as subscription lines).[11] Cited as a first-of-its-kind, that transaction should raise critical questions about banks' links with private credit funds, the absence of transparency, and piling on of risks – instead of being celebrated because it has "opened up a new asset class".[12]

Historically, private asset managers created funds for long-term investors who could afford to have their capital tied up for an extended period. But as they pursue unbridled growth, private credit managers are seeking out ways to sell to individual investors, raising concerns that individuals may end up with illiquid and opaque products—despite promises to the contrary in the offering documents. [13] Recent proposals for private credit exchange-traded funds, which would be broadly available to retail investors, raise novel and difficult questions about liquidity, conflicts of interest, and adequacy of disclosures.[14] One large lender that could have multiple roles in a private credit fund suggested that such exchange-traded funds could "unlock access to a relatively untapped market (the retail investor)."[15]

These are only a few of the developing risks in the private credit market. The Federal Reserve must prioritize data collection and risk monitoring of the private credit sector. In particular, private credit's links with the traditional banking system must be closely examined for hidden risks. To ensure continued financial stability, the Federal Reserve and other financial regulators must take steps to comprehensively supervise the ties between banks and private credit firms. As the private credit market continues to strengthen its bonds with banks, Americans will be relying on you to ensure the continued safety and soundness of the banking system.

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[11] https://www.wsj.com/livecoverage/stock-market-today-dow-sp500-nasdaq-live-10-17-2024/card/goldman-sells-first-bond-backed-by-capital-call-loans-py5KyiZcnWJxpB2eJvUe; https://www.wsj.com/finance/investing/watch-out-wall-street-is-finding-new-ways-to-slice-and-dice-loans-d80415dc?mod=livecoverage_web.

[12] https://www.investmentnews.com/industry-news/goldman-blackstone-partner-for-new-type-of-bond/257763

[13] https://www.wsj.com/finance/investing/wall-street-races-to-bring-private-credit-to-the-masses-8a25b624.

[14] https://www.sec.gov/Archives/edgar/data/1516212/000119312524216340/d878371d485apos.htm; https://www.businesswire.com/news/home/20241202595040/en/BondBloxx-Is-Launching-the-First-ETF-Providing-Direct-Exposure-to-Private-Credit; https://www.virtus.com/products/virtus-private-credit-strategy-etf#shareclass.698/period.quarterly; https://www.wsj.com/finance/investing/wall-street-races-to-bring-private-credit-to-the-masses-8a25b624?mod=finance_lead_pos1.

[15] https://flow.db.com/trust-and-agency-services/private-credit-a-rising-asset-class-explained; https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024.

Thank you for your attention to this matter.

Sincerely,

Sherrod Brown
Chairman
Senate Committee on
Banking, Housing, and Urban
Affairs

Jack Reed
United States Senator