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The Expansion and Diversification of Private Credit Funds

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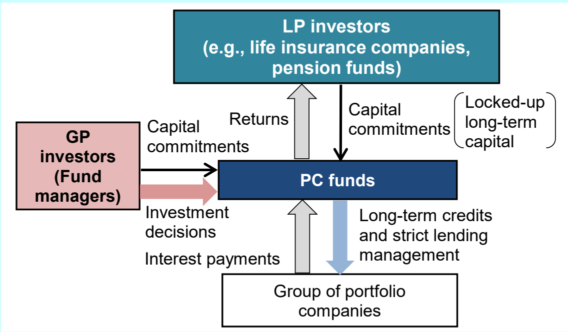
The private credit (PC) fund market has been expanding, particularly in the United States. The core strategy of PC funds has typically involved raising long-term capital from institutional investors and providing direct lending, primarily to medium-sized and small companies with lower creditworthiness, under strict credit management. However, in recent years, continued capital inflows have intensified competition among funds engaged in corporate lending, leading some to change their lending conditions. PC funds are diversifying in both asset types and structures; asset-based finance (ABF) funds backed by cash flows from specific assets and semi-liquid funds targeted at retail investors are growing. This suggests a shift in the risk profiles of some PC funds. In Japan, as financial institutions and institutional investors have been strengthening their interconnectedness with PC funds through investment and lending, it is necessary to pay attention to the shifting risk profiles and closely monitor the PC funds' investment practices as well as their credit developments.

Introduction

Private funds are investment vehicles that raise capital from investors through private placements. Among these, the recent expansion of private credit (PC) funds has drawn particular attention. While there is no common definition, PC funds are generally understood as funds that provide direct lending mainly to medium-sized and small companies with lower creditworthiness.[1] Their assets under management (AUM) have significantly increased, particularly in the United States. This growth has been driven by investors' search for yield in a low-interest-rate environment following the global financial crisis, as well as stricter financial regulations on banks.[2]

Most PC funds provide long-term credit to borrowers, funded by closed-end capital raised from institutional investors. Such investors are considered to have a higher degree of risk tolerance for long-term investments, and the closed-end structure restricts early redemptions. PC funds enhance returns by lending to medium-sized and small companies that pose relatively higher risk, while managing lending through the use of strict lending conditions and covenants. This structure appears to have effectively mitigated liquidity and credit risks thus far (Chart 1). However, in recent years, continued capital inflows have led to intensified lending competition among PC funds as well as diversification of their strategies and structures, which has, in turn, prompted changes in the risk profiles of some PC funds.

[Chart 1] Structure of PC Funds



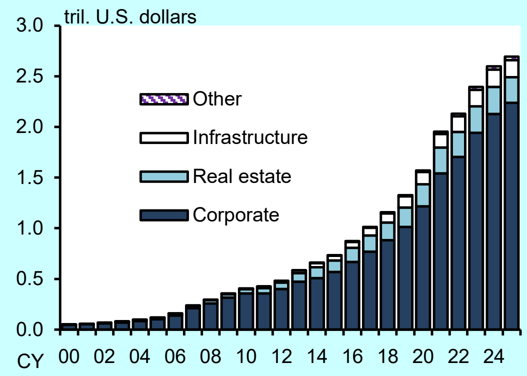
Note: GP (General Partner) investors are the management entities responsible for fund operations and investment decisions. LP (Limited Partner) investors are institutional investors that provide capital to the fund.
Source: BOJ.

This paper focuses on structural changes in the PC market and examines their implications for the stability of the financial system. Specifically, it reviews the developments in funds that extend credit to corporates, which is a core strategy of PC funds, and examines the possibility of changes in the competitive environment and lending conditions. In addition, it outlines the diversification of investment targets, investor segments, and fund structures, providing recent characteristics and changes in risk profiles. In light of the growing number of communications from overseas financial authorities, this paper also examines the key considerations for financial system stability.

Trends in Corporate Private Credit Funds Focusing on Direct Lending

PC funds are often defined narrowly as funds that lend to corporate borrowers, but the term is sometimes used more broadly to include funds that extend credit outside the corporate sector, such as those engaged in real estate and infrastructure lending, or asset-based finance (ABF). In the broadly defined PC market, although the asset size of funds focusing on credit to non-corporate borrowers has been expanding, corporate private credit funds remain the core of the market (Chart 2).

[Chart 2] AUM of PC Funds by Investment Strategy



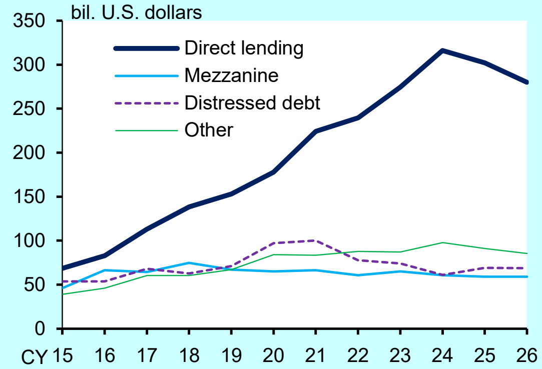
Note: Includes BDCs (Business Development Companies). **Excludes ABF funds**.

Source: Preqin; S&P Global Market Intelligence.

Among corporate private credit funds, the direct lending strategy -- which provides senior loans to medium-sized and small companies -- has been the main strategy leading the PC market expansion. As mentioned earlier, while the strategy has managed credit risk by establishing strict lending standards, continued capital inflows from investors may have shifted the competitive environment and the lending conditions within some PC funds.

In the direct lending strategy, dry powder -- capital committed by investors but not yet allocated to lending opportunities -- has significantly increased due to rapid capital inflows and remained high (Chart 3). At the same time, lending spreads have shown a narrowing trend, and the number of covenants -- legal clauses included in loan contracts that stipulate the obligations and restrictions on the part of borrowers -- is decreasing, which implies the easing of lending conditions (Charts 4 and 5). These developments suggest that funds' lending capacity has outpaced corporate borrowing demand, leading to intensified competition among funds for lending opportunities. Borrowers' bargaining power over lenders (i.e., the funds) appears to have strengthened, which may have led to some loosening of credit standards. While the number of fund managers continues to rise, the share of large-scale funds in total fundraising is on an increasing trend, suggesting a further intensification of competition particularly among medium-sized and small funds (Chart 6).

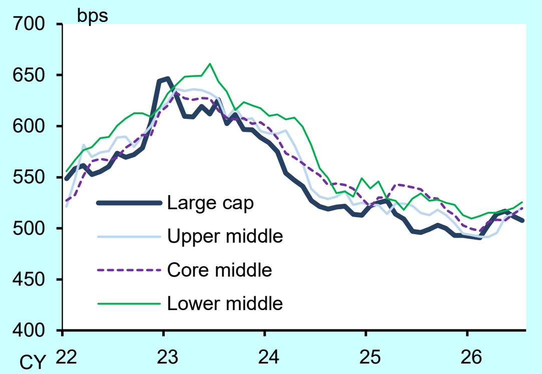
[Chart 3] Dry Powder of PC Funds



Note: Figures for 2026 are as of June 2026.

Source: Preqin.

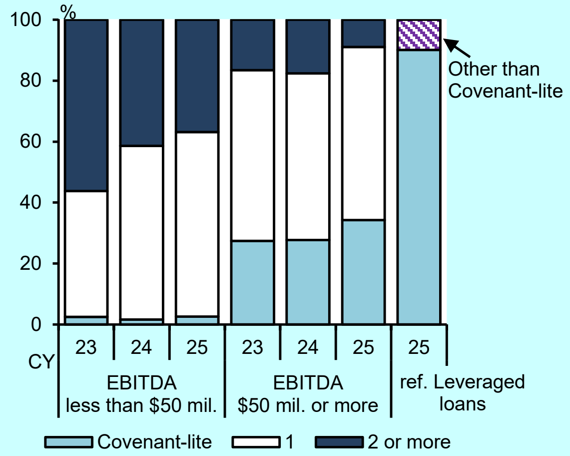
[Chart 4] Direct Lending Spreads



Note: 3-month rolling averages of first-lien term loans. "Large cap" refers to companies with EBITDA of $100 million or more, "Upper middle" to $50 million to $100 million, "Core middle" to $20 million to $50 million, and "Lower middle" to less than $20 million. Latest data as of July 2026.

Source: KBRA.

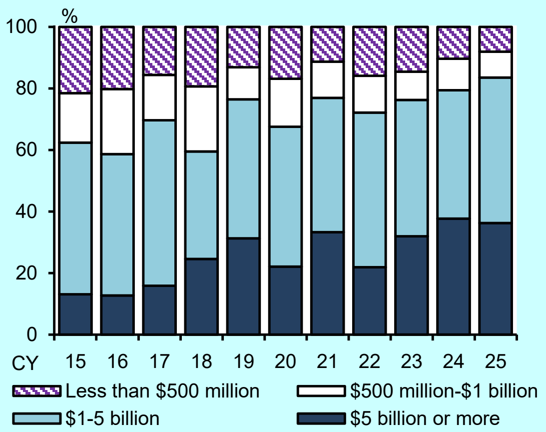
[Chart 5] Covenants Prevalence in Direct Lending



Note: Based on the number of covenants attached to new direct lending deals, backed by PE sponsors. "Covenant-lite" refers to loan agreements with relaxed covenants. Leveraged loan data is based on calculations by the Bank's staff using PitchBook data.

Source: KBRA; PitchBook Data, Inc.

[Chart 6] Fundraising Trends by PC Fund Size

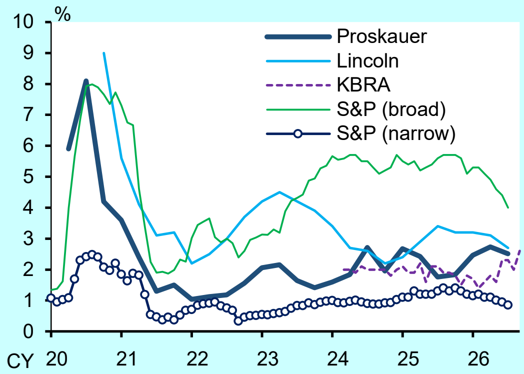


Note: Covers corporate lending, real estate, and infrastructure funds. Based on calculations by the Bank's staff using PitchBook data.

Source: PitchBook Data, Inc.

Against this background, developments in the creditworthiness of portfolio companies are drawing attention. While default rates of portfolio companies vary across data sources, owing to differences in the fund coverage and the methods used to aggregate defaults (e.g., number or amount basis, and inclusion of loan modifications), no significant deterioration appears to have occurred (Chart 7). In addition, among payment-in-kind (PIK) loans, where borrowers defer interest payments and repay both the interest and principal as a lump sum at maturity, the rising proportion of ex-post PIK loans, or so-called bad PIK loans, warrants attention. Ex-post PIK loans are loans in which PIK clauses have been newly incorporated or implemented following loan execution during the term of an existing loan (Chart 8). Although PIK loans enable companies with high growth potential to defer interest payments and allocate capital toward investment opportunities, some ex-post PIK loans indicate that portfolio companies may be facing heightened risks, such as a decline in borrowers' liquidity.

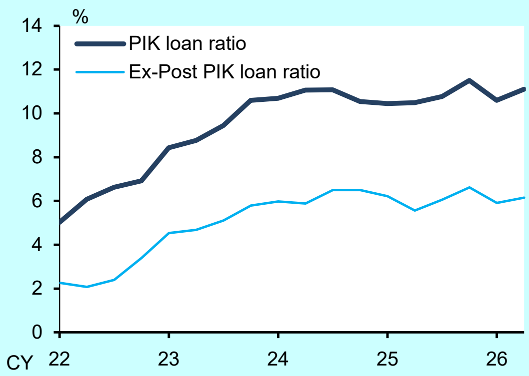
[Chart 7] Default Rates of PC Funds' Portfolio Companies



Note: The default rate of Proskauer is that of direct lending. Lincoln covers 5,750 companies, including those backed by PE sponsors. KBRA primarily covers BDCs. S&P's broader definition of default includes measures such as PIK conversions and repayment deferrals. Latest data as of April-June 2026 for Proskauer and Lincoln, June 2026 for S&P, and August 2026 for KBRA.

Source: Proskauer Rose LLP; Lincoln International; KBRA; S&P Global Market Intelligence.

[Chart 8] PIK Loan Ratio and Ex-Post PIK Ratio

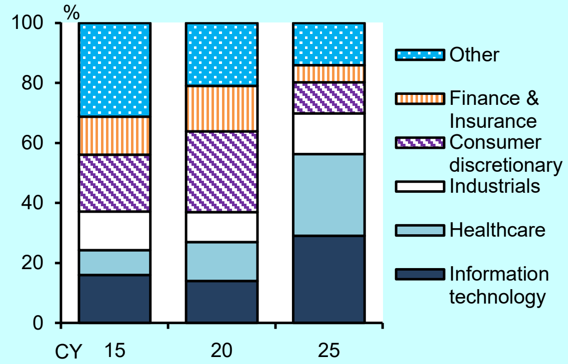


Note: Covers loans from PC funds to portfolio companies of PE funds. On a count basis. Latest date as of April-June 2026.

Source: Lincoln International.

In cases where the business performance of PC funds' portfolio companies deteriorates significantly, fund managers may undertake measures such as loan restructuring or debt reorganization, commonly referred to as "workouts," to facilitate long-term recovery of their investment. If the high-interest rate environment persists, the success of workouts will matter more; yet with the increase in fund managers noted above, workout ability is likely to vary across funds. In particular, it has been pointed out that PC funds have increasingly expanded their lending to software and AI infrastructure companies, which are sectors characterized by rapid changes in business conditions. It is necessary to closely monitor both the portfolio companies' credit quality and the corresponding responses of PC funds (Chart 9).

[Chart 9] Industry Composition of Firms Borrowing from PC Funds



Note: Covers corporate lending. On a deal basis.
Source: Preqin.

Diversifying PC Market

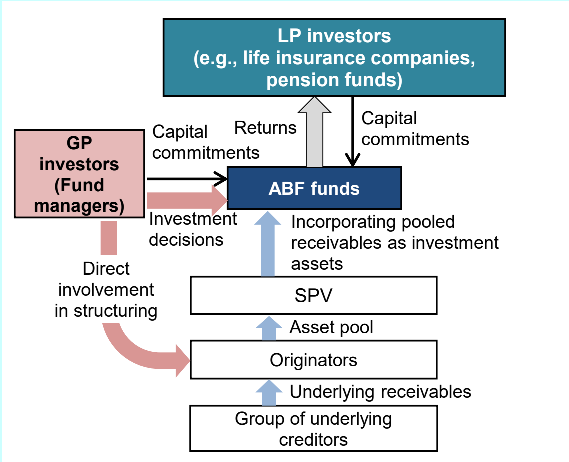
Investment strategies in the PC market remain centered on direct lending; however, diversification in investment targets, investor segments, and fund structures have been advancing. This section provides an overview of recent developments, focusing on the expansion of ABF funds and the growth of semi-liquid funds, which are mainly targeted at retail investors.

Diversification of Investment Targets: ABF Funds

In recent years, ABF funds have attracted attention as a growing area within PC. Although there is no universally established definition of ABF in the industry, the term often refers to credit strategies backed by specific assets or cash flows other than corporate credit. The potential market size for ABF is estimated to be around 5 to 6 trillion U.S. dollars, and the underlying assets include a wide range of categories, such as consumer credit (e.g., auto loans), commercial credit (e.g., leases and accounts receivable), fund finance, real estate and housing related assets, aircraft and infrastructure, as well as litigation claims and royalties.[3] The growth of ABF funds can be attributed to the increased investor demand for diversification within PC portfolios, following the rapid expansion of corporate private credit funds, as well as funds' efforts to expand into strategies beyond direct lending, where competition has intensified.

ABF funds typically invest in asset pools composed of small-scale receivables, and while the performance of corporate private credit funds is primarily influenced by the business conditions of their portfolio companies, the performance of ABF funds depends on the cash flow generated by the underlying assets, ongoing management, and their legal structure, including bankruptcy remoteness and collateral protection (Chart 10). Although both ABF funds and asset-backed securities (ABS) are backed by asset pools of small-scale receivables, ABS are standardized, liquidity-oriented securitized products, whereas ABF funds are said to achieve relatively higher spreads, reflecting fund managers' practice of negotiating with originators and designing flexible structures.[4]

[Chart 10] Structure of ABF Funds



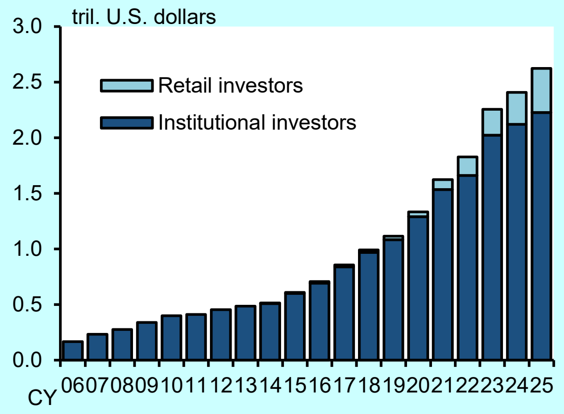
Source: BOJ.

At present, the scale of ABF funds accounts for only a few percent of potential underlying assets.[5] However, many expect that ABF funds will serve as a driver for the expansion of the PC market going forward. That said, ABF fund managers are required to possess a deep understanding of the market for the underlying assets, the characteristics of borrowers, and legal structures, as well as advanced collateral management skills, which are different from those needed for corporate private credit. Accordingly, it has been noted that ensuring quality remains a challenge in the current phase of rapid market expansion.

Diversification of Investors and Fund Structures: Semi-Liquid Funds for Retail Investors

PC funds have historically grown mainly through investment capital provided by institutional investors, but investments by retail investors have also been increasing (Chart 11). This has been attributed to fund managers responsible for establishing and administering their funds having sought to expand their AUM and management fees by cultivating new investor segments. PC funds, as income-oriented vehicles that aim to make regular distributions to investors, are also said to be well-suited to retail investors.

[Chart 11] AUM of PC Funds by Investor

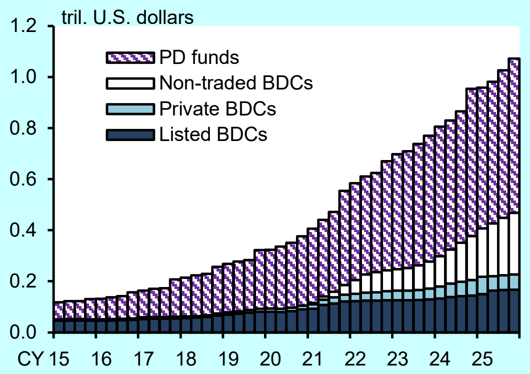


Note: "Institutional investors" includes insurance companies (estimates by PitchBook). Based on calculation by the Bank's staff using PitchBook data.

Source: PitchBook Data, Inc.

Amid these developments, there has been a capital inflow into semi-liquid funds to meet the needs of retail investors seeking some liquidity, allowing redemptions within a certain range on a monthly or quarterly basis. Non-listed business development companies (BDCs) in the United States are one example of such funds. These non-listed BDCs, while accounting for approximately 20 percent of the North American direct lending market, have expanded more rapidly than closed-end funds (Chart 12).[6] Other examples of semi-liquid funds are interval funds in the United States, which are investment funds that accept redemptions at fixed intervals, as well as European Long-Term Investment Funds (ELTIFs). These semi-liquid funds often target affluent retail investors as their primary investor segment. Generally, these funds adopt somewhat conservative management strategies to accommodate redemption requests and maintain liquid assets as cash buffers, and as a result, their returns tend to be slightly lower compared to closed-end funds.

[Chart 12] Total Assets of Direct Lending by Category



Note: Covers the North American region. Latest data as of end-December 2025.

Source: Preqin; S&P Global Market Intelligence.

Semi-liquid funds face redemptions in response to investor requests, and liquidity management is therefore relatively important. In this respect, semi-liquid funds exhibit different risk profiles compared to closed-end PC funds. However, in addition to the liquid assets held by these funds, interest and principal payments received regularly from borrowers can also be used as sources of funds for redemptions. Furthermore, the fund managers have a certain degree of discretion in determining the scale of redemptions. Reflecting on these features, at present, concerns regarding the liquidity risk of semi-liquid funds are generally considered to be limited.

On the other hand, with the increasing number of retail investors who are considered to have relatively low risk tolerance for long-term asset management, there is a possibility that redemption pressure on funds might persist at elevated levels beyond the funds' assumptions, as well as a possibility that, during a period of stress, the impact could spread to a broader range of investor segments compared to the past. While the majority of PC funds remain closed-end, it is important to monitor future developments regarding semi-liquid funds and retail investors.

Views of Overseas Authorities and International Organizations on the PC Market

In response to the rapid expansion of the PC market in recent years, overseas authorities and international organizations have been conducting a range of analyses and issued communications from a financial stability standpoint. The remainder of this section organizes the key considerations raised in these discussions.

First, PC funds are strengthening their interconnectedness with private equity (PE) funds, banks, insurance companies, and others through investment and financing relationships and fund financing. Therefore, there is a view that the impact of credit deterioration in the portfolio companies of PC funds on these entities could be larger than before.[7]

Second, there is growing attention to the resilience of PC during downturns in the credit cycle. As mentioned earlier, the increased flexibility in lending conditions, such as the use of PIK and the relaxing of covenants, may be delaying the materialization of credit deterioration. On this point, there is a shared understanding among authorities that default rates are lagging indicators and require careful interpretation, taking modifications to lending terms and other factors into consideration.[8]

Third, there are risks arising from the concentration of lending in particular sectors. With PC funds rapidly expanding their lending to AI and SaaS sectors, it has been argued that default rates in the PC market could rise if these sectors enter an adjustment phase.[9]

On the other hand, discussions are also taking place regarding the role that PC funds play in the financial system as providers of long-term risk capital. PC funds remain predominantly closed-end, enabling mitigation of liquidity risks compared to banks that rely mainly on deposits for funding. Some argue that they are better suited to providing long-term credit to high-risk entities[10] and claim that it is important to maintain a distinction between the roles of banks and non-banks in this regard.[11] Taking these discussions into account, efforts are being made to establish a comprehensive framework for assessing how PE and PC funds might impact macro-level financial stability and the real economy under stress scenarios.[12]

Conclusion

This paper has focused on structural changes in the PC market, examining the developments in corporate private credit, the changes in risk profiles considering the diversification of the asset types, segments of investors, and fund structures, as well as reviewing the risk perceptions of overseas authorities and international organizations.

In direct lending, a core strategy for corporate private credit, competition among funds has intensified due to the accumulation of dry powder, and there are indications that some relaxation of the strict lending standards traditionally associated with this strategy has taken place. Although data constraints on the borrowers' credit conditions are considerable, gaining an accurate picture of the situation remains an important challenge, particularly in light of the increased use of PIK loans.

From the perspective of market structure, the rapid growth of ABF funds and the entry of retail investors into semi-liquid funds are diversifying the risk profiles of PC. For ABF funds, attention needs to be paid to risks that differ from corporate credit risks, such as those arising from the management of underlying assets and the associated legal structures. For semi-liquid funds, it is necessary to not only manage liquidity risks but also consider the characteristics of retail investors.

Against the backdrop of increasing interconnectedness in the financial system and the untested resilience of PC through downturns in the credit cycle, overseas authorities and international organizations are paying increased attention to the PC market. Yet, it is also recognized that PC can serve as a provider of long-term risk capital, making the balance between market growth and financial stability an important point of discussion.

In Japan as well, domestic institutional investors, including banks, life insurer, and pension funds, are expanding their exposure to PC as part of their alternative asset investments. Furthermore, Japanese financial institutions, particularly major banks, are strengthening their linkages with the PC market through fund financing.[13] Against this backdrop, the need to accurately identify structural changes in the overseas market and the sources of risk has grown. In addition to focusing on traditional corporate credit risks, it is necessary to continue multifaceted monitoring in line with the market's expansion and diversification -- including the risks associated with underlying assets of ABF funds, liquidity risks in semi-liquid funds, and sector concentration risks. At the same time, attention to how these developments may be transmitted to Japan's financial system, will take on greater importance.

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* Currently at the Payment and Settlement Systems Department.

[1] The Financial Stability Board (FSB) (2026) states that, while there is no common definition, a narrower definition of PC refers to non-bank direct lending to medium-sized companies negotiated on a bilateral basis. For details, see FSB (2026) "Report on Vulnerabilities in Private Credit."

[2] For detailed information on PC funds' lending methods and past developments, see, for example, the following papers.

Naono, M., and Watanabe, S., "Lending Practices of Private Debt Funds: Traits of Direct Lending," Bank of Japan Review Series, no. 22-J-1, 2022 (available in Japanese)

Kuroda, K., Hasebe, A., Ito, S., and Ikeda, D., "Private Debt Funds: What They Are and Trends under Interest Rate Hikes," Bank of Japan Review Series, no. 2024-E-1, 2024

Takemura, K., Iwamura, Y., and Kutsunugi, M., "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, 2026.

Okubo, T., Kaido, Y., Yamamoto, K., Washimi, K., "Evolving Trends in Business Development Companies (BDCs) in the U.S. Direct Lending Market," Bank of Japan Review Series, no. 2026-E-1, 2026

[3] The perspectives on the market size of ABF vary across industry players, and there is no unified view on the matter. For example, according to Oliver Wyman (2024) "Private Credit's Next Act," the total outstanding pool of assets eligible for ABF in the United States, excluding residential and commercial real estate, is approximately 5.5 trillion U.S. dollars. In addition, according to KKR (2025) "Asset-Based Finance: Private Credit Hidden in Plain Sight," the private financial assets originated and held by non-banks based globally, related to household and business credit, excluding loans securitized, amounted to 6.1 trillion U.S. dollars in 2024.

[4] According to J.P. Morgan Private Bank (2026) "The Good News behind the Bad Private Credit Headlines," ABF offers roughly a 200-250 basis points premium compared to ABS.

[5] For example, Oliver Wyman (2024) notes that PC finances 3 percent to 5 percent of the ABF market in the United States.

[6] For details on the presence of retail investors in PC funds and redemption rates of non-traded BDCs, see Box 1 of the April 2026 issue of the *Financial System Report*.

[7] Governor Cook of the FRB (Cook, 2025) recognized that the interconnectedness between banks, insurance companies, and PC are becoming increasingly complex while also deepening, leading to an expansion of the transmission channels into the financial system. Similarly, Vice President Luis de Guindos of the European Central Bank (ECB) (ECB, 2025) noted that banks have important exposures to PE, PC, and hedge funds, and caution should be paid to the spillover risks during a time of stress. For further details, refer to the sources below.

Cook, L.D. (2025) "A Policymaker's View of Financial Stability," Speech at Georgetown University's McDonough School of Business Psaros Center for Financial Markets and Policy, Washington, D.C.

ECB (2025) "Interview with El Periodico," Interview with Luis de Guindos, Vice-President of the ECB, conducted by Pablo Allendesalazar.

[8] Cook (2025) noted regarding portfolio companies of PC funds that "Default rates remain low, but they are a backward-looking measure and could also reflect increased usage of payment-in-kind arrangements, or PIKs; loan amendments; and distressed exchanges." Meanwhile, the FSB (2026) pointed out that "Default rates of private credit borrowers are low but are showing an upward trend when using broader measures, such as selective defaults and distressed exchanges."

[9] For example, Chapter 1 of the April 2026 issue of the IMF's Global Financial Stability Report points out that, in the event of a significant shock, the broad default rate for direct lending claims could reach two to three times the levels observed in recent years.

[10] For example, Avalos, Doerr, and Pinter (2025), in the BIS Quarterly Review, March 2025, suggest that compared to banks, which are primarily financed via short-term deposits and uninsured deposits, which are prone to runs, PC funds, with their closed-end structure, may be better positioned to hold long-term loans. For details, see the following.

Avalos, F., Doerr, S, and Pinter, G., (2025) "The global drivers of private credit," *BIS Quarterly Review*, March, pp. 13-30.

[11] For details see the following.

Bank of England (BOE) (2025) "Challenges to financial stability -- Speech by Andrew Bailey" Given at the Klaas Knot Farewell Symposium.

[12] Specifically, initiatives such as the BOE's SWES 2.0 (System-Wide Exploratory Scenario) can be cited. This initiative involves the participation of traditional asset managers, alternative asset managers, large banks, and institutional investors in exploring the resilience of the funding provision from both private and public market to the UK corporate sector. The initiative is expected to be completed in 2026, with a report planned for release in early 2027.

[13] For details on Japanese banks' investment and domestic institutional investors' exposure to foreign private funds, see Box 3 of the April 2025 issue of the *Financial System Report*, and Ogawa, Y., Jimbo, M., Matsui, Y., and Washimi, K., "International Comparison of Life Insurers: Evolving Business Models and Financial Stability Issues," Bank of Japan Review Series, no. 2026-E-7, 2026.

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