OPINION

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Beyond the Surface: Hidden Vulnerabilities and Potential Systemic Risk in the U.S. Private Credit Market

The profitability of U.S. private credit borrowers appears to have deteriorated substantially. The potential for Fed policy rate hikes driven by inflation, combined with large-scale borrowing by hyperscalers, is expected to drive up interest costs for these companies. Weakening profitability and rising interest burdens will lead to borrower default, eroding the net asset value (NAV) of private credit funds. The recent surge in redemption requests from private credit funds is rooted in precisely these concerns. Moreover, the deterioration of the private credit market need not remain confined to that market alone—private credit is tightly interwoven with other sectors of the financial system. We must guard against the risk of missing the broader picture by confining the current problems to private credit alone.

Private credit refers to loans extended to private, unlisted middle-market firms through collective investment vehicles known as funds. Another entity frequently encountered in this space is the Business Development Company (BDC). While BDCs differ in that they are subject to specific requirements and leverage regulations, they are no different from funds in economic substance.[1)]

Of late, the persistent surge in investor redemptions from private credit funds has raised growing concerns about the health of the market. This paper assesses the soundness of the U.S. private credit market and examines the potential for systemic risk originating from it.

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* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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1) For convenience, this paper uses "private credit fund" or simply "fund" to refer to both private credit funds and BDCs without distinction.

Weakening Debt-Service Capacity of Borrowers

The performance of private credit funds is inextricably tied to that of their borrowers. Over the past two to three years, mounting evidence suggests that borrowers' debt-service capacity has been eroding. The first driver is the heavy interest burden. Private credit loans carry floating rates—specifically, the prevailing SOFR (Secured Overnight Financing Rate)[2] plus a credit spread of 500 to 700 basis points. Private credit surged during the zero-rate era following the pandemic, when average borrowing costs stood at just around 6%. As policy rates rose, however, SOFR exceeded 5% in 2023–2024. Spreads also tend to widen in rate-hiking cycles—indeed, spreads that stood at roughly 550 bps in 2020–2021 widened to 650 bps in 2022–2023, an increase of 100 bps.[3] As a result, borrowers now appear to be facing interest rates of roughly 12%—nearly double the zero-rate era.

As interest burdens increase, the profitability of borrowing companies is also deteriorating. Information Technology accounts for the largest share of private credit borrowers at 41%, and most of those borrowers are software companies—so-called SaaS (Software as a Service) firms.[4] The rapid advance of Artificial Intelligence has lowered entry barriers and compressed product development cycles, significantly eroding profitability. This is underscored by the fact that roughly 50% of SaaS-classified companies are currently generating negative EBITDA.[5]

With profitability weakening and borrowing costs nearly doubled, a substantial share of borrowers may already be unable to meet their interest payments. Indeed, as of 2023, approximately one-third of private credit borrowers were failing to cover their interest expense out of operating income.[6] Given the further market deterioration since then, the proportion of companies with an interest coverage ratio below 1.0 has likely grown even larger.

The trend in Payment-in-Kind (PIK) loans also signals stress. PIK is a structure in which a borrower does not pay interest in cash but instead takes on additional debt from the fund to cover the payment. Under this arrangement, the fund receives no cash inflow whatsoever; the interest is simply rolled into the principal.

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2) The rate applied to overnight borrowing collateralized by U.S. Treasury securities.

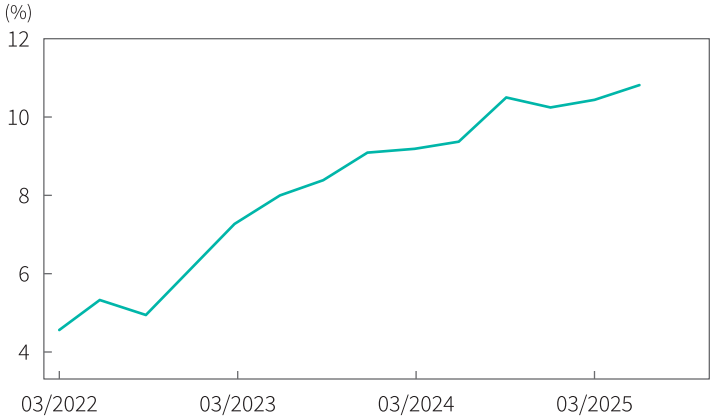
3) Cai, F., Haque, S., 2024, *Private credit: Characteristics and risks*, FEDS Notes.

4) When the analysis is limited to BDCs, the software sector's share (as of September 2025) falls to 20%. Mairone, N., 1. 5. 2026, *Research Note: Mapping software exposure across BDC portfolios*, Preqin.

5) *Economist*, 1. 4. 2026, "Briefing: Private-Equity Firms, A guide to the Private-Credit Crisis."

6) International Monetary Fund, 2024, *Global Financial Stability Report: The Rise and Risks of Private Credit*.

Figure 1. PIK Loan Share



Source: Bloomberg, 2025, "Private Credit's Rising Pile of 'Bad PIK' Points to Default Woes"

As shown in Figure 1, PIK loans accounted for 5–6% of the total in 2022 but surged from 2023 as interest rates rose, reaching 12% by 2025.[7] PIK effectively defers loss recognition by allowing borrowers that are functionally in default to avoid formal classification as such. Research confirms that loans with PIK features are significantly more likely to later experience delinquency or bankruptcy.[8] In short, the growth in PIK reflects a growing number of borrowers unable to service their debt on time—consistent with the decline in interest coverage ratios discussed above.

Erosion of Fund Value

Deteriorating borrower cash flows, falling interest coverage ratios, and rising PIK ratios all weigh on fund performance. While defaults by individual borrowers can have a limited impact on a well-diversified portfolio, that is unlikely to be the case here. Loans are concentrated in a handful of sectors—particularly Information Technology and other industries experiencing profitability declines—making meaningful diversification benefits difficult to achieve.

Concentration at the individual borrower level is also cause for concern. The average private credit fund holds loans to fewer than 100 borrowers, yet the top single borrower and top 10

7) According to PitchBook, PIK loans as a share of total loans stood at 14% as of March 2025. PitchBook/LCD, 30. 9. 2025, *US Private Credit & Middle Market Quarterly Wrap*.

8) Rintamäki, P., Steffen, S., 2025, *Pik now and pay later—how deferred interest reshapes private credit*.

borrowers account for 13% and 51% of the fund's total loans, respectively.[9] This means that defaults by just a few borrowers could inflict severe damage on fund value.

Recovery rates upon default are also weak. More than half of private credit is extended to sectors dominated by intangible assets—software, financial services, healthcare services—where collateral is difficult to secure. Reflecting this, the recovery rate when a private credit borrower defaults is just 33%.[10]

These problems are already beginning to manifest in Net Asset Value (NAV) declines. As of September 2025, loans in private credit funds that had been marked down by more than 50% of principal exceeded 10% of total loans. According to MSCI, the share of loans valued at less than 50 cents on the dollar stood at 12.6% for smaller funds and 8.3% for larger funds. By end-2025, fund returns fell to just 1.8%—roughly half the 3.7% reported six months earlier.[11]

Given the highly illiquid nature of loan assets, declines in valuations may be slow to feed through into NAV—so-called stale valuation. This risk is hard to dismiss: recognizing losses damages a manager's track record, and for some funds, management fees are tied directly to NAV.

With this in mind, the market prices of publicly traded BDCs may offer a clearer read on the true state of the broader private credit market. IMF research has found that when a listed BDC's portfolio deteriorates, its NAV adjusts slowly while its market price falls rapidly,[12] with NAV taking at least a year to converge to market price.[13] As of end-May 2026, the S&P BDC Index has fallen 29.3% from its February 2025 peak[14]—a strong signal that the intrinsic value of many private credit funds has been significantly impaired.

9) Davydiuk, T., Marchuk, T., Rosen, S., 2024, Direct lenders in the US middle market. *Journal of Financial Economics*, 162, 103946.

10) By comparison, the recovery rate for syndicated loans is 52%. Cai, F., Haque, S., op. cit.

11) MSCI, 12. 5. 2025, *The State of Private Markets 2026: Building for What's Next*.

12) This implies that market prices trade at a steep discount to NAV.

13) International Monetary Fund, op. cit.

14) S&P Global, https://www.spglobal.com/spdji/en/indices/equity/sp-bdc-index/#overview

Figure 2. S&P BDC Index

Source: S&P Global

A decline in fund value could raise concerns about fund insolvency. However, private credit funds are generally known to maintain quite low leverage.[15] Even for BDC structures, which bear relatively higher leverage, debt as a share of fund assets stood at 54% as of end-2024—not an excessive level. Accordingly, outright fund insolvency, despite NAV erosion, appears relatively unlikely.

One might consider whether mounting redemption pressure could trigger a liquidity-driven failure. But with a range of tools available to stem cash outflows—including gating (capping redemption volumes) and full suspension of redemptions—fund insolvency due to a liquidity crisis also seems remote.

The Underestimated Size of the Private Credit Market

How significant, then, is the systemic risk posed by private credit? The drivers commonly associated with systemic risk include size, interconnectedness, leverage, and short-term borrowing (liquidity risk). Starting with size: the U.S. private credit market is currently estimated at roughly $2.5 trillion, and the prevailing view is that this is not large enough to pose systemic risk.[16] However, this figure does not account for so-called dual borrowers. Roughly half of private credit borrowers also borrow from banks—and banks have been found to extend

15) International Monetary Fund, op. cit; Aldasoro, I., Doerr, S., Todorov, K., 2025, *Retail investors in private credit* (No. 106). Bank for International Settlements.

16) JP Morgan, 12. 3. 2026, *Private Credit Under the Microscope – Separating Headlines from Fundamentals*.

larger credit lines to companies that have successfully accessed private credit.[17] This suggests that banks carry substantial exposure to private credit borrowers. Moreover, banks provide loans to private credit funds, thereby gaining indirect exposure to private credit.

Life insurers' private credit exposure also warrants attention. While life insurers have traditionally accessed private credit through fund contributions, a structurally new form of exposure has been growing rapidly. Specifically, private credit funds transfer their corporate loans to special purpose vehicles (SPVs), which then issue private Asset-Backed Securities(ABS) backed by those loans—and life insurers buy these ABS.

The driving force is regulatory arbitrage. When a life insurer buys private ABS backed by loan assets rather than making a capital contribution to a fund, its regulatory capital requirements can be reduced by a factor of two to four. A similar effect can be achieved by purchasing privately placed bonds whose underlying asset is capital contributions to private credit funds.

Driven by this regulatory arbitrage, the market for private ABS and private bonds linked to private credit funds has surged to $849 billion—more than twice the size of the entire BDC market. These new types of assets are often not classified under private credit, yet their economic substance is no different from that of private credit. In recent years, life insurance companies have made substantial purchases of private ABS and private bonds (accounting for 65% of outstanding issuance), with these assets now representing 14% of life insurers' general account assets.[18] Given the typically large scale of life insurers, this is by no means a small figure.

Ultimately, when accounting for the existence of dual borrowers, bank lending to funds, and life insurers' holdings of private ABS and bonds, the actual size of the private credit market becomes substantially larger. In this regard, the argument that the market is too small to have any meaningful impact appears to warrant reconsideration.

High Interconnectedness

When multiple funds lend to the same borrower, they share a common risk exposure. In the U.S. private credit market, 61% of borrowers draw on two or more funds, and 18% borrow from

17) Haque, S., Mayer, S., Stefanescu, I., 2024, *Private debt versus bank debt in corporate borrowing*.

18) Meisenzahl, R. R., Overpeck, J., Polacek, A., 2026, *Life Insurers' Private Credit Investments and Annuity Market Share Capture*, Federal Reserve Bank of Chicago.

six or more.[19] There are also cases where one private credit fund invests as a limited partner in another—for example, a private credit fund under asset manager Cliffwater holds a one-third stake in a non-traded BDC managed by Barings.[20] Through overlapping borrower exposures and cross-fund investment chains, private credit funds are tightly interconnected with one another. This means that deterioration in borrower health can spread beyond individual funds to affect the private credit market as a whole.

The private credit market is also deeply entangled with other sectors. Banks are indirectly linked to borrower health through so-called back leverage—lending to funds. The dual borrower dynamic directly exposes banks to the health of the private credit market. Synthetic Risk Transfers (SRTs), which have been growing rapidly, add another layer of concern. An SRT is a contract in which a bank retains a loan asset on its balance sheet while transferring the associated credit risk to a counterparty, including private credit funds.[21] The bank pays a form of insurance premium in exchange for the risk transfer, while the fund assumes the credit risk and receives the premium in return, thereby enhancing fund returns. But as SRT activity grows, so does the link between private credit and banks—and the systemic risk across the financial system expands accordingly. There are even cases where banks lend to the very funds to which they have transferred credit risk via SRTs[22]—amplifying the web of mutual exposure still further.

The life insurance sector has the deepest ties to the private credit market. The acquisition of life insurer Athene by Apollo, a large asset management firm, in 2009 brought significant changes to the traditional life insurance business model.[23] The private equity arm (PE) of an asset management group acquires a life insurer, which then invests the insurance premiums paid by policyholders in private credit funds affiliated with the PE. In this structure, the life insurer becomes a large-scale source of capital, while the fund serves as a lending platform that provides that capital to middle-market companies. The model's success prompted other major asset management groups to race to acquire life insurers through their own PE arms.

19) Mairone, N., op. cit.

20) *Economist*, op. cit.

21) Basel Committee on Banking Supervision, 2026, *Synthetic Risk Transfers*.

22) Cortes, F., Dionis, G. F., Li, Y., Ramirez, M. S., Zhang, X, 2025, *Recycling Risk: Synthetic Risk Transfers*, International Monetary Fund; Berrospide, J., Cai, F., Lewis-Hayre, S., Zikes, F., 2025, *Bank lending to private credit: Size, characteristics, and financial stability implications*, FEDS Notes.

23) Kirti, D., Sarin, N., 2024, What private equity does differently: Evidence from life insurance. *The Review of Financial Studies*, 37(1), 201–230; Cortes, F., Diaby, M. M., Windsor, P., 2023, *Private Equity and Life Insurers*, Global Financial Stability Notes 2023/001, International Monetary Fund.

As a result, PE-owned life insurers' share of total life insurance industry assets rose from just 1% in 2010 to 14% by end-2024.[24] In this way, life insurers—especially those owned by PE arms of large asset managers— are directly exposed to the private credit market, meaning that any deterioration in the private credit market's soundness translates into broader vulnerability across the life insurance sector as a whole.

Mapping the Systemic Risk Transmission Channels

Whether the problems in the private credit market end with manageable losses for institutional and individual investors that have contributed capital to funds, as well as life insurers, banks, and others closely linked to those funds, or instead escalate into systemic risk, depends entirely on the health of borrowers. As discussed, borrowers' health has already been substantially compromised. Because private loans are not marked to market, however, fund NAVs are likely to adjust slowly absent a sharp external shock. In that case, loss recognition by financial institutions with direct and indirect private credit exposure would proceed gradually and to a limited extent—and systemic risk would remain contained.

The calculus changes, however, if NAV suffers a sharp downward adjustment. Artificial Intelligence advances are accelerating, rapidly eroding the profitability of borrowers—particularly software companies. Interest burdens are also mounting. The combination of potential rate hikes driven by inflation and large-scale borrowing by hyperscalers could squeeze existing private credit borrowers through rising funding costs and reduced credit availability. In 2026, spreads on bonds issued by BDCs have widened by as much as 140 bp[25]—a clear signal that private credit borrowers held in fund portfolios are under growing stress.

If the financial soundness of borrowers deteriorates rapidly, there are inherent limitations to adjusting fund NAV on a gradual basis. It is difficult to rule out the possibility that a sudden and sharp reassessment of risk could trigger a large, abrupt decline in NAV. Should such a scenario—where the NAV decline exceeds a threshold—materialize, the problems of the private credit market would no longer be contained within it. In that case, systemic risk would be expected to unfold as follows.

24) Meisenzahl, R. R., Overpeck, J., Polacek, A., op. cit.

25) Reuters, 22. 5. 2026, "Private credit bond spreads show smaller lenders priced at greater risk."

First, losses incurred by institutional investors such as pension funds that have contributed capital to the funds, as well as by life insurers and banks directly or indirectly exposed to private credit, breach thresholds. To rebalance portfolios or satisfy regulatory capital requirements, these institutions would begin liquidating high-quality, liquid assets such as investment-grade corporate bonds—pushing certain asset prices lower. When this happens, the hardest hit would be investment banks and some hedge funds that are highly leveraged and heavily reliant on short-term borrowing. This is because, as the value of the assets they hold declines, creditors that have provided short-term financing secured by those assets rush to recover their loans in competition with one another.

At this stage, not only size and interconnectedness but also leverage and short-term borrowing begin to emerge as full-fledged problems. In effect, all the conditions that can trigger systemic risk have been met. That is, a liquidity crisis erupts at financial institutions that have funded large volumes of debt through short-term borrowing, and as these institutions scramble to raise cash, large-scale asset disposals follow. Given the magnitude of the asset sales, the decline in asset prices is both sharp and broad-based. A self-reinforcing cycle of liquidity stress and falling prices would take hold—and from there, it would only be a matter of time before the broader financial system's soundness was compromised.

Whether this scenario will actually materialize is impossible to predict. But it is worth keeping in mind that years of expansionary monetary policy since the Global Financial Crisis allowed private sector debt to accumulate substantially. On top of this, nearly two decades without a financial crisis have left corporate sector inefficiencies to compound. The U.S. corporate sector currently harbors considerable vulnerabilities,[26] and should financial market volatility intensify for any reason, those vulnerabilities could surface all at once.

Over the past two decades, the boundaries between financial sectors have steadily blurred, leaving the overall financial system more tightly interconnected than ever. Viewing the private credit market in isolation risks missing the broader picture of the financial system as a whole. That is precisely why we cannot afford to let our guard down simply because private credit funds currently have low leverage and little likelihood of a liquidity crisis.

26) U.S. corporate bankruptcies in 2025 hit their highest level since 2010, extending a streak of three consecutive annual increases. Reuters, 14. 11. 2025, “US corporate bankruptcies set to hit 15-year high amid credit jitters, S&P data shows”; Mointordaily, 12. 1. 2026, “S&P: U.S. Corporate bankruptcy filings accelerate further in December 2025.”