The New Paradigm (Fourth of a Series)

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Why is private credit getting called out for potential bubbles and systemic risk when banks have been the ones failing? We posed that question to Van Hesser, the chief strategist for KBRA. Mr. Hesser produces a weekly podcast, "Three Things in Credit." His October 27th conversation about private credit, capital markets and the economy caught our attention.

"It's a reflection of what's new," he told us in our latest *Private Capital Call* podcast. "Post GFC regulators very successfully de-risked the banking system. We've seen a lot of capital coming into private capital markets over the past decade or so. The rush of money into that space gives some pause as they try to figure out is this a good or bad thing.

"We think this is a positive evolutionary step in the financial system. It takes the risk out of the hands of the twelve or so largest global banks, who cede control of their decision-making to regulators in times of stress. You've pushed and defused that risk across the globe into a thousand institutional investors. That's a much better shock absorber.

"The other thing we like," Hesser continued, "is you get out of short-funded banks with illiquid, long-term assets and move them to a more prudent funding framework with long-term, locked-up money holding those assets. That's a real improvement that will dampen the volatility of the credit cycle. We'll need to see this through a cycle, and it doesn't mean there isn't riskier lending out there. It just means it's in a much better place and funded in a much better way."

What about public credit such as broadly syndicated loans and high-yield bonds? Critics look at higher default rates in those markets and suggest things will be worse for private credit.

"The wisdom of crowds cuts both ways," he said. "Even in the investment grade markets, if they get a whiff of China slowing or the Fed hiking rates – particularly at dealer desks which are a lot smaller than they used to be relative to the markets they support – the public markets can be quite volatile around headlines. Private credit isn't going to be affected by every zig-and-zag.

"You are long-term lenders in there ready, willing, and able to work with borrowers to ride out their business over a long period of time. That is fundamentally different than the public market in all of its 'wisdom' is willing to treat the BSL market. It's apples and oranges. We want to be aware of what markets are telling us, but you have to be careful about taking that signal and applying it blindly to the private markets. They're really different."

You can extend that comparison to defaults rates, we suggested. The behavior of publicly traded loans with no financial covenants is not the same as illiquid loans with covenants.

"Twelve to eighteen months ago," Hesser said, "there was a broad consensus we were headed into a recession, and recessions aren't good. Recessions cause ten percent default rates in leveraged loans, and why is this one going to be any different? Well, we learned in 2023 why this one was different."