Into the Shadows of US Private Credit: *A China Perspective*

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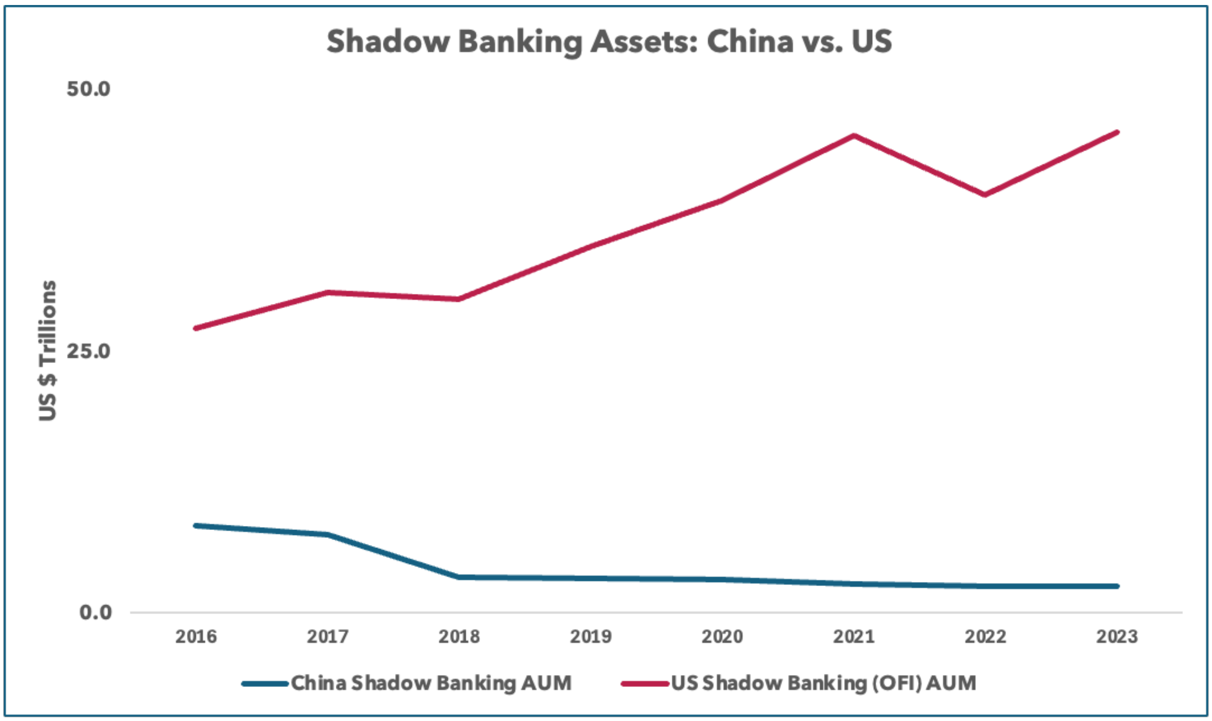
As we observe the booming US private credit market from our perch here in China, we see multiple striking parallels with China's shadow banking system (non-bank lending), which ballooned by trillions of dollars before 2017. Between 2017-2018, Beijing clamped down on the space, due to clear systemic risks. In contrast, despite US private credit's steadily expanding scale and weakening fundamentals, the US seems to be taking little action to mitigate the potential systemic risk. At this stage, we question whether the US will muster the discipline and regulatory coordination that Beijing showed.[1] Is a day of reckoning on the horizon for US private credit?[2]



Source: People's Bank of China and Financial Stability Board[3]

The credit cycles in the US and China often run counter to each other, and therefore are highly uncorrelated. In recent years, for instance, availability of credit from shadow banks to corporations in China has tightened dramatically, whereas the US has seen over 500 new private credit funds spring up

[1] The SEC attempted to tighten rules on private fund disclosures and valuation oversight, but these were struck down in full by the courts in 2024 (*SEC, 2023*).

[2] ShoreVest is not the only one asking. In 2025, pieces analyzing the question have been written by the US Federal Reserve, the Federal Reserve Bank of Boston, Moody's, and others.

[3] The Financial Stability Board's "Global Monitoring Report on Non-Bank Financial Intermediation 2024." Other financial intermediaries ("OFIs") are a subset of the NBFI sector (formerly called shadow banking), composed of all financial institutions that are not central banks, banks, public financial institutions, insurance corporations, pension funds, or financial auxiliaries.

since the 2008 global financial crisis ("GFC"). While the flood of capital into US private credit has created over-competition and weaker credit fundamentals for investors, Beijing's regulatory reform and shuttering its shadow lenders (such as wealth management products and P2P lenders) has created a vacuum of capital increasing the attractiveness of China's market for locally experienced institutional private credit investors like ShoreVest. In this piece, we will elaborate on one thing we think is clear: Explosive growth in unregulated US private credit is metastasizing systemic risks while China continues to regulate its shadow banks, creating opportunities for institutional private credit outside its shadow banking sector.

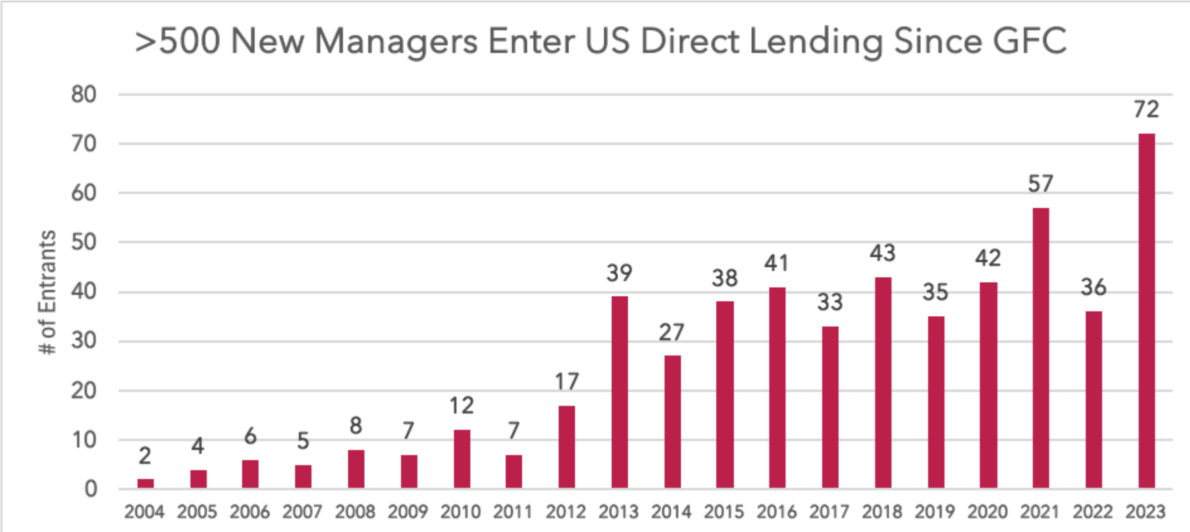
Before getting into the details of these matters, below we compare the US and China shadow banking markets side-by-side, laying out several general topics where the current US private credit market mirrors the pre-pandemic China shadow banking space:

	China pre-pandemic shadow banking	US post-pandemic private credit / shadow banking	China regulatory or investor-imposed restraint?	US regulatory or investor-imposed restraint?
Trillions of USD AUM growth in a few years?	Yes	Yes	Yes	TBD
Use of leverage dramatically increasing?	Yes	Yes	Yes	TBD
Commercial banks indirectly exposed to risk?	Yes	Yes	Yes	TBD
Insurance companies indirectly exposed to risk?	Yes	Yes	Yes	TBD
Large amounts of retail investor capital raised?	Yes	Yes	Yes	TBD

Source: ShoreVest

Lengthening Shadows

Booming US Private Credit. As investors in US private credit will recall, stringent banking regulations (namely the Volcker Rule and Basel III) instituted in the aftermath of the GFC forced US (and European) banks to disintermediate. Professionals departing the banks' proprietary desks set up direct lending funds outside the financial regulatory framework to lend to middle-market companies, facilitating private equity buyouts. The flexible capital from direct lenders commanded a liquidity premium, attracting hordes of yield-chasing investors into direct lending funds in a zero/low interest era. As a result, over 500 direct lending funds were newly formed, as shown in the graph below. Of US direct lending fund managers, less than 5% have experienced a credit cycle (the last one being the GFC in 2008), and less than 1% have a history in private credit as long as ShoreVest's team (over 20 years).



Source: Pitchbook

The symbiotic relationship between direct lenders and their PE sponsors saw US shadow banking expand at a blistering pace, attracting investors to various forms of private credit, namely: mega direct lending funds, business development companies ("BDCs"), special situation hedge funds, and so forth. The rapid growth has produced a number of issues for the US private credit space.

Struggling to Deploy and Exit. One major issue for US private credit is the massive amount of undeployed capital or "dry powder" which overhangs the industry. Due to the flood of new capital raised in the private credit space (most of which is in the US), around half a trillion dollars of dry powder has been awaiting deals for the last three years.[4] Inevitably, too much capital means compressed returns, but it also means less negotiating leverage to demand protective measures in the credit instruments.

On top of the difficulties with finding enough opportunities to invest in, challenges monetizing their existing investments is arguably a bigger problem for US private credit. Cash distributions to paid-in capital ("DPI") from private credit are at an all-time low as private equity sponsored deals face a lack of exits through M&A and IPOs. This has forced private credit managers to get creative in constructing new avenues to liquidity, which are arguably synthetic because they come from no "real" exit. Such avenues include selling portfolio positions in a rapidly developing GP-led secondary market, or setting up continuation funds to extend beyond the normal fund life (an indicator of more illiquidity in the foreseeable future). Other avenues create risks for banks, as we discuss in sections below.

Darkening Shadows

Beyond US private credit's existing challenges with deployment and exits, a number of broader and perhaps more concerning issues are appearing on the horizon.

[4] Pitchbook: "Global Private Market Fundraising Report" Q1 2025.

Weakening Credit Fundamentals. Going forward, we think a higher-for-longer interest regime is in the offing, driven primarily by a deteriorating US fiscal debt situation that is pushing up term premiums. In a stagflationary environment, higher interest rates compress operating margins, challenging debt servicing especially for over-levered companies. This prompts them to use PIKs (payments-in-kind) to preserve cash, thus spiking LTVs (loan-to-value). Loose debt covenants have been increasingly salient in US private credit (more common in larger broadly syndicated loans or "BSLs"), and are triggering creditor-on-creditor violence. The market is also seeing substantially more liability management exercises ("LMEs") to amend covenants, extend maturities, avoid formal defaults and essentially linger in "zombie" status. Such LMEs may just be kicking the proverbial can down the road, only to default later (recent studies by investment banks estimate that more than 60% of LME restructurings need a second restructuring within two years, as underlying operational issues are often left unaddressed). Although default rates are still low, the situation is grim with growing economic uncertainty.

Even just a few defaults in private credit funds might raise concerns about fund valuations given their illiquidity, infrequent marks and subjective models. Forward looking cash flows become difficult to estimate if operating margins and interest coverage are cratering, and debt has increased through PIKs or LMEs. For context, 43% of mid-market firms tracked by S&P Global Ratings reported negative free operating cashflow in Q1 2025.

US private credit funds that adopted a covenant lite approach to beat aggressive competition might find their weaker collateral requirements or lower-quality collateral face illiquidity in fire sales (to say nothing of unsecured private debt that has no collateral at all).

Double Exposure. Because many leveraged deals in US private credit involve a BSL underwritten by banks (and subsequently securitized in collateralized loan obligations or CLOs) and a privately placed junior tranche held by private credit funds, if a US company falters, both bank loans and private credit investors are affected. When an institutional investor, say an insurance company or a sovereign wealth fund, holds stakes in both the affected private credit fund and a CLO, losses in one investment may force the investor to liquidate assets elsewhere, propagating stress. Such risk correlations are growing as private credit funds have expanded in number and size, creating new interconnections through overlapping positions in club deals and co-investments, shared by common LP investors.

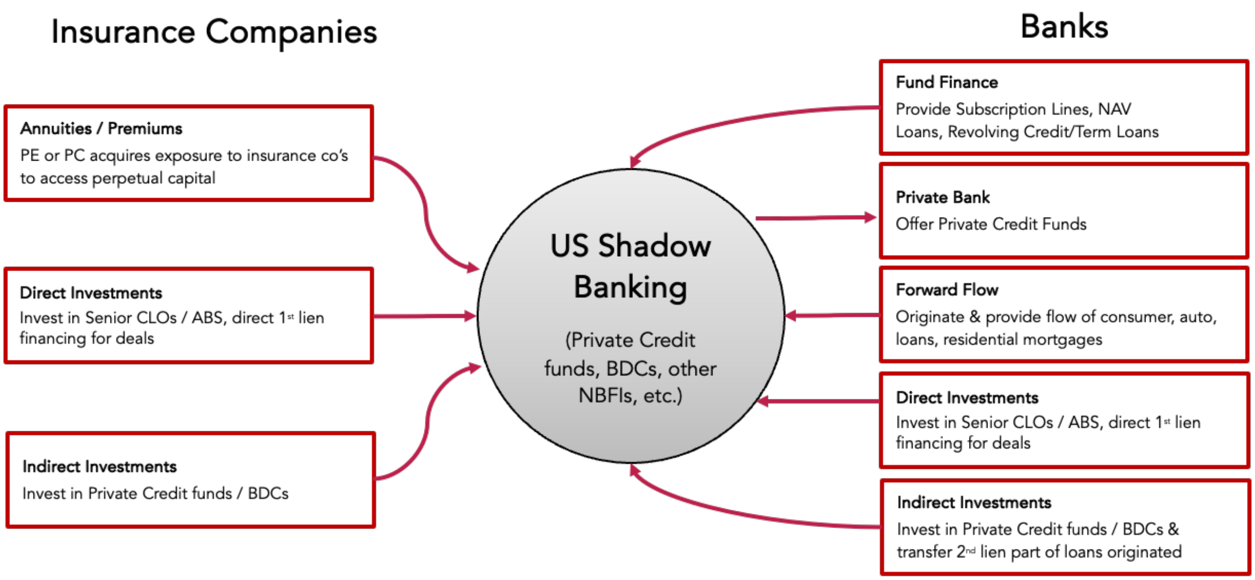
Distressed Opportunity Unclear. Some US distressed debt managers paint the issues discussed above as an opportunity on the horizon. But if defaults pick up, it may be very difficult for US distressed funds to know if they're catching a falling knife in the cycle that potentially unfolds. This seems apparent for a number of reasons, including:

- Global uncertainty arising from a multitude of geopolitical and global macro factors will have a strong bearing on pricing and realizable valuations of distressed assets.
- US private debt that took off after the GFC has never experienced a downcycle and therefore manager work-out experience and capabilities are grossly lacking. As shown in the chart in the preceding section, more than 95% of direct lending managers were formed after the last US downcycle.

- Any systemic failures (the likelihood of which is increasing for reasons discussed below) that require bailouts by a few large long-standing managers could find these managers compromised to deliver optimal results due to unprecedented government pressures and intervention.

Interconnectedness in US Private Credit Enhances Systemic Risk

Systemic Risk. While immediate risks to private credit vehicles appear limited due to their long-term capital lockups, the contagion from interconnectedness between US shadow banking on the one hand, and commercial banks or insurance companies on the other, portends heightened systemic vulnerabilities. Systemic linkages may reduce the chance of a single point of failure, but could also allow many smaller failures to interact outside the regulators' view.



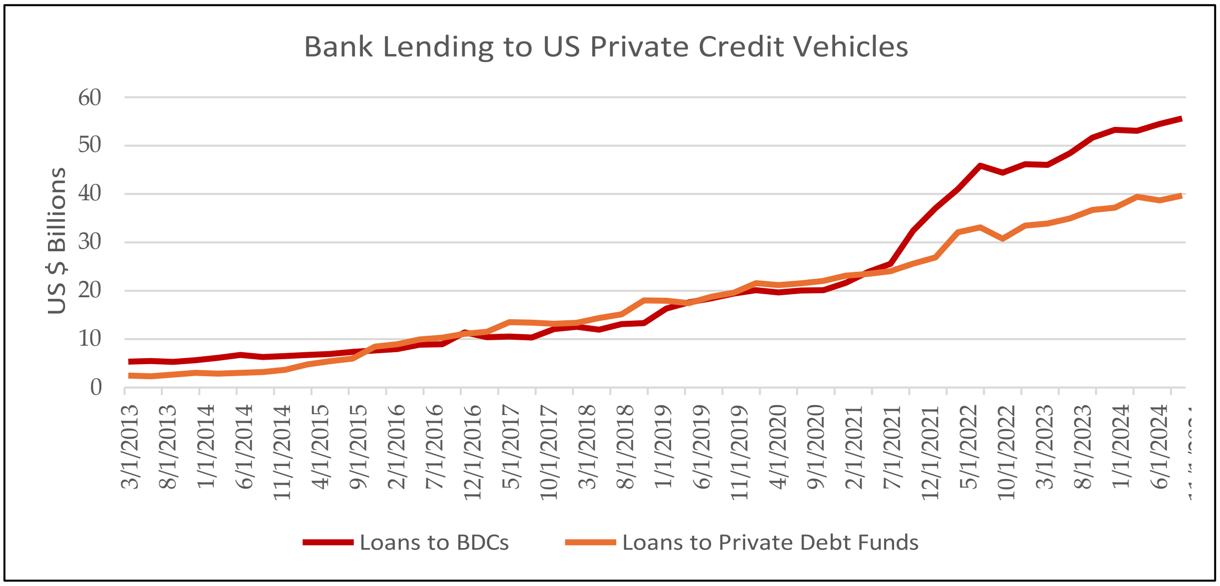
Source: ShoreVest: Adapted from FEDS Notes[5]

Illustrated in the graphic above are a few instances of how the interconnectivity between US shadow banks and financial institutions is manifesting itself. Recognizing contagion risk, S&P Global Ratings in its latest report[6] on financial stability highlights that hidden leverage in private credit carries "potential negative knock-on effects" to disrupt the orderly functioning of markets. Therefore, it suggests that transparency and oversight of banks also be applied to US shadow banking.

Connectivity with Commercial Banks. As noted above, US private credit funds have resorted to various creative avenues to liquidity where no real underlying exit has occurred (e.g. continuation funds). A potentially more concerning avenue to such synthetic liquidity involves debt from banks, thus provoking

[5] FEDS Notes: "Bank Lending to Private Credit: Size, Characteristics, and Financial Stability Implications" May 23, 2025
[6] S&P Global: "Private Capital Funds: Global Regulatory Push Could Catch Problems Before They Happen" June 16, 2025

systemic risk. As illustrated below, private credit and BDCs are increasingly arranging revolving lines of credit and term loans from major US banks to fund distributions or to inject cash into portfolio companies as business conditions sour.



Source: US Federal Reserve

Funds that use leverage may face margin calls or lose access to funding lines, forcing increased liquidity demands from private debt vehicles.

US private credit is not only involving the banks in its need for liquidity, but due to its massive overhang of dry powder discussed above, it is now involving banks in its need for deal sources as well. Large private credit managers are pushing into asset-based finance ("ABF") by entering into forward-flow arrangements with commercial banks to securitize pools of consumer and auto loans, residential mortgages, and account receivables, originated by the banks. ABF has become the new catchphrase to attract big investments into senior-rated tranches of securitized asset pools from banks and insurance companies, thus importing the very risk they attempt to transfer to the marketplace.

Connectivity with Insurance. In addition to bank connectivity, the growing private credit-insurance nexus is equally concerning. US private equity is on a buying spree to acquire or forge partnerships with insurance companies lured by inexpensive leverage and perpetual capital that insurance premiums provide to their portfolio companies and private credit businesses. In some cases, mega private equity firms not only own insurance companies, but create and originate private credit products for their captive insurers to purchase.[7] According to AM Best and Moody's, over 20% of the US insurance industry's total assets are in private credit holdings including CLOs, direct lending, asset-backed securities, etc. As the Bank of International Settlements put it in its 2024 annual report, "losses in private markets could propagate risks across an increasingly interconnected and complex insurance landscape."

[7] FT: "Rating Agency Bickering is a Healthy Sign for Private Credit."

Chasing Retail Investors. Tapped out of institutional markets for lack of distributions, private credit is also aggressively making a beeline for private wealth, either in commercial bank-connected private banks, or directly to retail investors. This is a movie we have seen before in China (discussed below) that does not end well, as also echoed by Moody's.[8] Some veteran bond investors have compared the excitement around US private credit with the exuberance that surrounded collateralized debt obligations in the years leading to the 2008 financial crisis.

Even without any major event triggering mass defaults or a systemic crisis, investors in US private credit still feel the pain as fund managers distribute very little cash relative to historic levels. The ability of a closed-end private credit fund to extend and pretend, and thereby avoid a loss realization event, does not remove the ultimate underlying problem. Rather, it simply means that just as Japan created "zombie" banks in the 90's with general unwillingness to recognize losses, over time US private credit could find itself full of many zombie funds extending terms indefinitely.

Lessons from China's Shadow Banking

US private credit's growing interconnectivity with banks, insurance companies and its beeline for private wealth, all remind us of the proliferation of wealth management products, P2P lending firms, trust accounts and bank-entrusted loans in China's shadow banking system prior to Beijing's 2017-2018 clampdown. Similar to present-day US, China's banks and insurance companies took off-balance sheet indirect credit risk in shadow banking. These risks were compounded by the fact that China's shadow banks raised massive amounts of capital from unsophisticated retail investors (mirrored today by US private credit's focus on private wealth).

Recognizing the lurking dangers of systemic risk from off-balance sheet finance in its commercial banks, as well as risk transferred to unsophisticated retail investors, in 2017-2018 China proactively cracked down on the entire shadow banking sector.

To mitigate such growing systemic risks, China's four leading regulatory bodies proactively adopted unified standards and rules greatly restraining "asset management" of the kinds found in the shadow banking system.[9] The regulatory bodies stipulated that private investment funds and certain areas of shadow banking would be governed more tightly by new laws and administrative regulations. Some noteworthy rules in China that we think could be relevant to today's US private credit industry are:

- A financial institution (such as a bank) shall not invest directly into the funds of its asset management products (i.e. off-balance sheet shadow banking analogous to US private credit funds) or in the credit assets of other commercial banks (e.g. consumer loans, auto loans, corporate loans, etc.);

[8] Moody's: "Private Credit & Systemic Risk" June 2025.
[9] "Yinfa No. 106 [2018]"; Guiding Opinions of The People's Bank of China, China Banking and Insurance Regulatory Commission, China Securities Regulatory Commission, and State Administration of Foreign Exchange on Regulating the Asset Management Business of Financial Institutions: April 27, 2018. Also see: China Banking Industry Financial Management Market Annual Report 2023.

- A financial institution is prohibited from providing any direct or indirect undertaking of or otherwise bearing risks on behalf of non-standard debt assets (e.g. private debt) invested in by an asset management product;
- The leverage ratio (total assets/net assets) of an asset management product (closed end publicly or privately offered) is capped at 200% of its net assets, and a unified maximum leverage ratio shall apply to the products of the same kind;
- Banks cannot provide implicit guarantees to any asset management product, or to businesses a commercial bank and asset management arm might do together. Also, banks cannot use trusts to engage in regulatory arbitrage; and
- Each financial regulation department shall submit the data on the asset management products issued by financial institutions to the People's Bank of China (China's central bank), communicating any information about material cross-industry or cross-market risks.

In sharp contrast, we find that the current US government is shying away from addressing potential systemic risks[10] and indirectly encouraging large asset managers to gather assets in retail private credit products,[11] just as institutional channels are drying up.

Regulatory Discipline Means Better Private Credit Opportunity

It is a commonly accepted axiom that more competing capital usually means lower returns. But an oft overlooked corollary is that more competing capital also means lower margins of safety, less negotiating leverage and weaker credit protections in a deal. Just as a flood of capital into US private credit has deteriorated both returns and risk mitigants, China has experienced the opposite environment in which regulatory restraints on shadow banking have made private credit more attractive (both in terms of returns and risk mitigants available).

From ShoreVest's experience executing private credit strategies in China for over two decades, we think proactive regulation fosters investment discipline among market participants and distinguishes astute investment/risk managers from asset-gatherers and untested new players. As Beijing's regulatory clampdown on China's shadow banks shut off unorganized alternative credit channels and untested new market entrants, this precipitated a historically unparalleled opportunity today for long-term institutional credit providers with local experience.

To avoid the excesses of shadow banking, executing private credit strategies like ShoreVest's involves obtaining clear regulatory approvals (from bodies such as the NDRC, etc.), structuring first-liens on borrower assets, and exercising creditor rights within a well-established legal framework (unlike the nascent and untested bankruptcy rules in India, another hot private credit market of late).

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[10] There have been some attempts, but generally these do not seem well coordinated. As noted in Footnote 1 above, one attempt by the US SEC was struck down by courts. NAIC is pushing forward new capital charges and oversight frameworks for insurance company holdings of private credit, particularly around privately rated securities, but any practical outcome remains to be seen.
[11] US private equity and private credit managers are now going after US retail investors' 401k retirement accounts, as discussed by Fitch.

When done through time-tested institutional managers, private credit is recognized approvingly by China's regulators as a risk-mitigating channel to de-lever and clean up bank balance sheets, as well as fuel growth with institutional credit alternatives to banks. Regulations limiting non-institutional shadow banking as noted above have opened a wide range of asset-based lending opportunities to more institutional funds like ShoreVest (in both traditional hard-asset industries like manufacturing, as well as industries in the new economy such as renewable energy, EVs, data centers, ecommerce, smart manufacturing, etc.). Furthermore, because in recent years China has forced its banks to recognize their non-performing loans (NPLs) at an unprecedented scale and speed, there is a significant opportunity to engage in debt restructurings of problematic loans on otherwise good assets.

China private credit has not experienced the same slow cash recovery or DPI issues seen in US private credit because China's non-sponsored asset-backed private credit opportunities have multiple pathways to exit not predicated on capital market conditions. These include repayment by a profitable borrower, liquidation of the collateral on which the debt has a first lien, sale of the debt to another investor, or taking ownership of the collateral in a loan-to-own transaction (each of which ShoreVest regularly does). This availability of multiple exit avenues is in stark contrast to US private credit, which is often tied inextricably to sponsored deals that depend on conducive public markets to realize cash.

We believe that for global allocators to private credit, it bears watching US shadow banking's growing threat to the US financial system as echoed by various industry participants. Concurrently, the allure of "US exceptionalism" is fading as investors are increasingly diversifying away their allocations to US equities (and even traditional safe havens like US treasuries) to more global opportunities. In this milieu, the appeal of contractual/collateral-based yield behooves investors to explore uncorrelated private credit opportunities in less-trafficked areas of the world like China, where private credit is a solution for the real economy and not a shadow banking threat to the financial system.