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Abstract

The “private” financial industry—which contains financial instruments not traded on open exchanges and financial institutions that are underregulated—is no longer an ‘alternative’ to open financial markets. Between 2020 and 2023, assets in private funds grew by 34 percent, from \$20.8 trillion to nearly \$28 trillion. While private equity funds have been subject to attention from academics and policymakers, another institutional formation is growing rapidly and has received far less scrutiny: private credit funds. The private credit market has drawn borrowers who cannot secure credit from regulated banks—raising questions about their suitability for such unregulated market transactions. While borrowers benefit from flexible lending terms, these terms come at a higher cost. The private nature of these loans offers another key advantage: unlike corporate bonds, the loan terms remain confidential. The global industry of private credit has \$1.8 trillion in assets under management, up from \$500 billion in 2015. This article examines the history of this evolution in credit provision and the risks to limited partners and the broader financial system posed by unregulated private credit funds.

Keywords: G2: Financial Institutions and Services; G3: Corporate Finance and Governance; G38: Government Policy and Regulation

1. Introduction

“Public funds are going to continue in aggregate to allocate more to private markets until something bad happens,” said Paul O’Brien, a trustee of the \$11.2bn Wyoming Retirement System. “Nothing bad has happened yet.”

The “private” financial industry—which contains financial instruments not traded on open exchanges and financial institutions that are underregulated—is no longer an ‘alternative’ to open financial markets. Between 2020 and 2023, assets in private funds grew by 34 percent, from \$20.8 trillion to nearly \$28 trillion. Public investment vehicles (mutual funds, exchange-traded funds, and closed-end funds) hold just under \$31 trillion combined, indicating that private funds—once the exception to securities rules—have nearly matched their public counterparts (Birdthistle 2024). While private equity funds have been subject to attention from academics (Appelbaum and Batt 2014, 2021) and policymakers (Warren 2024), another institutional formation is growing rapidly and has received far less scrutiny: private credit funds.

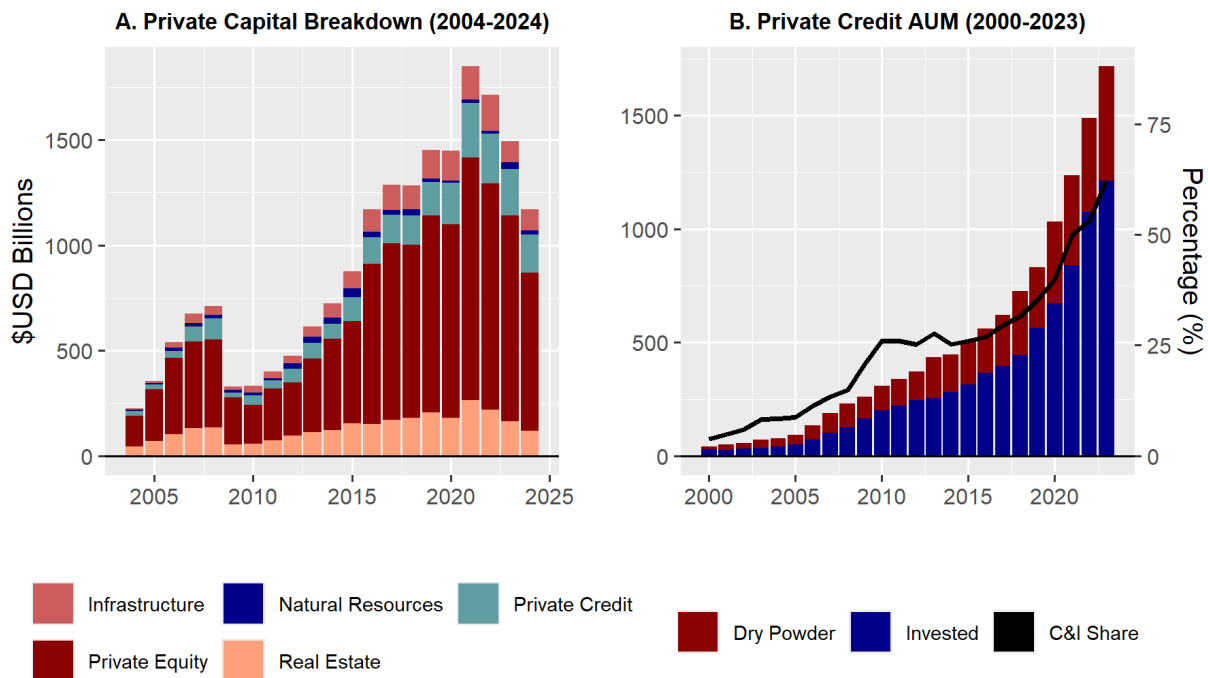
Private credit funds are closed-end funds that hold financial assets from the same types of limited partners involved in private equity funds—pension funds, insurance companies, sovereign wealth funds, and other institutional pools of capital (Block et al. 2023). The fact that private credit funds fall on the “private” side of financial markets under the Securities Act and Securities and Exchange Act, established in the New Deal era, means that there is virtually no data disclosure required by the managers of private credit funds. In other words, the benefit to lenders and borrowers—that neither party must disclose details on the transactions to financial regulators—can enable the kinds of buildup of risk in the financial sector that has led to past financial crises. The private credit market has drawn borrowers who cannot secure credit from regulated banks—raising questions about their suitability for such unregulated market transactions. While borrowers benefit from flexible lending terms, these terms come at a higher cost (IMF 2024). The private nature of these loans offers another key advantage: unlike corporate bonds, the loan terms remain confidential.

Private credit funds and their asset managers, like Blackstone and Apollo, manage assets for institutional shareholders and lend to nonfinancial businesses outside of the regulated banking sector (Cai and Haque 2024). Funds negotiate loans directly with borrowers and hold them until maturity, rather than trade them in open markets. These lending arrangements and institutional structure poses a unique set of potential systemic risks to the broader financial system because of their interrelationship with the regulated banking sector, the opacity of the terms of loans, the illiquid nature of the loans and potential maturity mismatches with the needs of limited partners to withdraw funds, and the fact that this growing market has never been through a downturn in the business cycle (Palladino and Karlewicz 2024).

According to Preqin, by the end of 2024 the global industry of private credit had \$1.8 trillion in assets under management (AUM), which is up from \$500 billion in 2015 (Hidalgo 2024). Both PitchBook and Preqin predict a valuation of \$2.3 and \$2.8 trillion by 2028, respectively (PitchBook

2024b; Preqin 2024). Prominent asset managers continue to predict strong growth: Marathon Asset Management’s Bruce Richards predict the sector will grow to \$15 trillion over the next decade, while Blackstone’s President Jon Gray predicts that private credit lending will grow to \$25 trillion over the long-term, and Apollo Global Management claims that the addressable market for private credit is \$40 trillion globally (Basak 2024; Morris 2024). The rapid growth of private credit funds has outpaced the actual extent of lending, with fund managers often having war chests of capital that have yet to be invested (referred to as “dry powder”); Preqin shows that funds held \$503.6 billion in dry powder reserves with \$1.2 trillion in invested capital as of 2023. While not larger than syndicated lending, the extent of private credit fund lending is comparatively more than half of all commercial and industrial bank loans (62%) in the United States.

Figure 1: Private Capital Markets - Total Fundraising & Private Credit AUM



Source: Preqin Pro. Charts & League Tables. Federal Reserve Bank of St. Louis. C&I refers to all commercial and industrial loans by banks. Panel A shows annual fundraising for private closed-end funds across five asset categories. These figures show committed, not yet invested, capital. Private equity includes buyouts and venture capital. Panel B shows the AUM of private credit funds, decomposed into invested capital and dry powder. The percentage of private credit loans as a share of all C&I lending is shown as a black line. Dry powder refers to committed but not invested capital. Accessed 05/28/25.

This article proceeds by examining the historical evolution of corporate lending (Section 2), the underlying flows of funds that structure these markets (Section 3), and the systemic financial risks that may emerge from these developments (Section 4). Although private credit is a global phenomenon, this study concentrates on the United States. The justification is twofold. First, the U.S. accounts for a disproportionately large share of the industry: Ares Management Corp. estimates that \$1.2 trillion of private credit AUM is located in the U.S. alone, including \$676 billion in direct lending—the segment that has driven the sector’s rapid expansion (Ares 2024; Cai and Haque 2024).

Second, this paper aims to inform policy, and doing so requires grounding the analysis in the institutional and legal frameworks of U.S. banking and securities regulation. The growth of direct lending in the U.S., particularly by private credit funds and business development corporations (BDCs), has targeted middle-market firms excluded from traditional bank financing or the broadly syndicated loan market. As such, the U.S. context has significant regulatory relevance for the policy recommendations developed here.

2. The Evolution of Corporate Lending

Traditionally, the debt financing of nonfinancial businesses involves the *regulated* banking sector (e.g., investment banks and others who act as financial intermediaries with federal oversight). When a company wants to borrow they approach a bank, who then engages in all of the necessary underwriting and begins finding capital for the loan. This is because investment banks themselves do not have the capital—they source it for the borrowing company by soliciting subscriptions from institutional pools of capital. Commonly referred to as the broadly syndicated loan (BSL) market, banks facilitate such lending through a regulated and open process (“public”), with multiple assessments of the fair value of a loan. This institutional structure historically operated in a bifurcated manner, with smaller firms only accessing financing on a secured basis, and larger, better known firms borrowing more frequently on an unsecured basis (Elias and de Fontenay 2025). However, the rise of private credit fundamentally changes this story, effectively displacing the intermediary role that investment banks had fulfilled in the past by directly lending capital to borrowing companies.

The evolution of private credit funds and BDCs as key corporate lenders is rooted in a broader shift away from traditional bank lending decades in the making. The origins of this transformation can be traced to the junk bond era of the 1970s and 1980s, when figures like Michael Milken pioneered high-yield debt markets to finance leveraged buyouts and fund companies excluded from conventional financing channels (Aggarwal 2024, p. 5-6). Following the collapse of Drexel Burnham Lambert in 1990 (and subsequently the high-yield debt market), banks revived risky lending practices with syndicating leveraged loans, but appetite for such instruments began to wane in the late 1990s and early 2000s. As banks retreated from smaller, below investment grade lending—particularly following the financial crisis of 2008—private credit funds rushed to fill the vacuum. Regulatory tightening post-2008 made lending more costly for banks, opening a niche for asset managers and private equity-backed vehicles to offer direct loans to middle-market borrowers, especially those with limited access to public debt markets (Elias and de Fontenay 2025; Block et al. 2023).

The continued growth of private credit in the 2010s and 2020s reflects both supply- and demand-side factors. On the supply side, institutional shareholders—especially public pensions—allocated more capital to private credit funds (and private assets in general) in search of yield amid low interest rates. On the demand side, middle-market firms backed by private equity sponsors preferred private credit for its speed, flexibility, confidentiality, and reduced disclosure obligations compared to public

bond markets (Block et al. 2023; Erel et al. 2024). BDCs—regulated investment vehicles created to support small and medium enterprises—became a popular structure for originating and holding such loans.¹ Together, these developments have led to the increasing privatization and concentration of corporate debt, mirroring earlier trends in equity markets and raising concerns about transparency, systemic risk, and corporate governance (Ellias and de Fontenay 2025).

Private financial market activity is coordinated with the use of pooled investment vehicles, otherwise known as “funds” (Palladino and Karlewicz 2024). These funds are “collective investment schemes” and in essence are “an aggregation of capital belonging to multiple [shareholders]” that use the pooled funds to purchase or originate financial and real assets (Christophers 2023). In the case of private credit, capital is deployed as direct lending to performing middle-market firms (that demonstrate an ongoing cash flow, typically EBITDA) or against collateralized assets that generate future income streams. Regulated banks can provide “back leverage” to aid in the lending private credit funds engage in, which would create some regulatory exposure for private credit. But opposed to the BSL market, these direct loans are originated by private credit with the intention to hold until maturity, which according to Ivashina and Lerner (2019) should, in theory, help incentivize lenders and owners to prioritize value generation and focus on the long-term growth and success of a company rather than short-term financial objectives. Whether this is true, given the regulatory opacity of private credit funds, remains to be seen.

Shown below in Figure 2 is a depiction of the relationships a borrowing company embeds themselves in when they opt to borrow from private financial markets. According to the IMF, over 70% of direct lending arrangements in private credit involve a private equity sponsor (IMF, 2024). Given that private credit funds often lend to companies that have a sponsor, Figure 2 assumes a portfolio company (the borrower) that has their entire capital structure owned by private funds—something Elias and de Fontenay (2025, 840-41) claim private credit has helped to facilitate and represents “a critical milestone in the movement of firms and capital away from public markets and into private markets.” Where each fund takes position in the capital stack is shown, with senior and junior debt occupying the first and second position, and preferred and common equity following as the last positions, respectively.

¹ Business development companies (BDCs) were legally created in the 1980s with amendments to the Investment Company Act of 1940 in the “Small Business Investment Incentive Act of 1980.”

Figure 2: The Capital Structure of Firms with Private Credit & Private Equity Relationships

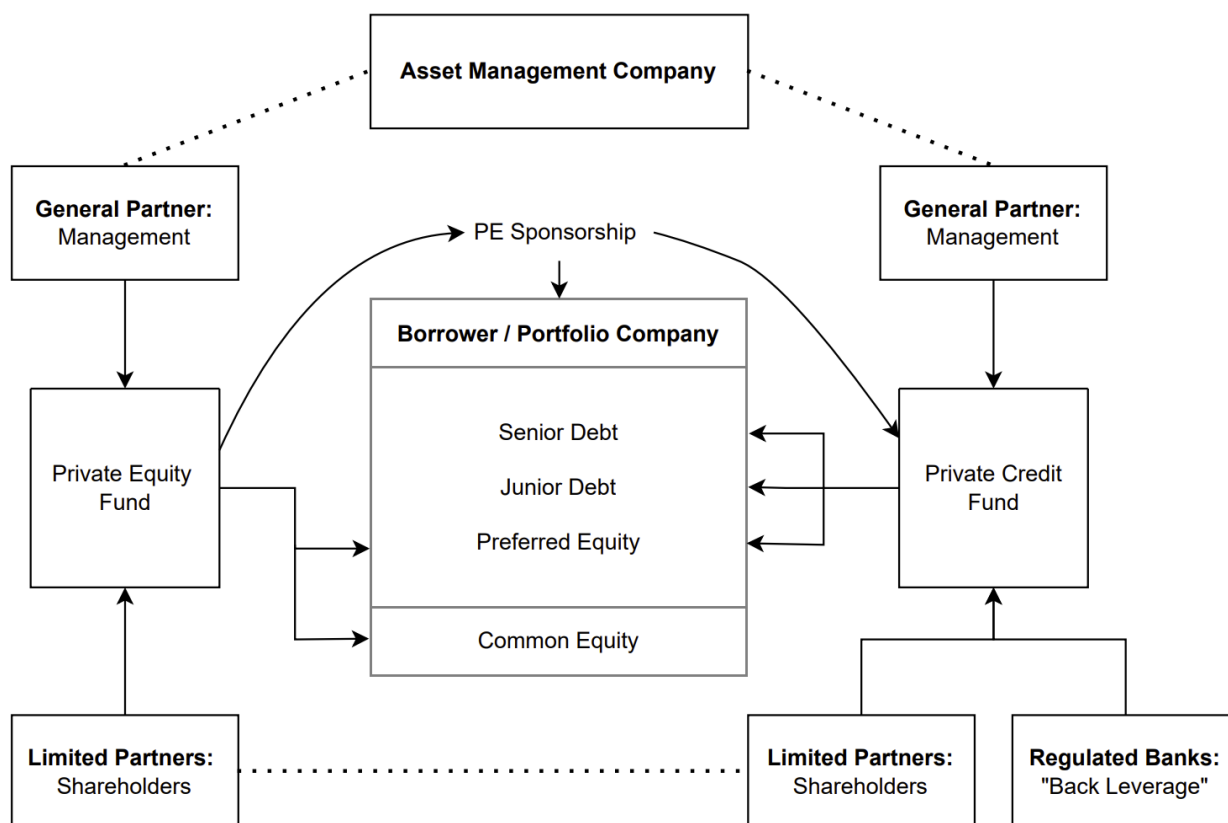


Figure 2: This is a stylized representation of how both private credit funds and private equity interact with the capital structure of the portfolio companies they engage with. Bold lines with an arrow indicate a relationship and the direction of that relationship. For example, limited partners commit capital to either private equity or private credit funds, while typically general partners act only as the fund manager. Dotted lines indicate that players may be the same entity--although this does not need be the case. Where each fund takes position within the capital stack of the portfolio company is also indicated by arrows. Finally, regulated banks may become involved by providing "back leverage" to private credit funds.

In this simplified case, equity is held by a private equity fund, while the debt is held by a private credit fund—an arrangement that is likely to occur after a privately financed leveraged buyout (LBO). Both funds are managed by a general partner and it is entirely possible that the general partners are the same entity. For example, KKR Private Equity could hold the equity of a company through a fund where they are the general partner, while simultaneously sponsoring a debt deal with a private credit fund that has KKR Capital Corp as the general partner. Both the debt and equity of the company would then be held by KKR & Co Inc. and financed by the capital of KKR’s limited partners in each fund, respectively. On the flip side of this, sources of capital take positions in both the equity and debt of a company as limited partners. Such an arrangement effectively makes the financial market activities of a firm “go dark,” (Ellias & Fontenay 2024), since a completely private capital stack is no longer under the same regulatory scrutiny in comparison to a company that gets its financing needs from the BSL market and public stock exchanges.

Further complicating the picture is the growth in bank lending to non-bank financial intermediaries (NBFIs), which includes private credit funds. Back leverage provided by regulated banks allows private credit funds to juice their returns without drawing on additional capital from their limited partners, which increases returns on equity. Private equity firms can also take net-asset value loans (NAV) from banks to facilitate secondary entry and exist for limited partners (Platt, Indap, and Pollard 2024). Levin and Malfroy-Camine (2025) report that, in total, exposure amounts to \$300 billion in bank lending to private equity and private credit, which is an overall small amount to the total assets held by the industry. Regardless, even with bank lending, the entirety of a firm's capital structure can still be taken private and "go dark."

A recent example that illustrates the relationships between a nonfinancial business and private funds is the take-private transaction of Walgreens Boots Alliance Inc.—an iconic pharmacy chain—by the private equity firm, Sycamore Partners. Specifically, HPS Investment Partners and Ares Management Corp both sought to provide \$4.5 billion in direct lending for the deal, with plans to collateralize Walgreens' inventory, receivables, and prescriptions to secure their loans (Schneider and Scigliuzzo 2025). A significant number of banks, such as Citi, Goldman Sachs, JPMorgan Chase and others, also put together financing proposals to work jointly with private credit, providing some access to the BSL market (Ruckin 2025). Overall, the deal agreed to by Sycamore is valued at \$23.7 billion, with over \$10 billion in committed financing by private credit funds and banks (Barnes et al. 2025). As such, Walgreens represents an instance of "going dark," but with a more significant presence of regulated banks—a growing development as more banks turn to cooperation, rather than competition, with private credit funds..

In summary, the growing relevance of private credit has altered the traditional means by which borrowing nonfinancial firms can debt-finance their capital needs. Instead of relying solely on investment banks and the BLS market, companies are increasingly engaged directly with private credit funds who act as investment funds and direct providers of capital. In addition, a growing number of firms who were previously locked out of syndicated lending (due to being considered below investment grade) now have access to financing. This development has only accelerated over the last decade, and raises significant concerns about the types and riskiness of private credit lending.

3. Sources and Uses of Funds

A. Sources of Funds

Are limited partners the ‘patsies of private equity managers?’ (Zingales and McLean 2024)²

Private credit fund asset managers are not the source of financial assets needed to engage in lending: these assets come from institutional pools of financial assets--referred to as “limited partners,” including are pension funds, insurance companies, family offices, sovereign wealth funds, and high net worth individuals, just as in private equity (Block et al. 2024). Interest from such institutions in allocating a portion of their portfolios to private credit funds is growing: a December 2024 global survey found that half of the public pension funds and sovereign wealth funds (managing \$6.5 trillion in assets) expected to increase their private credit exposure in the coming year (McDougall and Yu 2024). Different types of institutional shareholders have distinct risks as a result of their portfolio allocation to private funds: here, we describe pension funds and retail shareholders are limited partners, though endowments, sovereign wealth funds, and other forms of institutional shareholders also play a role.

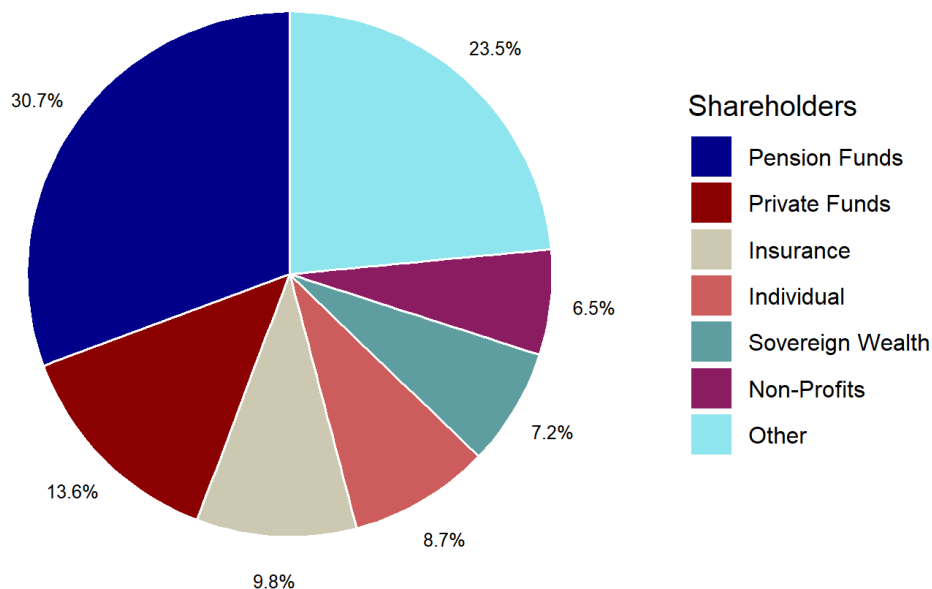
Pension Funds

U.S. public and private pension funds are the largest source of financial assets for private asset managers, which means that the retirement assets of non-wealthy U.S. workers are engaged in this market. Public and private pension funds have increased their portfolio allocation to unregulated financial managers significantly over the last five years, though some funds increased and subsequently decreased their allocation based on the potential for risk of rising interest rates (Cai and Haque 2024; Yu and Cumbo 2024). According to aggregate disclosures by private asset managers (contained in SEC Form PF), public and private pension funds held roughly 30 percent of private credit fund assets as of June 2024 (Avalos et al. 2025). Several large public pension funds are increasing their allocations to private credit: the 200 largest defined benefit funds increased their private credit assets 57.2% from 2023 to 2024 (Tomkiw 2025). The \$264 billion New York City Employees Retirement system stated that it was expanding into private credit because it is a “cheap asset,” accelerating its increase in allocation (Cumbo and Yu 2024). CalPERS, the largest defined-benefit public pension fund in the United States with \$503 billion in assets, increased its private credit allocation from 5 to 8 percent (McDougall and Yu 2024). Smaller public pension funds are

² “The surprising thing here is that both private equity and private credit are getting funded by mostly pension funds and maybe insurance companies, basically funded by the same people who should be a bit aware of what’s going on.” (Zingales and McLean 2024).

also increasingly engaged in private credit: the Public Employees Retirement Association of New Mexico, with \$17 billion in assets, increased its portfolio allocation 500% from 2023-2024 (Tomkiw 2025).

Figure 3: Composition of Institutional Shareholders (Q4:2021)



Source: Board of Governors of the Federal Reserve System (2023). Adapted from Avalos et al. (2025). Sample is based on private credit funds in the U.S. as of Q4 2021, the latest data available. Private funds refers to pooled investment vehicles that are not registered under the usual securities laws and regulations, such as hedge funds, private equity, and venture capital. Non-profits includes foundations, endowments, and charitable organizations. Other includes foreign entities, special purpose vehicles, family offices, trusts, estates or other investment vehicles.

Public pension funds are regulated at the state level, which means that state regulators set rules that govern the relationships between state-level public pension funds and federal private markets asset managers. While public pension fund trustees have different institutional arrangements in different states, most state pension codes include a definition of fiduciary duty that is modeled off of the federal definition in the Employee Retirement Income Security Act of 1974 (ERISA). How to interpret such duties has been the subject of much debate regarding the conflicts between short-term returns and the long-term negative impacts of climate change on public pension funds and their beneficiaries, public sector retirees (Palladino, Haedler and Karlsson 2023). Public pension fund managers' interpretation of their fiduciary duties—focusing solely on beneficiaries' economic interests—has sometimes led to extractive corporate governance practices that paradoxically harm those same beneficiaries, even though these managers are required to act in the beneficiaries' "best interests" (Webber 2014). Additionally, state regulation of public pension funds' relationships with

private funds is complicated by the fact that such funds have no federal disclosure requirements, and there are frequent ‘side letters’--i.e., bespoke agreements-- that public pension funds make with private managers (Clayton 2020). Strengthening the interpretation of fiduciary duty to take into account long-term risks from quickly growing asset classes, like private credit funds, may be an important step for state policymakers.

Retail Shareholders

Under U.S. securities laws, funds can remain unregulated as long as they only have “sophisticated” shareholders³, and while this has become a distinction without a difference in recent years, individual non-wealthy shareholders have had limited access to private financial markets (Georgiev 2021). One of the claims made by private financial institutions is that their risk is firewalled off from “Main Street” shareholders: as Yale Associate Director at the Program on Financial Stability Steven Kelly put it, the argument is made that “private credit need not be feared because the ecosystem would only be opened to sophisticated, institutional investors that understood and could bear the risks,” (Kelly 2024). However, private credit fund managers have been developing new strategies to bring retail shareholders into their funds (Masters 2024).

The most prominent recent example is that State Street and Apollo joined together to create a private credit ETF, the “SPDR SSGA IG Public and Private Credit ETF,” which launched in February 2025 and mixes public and private credit instruments (State Street Global Advisors 2025). The ETF skirted regulatory restrictions by contractually obligating Apollo to provide daily firm bids for the private credit assets held in the ETF, essentially turning illiquid loans into “liquid” assets for regulatory purposes. While the Securities and Exchange Commission allowed the ETF to launch, the day after the launch it issued a letter that continued to raise questions about the ETF, including the proportion of the ETF that can hold private credit assets. Despite questions from regulators, it is likely that the launch of the SSGA ETF will lead to other financial institutions getting on board: according to Morningstar’s Brian Moriarty, “Wall Street is on a race to demystify the world of private markets amid growing demand among mainstream investors to diversity into the asset class on the promise of elevated return with muted volatility,” (Moriarty 2025).

B. Uses of Funds

According to a survey of private credit fund managers (the best source because there is no mandatory disclosure of fund or deal data to the public) the majority of deals provide cash-flow based loans that fund managers believe would not be made by banks (Block et al 2023). They act as providers of capital for firms that are currently constrained by their existing leverage, or other

³ Under U.S. securities laws, only “accredited investors” are permitted to invest in private funds (17 C.F.R. § 230.501(a)).

factors, that had precluded them from accessing regulated banks. Historically, this has also meant a focus on lending to firms in “special situations” or buying “distressed debt.” However, as mentioned, the industry has swiftly moved to fill a financing void for small- and middle-market firms that opened up after the 2008 crash and with the implementation of legislation like Dodd-Frank. This development has allowed for the rapid expansion of direct lending arrangements by private credit funds and business development companies (BDCs).

First and foremost, private credit funds fashion themselves as providers of corporate credit, or “direct lending,” with significantly less leverage in comparison to banks (e.g., private credit firms are normally levered 2:1 while most chartered banks will be levered 10:1). This has, in effect, meant that private credit firms play the role of “investment fund” and operate their business as a form of narrow banking with more personal and consistent involvement with their borrowers (Levine 2024; 2025). The implication is that private loans have stronger stipulations and protective covenants when compared to the BSL market. This is often touted as a strength by the industry because it means loans are specifically tailored to the needs of the borrower in question, along with a long-term commitment by the lender. In other words, a close and hands-on relationship is a defining feature of the direct lending portfolios built up over the last decade—entailing greater monitoring and extensive covenants, a lender who holds the loan to maturity, and higher interest rates to compensate for greater risk (Aggarwal, 2024).

Beyond traditional corporate lending, private credit firms also engage in mezzanine lending, infrastructure and real estate debt (asset-based financing), and venture debt (PitchBook 2024a). Mezzanine loans commonly combine equity-like features into the structure of the loan. With asset-based finance (ABF), the main difference with direct lending is the basis of repayment. KKR & Co Inc. (2023) breaks ABF into four subcategories: (i) consumer and mortgage finance, (ii) hard assets (aircraft leasing, home rentals), (iii) commercial finance (accounts receivable payments and/or equipment leases), and (iv) contractual cash flows (intellectual property and royalties). Put simply, the distinction between direct and ABF lending is that the former relies on demonstrated cash flows to service the loan, while ABF relies on a range of collateralized assets that create an income stream. Per KKR (2023, 4): “... corporations themselves take on direct loans and are responsible for repayment, but asset-based finance is secured by collateral that produces potential [future income].”

Broadly defined, traditional corporate lending, newer ABF strategies, and other forms of lending such as distressed debt are the main business activities of the private credit industry, with fund strategies often explicitly geared towards one of these categories. Provided below in Table X is a breakdown of prominent strategies, the business purpose of that lending category (i.e., what does the loan supposedly do for the borrower), and its position in the capital stack. Despite the range of financial instruments originated by the sector, in 2024, more than half of all loans held by private credit firms are some variety of direct lending (Cai and Haque, 2024).

Table 1: Private Credit Financial Instruments by Loan Category

Loan Category	Financial Purpose	Priority
Direct Lending	Direct loan origination to middle-market or sponsor-backed firms, typically used for working capital or growth financing.	Senior, Second-Lien, Revolving, or Unitranche
Distressed Debt	Purchase of discounted debt in secondary markets with the intent to restructure or gain control through debt-to-equity conversions.	Subordinated
Special Situations	Opportunistic investments in event-driven scenarios, including rescue financing, convertible debt, or structured equity to influence or control outcomes.	Subordinated
Mezzanine	Subordinated debt with equity options (e.g., warrants), often used in leveraged buyouts (LBOs) to fill financing gaps.	Subordinated
Infrastructure & Real Estate	Credit strategies tied to physical assets, including lending for acquisitions, development, refinancing, or asset repositioning.	Senior or Subordinated
Venture Debt	Loans to early-stage, VC-backed companies to extend runway or support capital-efficient scaling; often includes warrants.	Senior
Multistrategy	Flexible mandate investing across capital structures, geographies, and credit cycles, often combining direct lending, opportunistic, and distressed strategies.	Hybrid

While direct lending constitutes the bulk of private loans, there has been a recent focus by private credit funds to further diversify their loan portfolios. Alongside growth in mezzanine debt, new funds increasingly have an asset-based orientation, focusing on lending against assets which generate income streams over longer periods of time. This market is traditionally dominated by banks with addressable market estimates between \$5 and \$20 trillion and represents a significant potential source of growth for private credit funds (PitchBook 2024a, p. 9).

Infrastructure funds are a key form of private credit funds. For example, in August 2023, Blackstone closed its energy transition private credit fund, Blackstone Green Private Credit Fund III (BGREEN III), with \$7.1 billion in committed capital, making it the “largest energy transition private credit fund ever raised” (Business Wire 2023). In November 2023, Brookfield announced the closing of its global infrastructure debt program, Brookfield Infrastructure Debt Fund III, for \$6.0 billion. Some private credit firms, such as KKR, have positioned themselves “as the current leader in the ABF space,” with \$45 billion of their \$78 billion AUM tied to asset-based lending arrangements. KKR Asset-Based Finance Partners recently closed in July 2023 with \$2.1 billion in raised capital for additional origination of ABF loans (PitchBook 2024a, 9). Therefore, while funds oriented towards ABF strategies do not currently make up the majority of the industry, there is a growing effort to move the industry in that direction.

While there are significant reasons to doubt that open financial markets are meaningfully “public,” it is important to note how the efforts of private financial markets to take the entire capital structure of companies private further reduces the ability for stakeholders and other interested parties to have democratic input on the capital development of the economy. For example, one key takeaway from Brett Christophers’ book about the private asset manager industry, *The Price is Wrong*, is that financiers determine which renewable energy projects go forward and which do not (Christophers 2024, 219-221). This means that the choices that behemoth asset managers make about how to direct their financial assets under management will have major societal consequences, especially in an era of government retrenchment under the Trump administration. Private finance may be attempting to diversify their lending into ABF style arrangements, but this doesn’t at all guarantee social and economic outcomes aligned with the goals of a just transition to address climate change.

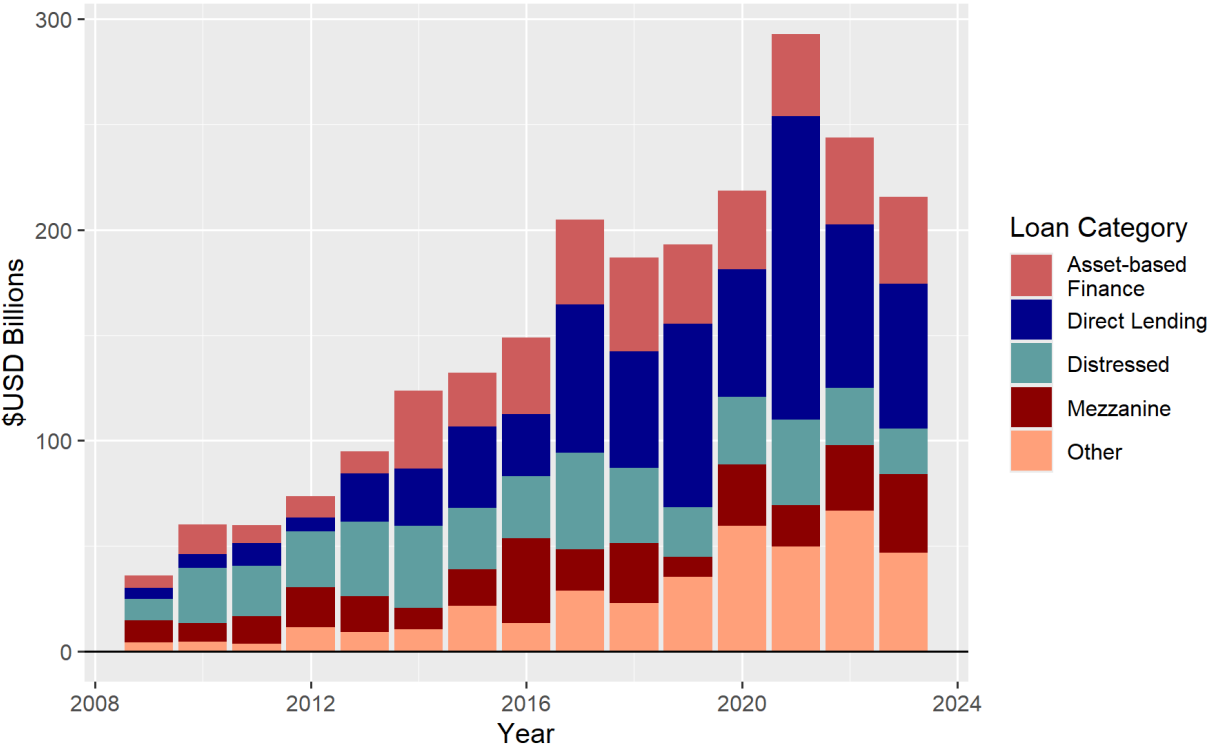
The extent of private lending of all sorts has grown extensively since the financial crash of 2008. Explained more in Section 4, this growth was compelled primarily by the low interest rate environment over the 2010s, as well as due to heightened regulation over bank lending to nonfinancial corporations. As a percentage of private capital fundraising, private credit has seen an increasing share of total fundraising for all closed-end funds. Shown above in Figure 1, private credit funds secured about 15.5% of all fundraising in 2024, or roughly \$181 billion. This is an increase from their 2005 low, which was a share of 6.2% or \$22 billion. This means that, while private equity still predominates in total fundraising, private credit funds have fast become the second largest category of newly committed capital in private financial markets.

We can examine what categories private credit funds have specifically been fundraising capital for lending. Shown below in Figure 4, fundraising for private credit peaked in 2021 for a total of \$293 billion in new commitments. For the same year, direct lending constituted \$144 billion in newly committed capital (or about 49% of total new capital). In fact, growth has been “most explosive in direct lending” over the last decade (PitchBook 2024a, 6). Throughout the 2009-2023 period, direct lending captured an average share of 26.5% of total fundraising or about \$47.5 billion in new capital annually. This reflects the growing relevance of private credit funds for corporate finance in general, as firms moved away from the BSL market and banks retreated—ceding market share to private lenders over the 2010s.

Second to this is distressed debt, with an average share of 24%, although its share of fundraising has dropped off since 2014, with the industry clearly pivoting to greater origination of direct loans and other strategies. Distressed debt fundraising peaked in 2010, with 43.5% of total or \$26.2 billion in new commitments. In magnitude this fundraising has continued to grow. For example, in 2021 this amounted to \$40.7 billion. But this was only a share of 14% and continues to shrink as a proportion of total new funds. As of 2023, distressed debt only made up roughly 10% of newly committed capital to private credit funds.

Mezzanine loans continue to be a relatively significant form of lending, responding to unmet demand for subordinated debt in the BSL market. In total this category of lending captured an average share of 16% or an average of \$20 billion in new commitments annually. In recent years, mezzanine lending has seen significant growth in comparison to other categories (Prequin 2024, 7). Given that this is a subordinated category of debt, mezzanine loans are attractive because they do not count against limits on senior loan ratios. Additionally, they often have payment-in-kind (PIK) structures, which allows for rolled repayment of interest into principal until the maturity of the loan (PitchBook 2024a, 8). As a whole, this means that mezzanine debt represents a greater risk to institutional shareholders than does direct lending.

Figure 4: Private Credit Fundraising by Loan Category (2009-2023)



Source: PitchBook Data Inc. Adapted from Avalos et al. (2025). Figure shows annual fundraising for private credit funds by loan category. Direct lending is the largest category, followed by asset-based finance (ABF), distressed, and mezzanine debt. ABF includes real estate, infrastructure, leasing, commodities, and natural resources. “Other” includes special situations, venture debt, and multi-strategy funds.

Finally, “other” forms of lending, which includes special situations, venture debt, and multi-strategy funds, captured an average share of 14.5% or an average of \$26 billion in new commitments annually. While distressed debt has represented a shrinking share of new commitments, categories such as special situations have seen “elevated fundraising” in recent years and provides “structured debt and structured equity alternatives” that are increasingly attractive among borrowing firms (PitchBook 2024a, 9).

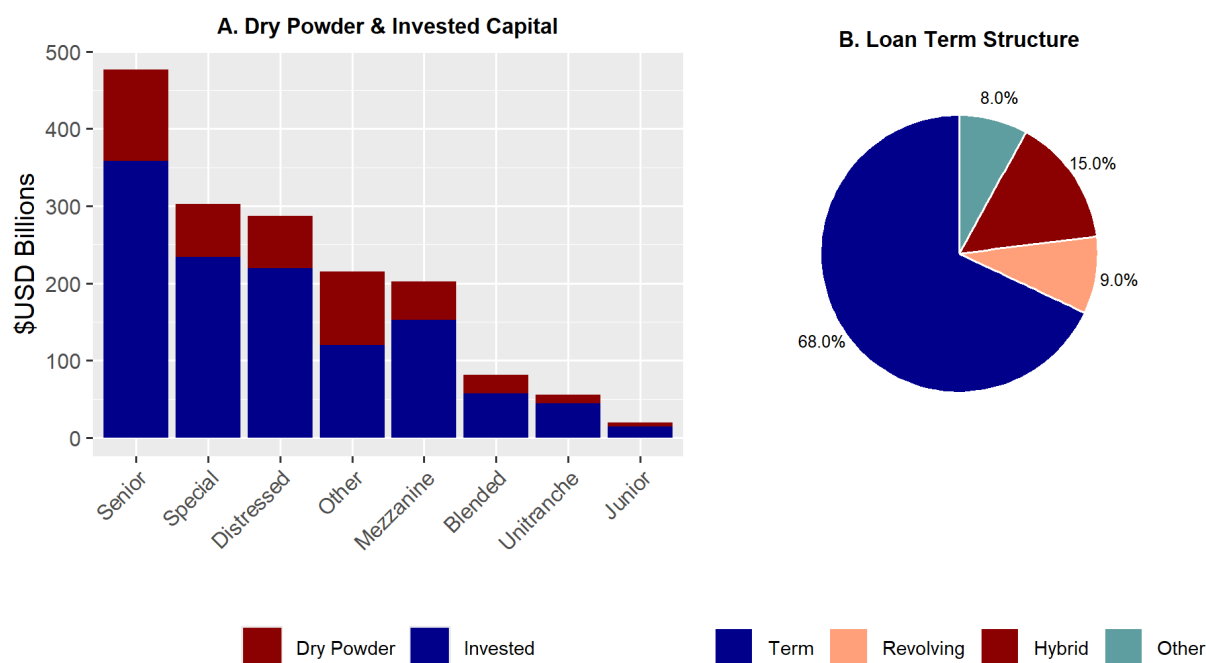
Clearly, direct lending continues to be the primary business of private credit funds, while distressed debt, mezzanine, and other arrangements remain an attractive option as well. Although most direct lending is senior in priority, the stability of these loan portfolios is unclear given the lack of market discovery over their fair value *and* the lack of regulatory oversight. Furthermore, forms of subordinated lending continue to capture a relatively consistent share of total fundraising (with the exception of distressed debt shrinking overall). Therefore, even with direct lending constituting the largest share, there is still significant exposure from riskier, subordinated debt for institutional shareholders.

As an alternative to subordinated debt, private credit funds have been “increasingly taking aim at asset-based finance” (PitchBook 2024a, 9). But despite the stated reorientation of private credit funds towards an ABF strategy, ABF-loans have not significantly increased as a percentage share of total fundraising, averaging at 18.75% of total over the entire period or roughly \$28.5 billion in new capital annually. This share has dropped to 16% on average since 2020. This in part appears as a lack of growth because of compositional change: infrastructure debt fundraising more than doubled from 2022, while real estate debt fundraising declined by roughly half (PitchBook 2024a, 9). It remains to be seen if the industry will truly begin building out a portfolio with greater distributions to infrastructure and real estate lending overall, among other forms of assets—such as intellectual property royalties or subscriptions to data center services—that generate potential future incomes.

Pivoting to the current stock of loan assets under management (AUM) by private credit funds, we can see even more clearly that direct lending constitutes the majority of assets. Shown in column A of Figure 5 below, direct lending with senior priority represents the largest category, with an AUM of \$477 billion as of 2024. Subordinated forms of direct lending are very small in comparison, with junior, blended, and unitranche deals representing \$20.1, \$81.3, and \$55.8 billion, respectively. About \$215 billion in direct lending is not categorized by priority and displayed as “other” in Figure 5. Taken altogether this means that direct lending represents roughly \$849 billion in loan assets, with \$254 billion (30%) in dry powder reserves and \$595 billion (70%) deployed as loans.

Concerning subordinated debt, distressed debt and special situations are almost tied as the second largest categories with an AUM of \$287.5 and \$302.5 billion, respectively. Combined this represents \$590 billion in loan assets, with \$137 billion (23%) in dry powder reserves and \$453 billion (77%) deployed as loans. Compared to direct lending (and ignoring dry powder), this means that deployed subordinated debt is roughly 70% of the size of all deployed direct lending arrangements—bringing doubt to the industry claim that subordinated debt is a marginal component of the industry’s overall business strategy. Indeed, if we recategorize all subordinated forms of direct lending to be included with distressed debt and special situations, this would mean there is a total of \$962 billion in deployed capital as subordinated debt compared to \$477 billion in senior direct loans.

Figure 5: Composition of Private Lending by Type and Term Structure (2024)



Source: Prequin Pro, Charts & League Tables; PitchBook Data Inc. Adapted from Cai and Haque (2024). Panel A shows assets under management (AUM) for private credit funds in 2024, split into invested capital and dry powder by loan type. Categories include senior, mezzanine, distressed, special situations, and others. Panel B shows the term structure of private loans. “Hybrid” loans blend senior and subordinated debt into a single facility with an intermediate rate. “Other” includes loans with atypical or unclassified structures. Fund-of-funds and secondary strategies are excluded.

This picture worsens if we include mezzanine debt arrangements, which have a total AUM of \$202 billion, with \$49.5 billion (25%) in dry powder reserves and \$152 billion (75%) deployed as loans. Combined with all subordinated debt, this number increases to \$1.15 *trillion* in deployed lending compared to the \$477 billion in senior direct loans.

While not shown in Figure 5 above, Prequin also reports that infrastructure and real estate funds held \$173 and \$260 billion in loan assets (including dry powder), respectively. Comparatively, there is only \$22 billion in venture debt assets as of 2024. Private credit funds then lend much more than other fund structures, despite these other funds (infrastructure, real estate, and venture capital) also dealing in lending arrangements. Unfortunately, Prequin does not provide a more granular picture of to what extent *private credit fund lending* constitutes loans to infrastructure and real estate deals.

Finally, Column B of Figure 5 gives us some idea as to what term structure looks like for the loan portfolios held by private credit funds. Over two-thirds of loans are structured as basic term loans. Roughly 15% of loans are hybrid *pari passu*, which is junior in the capital stack during a default and implies greater risk to institutional shareholders (Cai and Haque 2024). Generally speaking, hybrid loans refer to loan facilities that deal in senior and subordinated debt with a blended interest rate between the two debt categories. Revolving credit lines constituted 10% of lending, while “other” loans include lending arrangements such as term loans with delayed amortization (with PIK

structures as one form of this lending). Therefore, while most lending is conducted as simple term loans, there is a sizable share of lending engaged in riskier loan terms.

In conclusion, private credit funds have emerged as central players in corporate lending by filling the financing void left by retreating banks—particularly for small- and middle-market firms constrained by leverage or unable to access the BSL market. Initially focused on special situations and distressed debt, private credit has evolved into a dominant source of direct, cash-flow-based lending that fund managers argue would not be underwritten by traditional banks. These loans are typically held to maturity, involve bespoke covenants, and reflect a hands-on lender-borrower relationship, distinguishing them from the BSL market. Compared to banks, private credit firms operate at lower leverage ratios, effectively functioning as narrow banks with more conservative balance sheets and stronger oversight of borrowers. Over time, the industry has diversified into mezzanine lending, venture debt, and various forms of asset-based finance (ABF), such as infrastructure, real estate, and contractual cash flow-backed deals. While direct lending continues to dominate by share of assets and fundraising, recent years have seen increased capital allocations toward (some) ABF strategies. Yet, despite its growth and diversification, private credit remains opaque. Its expansion into subordinated and structured debt instruments raises concerns about portfolio stability and valuation transparency.

4. The Potential Risks of Private Credit Funds

In April 2024, the International Monetary Fund concluded that “credit migrating from regulated banks and relatively transparent public markets to the more opaque world of private credit creates potential risks,” (IMF 2024). In this section, we provide a catalog of the types of risks that private credit funds may pose: heightened borrower defaults, along with difficulties observing rising defaults because of the lack of data; risks from increased intersection with the regulated banking sector; and risks to limited partners, especially the public pension funds that are retirement security for the public sector workforce. Liquidity mismatch remains a significant source of systemic risk. Although private credit funds are generally closed-end, they serve limited partners—such as pension funds or insurers—who may need to liquidate assets in downturns. Funds’ growing interconnections with banks and insurance companies may transmit stress through less obvious channels, especially during capital calls or shocks that bring valuations into doubt.

A. Heightened Borrower Defaults

“Private debt funds have attracted highly leveraged borrowers that are unable to get adequate funding from heavily regulated banks,” (Cai and Haque 2024).

At the core of private credit's systemic risk profile lies a classic form of credit risk: the possibility that borrowers default due to non-prudent lending, firm-level fragility, or the broader business environment. Companies can default for reasons based on their underlying business: their product

lines becoming obsolete or overtaken by competitors, or companies are mismanaged or over-leveraged: according to Wigglesworth (2024), “for many companies [in private credit] the weight of their debt burdens have almost doubled in just a few years.” Borrowers in the private credit space tend to be more highly leveraged, often sponsored by private equity firms, and are frequently ineligible for bank loans due to weak fundamentals such as negative EBITDA or limited collateral (Cai and Haque 2024; Avalos et al. 2025). These characteristics make them inherently more vulnerable to financial and policy shocks, and the lack of public disclosure exacerbates this vulnerability. As Federal Reserve Governor Lisa Cook noted in her 2024 speech, many of these firms have been drawn to private credit for “easier deal execution and greater contractual flexibility,” particularly as traditional bank regulation tightened in the post-2008 era (Cook 2024). Macroeconomic conditions also can drive an otherwise healthy business into default, such as rising interest rates or macroeconomic downturns (IMF 2024). While all lending bears this risk, the structure of private credit—marked by regulatory opacity, illiquidity, and concentration in lenders—renders it particularly difficult to monitor or manage effectively.

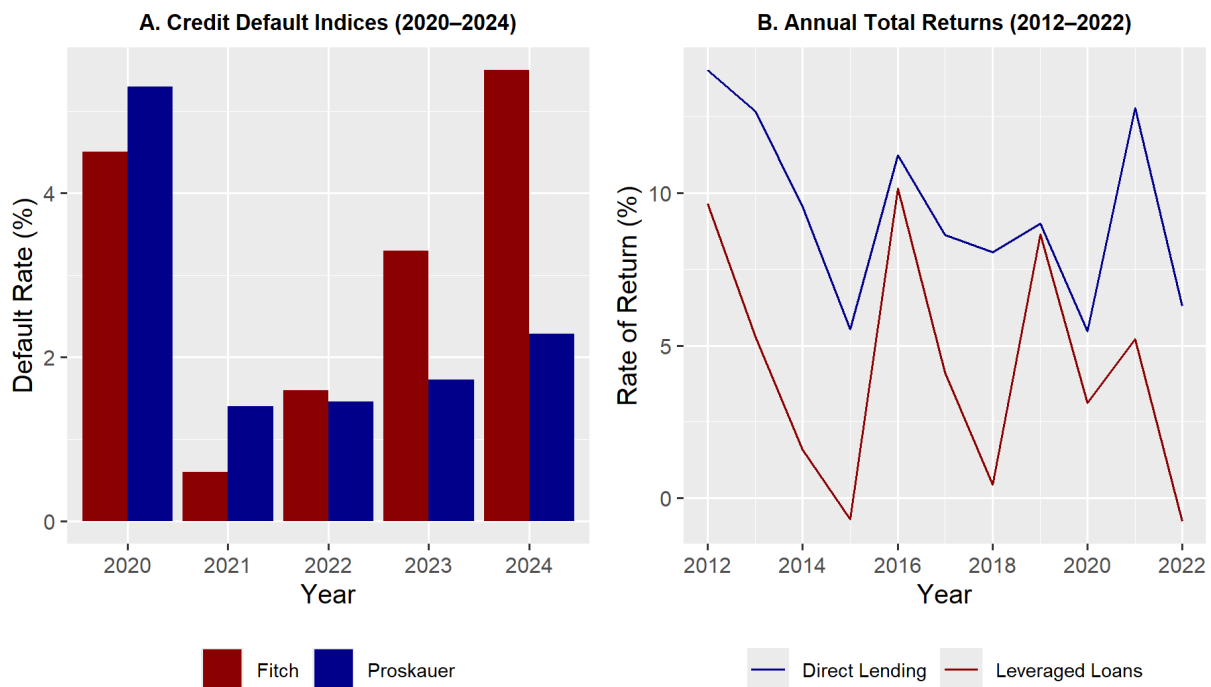
While private credit funds are often structured as closed-end vehicles and use relatively little leverage themselves—a structure Cook argues may bolster their capacity to hold the riskiest segment of corporate debt—the credit risk is not eliminated. Instead, it is shifted to borrowers through floating-rate arrangements, which dominate private credit portfolios. These loans adjust upward as benchmark rates rise, increasing borrowers' debt servicing costs just when their revenues may be most at risk. As Degerli and Monin (2024) find, monetary tightening has had muted effects on fundraising, but capital deployment slows during tightening cycles, suggesting a heightened sensitivity to credit quality.

Other challenges can arise for businesses that lead to other loan term modifications that push the problem later in time. Defaults can be avoided through distressed exchanges, wherein lenders change the conditionalities of the loan in exchange for greater priority or other stipulations from the borrower. This can allow asset managers to claim in a factually correct manner that the default rates for a lending fund are very low, while masking underlying issues (termed “volatility masking” by Jim Grant) in the health of the portfolio. Use of “payment-in-kind” (PIK) loans, which allow companies to roll interest payments into the principal, can be a short-term solution but create more debt burden and worsening long term conditions. According to private capital executive Jeffrey Diehl:

“... what has grown is the number of loans that are paying some or all of their interest in kind instead of cash. That is now up to 20 percent of some BDC portfolios.. This is a sign that people are kicking the can down the road on problem loans... If [interest] rates don't move down soon then we are for sure going to see a lot more companies go from cash to PIK, from PIK to non-payment, and from non-payment to handing the keys over to lenders,” (Wigglesworth 2024).

Lisa Cook has emphasized in 2024 that “most firms still have ample earnings to cover their scheduled interest and principal payments”, though without adequate disclosure it is unclear how this conclusion can be drawn. While this holds for large firms with bond market access, the middle-market borrowers that populate private credit portfolios may be far more vulnerable. These firms often lack diversified revenue streams and are more exposed to sector-specific shocks--something at greater risk due to the current dynamics of geopolitics and trade wars. Despite this concern, Cook is correct that there is little evidence that defaults are more common with private credit funds. As shown in Figure 6 below, the Proskauer Credit Default Index, which tracks senior-secured and unitranche loans by private credit funds, has generally lower default rates in comparison to the Fitch Ratings U.S. Leveraged Loan Default Rate Index. Of course, this could be an illusion produced by the aforementioned "volatility masking."

Figure 6: Comparative Defaults and Annual Total Returns



Source: Fitch Ratings; Proskauer Rose LLP. Annual total returns adapted from Degerli and Monin (2024). Panel A shows credit default rates from 2020–2024 using two indices: Fitch (broadly syndicated U.S. loans) and Proskauer (private credit). Panel B presents annual total returns for direct lending and leveraged loans from 2012–2022. Fitch measures defaults in syndicated loan markets; Proskauer covers private credit. Annual return data are unlevered and gross of fees.

Additionally, measures of private credit fund performance often show them generating returns greater than shown for the leveraged loan market (Degerli and Monin 2024). Of course, these returns are reported unlevered gross-of-fees. This is reflected in the finding of insignificant abnormal returns for the average private credit fund after considering management fees and the underlying loan portfolio risk (Erel et al. 2024). Therefore, private credit funds can potentially mask both the true default rate and rate of return of their loan portfolios.

Private credit’s opacity compounds these issues. The reality is that all of this data is unavailable to regulators and the larger public: “there’s an information gap, where you can see the mark, but you can’t actually see through to the financials of the company to understand the credit performance,” said Clay Montgomery, vice-president of Moody’s private credit team,” (Platt and Pollard 2024). Funds are not required to disclose individual loan terms, impairments, or covenant violations. This absence of transparency can mask volatility and delay recognition of asset quality deterioration—something Cook warned is characteristic of markets with “weak underwriting or excessive risk appetite.”

A dramatic case of these risks is the collapse of Pluralsight, an online education company, that defaulted on its \$4 billion in debt obligations to Vista and other private lenders (Platt, Yu, and Gara 2024). A group of private lenders, including Blue Owl Capital and Ares Management, arranged a \$900 *million* deal to take over the troubled company—a fraction of its initial value. Vista had purchased Pluralsight in 2021 when tech valuations were high, but due to the lack of market trading and opacity of disclosures, Vista and other lenders maintained par values of their loans above 95% leading up to the default. In other words, private credit funds are not immune to herding behavior and may be exposed to significant risks in an information scarce environment.

The pressure to deploy capital from limited partners—especially amid record “dry powder” reserves—adds further strain. Cai and Haque (2024) document a correlation between excess capital and weakening covenant protections. As funds race to make deals, underwriting standards may erode. This would be in addition to the already present share of subordinate debt—rather, the quality of senior secured lending may be deteriorating. The rise of “club deals,” in which multiple funds co-underwrite large loans, increases the probability of contagion: a single borrower default could simultaneously affect multiple balance sheets.

In sum, the financial stability of private credit funds remained untested. While Governor Cook views the sector’s growth as not yet systematically destabilizing, she—and the data—recognize that the sector has yet to undergo a full stress test in a prolonged downturn. The combination of borrowing firm fragility, floating-rate exposure, weak covenants, and growing interconnections make defaults not just a fund-level concern but a potential source of wider market instability—particularly as institutional shareholders continue to allocate more capital to private markets.

B. The Interrelationship with Regulated Banking Sector

The regulated banking sector is becoming increasingly intertwined with its ostensible rival, private credit funds: as one financial journalist put it, “many banks will have to partner with private credit firms to stay relevant,” (Steer 2024). The risk of this, as stated recently by the Financial Times, is that “private credit could amplify the next financial crisis,” creating a “locus of contagion,” (Platt and Indap 2025). An analysis by Levin and Malfroy-Camine (2025) of Boston Federal Reserve showed the scale of bank-non bank financial institution linkages, focusing on private equity and private

credit. They found that large banks have an outstanding loan balance of \$300 billion to private equity and private credit as of 2023, a drastic increase from \$10 billion in 2013. Regulated banks are progressively selling complex debt instruments to private fund managers in so-called synthetic-risk transfers in order to reduce regulatory-capital charges on the loans they make. Such instruments have limited transparency and pose hidden risks to the financial system,” (Jim Grant, quoted in McClean and Zingales 2024). An analysis by Morgan Stanley found 19 origination-focused partnerships between banks and private credit managers in 2024 (Steer 2024).

As a proportion of syndicated lending—taken here as the sum of all commercial and industrial loans by the banking sector—the global private credit industry was about 62% of the size of total syndicated bank lending in 2023. If we assume only the \$1.2 trillion in the U.S., that figure drops to about 43% of all syndicated loans. Overall, this compares to 2015 when private credit was roughly only 25% of syndicated lending or in 2000 when these financial markets were exceptionally small at around 4%. While bank lending has grown from roughly \$1 trillion in 2000 to \$2.8 trillion as of 2024 (an increase of ~154%), private credit has ballooned from only \$41.5 *billion* in 2000 to its current valuation of \$1.7 trillion in 2024 (an increase of ~4,034%). Private credit funds then have undeniably seen rapid growth in the realm of direct lending and, at a glance, appear to quickly be displacing much of the corporate financing traditionally sourced from the banking sector.

Asset managers that have historically focused on public markets have begun to establish themselves in the private financial markets. BlackRock, long the dominant asset manager in the publicly-traded financial markets, took major steps in 2024 to become a key player in private financial markets as well, especially in private credit and infrastructure. In January 2024, BlackRock purchased the second-largest private infrastructure manager, Global Infrastructure Partners, and at the end of the year, private credit manager HPS was brought into the BlackRock fold. This meant that BlackRock managed over \$600 billion in unregulated financial assets by the end of the year (Agnew 2024). BlackRock also purchased Preqin, the ‘alternative assets’ data provider, in July 2024, improving its data capacities to complement its Aladdin platform, with a potential goal of creating index funds for private markets. Apollo and State Street, another one of the “Big Three” asset managers traditionally focused on public markets, announced in September 2024 a plan to list an ETF that would hold private credit along with publicly traded equities. The ETF would hold mainly investment grade debt and would be open to retail investors. (Masters 2024).

These interlinkages mean that there are now firms with loans from banks and private credit firms, where the bank is also, separately, lending to the private credit firm: creating an opaque web of loans that none of the parties may have a clear picture of. These relationships have implications for the capital stack of borrowers: “for example, a bank may provide lender financing to a Private Credit manager, who then provides a NAV loan to a private equity sponsor, which also receives a subscription line from the same bank. The bank may also provide portfolio company financing to the underlying asset. These multiple overlapping exposures are difficult to track, as the financing is often provided by different parts of the bank or by different banks,” (Steer 2024).

Another challenge is that “the further removed a bank gets from the underlying assets it funds, the more challenging it is to analyze the risks of those asset bases,” (Steer 2024). As both regulated banks and private credit funds are attempting to make loans, “the natural inclination in competition is to make the terms of the loan weaker and weaker,” (Jim Grant, quoted in McClean and Zingales 2024).

C. Risks to Retirement Security & Insurance: Limited Partners Requiring Funds

The assets that fund managers use to make loans are not their own: they come from limited partners, including public pension funds and insurance companies. The risks described above for borrower companies and private credit funds themselves thus will have an upstream effect on the sources of funds. William Clayton (2020) poses the fundamental question of whether the investor qualifications for private funds are being met by public pension funds--should public pension funds be considered sophisticated investors who can bear the heightened risk of loss that comes with opaque asset allocation? While fluctuations in returns may be a normal part of the process, public pension fund trustees have a duty to ensure the funds remain adequate for the retirement security of beneficiaries-- outsized risks from private credit funds may end up violating this duty (Clayton 2020). For insurance funds, the risks are distinct: private credit fund managers have a contractual right to require limited partners who have made commitments to come up with the funds (the term used for this is “capital call”). Insurance companies may be required to put financial assets into the funds at a time when their own liquidity is threatened (Cai and Haque 2024). For example, Property and Casualty Insurance companies are facing increased unexpected risk due to the effects of climate change and are required to pay out short-term claims. If they face a “capital call” at the same time that their payments to insured households spike, this could cause a severe liquidity crunch. With so little information disclosed about what is happening inside private credit fund transactions, it is unclear how trustees can effectively manage such risks.

Conclusion

Private credit funds are a rapidly growing asset class within the unregulated financial markets. Private credit funds require regulation: The International Monetary Fund in 2024 recommended “a more intrusive supervisory and regulatory approach to private credit funds, their institutional investors, and leverage providers,” (IMF 2024). Some policymakers claim that private credit funds do not need to be regulated because their risk is not systemic, but this begs the question of whether systemic risk can be easily evaluated ex-ante. Are private credit funds capable of creating ‘systemic’ risk? Gary Gensler, former Chair of the Securities and Exchange Commission under the Biden Administration, stated in 2024 his judgment that “there are risks that can be built up inside of this private funds world..they are the risks that I’ve witnessed personally, like during the Long-Term Capital Management spillovers of 1998,” Platt and Pollard 2024).

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