CAPITAL MARKETS

REPORT

CFA Institute
Research & Policy Center

Private Credit Funds and the Retail Shift: Structural Vulnerabilities and Policy Responses

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Executive Summary

As private credit becomes embedded within the broader expansion of private markets,[1] its extension into retail and semiretail channels introduces new dimensions of market risk and regulatory complexity. Building on the structural analysis presented in "Private Credit: Market Structure, Fund Design, and Retail Access" (Wilson 2026), the current report examines how the defining features of private credit—illiquidity, opacity, and bespoke contracting—interact with retail-oriented liquidity structures, valuation practices, and evolving distribution models to create potential vulnerabilities for investors and the financial system.

Private credit has entered a new phase of development. What was once concentrated among pension funds, insurers, and institutional direct lending vehicles is now increasingly distributed through semiliquid funds, nontraded business development companies, feeder structures, digital platforms, and regulated long-term investment vehicles. This shift expands participation while altering the channels through which risk is transmitted, monitored, and managed.

This report focuses on the implications of that transformation. It is intended primarily for regulators, policymakers, and industry bodies while also offering insights for investment professionals navigating the changing private credit landscape. Its three objectives—risk diagnostics, analysis of market vulnerabilities, and policy guidance—are designed to inform regulatory frameworks, support responsible market development, and enhance investor protection.

[1]Preece and Wilson (2026) provided an overarching framework for subsequent CFA Institute publications in this area. The authors used a stakeholder ecosystem framework to examine the structural and distributional tensions arising from the growth of private markets. The term "private markets" includes private equity, private credit, real estate, infrastructure, and venture capital.

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The analysis proceeds through two complementary lenses: risk dynamics and policy design. Private credit offers attractive features, including floating-rate income, diversification, and contractual downside protections. These characteristics, however, are inseparable from structural features such as illiquidity, valuation subjectivity, and layered leverage, which can amplify vulnerabilities, particularly when combined with retail-facing liquidity expectations.

A central finding is that risks in private credit are not eliminated but transformed. Core vulnerabilities include liquidity mismatches between fund structures and underlying assets, valuation opacity driven by model-based pricing, concentration of exposures among borrowers and managers, and interconnections between private credit funds, private equity sponsors, and bank financing channels (see also Wilson 2026). As retail participation expands, these risks may become more visible and potentially more destabilizing under stressed market conditions.

Retail-oriented vehicles introduce additional dynamics. Semiliquid funds offering periodic redemptions may create the appearance of liquidity while relying on illiquid loan portfolios, raising the potential for redemption pressures, gating mechanisms, or forced asset sales during downturns. Similarly, valuation practices based on infrequent or model-driven assessments may delay the recognition of credit deterioration, contributing to procyclical behavior.

This report also highlights the erosion of traditional creditor protections. The increasing prevalence of covenant-lite structures and permissive loan documentation has shifted the balance of power toward equity sponsors, weakening lenders' ability to intervene early in distress scenarios and increasing uncertainty around recovery outcomes. These developments raise important questions about legal enforceability, governance standards, and the resilience of credit markets under stress.

Against this backdrop, regulatory frameworks face a structural lag. Existing approaches, largely designed for institutional markets, do not fully address the complexities introduced by retail participation, cross-border fund distribution, and evolving financial structures, such as NAV-based lending and tokenized credit vehicles. Gaps persist in valuation standards, liquidity risk management, disclosure practices, and the monitoring of interconnected exposures across the financial system.

The report outlines a forward-looking policy agenda centered on four priorities: strengthening retail investor safeguards through suitability and disclosure frameworks, enhancing valuation and fee transparency, improving cross-border regulatory coordination and data sharing, and addressing emerging structural risks associated with leverage, securitization, and sponsor conflicts of interest. These measures are intended not to constrain market development but to align innovation with investor protection and systemic stability.

Ultimately, the retailization of private credit represents a structural expansion of market participation and a test of regulatory adaptability. If managed effectively, it has the potential to broaden access to income-generating assets and support capital formation. If misaligned with appropriate safeguards, however, it risks amplifying the very vulnerabilities that financial reforms have sought to contain.

This report provides a framework for navigating that balance, emphasizing that sustainable growth in private credit depends not only on expanding access but also on strengthening transparency, governance, and oversight in line with the evolving structure of the market.

Key Takeaways

- **Risk Dynamics**

  Core risks include liquidity mismatch, valuation opacity, concentration, and layered leverage. Retail-facing structures may amplify market fragility in downturns through redemption spirals and *NAV smoothing*.[2]

- **Legal Protections**

  The increasing use of covenant-lite lending has weakened traditional creditor safeguards. Sponsor-led restructurings often favor majority lenders or insiders, increasing recovery uncertainty for others.

- **Policy Gaps**

  Regulatory oversight lags structural innovation. Gaps persist in valuation practices, stress testing of redemptions, cross-border fund oversight, and tokenized vehicle regulation.

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[2] *NAV smoothing* refers to the specific application of *valuation smoothing* (see Wilson [2026] footnote 29 pg. 20) for the definition of valuation smoothing techniques to the periodic calculation of a fund's NAV.

- **Regulatory Priorities**

  Urgent reforms include the following:

  - Standardized valuation practices (e.g., under SEC Rule 2a-5)
  - MiFID-style suitability testing
  - Global harmonization of liquidity requirements
  - Real-time exposure monitoring
  - NAV-based lending governance reforms

- **Market Outlook**

  Retailization is expected to continue through digital platforms and potentially in retirement accounts. Sustainable growth will depend on transparent disclosures, investor education, and globally coordinated oversight.

Introduction

Private credit is undergoing a moment of profound transformation. Once a peripheral strategy within institutional portfolios, it now commands the attention of asset managers, regulators, and investors alike. The expansion of private credit into the retail investment landscape raises first-order questions about market risk, investor protection, and regulatory readiness. Unlike public bond markets, private credit lacks uniform disclosure standards, consistent valuation methodologies, and liquidity guarantees. These limitations have long been tolerated in institutional contexts but may prove more consequential as access expands to semiretail and retail portfolios.

These questions build directly on the structural analysis of private credit markets and retail access mechanisms presented in Wilson (2026). They shift the focus toward how those structures shape risk transmission and policy challenges.

Why Are We Launching This Report?

Although substantial research exists on private equity and credit markets (Avalos et al. 2025; Bhardwaj et al. 2025; Clayton and de Fontenay 2026; Levin and Malfroy-Camine 2025), the implications of retail participation in private credit, particularly with respect to market risk, investor protection, and regulatory adequacy, remain insufficiently explored. This report addresses that gap through a focused analysis of how structural features of private credit interact with evolving distribution models to create new vulnerabilities.

Motivated by questions around market stability, investor protection, and regulatory readiness, we pursue three primary objectives:

- *Risk diagnostics* to analyze how retail-oriented liquidity structures, valuation practices, and credit market dynamics may amplify vulnerabilities in this illiquid and opaque asset class
- *Market vulnerability assessment* to examine key structural risks, including liquidity mismatches, valuation opacity, concentration, layered leverage, and the erosion of creditor protections through covenant-lite lending and permissive documentation
- *Policy engagement* to develop a forward-looking, evidence-based framework addressing valuation transparency, investor suitability, cross-border regulatory coordination, and emerging structural risks

The analysis is grounded in academic literature, regulatory research, and market data.

Who Is This Report for?

Stakeholders engaged in or affected by the expansion of private credit into retail and semiretail investment channels will be interested in this work, including the following:

- *Regulators, policymakers, and industry bodies* responsible for investor protection and financial stability who must evaluate how retail participation in an illiquid and opaque asset class alters market risk, liquidity dynamics, and the adequacy of existing regulatory frameworks
- *Investment professionals and market intermediaries*, including asset managers, financial advisers, private banks, and distribution platforms seeking to understand the risk implications of retail-oriented private credit products and evolving market structures

Across these audiences, the report's analytical lenses—risk diagnostics, market vulnerability assessment, and policy engagement—are intended to inform regulatory and supervisory decision-making and support more informed evaluation of private credit exposures.

What Do We Cover in This Report?

The *Alternative Investments: A Primer for Investment Professionals* (Chambers et al. 2018) established a foundational understanding of alternative assets, and *An Introduction to Alternative Credit* (Ricciardelli and Clements 2024) examined the structure of credit strategies across institutional markets. Recent work, including *Private Markets: Governance Issues Rise to the Fore* (Deane 2024), highlighted governance and regulatory considerations in private markets.

The foundational work *Understanding the Growth of Private Markets: Structural Shifts in the Investment Industry* (Preece and Wilson 2026) provides an overarching ecosystem analysis of private markets and lays the groundwork for subsequent publications. A related report, *Private Credit: Market Structure, Fund Design, and Retail Access* (Wilson 2026), examines how the structural evolution of private credit markets shapes both investment outcomes and market behavior. Building on both works, this report focuses on the risk and policy implications of private credit's expansion into retail and semiretail channels.

Risk Dynamics in Private Credit

As private credit matures into a central pillar of nonbank finance (also known as market-based finance), a sharper understanding of its risk architecture becomes indispensable, not only for allocators and managers but also for regulators and retail advisers. This section maps the structural vulnerabilities embedded in private credit vehicles and the ways in which growing retail participation may amplify market fragilities under stress. Two central questions guide this analysis: *What are the primary vectors of risk in private credit*? And *how might retailization intensify downside pressures during market dislocations*?

Core Vulnerabilities

Private credit's defining attributes—illiquidity, concentration, and opacity—form the core of its risk structure. These characteristics, while offering such benefits as yield premiums and reduced mark-to-market volatility, also introduce vulnerabilities that can be sharply exposed during market stress.

Illiquidity is inherent to private credit. Closed-end fund structures typically impose multiyear lockups, aligning investor capital with the bespoke and long-dated nature of private loans. Semiliquid and evergreen funds are open-end structures that provide for periodic redemptions (such as quarterly), subject to a cap, to limit the extent of the liquidity mismatch between the fund's shares and the underlying loans. Yet these structures cannot eliminate liquidity risk, and in times of distress, trapped capital and gated redemptions can erode investor trust (Avalos et al. 2025). Moreover, redemption tools, such as credit facilities and withdrawal limits, may be insufficient to alleviate selling pressure at the portfolio level in acute market stress.

Concentration risk compounds liquidity concerns. Private credit funds often cluster exposures within specific industries, geographies, or sponsors, creating portfolios with elevated Herfindahl–Hirschman Index (HHI) scores[3]—often between 0.7 and 0.8—far higher than those of diversified institutional portfolios (Avalos et al. 2025). This concentrated landscape extends to the asset

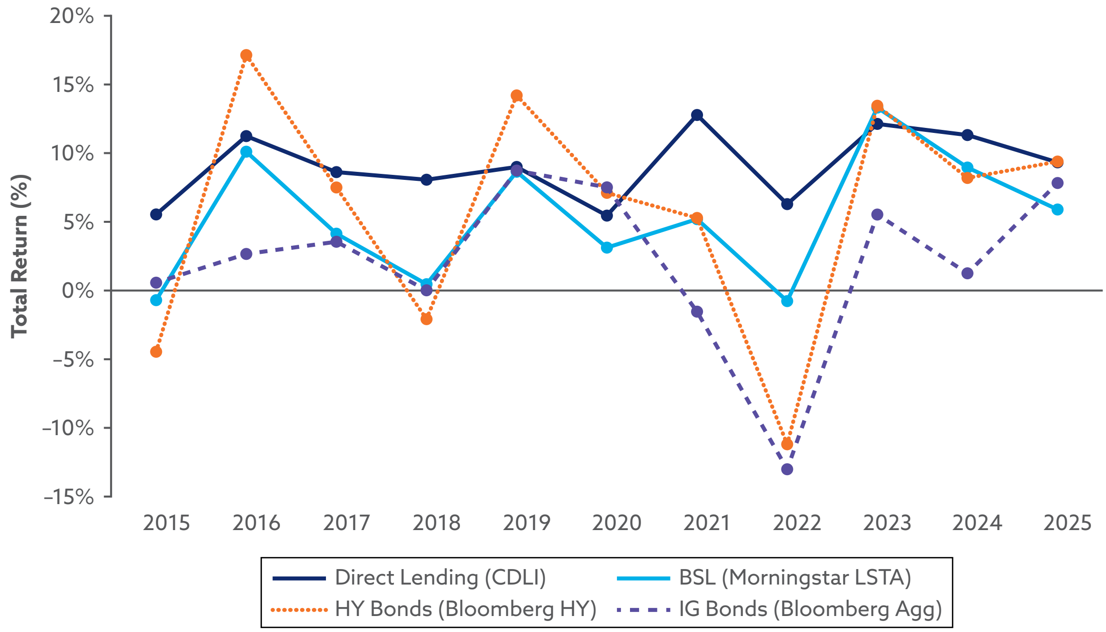
[3]The HHI is a quantitative measure of market concentration used to assess the competitive landscape of the private credit industry. It is calculated by summing the squares of the market share percentages of all private credit managers or lenders operating within a defined segment, such as direct lending, mezzanine finance, or NAV lending. A higher HHI score (on a scale from 0 to 1) indicates a more concentrated market, potentially signaling dependencies or reduced borrower choice.

management level: The top 10 firms control nearly half of US private credit assets under management, or AUM (Cai and Haque 2024), making idiosyncratic fund shocks a potential vector for market spillovers.

Opacity, from borrower profiles to valuation methodologies, can mask emerging stress indicators. Most private credit borrowers are unrated, and fund valuations rely on internal models or delayed third-party appraisals (Buch 2025; Ellias and de Fontenay 2025). This disconnect from market-based signals can delay the recognition of credit deterioration. The COVID-19 crisis illustrated how internal marks remained stable while underlying borrower performance declined, even though public markets recovered by year-end.

Exhibit 1 illustrates the annual total returns across four credit asset classes from 2015 to 2025: direct lending (DL), broadly syndicated loans (BSL),[4] high-yield (HY) bonds, and investment-grade (IG) bonds. DL, as measured by the Cliffwater Direct Lending Index (CDLI), delivered positive returns in every year of the period. The 2022 rate-tightening cycle is a case in point: CDLI returned 6.29% that year, while BSL, HY bonds, and IG bonds posted losses of –0.77%, –11.19%,

Exhibit 1. Annual Total Returns by Credit Asset Class, 2015–2025



Sources: Nesbitt (2026); graphic generated by Claude.ai, Anthropic (July 2026). Edited for style and content.

Notes: 2025 figures are Cliffwater's preliminary estimate, with 27% of loans reporting. CDLI returns are calculated quarterly from appraised NAVs reported by business development companies rather than from daily market transactions. This appraisal-based methodology inherently smooths returns and compresses measured volatility.

The indexes are as follows: Direct Lending = CDLI, unlevered, gross of fees. BSL = Morningstar LSTA US Leveraged Loan Index. HY Bonds = Bloomberg US Corporate High Yield Index. IG Bonds = Bloomberg US Aggregate Bond Index. Past performance is not indicative of future results.

[4] For a comparative analysis of the credit spread differential between BSL and private credit, see Wilson (2026, p. 8).

and –13.01%, respectively. This consistency, although partly attributable to the floating-rate structure and senior secured positioning of private loans, also likely reflects the mark-to-model valuation practices discussed previously. The absence of daily market pricing means that direct lending returns do not capture intraperiod volatility, potentially understating the true economic risk borne by investors. For retail participants unfamiliar with appraisal-based valuations, this smoothed return profile may create a misleading impression of stability.

These risks do not operate in isolation. When layered, they can generate nonlinear feedback loops. Ghamami et al. (2025) and Buch (2025) warned that the combination of leverage, opacity, and liquidity mismatch in nonbank credit intermediation can produce hidden market risk, especially as the sector grows in scale and interconnectedness.

Leverage Exposure

As discussed in Wilson (2026),[5] private equity operates as an equity-driven strategy that *implicitly relies* on leverage, whereas private credit uses a more parsimonious approach. This conservative stance reflects the structural asymmetry between private credit and private equity: Credit losses are not offset by large gains, as might occur in equity portfolios.

The *appearance* of lower leverage risk, however, can be deceptive. Private credit markets are increasingly exposed to *layered leverage*—multiple tiers of borrowing across funds, borrowers, and sponsors. A single stressed company may simultaneously impact its private equity (PE) owner, its private lender, and any bank that is financing that fund (Buch 2025). The European Central Bank (ECB) has warned that this opaque layering of risk heightens the potential for contagion (Galbarz et al. 2024).

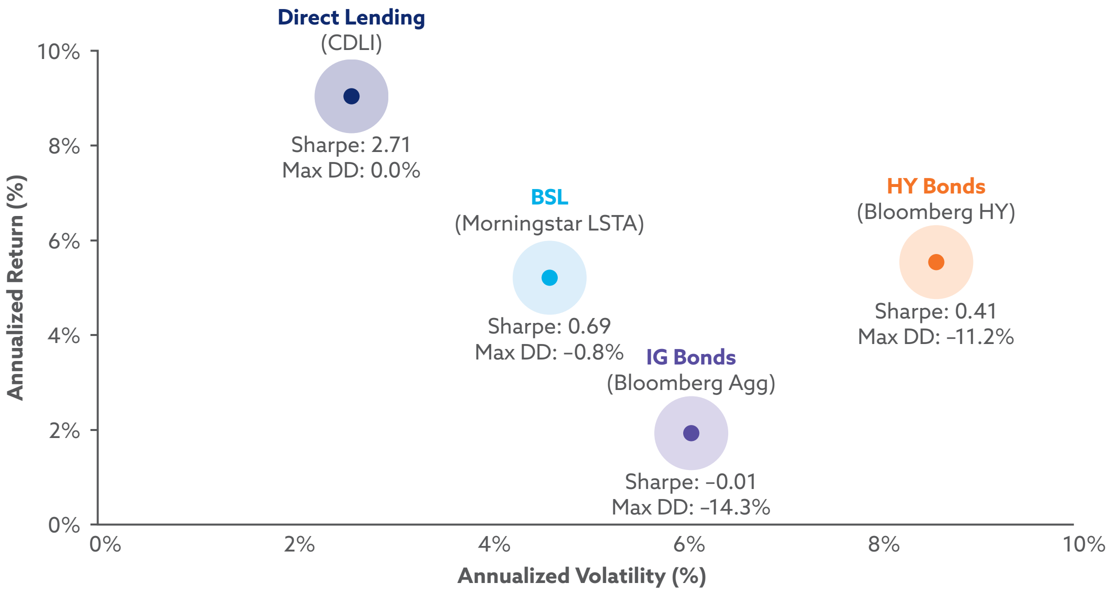
Furthermore, business development companies (BDCs) and retail-oriented vehicles are approaching regulatory leverage limits, narrowing the historical risk gap between banks and nonbanks (Avalos et al. 2025).

Although private credit funds maintain a defensive posture, their embedded leverage—especially when interconnected with PE—can still propagate systemwide stress under the wrong conditions.

Exhibit 2 plots the annualized return against the annualized volatility for each asset class over the 2015–2025 period. Direct lending occupies the upper-left quadrant—the highest return (9.04%) with the lowest reported volatility (2.60%)—producing a Sharpe ratio of 2.71, roughly four times that of broadly

[5]See the subsection “Use of Leverage versus Equity in Value Creation” (Wilson 2026, pp. 24–25).

Exhibit 2. Risk–Return Profile by Credit Asset Class, 2015–2025



Sources: Nesbitt (2026); Board of Governors of the Federal Reserve System, Federal Funds Effective Rate (RIFSPFFNA), retrieved from FRED, Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org/series/RIFSPFFNA). Graphic generated by Claude.ai, Anthropic (July 2026). Edited for style and content.

Notes: Annualized (geometric) return vs. annualized volatility (sample standard deviation), with Sharpe ratios and maximum drawdowns.

Risk metrics: Annualized return and volatility were calculated from calendar-year total returns. Sharpe ratios use the average risk-free rate over the period (2.0%), calculated as the simple average of the annual effective federal funds rate (FRED series FEDFUNDS). Maximum drawdown (Max DD) is the largest peak-to-trough decline observed in the period. CDLI recorded no negative return calendar year during 2015–2025—hence, a 0.0% Max DD on an annual basis.

Valuation caveat: CDLI volatility is understated relative to public indexes because of quarterly mark-to-model (appraisal-based) valuations versus daily market pricing.

The indexes are as follows: DL = Cliffwater Direct Lending Index (CDLI), unlevered, gross of fees. BSL = Morningstar LSTA US Leveraged Loan Index. HY = Bloomberg US Corporate High Yield Index. IG = Bloomberg US Aggregate Bond Index. Past performance is not indicative of future results.

syndicated loans (0.69) and more than six times that of HY bonds (0.41). This apparently superior risk-adjusted performance warrants careful interpretation, however.

The CDLI is calculated quarterly from appraised NAVs reported by BDCs, rather than from daily market transactions. This appraisal-based methodology inherently smooths returns and compresses measured volatility. Adjusting for this smoothing effect, as several academic studies have attempted, would materially raise the estimated volatility of direct lending materially and shrink the risk-adjusted gap with public credit.

This mechanism is well documented in the adjacent private equity literature: Appraisal-based net asset values understate true return volatility because they fail to reflect variation in market discount rates (Boyer et al. 2023; Stafford 2022). MSCI's private credit factor model finds the same pattern directly in private credit: Short-horizon returns appear smooth, but annualized volatility rises significantly as the measurement horizon lengthens, unlike liquid HY bonds (Xiong et al. 2025). For policymakers evaluating the suitability of private credit for retail portfolios, this distinction between reported and economic risk is fundamental.

Procyclicality and Market Behavior

Private credit's procyclical tendencies are shaped not only by its exposure to leverage but also by its structural ties to private equity sponsors and its evolving investor base.

Sponsor behavior plays a dual role. On one hand, PE owners may act as stabilizers during downturns, injecting equity or renegotiating terms to keep borrowers solvent. On the other hand, they may also delay loss recognition in affiliated credit funds, masking distress through "amend and extend" strategies (Deane 2024). This tension between transparency and preservation creates moral hazard, especially when the same sponsor is both owner and lender.

Retail-facing private credit funds exacerbate these tensions. The rise of semiliquid structures, such as nontraded BDCs and interval funds, has introduced liquidity mismatches into a traditionally illiquid asset class. Redemption windows appear to offer flexibility, but when sentiment turns, they can trigger a rush for the exits. The International Monetary Fund (IMF) has warned that these vehicles are yet untested in a severe stress event (IMF 2024). Forced sales or redemption gates could create the very instability they aim to prevent (Ghamami et al. 2025).

Moreover, market signals and investor behavior become procyclical catalysts. Public BDC prices, which are often volatile, can influence perceptions of stability in private credit. If sentiment deteriorates, retail investors may seek to redeem en masse, forcing illiquid funds to gate redemptions or sell assets at a discount (Davidow and Thakur 2026). These redemption spirals resemble historical episodes in money market and real estate funds and may produce broader credit market dislocations.

Monitoring and Transparency Challenges

The monitoring of private credit remains hindered by information asymmetries and fragmented oversight. Private credit's nonpublic nature means it lacks the standardized disclosures, credit ratings, and price transparency found in public markets. Valuation practices rely heavily on internal modeling and assumptions that may be biased toward smoothing volatility (Buch 2025). Without timely revaluation, fund investors—and regulators—may not detect stress until it is too late.

Worse still, exposure aggregation is often incomplete. Banks and asset managers may be exposed to different tranches of the same borrower's capital structure without realizing the extent of their combined risk (Galbarz et al. 2024). These blind spots are particularly dangerous in scenarios involving layered leverage, where a single failure can ripple across seemingly unrelated financial intermediaries.

Global regulatory efforts are responding. The US SEC's private fund rules and Rule 2a-5 have increased transparency and valuation oversight. Europe's revised Alternative Investment Fund Managers Directive (AIFMD 2.0) imposes similar reporting and liquidity mandates.[6] The Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) are coordinating cross-border frameworks to capture risks posed by nonbank credit intermediaries. US banking regulators are also conducting horizontal risk assessments across private fund exposures (Board of Governors of the Federal Reserve System 2025; Johnson et al. 2026). Collectively, these measures signal a recognition that private credit's opacity is no longer tenable at its current scale.

Key Takeaways: Risk Dynamics in Private Credit

- *Structural risk drivers*
  - Illiquidity traps capital in stress periods, even in semiliquid formats.
  - Concentration risk is high at both the portfolio and manager levels.
  - Opacity in borrower quality and valuations delays risk recognition.
- *Leverage and interconnection*
  - PE and private credit are deeply intertwined: PE amplifies upside via leverage; private credit absorbs downside via debt risk.
  - Layered leverage across PE sponsors, borrowers, and lenders obscures systemwide risk.
  - BDCs and retail funds use leverage nearing regulatory caps.
- *Retail amplifiers*
  - Liquidity mismatches in retail vehicles can trigger fire sales or redemption gates in market stress situations.
  - Infrequent valuations of underlying assets mask changes in credit quality.
  - Fees are often opaque and misaligned with investor interests.
- *Market and regulatory issues*
  - Procyclicality is embedded in both sponsor behavior and investor sentiment.
  - Blind spots persist in aggregated exposure monitoring.
  - Global regulators (e.g., SEC, European Union [EU] / European Securities and Markets Authority [ESMA], and FSB) are responding, but coordination remains incomplete.

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[6]Adopted in 2024, AIFMD 2.0 will impose stricter reporting and disclosure requirements on loan-originating funds, including more granular data on loan portfolios, leverage, and liquidity management. These new requirements should begin to take effect in 2026 (Buch 2025).

Covenant Erosion and Credit Quality

The growing use of covenant-lite (cov-lite) structures in private credit has reshaped the risk landscape for lenders, weakening traditional safeguards and shifting the balance of control toward equity sponsors. This section examines the structural erosion of covenant protections, the rise of permissive documentation, and the resulting implications for creditor recoveries and legal enforcement.

Covenant-Lite Trends and Documentation Risk

Initially developed in the syndicated loan market, cov-lite structures have now become widespread in large private credit deals. By the mid-2020s, more than 90% of new US syndicated senior secured loans lacked financial maintenance covenants (Panossian and Poli 2024). Similarly, fewer than 10% of large direct loans above USD500 million retain any maintenance covenants (Resonanz Capital 2025). Although smaller middle-market deals still tend to include one or more covenants, the broader trend reflects intense competition among lenders and growing sponsor leverage.

Maintenance covenants historically served as early-warning triggers, allowing lenders to detect borrower distress through leverage or interest coverage metrics. Their disappearance delays risk detection and undermines lenders' ability to negotiate proactively in distressed scenarios (IMF 2024). Permissive documentation compounds this erosion. Credit agreements may feature liberal **EBITDA add-backs**,[7] **uptiers**,[8] **drop-downs**,[9] and **PIK toggles**,[10] all of which can be exploited to provide upstream value to equity holders through **sponsor-directed liquidity events**,[11] raise new senior debt, or transfer collateral away from creditors (Panossian and Poli 2024; Resonanz Capital 2025).

Several high-profile restructurings illustrate how flexible documentation facilitates sponsor-friendly outcomes:

[7]EBITDA add-backs are nonrecurring, unusual, or nonoperational items that are added back to a company's earnings before interest, taxes, depreciation, and amortization (EBITDA) to more accurately reflect the company's ongoing profitability. In cov-lite structures, with fewer (or no) maintenance covenants, incurrence tests (e.g., borrowers may incur new debt only if leverage is less than 6× adjusted EBITDA) assume elevated relevance. As a result, some borrowers may exploit add-backs to inflate adjusted EBITDA in order to raise additional debt or pay dividends without breaching covenants.

[8]Uptiers allow borrowers to issue new debt that is senior to the existing debt by using loopholes in loan documents that permit (or fail to prohibit) the issuance of new senior debt. Uptiers usually favor a subset of lenders.

[9]In a drop-down, a borrower transfers collateral assets from the original credit group (where lenders have a security interest) to an *unrestricted subsidiary*—a legal entity outside the reach of existing lenders. This unrestricted subsidiary "can then issue new debt that is structurally senior to, or secured against, this transferred collateral. This new debt may be issued to third parties that do not hold debt in the capital structure, or to certain existing lenders" (Panossian and Poli 2024, p. 3).

[10]PIK toggles are a loan feature that allows the borrower to choose whether to pay interest in cash or payment-in-kind (PIK)—that is, by adding the interest to the loan principal instead of paying it in cash. Although PIK toggles may provide short-term relief to borrowers under stress, ultimately this debt-deferral mechanism may amplify lenders' losses if the borrower fails to meet its future debt obligations.

[11]For example, equity sponsors may use the cash proceeds of a drop-down transaction to return capital to the sponsor or its investors (e.g., through the payment of special dividends or stock buybacks).

- In 2017, J. Crew used “trapdoor” provisions to move intellectual property to an unrestricted subsidiary, a maneuver permitted legally under the agreement but damaging for lenders. The controversy led to the industrywide adoption of “J. Crew blockers” (Americans for Financial Reform 2020).
- In 2018, Neiman Marcus similarly transferred key e-commerce assets out of lenders’ reach, avoiding default but igniting litigation and eventual debt restructuring (Ellias and de Fontenay 2025).
- From 2020 to 2024, Serta Simmons prioritized majority lenders in an uptier transaction using broad “open market purchase” language. In 2020, the company orchestrated an out-of-court refinancing in which a majority of its first-lien lenders provided new money and exchanged existing debt into a new “super-priority” loan, leapfrogging the minority lenders in priority (Buccola and Nini 2024). After years of litigation, the US Court of Appeals for the Fifth Circuit (hereafter, the Fifth Circuit) ruled that the deal violated pro-rata sharing clauses (Klyman and Shelley 2025).
- In 2020, Boardriders and TriMark USA executed uptier transactions under similar cov-lite documents, with courts upholding their legality despite the fact that these transactions excluded minority lenders (Ellias and de Fontenay 2025).

Until recently, these transactions were largely a US phenomenon. That changed in 2025, as comparable transactions and litigation emerged in Europe:

- **Hunkemöller (2024–present)** exchanged EUR186 million of its largest noteholder’s notes for new notes with payment priority over the remaining holders, without offering minority holders the chance to participate. Minority noteholders are now litigating in New York, England, the Netherlands, and Luxembourg. A New York court has allowed breach-of-contract claims to proceed, while an English High Court claim invoking the *Assénagon* “abuse principle” remains pending (Fortune et al. 2025; Komsky and Ross 2025).
- **Selecta (2025–present)** transferred control to a group of “favored” noteholders through a Dutch share-pledge foreclosure. Excluded noteholders have sued in New York on antitrust and contract theories and are separately appealing the Dutch enforcement decision. Both proceedings remain unresolved (Harrow 2025; Poilpre 2025).

In response, many private lenders now demand “uptier blockers” and stronger definitions in loan documentation. Yet gaps persist, particularly when documents rely on ambiguous language that can be interpreted to support sponsor-led liability management transactions (Deane 2024).

Recovery Outcomes and Legal Enforcement

The erosion of covenant protections weakens lenders' ability to recover value. Without maintenance covenants, intervention often comes only after a payment default, by which point the borrower may already be insolvent (Fitch Ratings 2023).

Delayed Enforcement and Lower Recoveries

Although some early studies suggested comparable recoveries between cov-lite and covenant-heavy loans, more recent data show that recoveries are lower for cov-lite instruments in distressed scenarios. The difference is largely attributable to delayed intervention and diminished creditor leverage (IMF 2024).

The same pattern is emerging in private credit. Although direct lenders historically benefited from tighter governance and secured positions, the adoption of cov-lite structures in larger deals is eroding this advantage (Ricciardelli and Clements 2024).

Legal Enforcement and Case Outcomes

In the absence of proactive contractual triggers, enforcement increasingly depends on litigation, as the following examples show:

- In the case of Serta Simmons, subordinated lenders endured a multiyear legal battle before the Fifth Circuit finally upheld their claims (Klyman and Shelley 2025).
- The example of Pluralsight in 2023–2024 provides a contrasting outcome: After an equity-funded drop-down failed to prevent distress, Vista Equity Partners transferred control to lenders through a negotiated debt-for-equity swap, thereby demonstrating the strength of well-drafted rights, even in loose covenant environments (Goldstein et al. 2024).
- For TriMark and Boardriders, nonconsenting lenders were subordinated and courts refused to intervene, a result that reinforces the importance of precise legal drafting (Ellias and de Fontenay 2025).

Summary

Covenant erosion is no longer a side effect of competitive lending; rather, it is more a shift in credit structuring. For lenders, this shift means the real risk lies not only in borrower performance but also in how ambiguous terms and sponsor-led restructurings can reshape value waterfalls in distress. Effective protection now requires clear documentation, vigilant underwriting, and cross-jurisdictional legal awareness.

Policy Implications and Recommendations

As retail participation in private credit grows, so too does the urgency for a coordinated policy response. The recommendations in this section aim to address key vulnerabilities (ranging from investor safeguards to global regulatory harmonization) while preserving the benefits of innovation and access. **Exhibit 3** summarizes how current regulatory frameworks interact with the evolving structure of private credit markets. This regulatory crosswalk highlights the alignment challenges between fund manager incentives and investor protection goals, as well as the gaps in market risk detection that emerging reforms are attempting to close.

Retail Investor Safeguards

Retail investors increasingly access private credit through such vehicles as feeder funds, interval funds, and nontraded (private) BDCs. Although these vehicles democratize access, they also introduce risks tied to liquidity mismatches, opaque fees, and product complexity.

Policy Recommendations

- *Enhanced suitability testing:* Regulators should implement product-specific appropriateness tests for semiliquid private credit funds distributed in broker-dealer channels. The EU's MiFID II appropriateness test and product governance frameworks (ESMA 2023; Projective Group 2019) provide a model for how regulators can ensure that complex financial products are sold only to investors who understand them and for whom they are suitable.[12]
- *Accreditation reforms:* In the United States, the SEC's 2020 amendment to the accredited investor definition permits access based on professional qualifications or regulatory licenses (e.g., Series 7, 65, 82) rather than on meeting wealth or income thresholds alone (SEC 2020). Legislative proposals introduced in 2023 seek to further expand these credential- and exam-based pathways (US Congress 2023). To promote more risk-appropriate and inclusive access globally, regulatory harmonization across jurisdictions is needed to support the wider adoption and standardization of credential-based investor accreditation frameworks.
- *Investor education:* Mandatory presale disclosures and basic product education modules, especially for complex or semiliquid funds, can reduce mis-selling risks. Although such jurisdictions as the EU mandate standardized disclosures for retail investors—via Key Investor Information Documents (KIIDs) under the undertakings for collective

[12]The MiFID II appropriateness test requires that for nonadvised services, firms must assess whether a product aligns with a client's knowledge, experience, financial situation, and investment objectives. For complex products, this test must go beyond basic checkbox questions. It must use objective queries that assess actual understanding of product features and risks—especially critical for those investing directly in semiliquid private instruments.

Exhibit 3. Regulatory Crosswalk: Incentives, Gaps, and Responses

	Liquidity Risk Management	Transparency and Disclosure	Leverage Oversight (Fund-Level)	Interconnectedness and Counterparty Risk	Sponsor Conflicts of Interest	Retail Investor Protection	Market Risk Surveillance
Issue in Private Credit	Semiliquid and open-ended funds promise periodic redemptions despite holding illiquid assets	Quarterly NAVs based on internal valuations; sparse public reporting	Use of credit facilities, subscription lines, BDC leverage near 2:1 regulatory cap	Banks lend to private credit funds, co-invest with sponsors, hold overlapping portfolio exposure	PE firms managing both borrower (equity) and lender (credit) entities within the same deal	Rise of feeder funds, non-traded BDCs, and interval funds; product complexity and limited suitability safeguards	NBFI sector lacks consolidated regulatory view across jurisdictions
Regulatory Responses	**US** SEC private fund rules (2023) **Global** IMF and IOSCO guidance **EU** LTAFs/ ELTIFs; AIFMD 2.0 liquidity mandates	**EU** AIFMD 2.0 reporting **US** SEC disclosure rules	**US** SEC BDC monitoring; Fed horizontal reviews of fund exposure **Global** FSB nonbank leverage review	**EU** ECB data aggregation calls **Global** FSB enhanced supervisory coordination	**US** SEC preferential treatment rules **Global** CFA Institute, IOSCO and IMF highlighting dual-role conflicts	**EU** MiFID II suitability and appropriateness testing; PRIIPs KID **US** SEC fee disclosure, accreditation reforms (2020, 2025) **Global** IMF and IOSCO liquidity guidance	**Global** FSB and IOSCO data harmonisation **EU** ESRB macroprudential monitoring
Incentive Misalignment	Redemption pressure may force fire sales, harming remaining investors and crystalizing losses at the worst time	LPs and regulators may miss early signs of credit deterioration or mounting default risk	Rising leverage may not be visible systemwide; layering across entities obscures true exposure	Fragmented bank data systems fail to capture market links with fund counterparties	Affiliated credit funds may delay loss recognition to preserve equity fund returns and carried interest	Retail investors may not fully understand illiquidity risk; periodic redemption promises may be misinterpreted as liquidity guarantees	Regulators operate with lagged or incomplete info on market-wide exposures and systemic concentration

Jurisdiction: **US** United States **EU** European Union **Global** International (FSB, IOSCO, IMF, CFA Institute)

Notes: ELTIF = European Long-Term Investment Fund; LTAF = Long-Term Asset Fund (UK); NBFI = nonbank financial institution; ESRB = European Systemic Risk Board; MiFID II = Markets in Financial Instruments Directive II; PRIIPs = packaged retail and insurance-based investment products; KID = Key Information Document; LPs = limited partners.

investment in transferable securities (UCITS) directive (ESMA 2021) and Key Information Documents (KIDs) under the PRIIPs regulation (European Commission 2021)—these types of disclosure safeguards are not universally adopted. *Even where disclosure regimes exist for private funds, recent research highlights that retail investors often misinterpret such features as stable NAVs or high yields as indicators of safety, despite significant underlying risk exposures* (IMF 2024). Harmonizing presale disclosure requirements across jurisdictions would facilitate cross-border distribution and enhance comparability while reducing mis-selling risk.

- *Access expansion:* The SEC's 2025 decision to lift the 15% cap on private fund investments in registered closed-end funds, opening these funds to nonaccredited retail investors, requires parallel measures that ensure access does not compromise protection.[13] These measures should include enhanced presale disclosures, suitability and appropriateness testing, optional investor education modules, and robust liquidity management and valuation oversight. Drawing from existing global practices, such as the EU's PRIIPs KID regime, MiFID II investor suitability tests, and IOSCO liquidity recommendations, such safeguards should help preserve market integrity and align retail investor outcomes with informed consent.
- *Retirement plan inclusion:* Such measures as the 2025 executive orders are opening the 401(k) market to private credit inclusion (Binnie and Bose 2025; Groom Law Group 2025; Primack 2025).[14] Such initiatives heighten the need for global fiduciary standards, transparency, and cost-effective fund design to protect savers worldwide. The CFA Institute comment letter on the rule proposed by the US Department of Labor for selecting designated investment alternatives in 401(k) plans supports an asset-neutral approach to private market investing and emphasizes stronger investor protections (Fines et al. 2026).

Disclosure and Valuation Standards

Retail private credit funds often rely on internal models to value illiquid loans, yet they report quarterly NAVs that form the basis for fees and redemptions. This creates NAV smoothing risks and asymmetric information. **Exhibit 4** decomposes the gross yield of each credit asset class into its constituent risk premiums: the risk-free rate, maturity or duration premium, default and credit spread, illiquidity premium, and size or complexity premium.

The analysis highlights that the majority of direct lending's yield advantage over public credit reflects compensation for illiquidity (estimated at 150 bps–200 bps) and the additional complexity of lending to middle-market borrowers, rather than a proportionally higher credit risk alone. These premiums are structural: They reflect the cost of capital lockup, limited secondary market liquidity, and the due diligence burden inherent in bespoke loan origination.

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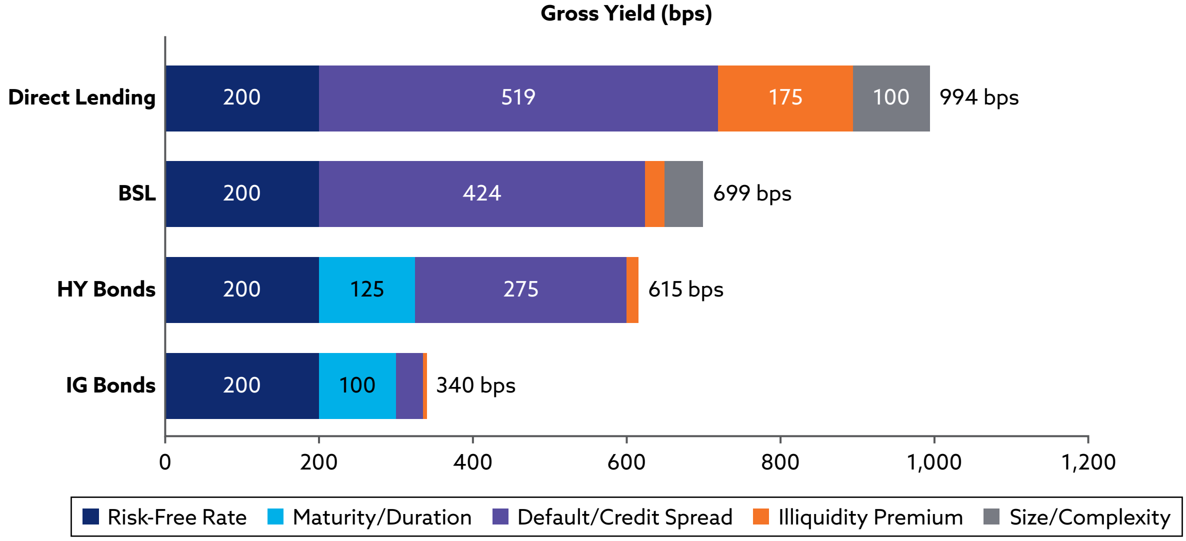
[13]In May 2025, the SEC announced it would no longer enforce the informal 15% cap that had historically limited how much a retail closed-end fund could allocate to private funds. Previously, funds exceeding this threshold were required to restrict access to accredited investors and typically imposed USD25,000 minimum investment requirements (Stradley Ronon Stevens & Young LLP 2025).

On 15 August 2025, the SEC formalized this policy change through Accounting and Disclosure Information guidance ADI 2025-16, issued by its Division of Investment Management. The new guidance allows registered closed-end funds and BDCs to invest more freely in private funds and offer those exposures to all retail investors, not only accredited ones. In place of strict investment limits, the SEC now requires enhanced disclosure around fees, liquidity, risks, and conflicts, relying on the structural safeguards of the Investment Company Act of 1940 to protect investors (SEC 2025; Ropes & Gray LLP 2025).

[14]In August 2025, a new executive order directed US agencies to expand access to alternative assets—including private credit—in 401(k) retirement plans, removing previous constraints that limited these strategies to institutional settings (Binnie and Bose 2025; Groom Law Group 2025; Primack 2025). The move opens the door for retail retirement savers to invest in private markets, prompting calls for stronger fiduciary standards, cost transparency, and clearer risk disclosures under ERISA protections (Cavanaugh 2025; Light and Alpert 2025; Masters, Indap, and Miller 2025).

Exhibit 4. Illustrative Gross Yield Decomposition by Asset Class, 2015–2025



Sources: Nesbitt (2026); Board of Governors of the Federal Reserve System, Federal Funds Effective (RIFSPFFNA), retrieved from FRED, Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org/series/RIFSPFFNA). Graphic generated by Claude.ai, Anthropic (May 2026). Edited for style and content.

Notes: Figures represent gross yield as of 31 December 2025—that is, the prevailing income rate at that point in time, prior to price changes or credit losses. Verified vs. illustrative: Direct Lending (994 bps) and BSL (699 bps) totals are Cliffwater's reported current yields for the CDLI and the Morningstar LSTA US Leveraged Loan Index, respectively, as of 31 December 2025 (Nesbitt 2026). HY Bonds and IG Bonds totals are illustrative, representative levels for comparison. Component splits are an illustrative allocation constructed to reconcile with the verified totals and are not independently sourced. Risk-free rate is the verified average annual effective federal funds rate from 2015–2025 (2.00%).

For retail investors, understanding this decomposition is essential: The higher yield of private credit is not "free" income but, rather, compensation for bearing risks that differ qualitatively from those in public bond markets. Disclosure frameworks should therefore require that fund materials qualitatively describe which risk factors contribute to the stated yield, enabling investors to understand the return drivers and assess whether the compensation is commensurate with the risks assumed.

Policy Recommendations

- *Enforce Rule 2a-5 (United States):* This rule mandates that for investments by registered investment companies and BDCs, fair value must be determined in good faith and subject to board oversight (SEC 2020). Globally, regulators should prioritize audits of valuation methodologies and consider independent third-party valuation for NAV-based retail funds—already required in the EU and the United Kingdom under the AIFMD for most alternative funds (European Union 2011; Financial Conduct Authority 2016)—as a safeguard against valuation opacity and mis-selling. Harmonizing these expectations across jurisdictions would support investor confidence.
- *Fee transparency:* Retail vehicles often charge multiple layers of fees. Disclosures should clearly show upfront fees, AUM charges, and NAV-based incentive structures to facilitate investor comprehension of the impact of fees on the real return.

- *Stress-testing redemptions:* Funds offering quarterly redemptions must demonstrate that redemption liquidity is robust under scenarios of rising interest rates or default risk or otherwise augment the calibration of liquidity risk management tools. Policymakers should reinforce manager accountability for the calibration, activation, and communication of liquidity risk management tools through enhanced governance and investor disclosures (Pang and Soni, forthcoming 2026).

Cross-Border Regulatory Coordination

As global managers distribute private credit products across multiple jurisdictions, the absence of coordinated regulatory frameworks increases market risk. Divergent liquidity rules, valuation protocols, and fund structures can create arbitrage opportunities and supervisory blind spots.

Policy Recommendations

- *Global alignment on fund liquidity frameworks:* Variability in US, EU, and APAC rules creates the potential for inconsistent standards of investor protection, posing a particular challenge for cross-border funds. Harmonizing valuation standards, liquidity risk management, and suitability frameworks provides greater certainty for investors. International bodies such as IOSCO should continue to work with national regulators to strengthen regulatory harmonization and foster the development of best practices (FSB 2025; IMF 2024).
- *Shared data infrastructure:* Coordinated reporting across private credit platforms, fund exposures, and flows (via FSB, IOSCO, and AIFMD 2.0) can surface tensions early and support macroprudential oversight (IOSCO 2024). Shared frameworks are essential to map interconnected credit risks across sponsors, funds, and lenders.
- *Managing sponsor conflicts:* Dual-role sponsorship, in which the same entity serves both lender and equity sponsor, poses conflicts of interest. IOSCO has taken a first step in this area by identifying conflicts where PE sponsors also act as lenders as part of its 2024 good practices for leveraged loans and collateralized loan obligations, or CLOs (IOSCO 2024). This guidance, however, remains nonbinding and scoped narrowly to leveraged loans and CLOs. It remains imperative for industry bodies to extend global best practices for managing dual-role conflicts (including disclosure of preferential treatment, amendments, and debt restructurings) explicitly to direct lending and other private credit fund structures, while working toward more consistent cross-jurisdictional adoption (Deane 2024; SEC 2023).

Emerging Structural and Regulatory Dynamics

As private credit evolves, regulators must look beyond current supervisory tools and anticipate how structural innovations may reshape market behavior, investor exposure, and market risk. The rise of NAV-based lending, tokenization, and deeper interlinkages between public and private markets poses challenges not only for investor protection but also for macroprudential oversight. The following three areas require urgent attention.

Market Complexity and Regulatory Focus

With global AUM estimated at more than USD2.6 trillion in mid-2025 (Hinds et al. 2026), private credit has become a structurally important asset class. Both the Bank for International Settlements and Fitch Ratings have warned that embedded leverage, opaque fund structures, and increasing links to bank financing could transmit stress across markets, particularly if multiple private credit funds face simultaneous redemptions or defaults (Avalos et al. 2025; Masters et al. 2025).

- **Policy recommendation:** Regulators should prioritize systemwide surveillance of private credit exposures, including the following:
    - Developing real-time dashboards to track fund-level leverage and sponsor–bank interconnections
    - Mandating disclosure of cross-holdings between equity sponsors and credit vehicles
    - Incorporating private credit into macroprudential stress-testing frameworks typically conducted by central banks, particularly as the sector becomes a substitute for traditional bank lending. A welcome development in this area is the Bank of England's system-wide exploratory scenario (SWES) test which focuses on private markets (Bank of England 2026). Exercises such as the SWES help regulators move from assessing individual institutions in isolation toward understanding how stress may propagate across the modern financial system.

Challenges from NAV Lending

NAV-based credit facilities, in which private funds borrow against the NAV of their portfolio, are becoming increasingly common, especially as traditional liquidity sources tighten. When paired with continuation vehicles or multilayered fund structures, these facilities can create "leverage-on-leverage" effects that obscure risk and delay recognition of underlying asset distress.

This practice is particularly disconcerting when NAV marks are model driven and subject to valuation smoothing, making it difficult to assess when a fund is approaching liquidity strain. The Institutional Limited Partners Association (ILPA) has responded by issuing guidance on NAV lending, including recommendations for disclosure, leverage thresholds, and governance (ILPA 2024).

- **Policy recommendation:** Regulators should monitor the extent of NAV-based lending practices and consider the following as part of the ongoing supervision of registered firms:
    - Disclosure of NAV facility terms and lender identity
    - Periodic stress testing under declining NAV scenarios
    - Restrictions on layering NAV debt over already-levered portfolio positions

Rating Integrity and CLO Risks

Reforms initiated after the 2008 Global Financial Crisis, such as the Dodd–Frank Act Title IX, Subtitle C, in the United States and the EU's CRA III Regulation, strengthened regulatory oversight of *public market credit ratings* through measures that included enhanced methodology disclosure and conflict-of-interest controls (US Congress 2010; European Union 2013). Private credit ratings, however, have grown outside much of this visibility: They are not publicly disclosed,[15] are concentrated among smaller nationally recognized statistical rating organizations (NRSROs)[16] (SEC 2025), and are used directly by insurers to determine regulatory capital charges.[17]

The growing reliance on private credit ratings, particularly in CLOs and securitized private debt portfolios, has reignited concerns over rating shopping and opacity. Regulatory reviews in both the United States and the EU have pointed to inconsistencies in rating methodologies and insufficient disclosure on asset-level credit quality. These risks highlight the gap between existing reforms and private credit sector growth. In response, policymakers are exploring dual-rating requirements, enhanced stress testing of CLOs, and reforms that would standardize risk disclosures for securitized private credit (Taylor 2025).

- **Policy recommendation:** Regulators should attend to the following:
    - Encourage independent secondary ratings for all securitized private credit instruments
    - Require managers to disclose underlying asset ratings, deal concentration, and recovery assumptions.

The retailization of private credit demands a progressive regulatory agenda, balancing market innovation with robust protections, transparency, and systemwide resilience. Policymakers must evolve from reactive oversight to

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[15]S&P Global Ratings, "Credit Ratings," S&P Global, accessed August 2026, https://www.spglobal.com/ratings/en/products/credit-ratings.

[16]The NAIC found that over 80% of private ratings on insurer investments are issued by small and medium-sized agencies (SEC 2025).

[17]National Association of Insurance Commissioners, "Insurance Topics | Private Credit," NAIC, accessed August 2026, https://content.naic.org/insurance-topics/private-credit.

forward-looking stewardship, ensuring that private credit remains a sustainable component of the broader financial ecosystem.

Conclusion

As private credit becomes a larger component of household wealth portfolios, its failures or fragilities will no longer be confined to professional investors. The risks associated with layered leverage, sponsor conflicts, and delayed valuation may affect retail sentiment, market liquidity, and financial stability, particularly if redemption pressures exceed available liquidity in stressed environments.

The expansion of retail participation introduces new channels through which risk can propagate. Liquidity mismatches in semiliquid structures, valuation practices that delay loss recognition, and increasingly permissive credit documentation all contribute to a market environment in which vulnerabilities may remain latent until conditions deteriorate. When they do, adjustment may be abrupt and procyclical.

For regulators, these dynamics imply that oversight must evolve from a posture of accommodation to one of anticipation and alignment. Product innovation should be matched with advances in transparency, investor protection, valuation standards, and cross-jurisdictional coordination. Frameworks originally designed for institutional markets must be recalibrated to reflect the realities of semisophisticated retail participation and increasingly complex market structures.

Industry leaders face a dual task: to design investment vehicles that accommodate broader access *without diluting asset quality and liquidity safeguards* and to ensure that distribution practices, disclosures, and governance frameworks adequately reflect the risks embedded in illiquid credit strategies.

For investors, particularly those accessing private credit through digital platforms or retirement vehicles, understanding the trade-offs among income, liquidity, and risk is essential. Returns are a function not only of yield but also of structure, valuation discipline, and the timing of cash flows under varying market conditions.

Ultimately, retailization is best understood as a calibrated expansion of market participation—one that offers potential benefits in terms of access and capital formation but also introduces new complexities that must be carefully managed. If aligned with appropriate safeguards, it may enhance diversification and support long-term investment objectives. If misaligned, it risks amplifying vulnerabilities that previous financial reforms sought to address.

This report provides a framework for identifying those risks and developing policy responses that support both market innovation and financial stability. Applying this framework enables financial market participants, policymakers, and regulators to ensure that the evolution of private credit remains consistent with long-term investor protection and systemic resilience.

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