By Global Markets | 1 April 2026

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Developed Market Financials

Private credit; public concerns

Executive Summary

- Private credit has expanded rapidly in an unusually benign cycle, driven by ultra-low rates in 2020-21 and limited credit stress, leaving asset quality largely untested until now.
- An approaching maturity wall and higher-for-longer rates are set to intensify refinancing risk, particularly for highly leveraged, floating-rate loans to middle-market borrowers. While much of the maturity was addressed through refinancing and extensions in 2024-25, this has largely deferred risk into 2027-28, potentially entrenching weaker credits and delaying necessary restructurings.
- Elevated PIK usage creates structural vulnerabilities, inflating LTVs, obscuring underlying cash flow weakness and generating fund-level liquidity mismatches. For BDCs, high PI income complicates dividend requirements.
- Default rates are likely to rise, with loss severity tied to tighter monetary conditions and slowing growth. The adjustment process is likely to be gradual - through reduced distributions, widening secondary market discounts and isolated credit losses - rather than through sudden or systemically disruptive events.
- This cycle is particularly vulnerable due to interlinkages with banks, insurers and public markets. As redemption pressure builds, bank lending tightens, defaults rise and valuation opacity persists, the stress in private credit risks spilling outward if macro conditions deteriorate further.
- Whether localized stress becomes systemic hinges on two key variables: the trajectory of software sector fundamentals amid AI disruption, and the ability of the private credit refinancing cycle to proceed without a liquidity shock.
- The market appears to be under-pricing late-cycle risks, as spreads remain near historical tights despite shrinking margins for error amid AI-driven valuation uncertainty, tightening underwriting standards, waning investor appetite and increased redemptions.
- We continue to favour a defensive stance at this stage of the cycle, as we anticipate more attractive entry points ahead. We reiterate our preference for high quality credits.

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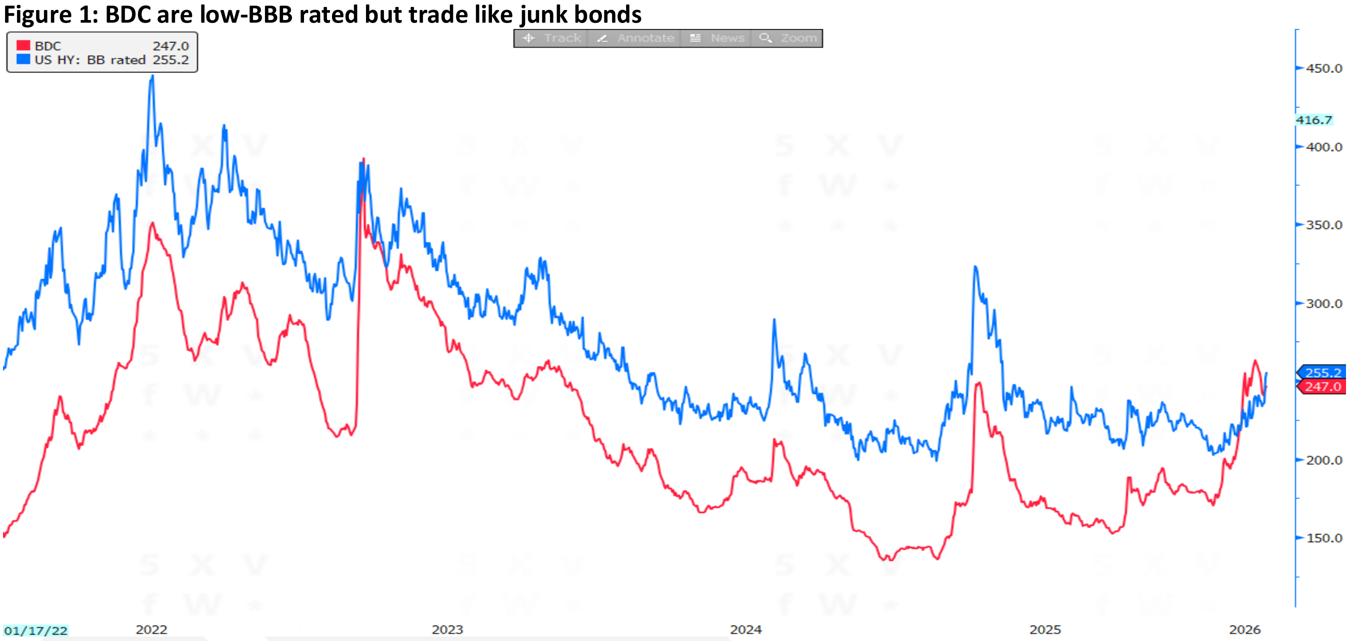
Private credit at the inflection point: For much of the post-2020 cycle, private credit appeared insulated from broader market volatility. Returns held up, defaults were manageable and the asset class attracted record capital inflows. But the asset class has entered a decisive inflection point.

Concerns about underlying borrower health are surfacing even as headline expected economic growth remains relatively resilient. Deterioration in the macro environment – particularly from an external which such as the current conflict in the Middle East – would likely amplify these vulnerabilities. Even short of a full-scale crisis, such shocks could intensify the slowdown by accelerating credit deterioration, tightening financial conditions and reinforcing negative transmission channels across the financial system.

What makes this cycle especially vulnerable is that private credit is deeply intertwined with banks, insurers and public markets. As private credit headlines become more dominated by redemption pressure, banks restricting lending, rising defaults, valuation opacity and weakening returns, these risks may no longer be contained. The longer macro conditions remain restrictive, the higher the likelihood that pockets of stress escalate into broader financial spillovers.

Markets are clearly taking note and starting to price the structural vulnerabilities of private credits. Recent spread movements suggest a high risk premium is being demanded for Business Development Companies ("BDC"). Despite having an average rating of low BBB, spreads have converged with the HY (BB) sector – Figure 1.

Figure 1: BDC are low-BBB rated but trade like junk bonds



Source: Bloomberg

Similarly, given the closer interlinkage between private credits with Banks and Insurance, Financial spreads have underperformed the Corporates – both at the Senior tranches (Figure 2) and at the more subordinated structures in AT1 (Figure 3).

Figure 2: Senior tranches underperforming IG Corporates…

Source: Bloomberg

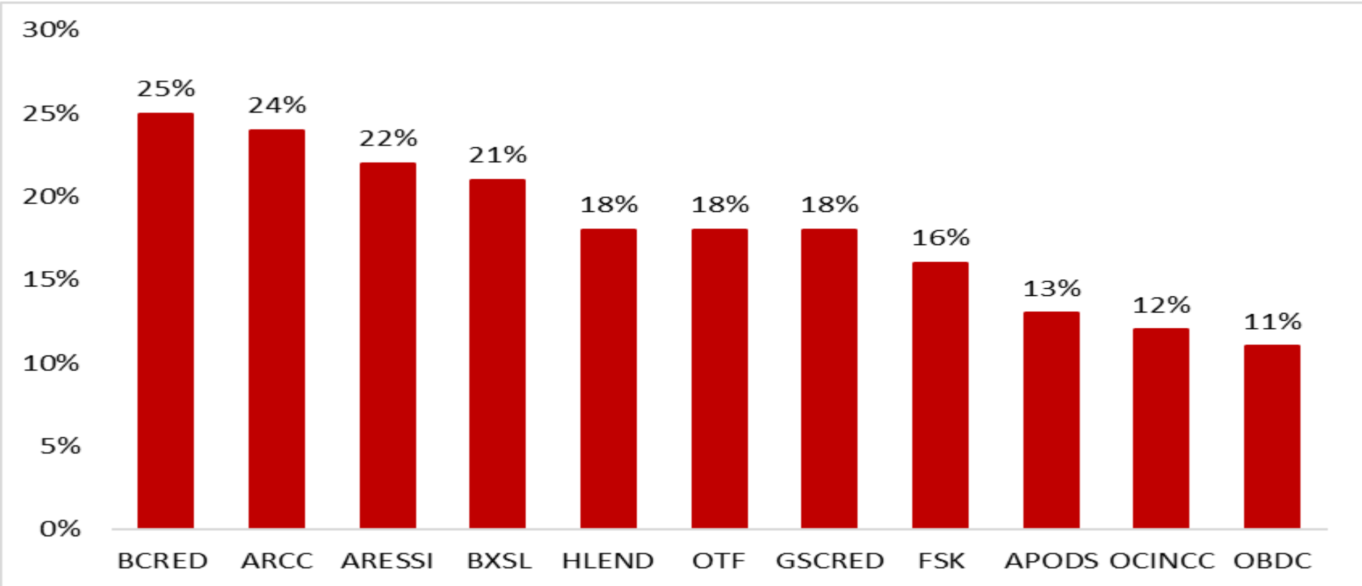
Figure 3: …similarly in the AT1 segments

Source: Bloomberg

AI disruption as a structural shock: The single most concentrated risk in private credit portfolios today is exposure to the software and services sector – and specifically, the AI disruption unfolding within it.

Software and services represent nearly a third of all BDC loan exposure. Figure 4 shows reported software exposure across the largest BDCs. Although they may appear below 30%, this likely understates true risk once adjacent sectors such as business services, payments, and healthcare are included.

Figure 4: Reported Software Portfolio Exposure (% of Loans); but likely understating true risks



Source: Bloomberg, Company Data

Why AI is making this worse: Many of these businesses rely on recurring enterprise contracts. As AI clients begin insourcing AI-enabled functions, revenue visibility collapses quickly. The risks compound rapidly:

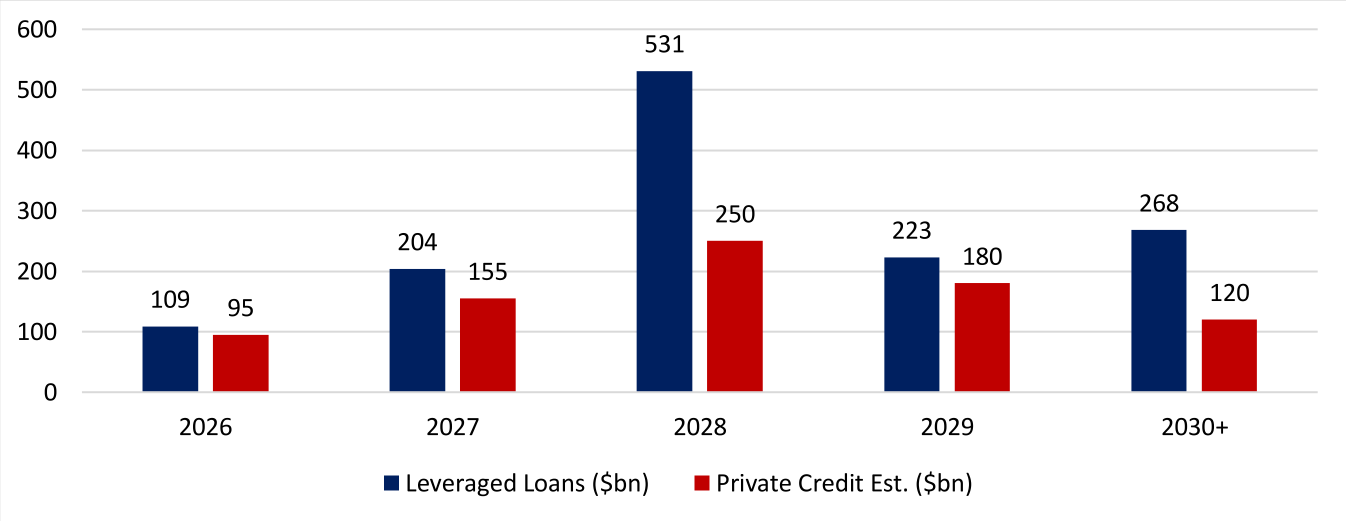
- Recovery values in distress are inherently limited – asset-light businesses leave little collateral behind.
- Valuation multiples compress, eroding equity buffers even where starting loan-to-value ("LTV") ratios appeared conservative.

The Maturity Wall; and the "Extend-and-Pretend" trap: A pressing concern is the approaching maturity wall. Leveraged loans and private credit maturities are concentrated in the 2027-28 window, with over USD531bn in leveraged loans due in 2028 alone, rising to over USD268bn in private credit by 2030+.

Much of the 2025 maturity wave was addressed through refinancing and maturity extensions during the 2024-25 window – but this strategy has merely shifted the problem forward, concentrating in the 2027-28 period. While these arrangements provide temporary breathing room and allow lenders to avoid near-term markdowns, they also risk entrenching weak credits and postponing necessary restructurings.

Borrowers who cannot refinance at current rates face a choice: accept worse terms or default. The risk of defaults gets compounded as banks (such as JP Morgan and likely others that may follow) tighten these facilities to AI-driven business model uncertainty. If banks tighten these facilities as maturities approach (following JPMorgan's lead or Barclay's restrictions on asset-based lending), the refinancing bottleneck will worsen.

Figure 5: Approaching maturity wall in Leveraged loans and Private Credit (USD'bn)



Source: BRG ThinkSet, S&P Global, Fitch Ratings

PIK as a warning signal: Paid-in-kind ("PIK") usage has surged from ~7% of loans in 2021 to over 11% by end 2025, according to Lincoln International. While PIK can serve as a legitimate financing tool to support growth (Good PIK), it can also function as a "shadow default rate" indicator. Bad PIK accounts for 6.4% of loans in 4Q2025 and serves as a proxy for borrowers that may have otherwise defaulted absent this relief.

The mechanics are problematic as elevated PIK usage inflates LTV ratios and obscures underlying cash flow weakness. Elevated PIK also creates liquidity mismatches at the fund level. This is because BDCs are required to distribute 90% of taxable income as dividends and when PIK exceeds ~10% of a fund's earnings, managers may be forced to sell assets, raise external capital or cut dividends to meet distribution requirements. Notably, PIK usage is higher in sectors such as software and healthcare technology.

Redemption Risk and the Liquidity Feedback Loop: Liquidity mismatch remains the key accelerant in private credit markets. Redemption requests at several semi-liquid vehicles, including BDCs and interval funds, have exceeded the usual 5% quarterly limits, forcing managers to cap withdrawals.

The feedback loop is dangerous: while this provides temporary relief, unmet demand is likely to roll forward and intensify at the next redemption window. As retail and wealth investors reduce exposure amid default concerns, these structures face mounting strain - from offering periodic liquidity against illiquid assets, to triggering forced price discovery and amplifying valuation pressure across the private credit ecosystem.

Rising redemptions can set off a negative investor confidence feedback loop. Sustained outflows, coupled with restricted bank lending, risk triggering forced price discovery, amplifying valuation pressure across the private credit ecosystem.

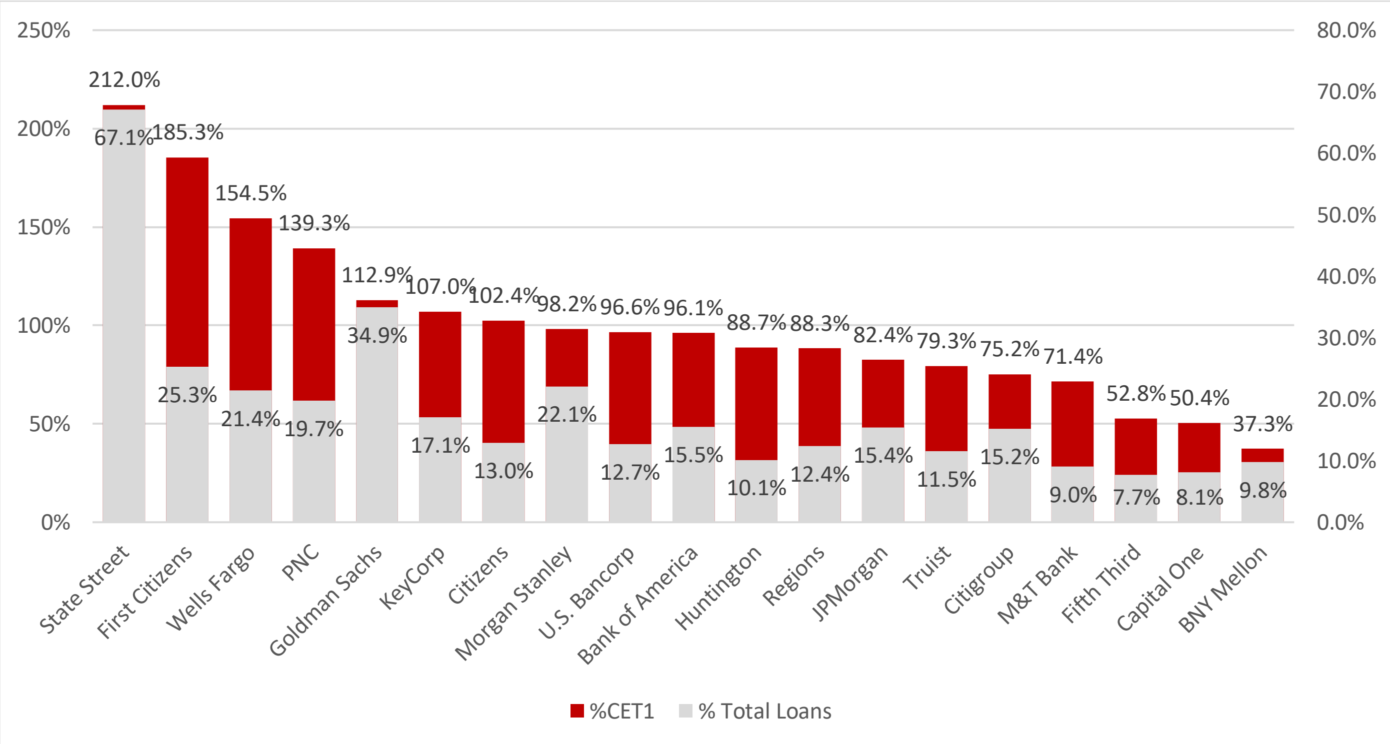
The stress that currently appears contained within individual private credit vehicles risks migrating outward, particularly given the deepening links between private credit, regulated financial entities and public markets.

Quantifying the exposure at banks:

- Total bank lending to Non-depository financial institutions ("NDFIs") reached ~USD1.57tn across US banks as of 4Q2025, with USD410-540bn in direct lending to private credit entities – see Appendix 1.
- The Financial Stability Oversight Council pegged total loan commitments to private credit funds at ~USD445bn (2Q2025). This is a contingent exposure, where banks may be called upon to fund commitments during periods of stress, precisely when liquidity is most scarce.
- Federal Deposit Insurance Corporation data shows NDFI has grown from <1% in 2010 to approximately 11% of loan portfolios by end-2025.

Concentration is highest among large banks, while regional banks often show higher exposure relative to equity capital. The largest diversified banks (JPM, BofA, WFC, Citi) sit at 75-150% of CET1 in NDFI exposure. By contrast, some regionals (EverBank, Axos Bank, Merchants Bank of Indiana) run NDFI exposure at 3-4x their equity. At the same time, these institutions also maintain commercial real estate ("CRE") exposure about 3x of their equity base, creating meaningful tail risk in the event of a simultaneous downturn in both CRE and private credit. Overall, we view the risk profile as materially higher for regional banks relative to US GSIBs.

Figure 6: Total NDFI loan as % Common Equity Tier 1 and % of Gross Loans



Source: FFIEC, OCBC

The Insurance Channel: With ~30% of US life insurers' portfolios allocated to private markets, insurance balance sheets represent an increasingly important channel for potential systemic transmission. Major insurers are steering sizeable volumes of insurance capital into private credit strategies, in affiliations with major private equity groups such as Apollo, KKR and Blackstone.

While insurers are less susceptible to run risk, widespread downgrades or valuation markdowns could trigger higher capital requirements. This may, in turn, force insurers to liquidate other holdings—such as investment-grade bonds and mortgage-backed securities—to restore capital buffers, potentially exerting selling pressure on otherwise liquid markets. For more information, please refer to our earlier work ("Shades of Grey: Looking at Insurers' private credit exposures, 19 March 2026).

From private credit stress to public market repricing: Looking ahead, banks are likely to adopt a more cautious approach toward NDFIs, tightening underwriting standards and constraining system-wide liquidity. This increases the risk of spillovers into public bond markets with spread decompression most pronounced at the lower end of the high-yield spectrum (B-rated and below). A broader reassessment of credit risk could drive tighter financial conditions, pushing up funding costs even for fundamentally stronger issuers. While fund-level liquidity management has so far limited forced selling and supported net asset value ("NAV") stability, sustained redemption pressures—particularly if subscription growth slows—could compel managers to liquidate Level 1 assets (liquid instruments with observable market prices), raising the risk of volatility and price dislocations across leveraged loans, high yield, and ultimately investment-grade credit.

Defensive positioning: We continue to favour a defensive stance at this stage of the cycle, as we anticipate more attractive entry points ahead. As a base case, we think US GSIBs are able to comfortably manage a late-cycle plateau; supported by strong capital and liquidity profiles. In addition, recent proposals by US regulators to reduce capital requirements for large and smaller banks may facilitate higher credit creation at the margin. Nevertheless, we reiterate our preference for high quality credits. Our preferred positioning within the banking sector remains unchanged, with a focus on:

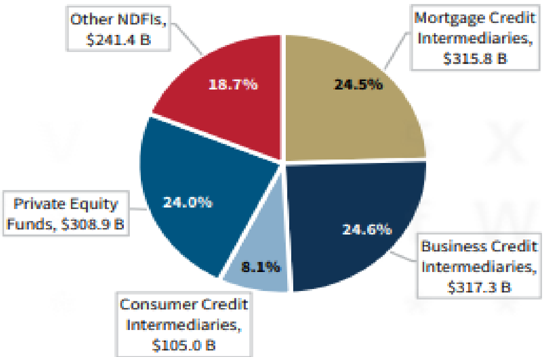
- Preference for 3-5Y maturities across Senior and T2 Subordinated capital instruments,
- AT1 structures with nearer call dates and a higher likelihood of calls; offering a more defensive way to capture yields while limiting downside risk

APPENDIX 1 – Constituents of NDFIs and interlinkages with Banks

As a background, NDFIs encompass a wide range of financial entities that provide services similar to those of traditional banks but do not accept deposits from the general public and are not regulated by the Federal banking agencies. Banks segment their NDFI exposures into five categories, in accordance with FDIC's guidance:

- **Mortgage credit intermediaries:** Include loans to mortgage companies that specialize in residential or commercial mortgage loans, with underlying assets predominantly comprised of residential or commercial mortgages. Includes loans to direct lenders, REITS, CDOs, CLOs, ABCP conduits.
- **Business credit intermediaries:** Includes loans to direct lenders, BDCs, private credit funds, equipment lessors or small businesses.
- **Private equity funds:** Includes loans to private equity funds, capital call commitment and other subscription-based facilities to PE and VC funds.
- **Consumer Credit intermediaries** include loans to auto lenders, consumer finance companies.
- **Others** Includes loans to other depository institutions, insurance companies, hedge funds, pension funds, securitization vehicles.

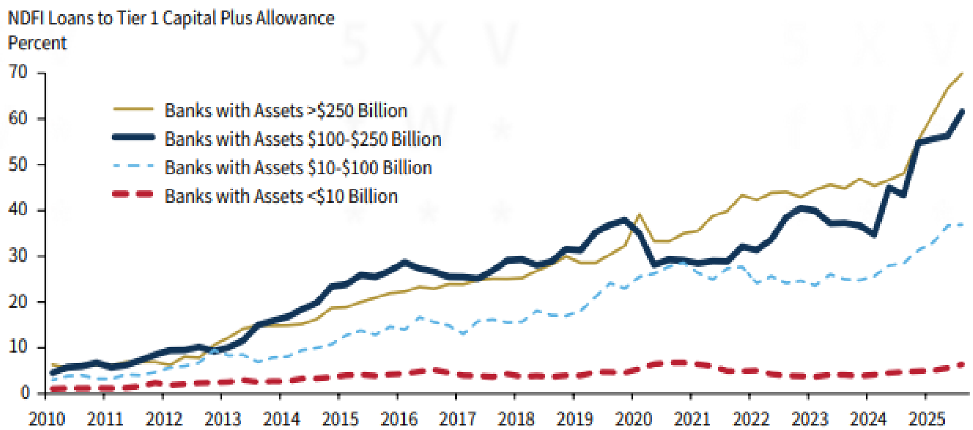
Figure: NBFI loans by Sub-sector



Source: FDIC.
Note: Data are for third quarter 2025 and include only funded commitments. Only banks with more than $10 billion in assets reported. NDFI stands for nondepository financial institution.

Growth in bank lending to NDFIs rose from USD56bn in 2010 to USD1.32tn as of 3Q25; comprising ~12% of banks' total loans. Banks with assets greater than USD250bn hold about 71% of total loans to NDFIs. For these banks, about 57% of NDFI lending was to credit intermediaries.

Figure 7: Larger banks have the highest concentration of loans to NDFIs



Source: FDIC

Figure 8: More than half of NDFI lending is to Business Credit Intermediaries

Stress in private credit typically transmits to the banking sector through three primary structural links: fund financing, correlated liquidity demands, and "business credit intermediary" ("BCI") lending.

- Fund Financing: Regional and super-regional banks provide critical leverage to private credit funds through various credit facilities. If fund performance deteriorates, these facilities can become sources of rapid liquidity stress.
- Subscription Lines: These are short-dated loans secured by investors' unfunded capital commitments. While they have low historical loss rates, banks are increasingly viewing them through a capital markets lens, as higher funding costs and balance sheet constraints force some banks to securitize these portfolios.
- NAV Financing: Banks also provide loans secured by the NAV of a fund's underlying portfolio. Declining performance directly reduces the value of this collateral, potentially triggering margin calls or forced asset sales (fire sales) by funds to meet liquidity needs.

Built-in protection/mechanism: Most bank lending to BDCs is secured by first liens, with significant overcollateralization by, for each fund, a diversified pool of loans. Private credit funds and BDCs are not highly leveraged, largely due to regulatory restrictions on leverage for BDCs as well as sponsors' efforts to maintain investment grade ratings. Additionally, many of the sector's loans to private equity funds and closed-end private credit funds are in the form of subscription facilities and secured by unfunded commitments from fund limited partners, which typically comprise large, often higher-rated institutional investors such as pension funds.

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