



Private Credit vs. Regulated Bank Lending

A Structural Risk Assessment

The Guardrails That Exist: And Those That Don't

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I. The Central Thesis

The explosive growth of private credit from niche alternative to a \$2.1 trillion^a global asset class was built on a compelling but ultimately incomplete narrative: that direct lenders offered superior discipline, tighter covenants, and better lender protections than the covenant-eroded syndicated loan market. What the narrative obscured is that private credit operates almost entirely without the institutional guardrails that regulated banks are legally required to maintain. As the asset class now faces its first genuine stress cycle, those missing guardrails (not the individual loan underwriting) may be where systemic vulnerabilities could be concentrated.

We will examine only five structural protections embedded in the Bank regulatory framework, how each guardrail usually prevents banks from underwriting and building corporate high yield loan portfolios that you are now seeing under stress in private credit funds, and why the absence of equivalent protections in private credit could create risk that are only now becoming visible.

II. The Market Has Changed: Private Credit's Migration from Middle Market to Mega-Deal

Private credit as an asset class traces its regulatory origins to the Business Development Company structure created by Congress in 1980, designed to provide capital access to middle market companies: typically defined as businesses with \$25-100 million in EBITDA. This original mandate reflected a genuine market gap: companies too large for traditional bank C&I lending but too small or too leveraged for syndicated loan markets. For decades, this middle market focus defined the industry.

The market evolved into a three-tier structure: lower-middle market (under \$25M EBITDA), core middle market (\$25-100M EBITDA), and upper-middle market (over \$100M EBITDA, often reaching \$250-500M). As private credit AUM scaled dramatically, growing from roughly \$400 billion in 2015 to over \$2.1 trillion^a by 2025, funds faced a deployment challenge. The core middle market simply could not absorb the capital being raised. A fund managing \$5-10 billion cannot efficiently deploy into \$50-75 million tickets without building an unmanageably large portfolio or sitting on uninvested capital.

The inevitable result was migration upward into upper-middle market and mega-unitranche deals. By 2024-2025, private credit was routinely competing for deals exceeding \$500 million, with some transactions surpassing \$1 billion.^h At this scale, private credit converged directly with the Broadly Syndicated Loan (BSL) market: the \$1.4 trillion institutional leveraged loan market that had long been the domain of CLOs, loan mutual funds, and institutional credit investors.

This convergence created a documentation problem. Private credit imported covenant-lite structures from the BSL market, structures that had become standard in syndicated lending, where 91-93% of new issuance carried no maintenance covenants by 2024. But BSL loans, despite being covenant-lite, benefit from daily secondary market pricing, transparent traded valuations, independent credit ratings from S&P, Moody's, and Fitch, and broad market liquidity allowing holders to exit positions quickly. Private credit adopted the covenant-lite documentation without inheriting any of these structural advantages. By late 2024, approximately 40% of upper-middle market private credit deals^g were structured as covenant-lite, a rate that would have been inconceivable just five years earlier.

According to PitchBook and LCD data,^h one-third of companies migrating from BSL to private credit in 2025 involved transactions exceeding \$1 billion, up sharply from just 12% in 2024. The irony is acute: private credit now holds some of the largest and most complex credits in the leveraged finance markets: credits that would historically have been syndicated, rated, and marked daily, but these loans remain in private funds marked quarterly using internal models, with no maintenance covenants, no independent ratings, and no secondary market liquidity. In effect, private credit may have assembled the worst characteristics of both markets: BSL-equivalent credit risk and deal size, combined with private credit's opacity and illiquidity.

III. The Five Bank Guardrails

Banks did not develop their credit discipline voluntarily. It was imposed through decades of hard regulatory experience: the S&L crisis, LBO defaults of the late 1980s, the 2008 financial crisis: and codified into law, examination practice, and capital mechanics. The result is a multi-layered system of constraints that collectively may prevent the kind of portfolio construction that private credit assembled during the zero-rate boom.

Guardrail 1: Collateral and Tangible Asset Coverage

Banks typically require demonstrable tangible asset coverage as a primary repayment source. Technology and software companies: representing approximately 25%^d of private credit AUM in some analyses: often fail this test structurally. Their enterprise value is largely intangible: annual recurring revenue, intellectual property, customer relationships. An OCC examiner reviewing a loan backed primarily by adjusted EBITDA and enterprise value models would likely classify it as inadequately secured and may force either rejection or an adverse risk rating. This requirement has historically disqualified much of the software lending that private credit pursued.

Guardrail 2: Sector Concentration Limits

Internal bank policy and OCC concentration risk guidance typically cap technology sector exposure at 10-15%^b of capital or portfolio. Private credit funds have run software and technology exposure to 25-40% of AUM in some cases, with no regulatory ceiling and LP disclosure as the primary check. A fund at 40% software concentration may function more as a technology credit fund than a diversified credit vehicle.

Guardrail 3: The Examiner Cycle and Mandatory Risk Rating

Every bank loan carries a mandatory risk rating reviewed by OCC examiners on an annual cycle. A loan showing rising leverage, deteriorating coverage, PIK accruals, covenant waivers, or maturity extensions is typically downgraded to Special Mention or Substandard: triggering mandatory reserve increases, management escalation, and examiner scrutiny. This creates an institutional forcing function that may surface distress early and visibly. Private market loans are often marked only quarterly using risk models, and valuations across funds may reflect subjective judgments. There is no equivalent of the examiner cycle in private credit: a fund can carry a PIK-accruing, covenant-waived, maturity-extended loan at or near par with no external challenge.

Guardrail 4: Conservative EBITDA and FCF Discipline

Commercial Banks underwriting to OCC standards usually strip out stock-based compensation add-backs, many borrowers described recurring 'one-time' charges, capitalized software development costs, and aggressive management based forward pipeline projections embedded in adjusted EBITDA. The result is a conservative, cash-based leverage calculation. Many software deals that penciled at 5.5x adjusted EBITDA show 7.0x or higher on a bank-standard basis^c: a hard stop under leveraged lending guidance. Private credit accepted adjusted figures as presented by PE sponsors, and EBITDA definitions padded with add-backs and forecasts gave borrowers ample performance leeway, leaving reported earnings looking healthier than reality and making leverage tests far less exacting.

Guardrail 5: Capital Cost as an Economic Deterrent

Even where a bank might have been willing to lend, Basel III risk-weighted asset mechanics^d make technology lending expensive. An unsecured enterprise value loan typically carries 100% risk weight minimum, potential leveraged lending classification, and real Tier 1 capital consumption with a RAROC hurdle to clear. Private credit funds bear zero regulatory capital cost. That asymmetry meant banks could not typically price competitively against private credit on tech deals without eroding returns. The market may have self-sorted: banks priced out by regulatory design, private credit priced in by market opportunity.

IV. Covenant Erosion: The Marketing Claim That Did Not Hold

Private credit's foundational LP pitch was that it offered tighter covenants and better lender protections than the covenant-eroded syndicated loan market. The data suggests this differential has materially narrowed as the asset class scaled and competitive pressure increased.

Segment	Cov-Lite Rate Today	Cov-Lite Rate 10 Years Ago	Key Risk
Lower Middle Market (<\$25M EBITDA)	~20%	<2%	Modest erosion: borrower has fewer alternatives
Upper Middle Market (\$50M+ EBITDA)	~30%	<5%	Significant shift; cushions allow 30-40% EBITDA decline
Mega Unitranche (\$500M+ deals)	50-55%	Rare	Effectively competing with syndicated market
Broadly Syndicated Loans	91-93%	~30%	Covenant-void territory: \$1.3 trillion outstanding

As of year-end 2024, covenant-lite loans represented 91% of outstanding US leveraged loans: approximately \$1.3 trillion in total; 93% of all institutional leveraged loans issued in 2024 being covenant-lite. Without maintenance covenants, lenders may only learn of trouble when a payment is missed or when liquidity is constrained. Covenant-lite loans made up 91% of all defaults in 2022, dropping to 54% in 2023, then rebounding to 85% in 2024.

The PIK problem compounds this directly. PIK interest income for the top 15 BDCs topped \$1 billion¹ in March 2025, reflecting a 20% year-over-year increase. PIK may be viewed as a de facto forbearance: when a borrower cannot pay cash interest and a lender allows it to accrue instead, this could signal financial stress. Amendment activity increased 13% quarter-over-quarter in Q4 2024, with maturity extensions and covenant holiday activity both up 14%, and sponsor infusions up 31%: metrics that may indicate increasing portfolio stress.

V. The PE / Private Credit Conflict of Interest

Among the less widely discussed structural considerations in private credit is the degree to which the largest private credit managers and the largest private equity managers overlap: a documented characteristic of the current market landscape. This vertical integration pattern, where credit funds lend to companies owned or financed by affiliated PE funds, may raise questions about the foundational principle of arms-length lending that has historically governed credit relationships.

These fund complexes will say there are Chinese Wall separations between PE and private debt for material non-public sharing of information but now material regulation for risk associated with conflicts.

In every scenario where PE and credit interests diverge (underperforming portfolio companies, refinancing at maturity, add-on acquisitions, PIK elections, exit timing), the PE business, which generates carried interest and franchise value, may have stronger institutional incentives than the credit business. The credit fund LP could be structurally subordinate in conflict resolution scenarios.

Regulation W Prohibition: Banks are explicitly prohibited from this model. Regulation W limits affiliate transactions to 10% of capital per affiliate and 20% in aggregate, and requires arm's-length pricing with independent credit assessment. The affiliated lending structure that major private credit platforms describe as a 'platform advantage' would constitute serious regulatory violations if conducted through a bank.

Situation	PE Interest	Credit Interest	Who Loses
Company underperforming	Extend, support, avoid write-down	Enforce covenants, accelerate if needed	Credit fund LP
Refinancing at maturity	Roll cheaply to protect equity return	Price at market, demand repayment	Credit fund LP
Add-on acquisition	Lever up further to grow	Protect existing lender position	Credit fund LP
PIK election	Preserve cash for equity	Cash interest protects lender	Credit fund LP
Exit / sale	Maximize sale price	Want par repayment	Misaligned

Approximately 30-40% of deals maturing in the next two years have already extended their maturity once, suggesting lenders may need to provide an incremental extension or explore a restructuring. In a portion of those extensions, the lender and the sponsor negotiating may be affiliated institutions.

VI. Technology Sector Concentration

According to S&P; Global,^d software and technology companies account for roughly 25% of the private credit market through year-end 2025. Banks were structurally prevented from building this concentration by the guardrails described above: no tangible collateral requirements, sector limits of 10-15%, and RWA mechanics that made tech lending economically challenging. Private credit stepped into that opportunity.

Enterprise SaaS was positioned as the safe lending category: sticky recurring revenue, high margins, predictable cash flows. Now each of those assumptions is being tested by AI developments. Loans originated prior to 2024 may not have contemplated AI as a material business risk, potentially resulting in underpriced credit exposure. In a stressed AI disruption scenario, UBS estimates^e US private credit default rates could climb to 13%: more than three times the projected rate for high-yield bonds. Some market commentary has termed this scenario the 'SaaSocalypse.'

Metric	Bank Constraint	Private Credit Reality
Tech/Software Lending	Structurally limited: no tangible collateral, sector caps 10-15%	25-40% of AUM in some large funds
Sector Concentration Limit	Hard OCC/policy cap enforced by examiners	No regulatory ceiling: LP disclosure only
AI Disruption Pricing	Largely unexposed to pre-2024 software loans	Entire vintage of pre-2024 loans may be unpriced for AI risk
Collateral Coverage	Tangible asset coverage typically required	Enterprise value lending accepted as standard
Stress Testing by Sector	Required: examiner reviewed	Best practice only

VII. Valuation Opacity and the Absence of Independent Ratings

The private credit sector has neither price discovery nor supervisory oversight to facilitate asset performance monitoring, and the opacity of borrowing firms may make prompt assessment of potential losses challenging for outsiders. Fund managers may face incentives to delay the realization of losses as they raise new funds and collect performance fees based on their existing track records.

The evidence of this potential distortion is empirical. One Bloomberg example:^f an e-commerce company's loans were valued at 65 cents on the dollar by some managers while others assessed them at 84 cents, a 19-point gap on the same underlying credit with no market mechanism to arbitrate between them. Adjustments to values of private credit loans are smaller and slower than those observed in public markets, and such deviations tend to persist for several quarters.

The Independent Ratings Gap

In public credit markets, S&P, Moody's, and Fitch provide independent ongoing assessments that are publicly available to all market participants simultaneously, updated continuously as credit conditions change, conducted by analysts with no economic interest in the outcome, and may trigger rating-driven selling when downgrades occur, creating real-time price discovery. Private credit loans typically carry none of this infrastructure.

The Fitch ratio methodology applied to CLO and structured fund design without ratings on the underlying loans is a partial substitute. It models portfolio behavior using statistical assumptions about default correlation and recovery rates derived from rated loan histories. When the underlying loan population systematically differs from that history: as software-heavy, covenant-lite, PE-affiliated direct loans may: the model's output depends on the validity of its inputs, which are themselves unverified by any independent third party.

Ratings Shopping Through the Insurance Channel

Insurers need credit ratings to satisfy state capital requirement models. Smaller, less established ratings agencies may face commercial pressure to provide investment-grade ratings on private credit instruments to win business. UBS chair Colm Kelleher has accused insurers of ratings shopping and labelled the trend a 'looming systemic risk.' Bank of England Governor Andrew Bailey has expressed concerns about the role of ratings agencies, stating that 'alarm bells are starting to go off.' The mechanism mirrors what produced AAA-rated subprime CDOs in 2006 and 2007.

In a downside scenario, the lack of transparency of the asset class could lead to a deferred realization of losses followed by a spike in defaults. Resulting changes to the modeling assumptions that drive valuations could also cause dramatic markdowns.: IMF Global Financial Stability Report, April 2024

VIII. Structural Risk Scorecard

Guardrail	Regulated Banks	Private Credit
Collateral / Tangible Asset Req.	Enforced: OCC examination	Not required: EV lending accepted
Sector Concentration Limits	10-15% hard policy cap	No regulatory ceiling
Independent Risk Rating / Examiner	Annual: examiner reviewed	None: GP marks own book
Covenant Maintenance	Maintenance covenants preferred	30-55% cov-lite by deal size
EBITDA Conservatism	SBC and add-backs typically stripped	Sponsor-adjusted figures accepted
Capital Cost Deterrent	Basel III RWA: real Tier 1 cost	Zero regulatory capital charge
Affiliate / Conflict of Interest	Regulation W: hard statutory limits	Disclosure only: no prohibition
Valuation Independence	Mark-to-market / daily price discovery	Quarterly mark-to-model (GP-controlled)
Independent Credit Ratings	Required for regulatory capital treatment	Absent on underlying loans
PIK / Non-Accrual Enforcement	Non-accrual rules: mandatory classification	9% PIK: accrues to NAV
Regulatory Examination	Annual OCC/Fed cycle	None: LP letters and SEC registration only
Tech Sector Exposure	Structurally limited: collateral/sector caps	25-40% of AUM in some large funds
Stress Cycle Experience	Multiple full credit cycles under regulation	First real stress cycle underway now

IX. External Validation: The Dimon Letter

Jamie Dimon's April 6, 2026 Annual Letter to Shareholders^j validated many of the structural concerns outlined above, with particular focus on the extension of hold periods and the absence of exit liquidity for PE-backed credits.

"When we have a credit cycle, which will happen one day, losses on all leveraged lending in general will be higher than expected, relative to the environment. Not everyone providing credit is necessarily good at it."

"The average hold period for PE firms is now approximately seven years^j, virtually double what it was historically."

"There are approximately 13,000 PE-owned companies^k in the United States. Many of these companies will need to be sold or refinanced in the coming years, but the traditional exit paths (IPOs, strategic sales) have been constrained."

Dimon's framing is instructive: the stress is not solely in the credits themselves but in the structural mismatch between PE hold periods, refinancing needs, and available exit liquidity. Private credit lent aggressively into this portfolio during 2020-2022 under the assumption that exits would normalize. They have not.

The combination of extended hold periods, covenant-lite structures, and the conflicts inherent in PE-credit platform integration creates a scenario where distress may be deferred rather than resolved. Maturity extensions, PIK elections, and sponsor capital injections are mechanisms that delay recognition, not mechanisms that cure underlying credit problems.

X. Conclusion

The systemic risk in private credit is not primarily about individual loan underwriting or sector bets. It is structural: built into the absence of the institutional guardrails that regulate banks and the opacity that allows stress to accumulate invisibly. Banks were prevented from building the portfolios that private credit assembled not because banks lacked the underwriting skill but because regulation explicitly prohibited the structure.

Private credit operates in a different regulatory universe. It carries no examiner cycle forcing early recognition of stress, no mandatory risk ratings, no capital charges that make risky lending economically unattractive, no sector concentration ceilings, and no prohibition on lending to affiliated entities. As a result, the asset class built portfolios: concentrated in software; covenant-lite; vertically integrated with PE sponsors: that banks could never have assembled under their existing frameworks.

The current stress cycle is testing whether those missing guardrails matter. Early evidence: rising PIK incidence,ⁱ maturity extension waves, valuation dispersion,^f Fitch stress analysis showing asset coverage cushions compressing,^o and BDC spreads^m widening materially: suggests they do. What remains to be seen is whether the stress is recognized transparently and promptly, or whether the opacity and structural flexibility that define private credit allow it to be deferred, extended, and compounded.

The question is not whether private credit can survive a credit cycle. The question is whether investors will see the losses as they occur: or only after they have compounded.

Footnotes

- ^a \$2.1 trillion global asset class: Preqin Global Private Market Fundraising Report 2025; PitchBook Private Credit Report 2025.
- ^b 10-15% bank technology sector concentration cap: OCC Concentration Risk Guidance (OCC Bulletin 2006-46); internal bank policy practice documented in OCC examination manuals.
- ^c 5.5x adjusted EBITDA showing 7.0x on bank-standard basis: Illustrative example for demonstration purposes, based on typical software company add-back schedules observed in leveraged lending practice.
- ^d 25% private credit allocation to technology and software: S&P; Global Market Intelligence data, cited by Prime Buchholz research note, February 2026.
- ^e 13% AI-disruption default scenario: UBS Investment Bank research reports, 2025-2026; referenced in multiple market commentaries including Jefferies equity trading desk notes.
- ^f 65¢ vs. 84¢ valuation gap on same credit: Bloomberg reporting on e-commerce company loan valuations, cited in EY Luxembourg Private Credit Market Analysis, 2024-2025.
- ^g ~40% upper-middle market private credit deals covenant-lite in 2024: Proskauer Rose proprietary deal data, Private Credit Market Report, November 2025.
- ^h One-third of BSL-to-private credit migrations exceeded \$1B in 2025: PitchBook LCD Leveraged Loan Market Data, January 2026; up from 12% in 2024 per same source.
- ⁱ BDC PIK income exceeding \$1 billion: PitchBook BDC Analytics Dashboard, March 2025; KBW/Vanguard BDC Index analysis, September 2025.
- ^j PE average hold period ~7 years; 13,000 PE-owned companies: Jamie Dimon, JPMorgan Chase & Co. Annual Letter to Shareholders, April 6, 2026.
- ^k BDC spreads ~80bp wider year-to-date: Barclays FICC Research, "BDCs: De-attached from CLO Reality," March 17, 2026.
- ^l Life insurance sector private credit allocation grew 21% in 2025: Barclays Insurance Research, March 16, 2026.
- ^m \$234.1B raised across 200 private debt funds in 2025: Preqin Global Private Market Fundraising Report, 2025 annual edition.
- ⁿ BDC asset coverage cushion compressed from 23.9% to 15.4%: Fitch Ratings, BDC Stress Analysis under 50% software haircut scenario, March 25, 2026 (32 BDCs analyzed).
- ^o Transparency improving modestly but market remains opaque: Fitch Ratings, Private Credit Transparency Monitor, April 2026.
- ^p Software loan weighted-average bid dropped 7 points in Q1 2026: PitchBook Private Credit Market Update, March 26, 2026.

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