

Private credit in Australia

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1 Methodology

This report is a high-level review of the private credit market in Australia. Information for this report has been obtained from a variety of sources, and includes public and non-public information. As part of the work, a diverse group of more than 30 parties involved in or with knowledge of private credit were interviewed during a consultation process.

By the very nature of the private credit market, much information about borrowers, lenders, fund constructs, and credit exposures and terms is not readily available. Accordingly, the report is not intended to be an exhaustive examination of private credit in Australia.

The report does not provide an opinion on the merit or otherwise of investment models such as platforms, feeder vehicles or exchange traded funds (ETFs), nor on direct versus indirect investment.

A key focus for the report is to consider what good operating practices exist in the market and to suggest areas where they can be improved for the benefit of the private credit market overall and its participants.

References to superannuation in the report are made in the context of superannuation funds as investors, as opposed to the provision of superannuation to members.

In this report, the term 'manager' is used generically to refer to the entity managing the loan portfolio.

The report does not consider the quality of credit exposures in the Australian private credit sector, either at the sector level or at an individual fund or manager level.

2 Executive summary

Private credit, done well, has a valuable role to play in the Australian economy. It can make an important contribution to economic growth. Private credit complements other sources of debt financing for businesses, including banks and public markets. Its development has largely occurred since the global financial crisis (GFC) – when prudential regulators increased bank capital requirements on higher-risk, leveraged corporate lending, as well as real estate construction and development financing – and its growth has partly been supported by the growth in superannuation savings.

The Australian private credit market has grown in recent years and continues to grow strongly. The size of the market is estimated at around \$200 billion, approximately half of which is real estate-focused finance.

The funds with large superannuation and institutional investment, and the best international private credit managers operating in Australia, generally demonstrate sound governance, and transparent valuation and fee practices. Segments of the market targeting wholesale investors using the ‘sophisticated investor’ exemption and retail-based offerings, including platforms, have practices that do not compare favourably against international practice. Lenders in these segments are more likely to have conflicts of interest, opaque fee and interest margin arrangements, inconsistent and non-independent valuation methodologies, and ambiguous terminology. These practices are more prevalent in real estate-based funds. We have noted some improvement in practices over the past 12 months, as international managers have invested into local managers.

Investors in private credit are, in most cases, appropriately rewarded for taking sub-investment grade credit risk and maturity/liquidity risk; however, these risks are not always adequately described in offer documents and subsequent performance reporting.

While we have not assessed the systemic risk to the Australian financial system from private credit, we note the concentration in real estate construction and development finance, which has represented the majority of credit losses in past economic downturns in Australia and overseas. This segment of the market may present as a systemic risk for small and self-managed superannuation funds and ‘sophisticated’ investors in a downturn.

The concentration of Australia’s private credit market in higher-risk real estate construction and development is where we see the greatest area for improvement for investor protection and market integrity. This market segment has a higher concentration of investors using the wholesale sophisticated investor exemption, and with less transparency on conflicts of interest, manager remuneration disclosure, and valuations and portfolio reporting.

We have not assessed, and are not making a judgement on, whether managers are complying with their obligations under Section 912A of the *Corporations Act 2001* (Corporations Act) for Australian financial services licences (AFS licences) or managed investment schemes. We believe ASIC could consider whether additional guidance on the matters discussed in this report may be useful.

Ongoing trust and confidence in the sector will depend in part on the conduct and performance of all market participants, including managers, trustees, auditors, advisers, valuers, and research and fund rating houses.

This report highlights four key areas of operation that require improvement.

1. Conflicts of interest

Conflicts are prevalent across fee structures, valuations, related party transactions and loan structuring.

Fee incentives

Some managers retain 50–100% of upfront and other fees paid by borrowers or default-related fees. In borrower negotiations, this structure could be in conflict with maximising the interest margin to the benefit of the fund investors. In some cases, interest could potentially be paid from the loan capital.

Net interest margin capture

Lenders make use of Special Purpose Vehicles (SPVs) to lend to borrowers at higher rates than passed on to investors for the same discrete loan, with managers retaining the excess margin. This means the manager may be acting on behalf of investors and on their own account as the lending intermediary. It also means the true interest return for the risk being taken is not being passed on to investors, or is not completely transparent to investors, impacting their potential understanding and assessment of credit risk.

Related party transactions and independence

Loans to related developers or transfers between funds managed by the same group may be made without robust, independent valuation oversight. This can be compounded by a lack of independent governance in fund management.

Multiple capital stack exposures

Holding any combination of senior debt, mezzanine debt and equity positions in the same borrower can conflict decision making and actions during distress. While conflicts are not inherently detrimental, their existence increases risks for investors, without full disclosure, independent oversight and clear governance protocols.

2. Fees and remuneration

Fee and remuneration structures in the sector vary widely and are often opaque and not quantified.

Disclosure gaps

Many funds do not quantify total manager remuneration, particularly from borrower-paid fees and net interest margins, as a proportion of funds managed. Non-disclosed remuneration can be a multiple of up to three to five times the publicly disclosed fund management fees.

Inconsistency

International and some other managers typically pass all borrower fees to investors, as it is investor capital at risk, and as a result tend to have higher disclosed management fees. Many domestic funds retain 50–100% of borrower fees for the manager. The fee amounts are usually not disclosed and, as a result, these funds tend to have lower headline disclosed management fees.

Form of disclosure

Borrower-paid fees are often excluded from fee disclosures. This may see headline management fees significantly understated to investors for the total manager remuneration associated with managing the fund. It also makes direct comparisons between funds difficult. As a result, some investors may not be aware of the true cost of the fund.

Best practice, consistent with most international practice, is for borrower fees to be paid directly to fund investors, with managers charging transparent management fees needed to sustainably manage the funds through growth and downturn scenarios.

At a minimum, any remuneration received by managers from borrowers directly should be disclosed transparently to investors as a percentage of the fund assets. If these fees are not disclosed, the question asked should be ‘why not?’, as it is the investors’ capital at risk and the investors’ capital supporting the manager’s fee generation.

Potential misalignment

Short-tenor loans and restructures can increase the frequency of events that generate manager fees, creating incentives that are misaligned with investor outcomes.

3. Portfolio transparency and valuations

Valuation practices and portfolio disclosures are inconsistent. This may have implications for reported performance and investor risk assessments

Frequency

Many funds do not undertake quarterly valuations, and some rely on internal processes without independent review.

Independence

Internal valuations by credit staff or deal teams create conflicts where fees depend on those same asset values.

Methodology

In real estate lending, quoting loan-to-valuation ratios (LVRs) on completion value rather than cost can understate risk throughout the construction period. Outdated valuations may further distort credit metrics. Real estate valuations are often conducted on a gross rent rather than a net effective rent basis, inflating valuations. There can also be lack of clarity on whom the valuation was prepared for – the borrower, or the lender or securityholder.

Provisioning

Despite high sub-investment grade exposure, and higher-risk real estate construction and development financing, some funds report no impairments. This is surprising and inconsistent with rating agency expectations of 1 year probability of default, which can range between 0.5% and 15% on BB+ to CCC rated loans.

Portfolio reporting

A wide range of detail is supplied in portfolio reporting, from marketing-style documents to more granular portfolio reports, similar to listed and unlisted Business Development Company (BDC) reporting in the United States (US). We believe that industry views should be sought on the minimum portfolio reporting required, with some good examples in the Australian market. Such reporting should include, but not be limited to, credit and borrower concentrations, non-performing loans, and percentage of loans using payment in kind (PIK).

Portfolio distributions

Marketing material often focuses on regular, monthly distributions, which in some cases appear to be too consistent to reflect the risks and lack of cash income from real estate construction and development finance. To highlight where distributions are being paid partly or fully from new investor or existing capital, there should be disclosure on the percentage of loans (by value) where cash interest cover, used to pay distributions, is less than 1 times.

Best practice by large international managers includes independent quarterly valuations, transparent valuation methodologies, and disclosure of valuation policies to investors.

4. Terminology

Key terms are inconsistently defined, creating investor confusion.

Investment grade

'Investment grade' is often used without formal rating agency involvement, sometimes based on internal models or rating agency methodology but without rating agency adjustment for qualitative factors.

Security

The nature of 'security' is not always clear. Does 'secured' mean direct asset security, via an SPV or over shares in a holding company (structural subordination)?

Loan-to-valuation ratio

There is lack of clarity on whether LVR is based on cost, current value or forecast completion value.

Senior debt

'Senior debt' is sometimes used without confirming that no other claims rank ahead.

3 Introduction

Private credit, done well, has a valuable role to play in the Australian economy. It can make an important contribution to economic growth. Private credit complements other modes of debt funding by facilitating financing for businesses that may not be able to access appropriate funding in the bank or public markets. This has partly occurred as bank capital rules have favoured income-producing real estate lending and less highly leveraged corporate loans.

While small on a global stage and on a relative basis within the Australian market, the private credit market in Australia has grown materially since the GFC, in aggregate terms and in breadth of activity. There are both supply and demand reasons for this growth, with one of the drivers found in an increasing pool of money (superannuation and private wealth) seeking yield and investment diversification.

This report outlines broadly the makeup of the Australian private credit market. It examines where the market is operating well or effectively, and identifies areas where operating practices could be improved for the benefit of the market and investors (and, in some cases, borrowers).

It is extremely difficult to obtain definitive data about the size of the market. Likewise, much operational information is not publicly available or not transparent. What we do know is that private credit is not a homogenous product. The structure, terms, pricing and general risk of loans can vary significantly across the asset class.

Having noted the challenge of obtaining a precise gauge of the size of the Australian private credit market, some estimates place it at around \$200 billion (EY, *2025 Australian Debt Market Update* – \$213 billion; Alvarez & Marsal, *Australian Private Debt Market Review 2024* – \$205 billion). Other lower estimates are based on more restricted structures such as closed-end funds only.

Private credit has many different definitions within the industry. Some define it as direct, non-bank one-to-one lending to corporates, while others define it as, effectively, all non-bank lending of a non-consumer nature.

Private credit originally began in offshore markets as longer tenor, illiquid, direct lending by non-bank institutions to help match their liability profiles. Over time, the nature of private credit has expanded significantly in terms of structures, tenors, risk profiles and underlying asset exposures, such that it is now a very broad and diverse investment class.

At the same time as investment structures have become more complex, open-end (evergreen) funds and, more recently, exchange traded funds (ETFs) are enabling more investors to gain exposure to the investment class. At a transaction-specific level, private credit spans everything from senior debt to equity-like instruments. This wide range of exposures through the capital stack plays directly into some of the key observations in this report.

For the purposes of this report, we are less concerned about putting accurate boundaries around and labels on the investment class of ‘private credit’ and more concerned about trying to understand the environment of non-bank, non-consumer lending in Australia. Accordingly, we have taken a wide interpretation of ‘private credit’ (as defined in section 6 of this report).

From a borrower perspective, the private credit market is serving its purpose. Borrowers are obtaining access to debt capital where otherwise they may not have, supported by the market’s growth. However, this is not to say that all this additional debt capital is invested well.

Private credit in Australia can be divided into three broad underlying exposure groups or asset classes: corporate lending, asset-backed lending and real estate. Distressed debt and equity-like instruments can sit within each of these groups, as a sub-asset class.

Four features of the Australian market differentiate it from overseas markets:

- The proportion of private credit invested in real estate and the concentration in higher risk construction and development
- The relative lack of transparency in fund disclosure from many funds in relation to portfolio mix, impaired assets, income-producing versus non-income-producing loans and related party transactions
- The lack of funds obtaining independent loan valuations on a quarterly basis. It should be noted that there is a link between valuations and management fees
- The fee structures of many Australian private credit funds, which include fees paid by borrowers directly to the manager and which are retained by the manager in some proportion, generally in the range of 50–75% in the case of upfront fees.

Key issues from an investor protection perspective, as highlighted by these four points, are a lack of transparency and the potential for conflict of interest (real or perceived) between manager interests and investor interests.

The private credit investor base now spans large institutions such as top-tier superannuation funds and insurance companies, wholesale investors using the sophisticated investor exemption, and self-managed super funds and retail investors.

Sophisticated investors who are prudentially regulated, such as very large superannuation funds and insurance companies, are typically investing in funds that offer transparent fees and valuations or have bespoke arrangements and are sophisticated enough to understand those arrangements.

Those funds that raise money from less sophisticated investors appear to have less transparency on portfolio composition and fee arrangements. We have seen some good examples of portfolio disclosure, but few are at the level of the US market BDCs, noting that many of these are listed entities.

The growth in the market does raise questions about the quality of credit, and especially whether investors fully understand the investment exposure they are taking on for the returns being promoted.

In particular, there are legitimate questions about whether, in some cases, retail investors could fully understand and appreciate the nature of their private credit investment exposure, based on readily available information.

In light of our review, we believe that the institutional end of the private credit market (including very large superannuation and insurance companies) is operating in a manner that demonstrates good operating practice. As the Australian private credit market has grown and matured, it has incorporated many of the established practices from the more advanced markets of the US and Europe. However, we believe there are areas that warrant improvement – including the transparency of pre-investment information and documentation, and ongoing investment performance information.

Those funds targeting wholesale ‘sophisticated’ and retail investors should provide more transparency on risks, loan valuations and loan characteristics. Their fee structures also have potential to create conflicts of interest for managers.

Funds targeting higher-risk real estate construction and development finance likely represent the greatest priority for addressing potential conflicts of interest and improving transparency.

Growing retail investment exposure to private credit should be another focus area for operational review and improvement. The greatest area of opacity and investor risk is at the intersection of these two components (that is, retail investment *into* real estate private credit).

We believe the areas of market operation that warrant closer inspection by ASIC and potential action are:

- Management and disclosure of conflicts of interest
- Valuation practices
- Fee arrangements – disclosure (including quantum relative to size of fund) and alignment of interest between managers and investors
- Liquidity facilitation
- Investment report information
- Distributions paid out of capital without confirmation of this nature
- Definitions of key terms.

Our observations are aimed at encouraging ASIC to address parts of the private credit market that would benefit from the availability of more clear and transparent information.

Significantly, we note that the Australian private credit market has not yet experienced a credit cycle and associated downturn. Thinking about private credit business models, there is a question about the stability, during a downturn, of remuneration structures that derive a majority of their income from borrower and other non-investor-paid fees. Unsustainable business models may ultimately have an impact on fund management and investor outcomes in a decline.

In terms of systemic risk, and noting that consideration of this risk is beyond the scope of this report, we observe that the commercial property construction and development segment of the market presents the greatest potential risk of impairment or credit loss based on asset concentration and investment disclosure.

From an overall sector risk perspective, ASIC could consider implementing a reporting framework that would allow it to obtain important market data relevant to any systemic risk concerns.

4 Issues for ASIC's consideration

The tables below outline issues for ASIC to consider. These are areas of market practice and operation where improvements can be achieved for the overall benefit of the market and investors. Improved standards and disclosure across the board would be expected to build trust and confidence in the Australian private credit market.

These matters are separated into Priority and Secondary categories.

Priority issues

Topic	Issues for consideration
Remuneration and fees	<ul style="list-style-type: none"> ▪ Potential for misalignment between manager and investors through various forms of manager remuneration (e.g. fees payable to a manager directly by borrowers) ▪ Disguising of manager remuneration or otherwise poor disclosure ▪ Weak disclosure and often non-existent quantification of manager fees and other forms of remuneration not directly payable by investors (e.g. managers not disclosing an interest rate differential (net interest margin) between the ultimate lenders (investors) and borrower where this is facilitated by use of an SPV)
Related party transactions and governance	<ul style="list-style-type: none"> ▪ Managers lending to related parties ▪ Managers holding debt and equity in the same entity via the same fund or via related funds, potentially creating valuation and governance issues ▪ Managers holding debt positions in the same entity via related funds (e.g. senior debt fund and mezzanine fund) ▪ Transferring investments between funds managed by the same manager, potentially creating valuation and governance issues ▪ Disclosure of fees payable to or received from related parties
Valuations	<ul style="list-style-type: none"> ▪ Frequency of valuation ▪ Method of valuation ▪ Beneficiary of valuation ▪ Independence of valuation

Secondary issues

Topic	Issues for consideration
Liquidity	<ul style="list-style-type: none"> ▪ The adequacy of disclosures about opportunity and process based on type of fund (closed-end, open-end) ▪ Facilitation of liquidity and addressing risk of liquidity mismatch between investor liquidity requirement and asset pool or funding source, including portfolio stress testing
Investment reporting	<ul style="list-style-type: none"> ▪ Mixed investment reporting across the market, leading to lack of visibility of investment exposure, especially for retail segment of market
Definitions and use of key terms	<ul style="list-style-type: none"> ▪ Clear and consistent explanation of key terms where some key terms are inconsistently used or vague
Concentration	<ul style="list-style-type: none"> ▪ Risk of an unknown amount of debt and level of credit risk in any sector, particularly real estate ▪ Exposure of retail investment to private credit market

5 Overview of good practices

We believe that the list of items below represents industry good practice for the operation of the Australian private credit market and that, if widely adopted, they would assist with a well-functioning market.

1. Fund composition reporting and disclosure happens quarterly and includes the:
 - a. number of loans and borrowers in portfolio
 - b. percentage of loans and/or related borrowers representing greater than 5% of the fund and, in that case, the specific percentage of the fund
 - c. percentage of the fund where loans may be stressed or impaired, including number of loans in arrears and time in arrears
 - d. proportion of distributions paid from (i) cash income from investments and (ii) other sources
 - e. number of loans and percentage of the fund by value not paying cash interest or paying from principal drawdown (either structured or not structured)
 - f. percentage of fund invested in credit rating bands (investment grade or non-investment grade).
2. Loan valuations are undertaken quarterly by an independent third party, or at least audited or signed off quarterly by an independent third party.
3. Where credit ratings or terms such as 'investment grade' are used, information on whether ratings are internal or from an accredited third-party rating agency is clearly articulated.
4. Where private credit funds are invested in mezzanine debt and/or equity, this fact is confirmed and the percentage of fund invested is disclosed.
5. Fees – all fees and earnings (including any interest earned) by managers as a result of managing investor money are disclosed, including but not limited to upfront, establishment, arrangement, origination, base and performance and workout fees, and default interest and net interest margin. Note: the treatment and reporting of 'fee sharing' from borrowers could be reviewed. Best practice would be that all fees received by managers from the fund or borrowers are disclosed as a proportion of funds invested.
6. Related party or inter-fund transactions (managed by the same or related manager) are transparently disclosed and have been reviewed and signed off by an independent third party.
7. Liquidity – the prospect (or otherwise) of liquidity, the mechanics of liquidity and the potential impact on investor returns of achieving liquidity are clearly disclosed in marketing and product information and ongoing investor reports.

8. Leverage – fund leverage is disclosed in investor reports, along with the fund's leverage policy and guidelines (and limit if applicable).
9. Terminology – key investment terms are clearly defined, such as:
 - a. security: with a clear statement of what the security is – i.e. whether security is direct over an asset or property (mortgage) or whether over shares in the borrower or a holding company or an SPV (structural subordination)
 - b. senior: with confirmation that no other potential form of security ranks above (refer to previous point)
10. Real estate terminology and explanations:
 - a. LVR signed off by an independent third party quarterly, as at the disclosure date, to help mitigate both historical and future LVR issues
 - b. for construction/development projects, statement of both a loan-to-progress value (i.e. based on the percentage of construction achieved) and an expected loan-to-completion value (i.e. based on an estimate of value at completion)
 - c. valuation prepared on a net effective rent basis
 - d. valuation prepared for the lender/securityholder to gain the benefit of reliance
 - e. use and disclosure of an independent third-party valuation where real estate is refinanced from one fund to another
 - f. disclosure of the percentage of loans (by value) where cash interest cover, used to pay distributions, is less than 1 times.

We believe there will be industry support for industry-led guidance on best practice operations and reporting for Australian private credit. Despite the market being broad, and the wide range of quality and capability among private credit operators, it is likely that the larger and more significant participants would coalesce around practices similar to what we have outlined as good practices. Smaller, less sophisticated operators may be less interested in voluntarily signing up to improved practices for a variety of reasons, including cost, time and an aversion to greater transparency.

We note that in its submission to ASIC, the Financial Services Council (FSC) raised the prospect of industry-led work on best practice principles. Groups such as the FSC, Australian Investment Council and Alternative Investment Management Association and their key members could be ideal organisations to participate in industry initiatives and test the thinking on such a process.

6 What is private credit?

Private credit has many different definitions within the industry. Some define it as direct, non-bank one-to-one lending to corporates while others define it as effectively all non-bank lending of a non-consumer nature.

At a transaction-specific level, private credit spans everything from senior debt to equity-like instruments. This wide range of exposures through the capital stack plays directly into some of the key observations contained in this report.

Moody's defines private credit as follows:

Private Credit is a broad term describing non-bank lending that is not publicly traded or issued. It has comparatively light regulation and lacks transparency. It is an evolving asset class that includes private corporate lending, notably to middle market companies owned by private equity, but also various types of private financing including of real estate and infrastructure projects, as well as private loans against a vast array of assets that can be grouped under the term ABF. Direct lending is the largest segment of private corporate credit, encompassing senior debt, junior/subordinated debt and unitranche debt. It is generally cashflow based, floating rate and secured by the borrower's assets. Apart from some larger transactions, direct lender covenants are typically more robust than in the broadly syndicated loan or high yield bond markets. Other corporate lending strategies can include mezzanine, special situations, venture debt and distressed debt.¹

Some market participants and observers may take a different and more limited view of what private credit includes and where the boundaries lie.

We are less concerned about labels and putting accurate boundaries around the private credit investment class and more focused on understanding the environment of non-bank, non-consumer lending in Australia. Accordingly we have taken a wide interpretation of 'private credit', as defined below.

For the purposes of this report and for suggesting where ASIC could focus its attention, we define 'private credit' broadly as non-bank lending that is not publicly traded or widely issued publicly.

Private credit emerged globally to fill a gap in the market that wasn't being serviced sufficiently by banks, due to risk appetite and regulation. In its original incarnation, private credit loans were longer-dated, floating rate, hold-to-maturity instruments designed to match the liability profiles of the lenders. Private credit offerings expanded during a prolonged period of low interest rates as investors sought higher-yielding investments. From there, the type and structure of private credit funding have changed substantially, as we discuss in this report.

¹ Moody's, 'Private credit, a refuge in turbulent times, set to take share again', 17 April 2025.

7 Composition of private credit market in Australia

The Australian private credit market is largely divided into three main segments:

- Corporate/commercial – comprising mostly direct loans to a wide variety of businesses across the economy, and often including lending to businesses owned by private equity
- Asset-backed/securitised – comprising largely structured lending to or investment into tranching pools of assets such as mortgages and consumer receivables
- Real estate – comprising residential, commercial and office property, and including construction and development financing.

It is estimated from reference to various sources that the Australian market is broken up as follows:

- | | |
|----------------------------|--------|
| ▪ Corporate/commercial | 20–40% |
| ▪ Asset-backed/securitised | 10–30% |
| ▪ Real estate | 40–60% |

The Australian private credit market has grown rapidly and was estimated to be around \$200 billion in 2024.

A number of factors appear to be driving growth in private credit in Australia, such as:

- Increasing inflows into superannuation accounts due to the superannuation guarantee levy
- Changes in asset allocation in investment/superannuation portfolios towards ‘alternative’ investments, in an effort to improve diversification and investment returns (seeking yield)
- Offshore fund and asset managers seeking to access increasing investment and superannuation fund flows in the Australian market
- Growing ‘private’ wealth from family office and similar types of money.

Private credit is not a homogenous product. The risk appetite and approach of managers, expressed via portfolio construction, terms and conditions, covenants, pricing and leverage, can vary widely.

7.1 Breadth of market

Private credit offerings span an extremely broad range of offerings, from those that are large, widely diversified and global in nature to smaller, concentrated, domestic, sector-specific funds.

‘Warehousing’ refers to a private credit investment structure where loans are accumulated within a vehicle, and securities of various priority and security are subsequently issued by that vehicle, providing exposure to the underlying pool of assets in the warehouse.

These warehouse-type structures provide indirect or synthetic exposure to underlying loans for the investors, rather than direct lending exposure.

7.2 Who are the borrowers?

Borrowers of private credit funding fall within the classes of activity described earlier in section 7 of this report. They include:

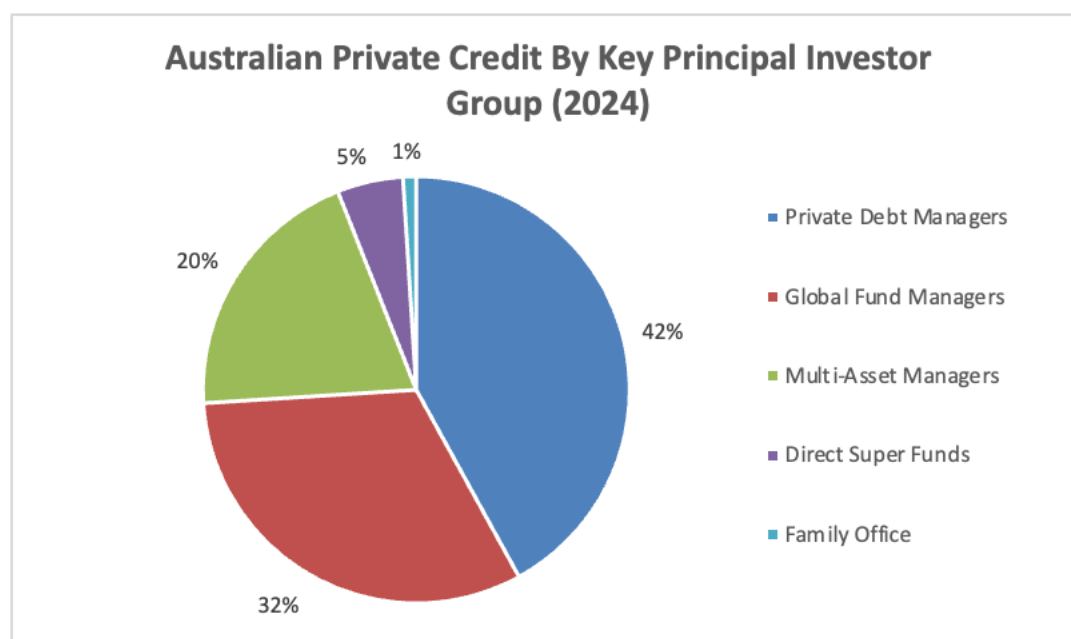
- Corporates – listed, unlisted, private equity-owned businesses
- Infrastructure
- Structured credit arrangers
- Real estate developers and property asset managers
- Non-bank financial firms.

7.3 Who are the investors?

Underlying investors in private credit come from a broad spectrum and include:

- Superannuation funds – large and small (where we refer to ‘superannuation’, we are referring to individual funds as investors and not to platforms offering choice in underlying products)
- Institutions
- Insurance companies
- Asset managers
- Wholesale/‘sophisticated’ investors
- Family offices, private wealth
- High-net-worth individuals
- Retail.

A useful breakdown of the key classes of principal investors (not the underlying investors) in Australian private credit is shown in the pie chart below.



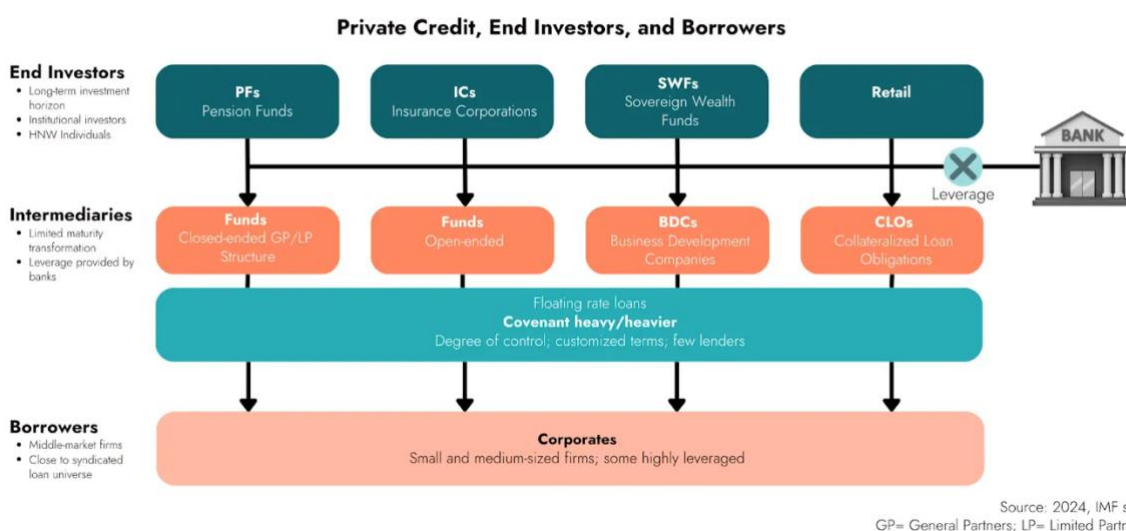
Source: Alvarez and Marsal, Australian Private Debt Market Review 2024

There is a variety of investment structures, including direct, open-end funds, closed-end funds, feeder funds, platforms, and listed and unlisted vehicles.

The diagram below provides a generic representation only of private credit investment from lender through intermediary to borrower. It does not show the full spectrum of activities and should not be taken as an illustration of the Australian private credit market.

Private Credit Structure

Private credit funds are intermediaries between end investors and corporate borrowers that offer floating rate loans to middle-market firms.



The divergence of sophistication and investment experience across the market is vast. Superannuation funds and insurance companies are regulated by the Australian Prudential Regulation Authority (APRA) and operate within an established financial oversight regime. At the other end of the spectrum, wholesale investors using the sophisticated investor exemption, and, more recently, retail investors, are gaining increasing exposure to the sector.

In the main, private credit finance is 'equity' funded. The use of leverage as part of private credit investment is generally low in the Australian market and tends to sit in the range of 0–1x. Leverage can take several forms, with subscription finance or net asset value (NAV) financing and revolvers being the most common. NAV financing is lending to a fund against the net assets of that fund, and ranks ahead of investor equity in terms of liquidation priority. There is little data on NAV financing to private credit. There is some limited data on NAV financing to private equity, which indicates that NAV financing to that segment is growing. It would, therefore, be reasonable to expect that NAV financing to private credit is also growing.

Banks are often the providers of these facilities but other institutions also provide them. Leverage is used with a number of objectives: to provide liquidity for investors, to provide flexibility for managers and to boost overall investment returns. In comparison, leverage as part of private credit structures is higher in the US market than in Australia, tending to sit in the range of 0.5–2x. However we may see the leverage in Australian private credit increase over time.

Retail

As highlighted earlier, growing retail investment into private credit is a feature of the market.

Retail investors gain their exposure to private credit either through APRA-regulated superannuation funds or from collective investment schemes under the AFS licence regime.

As noted in section 9.2, existing models in the US, the European Union and the United Kingdom (UK) can inform how to successfully create product types that will support retail investors to gain exposure to private credit while maintaining high levels of protection and regulatory oversight.

8 The relationship between banks and private credit

Private credit should be regarded as complementary to bank and public market bond funding, with a different risk appetite and fewer terms and conditions.

One of the main reasons for the emergence of private credit was the tightening in bank capital rules for higher-risk credit after the GFC. This is especially so in the case of lending to real estate. It is uncommon now in Australia for banks to be competing against private credit for assets based on risk appetite and capital adequacy requirements.

Relationships between banks and private credit providers are becoming more common as both parties see the strategic advantages of working together. These relationships can involve:

- Banks divesting or tranching loan exposures to private credit providers, either directly or into warehouses
- Banks providing subscription or NAV financing to private credit providers
- Banks originating loans for private credit.

Through lending to private credit, banks can retain indirect exposure to private credit assets without tying up valuable bank capital. This is lower-risk lending than direct lending, attracting lower capital weightings for prudential regulatory purposes.

A survey of 32 global banks by Moody's showed that there was around US\$525 billion in loan commitments to private credit at year-end 2023. However, this represented only around 3% of total loan commitments.²

According to Federal Reserve Y-14 data, in the US 'banks represent a nontrivial portion of private lenders' liabilities'.³ Similar to Australia, much of the bank lending to private credit is to facilitate liquidity and is typically secured and more senior ranking in claims against fund assets than investor claims.

² Moody's, 'Bank funding of private credit grows rapidly, in step with sector's capital-raising', 15 October 2024.

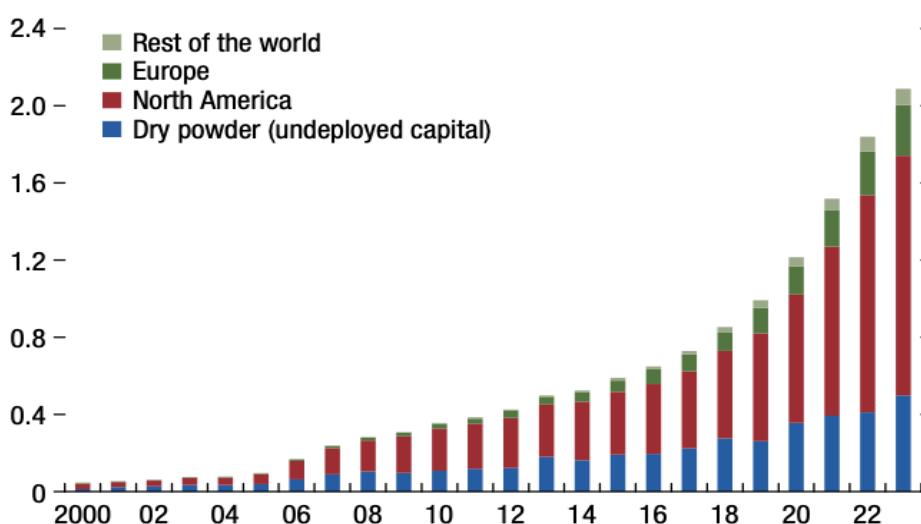
³ Independent article on Federal Reserve Bank of Boston website, 'Could the growth of Private Credit Pose a Risk to Financial System Stability?', 21 May 2025.

9 Overseas comparisons

The global private credit market in 2024 was estimated as being around US\$2.5 trillion. The market has grown substantially over the past 10 years. The International Monetary Fund (IMF) estimates that global private credit assets under management have quadrupled over the decade to 2023.

The chart below illustrates global private credit growth since 2000. These numbers should be taken as a guide, given that Preqin does not have data for all open-end funds.

Figure ES.7. Private Credit Growth
(Trillions of US dollars)



Source: Preqin.

Note: The measure of assets under management includes those from private credit funds, business development companies, and middle-market collateralized loan obligations, with the last two being mostly US focused.

According to Pitchbook, North America accounts for approximately 70% of global private credit raised since 2008, and Europe approximately 25%. In the US, the size of the private credit market is around the same as the broadly syndicated loan and high-yield bond or leveraged loan markets.

As noted in section 8, bank funding to private credit in the US is growing, and we would expect to see the same trend continue in the Australian market.

As the market has developed, investment structures have become more interlinked, and relationships between market participants have increased.

9.1 Market developments

Recent developments in offshore markets, particularly the US, have been:

- Partnerships between asset managers and life insurers, including assistance to access loan origination
- The growth of evergreen or open-end funds
- The emergence and growth of exchange traded funds (ETFs)
- Increased retail investment.

In Australia, these developments point to an ever more structurally complex market with a higher proportion of retail and less sophisticated investment flowing into it.

9.2 Regulation

There has been debate in the US in recent years about the opacity of private credit and the quality of information in reporting. A particular focus has been on Private Fund Adviser Rules that would require more disclosures on fees and expenses, and stricter provisions for secondary transactions, among other requirements. The U.S. Securities and Exchange Commission's (SEC) move towards greater reporting was stymied by the investment industry as various groups brought a suit against the SEC, preventing the new rules for advisers to private funds.

The SEC Division of Examinations' 2025 priorities highlight the increased focus on private credit firm disclosures and private fund advisers – who make up a significant portion of the SEC-registered investment adviser population. The Division will continue to focus on advisers to private funds and prioritise specific topics, such as those described below.

- Whether disclosures are consistent with actual practices and advisers have met fiduciary obligations in times of market volatility, as well as private fund exposure to interest rate fluctuations. Examples of investment strategies that may be sensitive to market volatility and/or interest rate changes include commercial real estate, illiquid assets, and private credit. The Division may particularly focus on examinations of advisers to private funds that are experiencing poor performance and significant withdrawals and/or hold more leverage or difficult-to-value assets.
- The accuracy of calculations and allocations of private fund fees and expenses (both fund-level and investment-level). Examples of areas that may impact the accuracy of fee calculations include valuation of illiquid assets, calculation of post-commitment period management fees, offsetting of such fees and expenses, and the adequacy of disclosures.
- The disclosure of conflicts of interest and risks, and adequacy of policies and procedures. Examples of products or practices for the focus of such conflicts, controls and risk reviews include: (1) use of debt, fund-level lines of credit, investment allocations, adviser-led secondary transactions, transactions between fund(s) and/or others; (2) investments held by multiple funds; and (3) use of affiliated service providers.

Nevertheless, areas that could become the focus for US regulators include:

- Conflicts in bank partnerships
- Investing across multiple capital structure layers
- Valuations.

Current topics being considered in some overseas markets are appropriate forms for long-term private capital investment and, as part of this, protections for retail investors. These initiatives, outlined briefly here, are not specific to private credit and are largely aimed at fund structures and investment mandates for long-term investment rather than specific market operations.

UK Long-Term Asset Fund

The UK's Long-Term Asset Fund (LTAF) initiative was introduced by the Financial Conduct Authority (FCA) in 2021 in relation to open-end funds investing in long-term illiquid investments such as private equity, venture capital, private debt, infrastructure and real estate. While not aimed specifically at private credit, the LTAF does put rules around the structure of long-term illiquid assets. In particular, it mandates:

- Minimum 50% assets in unlisted securities and other long-term assets
- Maximum 30% fund borrowing.

European Long-Term Investment Fund

The European Long-Term Investment Fund (ELTIF) is a collective investment framework designed to allow investment into entities requiring long-term capital. Part of the rationale for ELTIFs was to increase the amount of non-bank finance available for companies investing in the real economy of the European Union. ELTIFs are not specific to private credit.

Singapore

The Monetary Authority of Singapore (MAS) is considering how retail investors can participate in private market investments in a risk-appropriate way via fund structures. As MAS states in its March 2025 'Consultation paper on Providing Retail Access to Private Market Investment Funds', it is 'seeking feedback on a regulatory framework to allow retail investors to access private market investments through authorised long-term investment funds with appropriate safeguards in place'. The primary objective of the proposed framework is to provide retail investors access to private market investments in a risk-calibrated manner, as part of a diversified investment portfolio. Topics for consideration include matters relating to fund structure, investment criteria and manager qualifications. As with the UK's LTAF and Europe's ELTIF, the Singaporean considerations are not specific to private credit.

Liquidity

The Financial Stability Board (FSB), an international body monitoring and making recommendations on the global financial system, has been considering the issue of liquidity mismatch in open-end funds for several years. This work is largely aimed at identifying and mitigating potential structural vulnerabilities that could exist in markets, rather than on investor protections. However, the issue of liquidity mismatch and its impact in difficult economic and market times should be kept in mind.

FSB contends that:

Unmitigated structural liquidity mismatch may amplify shocks by driving ‘excess’ redemptions that require managers to engage in asset sales larger than in the absence of liquidity mismatch, especially in times of stress.

‘Excess’ redemptions, and associated asset sales to meet those redemptions, could contribute to greater market volatility and additional pressure on asset prices in times of stress. In turn, these dynamics can affect the functioning of core markets (including primary markets) in times of stress, depending on, among other things, the concentration and/or scale of asset holdings by OEFs in particular markets, the size of OEF trades, and the behaviour of other investors in those markets or asset classes.

See the link below to the FSB report dated 20 December 2023 – *Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds*.

www.fsb.org/uploads/P201223-1.pdf

10 Operations

10.1 General

When viewed in totality, the private credit market in Australia has areas for improvement.

From a borrower perspective the market is serving its purpose. Borrowers are obtaining access to debt capital where otherwise they may not have, supported by the growth of the market. This, however, does not mean that all this additional debt capital is invested well.

The rapid growth in the market raises questions about the quality of credit and especially whether investors fully understand the credit and liquidity risk they are taking for the returns being offered. This is especially the case in the sub-investment grade segment of the market.

When investing in private credit, investors are receiving returns from taking credit risk and liquidity or maturity risk. Much private credit is invested in sub-investment grade credit risk in the BB+ to CCC range. There are some construction and development real estate funds that would appear to be taking substantially more risk. Sub-investment grade credit should attract yields of Bank Bill + 2.5–5.0% with expected 1-year probability of default rates in the range of 0.5% to 15%. Given these expected default rates, which are based on rating agency long-term industry default data, it is inconceivable that some funds show no history of impairments. Investors should expect considerably higher losses in an economic downturn, particularly in the real estate construction and development sector.

Individual credit exposures within funds can sometimes be disguised by the credit rating terminology. A fund may quote an average credit rating of, say, BBB–, but if a barbell strategy is being used, the effective credit ratings of underlying loans may span from BBB+ to CCC.

At the strong end of the market, Australian private credit is characterised by:

- Diverse product offerings
- Well-resourced, experienced professional managers
- Appropriate disclosure (before and during investment)
- Relatively higher disclosed management fees
- All fees and interest typically being paid to the underlying fund.

However, there are a number of areas where operations exhibit practices that are short of best practice or, in some cases, are more manager-friendly than investor-friendly. These areas are addressed in section 11 of this report.

As a general observation, larger managers and overseas headquartered firms have well-established, professional operations with appropriate resource levels. They have sufficient staff with appropriate skills to manage investor money and their loan book, including staff experienced with workouts.

In recent years a significant number of entities and vehicles have been established as participants sought to benefit from the growing private credit market. In some cases, these parties lack sector experience and organisational capacity, as well as size and scale.

Smaller managers may not have sufficiently skilled staff to undertake activities such as due diligence, site visits and progress payment evaluation (in property development), and manage troubled loans, which can be time-consuming and difficult.

Valuation impairment is also a topic of discussion in the sector. There are examples of managers promoting the fact that they have never taken a loan write-down or impairment.

PIK is a feature of some loans in private credit portfolios. PIK refers to a situation where interest payments are not paid in cash to the lender but rather are capitalised to the loan, with the interest effectively being 'paid' by adding it to the loan. Sometimes PIK arrangements are deliberately structured upfront by the lender (in cases where a new business may be growing). In other cases, a PIK arrangement may be temporarily negotiated where a borrower does not have cash to meet all its interest obligations. Construction loans will sometimes use a PIK during the build phase, as the underlying asset is unable to generate revenue to meet interest costs until it is operational. An alternative example of construction funding to facilitate interest payments is where a lender makes, for example, a \$100 million loan to a developer, with \$80 million being used for construction, and \$20 million being used to pay the interest on the \$80 million loan during the construction period.

Moody's Ratings commented in a recent report that the rising use of PIK loans in private credit mirrors a broader trend across all corporate lending toward distressed exchanges, where companies restructure debt to avoid a payment default, potentially resulting in larger ultimate losses for investors.⁴

Investor liquidity may become a more significant issue. There may be a potential mismatch between investors' and fund managers' expectations of loan maturity dates and liquidity. Liquidity has not been a major issue to date, as loan supply and investor demand have been growing rapidly. Should this growth slow or even reverse, liquidity will be an issue. Funds can protect themselves with redemption and lock-up clauses; however, in a serious financial downturn, the maturity date of loans may be seen by managers as an opportunity to renegotiate terms and extend loans rather than to effect loan repayment.

Some of the more aggressive practices in the market can include:

- 'Amend, extend and pretend', in the case of troubled loans, which can be restructured or renegotiated to push the problem down the track
- 'Loan-to-own', referring to structures and loan term seeking to more readily convert debt to equity (or ownership) if a borrower gets into difficulty servicing the loan
- Manager reducing fees to top up the monthly return to 1.00% (net) exactly, impacting actual fund performance but not disclosing the adjustment
- Manager placing impairment provisions over a 2-month period to show monthly return as exactly 0.00% and to demonstrate the fund has not had a negative return.

⁴ Moody's, 'Private credit and systemic risk', June 2025.

10.2 Real estate financing concentration

Although recognised as high risk, when well structured, real estate development financing can offer high returns for debt investors. After the GFC, prudential regulators made bank capital requirements for this financing unattractive for banks because of the systemic risk faced in economic downturns. In Australia, this circumstance has fuelled the growth of property credit funds focused on real estate development, which has seen property development risk largely transferred from the bank sector to the non-bank sector.

Institutional and sophisticated investors have benefited from these higher returns since the GFC, in what has been a benign credit environment with strong demand for finished projects.

Real estate development is regarded as higher risk than income-producing real estate financing because it is effectively negative cash flow lending – there is no or insufficient income to pay interest and, as such, interest is either capitalised or paid from the drawdown of capital. The return of the capital and payment of interest comes from selling or refinancing the completed project. The full lifecycle may take 36–60 months. Any unsold units are often financed by residual stock financing to repay construction finance.

Construction finance requires specialist skills and management of finance, funds release and cost management.

A number of the real estate funds targeting self-managed superannuation funds offer monthly distributions of approximately 0.70–1.00%, despite these loans not generating regular interest payments. The question needs to be asked as to whether distributions are being paid from capital – from loan capital drawdown or new investor funds. More transparency of the cash income the funds produce to support fund distributions to investors is needed. A suggestion for addressing this point, is to require that fund reporting show the proportion of distribution income coming from cash income received by the fund and from capital. Such a ratio will be easier for retail investors to understand than a detailed cash flow statement.

Real estate development funds are heavily marketed as having conservative LVRs, with little definition on how the LVR is determined, who the valuation was prepared for (investor or borrower), when it was completed, and who has independently validated the LVR (if independently verified).

Questions about LVRs can be:

- Is the LVR based on the current value?
- When was the LVR completed?
- Is the LVR based on assumed developed value?

By way of example, some development sites purchased in 2021–22 are now lower in value due to building cost inflation of more than 20%. If funds are still using a 2021–22 valuation or original LVR, that value could be misleading.

Most in the industry do not use LVRs for day-to-day management but instead use loan-to-completion cost. This is not used in marketing material.

We also understand that some real estate private credit managers are conducting valuations for office or commercial property on a gross rent basis rather than a net effective rent basis. In cases where substantial rental incentives are being offered (potentially up to 30% or even 50%) valuations conducted on a gross rent basis are materially overstating property values.

In considering property valuations it also needs to be clear whether a valuation is for the benefit of the lender for its' security purposes or whether the valuation is for the benefit of the borrower and only provided to the lender.

A reasonable consideration is whether fund managers should be providing the metrics that they use to manage the loan portfolio. Most offer and fund documents do not appear to adequately describe the risks and characteristics of their construction and development lending portfolios to investors.

10.3 Disclosure

The depth and quality of disclosure by private credit managers varies greatly. As a generalisation, larger managers, particularly global managers, tend to provide more granularity in their reporting, supplying investors with useful and important information about their investment exposure.

Feedback received during the market consultation process indicated that while investment or fund reporting may appear good on its surface, it has yet to be tested by an adverse market.

Given the wide variety of structures and credit exposures within private credit portfolios, more fulsome disclosure is good for the sustainability and maturity of the market. Being unlisted or 'cost' are not good reasons for not disclosing information to help investors understand their investment.

Example of Business Development Companies

Purely for comparison purposes, we have examined the disclosure by listed and unlisted BDCs in the US.

BDCs have a regulated leverage limit of 2:1 debt-to-equity ratio. Nevertheless the BDC's disclosure rules make for an interesting reference point.

Sample BDCs we reviewed disclosed:

- For individual loans by borrower name and country:
 - type of loan (i.e. first lien term loan)
 - coupon
 - spread
 - maturity date
 - principal amount
 - current fair value.
- For revolvers and delayed draw loans:
 - total loan amount
 - funded commitment
 - unfunded commitment.
- Top holdings by loan
- Portfolio allocation by industry.

It is notable that in the US, non-publicly traded BDCs are required to publicly file the same periodic reports – including forms 10-K, 10-Q and 8-K – as publicly traded BDCs, containing information about the BDC's business and financial condition, financial statements, and information about certain material corporate events.

While we do not suggest that the BDC disclosure regime be adopted completely in the Australian private credit market, it does provide a good reference point for testing what disclosure might be appropriate for unlisted private credit.

We do think that disclosure of individual borrower names is not appropriate in the Australian market context, given the small size of the market.

Some areas of investment reporting can be unclear or insufficient to inform investors of details they should know. Reporting on distributions is often high-level, not including information about the proportion of distributions being paid from non-cash income, such as from investor capital (existing or new).

A useful working template for reporting could encompass the following features:

- Investment returns – 1-month, 3-month, rolling 12-month, and since inception returns (before and after fees)
- Number of loans in portfolio
- Number of loans greater than 5% of the portfolio
- Summary of geographic spread of loans
- Number of loans in arrears
- Time period in arrears
- Number of loans using PIK, and proportion of portfolio by value
- Proportion of distributions paid from (a) cash income from investments and (b) from other sources
- Fund gearing.

In relation to real estate investment specifically, and noting some overlap with the points above, ASIC Regulatory Guide 46 *Unlisted Property Schemes: Improving disclosure for retail investors* (RG46) already contains some useful guidelines in relation to disclosure principles for:

- Gearing ratio
- Interest-cover ratio
- Scheme borrowing
- Portfolio diversification
- Related party transactions
- Distribution practices
- Withdrawal arrangements
- Net tangible assets.

A form of these disclosure principles could also be considered in relation to retail private credit investment in real estate. A further question for consideration is whether there is merit in creating a version of RG46 for wholesale private credit investors.

11 Market practices

Areas of operation where we consider there is opportunity for better practice or room for improvement are set out in this section. Some of these features are interlinked – for example, how conflicts of interest intersect with fees and valuations.

11.1 Conflicts of interest

Conflicts of interest can arise in a variety of operational areas, including fee structure, valuations, related party transactions and loan structure.

We note that conflicts of interest are not always a bad thing. The important factor is how they are managed and that they are transparently disclosed to investors.

Examples of potential conflicts of interest for each of these areas are summarised below.

Fee structure

- Funds or managers taking greater than 0% up to 100% of establishment or other upfront fees may be incentivised to write more business, or churn, renegotiate or extend loans, regardless of loan quality.
- A manager investing against a target investor return but taking higher returns (via a net interest margin) through higher negotiated interest rates with the borrower and through performance fees calculated on this 'outperformance' generated by the net interest margin. This can occur through the use of SPVs or warehouse structures.
- Managers with an economic interest in an originator may benefit from loans provided by that originator, beyond their fees from managing the fund or investment.

The behavioural incentives that can be created by various fee structures also need to be considered. While clearer and certainly more quantifiable disclosure of such fee structures is desirable, the existence of these models could encourage behaviour from managers that is more in their own interests than the interests of investors.

Overall, in relation to remuneration and fee disclosure, it's reasonable to ask whether information is not being disclosed. And if not, why not?

Valuations

- Valuations that are performed 'in-house' by team members whose remuneration may be affected by loan performance – for example, stressed loans not written down will result in higher management fees.

- Less frequent valuations, whether 'in-house' or independent, could result in higher management fees in instances where loans might have been written down in between valuations.

Related party transactions

- Loans being transferred between funds managed by the same head entity can create conflict points in relation to asset value in the selling fund and the buying fund. We note that many managers deal with such conflicts by having separate trustees or responsible entities for each fund.
- When a manager may have separate debt and equity exposures to the same entity, in the same or different funds, the potential for conflict arises, especially if the underlying entity encounters financial difficulties.
- Loans to related party property developers can create conflict points in relation to valuation, fees, loan interest rates and loan terms.

Investor treatment

- Manager conflicts can arise through provision of different arrangements for investors in relation to fees, loan access or other investment terms, contained in 'side letters' or other forms of documentation.
- Preferential redemption arrangements for particular investors could create conflicts for a manager when facilitating fund liquidity.

Loan structure

- Shorter-tenor loans requiring more frequent refinancing or rollover could result in higher management fees where establishment or other upfront fees go in part or full to the manager.
- Sometimes, impairments can be addressed, or loan repayment can be deferred via renegotiation, and this may result in financial benefits to the manager.

11.2 Valuations

Valuation practices would seem to be a point of discussion or contention for many market participants. Areas where valuation practices may require closer inspection are:

- Frequency
- Independence
- Loan valuations versus asset valuations (especially in the case of property)
- The basis of valuation (e.g. for property development, loan-to-cost versus loan-to-completion value)
- Recognition of impairments.

Managers use a variety of measures to assess valuation. Reference measures to cross-check income or cash flow-based valuations can include market data points (for example, a BB corporate curve on Bloomberg) and specific trading information points (where individual loans

are traded). Sometimes managers can be reluctant to impair loans based on market information where they are on a hold-to-maturity basis as opposed to a 'held-for-sale' basis.

Based on the credit profile of many private credit funds, which can contain high proportions of sub-investment grade assets, we would expect to see economic provisioning for expected credit losses and also impairments in most funds. Many managers have regard to Australian Accounting Standards Board Standard 9 (AASB 9) or International Financial Reporting Standard 9 (IFRS 9) for assessing expected credit losses. While we were not able to view financial statements in many cases, it appears that economic provisioning for expected losses is not widespread in the sector. This casts a question as to how valuation methodologies are being applied. Likewise with impairments, there is a question over the assessment of impairments and how and when they are recognised.

Valuations in the construction and development sector can often lead to confusion and potential distortion, depending on what measure of LVR is used. In many cases, LVRs are quoted on a completed value, as opposed to a loan-to-cost basis, even early in construction. This approach understates LVRs on a going-concern basis, as an LVR on a completion basis may be, say, 70% of cost, but during construction it is likely closer to 80–90%. A comment on LVR definitions is set out in section 5 of this report.

As noted in section 10.2, commercial and office real estate valuations are sometimes valued on a gross rent rather than net effective rent basis, producing distortions in value.

Best practice would involve valuations being conducted at least quarterly by an independent party, regardless of whether a fund is listed or unlisted.

11.3 Fees

This report considers the structure and disclosure of fees rather than their commercial level.

A range of fee structures is apparent in the market. Some are more manager-friendly and some more investor-friendly. In the case of domestic funds, many are not explained simply or transparently.

Some managers pass on all fees to investors, while others keep some or all upfront fees and other fees such as origination fees, workout fees and in some cases, default interest.

There are inherent conflicts or potential conflicts in many of these fee structures, as discussed in section 11.1 of this report.

Examples of fee structures observed are:

- Base fees only – ranging from 0.25% to 2.0% per annum, depending on whether the manager receives remuneration from other sources identified below
- Base fees and performance fees – where outperformance of a nominated benchmark return is rewarded with a share of that outperformance
- 'Fees' taken as net interest margin, representing a differential between the rate of interest a manager charges an underlying borrower and the rates of interest the manager pays

investors. This is often achieved via the interposing of an SPV between the investor and the borrower to create a lending vehicle, in which case the manager is the same entity or a related entity of the borrower

- Variation in sharing 'upfront' and other associated loan fees between the manager and investors – ranging from 100% to investors, which we would regard as best in class to varying levels of split between manager and investors, to 100% to managers with no disclosure of quantum of fees
- Sharing in a split of default interest between manager and investors – from 100% to investors, to varying levels of split between manager and investors, to 100% to managers
- Sharing in a split of workout and similar type fees between manager and investors – from 100% to investors, to varying splits between manager and investors, to 100% to managers.

Fee disclosure can tend to be opaque or difficult to understand. More importantly, from an investor perspective, the total level of manager remuneration relative to fund size can be difficult to quantify or, in some cases, impossible to quantify.

A feature of some Australian private credit funds is that a number of managers retain up to 100% of upfront fees paid by borrowers from the fund. These arrangements make total cost comparisons across funds very difficult, as these fees are excluded from management fee disclosures.

In general, international fund managers and those sourcing funds from very large superannuation and insurance funds retain lower or no borrower origination fees, while often in real estate funds and those funds sourcing investment from small to medium-sized superannuation funds and the general public, managers retain higher borrower fee percentages.

While this arrangement is explained as an 'alignment of interest' between the fund manager and the fund investors, these fees are sometimes excluded from the fee disclosure, the quantum of these fees is not disclosed, and these fees are often a multiple of the fund management fees. Notwithstanding legal disclosure obligations, the non-disclosure of the quantum of such fees received by managers directly appears hard to defend.

Product Disclosure Statements (PDSs) often disclose these fee arrangements without quantifying them. For example:

The Manager may receive additional fees from the borrowers of the relevant loans of the Sub trust and Wholesale Funds. These fees will not be paid from the assets of the Trust but will be paid by the Borrower to the Manager. These fees will not be a cost to the Trust and do not affect the returns of the Trust ...

Some PDSs are publicly available. However, for a number of funds the PDS was not readily available without contacting the manager.

There are a number of potential issues with some of these fee arrangements:

1. The fees are not transparently disclosed, and there is no consistency across the market. In some funds, all borrower fees are paid to the fund, while in other funds 100% of the fees are paid to the manager. Those funds where borrower fees are paid to the fund tend to have higher disclosed management fees to investors, when often, the total fee cost may be lower.

2. Although some funds reference this practice as an alignment of interest between managers and investors, it is hard to see how this stands up completely in practice. It is investors' capital that is at risk, yet it is the manager that is negotiating the loan. There is normally a trade-off between the fee percentage and loan margin. Shorter-tenor loans may increase the frequency of upfront or restructuring fees.
3. In addition to upfront fees paid by the borrower, fees can also include default interest, loan variation fees, and other fees that can create perverse incentives.
4. Fund managers argue they need these fees to pay for the cost of origination and fund management. This may be true; however, the fees as a proportion of fund size should at the very least be included in disclosures so that investors can make a true comparison of total cost.

There is a real question as to whether such fee structures, which are largely predicated on growth, underpin a sustainable business model in a downturn.

Use of Special Purpose Vehicles

In addition to receiving borrower fees, some managers, primarily in real estate funds, also capture fund economics from interposing SPVs between the borrower and the fund. The fund lends to the SPV, and the SPV lends to the underlying borrower at a higher rate of interest, with the fees and interest differential margin received by the SPV being for the benefit of the manager.

An example would be a Manager disclosing fund fees as say 0.5% pa however also disclosing in an Information Memorandum:

Borrower fees and costs

- *The SPVs that the Fund lends to (or its related entities) are entitled to receive the interest differential between the amount payable to the Fund and the amount payable by the borrower on each Loan and may receive other fees and costs directly from borrowers, including but not limited to Loan application and assessment fees and ongoing Loan management fees, which will not form part of the assets of the Fund. The rights of lender and borrowers are managed in accordance with the respective loan documents however, in order to manage any potential for a conflict of interest that may arise between related parties, the Trustee has implemented conflicts management policies and procedures to effectively manage these potential risks.*

Loan application and ongoing management fees

- *The SPVs may charge the borrower an establishment and ongoing fee according to the complexity and competitiveness of the Loan or investment. These fees, which may be shared with introducing brokers, are to pay for the cost of servicing the underlying loan or investment sourcing network, advertising, the underlying loan application assessment and approval process, instructing valuers and solicitors and advancing the underlying loan or investment.*

- *The SPVs may receive a brokerage fee, which is paid by the borrower in addition to the underlying loan interest rate or investment fixed returns, where the underlying loan or investment is directly sourced by the SPV.*

In some cases, managers are potentially manufacturing an arbitrage by taking both sides of the same transaction (product) but providing investors with a lower rate of return than they are charging the borrower for essentially the same credit risk.

It is very unlikely that investors will know precisely what interest rate an individual borrower is being charged with the use of their funds. It is also very unlikely that borrowers will know what effective interest rate is being paid to underlying investors (via fund distributions) from the proceeds of their loan. In some cases, managers are then taking a performance fee for the 'outperformance' created by this interest rate arbitrage.

There can be valid reasons for lending via an SPV, such as creating a bankruptcy remote structure. However, clear disclosure of information relevant to the risk and for underlying investors is important.

The table below provides examples of language used by Managers to describe real or potential conflicts of interest regarding fees present in the market.

Fee explanation
<p><i>The SPVs may charge the borrower fees and costs for dealing with managing underlying loans and investments in arrears or default. In addition, the SPVs may charge project management, development fees and costs and other similar charges, where it is required to undertake default management workout programs for construction and development loans or investments.</i></p> <p>.....</p> <p><i>The investment entity will retain an interest margin. The interest margin is the difference between the interest rate charged under the underlying investment to the borrower and the rate the fund receives on the investment. The interest margin provides compensation for successful deals.</i></p> <p>.....</p> <p><i>The interest margin will typically fall between 2% and 4% on performing loans. In the event of a loan default where a default interest rate is charged to the borrower, the interest margin will typically fall between 4% and 8%.</i></p> <p>.....</p> <p><i>Some underlying investments will also include an exit fee or other bullet payment charged to the borrower during or at the conclusion of the term of the facility, often linked to defined trigger events. The Manager may be entitled to a proportion of such a fee.</i></p> <p>.....</p> <p><i>The manager or its related parties and affiliates may be the recipient of an upfront origination fee paid by borrowers on settlement of new loan facilities or where a loan is varied or extended. The origination fee is a one-off amount paid by the borrower to the manager, its related parties or affiliates, as compensation for the work in originating, negotiating, structuring, analysing and documenting the loan facility.</i></p>

Managers taking 'default interest' is probably the most egregious example of managers benefiting at the expense of investors. Default risk is part and parcel of lending, and in the world of private credit should be expected to occur occasionally. Managers benefiting financially from a default on a loan they made arguably raises questions about appropriate conduct. Arguments about increased time commitments and strains on resources in managing a default scenario requiring fees to be kept by a manager, and not passed on to investors, are questionable in a lending business if appropriate management fees are being charged.

There is a view in the market that fee structures are being designed by some managers to allow them to charge low management fees while taking a significant share of their remuneration through other means, as described above. This can encourage investors, including superannuation funds, to choose managers with low observable management fees but other 'hidden' fees.

A question needs to be asked about how managers can show an amount of fee revenue to prospective purchasers in a transaction scenario and in ASX reporting, but a completely different (and materially lower) amount of 'management' fees to fund investors.

The true total cost of running funds is often hidden from investors, when best practice dictates that it should be apparent to all investors, regardless of their level of sophistication.

There is a risk that more managers (including some of the larger managers) that have higher fees but pass on all other revenues to the lenders move towards the 'low management fees – manager keeps other revenues' model if they are losing material business with their existing fee structure. Such a development could validate and entrench the 'low management fees – manager keeps loan revenues' model in the market, which would be a negative development.

More transparent fee structures involve all fees and payments received by the manager going to investors, with clearly identifiable and quantifiable management fees (including performance fees) being disclosed on a regular basis so that the true cost of managing the fund is transparent to investors. This is the model used by most of the major global fund managers.

In summary:

- (1) Many fee structures in the market create potential for misalignment between managers and investors.
- (2) Fee structures often do not present a quantifiable and readily observable true cost of the management of the fund.

11.4 Liquidity

Closed-end funds typically have multi-year lock-up arrangements, which restrict the ability of investors to withdraw funds during the lock-up period.

While early private credit structures were designed as illiquid structures, there is rising demand for liquidity as more money comes into private credit. Many managers offer restricted, occasional liquidity, sometimes through borrowed funds and sometimes through holding a portion of the fund in liquid assets that can be readily sold to facilitate liquidity.

Open-end funds, listed funds and ETFs offer liquidity for those who wish to invest in private credit but do not wish to have funds locked up for long periods.

In unlisted funds, there is the potential for misalignment between investors' expectations of liquidity and the reality of loan portfolio management to achieve liquidity.

Liquidity in non-ASX-listed funds comes from capital supplied by new investors in the fund or the maturity and repayment of loans within the fund. Individual loan maturities do not automatically result in principal repayment. Some market participants commented in the consultation process that in property, loan maturity dates are sometimes seen as an opportunity to renegotiate – they are not always treated as repayment dates unless the project is sold or refinanced by another fund.

Funds generally appear to have documented liquidity lock-up terms and conditions that work well from a fund perspective. Where funds don't have cash available to process fund redemption requests on 30–90 day's notice from investors, a number of lock-up mechanisms are used. One of these mechanisms is the classification of investor redemption requests into 'redemption units' in the fund, which are repaid as loans mature.

It is important that liquidity, and its potential consequences, are described in terms of exit price or valuation, and timing is clearly explained to investors in fund material.

Liquidity for unlisted funds is challenged in times of market downturn and volatility. Given that private credit in Australia has not witnessed a prolonged downward credit environment, it is not clear whether liquidity arrangements and investor expectations are matched. We would expect this to be tested in an economic downturn.

A current example of liquidity challenges can be seen with a fund recently advising investors that it will be delaying redemptions because there is no 'unallocated cash' to distribute to them.

In lieu of a redemption, the fund offered investors who want their money returned a new class of unit, which would continue to receive dividends but wouldn't be forced to contribute to any new loans. It is understood that depending on loan repayments, redemptions would likely start to be processed in 6-monthly increments commencing in December 2025 through to June 2027.

Refer to section 9.2 for comment on work being done by the FSB in relation to liquidity mismatch in open-end funds.

11.5 Distributions

Often the nature or composition of distribution payments in investment reports is not clear. In some instances, distributions may not be composed 100% from cash flows, with the balance being made up effectively from capital (including from new investor contributions). However this is not always clear.

The property construction sector is the most likely source of distributions not being paid fully from underlying loan interest. With no cash flow to pay interest during the construction period, distributions are generally paid from investor capital, either via over-funding of a loan to effectively fund distributions, or from new investor capital.

This may not be understood by all investors, especially retail investors.

The nature of distributions payments should be clearly set out in regular investor reports, as noted in section 5 of this report.

11.6 Governance

Mixed practice is observed in the market in relation to the achievement of independence in fund governance.

Some managers prefer to use independent trustees, while others set out to achieve independence via the inclusion of independent directors on the board of the responsible entity related to the Manager. Either approach can provide independence. Regardless of the approach, the true test of effective governance will be found in the processes and procedures document and adopted.

Some larger funds have various internal committees as part of their governance arrangements. These can include investment committees, valuation committees, risk management committees and, in some cases, compliance committees. Such committees may include independent representatives or a structural separation internally within a manager (e.g. in the case of valuation committees, where credit team members do not participate in determining valuations).

There is potentially a scale argument at play here, as small managers may contend they are unable to support a bigger or more sophisticated internal governance structure. However, cost should not be a barrier to good governance and the appropriately skilled resourced management of investor funds.

Superannuation funds

In this report we have predominantly considered superannuation funds as being the largest and most sophisticated funds. However, it is important to consider the governance of all superannuation funds in relation to private credit, regardless of size and sophistication.

Regardless of third-party advice and recommendations, fund trustees need to ensure that they are sufficiently aware and educated about the nature and risks of their private credit investing. In what can be a complex asset class, it is possible and even probable, that many superannuation fund trustees do not yet have a proper understanding of private credit. This is a potential problem for the sector.

11.7 Good practice

In the following table, we set out descriptions of good and weaker market practice in a number of areas.

	Good practice	Weaker practice
Fees	<ul style="list-style-type: none"> ▪ Full disclosure of all fees and remuneration received by the manager in connection with the fund, including quantification of amounts 	<ul style="list-style-type: none"> ▪ Non-management fees either not disclosed adequately or otherwise not quantified to show amount relative to fund size
Portfolio disclosure	<ul style="list-style-type: none"> ▪ Detailed disclosure of loan and portfolio information on a quarterly basis (refer to section 10.3 of this report) 	<ul style="list-style-type: none"> ▪ Aggregated reporting with limited or no reporting on portfolio composition, loan impairments, PIK loan exposure or distribution makeup
Valuations	<ul style="list-style-type: none"> ▪ Quarterly independent valuations, or at least reviewed by an independent third party quarterly ▪ Valuations for benefit of lender or securityholder 	<ul style="list-style-type: none"> ▪ Valuations six-monthly or less frequent ▪ Valuations performed internally by staff involved in assessing the initial loan
Related party transactions	<ul style="list-style-type: none"> ▪ No related party transactions or, where they occur, review and sign-off of price and terms by an independent third party 	<ul style="list-style-type: none"> ▪ Transfers between related funds at differing valuations or with no independent review and oversight
Governance	<ul style="list-style-type: none"> ▪ Independent trustee or sufficient independent members on Responsible Entity board 	<ul style="list-style-type: none"> ▪ No independence achieved through Responsible Entity board membership or independent trustee
Investor treatment	<ul style="list-style-type: none"> ▪ Same fees as well as terms and conditions offered to investors in the same fund 	<ul style="list-style-type: none"> ▪ Differential fees, differential access to loans, preferential liquidity requirements ▪ Limited or select disclosure to investors of differential treatment

12 The problem of definitions

From our review of material to date, it appears that a number of key investment terms are used in different ways in investment material.

Clear and consistent explanations of key terms is important for investors. Definitions of commonly used terms can be a problem where the terms are used inconsistently or vaguely. This can cause confusion in the mildest sense or potentially be misleading at the other end of the spectrum.

Examples of terms that are used but where a consistent definition may not be evident are noted below.

Investment grade – typically refers to rating agency methodology and rating grids but is regularly used in relation to loans that are not formally rated. In some cases the ‘rating’ may be a manager using the methodology of a rating agency but in other cases it won’t be. The manager using a rating agency methodology will not capture the qualitative assessments of the rating agency, which form part of a rating. Either way, it is often not clear. The implication of investment grade is that a credit is equivalent to or better than a formally considered BBB–S&P Global rating or Moody’s equivalent rating.

First-ranking or senior – typically used to describe the security position of a loan as being the highest or best, but may not account for borrower structures that use SPVs or interposed entities which could subordinate a security.

Senior secured – sometimes does not explain the nature of the security.

Junior – sometimes does not explain where exactly security ranks in the credit structure of an investment.

Loan-to-valuation ratio – can refer to an independent or external valuation, or an internal valuation. In the case of construction loans, it can refer to an expected loan-to-completion valuation or an ongoing loan-to-progress valuation with very different implications.

Guidance on the definition of key terms would be beneficial to investors and help to bring clarity and consistency to investment material.

13 Advice and analysis

Private credit offerings are frequently subject to review and recommendations or otherwise by asset consultants, research houses, financial advisers and other brokers. These organisations play an important role in the private credit ecosystem, especially in the wholesale and retail investor segments of the market. Their views are considered and often relied upon by investors who do not always have the skills to assess private credit offerings for themselves. As a result, these organisations hold considerable power and influence.

From an overall market information and education basis, greater numbers of independent research reports and public analysis of private credit offerings can only be beneficial for the sector.

Retail

At this stage, we have not been able to build an accurate picture of how and where in the adviser or wealth management sector – including platforms – that retail investors are being introduced to private credit offerings. Traditional avenues would include financial and wealth advisers, accountants and brokers. Anecdotally, we understand that there are instances of brokers being paid an introduction fee for recommending investors into private credit funds.

We expect the retail component of the market to grow, boosted in part by a potential influx of capital as the \$40 billion bank hybrid market matures. As retail demand continues to grow as expected, it would be helpful for ASIC to develop a good picture of the retail segment's avenue to the private credit market. That information may also be useful for providing some insight into the knowledge and capability of those parties making investment recommendations to retail investors to invest in private credit.

14 Systemic risk

Given the relative small size of the Australian private credit market, systemic risk is unlikely to be a major concern today. However, regulators should monitor the market closely as it continues to grow in the future.

Areas that may warrant attention in the future are:

- The property construction and development sector and particularly the exposure of retail and less sophisticated investors to this part of the market
- Managers that hold a material exposure to one particular sector or industry, particularly property
- Increased bank exposure to private credit through partnerships and funding.

Linked to systemic risk, the integrity of the market depends upon investors, borrowers and the broader financial community having confidence in the transparency and workings of the sector.

When looking at system risk, consideration should be given to what type of reporting to regulators would be helpful to allow them to monitor the market and to equip them with relevant and sufficient information to assess risks.

Stress testing for the impacts of an economic downturn, especially on real estate values, would be particularly instructive for managers and regulators.