LPL Financial

# Rate and Credit View

## *Private Credit at a Crossroads: Stress, Liquidity, and the AI Disruption Cycle*

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## Executive Summary


- **AI disruption, higher rates, and rising redemption pressure** are exposing liquidity mismatches and valuation lags in private-credit portfolios, especially those concentrated in software and SaaS lending.
- **A large share of private-credit portfolios is tied to enterprise software**, with unrealistic 2020–2021 underwriting assumptions now colliding with margin pressure, poor interest coverage, and elevated "bad" PIK usage.
- **Semi-liquid vehicles and appraisal-based NAVs are being stress-tested** as retail redemptions surge, forcing gates, withdrawal caps, and slower distribution cycles across major private-credit products.
- **Default expectations are increasing**, but structural safeguards — gates, collateralized loan obligation (CLO) protections, insurance-company liquidity buffers — limit forced selling, and corporate debt-to-GDP ratios do not indicate system-wide fragility.
- **Loss rates remain low overall**, but the cycle will expose weak underwriting. Managers with conservative valuations, senior-secured portfolios, and prudent leverage that may have better positioning as liquidity tightens.


### Private Credit Faces Its First Real Stress Test of the Cycle

As we wrote in February's *Rate and Credit View*, "When AI Disruption Meets Leveraged Balance Sheets: Credit Market Risks in the Software Sector", corporate credit markets have become unsettled about the potential for advanced agentic AI tools from firms such as Anthropic and OpenAI to automate functions across legal, analytical, marketing, and sales workflows, effectively targeting the software as a service (SaaS)/enterprise software space. Those concerns are highest within the private credit market, and that market is confronting its most meaningful stress test since becoming a dominant source of non-bank financing, with an emerging wave of redemption pressure providing the clearest early signal of underlying liquidity mismatches. The suspension of redemptions across several large non-traded vehicles has exposed how appraisal-based valuations, limited secondary-market liquidity, and concentrated exposures in enterprise software can interact in a higher-rate environment. These events are occurring against a macro backdrop defined by tighter financial conditions for some, weakening borrower fundamentals, and accelerating AI-related disruption, all of which are challenging the optimistic underwriting assumptions embedded in loans originated mostly during the 2020–2021 cycle. As redemption requests rise and managers respond through asset sales, return-of-capital programs, or permanent gating, we continue to advocate for investing in managers who apply disciplined, conservative valuation methodologies, with portfolios composed of senior secured debt securities.

### What is Private Credit?

Private credit is a broad asset class that is roughly $40 trillion in size and encompasses non-bank lending and debt investments that are not publicly traded. Unlike bonds issued in public markets, private credit transactions are negotiated directly between borrowers and investors, resulting in bespoke structures tailored to the specific needs of each deal. The asset class spans several strategies, including mezzanine financing, real estate debt, distressed debt, and asset-backed lending — and while most of the categories listed above are still in very solid positions, direct lending, which is a small piece of the private credit ecosystem, is the area that has been in the headlines recently.

At its core, direct lending involves non-bank lenders — typically alternative asset managers — providing senior secured loans directly to middle-market companies. These businesses are generally too large to rely solely on community banks yet too small to access broadly syndicated loan (BSL) markets efficiently. Direct lenders step into this gap, offering speed, certainty of execution, and flexible structures that traditional capital markets struggle to match.

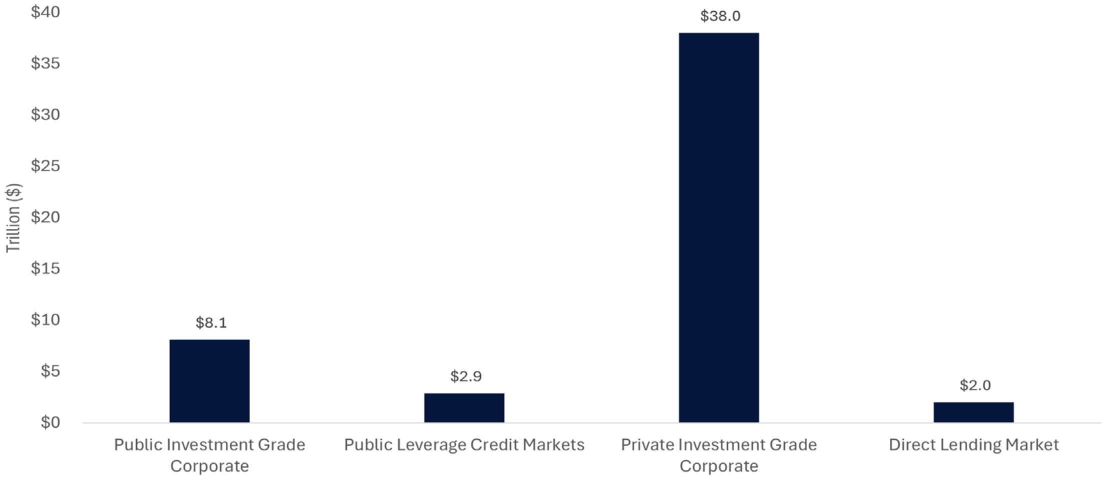
The loans generated through direct lending are typically floating-rate instruments, tied to benchmarks such as secured-overnight financing rate (SOFR), which generally become more attractive to investors as interest rates rise but more onerous to borrowers as interest expenses rise as well. They are also senior in the capital structure, meaning lenders hold the first claim on borrower assets in a default scenario. This combination of seniority, collateralization, and floating-rate income has made direct lending particularly attractive to institutional investors — pension funds, insurance companies, and endowments — seeking income with meaningful risk mitigation.

## Unintended Consequences?

The Volcker Rule, part of the Dodd-Frank Act implemented after the 2008 financial crisis, prohibited large banks from engaging in proprietary trading and significantly restricted their ability to sponsor, invest in, or have certain relationships with private equity and hedge funds (as "covered funds"). This, combined with other post-crisis regulations like Basel III capital requirements, constrained banks' capacity and willingness to hold leveraged loans on their balance sheets or provide high-leverage financing to riskier borrowers, particularly in the middle market and for private equity-sponsored deals.

As such, growth in direct lending accelerated sharply following the 2008 Global Financial Crisis, as tightened bank regulation curtailed pushed lending appetite elsewhere. Alternative managers filled the void, and today the direct lending market represents nearly $2 trillion in deployed capital in the U.S. For middle-market borrowers, it offers a reliable funding partner. For investors, it delivers a yield premium over public credit — the so-called illiquidity premium — in exchange for capital lock-up (this is important).

## Private Credit Markets are Larger than Public Credit Markets




Source: LPL Research, Apollo Global Management 03/15/26
Past performance is no guarantee of future results.

Business Development Companies (BDCs) offer retail investors the most accessible entry point into private credit direct lending, providing high dividend yields due to their requirement to distribute 90% of taxable income. By investing mainly in the debt — and occasionally the equity — of middle-market companies, they give individuals exposure to private credit strategies typically reserved for institutional investors. However, BDC portfolios can be opaque, often employ leverage, and experience NAV volatility unrelated to loan performance. Major players such as Ares Capital, Blue Owl Capital, and FS KKR now anchor an industry exceeding $500 billion in assets.

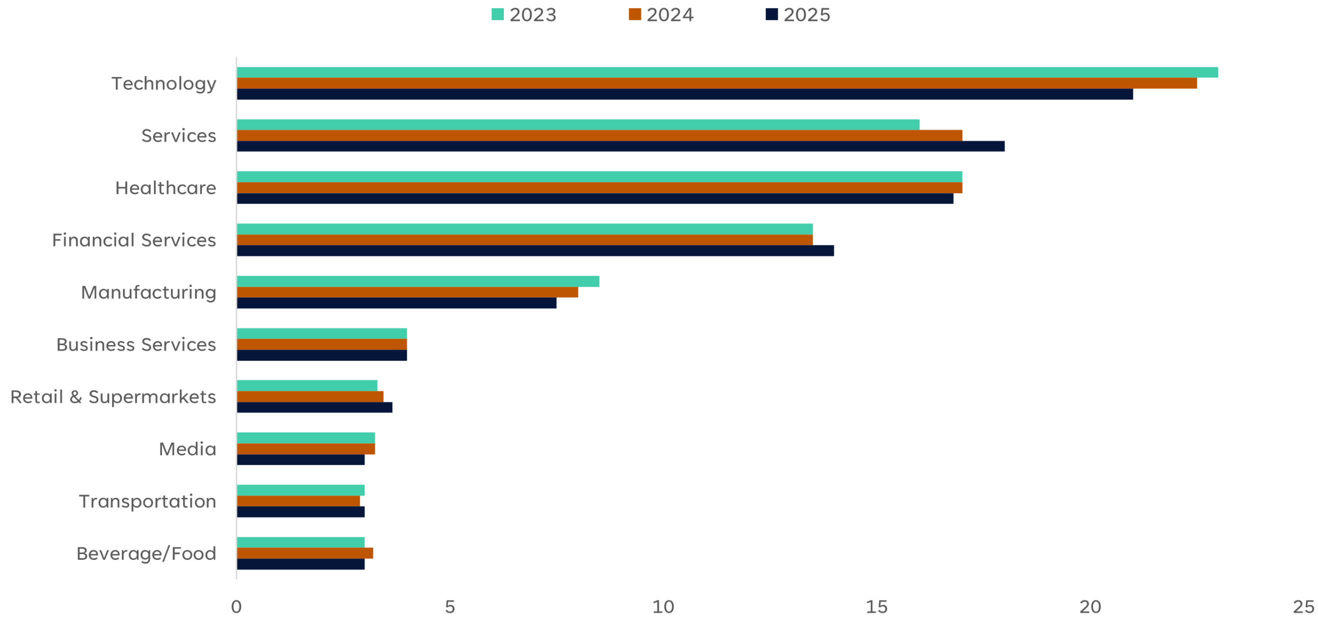
Meanwhile, private-credit ETFs are emerging rapidly, though they face structural challenges since illiquid private loans must be housed within vehicles offering daily liquidity. As a result, most ETFs combine true private loans with syndicated or investment-grade credit to manage redemptions and preserve liquidity. For investors, the appeal is higher yields with familiar ETF mechanics — but the exposure is only an approximation of private credit, and liquidity risks remain significant.

## Private Credit: The Opaque Core of the Problem

Note: throughout the rest of this publication, we will refer to the direct lending segment as "Private Credit" as that has been the preference within the financial media.

Private credit remains the area where structural risks are most deeply embedded — and least visible. Over the past five years, enterprise software has become a core theme for private credit and private equity, with direct lenders funding 40% – 70% of leveraged buyouts between 2022 and 2023, up sharply from 15–25% pre-pandemic. Software and technology companies now represent over 20% of BDC investments, and market estimates are that between 25–35% of private-credit portfolios carry some degree of AI-related disruption risk.

### Technology is the Largest Sector Within BDCs




Source: LPL Research, Pitchbook. 03/15/26
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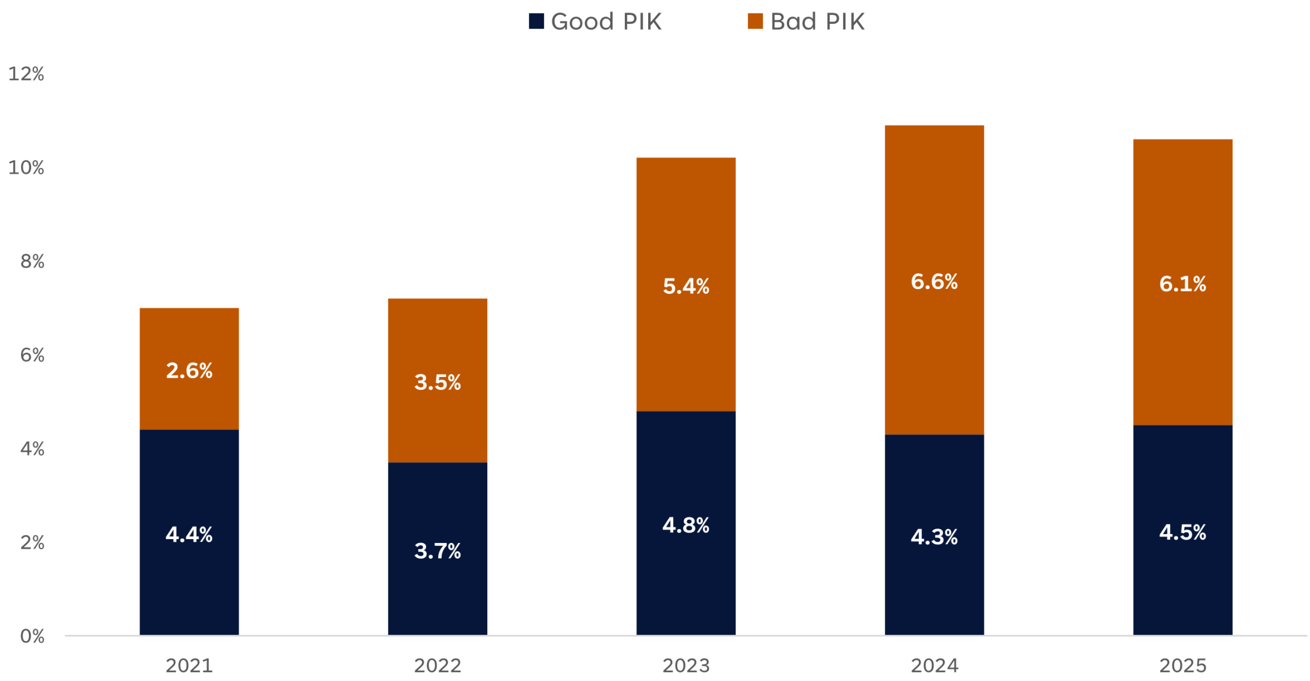
Compounding this, many loans were underwritten with optimistic EBITDA growth expectations that are proving unrealistic in today's higher-rate, slower-growth environment. Borrowers face margin pressure, deteriorating interest coverage, and increased use of payment-in-kind (PIK) features — where borrowers accrue, rather than pay interest — while valuations have compressed and venture funding has cooled. With roughly 15% of SaaS borrowers struggling to cover interest expenses, the sector holds hundreds of billions of dollars that may be more susceptible to default than comparable public-market credit. Importantly, the use of "Bad" PIKs (payment-in-kind terms not part of origination) remain elevated and suggest more loans may have otherwise been stressed/distressed without these provisions.

### Bad PIKs Remain Elevated




Source: LPL Research, Lincoln International VOG 03/15/26
Past performance is no guarantee of future results.

That said, most loans are private equity-backed or sponsored. This ties the activity closely to private equity (PE), as PE firms use private credit to finance leveraged buyouts (LBOs), acquisitions, refinancings, or growth for their portfolio companies, often preferring it over traditional BSLs for its certainty of execution, customized terms, and relationship-driven approach.

In this context, loan-to-value (LTV) ratios — which measure the loan amount relative to the enterprise value of the company — typically incorporate sizable equity cushions to protect lenders. Private credit loans often feature conservative LTVs in the range of 40–60% (frequently mid-40s to around 50–60%), meaning private equity sponsors contribute substantial equity (often 40–60% or more of the deal value). This creates a meaningful buffer that must be significantly eroded — through declines in company value, EBITDA drops, or other stresses — before the senior debt faces material impairment, enhancing risk mitigation compared to higher-leverage structures in some syndicated markets.

A key vulnerability is the absence of mark-to-market pricing. Unlike public loans, private-credit valuations are updated only periodically, which can lag fundamentals by quarters. Many software-focused loans were originated at elevated revenue multiples in 2020–2021, when recurring-revenue models commanded premiums and AI risk seemed remote. As those assumptions weaken, some loans are still carried near par, causing stress to emerge gradually through NAV erosion and rising redemption pressure rather than through immediate spread widening.

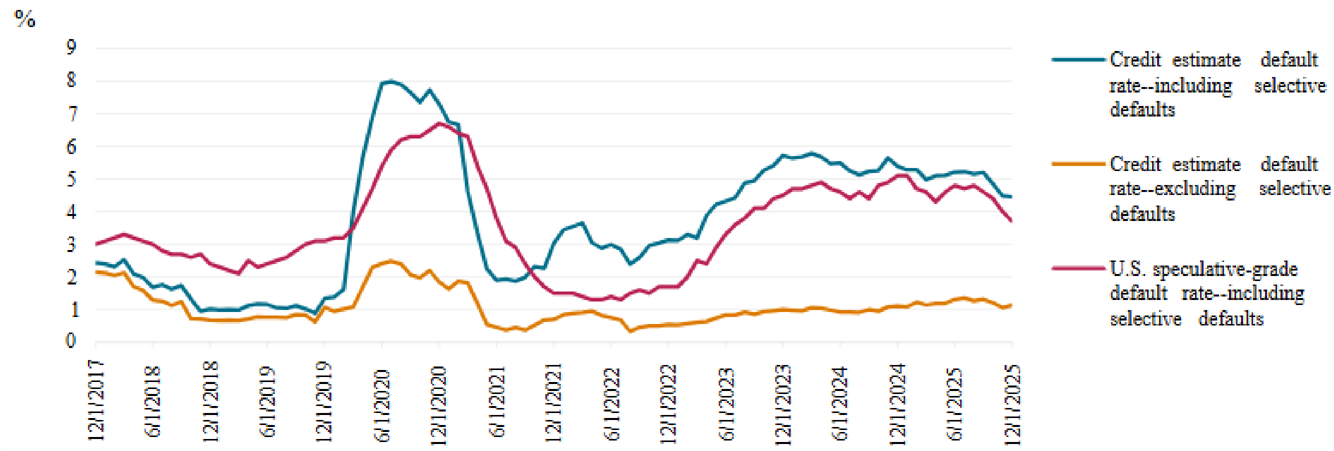
Finally, the illiquidity of these loans creates a structural mismatch for semi-liquid and evergreen vehicles that offer periodic redemptions. As sentiment has shifted, withdrawal requests can quickly exceed the typical quarterly limits, amplifying stress across the ecosystem, as we've seen recently.

## When Redemption Structures Collide with Illiquid Assets

Growing unease about today's private credit market reached a crescendo last week — with comparisons to the mortgage excesses that fueled the run up to the Global Financial Crisis almost overshadowing the escalating conflict in Iran. Market commentators continue to warn that private credit's surge, driven by nonbank firms stepping into roles once dominated by traditional lenders, echoes how subprime mortgage origination moved outside the banking system before 2008. In turn, this reduced market transparency and the overall health of financial markets. The recent bankruptcies of smaller private credit-backed portfolio companies and warnings from major market participants, most notably JPMorgan Chase CEO Jamie Dimon, have only fueled the already high levels of concern from investors.

Against this backdrop, market expectations now call for private credit default rates to rise to around 6% this year (from 4.5% including selective defaults), with a more severe disruption scenario pushing that estimate toward 15%. The conversion of cash-pay loans to bad PIK loans caused most selective defaults for private credit borrowers and accounted for 68% of total defaults. Similar to the trailing 12-month default rate for credit-estimated companies (a euphemism used by rating agencies for private credit issuers), the default rate for rated U.S. high yield issuers — including selective defaults — declined to 3.70% in 2025, from 5.10% in 2024.

### Private Credit Defaults Remain Below COVID-19 Levels




Source: LPL Research, S&P Global 03/15/26
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The recent episode was triggered by a combination of AI/software disruption fears, broader market unease, and the realization that inflows could no longer absorb outflows in a declining-rate environment where retail investors reassessed liquidity and risk. Industry-wide redemption requests spiked in late 2025 and early 2026, with several other large non-traded BDCs and interval funds capping or slowing withdrawals. Sales volumes in some of the largest retail private credit vehicles have slowed markedly. As well, similar to a modern-day bank run, news stories highlighting increased withdrawal requests caused additional withdrawal requests, which were only amplified by the opaque nature of these strategies.

This liquidity crunch highlights a core tension: private credit may offer higher yields but holds long-dated, hard-to-sell assets. When redemptions hit critical mass, managers must either sell loans (often at a discount in stressed markets), gate withdrawals, or restructure the vehicle — each option risking further investor outflows and reputational damage. The gating has already moderated retail inflows, sparked legal scrutiny over disclosure practices, and prompted debate about whether illiquid strategies belong in retail-accessible products.

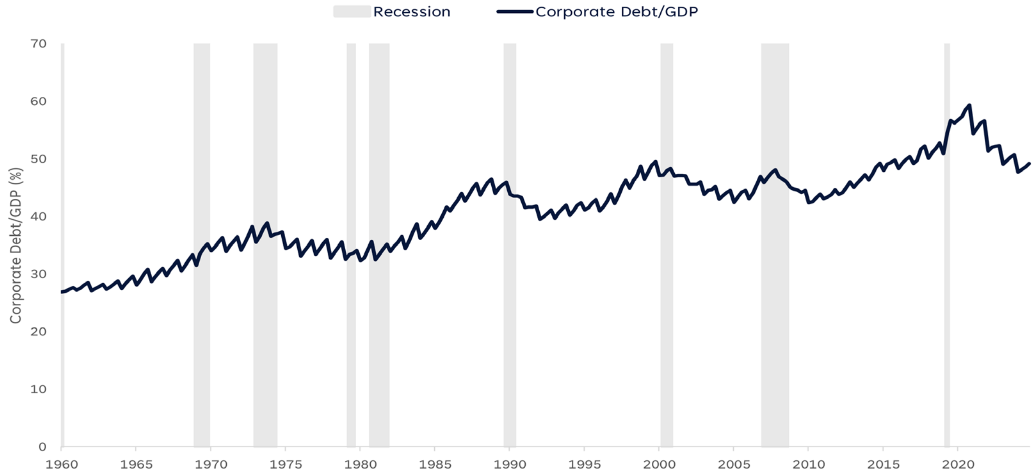
This SaaS stress is a key driver of rising default expectations across the asset class as well, with some forecasts suggesting private credit defaults could outpace those in leveraged loans or high-yield bonds in an aggressive disruption scenario. The opacity of private portfolios, limited real-time pricing, and concentrated sector exposure amplify contagion fears, contributing to sharp sell-offs in shares of major private credit managers.

That said, since these are private loans, the direct lender(s) is generally incentivized to “amend and extend” and provide the borrower more time and better terms to remedy its cash flow needs to remain a going concern. Though default activity remains low but 2020 and 2021 vintages, which borrowed at extremely low rates and perhaps better leverage ratios, will need to refinance debt soon so we could see a spike in defaults over the next few years. Also, the recent rise in bad PIKs suggests there are companies that would otherwise be in stressed/distressed scenarios, which keeps the current default rate low.

## Should We Be Concerned About Systemic Risks?

While it is important to acknowledge the rise in credit risks, it is equally important to separate credit risk from systemic risk. For those of us that lived through the Global Financial Crisis, we see some similarities but distinct and important differences. What we’re seeing today looks more like a healthy repricing and shift in sentiment — not the start of a broad credit unwind. Historically, systemic risk becomes a concern when corporate debt grows significantly faster than the overall economy. By that measure, we are not seeing red flags. Sub-investment-grade lending remains manageable relative to GDP, and even with the growth of private credit, the total share of non-investment-grade corporate lending is roughly where it was a decade ago. In fact, overall corporate debt-to-GDP levels have actually come down in recent years.

### Corporate Debt to GDP Has Fallen Recently




Source: LPL Research, Bloomberg 03/15/26
The National Bureau of Economic Research (NBER) defines a recession as a significant, widespread, and sustained decline in economic activity lasting more than a few months.
Past performance is no guarantee of future results.

As it relates to redemption requests turning into forced selling — especially after a few private credit managers activated redemption gates, including industry heavyweight BlackRock that enforced its 5% redemption gate on its HPS Corporate Lending Fund — but gating isn't a signal that something is breaking; it's the structure doing exactly what it was designed to do. These vehicles exist to invest in illiquid loans, and the guardrails are built to prevent fire-sale conditions during periods of stress. When redemption requests rise, managers may use these gates to protect existing investors and avoid selling assets at poor prices. This mechanism helps contain stress and reduces the likelihood of broader market spillovers.

This protective design is common across the private credit ecosystem. Private-credit CLOs, for example, have structural features that automatically redirect cash flows during periods of strain, limiting the need to sell assets. Insurance companies, another key investor group, are also insulated from forced selling thanks to surrender penalties, liquidity facilities, and allocations to more liquid bonds that can be tapped first. Taken together, these structural safeguards help ensure that forced selling is unlikely to become a meaningful source of systemic risk, in our view.

As well, it's important to remember that non-bank financing has underwritten these risks, and while private credit has emerged as one of the fastest-growing segments of nonbank financial intermediaries (NBFIs) for traditional banks, it is not yet seen as a risk. The conclusion of the recent Federal Reserve study*: Bank Lending to Private Credit: Size, Characteristics, and Financial Stability Implications* notes:

- Based on the data available, banks' credit provision to private credit vehicles is growing fast but still small relative to other NBFIs, and the financial stability implications seem limited. Bank loans to private credit vehicles have higher utilization rates, higher interest rates, lower probability of default, and lower delinquency rates compared with those extended to other NBFIs. We also find that U.S. banks remain well capitalized and highly liquid, allowing them to absorb a significant drawdown risk from private credit vehicles. However, we also see public BDCs' increasing use of leverage compared with other NBFIs. Further, banks are also increasingly expanding their strategic partnerships with private credit vehicles. These developments and the increasing interconnectedness warrant close monitoring.

## Insurance Companies as a Concentration Risk?

Finally, insurance companies, particularly life insurers, have become major investors in private credit in recent years, drawn by the asset class's attractive illiquidity premiums, floating-rate structures that match long-duration liabilities, and higher yields compared to traditional fixed income. Allocations have grown significantly — with U.S. life insurers often seeing private credit exposures averaging over 10–35% in some cases (higher for those tied to alternative investment managers or PE-linked firms). This provides insurers with diversification benefits and income stability, especially in a post-low-rate environment where they seek to enhance returns without excessive duration risk. Moreover, their long-term investment horizon provides a stable investor base generally needed for a private credit allocation.

However, concentration risks are a valid concern in pockets of the industry. Some insurers — particularly those affiliated with private equity or alternative managers — exhibit higher concentrations in private credit and Level III (illiquid) assets, alongside sectoral, geographical, or manager-specific clustering that can amplify losses during downturns. The Bank for International Settlements (an international financial institution that serves as a bank for central banks) and rating agencies, Fitch, and Moody's, have highlighted vulnerabilities such as illiquidity, valuation uncertainty, hidden leverage, and potential conflicts of interest. Despite these, widespread systemic issues appear contained: insurers benefit from strong capitalization, robust asset-liability management, and diversified overall portfolios, with rating agencies like Fitch noting limited near-term rating pressure even if private credit weakens, as exposures are held by sophisticated long-term investors rather than creating bank-like run risks.

Our view is that while the asset class is facing a genuine credit cycle — one that will produce winners and losers — the evidence does not indicate that these stresses are building into a broader, system-wide threat, at least not yet.

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## What Does This Mean for Investors?

As noted investor Warren Buffett famously said, when the tide goes out, you see who has been swimming naked. And over the past few years, liquidity has been abundant, but that liquidity is now ebbing. Private markets enjoyed a powerful tailwind during the period of ultra-low interest rates, and it is highly likely that many deals were underwritten with overly optimistic assumptions during that stretch. That suggests there is still likely additional adjustment and potential pain ahead. However, this does not imply that the broader private-market asset class is in jeopardy.

Overall loss rates remain extremely low, and even if they were to double or triple from current levels, they would still represent a very small share of total assets. As with every cycle across financial markets, firms that managed risk, prudently, avoided excess leverage, and maintained disciplined underwriting standards are positioned to come out stronger on the other side. The current environment is clearly more challenging and likely to stay so, but it also sets up a clearer differentiation between weaker managers and those with genuinely robust long-term approaches that will do just fine.

The era of ultra-low interest rates (post-GFC through much of the 2010s and early 2020s) played a key role in fueling current excesses in private credit by driving a relentless "search for yield." With traditional safe assets offering near-zero returns, institutional investors (including insurers) piled into higher-yielding alternatives like private credit, enabling looser underwriting, higher leverage in some deals, and rapid AUM growth. This contributed to competitive dynamics where capital chased deals, sometimes compressing spreads and accepting lower-quality borrowers — a classic late-cycle behavior. Yet this is part of the natural credit cycle: low rates inflate asset prices and encourage risk-taking, while rising rates (as seen recently) discipline the market, force selectivity, and reset valuations. Overall, while excesses built during the low-rate regime warrant caution (particularly as 2020 and 2021 vintages need to refinance into a higher interest rate environment), the asset class's investor protections should limit spillovers into the broader economy.

Private credit is undeniably facing real, observable risks today. However, an immediate shock and contagion from the asset class failing is not in our forecasts. Rising defaults, an increase in PIK usage, and lower interest rate coverage ratios are immediate concerns to consider. Additionally, while less than 20% of private credit capital is invested in a vehicle offering some type of liquidity, much of that is within the retail industry and directly impacts our advisors. As such, we continue to advocate for investing in managers who apply disciplined, conservative valuation methodologies, with portfolios composed of senior secured debt securities.

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Private credit carries certain risks – illiquidity, opacity, borrower concentration, and bespoke structures – that distinguish it from corporate bonds and bank loans and complicate its evaluation and oversight.

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The Bloomberg U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

All index data from FactSet.

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