CREDIT · May 12, 2026

Private Credit Boom: Opportunity or Systemic Risk?

Private credit AUM has grown rapidly. We examine covenant quality, illiquidity premiums, and whether the market is pricing default risk correctly.

1. How the Market Got This Big

Private credit — loans originated and held by non-bank lenders such as direct-lending funds, business development companies (BDCs), and insurance-affiliated credit platforms rather than syndicated through banks — has grown from a niche allocation into a multi-trillion-dollar global asset class over roughly fifteen years, with assets under management roughly doubling over the five years leading into the mid-2020s.

The growth has structural roots. Post-2008 bank capital regulation (Basel III and, in the U.S., the Volcker Rule) made leveraged lending materially more expensive for banks to hold on their own balance sheets, creating a persistent vacuum in mid-market corporate lending that private credit funds stepped in to fill. Institutional investors — pensions, insurers, endowments — chasing higher yields in a near-zero-rate world for much of the 2010s found private credit's floating-rate structure and yield premium over public leveraged loans an attractive complement to traditional fixed income.

2. What Borrowers and Lenders Each Get

For borrowers, typically private-equity-owned mid-market companies, private credit offers speed and certainty of execution that a syndicated bank loan process cannot match — a single lender or small club can commit capital in weeks rather than the months a broadly syndicated deal requires, and can flex deal terms without the coordination problem of dozens of syndicate participants.

For lenders, the appeal is the illiquidity premium: private credit has historically priced 150–300 basis points above comparable public leveraged loans, compensating investors for the inability to easily exit a position before maturity.

3. The Covenant Quality Question

The rise of 'covenant-lite' structures, loans stripped of the maintenance covenants that once gave lenders early warning and renegotiation leverage when a borrower's financial performance deteriorated, has been a defining trend across both broadly syndicated and private credit markets. Proponents of private credit argue direct, concentrated lending relationships allow for better ongoing monitoring than covenant structures alone provide, since a private lender typically has closer, more frequent access to borrower financials than a diffuse syndicate of public loan holders.

Skeptics counter that the same competitive pressure pushing yields down as more capital chases private credit deals has also pushed covenant packages weaker over time, and that aggressive EBITDA 'addbacks' — adjustments that inflate reported earnings used to calculate leverage ratios — have become increasingly common in deal documentation, obscuring the true leverage a borrower is carrying.

4. Is the Illiquidity Premium Priced Correctly?

A structural critique of the asset class centers on valuation methodology: because private credit loans do not trade on a public exchange, they are typically marked at model-based fair value by the fund manager rather than at an observable market price, which tends to produce smoother, less volatile reported returns than the underlying economic risk actually carries — a phenomenon well documented in the broader private markets literature as 'volatility laundering.'

This matters because investors comparing private credit's smoother return series against public leveraged loans' visibly volatile mark-to-market series may systematically underestimate private credit's true risk, and by extension may be accepting an illiquidity premium that is smaller, in genuine risk-adjusted terms, than the headline yield spread suggests.

5. Payment-in-Kind and the 'Extend and Pretend' Debate

A trend that has drawn increasing regulatory attention is the rise of payment-in-kind (PIK) toggle features, which allow a stressed borrower to pay interest by adding it to the loan principal rather than in cash. Used prudently, PIK toggles give a fundamentally sound but temporarily cash-constrained borrower breathing room. Used as a default-avoidance mechanism, they can allow lenders and PE sponsors to avoid recognizing a troubled loan as impaired, effectively extending the loan's life on paper while the underlying credit quality continues to deteriorate — a dynamic regulators have flagged as a potential source of delayed, rather than avoided, credit losses.

6. Interconnectedness and Where Systemic Risk Could Emerge

Private credit's growth has coincided with growing allocations from insurance companies and pension funds, institutions whose stability is itself systemically important, creating a channel through which stress in private credit could transmit into the broader financial system in a way that was less true when the asset class was smaller and more narrowly held by specialist funds.

Because private credit funds are typically structured as closed-end vehicles with locked-up capital rather than daily-redeemable funds, they are structurally more resilient to the kind of investor-run dynamics that have caused stress in open-ended bond and loan funds during past periods of market turmoil — a genuine structural strength of the asset class that is often understated in more alarmist commentary.

7. Conclusion

Private credit is neither the unambiguous free lunch its most enthusiastic allocators sometimes present nor the ticking systemic time bomb its harshest critics describe. It is a genuine structural response to a real gap left by post-2008 bank regulation, offering real diversification benefits and a defensible illiquidity premium — but one operating with materially less transparency, weaker average covenant protection, and smoother-than-true reported volatility than its public-market equivalents. The risk is not that private credit collapses on its own; it is that its true risk only becomes visible with a lag, well after the capital allocation decisions that created it have already been made.
