Comments on:
"Credit Risk to NBFIs, Liquidity Risk to Banks: A Conceptual Framework"

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Complementary Roles of Banks and NBFIs

- Take case of private credit and BDCs as concrete example.
- Regulation makes it less economic for banks to lend directly to riskier credits.
- So, PC funds and BDCs make the loans, financed (roughly) half with capital, half with senior debt, much of it from banks.
- Because banks have a senior position in a portfolio of loans, can participate with less capital.
  - Regulatory risk weight on loans to PC/BDC is only 20%, vs. 100% on direct lending.

- Crucially, bank loans are largely in form of credit lines, with substantial undrawn commitments.
  - By mid-2025, U.S banks had approx. $300B of funded loans, and $340 of undrawn commitments, to private credit providers (Moody's).

- Provision of credit lines may be the single most distinctive and enduring form of bank lending.
  - Banks still have nearly 100% market share in credit lines.
  - Banks are most fundamentally liquidity providers, in part due to deposit insurance and LOLR.
  - Easier for other functions, e.g., screening and monitoring of borrowers, to migrate outside banking sector.

- A clear and compelling story. And an extremely helpful perspective on these issues.

Should We Worry About the Banks?

- Optimistic view: currently outstanding bank loans are senior, on a diversified portfolio (pooling and tranching) and generally well collateralized.
  - Also, scale of lending so far to PC/BDCs is not all that large.

- A caveat: credit lines likely to be drawn down in a highly adverse state of the world.
  - More so than a credit line to an individual firm: a diversified pool of loans only goes bad in a systemically adverse state, e.g., a deep recession (Coval-Jurek-Stafford 2009).
  - These are liquidity puts on the aggregate market, with very high and non-linear beta.
  - Have banks properly priced and risk-managed this systemic exposure?

- For NBFIs more generally, estimates are that undrawn commitments from banks are on the order of $1.0 to $1.5 trillion.
  - And these may have drawdowns with similar, highly systemic and correlated properties.
  - This is the scenario to worry about from a financial-stability perspective.

BDCs and PIK Loans as an Illustration

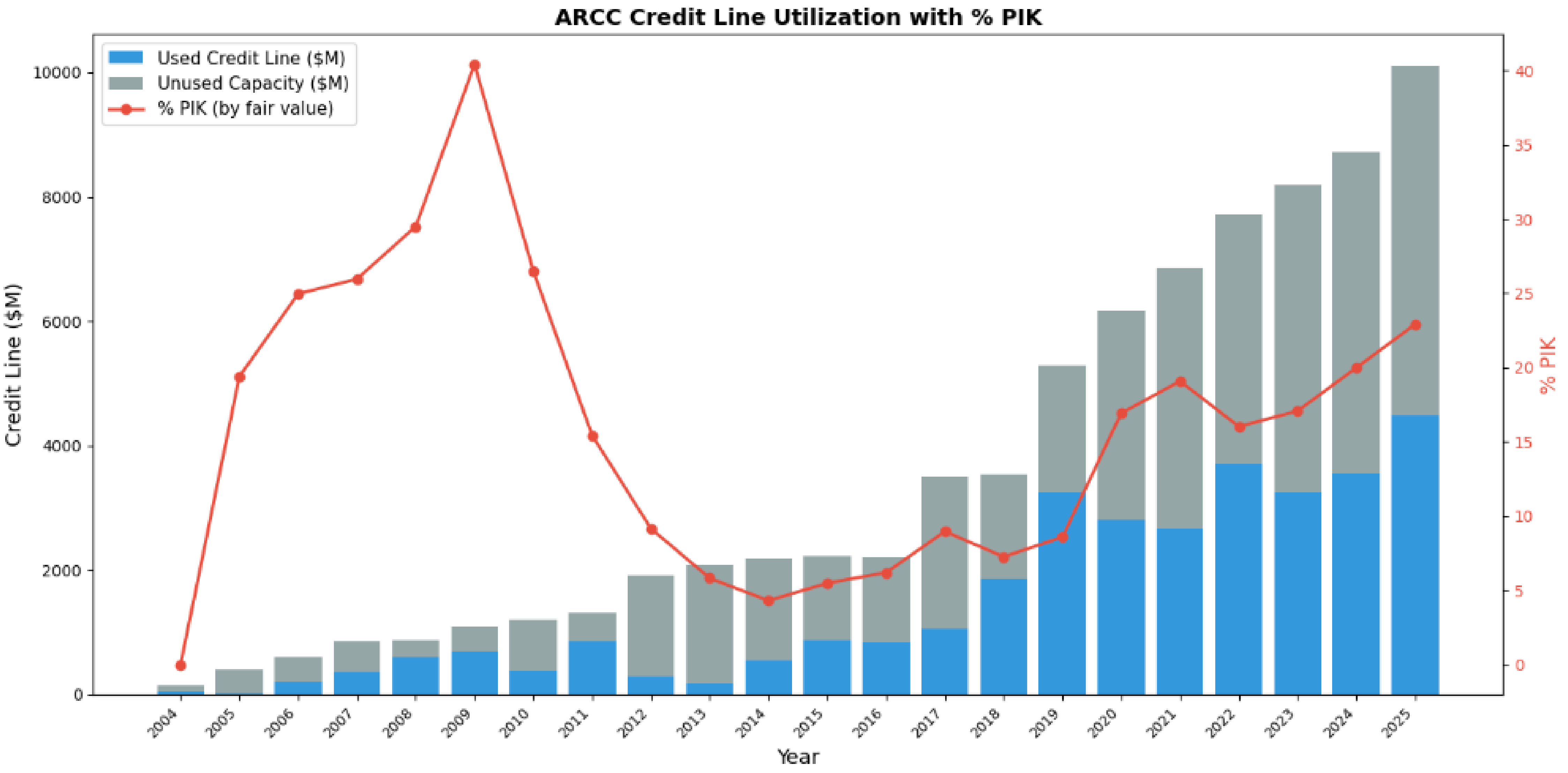
- As regulated investment companies, BDCs must distribute at least 90% of their taxable income to shareholders each year.
  - This creates a pass-through structure similar to mutual funds, avoids corporate tax at BDC level.

- Crucially, non-cash PIK interest counts as income for this purpose.

- To fund payouts in presence of PIK income, a BDC can draw down its bank lines.

- Likely to be more of an issue when loans in its portfolio are near default and are being restructured with PIK features to reduce cash drain on underlying firms.

The Case of Ares Capital Corp (with thanks to Jaan Rothschild)



And Recall ABCP Vehicles During Run-Up to the GFC

- Acharya-Schnabl-Suarez (2013): when asset-backed commercial paper (ABCP) market collapsed in 2007, banks were on the hook to pay off maturing paper at par, thanks to liquidity guarantees they had provided to ABCP vehicles.
    - Liquidity guarantees—as opposed to full credit guarantees—had minimal capital requirements at the time. In retrospect, a clear opportunity for regulatory arbitrage.
    - So, a ton of bank exposure was in this off-balance-sheet liquidity commitment.
    - And the bill on all of this came due at once, in a highly adverse state of the world.

- Key point: liquidity commitments to financial firms and vehicles are fundamentally different in nature, and more systemic, than commitments to operating firms.

- “History doesn’t repeat itself, but it often rhymes”
    - Mark Twain

Is Regulation Really Responsible for Rise of Private Credit?

- It's frequently asserted that tougher post-GFC bank regulation is primary reason for rapid growth of private credit vehicles.
  - And bank capital requirements play a key role in the model.

- But private credit vehicles have *much* more capital than banks! What gives?

- My guess: we need to think about the investors in private credit, and their incentives.
  - Example: life insurance companies don't typically hold stock in banks. But they are big investors in levered claims on private credit funds, which plausibly have equity-like risks.
  - Perhaps because incentives are for them to categorize this as "debt". And smoothed nature of reported returns surely helps.
  - If so, are they being fully compensated for the risks?

- Why I worry about there being something of a bubble in private credit.
  - Key question: is this just bad news for investors in PC, or is there meaningful systemic risk?
  - I don't know. But if there is, bank credit lines will likely be at the center of the story.
  - And it won't be the first time.