



SALT INSIGHT

By: **Bevan Graham**, Economist
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The Next Financial Stress May Not Come from Banks

When people think about financial crises, they usually think about banks. That instinct is borne from historical precedent. The global financial crisis of 2008 was rooted in excessive risk-taking within the banking system, and the policy response since then has focused heavily on making banks safer. Capital requirements were increased, lending rules tightened and regulators expanded their oversight of financial institutions.

But finance rarely stands still. When regulation makes one part of the system safer, activity often migrates elsewhere. Over the past decade, one of the most important shifts in global finance has been the rapid growth of private credit, lending carried out not by banks, but by investment funds, asset managers and insurance-backed lenders.

These lenders provide loans directly to companies, often those owned by private equity firms, bypassing traditional bank lending channels. The appeal has been straightforward. Borrowers gain access to capital more quickly and often with greater flexibility. Investors, meanwhile, receive higher yields in exchange for tying up their money for longer.

What began as a niche investment strategy has become a major pillar of corporate finance. The global private credit market is now estimated to be worth roughly US\$3 trillion and continues to expand rapidly.

Higher interest rates are now testing the model

For years, the model has worked remarkably well. But the environment that allowed private credit to flourish has now changed. Interest rates have risen sharply across the global economy as central banks responded to the inflation surge that followed the pandemic. Because many private credit loans carry floating interest rates, higher policy rates have translated directly into higher borrowing costs for companies.

Put simply, many firms are now paying far more to service their debt than they were just a few years ago.

That shift does not automatically signal trouble. Credit markets are cyclical, and some increase in financial stress is a normal part of the adjustment when borrowing costs rise. But the private credit sector is now entering the first genuine test of its resilience in a higher interest rate world.

Investors are beginning to watch for signs of strain. One signal is the growing use of “payment-in-kind” interest, where borrowers are allowed to defer interest payments and instead add the unpaid interest to the total loan balance. This can give companies breathing room during periods of financial pressure, but if used widely it may also mask underlying stress by delaying the recognition of losses.

Another sign is an increase in loan restructurings, where lenders extend loan maturities or adjust repayment terms to help borrowers manage higher debt costs. Such restructurings are common in private credit because lenders often work closely with borrowers and their owners. In moderation they are sensible. But a surge can indicate that companies are struggling to refinance under normal market conditions.

The real issue may be liquidity

Yet the most important risk surrounding private credit may not be borrower defaults at all. It may be liquidity. Private credit loans are inherently illiquid. Unlike publicly traded bonds or shares, they cannot easily be sold at short notice. Investors typically commit their capital for years at a time, accepting that their money will be tied up while loans are repaid.

That structure works well when investors are patient and markets are calm. Problems can arise when liquidity is offered in ways that the underlying assets cannot easily support.

In recent years, the private credit industry has expanded beyond its traditional base of large institutional investors. A growing number of funds now allow investors to withdraw money periodically, often through quarterly or annual redemption windows.

The tension is obvious. If too many investors seek to withdraw their capital at the same time, funds may struggle to raise cash without selling loans at distressed prices. In some cases, managers have responded by limiting withdrawals or “gating” redemptions until conditions stabilise.

This mismatch between the illiquid nature of the loans and the liquidity offered to investors is increasingly attracting the attention of regulators and financial markets.

Risk has migrated beyond the banking system

None of this means private credit is destined to trigger the next financial crisis. In fact, one argument in its favour is that the capital backing these loans tends to come from pension funds, insurers and other long-term investors who are less prone to sudden withdrawals than banks or short-term funding markets.

But the rapid growth of the sector means the stakes are becoming larger. Private credit has moved from a niche investment strategy to a central source of corporate financing. More companies rely on these markets for funding, and more global savings are invested in them.

That reflects a broader structural shift in the financial system. Over the past decade, credit creation has steadily migrated away from highly regulated banks and into what is often described as the private capital or “shadow banking” sector.

In some respects that may make the financial system safer. Losses are spread across a wider group of investors rather than concentrated inside banks. But it also means financial risks may now develop in places that are less transparent and less familiar to policymakers.

The last global financial crisis was rooted in problems inside the banking system. The next episode of financial stress, if it comes, may begin somewhere else entirely.

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