

Evolving Trends in Business Development Companies (BDCs) in the U.S. Direct Lending Market

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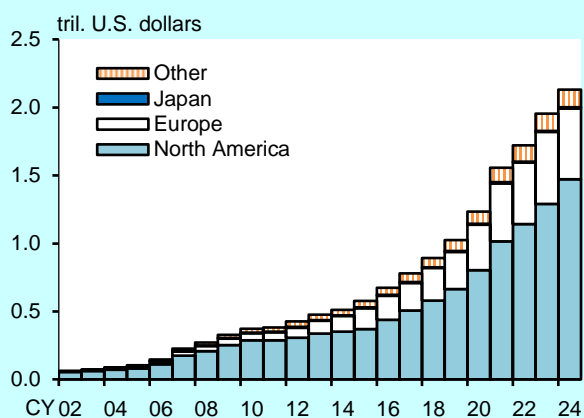
In recent years, private credit has attracted growing attention as a form of financial intermediation by the NBFIs that mainly involves lending to unlisted firms. In particular, direct lending has been expanding, which provides loans to medium-sized firms and small firms, including through investment vehicles known as BDCs. BDCs are a U.S.-specific type of investment company and are considered relatively transparent due to mandatory quarterly disclosure requirements. At the same time, BDCs have a distinct liability structure compared to other direct lending funds (PD funds), as they raise capital from retail investors. This paper outlines trends and risks in the direct lending market, focusing on BDCs. Amid increasing linkages between Japanese banks and domestic institutional investors with BDCs and PD funds through investments and loans, the environment surrounding private credit markets could impact Japan's financial system. Close monitoring remains necessary.

Introduction

In recent years, private credit has attracted increasing attention as a form of financial intermediation activity by the non-bank financial intermediary (NBFI) sector.¹ Private credit mainly involves funds extending loans to unlisted firms. The size of the private credit market has been expanding, primarily in the United States (Chart 1). Private credit generally provides loans to firms by leveraging funds from institutional investors, which are characterized by a higher risk tolerance for long-term asset management. Borrowers benefit from shorter processes to disbursement and the flexibility of private credit to provide large credit facilities and long-term

loans that would be difficult under banking regulations.² On the other hand, there are risks such as a lack of transparency regarding the actual lending practices in the private credit market, the recent rapid market expansion and the increasing linkages between the banking sector, the relaxation of lending standards when extending credit to certain firms, and the increase in the number of redeemable investment products for retail investors (Chart 2).³

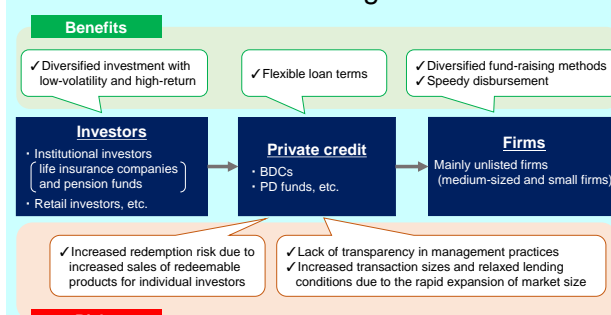
[Chart 1] Private Credit Market Size



Note: Classified based on primary focus region. "North America" includes BDCs (hereinafter the same). Latest data as of December 2024.

Source: Preqin; S&P Global Market Intelligence.

[Chart 2] Benefits and Risks Surrounding Private Credit



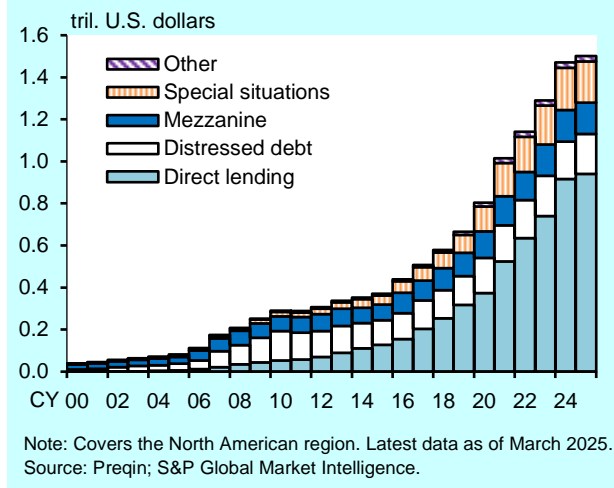
Note: Based on various materials. Arrows indicate fund flows.

This paper provides an overview of developments and risks in the direct lending market by examining direct lending as part of private credit, with a particular focus on credit extension through business development companies (BDCs) -- a type of investment vehicle.⁴ It is necessary to keep in mind that BDCs represent one of the components of the direct lending market and do not necessarily capture the entire picture.

Overview of Direct Lending

The specifics of private credit vary considerably depending on the strategy, and a review of major investment strategies indicates that the recent growth has been driven primarily by direct lending, in which funds provide loans mainly to unlisted medium-sized firms and small firms (Chart 3).⁵

[Chart 3] Breakdown of Total Assets of Private Credit by Investment Strategy



The U.S. direct lending market is characterized by a high proportion of private equity (PE) portfolio companies -- that is, sponsor-backed firms -- among borrower firms. It is also notable that a substantial portion of credit is used to meet financing needs for leveraged buyouts (LBOs) and mergers and acquisitions (M&As), and that the majority of funding and investment is executed at floating interest rates.

Factors contributing to the market's expansion include the supplementation of financial intermediation to firms through private credit, particularly in the United States, amid the strengthening of financial regulations on banks after the global financial crisis.⁶ Moreover, recently, borrowing firms have increasingly preferred the flexibility in loan terms that private credit offers, as traditional financial institutions such as banks have adopted a more cautious lending stance in response to the rise in interest rates and the bankruptcy of U.S. regional banks. Against the backdrop of the past rises in interest rates in the United States, private credit has maintained strong performance, supported by features such as floating interest rates and wide lending spreads reflecting the risks of borrowing firms (Charts 4 and 5).⁷

Examining the composition of the corporate debt market in the United States to position direct lending as a financing method reveals that, while corporate bonds constitute more than 50 percent, the market size of

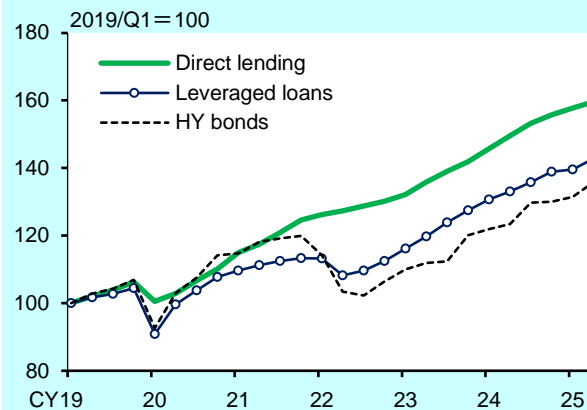
private credit, centered on direct lending, is approaching that of leveraged loans and high-yield (HY) bonds (Chart 6).

[Chart 4] Characteristics of Direct Lending

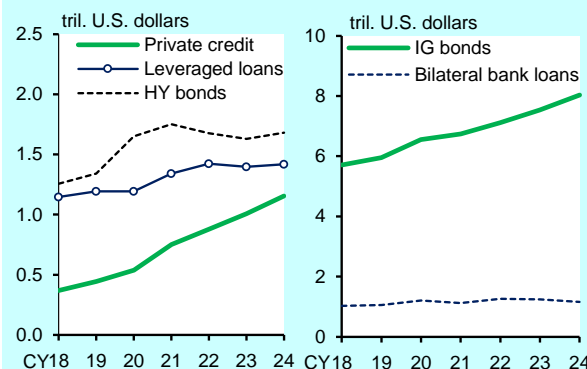
	Direct lending	Bank loans	HY bonds
Type	Bilateral loans	Bilateral loans, syndicated loans	Corporate bonds
Interest rate	Floating interest rates	Floating interest rates Fixed interest rates	Fixed interest rates
Liquidity	Illiquid	Moderately liquid	Liquid
Lending period	5-10 years	1-7 years	1-10 years
Covenants	Strict	Relaxed	Relaxed
Collateral	Necessary	Necessary	Unnecessary
Market size	About 0.9 tril. U.S. dollars	About 3.3 tril. U.S. dollars	About 1.7 tril. U.S. dollars

Note: "Market size" of "Direct lending" refers to that in the North American region, and "Market size" of "Bank loans" (to the non-financial corporate sector, including leveraged loans) and "HY bonds" are those in the U.S. Data as of December 2024.

[Chart 5] Performance of Direct Lending



[Chart 6] Size of the U.S. Corporate Debt Market



Firms raising funds through direct lending are medium-sized firms with sales ranging from 10 million

U.S. dollars to 1 billion U.S. dollars and are generally considered to overlap with borrowers in the leveraged loan market to a certain degree. On the other hand, these firms are smaller in size than typical issuers of HY bonds. That said, in recent years, there have been cases of large-scale financing through direct lending, leading to the observation that these firms are approaching the size of HY bond issuers.

Characteristics by Type

Direct lenders can be broadly classified into BDCs and private debt (PD) funds. BDCs are investment companies unique to the United States that focus on investing and lending in private credit markets. There are no significant differences in terms of borrower firm size or credit risk between BDCs and PD funds. However, compared with PD funds, BDCs are designed to ensure a certain degree of higher transparency and risk mitigation for investors. This is achieved through mandatory quarterly disclosures and limits on leverage ratios, among other measures (Charts 7 and 8).⁸

[Chart 7] Characteristics of Direct Lending Funds

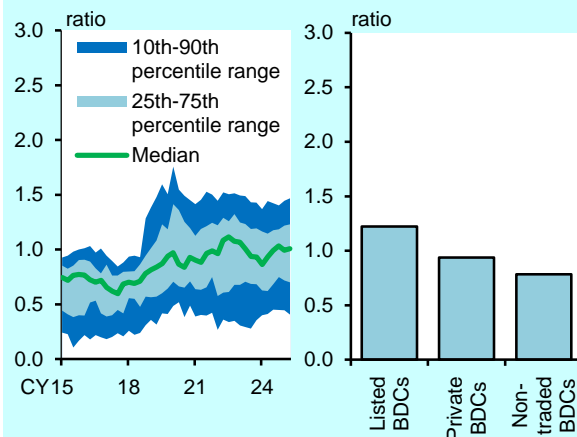
	BDCs			PD funds
	Listed BDCs	Non-traded BDCs	Private BDCs	
Overview	Lending to and bond investments in medium-sized/small firms Eligible for tax advantages			Lending to medium-sized/small firms
Investors	A broad range of investors, including small retail investors		Institutional investors, high-net-worth individuals	
Duration	Indefinite		5-7 years	
Early redemption/liquidation	Immediate liquidation through market sale is possible	Quarterly/monthly redemption (usually capped at 5%) is possible	Early redemption is basically not allowed	
Information disclosure	Filing of documents with the SEC is required (e.g., Form N-2, 10-Q)		Filing of documents with the SEC is required (e.g., Form 10-Q)	None
Leverage	Required to maintain a leverage ratio (total debt divided by net asset value) within 2x			Remains relatively low, although there is no restriction

Additionally, while PD funds primarily raise funds from institutional investors, BDCs secure funding from a broader range of investors, including retail investors. In the case of BDCs offered to retail investors, in addition to listed BDCs that allow shares to be traded on the open market at any time, there has recently been a significant increase in non-traded BDCs that allow redemptions (Chart 9).

Underlying assets in direct lending are characterized by the low liquidity, which makes it difficult for these assets to be sold in the market, unlike open-ended funds. Therefore, while non-traded BDCs allow early redemption by investors, certain restrictions are imposed to mitigate liquidity risks. However, it is important to note that, in addition to institutional investors and university endowments,

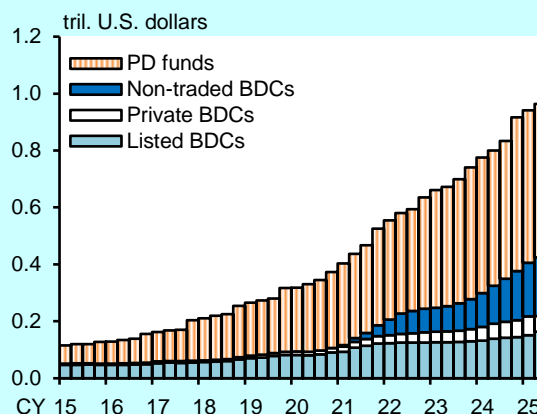
which are assumed to have a higher risk tolerance for long-term investments, retail investors with different levels of risk tolerance have also entered these investments.

[Chart 8] BDC Leverage <Distribution> <Comparison>



Note: Shows total debt divided by net asset value. Latest data for the left-hand chart are as of September 2025. The right-hand chart shows the median value as of September 2025, by type of BDC. Source: S&P Global Market Intelligence.

[Chart 9] Total Assets of Direct Lending by Category



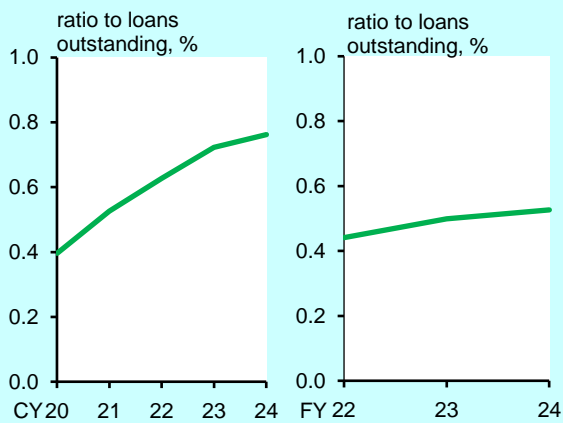
Note: Covers the North American region. Latest data as of June 2025. Source: Preqin; S&P Global Market Intelligence.

Risks of Direct Lending

Credit Risk in Direct Lending

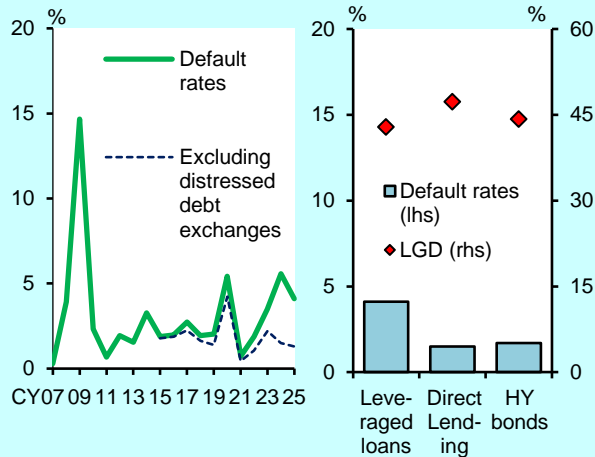
At present, the proportion of direct lending loans in total lending by Japanese banks and U.S. banks remains low, and default rates seem to be restrained (Charts 10 and 11).⁹ It should be noted that data on private credit are significantly limited in general and accurately understanding default rates poses difficulty to a certain degree.

[Chart 10] Loans to Direct Lending
<U.S. banks> <Japanese banks>



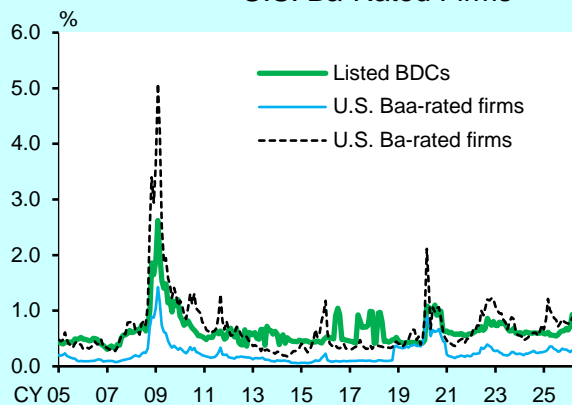
Note: Includes credit lines. "Japanese banks" covers loans made by the three major Japanese banks to the Americas (denominator is loans to private sector by domestic banks). "U.S. banks" covers loans to private credit as shown in Chart 17.
Source: Fed; BOJ.

[Chart 11] Developments in Leveraged Loans
<Default rates> <LGD>



Note: By volume. Data for the right-hand chart is as of 2025.
Source: KBRA DLD.

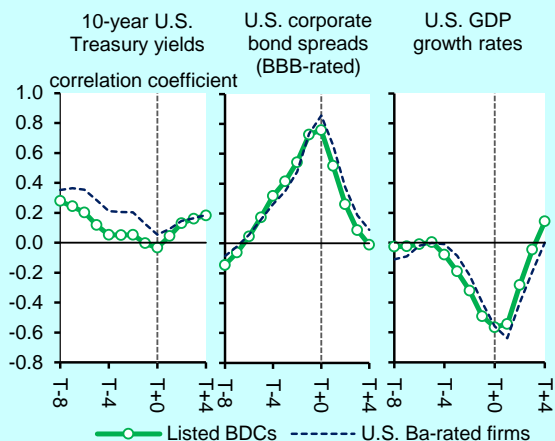
[Chart 12] EDF for BDCs and U.S. Ba-Rated Firms



Note: Shows the average of 1-year EDF for each group. "U.S. Baa (Ba)-rated firms" is defined by Moody's. Latest data as of March 31, 2026.
Source: Moody's.

The expected default frequency (EDF) of listed BDCs remains at approximately the same level as that of Ba-rated firms (equivalent to BB-rated firms) (Chart 12). As suggested by the relationship between developments in EDF of listed BDCs and macro-economic and financial variables, trends in direct lending could be affected by changes in economic conditions to a certain degree, such as a slowdown in GDP growth or rising interest rates (Chart 13). Furthermore, there are several factors specific to direct lending that warrant attention. For example, despite the predominance of senior secured loans in direct lending portfolios, the loss given default (LGD) tends to be relatively high in the event of default. This is attributed to the fact that borrowing firms often possess illiquid intangible assets, such as software and patents, whose value is relatively difficult to assess.

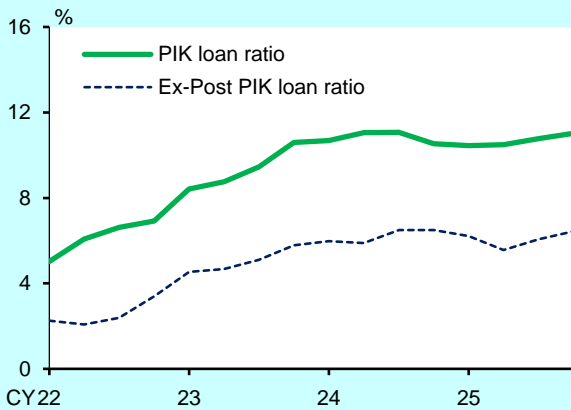
[Chart 13] Correlation between EDF of Listed BDCs and Macro-Economic/Financial Variables



Note: Correlation coefficients between the EDF level and the levels of macro-economic and financial variables (GDP represents growth rate) are calculated. The observation period for the correlation coefficients is January 2006 to October 2023 (GDP: 2006/Q1-2023/Q2). Quarterly lags are applied to macro variables.
Source: FRED; Moody's; BOJ.

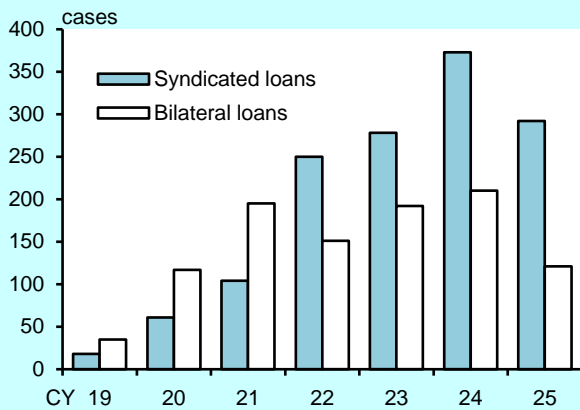
In addition, it has been pointed out that, given that some borrowers have increasingly been provided with payment-in-kind (PIK) loans, in which lending terms are relaxed (i.e., where interest payments can be deferred and repaid in a lump sum at maturity), the materialization of defaults has been delayed (Chart 14). While PIK loans are aimed at easing short-term repayment burdens and do not necessarily lead to defaults, attention has recently been drawn to the growing prevalence of so-called bad PIK loans, in which PIK provisions are added to existing loans during their term as a result of unexpected financial difficulties.

[Chart 14] PIK Loan Ratio and Ex-Post PIK Ratio



Note: Count basis.
Source: Lincoln International.

[Chart 15] Syndicated Loans by Multiple BDCs

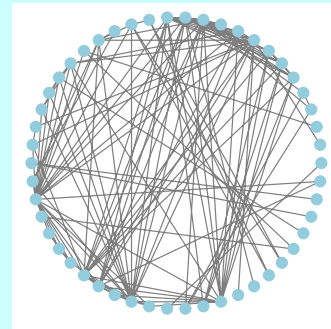


Note: Based on deal data.
Source: KBRA DLD.

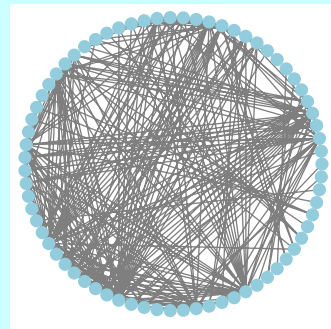
Concerns have also been raised regarding the risks associated with common exposures among funds. This is due to the trend of firms, which had previously relied on leveraged loans for financing, shifting toward direct lending, thereby increasing the size of borrowings per individual loan transaction.¹⁰ From the perspective of diversifying credit exposures, the number of syndicated loans among funds has been growing, with similar trends evident between listed and non-traded BDCs (Charts 15 and 16).¹¹ The increase in common exposures could potentially spread the stress affecting specific borrowers or certain funds more broadly.¹²

[Chart 16] Overlapping New Loans among BDCs

<CY2022>



<CY2024>

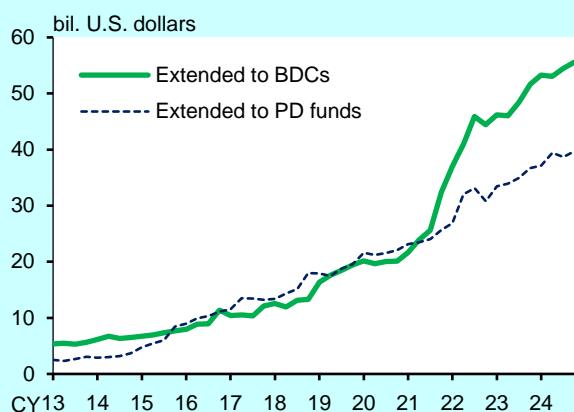


Note: Based on deal data. Shows five or more overlapping cases of new loan transactions in the relevant year.
Source: KBRA DLD.

Interconnectedness between the Banking Sector and Direct Lending

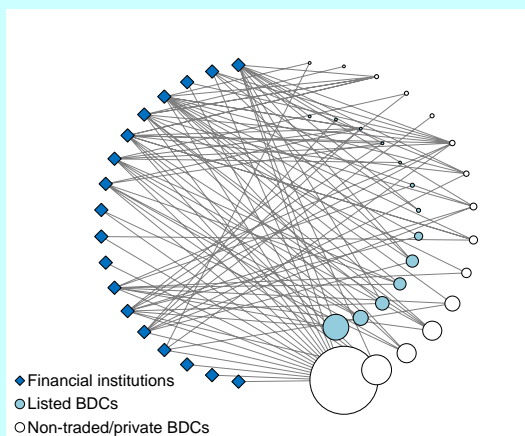
From the perspective of interconnectedness between the banking sector and NBFIs, which is one of the key financial stability concerns related to NBFIs, the increase in loans extended by U.S. banks to private credit draws attention.¹³ In fact, the amount of credit lines set for PD funds and BDCs has increased significantly since 2022, indicating a heightened level of interconnectedness (Chart 17). Regarding the past drawdowns on credit lines for BDCs, it has been noted that the amount drawn increased during the pandemic, reflecting heightened demand for liquidity funding by borrowing firms, and in the period of rising interest rates in the United States, and that the upper limits were raised in many cases. Moreover, exploratory analysis conducted in the Federal Reserve's stress test for 2025 examined the impact of a deterioration in the creditworthiness of borrowers of PD funds and BDCs following the global recession, as well as the spillover effects on the banking sector caused by the expansion of drawdowns on lines of credit, similar to those observed during past shocks.¹⁴

[Chart 17] Loans Extended by U.S. Banks to Private Credit



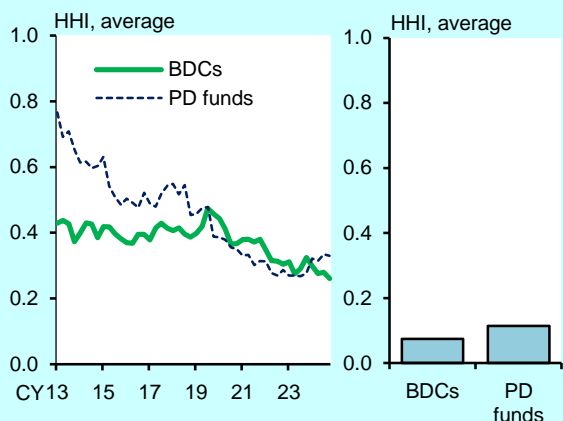
Note: Includes credit lines. Latest data as of December 2024. Source: Fed.

[Chart 18] Network Diagram of Loans to BDCs



Note: Circle size indicates the AUM of BDCs. Covers major BDCs and financial institutions in the United States, Europe, and Japan. Data as of June 2025. Source: SEC.

[Chart 19] Concentration of Loans to BDCs and PD Funds <U.S. banks> <Japanese banks>



Note: Latest data for the left-hand chart are as of December 2024. Data for the right-hand chart are as of March 2025 (covers three major Japanese banks). Shows the degree of concentration (average figure of individual bank) based on the share of loans to each BDC and PD fund. Source: Fed; BOJ.

There are also issues related to common exposures among banks, such as lending by multiple banks to a specific PD fund or BDC. A network diagram of loans to BDCs based on disclosure documents (Form 10-Q) indicates that financial institutions, including Japanese banks, are providing credit lines to multiple borrowers, particularly to BDCs with large asset sizes (Chart 18).¹⁵ This suggests that stress on a specific BDC is more likely to spread to multiple financial institutions. However, a look at the concentration levels of U.S. banks' lending to BDCs and PD funds reveals a gradual declining trend in both cases. Moreover, in the case of Japanese banks, the concentration levels are considerably lower than those of U.S. banks (Chart 19).

Concluding Remarks

This paper has outlined recent developments in the U.S. private credit market, which has been expanding rapidly in recent years, with a particular focus on direct lending by BDCs. Key considerations and issues regarding financial stability can be summarized as follows:

First, the banking sector's exposure to direct lending remains limited in both the United States and Japan, and there has been no significant materialization of credit risk so far, at least based on the available data. However, in addition to common exposures among banks, there has been an increase in common exposures among BDCs due to syndicated loans. Thus, stress at specific entities could more easily spread throughout the entire financial system.

Second, regarding the frequently noted lack of transparency in the management practices of the direct lending market, the expansion of BDCs, which are required to disclose documents quarterly, could be contributing to improving transparency to a certain degree.

Third, the broadening of the investor base, occurring in tandem with increased transparency in management practices, may be altering the liability structure of private funds. In particular, in recent years, driven by investors' demand for portfolio diversification, the proportion of funds raising capital from retail investors -- mainly non-traded BDCs -- in the direct lending market has been increasing. While the risk of concentrated redemptions is considered to be limited given the redemption restrictions, close monitoring of the extent to which such funds can maintain resilience during periods of stress is necessary.

The Bank of Japan regularly assesses changes in the size of the NBFIs sector, including private funds, and the underlying factors in the *Financial System Report*. Additionally, the Bank has been addressing challenges related to the management and monitoring of the NBFIs sector through various international initiatives.¹⁶

Going forward, the Bank will continue these efforts while enhancing its understanding of how recent changes in the NBFIs sector might alter the risks inherent in the financial system.

¹ Recently, it has been noted that the expansion of private credit reflects a response to various funding needs, such as those for consumers -- in addition to firms -- and for real assets.

² For instance, the following prior study pointed out that loan maturities of direct lending are relatively long compared to bank lending: Haque, S., S. Mayer, and I. Stefanescu, "Private Debt versus Bank Debt in Corporate Borrowing," *Proceedings of the EUROFIDAI-ESSEC Paris December Finance Meeting 2024*, May 2024.

³ For details, see Cai, F., and S. Haque, "Private Credit: Characteristics and Risks," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, February 2024.

⁴ BDCs are governed by the Investment Company Act of 1940, which requires them to invest at least 70 percent of their assets in small and medium-sized firms in the United States, etc.

⁵ Strategies other than direct lending include providing subordinated loans (Mezzanine), lending to distressed firms (Distressed Debt), and providing loans by leveraging unique corporate management circumstances, such as M&A (Special Situations). For details of developments in PD funds, which primarily provide loans, see, for example, Kuroda, K., H. Hasebe, S. Ito, and D. Ikeda, "Private Debt Funds: What They Are and Trends under Interest Rate Hikes," Bank of Japan Review Series, no. 2024-E-1. Also see Takemura, K., Y. Iwamura, and M. Kutsunugi, "Recent Developments in Private Funds -- Increasing Presence of PE and PD Funds and Their Recent Traits," Bank of Japan Review Series, no. 2026-E-3.

⁶ For example, see Avalos, F., S. Doerr, and G. Pinter, "The Global Drivers of Private Credit," BIS Quarterly Review, March 2025.

⁷ Leveraged loans and HY bonds are marked to market, whereas direct lending is generally based on fair value assessment, primarily centered around BDCs. Therefore, when making comparisons, they should be interpreted with considerable latitude.

⁸ For example, the following report indicates that there is no significant difference in the default rates between PD funds and BDCs, using loan-level data from U.S. financial institutions; Berrospide, J., F. Cai, S. Lewis-Hayre, and F. Zikes, "Bank Lending to Private Credit: Size, Characteristics, and Financial Stability Implications," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, May 2025.

⁹ One of the factors behind this is the practice in direct lending of maintaining close relationships with borrowers and setting detailed covenants, enabling early identification of credit deterioration and proactive engagement in efforts to improve their business. Notably, regarding the debt repayment capacity of investee firms of foreign PE funds, the default rate of leveraged loans, which are frequently utilized during LBOs, has somewhat increased, including factors such as modifications to repayment terms.

¹⁰ Amid the increasing size in deals, the proportion of covenant-lite agreements, which loosen restrictions on borrowers, has

risen reflecting intensified competition both with bank loans, such as leveraged loans, and among funds. However, while this proportion exceeds 90 percent in the leveraged loan market, it remains at around 30 percent even for relatively large transactions in the direct lending market, suggesting that relatively strict risk management practices are being implemented.

¹¹ The number of edges (connections between nodes) in the network diagram has been rapidly increasing, with 137 in 2022, 202 in 2023, 310 in 2024, and 238 in 2025.

¹² That said, according to exploratory analyses conducted in the Federal Reserve's stress test, even under assumptions of a one-notch rating downgrade or full drawdowns of credit lines across the entire NBFIs sector, the reduction in banks' CET1 ratios is expected to remain relatively limited at approximately 1.6 percentage points.

¹³ In addition to the direct channels through lending, there has been an increase, particularly among financial institutions in the United States and Europe, in the use of Synthetic Risk Transfers (SRTs) -- transactions aimed at reducing capital costs by transferring the credit risk of held loan assets to investors such as pension funds and hedge funds. It has been pointed out that cases where PD funds act as buyers in such transactions indirectly strengthen the interconnectedness between banks and PD funds. In addition, identifying exposures and leverage when institutional investors, such as those investing in PE and PD funds, as well as borrower firms, are taken into account has become complex. For details, refer to Cai and Haque (2024) mentioned above.

¹⁴ As mentioned above, an assumption is made in which drawdowns on lines of credit expand in a manner similar to that observed during the pandemic. Specifically, funds make additional drawdowns from banks' credit lines to address the increased utilization of lines of credit triggered by the deterioration in business conditions of borrower firms.

¹⁵ It should be noted that disclosure materials are not always comprehensive, as they may only present major financial institutions.

¹⁶ For details on Japanese financial institutions' exposure to foreign private funds, see Box 3 in the April 2025 issue of the *Financial System Report*.

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