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Private Credit at a Systemic Inflection Point

The US private credit (PC) market is currently undergoing its first comprehensive stress test since its dramatic expansion following the 2008 Global Financial Crisis (GFC).

With global assets under management (AUM) projected to exceed $3 trillion by 2028, and already totaling over $2.1 trillion, PC has fundamentally altered the landscape of US corporate finance. The primary difficulties looming over this sector are rooted in the confluence of structural underwriting erosion, marked by high borrower leverage and looser covenant protections, plus severe cyclical pressure from high floating interest rates.

While the asset class offers structural advantages, such as long-term committed capital and the ability for lenders to negotiate and manage loans directly, these benefits are now being severely tested.

The structural advantages are partially offset by opacity risks, which stem from subjective valuation methodologies and the widespread use of financial engineering mechanisms that delay the recognition of credit stress.

Key Vulnerabilities and Market Signals

The financial vulnerabilities in the private credit market are concentrated in two primary areas: borrower fragility and systemic interconnectedness.

Borrower fragility is quantified by deteriorating Interest Coverage Ratios (ICRs), which measure a company's ability to service interest payments from earnings.

Median ICRs are tightly clustered around 1.8x to 2.0x in the middle market , signaling minimal operating buffers against further economic contraction or sustained high rates. This fragility is critical, as analysts estimate that 20% of middle-market companies are now running below a 1x ICR.

Systemic interconnectedness involves the traditional banking sector. Federal Reserve data indicates that banks have become a key source of liquidity for PC funds, providing substantial committed credit lines that amounted to approximately $95 billion as of the fourth quarter of 2024. This deep entanglement links the stability of the nonbank sector back to regulated financial institutions.

Market concern regarding these vulnerabilities is clearly visible in the persistent and often widening discount observed between the share price of publicly traded business development companies and their reported Net Asset Value (NAV). This price/NAV discount is widely

interpreted as the market expressing skepticism over the reliability of management's mark-to-model valuations.

Projected Near-Term Outcome

In the near term, the analysis suggests a continuation of relatively low *reported* default rates. This is not necessarily an indication of robust health, but rather the consequence of active management of distressed assets through sophisticated financial forbearance strategies. These strategies include the aggressive use of Amend-and-Extend protocols, whereby maturity dates are deferred; Equity Cures, where sponsors inject cash to temporarily remedy covenant breaches; and the increasing use of Payment-in-Kind (PIK) interest capitalization.

Distressed assets are expected to be resolved predominantly through out-of-court restructurings, often leading to debt-for-equity swaps or shifting assets into continuation funds. These mechanisms effectively defer or privatize the realisation of losses, preventing a sudden, disruptive spike in public default metrics.

Why Difficulties are Looming (Causation)

The current difficulties in private credit are the result of structural changes in the US capital markets colliding with cyclical economic pressures, leading to a decade of weakening underwriting standards.

Post-Global Financial Crisis Disintermediation

The primary structural driver for the rise of private credit was the regulatory response to the 2008 financial crisis. Post-GFC regulations, such as Basel III, increased capital requirements for traditional banks and restricted their involvement in riskier, leveraged corporate lending. This created a market disintermediation, pushing leveraged financing out of regulated bank balance sheets and into non-bank financial institutions, including private credit funds and BDCs. This process created a multi-trillion-dollar financing gap that private credit was uniquely positioned to fill.

The search for yield by institutional investors further fueled this expansion. Pension funds and insurance companies, seeking to meet long-term liabilities in a persistently low-interest-rate environment post-GFC, were drawn to private credit's promise of higher returns and an illiquidity premium. The asset class saw AUM grow at an annualized rate of 14.5% over the past decade.

Efficiency and Flexibility

Private credit, particularly direct lending, proved highly attractive to private equity (PE) sponsors because it offers customized loan structures, flexibility, and certainty of execution that are often superior to the slow, syndicated processes of traditional banks. Direct lending frequently involves unitranche debt, combining different debt classes into a single loan, further streamlining complex leveraged buyouts.

The Systemic Migration of Risk

The rapid growth of the nonbank sector did not eliminate systemic risk; rather, it shifted the risk from the heavily regulated banking system to the less-regulated "shadow banking" sector.

Federal Reserve analysis confirms that this shift involves a critical feedback loop: banks have become a key source of liquidity for these private credit vehicles through the provision of committed credit lines.

This arrangement, where banks fund the NBFIs that hold the riskier assets, suggests that regulatory constraints redirected financial risk rather than reducing the financial system's overall exposure to highly leveraged corporate borrowers. This process of systemic migration and interconnected funding warrants close monitoring by macroprudential authorities.

Erosion of Underwriting Standards: Leverage Creep and Covenant Risk

The substantial influx of institutional capital into the private credit space has led to the emergence of large funds facing "significant pressure to deploy capital efficiently. This structural imperative, compounded by fee structures often tied to AUM or reported NAV, creates an inherent incentive for managers toward forced deployment, which can often translate into accepting diminished credit quality and looser loan terms to secure deals.

Leverage Multiples

A clear manifestation of eroding standards is the rise in borrower leverage. While private credit offers bespoke risk structures, leverage ratios have increased, particularly in the middle market. Direct lenders frequently facilitate leverage multiples of 5.0x–5.5x EBITDA, which generally exceeds the 3.5x–4.0x cap favored by traditional banks. For middle-market LBOs in 2024, leverage tends to clear around 5.0x EBITDA.

However, more concerning data reveals that the average leverage across the broader US middle-market credit estimate population reached an average of 7x in 2024. This elevated debt burden increases the corporate sector’s vulnerability to financial shocks.

The Deterioration of Covenant Protection

The erosion of underwriting is perhaps most evident in the documentation standards. As private credit funds increasingly compete with the broadly syndicated loan (BSL) market for larger, upper-mid-cap transactions, they have adopted Cov-Lite (absence of maintenance covenants) and Cov-Loose structures.

Maintenance covenants, which historically included tests for maximum leverage, minimum interest cover, and minimum cashflow cover, serve as essential risk management tools that allow lenders to intervene proactively. These tests alert lenders to a borrower's divergence from agreed financial parameters *before* catastrophic liquidity failure.

The shift toward Cov-Lite and Cov-Loose structures forces lenders to wait until an outright payment default occurs, severely limiting restructuring optionality and potentially reducing ultimate recovery values.

To illustrate the competitive environment and the financial risks assumed, the table below provides a comparison of credit stress metrics between private and public debt structures.

Comparative Credit Stress Metrics: Private vs. Public Debt

Metric	Private Credit (Direct Lending)	Broadly Syndicated Loans (BSL)	Significance
Median Leverage (Debt/EBITDA)	~4.0x–5.0x (Mid-Market LBOs, 2024)	~5.8x (Upper Market, 2024)	Indicator of borrower debt capacity and enterprise risk.
Median Interest Coverage Ratio (ICR)	~1.8x – 2.0x (2023/2024)	N/A (Generally higher and more robust)	Stress indicator reflecting burden of high floating interest rates.
Financial Covenants	Maintenance Covenants (Pervasive, but weakening)	Cov-Lite (Majority, ~90%)	Lender control mechanism; difference drives restructuring optionality.
Trailing 12-Month Default Rate (Q1/Q2 2025)	1.76% – 2.42% (Proskauer Q1/Q2)	1.2% (Leveraged Loan Index, March 2025)	Comparative realized credit risk; requires careful interpretation due to PIK/Amend-and-Extend actions.

The Floating-Rate Stress Test and Interest Coverage Failure

Interest Rate Sensitivity

A defining characteristic of private credit risk is its exposure to interest rate fluctuations. Private credit loans are predominantly floating-rate instruments, typically benchmarked to the Secured Overnight Financing Rate (SOFR). Consequently, the rapid and sustained normalization of rates by the Federal Reserve, resulting in an approximate 450 basis point increase in base rates since mid-2022, has translated directly into significantly higher interest expenses for borrowers.

Compression of Interest Coverage Ratios (ICR)

The effect of increased borrowing costs is measured through the compression of the Interest Coverage Ratio (ICR). KBRA analysis confirms that interest rates averaging 12% have arrived for most borrowers. Despite many middle-market companies improving operating margins in 2023, the median EBITDA-to-interest coverage remains constrained at 1.8x–2.0x. A significant minority, estimated at 20% of the middle-market population, has an ICR below 1x.

These firms are technically insolvent on a cash flow basis, unable to cover their interest obligations from operating earnings, forcing them to rely on existing liquidity, revolving credit drawdowns, or sponsor support.

Sectoral Stress Amplifiers

This stress is amplified in specific sectors where private credit exposure is high. In Commercial Real Estate (CRE), private credit funds are actively purchasing distressed debt from banks, stepping into a market where severe monetary tightening and structural shifts (e.g., hybrid work) have caused property values to reset. Analysis indicates that 44% of office loans are in negative equity. Furthermore, private credit funds actively lend into the leveraged Technology/SaaS sector, providing financing at high multiples, sometimes reaching 5-6x monthly recurring revenue (MRR), making these high-growth models highly vulnerable to sustained high capital costs.

PIK and Amend-and-Extend Mechanics

The private credit market utilizes flexible structuring tools that, while intended to maintain borrower liquidity, can also function to mask underlying credit distress and defer loss realization.

Payment-in-Kind (PIK) Mechanics

Payment-in-Kind (PIK) interest allows a borrower to conserve cash by deferring regular interest payments and instead adding the accrued interest to the loan’s principal balance. This mechanism has seen a pronounced rise, driven by borrowers facing severe cash flow pressure from high floating rates. Public BDCs reported that 11.7% of their loans involved PIK payments in the second quarter of 2024, up nearly two points year-over-year.

The consequence of this PIK usage is the creation of a "shadow default rate." Lenders record this non-cash interest as revenue, inflating reported portfolio yields and returns (e.g., peak BDC returns of 12% seen post-2022 rate hike).

Since management fees are often calculated on reported AUM or NAV, this practice generates a structural incentive for fund managers to accept PIK arrangements and avoid necessary markdowns, thereby concealing the true trajectory of liquidity distress among their borrowers.

Amend-and-Extend Protocols

The preferred method for navigating borrower difficulty in private credit is the Amend-and-Extend protocol, which modifies the financing terms, primarily by deferring the maturity date. This strategy often involves lenders negotiating improved terms, such as higher margins or resetting of non-call periods, in exchange for avoiding default.

Crucially, sponsors frequently use "equity cure" provisions, contributing cash equity to temporarily restore compliance after a financial covenant breach. This "can kicking" strategy, along with covenant waivers, delays loss realization for the lender but prolongs the existence of high debt levels in companies that may not be fundamentally solvent in the current rate environment.

Market Contagion and Systemic Jitters: Why the Market Reacts

The market reacts not just to the underlying deterioration of credit quality, but to the specific lack of transparency and the channels through which private credit risk can transmit across the financial system.

The Valuation Conundrum: Mark-to-Model and Opacity

Illiquidity and Fair Value Hierarchy

Private credit loans are inherently illiquid due to their bespoke nature and the absence of a secondary trading market. Consequently, these assets are categorized as Level 3 under US GAAP (ASC 820) or IFRS 9 fair value standards, meaning their valuation relies on unobservable inputs.

Subjectivity of Mark-to-Model (MtM)

In the absence of observable market prices, private credit valuations utilise mark-to-model (MtM) approaches. While valuation policies must conform to fair value standards, accounting guidelines do not mandate any specific technique for asset valuation, granting managers significant discretion. This discretion extends to critical inputs, such as discount rates and the selection of comparable transactions, introducing substantial subjectivity and increasing the potential for management bias.

The outcome of MtM valuation is a distinct difference in reported volatility compared to public markets. Private credit asset values tend to adjust slower and move less than publicly traded leveraged loans and high-yield bonds. This low correlation is often cited as a benefit of diversification, but it also represents stale valuations that mask the true severity of credit shocks.

Market Skepticism of BDC NAVs

The market's recognition of this valuation opaqueness is reflected in the persistent and widening discount between the public share price of BDCs and their reported NAV. This price/NAV discount acts as the market's compensatory mechanism, adjusting for the perceived risk of future write-downs and the potential hidden impairment embedded in managerial marks.

Valuation Risk Profile: Mark-to-Model

Risk Factor	Mechanism of Opacity/Bias	Affected Entity	Supporting Source
Valuation Subjectivity	Lack of mandated technical methodology grants discretion over discount rates and comparable selection.	All Private Funds	Chapter 2 The Rise and Risks of Private Credit in Global Financial
Volatility Suppression	Infrequent appraisal leads to stale marks and lower correlation with true market volatility.	All Private Funds	Global Financial Stability Report, April 2024, Chapter 2: "The Rise and Risks of Private Credit,"
Investor Distrust	Persistent discount of BDC Price-to-NAV signals market expectation of future write-downs.	Semi-Liquid Funds (BDCs)	Global Financial Stability Report, April 2024, Chapter 2: "The Rise and Risks of Private Credit,"
Interconnected Leverage	Multiple layers of leverage makes true system-wide fragility difficult to assess.	Banks, Funds, Regulators	Chapter 2 The Rise and Risks of Private Credit in Global Financial

Interconnectedness and Liquidity Risk:

Banks as Primary Liquidity Providers

The interconnectedness between private credit funds and the traditional banking sector represents the key channel for systemic risk transmission. Banks provide crucial liquidity through revolving credit lines and term loans to private credit vehicles and BDCs. As of Q4 2024, banks maintained approximately $95 billion in committed lending to the sector, with BDCs accounting for about $49 billion of the revolving credit facilities.

The risk of contagion stems from the high utilization rate of these facilities—which stood at 56% on average in Q4 2024 and the nature of the commitment. In a stress scenario, such as a sharp rise in borrower defaults or a severe economic downturn, multiple private credit funds could simultaneously draw down their remaining committed lines. This sudden demand for liquidity would immediately stress bank balance sheets, particularly those of regional banks which have been under scrutiny due to concentrated exposure to credit risk. The collapse of firms like First Brands and the sub-prime auto lender Tricolor has already sparked market jitters and resulted in write-offs at regional banks.

Retailisation and Mismatch Risk

A further complication is the growth of semi-liquid fund structures, such as non-traded perpetual BDCs and interval funds, which target high-net-worth and individual investors. These vehicles, which amounted to $128 billion in non-traded BDC assets as of Q1 2025, invest in highly illiquid, long-duration assets but offer frequent redemption windows (sometimes quarterly or daily).

This structural mismatch between asset illiquidity and investor redemption rights introduces an untested liquidity risk. Should credit quality deteriorate significantly, simultaneous redemption demands could trigger liquidity management tools (such as gates) or, in a severe scenario, force the managers to sell underlying loans at fire-sale prices, magnifying losses across the entire ecosystem.

Default Trajectory and Loss Quantification

Realised Defaults

Private credit has managed to maintain relatively resilient reported default rates, despite the stress. Proskauer’s Private Credit Default Index reported rates of 2.42% in Q1 2025 and 1.76% in Q2 2025.

These figures, while showing volatility, remain constrained, confirming the immediate effectiveness of financial forbearance strategies like PIK and Amend-and-Extend. However, Moody's projects that realised default rates for loan borrowers are likely to drift sideways around the 7% level over the next year, indicating a prolonged cycle of workouts.

Loss Rate Dependence

The ultimate impact on investor capital will be determined not just by the default rate, but by the loss rate, which is calculated as: Loss Rate = Default Rate $\times$ (1 – Recovery Rate). Historically, first-lien debt has maintained an ultimate recovery value of approximately 70%.

If recovery rates decline—due to increased debt principal resulting from PIK capitalisation, weaker collateral quality, or protracted restructuring negotiations, even moderate default rates could translate into significantly higher realised losses.

Consensual, Out-of-Court Restructuring

A key advantage of private credit's concentrated lending model (often involving only a handful of managers) is the ability to execute timely and less costly out-of-court restructurings. This centralized control avoids the volatility and complex litigation, including non-pro rata liability management exercises, that have become common in the fragmented BSL market. Private credit funds tend to prefer driving consensus among stakeholders to maximise enterprise value recovery.

Debt-for-Equity Swaps

When a borrower is severely distressed and the existing equity is far out-of-the-money, private credit funds are prepared to pursue debt-for-equity swaps. This strategy, distinct from distressed-for-control strategies where equity is the explicit purpose, converts senior secured debt into majority ownership. This allows the fund to take operational control and restructure the company outside of bankruptcy, preserving enterprise value.

The Private Credit Secondaries Market

The maturation of the private credit secondaries market acts as a mechanism for managing illiquidity and mitigating forced sales. This market, projected to grow significantly to $50 billion by 2027, enables Limited Partners (LPs) to exit illiquid positions. More importantly, it facilitates GP-led Continuation Funds, where a manager transfers existing, often aging, distressed loans from one fund to a new vehicle with fresh capital commitments. This provides liquidity to existing investors while allowing the manager to hold and manage the illiquid assets longer, preventing a market-disruptive fire sale.

Systemic Risk Assessment

The difficulties currently faced by the private credit market, primarily rising borrower fragility and concerns over valuation, do not yet pose an immediate, systemic risk to the broader US financial sector. The segment, though large at over $2.1 trillion, still represents only about 9% of total corporate borrowing. Furthermore, its use of long-term locked-up capital reduces the vulnerability to bank-style runs.

However, the analysis of ongoing trends indicates that the inherent vulnerabilities including opaque valuations, increasing fund leverage, the growing share of semi-liquid retail vehicles, and banks' concentrated exposure via credit lines are building.

If the current rapid, opaque growth trajectory continues with limited prudential oversight, these factors could eventually become systemic. The vector of future systemic risk points directly to

the banking sector's role as a liquidity provider and the untested liquidity mismatch in retail-facing funds.

Private Credit Systemic Interconnectedness and Liquidity

Exposure Channel	Quantification/Mechanism	Risk Implications	Supporting Source
Total US Private Credit AUM	$\sim\$2.1$ to $$$2.5 trillion (2024)	Growing relevance, market share nearing that of syndicated loans/HY bonds.	Fast-Growing $2 Trillion Private Credit Market Warrants Closer Watch - International Monetary Fund (IMF)
Bank Committed Lending to PC	$\sim\$95$ billion (Committed lines, Q4 2024)	Direct linkage; banks are key liquidity providers to NBFIs.	The Fed - Bank Lending to Private Credit: Size, Characteristics, and Financial Stability Implications - Federal Reserve Board,
Credit Line Utilization Rate	56% (Average, Q4 2024)	High reliance; simultaneous drawdown poses liquidity risk to banks.	The Fed - Bank Lending to Private Credit: Size, Characteristics, and Financial Stability Implications - Federal Reserve Board,
Retail/Semi-Liquid Fund AUM	$\sim\$128$ billion (Non-traded Perpetual BDCs, Q1 2025)	Untested liquidity mismatch; potential for redemption demands to force asset sales.	Private Credit's Rapid Growth Through BDCs Could Erode Quality, Returns,

To navigate this environment, institutional investors must apply rigorous, risk-adjusted scrutiny.

Prioritise Senior Secured Exposure: Given the high starting yields available today, senior secured direct lending remains a compelling strategic hold and is expected to exhibit resilience. Portfolio construction should emphasise diversification across traditional direct lending, asset-backed finance, and opportunistic credit strategies.

Enhance Due Diligence on Fund Practices: Investors must look past reported returns and scrutinizs manager behavior, specifically auditing valuation policies (MtM methodology), observing trends in PIK utilization, and enforcing maintenance covenant quality. Filtering out hyperscalers who show evidence of underwriting erosion is paramount to mitigating long-term losses.

For macroprudential stability, policy responses must focus on transparency and managing interconnectedness.

Address Transparency and Data Gaps: Enhanced reporting requirements for private credit funds, potentially via expansion of Form PF, are essential to allow regulators to comprehensively assess exposures, credit quality, and interconnections within the ecosystem.

Monitor Interconnectedness: Regulators must continue to monitor the bank channel, tracking dedicated bank credit lines to PC funds using supervisory data (like FR Y-14Q). Authorities should consider whether to expand the regulatory perimeter to significant private credit funds and stress-test banks' preparedness to manage a liquidity crunch scenario arising from simultaneous credit line drawdowns.

Test Liquidity Risk: The liquidity and conduct risks associated with the rapid growth of retail-facing, semi-liquid funds must be a priority for supervisory bodies. These funds require careful monitoring, and their liquidity management tools (e.g., redemption gates) must be tested against potential severe runoff scenarios.