

## Theory Meet Practice

### Private Assets

## Episode 2: Rethinking Private Credit with David Robinson

### Transcript

Wendy	Private credit looks like debt, but it acts like equity.
David	They invest much more like a private equity firm than like a bank.
David	If we approach them with a bank regulatory framework in mind, I think we're likely to make important mistakes from the outset.
TITLE CARD	
Wendy	<p>Hello everyone, welcome back to <i>Theory Meet Practice</i>, where we explore how academic research can help investors make smarter decisions.</p> <p>Private credit has exploded over the last decade. It's often described as "shadow banking" - a safer, higher-yield alternative to traditional loans.</p> <p>But is this description missing the point entirely?</p> <p>Today, I'm thrilled to be speaking with Professor David Robinson from Duke University, whose latest research unpacks why private credit might actually have more in common with private equity than traditional lending.</p> <p>Hi David, it's wonderful to see you here.</p>
David	It's great to be here, thanks for having me.
Wendy	<p>In your paper, <i>'Why is private lending so popular?'</i>, you highlight a paradox:</p> <p>Private credit looks like debt, but it acts like equity.</p> <p>That paradox makes this market so interesting. Private credit has grown dramatically, yet many people still think of it as "shadow banking."</p> <p>David, why is private credit often viewed that way?</p>
David	<p>Well, it's easy to forgive people for thinking it's shadow banking when it's got the words credit and lending in the very name of it.</p> <p>When we look at BDCs, we look at private credit, we see that they invest with a mix of traditional loans, and then non-traditional kind of hybrid securities - common equity, preferred equity, interest that has paid-in-kind elements to it. And so they operate from a much wider contracting space</p>

	relative to a bank. They invest much more like a private equity firm than like a bank.
Wendy	How do these hybrid securities with both debt and equity elements reshape the risk and the return picture of the private credit market, given its complexity?
David	<p>When you're talking about a private credit firm, they're investing with this hybrid security that has some loan-like features to it, but it also exposes them to the upside of the firm they're investing in to a much greater degree.</p> <p>How does it differ from banks? It looks much more like the risk and return profile of investing in private equity. They can generate return through current yield in the same way that a bank would, but they can also generate return by offering flexibility in the interest structure and by taking equity in the firms that they're investing in.</p>
Wendy	Talking about the complexity in these hybrid securities, as for allocators, how can they tell whether this complexity is genuinely useful versus a sign of a hidden risk?
David	Well, I mean, I think that's an important question. And one way we looked at this was, we said - if you thought that this complexity, this hybrid security that we were seeing in their portfolio - if that was really coming about because they were negotiating out of special situations, then the hybridization would evolve afterwards. That's not what we see. Most of these relationships - they start as complex hybrid investments that mix debt and equity from the outset.
Wendy	Yeah, great point. If it is designed at the beginning of the product, then it means it's more about genuinely useful features instead of a sign of financial distress.
David	<p>Yeah, yeah that's right. It suggests that the lender really knew the risks that they were facing at the outset - that these aren't evolving out because there's been a surprise.</p> <p>But at the same time, we do have to acknowledge that there's evidence that suggests that they are catering to a class of firms that would find it otherwise difficult to obtain traditional bank loans. So I think there's a mix of both.</p> <p>But I think the fact that firms are going into these investment relationships with hybrid securities really tells you that this complexity is really part of the plan from the outset.</p>
Wendy	So with the growth of private credit, how do you think institutional investors can make the most out of this opportunity?
David	<p>Yeah, this is a super interesting point.</p> <p>Institutional investors across the market, they all have different appetites for liquidity. Some investors can really afford to take a lot of liquidity risk. Other investors need to take less liquidity risk when they think about their allocations to PE. And so I think one of the things that private credit really offers investors is a way to earn PE-like returns, but with current yield that really reduces the liquidity risk that you're otherwise facing.</p>

	<p>And so I think mastering that component of it is going to be really critical, and I think it's going to offer up a lot of opportunities for investors of all types, whether we're talking about institutional investors or just the growing retail investment class.</p> <p>One of the things that we found was that the non-institutional investor base for BDCs has been growing a lot over the last 10-15 years, suggesting that BDCs are popular in the retail investment community. Private credit is going to play an incredibly important part of that story.</p>
Wendy	<p>So for policymakers, do you think it may have an impact with some more retail investors joining this community?</p>
David	<p>I think understanding the regulation of private credit is a super interesting and important point going forward from here. If we approach them with a bank regulatory framework in mind, I think we're likely to make important mistakes. What you've seen here in this market is lenders who are holding the maturity - risky loans rather than selling them out into the marketplace. And I think that's probably a net benefit in terms of decreasing systemic risk.</p> <p>But on the other hand, to the extent that we're appealing to retail investors, then we need to start asking questions about who is actually holding the risk that is represented in these investments. And so maybe we need to think about a regulatory framework that kind of balances insights from consumer financial protection with insights from standard bank regulation.</p>
Wendy	<p>That's an interesting point. Totally agree David, yeah. Given this equity element of private credit and also with more retail investors coming into the picture, the regulatory lens may need to adjust for this.</p> <p>Thank you so much. It's always a pleasure talking with you.</p>
David	<p>It's great to see you, Wendy. Thanks for having me.</p>