Private credit faces ‘alarming surge’ in selective defaults – S&P

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S&P Global Market Intelligence has flagged an “alarming surge” in selective defaults in the private credit market, owing to a deterioration of maintenance covenants and the increasing prevalence of payment-in-kind interest.

Pointing to the market’s increasing concentration of assets under the

largest managers, and more than $1 trillion of loans tying banks to non-bank financial institutions (NBFIs), the ratings agency warned of potential systemic risks in its July 31 report, "Private Credit: The Rising 'Defaults.'"

"There is an increasing flexibility in payment terms across private markets – a trend that can obscure or delay early warning signals of trouble or allow a company to deteriorate even further before triggering a conventional default," S&P wrote.

"More than a third of borrowers from [S&P Global Ratings'] CE [credit estimate] pool that were subject to actively tested leverage-based maintenance covenants appear to have loose thresholds with current headroom above 40%, and even higher proportions in the core and upper segments of the middle market. These large cushions reflect covenants that were set very wide to closing levels, as opposed to signaling meaningful deleveraging."

"These generous covenants are leading to a rising trend in selective defaults, which is quite concerning," the agency wrote.

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Last year, distressed exchanges that S&P typically classifies as selective defaults comprised roughly 60% of global corporate defaults, according to the report. Selective defaults outpaced conventional defaults by a ratio of five to one in 2024. The Morningstar LSTA US Leveraged Loan Index showed a similar ratio of selective defaults to conventional defaults.

PIK interest in particular has been increasing; an S&P analysis of public and private BDCs found a median uptick of 100 bps of PIK income between 2023 and 2024.

An increasing number of deals are struck with PIK toggles at issuance. While such toggles are attractive to borrowers, and PIK in general can enhance returns for investors, S&P noted that lenders give up opportunities to tighten protections or close off covenant loopholes.

"The market's concentration, with the top 20 firms controlling 36% of

global dry powder, signals potential systemic risks," said S&P, adding that regulatory oversight remains "constrained."

The agency also pointed to a recent paper from Moody's Analytics, which identified the private credit market as a potential source of financial contagion and systemic risk during a downturn.

Globally, systemically important banks have provided a majority of loans to non-bank financial institutions, or NBFIs, a category that includes private equity, credit funds and non-bank lenders, according to S&P. Wells Fargo had the largest exposure by dollar amount, with $158.3 billion of loans to NBFIs (or 17.3% of total loans). JPMorgan Chase, Bank of America and Citigroup each had more than $100 billion of exposure to NBFIs.

S&P stressed that robust regulation would be "essential" to safeguard investors and market stability as the private credit market continues its rapid pace of growth. It also flagged risks for retail investors ahead of a widely anticipated executive order that may open the door to introducing private market assets in retirement accounts.

"A major selling point of private credit is the low default rates. However, this reputation hinges on a narrow definition of default, typically covering only traditional defaults, such as missed payments or Chapter 11 filings. It often overlooks instances like conversion of cash pay interest to PIK, amortization holidays or maturity extensions without adequate offsetting compensation," S&P wrote.

The report was authored by Zain Bukhari, associate director, risk and valuations at S&P Global Market Intelligence.

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