Working Paper No. 1117

Money Manager Capitalism and the Growth and Spread of Ponzi Finance, Private Market Version

by

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June 2026

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ISSN 1547-366

ABSTRACT

Private debt and equity markets have been a funding source for nascent and credit constrained businesses for several decades. Following the 2008 financial crisis, an economic environment characterized by low interest rates, cautious banks, and tighter financial regulations—together with money managers on the hunt for higher yielding assets—provided a fertile ground for the rapid growth of the private debt market. The defaults of two major borrowers in 2025, the growing concerns about the sustainability of AI businesses, and the ongoing wave of redemption requests, have all led to worries that private markets may be a source of financial instability. The current dominant view has brushed these worries aside by arguing that the private debt market is small, that private debt deals have a lot of equity buffer (leverage is low), that covenants attached to private debt allow for the quick correction of problems in a way that promotes the long-term success of businesses, and that low default rates reflect the inherent soundness of private markets. This paper challenges such a narrative. Private markets are major contributors to the growth and spread of financial fragility. The financial practices that preceded the Great Recession are once again becoming more common: loose underwriting and credit rating; the growing use of interest refinancing; the growing use of opaque asset-pricing methods; the rise of financial engineering that hides leverage, embeds leverage, and generates ephemeral liquidity; and a policy environment that promotes deregulation, desupervision, and deenforcement. Together with the growing interdependence between private debt markets, private equity markets, banks, and money managers, these dangerous financial practices generate a financial environment in which fraud can grow quickly and financial instability can materialize.

JEL CODES: E42; G01; G23; G24

KEYWORDS: Financial instability; money managers; Ponzi finance; private credit

INTRODUCTION

Since the 1960s, the United States has experienced several periods of financial instability that have grown in severity as money manager capitalism replaced managerial capitalism (Minsky 1983, 1990; Wolfson 1994; Aglietta 1998; Bordo et al 2001; Black 2005, Tymoigne and Wray 2014). The clout of money managers (institutional investors, hedge funds, mutual funds, etc.) grew during the "golden age" of capitalism, as tens of millions of households accumulated financial wealth and sought high-yielding portfolio positions. This greater involvement of money managers in the economy (i.e., financialization) has been a source of financial fragility, because the realization of targeted yields has relied heavily on portfolio strategies that involve asset-price inflation and leverage. The Great Recession was the latest illustration of this instability-prone form of capitalism: the financial system collapsed under the weight of high leverage and poor (and fraudulent) underwriting in the subprime mortgage market, prime mortgage market, and securitization markets attached to them.

In a fragile economy, it is not a black-swan event (or a once-in-a-century credit tsunami as Alan Greenspan put it) that generates financial instability, but rather the usual wing flaps of a butterfly over a weak financial structure (or, a house-of-cards event). Almost 20 years after the worst post-World War II financial crisis, there are signs that financial fragility has been growing for a few years. A low-interest-rate environment, market saturation, and regulatory barriers have all incentivized economic entities seeking financing and those willing to accommodate them to "innovate." This time, the channels of fragilization involve the participation of money managers in private markets (private debt and private equity).

The dominant view has brushed these worries aside by arguing that the private debt market is small, that private debt deals have a lot of equity buffer (leverage is low), that covenants attached to private debt deals allow for the quick correction of problems in a way that promotes the long-term success of businesses, and that low default rates reflect the inherent soundness of private markets. The paper challenges such a narrative. Private markets are major contributors to the growth and spread of financial fragility. The financial practices that preceded the Great Recession are once again becoming more common: loose underwriting and credit rating: the

growing use of interest refinancing; the growing use of opaque asset-pricing methods; the rise of financial engineering that hides leverage, embeds leverage, and generates ephemeral liquidity; and a policy environment that promotes deregulation, desupervision, and deenforcement. Together with the growing interdependence between private debt markets, private equity markets, banks and money managers, these dangerous financial practices generate a financial environment in which fraud can grow quickly and financial instability can materialize.

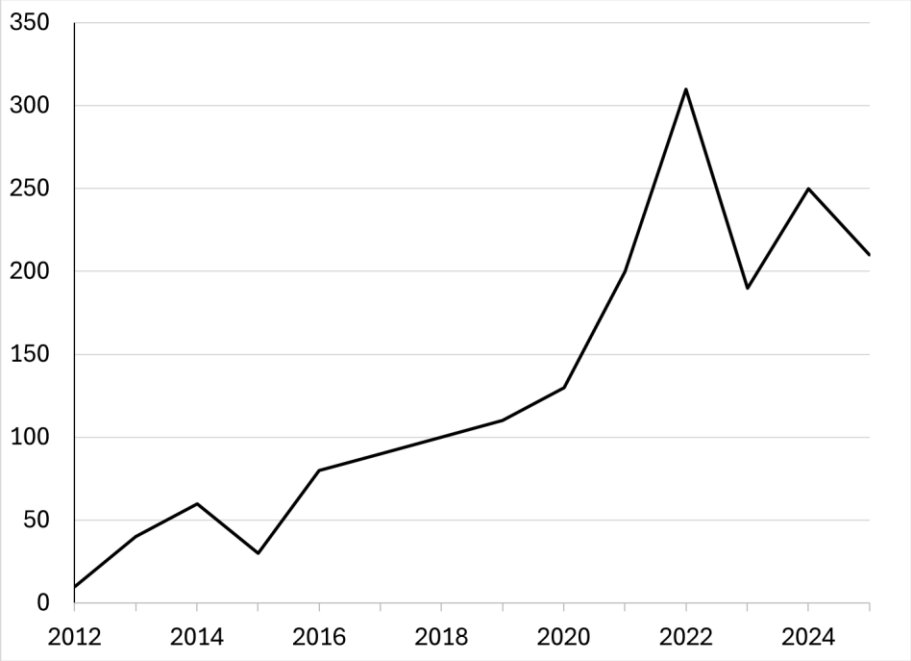
Financial stability is further eroded by the retailization of private markets. Private capital firms and the regulators they lobby have pushed for "democratizing" (White House 2025) private markets and liberating dormant savings in banks to "channel them into productive investments" (Rachel Lord, head of international at BlackRock, in Dunkley 2026). In reality, private capital firms want to tap the trillions of dollars held by retail money managers in order to grow private markets, gain market share in the financial sector, sustain and prop up asset prices in private markets, and earn billions of dollars of fees in the process. Such initiative is short-sighted unless very strict conditions are put in place to limit the growth of financial fragility. Retailization and the accommodation of higher liquidity preference that accompanies it, incentivize further erosion of already weak underwriting standards—the use of Ponzi finance grows in private markets—and make a greater share of financial market participants reliant on the ability to sell private-market positions at rising prices in order to meet their own financial commitments—Ponzi finance spreads to other parts of the economy.

After reviewing the state of private markets and the process of financial fragilization, the paper concludes on what ought to be done from a regulatory perspective. Federal and state regulatory bodies need to be proactive by regulating and supervising the financial practices of private market funds and who can participate in them. The decision to enter private markets requires a strong tolerance for high risk, careful analysis, and patience. While the lure of higher yields and credit/liquidity "enhancements" will attract retail portfolio managers, they are less able to judge and cope with the risks involved in opaque private markets.

THE BOOM OF PRIVATE MARKETS

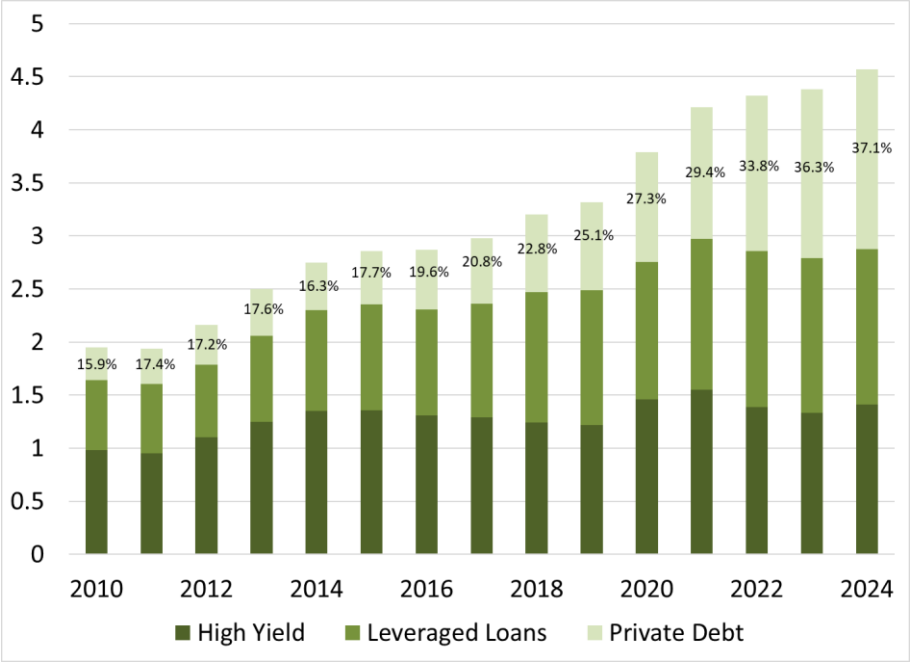
Following the 2008 financial crisis, the US entered an economic environment characterized by low interest rates, cautious banks and tighter financial regulations. As a consequence, businesses that were too small to issue securities faced a credit crunch while money managers were on the hunt for higher yielding assets. Private markets that have existed for decades have provided a solution to that double problem by offering to channel funds provided by money managers to credit-constrained businesses. As of 2025, private equity funds hold $24 trillion of assets globally (Edlich et al. 2026, 24) and private debt funds have $2.6 trillion of assets under management (Hinds et al. 2026, 5). Private markets are the most developed in the United States; in 2000 the number of private debt funds was negligible but rose rapidly during the housing boom and after 2008 (Matvos et al. 2026, 26). The inflow of funds into private debt funds accelerated further after 2020 before stabilizing around $200 to $250 billion since 2023 (Figure 1). While the private debt market is still relatively small compared to the private equity market, it has gained in importance within the financing of already highly-leveraged firms (aka leveraged financing), with over a third of leveraged debts under management held by private debt funds in 2024 (Figure 2). Similarly, private equity recorded a boost in fundraising in the early 2020s that plateaued by the mid-2020s (Edlich et al. 2026, 23). Information about private markets is limited because of limited regulatory requirements for transparency. Figure 3 presents a schematic version of the private debt market; a similar picture can be drawn for private equity. Private markets involve six participants: money managers, private market funds in the primary and secondary markets, sponsored financial vehicles, businesses, banks and credit rating agencies.

Figure 1. Flow of Assets Under Management by Private Debt Funds (Business Development Companies and Closed-End Funds Only), Billions of Dollars



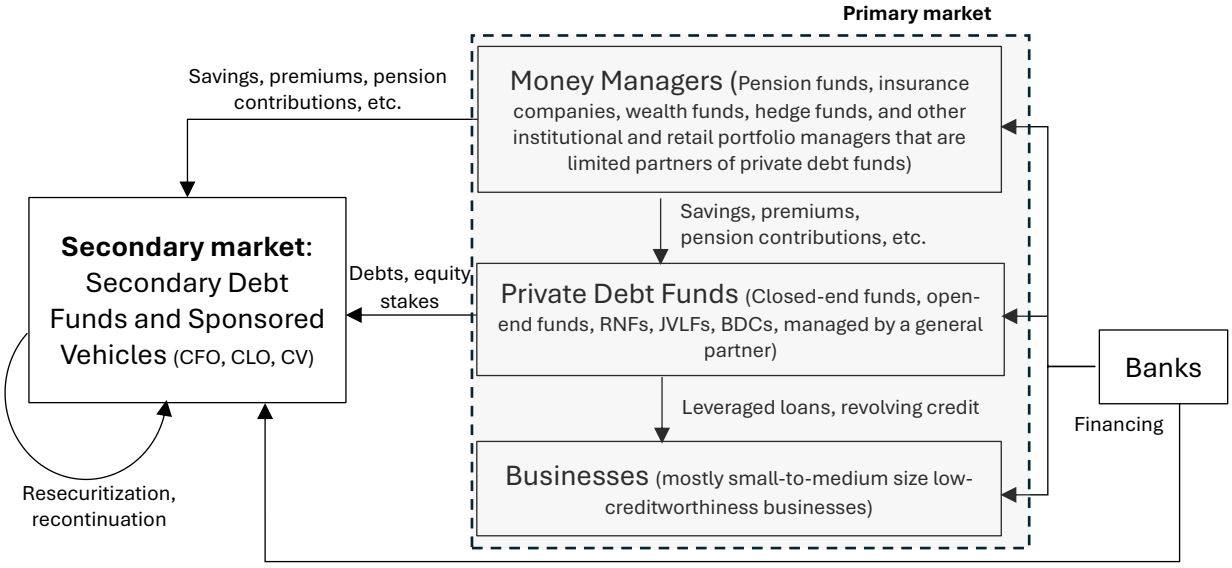
Source: Gara et al. (2026)

Figure 2. Size of the US Leveraged Finance Market ($ Trillions) and Share of Private Debt in Leveraged Finance



Source: Mink (2025)

Figure 3. Private Debt Market and Financial Interconnectedness



Money Managers

Money managers buy limited partner (LP) equity stakes/shares/interests in private market funds as well as securities linked to private markets. In their search for yield, pension funds and insurance companies have rapidly increased their stakes in private debt funds in the 2020s, with insurance companies taking the lead recently. They are currently holding over a third of the stakes in private debt funds (International Monetary Fund 2024, 68). Together with mutual funds, sovereign wealth funds, and individuals (retirees and others), they hold two thirds of the stakes in private debt funds (Berg and Lee 2026; Board of Governors of the Federal Reserve System 2023, 46). Banks hold about two percent of such stakes. Until recently, LPs were committed to keeping their shares in a fund until the private debts held had matured. In recent years, as a broader set of money managers entered private markets, the liquidity preference of LPs has increased. They have expressed a desire to be able to redeem their stakes in a private debt fund before the underlying private debts mature, and private debt funds have accommodated that desire.

Private Market Funds in the Primary Market

Private market funds are managed by a general partner (GP) from Blackstone, Apollo, BlueOwl, EQT, or another private capital firm. GPs fundraise from money managers in order to buy debts

and equity stakes issued by businesses. While private debt funds are focused mostly on credit-constrained companies, they have also competed with investment banks to finance large, well established corporations that are able to fundraise in public markets (International Monetary Fund 2024, 57).

The assets, liabilities, and shares of private market funds vary greatly (S&P Global 2025; Edlich 2026). In terms of shares, some periodically issue perpetual shares (the fund never promises to redeem them, i.e., the fund does not have a given timeframe after which it must liquidate its assets) and may redeem them periodically at the discretion of the GP. Other funds issue shares with a finite term that are not redeemable until the required holding period (at which point the fund is liquidated), while others issue and redeem their shares on demand (open-end funds). Some funds issue shares on public markets while others do not. About 80 percent of private debt funds are closed-end funds (International Monetary Fund 2024, 64). Such a fund issues a set number of shares and LPs cannot redeem them until the fund is liquidated, which means that the term to maturity of private debts (assets of the fund) closely matches the required holding period of closed-end fund shares (liabilities of the fund). Given that maturities are matched (around 5 to 10 years), the main risks are credit risk (businesses default) and refinancing risk at maturity. The latter materializes if businesses need to refinance, and the GP is willing to oblige but cannot find enough new LPs to offset the outflow of funds induced by LPs redeeming their stakes in the fund.

To accommodate the higher liquidity preference of LPs, hybrid closed-end funds, called Business Development Companies (BDCs) have grown in popularity. BDCs provide some redemption options (aka “redemption gates”), albeit limited given the underlying nature of the assets they hold. The dollar amount of private debts managed by BDCs has accelerated rapidly since 2020 to reach $400 billion by the end of 2024 (S&P Global 2025), or about 15 percent of outstanding private debts in 2023 (International Monetary Fund 2024, 62). Most of that growth came from the popularity of nontraded BDCs (particularly those that issue perpetual shares). They provide leveraged returns and do not list their shares on a public market—which can make their prices volatile—but rather value them according to the net asset value (NAV) of the fund (Hinds et al. 2026, 6, 10; Edlich 2026, 24; S&P Global 2025). Given that there is no active market for the

assets of BDCs and limited information, the valuation of the assets of a BDC (and so the valuation of its shares) involves considerable discretion on the part of GPs. Level 3 valuation is commonly used[1] together with the GP's own estimation of expected default probabilities, loss given default, and expected cash flow (S&P Global 2025).

A similar trend toward accommodating liquidity preference is ongoing in private equity funds and it is expected that the "five-year holding period is in the rearview mirror, and new, adaptive liquidity solutions will remain a permanent and significant part of private markets infrastructure going forward" (Edlich 2026, 16). Given the illiquid and long-term nature of the core assets of private market funds (debts and equity stakes issued by credit-constrained businesses), the willingness to accommodate the higher liquidity preference of LPs means that refinancing pressures on private markets is growing. Such pressures take the form of a maturity mismatch, or a need to roll over the fund's shares more frequently as the required holding period shortens, but businesses need long-term financing.

Finally, GPs have sponsored rated note feeders (RNFs) to accommodate money managers who want to participate in the primary private markets, but do not want to, or cannot, hold (unsecured) equity stakes directly in a private fund. An RNF is special purpose entity (SPE) that acquires LP stakes in private funds by issuing rated notes (rated AA to B) and unrated notes (equity stakes in the feeder). Insurance companies have been major buyers of rated notes because they can take positions in private market funds while economizing on capital; unlisted LP stakes carry a 49 percent capital charge while rated notes only carry, at most, a 15 percent capital charge (AlterDomus 2025; Bates 2024).

Secondary Market: Private Market Funds and Sponsored Financial Vehicles

The secondary private market used to be small and underdeveloped. An LP willing to sell his stakes in a private market fund could either find another person, or a private market fund that specializes in buying existing LP stakes, i.e., a secondary fund. This was not easy to do and

[1] Financial institutions may price their assets according to three methods. They may follow the market price if it exits (level 1) (which is not possible for many private-market instruments that are illiquid and/or unlisted), they may price their assets according to a proxy market (level 2), or they may make up their own valuation based on a proprietary methodology, aka mark-to-model or, pejoratively, mark-to-myth (level 3).

involved a deep discount. In order to accommodate the growing refinancing needs of primary private market funds induced by the higher liquidity preference of money managers, GPs have promoted the development of financial vehicles for the secondary market (SS&C 2025, 2, 4). These vehicles aim at "engineering liquidity" (Bose 2026) by acting as buyers for what their sponsors want to sell; the seller effectively creates its own buyer (The Carta Team 2026a; Macpherson et al. 2025). Such financial vehicles can be sponsored by LPs trying to sell their stakes in private-market funds. They can also be created at the request of GPs trying to sell the fund's assets to meet redemption requests and roll over shares, to prop-up or maintain the value of their assets by creating a transaction that gives some semblance of market validation, or to liquidate the fund. One of the barriers to the growth of the secondary market is that "secondaries [i.e., secondary transactions] are by nature more data-intensive and operationally complex than primary fund investments" (SS&C 2025, 3); however, artificial intelligence (AI) and blockchain technologies are expected to help reduce the cost of creating and managing secondary transactions.

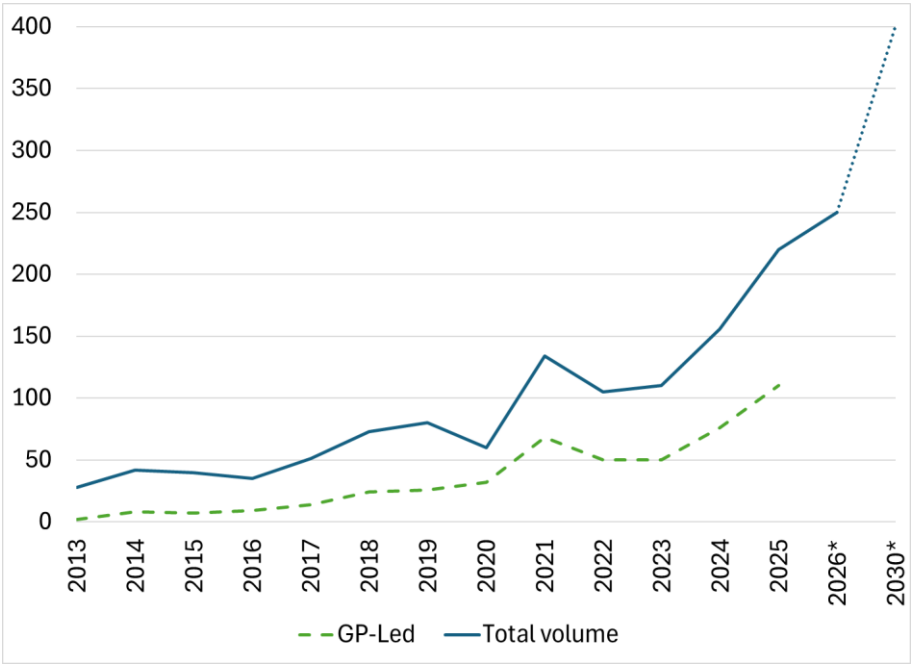
There are two broad types of sponsored financial vehicles used in the secondary private markets. The first type involves GP-led transactions, among them the continuation vehicle/fund (CV) is the most popular at the moment (William Blair's Private Capital Advisory Team 2026, 3). A CV buys the assets that one or several funds want to liquidate, either because no buyer was found or because the GP thinks it is worthwhile continuing the partnership with underlying businesses. In order to fund itself, a CV relies on rolling over its shares, injection of funds by the sponsoring GP and attracting new participants. When a GP creates a CV, LPs are asked if they want to roll over their shares or redeem them; recently, most LPs have preferred redemption and CV have typically a smaller number of LPs (Cummings and Clovis 2025). To entice money managers to buy stakes in a CV, the GP may use leverage by sponsoring a secondary fund that lend to the CV. In such case, debt may represent about half of the CV's funding structure (Heal et al. 2026). GPs may create a CV not only to buy assets from a primary funds, but also to buy from an existing CV; thereby further refinancing the principal of a previous primary transaction.

The second type of vehicles uses structured finance and has been sponsored by both LPs and GPs. They do something similar to RNFs but focus on the secondary market. Such vehicles are

highly flexible in terms of the assets they hold and their funding structure. SPEs that issue collateralized fund obligations (CFOs) (AAA to unrated) hold a broad variety of assets (Stone and Zissu 2004; Mitchell 2026) that may include "LP interests in private equity funds, venture capital funds, credit funds, hedge funds, real estate funds, energy funds, and infrastructure funds, […] interests in CLO equity and CLO equity funds, equity in ABS securitisations, direct co-investment in portfolio companies' broadly syndicated loan assets, and others" (Duerden, et al. 2025, 203). The CFO is the ABSCDO of private markets, a catch-all SPE security issued for securitization and resecuritization deals. Collateralized loan obligations (CLOs) linked to private markets (middle market CLOs) are backed by non-investment grade first-lien senior private debts (Hwang 2021; S&P Global 2025b). BDCs are major sponsors of SPEs that issue CLOs because they are a funding mechanism; BDCs sell their senior private debt to the SPE in exchange for funds that can be used to provide more private credit. SPEs are also used for arbitrage purpose, i.e., money managers sponsor a CLO or CFO SPE to profit from yield differential.

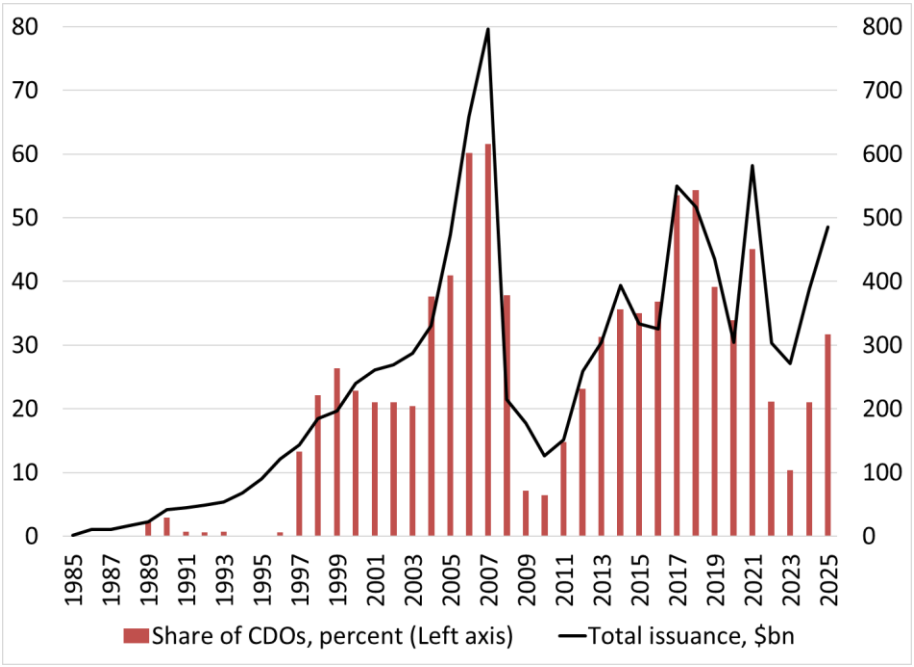
The success of a secondary vehicle depends on its ability to fundraise in order to use the proceeds to buy whatever the LPs or GPs want to sell. In order to attract funders, sponsored vehicles that are LP-led target a yield that is "200-400 bps higher than primary investments in similar funds" (Feigenbutz et al. 2024, 1). They do so by buying the shares of LPs at a discount that represents 15 percent of the NAV of the primary private debt fund, such discount is higher than in the private equity secondary market. The growth of the secondary debt market has been very rapid and is expected to continue over the next few years (Figure 4). The popularity of structured finance products has generated a rebirth of the CDO market since the mid-2010s, albeit with a slowdown in the early 2020s (Figure 5). In the CLO market, the share of issuances of middle-market CLOs has quadruple from 5 percent of total issuances in 2014 to 20 percent in 2024 (Lu et al. 2021; S&P 2025b). As a consequence of the growing popularity of the secondary market, "many LPs now make primary commitments with the expectation that secondaries will be available as a future portfolio management tool, which has fundamentally changed how investors think about commitment pacing" (Bose 2026, 6). As explained below, such change in portfolio strategies increases financial fragility given that short-term capital gains become a core component of expected yield calculations when deciding to enter private markets.

Figure 4. Global Secondary Market Deals, Billions of Dollars



Sources: William Blair's Private Capital Advisory Team (2026)
Note: 2026 and 2030 are estimates

Figure 5. Issuance of Asset-Backed Securities.



Source: Securities Industry and Financial Markets Association
Note: All tranches of CDOs denominated in USD, regardless of collateral source. Issuance include structured finance CDOs, trust preferred CDOs, collateralized bond obligations, collateralized loan obligations, and collateralized fund obligations

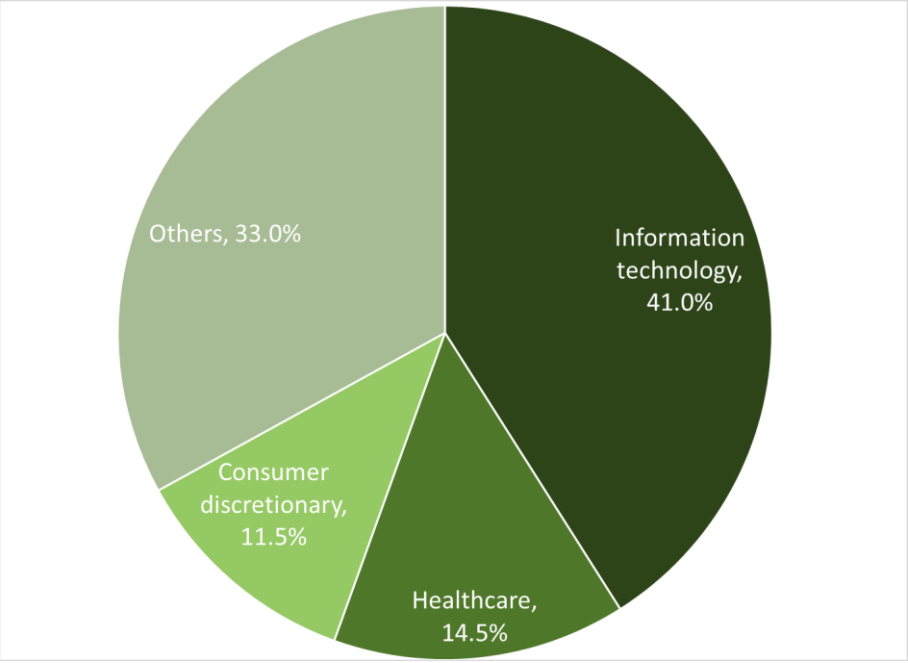
Businesses

Private debt consists of debts owed by businesses to private debt funds and, more broadly, business debts owed to non-bank financial institutions. Such businesses are usually not able to access traditional financing channels (bank credit and public offerings), because they are mostly of a small to medium size, already carry a high debt load, and are expected to generate negative to low earnings before taxes for a considerable period of time (International Monetary Fund 2024, 58). Private debt funds are willing to provide credit on more flexible terms than banks or high-yield bond markets. These terms may include delayed draw terms loans (DDTLs) that allow a business to use principal progressively over one to two years instead of all at once, or the ability to refinance interest service (i.e., interest paid in kind [PIK]) when the borrower wants (PIK toggle). Besides financing for business expansion, private debt funds also provide revolving lines of credit to businesses; such lines of credit are financed by the use of credit lines provided by banks. The rapid growth of the AI sector has been a key driver of the growth of private debts, with 41 percent of private debts issued in 2022 by businesses involved in information technology (i.e., software, IT infrastructure) (Figure 6), together with manufacturing, healthcare and professional services (William Blair's Private Capital Advisory Team 2026, 4). The private equity market has also accommodated the financial needs of AI businesses.

The availability of refinancing channels is sought by credit-constrained businesses because they generate a significantly positive operational income mostly toward the end of the term of their debts. For example, "for deals exited since 2019, 6 percent of the total ending EBITDA margin is generated in the final year, while 4 percent is derived in the penultimate holding year with roughly 1 percent accrued each holding year prior to that." (Edlich 2026, 18). In the meantime, the private debt owed by a business may grow, given that it is understood by both parties to a private debt deal that interest service may need to be refinanced. By the time its private debt matures, the operational profitability of a business is supposed to be established and it is either sold, goes public, can refinance the principal with traditional lenders, or is refinanced in the private market through a CV. The monetary proceeds from these financial channels are used to redeem the stakes of the partners in the fund and repay other creditors.

Private debts include more covenants (e.g., maximum debt-to-income ratio) to allow a GP to intervene quickly to restructure private debts. In principle, this allows for a swift resolution of problems in a way that maximizes the operational viability of businesses, but, as explained below, GPs have loosened covenants or found means to bypass them. About half of outstanding private debts are secured, although the size of the collateral is small for businesses such as software or healthcare services (International Monetary Fund 2024, 60). About 70 percent of private debts involves variable rates (Maddy-Weitzman 2025) with rates that are higher than on high-yield bonds (International Monetary Fund 2024, 58), which signals a very high credit risk. The term to maturity averages five years (Cai and Haque 2024), which means that businesses expect that principal refinancing will be available until more traditional external financing sources become accessible. Default rate is currently lower than on high-yield bonds, and mostly concentrated on private debts issued between 2019 and 2022 (Gara et al. 2026). When default occurs, the recovery rate 30-day post default is low—about 33 percent on average—compared to high-yield bonds and syndicated business debts, because of the lower level of collateral demands compared to loans of similar risk level (Cai and Haque 2024). Fitch (2024) notes that "recoveries for first-lien term loans in the PMR [privately monitored ratings] portfolio during bankruptcies and liquidations have been notably weak. Fitch estimates lender recoveries were below 25% in eight out of 11 cases. This contrasts with public market recoveries, where most first lien instruments recover over 75%." (Margolis and Chin 2024) Debts issued by technology companies had an especially low recovery rate (Fitch 2024). The low recovery rate on private debts has pushed down the overall recovery rate in the middle market (Gunter et al. 2025).

Figure 6. Main Sectors in Which Private Debt Funds Provide Credit



Source: International Monetary Fund (2024).
Note: Others include businesses involved in industrial production, natural resources exploitation, financial services, media and telecom, among others.

Banks, Credit Agencies, and Horizontal and Vertical Integrations

Given that banks are not involved directly, credit rating agencies (CRAs) are essential to the underwriting of securities and the credit-risk assessment of private market funds and businesses. Credit-risk opinions provided by CRAs matter for private markets in two ways. First, if private debt funds can obtain a favorable credit-risk opinion, this encourages a broader range of money managers to participate in the fundraising operation of a fund. Second, money managers who already hold financial instruments linked to private markets seek the highest rating in order to hold as little capital against them as possible.

The share of financial assets held by banks has fallen in favor of non-bank financial institutions (NBFIs), (e.g., mutual funds, pension funds, hedge funds, and private equity and credit funds) (International Monetary Fund 2025, 10). Banks have responded to these competitive pressures by partnering with NBFIs, via the provision of credit to them, and by competing against them by opening their own private debt affiliate (International Monetary Fund 2025). Goldman Sachs, for

example, has provided private credit since 1996 and owns one of the top-10 largest private credit funds, with $130 billion worth of assets under management. Goldman also opened a Private Credit Collective Investment Trust (CIT) in 2025 to respond to the opening of private markets to retail pensioners (Goldman Sachs 2025a; 2025b). Private debt CITs are expected to become a key element of the retailization of private markets by "unlocking broader access to sophisticated strategies that were once out of reach for everyday savers" stated the CEO of Great Gray Trust Co., a CIT specialist that partners with Goldman (Bodamer 2025).

This growing involvement of banks in the private market points toward the growing interdependencies within private markets. While Figure 3 presents the different participants in private debt markets as independent entities, the private debt market is becoming more horizontally integrated, as banks get involved directly in private lending, and is already vertically integrated via private equity firms playing a critical role in private debt markets. Private capital companies have acquired, or partnered with, life insurance companies and retirement annuities funds, to allocate the funds received from pension contributions and insurance premiums toward private debts (Table 1). Insurance companies have affiliates that manage the securitization of private debts into CLOs and create BDCs. They partner with BDCs to put equity in the creation of a joint venture loan fund (JVLF) that buys private debts; this increases leverage and yield without violating leverage limits on BDCs (Johnson, Carelus and Lee 2025b; Carlino et al. 2025; Regulatory Compliance Watch 2025). Downstream, about 70 percent of private credit in Europe and the USA is sponsored by private equity firms that have already increased leverage in the balance sheet of credit-constrained businesses, in order to boost the return on equity (International Monetary Fund 2024, 59). All of this is very similar to the vertical integration of the mortgage industry in the early 2000s; financial companies owned mortgage brokers that fed mortgages to their investment banking operations in order to sustain the supply of securitization products sold to pension funds and other asset managers (e.g., Aurora was owned by Lehman Brothers).

Table 1. Number private-equity owned insurance companies

2018	2019	2020	2021	2022	2023	2024	2025
90	90	117	132	132	137	137	139

Source: Johnson, Wong and Lee (2025a)
Note: 2025 data goes until June.

THE ROAD TO INSTABILITY: THE GROWTH AND SPREAD OF PONZI FINANCE

The growth of private markets relies on a continuously growing supply of funds by money managers and banks, and a continuously growing demand for loans by businesses. In order to sustain that growth, managers of private market funds have been involved in financial practices that are highly reminiscent of the pre-2008 financial crisis. These practices are increasing financial fragility by making a growing proportion of the economy susceptible to the success or failure of financial deals that use Ponzi finance.

Ponzi finance involves the expectation by creditors that principal and interest services (more broadly the capital and income dues of any financial commitments) will need to be refinanced until, either the operational income of debtors rises enough (income-based Ponzi finance), or the assets of debtors are liquidated at a high enough price to make the financial deal profitable (asset-based Ponzi finance).[2] Ponzi finance relies on the smooth functioning of the financial sector because growing refinancing and rising asset prices are required to sustain it. Ponzi finance also increases the interdependence of asset prices and debts because rising asset prices are needed to sustain growing refinancing needs and growing debts sustain the growth of asset prices. In short, Ponzi finance promotes a debt-inflation process that, if it is allowed to grow and spread, creates favorable conditions for the occurrence of a debt-deflation process. In the context of the private market, this interdependence on the upside involves the growing use of leverage to sustain the demand for private market financial instruments (and so sustain their prices) and rising prices of such financial instruments to sustain rising leverage.

While income-based Ponzi finance increases financial fragility, financial fragility in the economy eventually recedes once operational income is high enough, and as long as such a form of Ponzi

[2] "The overall fragility-robustness of the financial structure, upon which the cyclical stability of the economy depends, emerges out of loans made by bankers. […] An emphasis by bankers on the collateral value and the expected values of assets is conducive to the emergence of a fragile financial structure. […] One measure of the riskiness of financial instruments is the expected source of the funds that are needed to fulfill financial contracts." (Minsky 1986 (2008): 261, 265 n. 13) This does not necessarily mean that the operational income of a debtor is low, rather it means that operational income (wage, profit from running a business, among other income tied to productive activities) is deemphasized in the process of determining ability to service debts. For example, over a third of prime mortgage origination had low documentation in 2006, compared to 15 percent in 2001 (Zelman 2007).

finance does not spread in the economy.[3] However, as underwriting weakens and the engineering of liquidity rises, not only does the use of income-based Ponzi finance spread, but so does the use of asset-based Ponzi finance. In the latter case, participants of the primary and secondary markets use speculative leveraged positions on (questionable or solid) assets, that are then sold in order to realize quick capital gains used to cover the debt commitments of the speculator. In the case of private markets, retailization generates these trends because it opens private markets to trillions of dollars held by "less-sophisticated" individuals looking for higher yields. This will inflate private markets and put pressures on private capital funds to maintain the inflationary process through further engineering of liquidity and decline in underwriting.

Priming the Demand for Private Market Products: Regulatory Loosening and Credit Rating Shopping

Money managers hold tens of trillions of dollars of assets but accessing such financial boon to expand private markets is not straightforward. Pension funds, insurance companies and other money managers may have to follow bylaws or regulations that emphasize prudent portfolio choices, and that disincentivize taking positions in private markets. This limits the types of financial instrument they can buy to investment-grade securities, well-established economic activities, secured debts and transparent markets. Private markets are lacking on all these fronts. The clearance of this hurdle has necessitated regulatory guidance and the aggressive use of credit ratings.

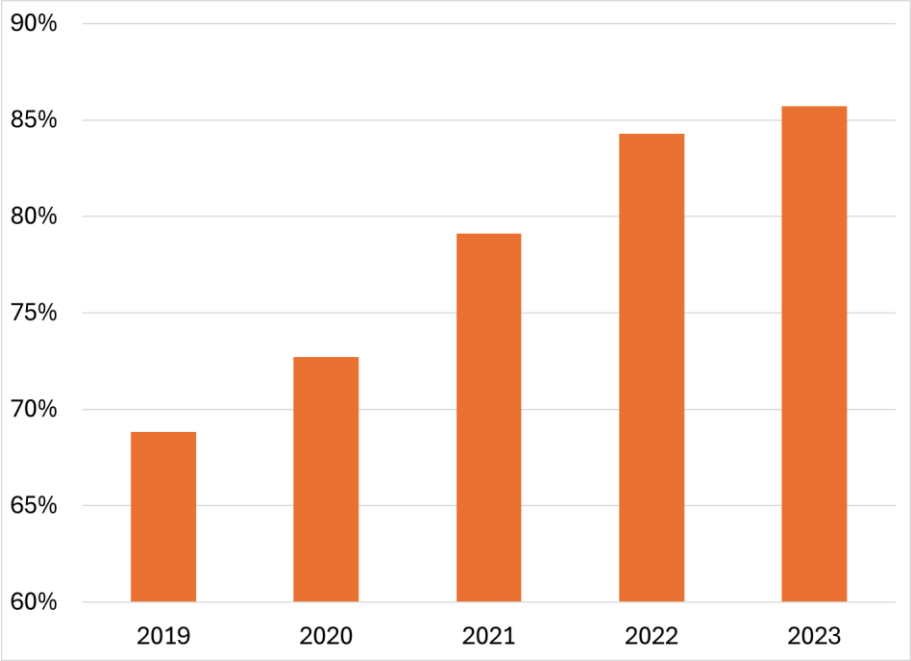
In terms of regulatory guidance, Blackstone, Apollo and KKR have long lobbied Congress to gain access to participant-directed individual account retirement plans (401(k), 403(b), IRA, etc.) (Alper 2026). While the Trump Administration provided regulatory guidance in 2020 that encouraged the inclusion of private equity, the Labor Department under the Biden Administration concluded that private equity was not prudent for retail pension plans (US Department of Labor 2021). However, the Department of Labor under the second Trump Administration has encouraged fiduciaries of retail pension funds to consider private market

[3] For that reason, Minsky characterized this form of Ponzi finance as "respectable" (Minsky 1991: 16), and noted that trying to be too strict on its use may kill entrepreneurial spirit. Market-driven innovations and economic growth may require some growth of financial fragility for a time and "lessening the possibility of disaster might very well take part of the spark of creativity out of the capitalist system." (Minsky 1986: 328)

financial instruments, as well as other “alternative assets” such as cryptoassets (White House 2025). Under the leadership of Chairman Atkins, the Securities and Exchange Commission (SEC) has removed private-asset allocation limits on closed-end funds offered as portfolio choice to retail clients. The retailization of private markets is expected to shift the retail portfolio allocation in private markets from less than 5 percent “toward double-digit exposure across all advisor channels by 2030” (Edlich 2026, 27). This threshold has already been reached in the private debt market, where the share of holdings by retail money managers has gone from almost negligible in 2020 to 15.5 percent in 2025 (Hinds et al. 2026, 3). A similar pension fund reform is happening in the United Kingdom with explicit targets for retailization by 2030.

In addition to the push for retailization, there has been a growing reliance on private letter ratings (PLRs) to assess the riskiness of private market deals (National Association of Insurance Commissioners 2024). Since the Financial Crisis Inquiry Commission (2011) unveiled that the three largest credit rating agencies (S&P, Moody’s, Fitch) drastically loosened their rating standards to compete for market shares, the 2010 Dodd Frank Act has put in place regulations aimed at limiting credit rating shopping. Such shopping, however, has not disappeared, quite the contrary. US insurance companies have sought better credit ratings by moving away from the rating provided by the Securities Valuation Office (SVO) of the National Association of Insurance Commissioners (NAIC) toward PLRs provided by CRAs. Insurance companies have relied especially on smaller CRAs such as Egan-Jones (to rate private debts) and DBRS and KBRA (to rate structured finance products). The request for PLRs has increased with the growth the private debt market and the number of PLRs has almost tripled in six years from 2850 in 2019 to 8150 in 2023. The share of PLRs done by small CRAs has grown from 70 to 85 percent (Figure 7); among the top three, Fitch is the leading provider of PLRs. Egan Jones has been especially aggressive in the production of PLRs with around 250 ratings per analyst in 2025, compared to 50 or less for most of the other CRAs (Palma 2025).

Figure 7. Share of PLR Provided by Small CRA



Source: Johnson, Wong and Phelps (2024)

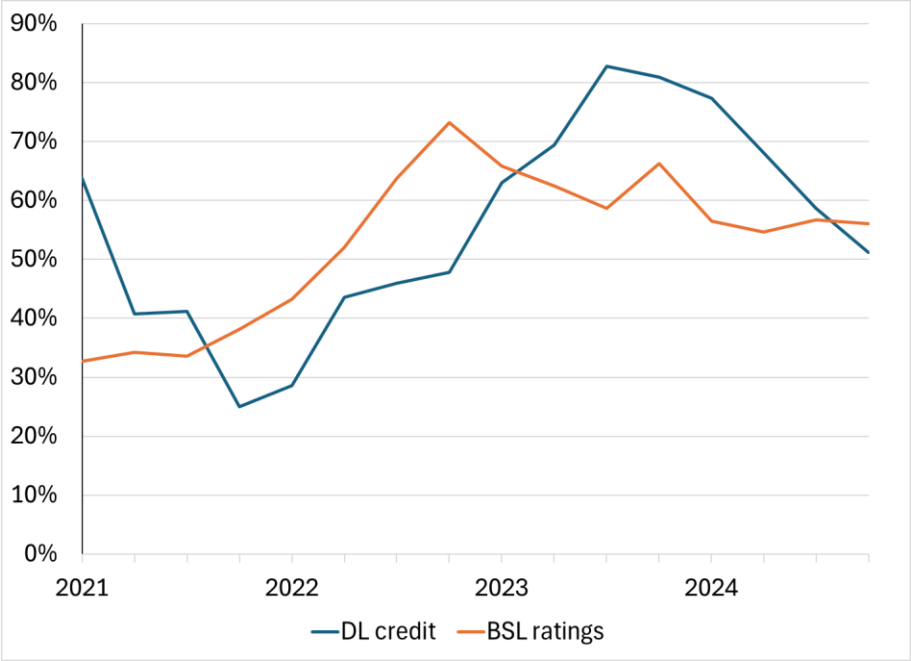
As a consequence of this credit rating shopping, evidence of rating inflation is emerging. By switching from a SVO rating to a PLR, insurance companies obtained a better rating in 97 percent of the cases and "on average, designations were 2.74 notches higher, with designations 3.01 notches higher at small [CRAs] and 1.9 notches higher at large [CRAs]" (Johnson, Wong and Phelps 2024, 4). This has allowed insurance companies to avoid $30 to $35 billion of capital charges (Harris and Healy 2025), while also broadening access to private-market–related portfolio positions to meet yield targets.

The reliability of PLRs for the private debt market has been questioned by NAIC because of the lack of transparency in rating methods, the difficulty in assessing credit quality given the opacity of the primary and second private markets, and the large discrepancy with SVO rating (Johnson, Wong, and Phelps 2024). While the NAIC had to withdraw its critical report following pressures by the small CRAs, the Bank for International Settlements has expressed similar concerns (Aquilina et al. 2025), as did the Office of Credit Ratings of the SEC in its various issues of the *Staff Report on Nationally Recognized Statistical Rating Organizations*. The Office of Credit

Ratings of the SEC (2025, 7) also notes that "the statutory limitation on the SEC's authority to regulate the substance of credit ratings […] may result in 'blind reliance' on credit ratings without any process to assess whether such ratings are reasonable." The SVO has been pushing against the trend of credit rating inflation by requiring a comprehensive rationale from insurance companies for preferring PLR over a SVO designation (Kessler et al. 2025).

The rapid uptick in the share of rating downgrades in the early to mid-2020s is a cautionary reminder of the importance of a proper rating methodology, together with a proper regulatory and supervisory environment to account for potential uncertainty about credit ratings (Figure 8). Too large downgrades would lead some money managers to sell their positions in private-market financial instruments, which would generate a major decline in their prices that would be compounded by margin calls and the need to meet capital requirements. Money managers may have to make positions in private markets by selling positions in public markets.

Figure 8. Share of Downgrades in Rating Changes on Direct Lending (DL) and Broadly Syndicated Loans (BSL)



Source: International Monetary Fund (2025a)

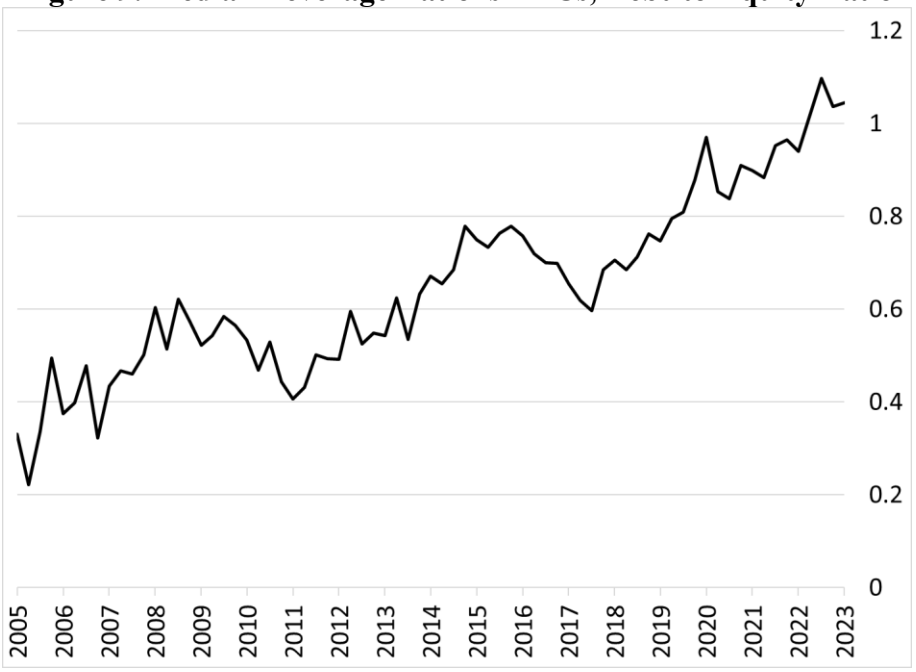
Pumping Up the Demand for Private Market Products: Engineering Liquidity, Embedding Leverage, and Marking to Myth

Given that private funds want to attract a broader range of money managers, they must accommodate a broader set of preferences regarding credit risk, timing of yield distribution, and liquidity. This needs to be done on the basis of a financial industry grounded in taking long-term illiquid positions in high-credit-risk businesses with limited collateral and a delayed expected ability to generate operational earnings. The growth of secondaries has been crucial to manage the conflict between the liquidity preference of money managers and the nature of private market business deals, and the burden put on secondaries to sustain market liquidity is expected to grow with retailization: "the ability to provide liquidity to LPs […] continues to resonate with sponsors [of continuation vehicles] […] There is also a continual need for LP liquidity in private markets, particularly as more retail capital enters [due to] the secular 'democratization of alternatives'." (William Blair's Private Capital Advisory Team 2026 3, 9). However, the heavy reliance on secondaries to maintain the liquidity of private markets creates an environment favorable to the growth of financial fragility, not only because there is a potential conflict of interest given that secondaries are created at the initiative of the sellers, but also because the maintenance of liquidity involves continuously creating new sponsored vehicles that buy from other sponsored vehicles.

Regarding CVs, "LPs express concern that continuation vehicles may be used to hide underperforming assets" (Edlich et al. 2026, 16) and the founder of a secondaries investment firm noted that it is not easy to decipher "lemons" from sound CVs (Heal and Gara 2025). Structured finance vehicles are a source of growing financial fragility by giving a false sense of safety and liquidity. They give a false sense of safety because the rating attached to them is not linked to the credit risk of the underlying assets. They give a false sense of liquidity because they require further financial engineering to maintain liquidity. Finally, while CFOs increase yield for a given credit rating, such a yield enhancement comes from increasing embedded leverage in private markets because the success of CFOs depends on the success of CLOs, that itself depends on the success on non-investment grade business debts. Each layer of leverage increases yields as well as the sensitivity of a SPE security to losses on private debts (Carlino et al. 2025). The

embedded leverage induced by, joint venture loan funds, securitization and resecuritization has been compounded by the rapid rise of leverage among BDCs. Following a loosening of their maximum allowed leverage in 2013 and 2018 (S&P Global 2025a), the median leverage of BDCs has almost doubled (Figure 9). Average leverage in private debt funds was 1.9 in 2025, reaching as far as 3.6 or higher for the top 5 percent most leveraged private debt funds (Berg and Lee 2026, 4).

Figure 9. Median Leverage Ratio is BDCs, Debt-to-Equity Ratio

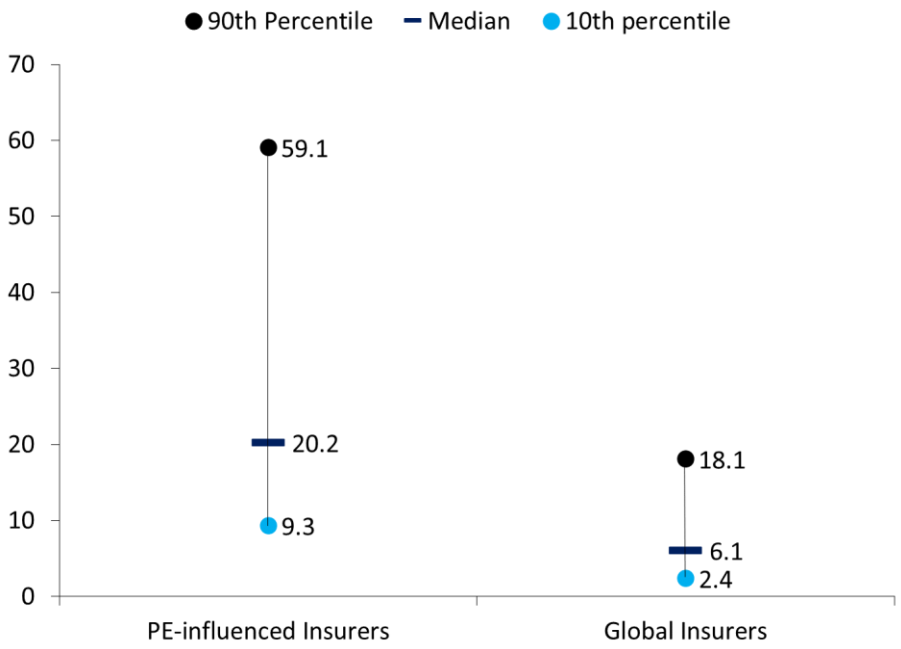


Source: International Monetary Fund (2025a)

Besides the rise of direct and embedded leverage, the growing reliance on level 3 valuation has increased financial fragility by linking the continuous availability of refinancing to untested asset-price valuations. The increasing preference of financial institutions for level 3 valuation is directly related to the rise of private markets. Insurance companies tied to private equity funds have a much larger share of level 3 assets; 20 percent is the median share compared to 6 percent for other global insurers (Figure 10). Similarly, 42 percent of the assets of pension funds were valued that way in 2022 compared to 31 percent in 2016 (Figure 11), and the growing share of private debts was responsible for half of that increase (International Monetary Fund 2024, 69). The use of level 3 valuation increases the dependence on a bonanza to make a private market deal viable, and increases the uncertainty about the solvency of private-market participants.

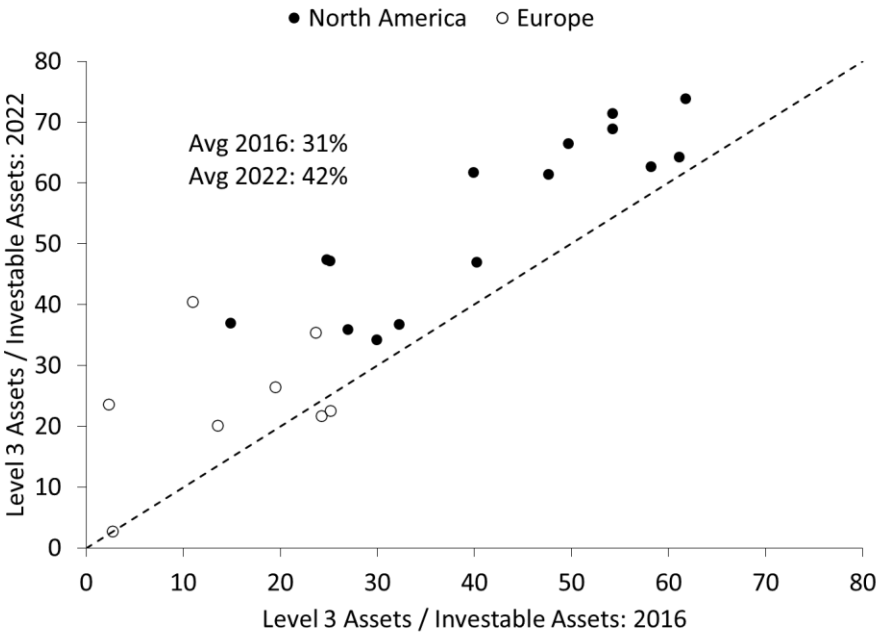
Level 3 valuation is also ripe for abuses with financial firms using different pricing models to value financial assets for their customers and internally (Counterparty Risk Management Policy Group III 2008, 88). Arbitrariness in valuation creates potential conflicts of interest and market manipulations, such as a GP recording inflated asset value in order to attract lenders and sustain the refinancing process (Financial Conduct Authority 2025). In times of stress, the value of private fund assets is likely to fall dramatically, with cascading effects on the valuation of all private-market financial instruments and their ratings as "reported values of the underlying investments may not be accurate indicators of market values, and weak realizations can depress ultimate cash flow for LP stakes" (Mitchell et al 2026). The use of such a pricing method grew very rapidly at the onset of the Great Recession, because financial institutions did not want to recognize losses that were mounting by late 2006 based on market prices (International Monetary Fund 2008, 114).

Figure 10. Share of Private Assets Valued with Level 3 Valuation Among Insurance Companies



Source: International Monetary Fund (2024)
Note: Based on a sample of 26 of the largest pension funds managing a total of $7 trillion in assets or about 17.5 percent of global pension fund assets

Figure 11. Share of Assets Valued with Level 3 Valuation Among Pension Funds



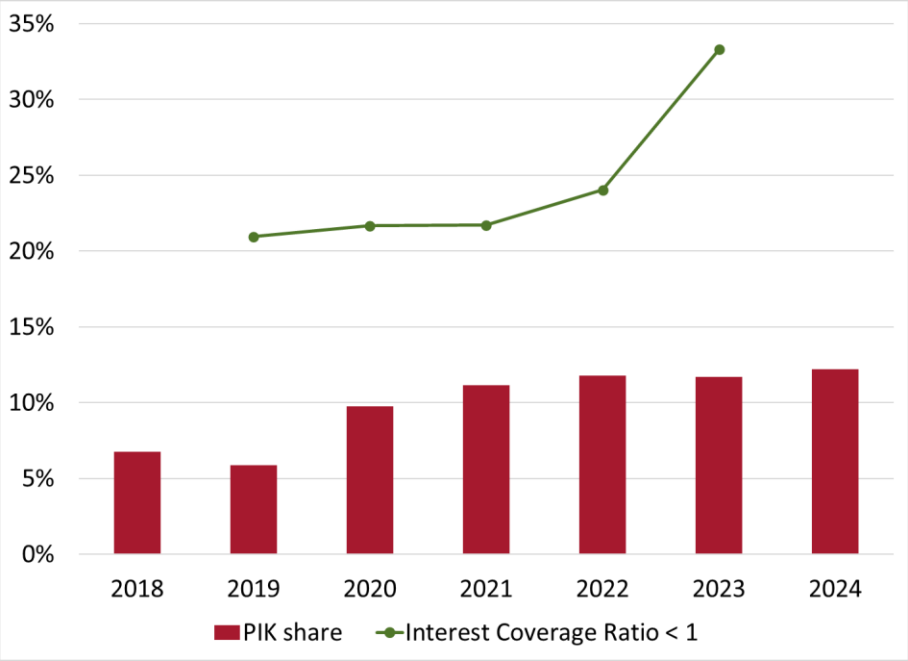
Source: International Monetary Fund (2024)
Note: Based on a sample of 26 of the largest pension funds managing a total of $7 trillion in assets or about 17.5 percent of global pension fund assets

On the Supply Side: Incentives to Loosen Underwriting and Hide Problems

The ability of private borrowers to service interest is declining; in 2023, a third of businesses has a negative interest coverage ratio and the share of interest PIK in total interest service rose (Figure 12). If interest rates continue to rise, interest service will continue to increase given that most private debts carry a floating rate. This will lead to further increases in interest PIK, and so increase the size of the operational income necessary to make a business viable based on income-based Ponzi finance. At the same time, lenders may refuse to refinance interest if the value of the underlying assets does not rise fast enough or certain triggers are reached in the debt contracts, leading to a credit crunch and the forced liquidation of positions. Taken together, asset-price direction comes to take a bigger role in the viability of private debt deals. Retailization will help expand the pool of potential buyers and sustain asset prices, but this can only go on for a time until forced liquidations rise and spread to public markets.

The data about the share of interest PIK in funds' interest income underestimate the presence of interest refinancing, a key feature of Ponzi finance, because of lending practices that hide such refinancing. Currently, there is a growing demand by businesses for private debts that contain interest PIK features (Mincemoyer and Laor 2025). Private debt funds have an incentive to accommodate such demand because PIK debts generate a higher yield, and all interest service can be recorded as income under accrual accounting rules, even if not all of it is serviced. In 2006, deferred interest represented up to 67 percent of the pre-tax profit of some mortgage lenders (Tymoigne and Wray 2014). However, there is usually a limit on the dollar amount of PIK debt a fund can hold (Mincemoyer and Laor 2025), i.e. the ability of a fund to refinance interest service is limited by covenants. In addition, CRAs may record a default when interest PIK occurs, which negatively impacts ratings (Margolis and Chin 2025). To bypass these problems, private debt funds have innovated. One such innovation is the inclusion of "synthetic PIK" features in private debts; this allows a business to request a DDTL from a different financial institution (e.g., another private debt fund); this line of credit is used exclusively to service the interest dues. This is equivalent to opening a credit card to service interest payment on an existing card, "essentially PIK-ing interest payments (the interest is paid in cash, but by [sic] the borrower is increasing its debt/term loans). Synthetic PIK is not reported as PIK and may not be fully represented in loan valuations with respect to underlying credit issues" (Mincemoyer and Laor 2025).

Figure 12. Share of Interest PIK in BDCs' Interest Income and Share of Businesses With Interest Coverage Rate Less Than One



Source: International Monetary Fund (2024, 2025a)
Note: The ICR data is for public firms with size and leverage characteristics similar to private debt fund.

One should not be surprised to observe a greater use of Ponzi financing in private markets, given that their specialty is to finance nascent or high-risk businesses with great potential operational earnings but growing refinancing needs for the foreseeable future. Income-based Ponzi finance is a feature of the primary private market. On its own it is not a problem as long as underwriting is thorough, creditors have enough protections against potential losses, these protections are strong and the use of Ponzi finance is limited to a few sectors; operational income will eventually be high enough to cover the debt service. There are, however, market forces that incentivize private market funds to increase the use of income- and asset-based Ponzi finance.

First, the growth of the private debt market requires finding new potential borrowers. As the market saturates for a given set of credit standards, it is necessary to loosen them or to move beyond credit-constrained businesses. In the latter case, banks will have an incentive to lower their credit standards, weaken covenants and to include PIK and other innovations in their credit practices in order to maintain market share; this is already occurring for private credit provided

to large corporations (International Monetary Fund 2024, 71) as well as private credit provided to small and medium enterprises:

> Competition between banks and direct lenders has fostered a trend toward loan terms favorable for borrowers, including the increased prevalence of covenant-lite structures, PIK toggles, and synthetic PIK facilities. (S&P Global 2026)

As Mr. Blankfein (2009), former CEO of Goldman Sachs, noted in the case of the pre-2008 financial dynamics:

> It should be clear that self-regulation has its limits. We rationalised and justified the downward pricing of risk on the grounds that it was different. We did so because our self-interest in preserving and expending our market share, as competitors, sometimes blinds us—especially when exuberance is at its peak.

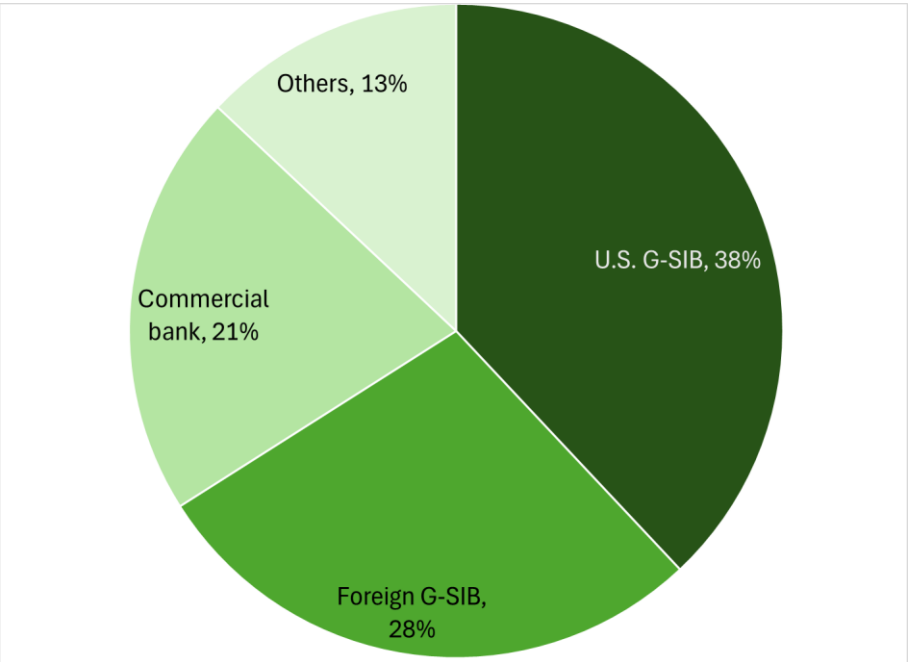
Second, the retailization of private markets will lead to a large inflow of funds looking for yield. This may further push credit standards down as private market funds are pressured to use their "dry powder" (i.e., liquid assets) to buy riskier assets, in order to generate the rate of return expected by retailed portfolio managers. Such riskier assets may include synthetic PIK debts (thereby sustaining the refinancing process), loans to companies that were previously deemed too risky (thereby growing the use of Ponzi finance in private markets), and structured finance products (thereby sustaining refinancing operations and liquidity). Retailization spreads the use of Ponzi finance by making market participants focus their attention on asset-price dynamics instead of the operational income-generating capacity of underlying businesses. As noted above, this is already happening with LPs taking positions in the primary market, with the expectation to be able to liquidate them quickly at low cost ahead of schedule (Bose 2026, 6) because "secondaries are now recognized as a strategic portfolio management mechanism for both private fund managers and investors" (SS&C 2025, 2). Finally, GPs are also increasingly relying on the ability to sell and refinance their positions, which lowers their incentive to carefully judge the creditworthiness of the underlying businesses.

Third, “the lender-sponsor partnership involves a quid-pro-quo approach in times of stress, where both parties provide concessions to stabilize the issuer” (Margolis and Chin 2025). The availability of flexibility of private debt contracts is touted as a benefit over bank credit. However, such flexibility compounds the problems if too much discretion is used to loosen covenants and evaluate assets, with the hope of reselling to someone else by hiding problems through overvaluation, synthetic PIK, credit rating inflation, and other measures. Too much flexibility may give an incentive to avoid fixing problems.

Exposure of Banks

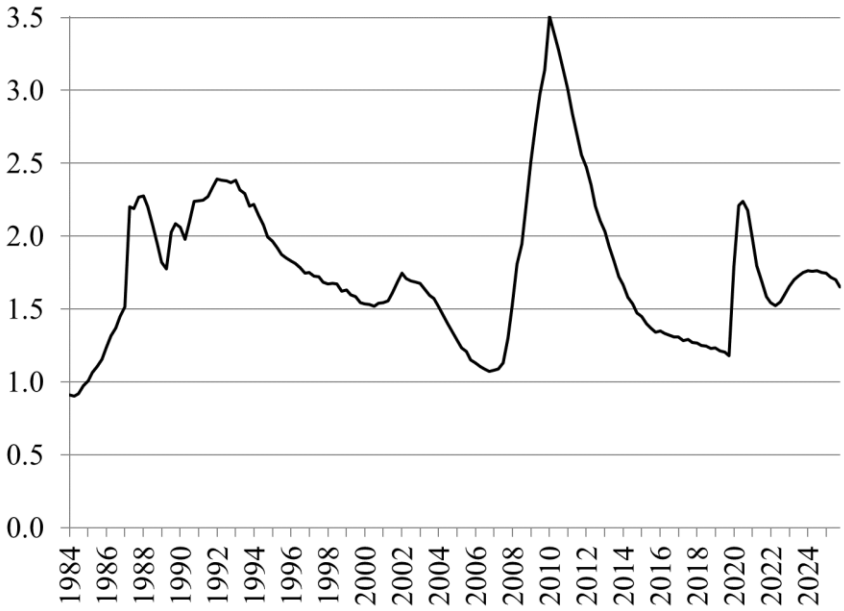
In addition to being direct participants in private market by sponsoring their own private market funds, banks are exposed to private market because all participants in private markets are dependent on the provision of credit by banks. Hedge funds rely on banks for 50 percent of their funding (International Monetary Fund 2025a, 9). Private debt funds rely on bank revolving credit to manage their liquidity needs and to provide revolving credit to businesses. In 2024, systematically important banks provided 64 percent of all credit provided to private debt funds, most of the rest was provided by other commercial banks (Figure 13). In the secondary credit market, CFO issuers rely on the access to revolving bank credit to manage their operational expenses and debt services (Duerden 2025, 201). Together, banks had slightly more than $500 billion of credit exposure to private debt markets in 2023, or about 4 percent of the total bank loans outstanding (Moody’s Investors Service 2024), and the “total bank exposure likely exceeds 25 percent of total assets under management in private debt funds” (International Monetary Fund 2025a, 25). As long as the primary and secondary private debt markets remain relatively small, the losses of banks will be contained in case of problems. However, while the direct exposure of banks is currently low, indirect exposures through the contagion of public markets and other debtors is another channel of loss transmission. In addition, loan-loss reserves are once again trending downward, even though financial fragility in private markets is rising and banks’ exposure to potential losses is growing (Figure 14). The decline in loan-loss reserves has sustained the profitability of banks (International Monetary Fund 2025a, 9).

Figure 13. Credit Providers to Private Debt Funds in 2024



Source: Berg and Lee (2026)

Figure 14. Loan-Loss Reserve Relative to Loan and Leases.



Source: Federal Deposit Insurance Corporation

Regulatory Environment: Free Market Ideology

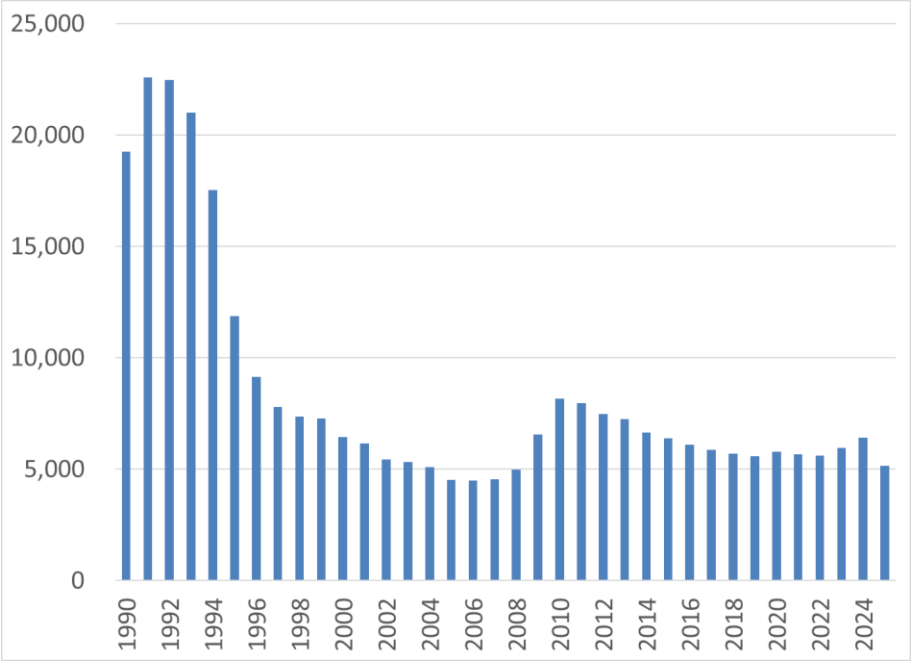
The credit rating, debt underwriting, and valuation practices that are increasing financial fragility have been encouraged by a policy environment, set by the past and current leadership of US regulatory institutions, that promotes deregulation, desupervision, and deenforcement. Such a trend has accelerated under a Trump administration that sees government oversight as "regulatory adventurism," and, despite abundant evidence of the contrary, considers competition to be a cleansing mechanism that roots out dangerous financial practices by allowing "market forces—not the regulator—to drive the disclosure of any additional aspects that may be beneficial" (Atkins 2026). Long set aside are the *mea culpas* of Kohn, Greenspan, and others who conceded that they "placed too much confidence in the ability of the private market participants to police themselves" (Kohn in House of Commons 2011, Ev3), and that we "made a mistake in presuming that the self interest of organizations, specifically banks and others, were such is [*sic*] that they were best capable of protecting their own shareholders and their equity in the firms" (Greenspan in U.S. House of Representatives 2008, 34). The Trump family is profiting enormously from such a lax regulatory environment (Protess et al. 2025; Lafraniere and Yaffe-Bellany 2026).

The FDIC staffing has once again been on a downward trend since 2011 and is close to its pre-2008 crisis with 5000 employees in 2025 (Figure 15). The Consumer Financial Protection Bureau has been gutted by layoffs and refusal by Russell T. Vought to fund it properly. Since 2012, the SEC (a key regulator for private markets) has recorded a growing number of departures by experienced supervisors (Figure 16), while its staffing has stagnated and then significantly declined in 2025 (US Government Accountability Office 2026). The SEC staff has found problems in CRA's rating practices and has reported the problems to its Division of Enforcement when appropriate (and has also recognized the needs for a better regulatory framework for CRAs), but the SEC enforcement actions are significantly down since 2024 (Figure 17). Similar trends are occurring at the Commodities and Futures Trading Commission (Lafraniere and Yaffe-Bellany 2026). SEC Commissioner Caroline A. Crenshaw pushed for more information to be provided to the SEC but was outvoted. She noted "my colleagues use lots of buzz words—freedom, diversification, democratization. Call it what you will, at bottom it's risky and it's

reckless" (Crenshaw 2025). Abroad, the FCA has also pushed for improved reporting of information regarding private credit (Arnold 2026).

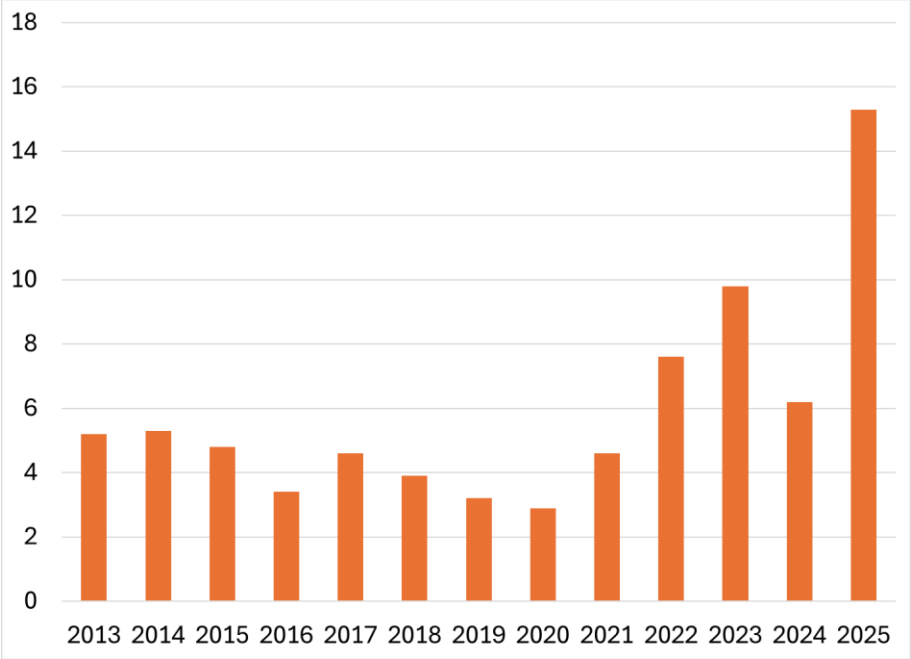
Prosecutions (as well as convictions) of white-collar crimes have declined significantly since 2011, from an average of 9000 yearly prosecutions by the Department of Justice across administrations until the middle of the Obama Administration, to 4000 currently (Figure 18). Such criminogenic environment is prone to generate further growth of Ponzi finance in private markets and the overall financial industry. This is all the more so that Jay Clayton, US Attorney for the Southern District of New York (and SEC Chairman under the first Trump Administration), has pushed for the self-reporting of fraudulent activities with a promise of declination (Southern District of New York US Attorney Office 2025). This program applies even when "alleged fraud was pervasive, caused severe harm, involved senior leaders and had already been reported in the process or by a whistleblower" (Wiggins 2026). Clayton argues that this policy will speed up the discovery and cleaning up of fraudulent activities, which is "what the shareholders want" (Clayton 2026). This push for self-reporting and leniency is occurring at the same time as AI may possibly be used to reduce the size of the staff in risk and compliance offices (Alim 2026). In such case, senior management sets the rules regarding what AI should look at and ignore, giving less space for critical human analysis outside these rules (and of the rules themselves) and reducing the "risk" of whistleblowing.

Figure 15. Employees of the Federal Deposit Insurance Corporation



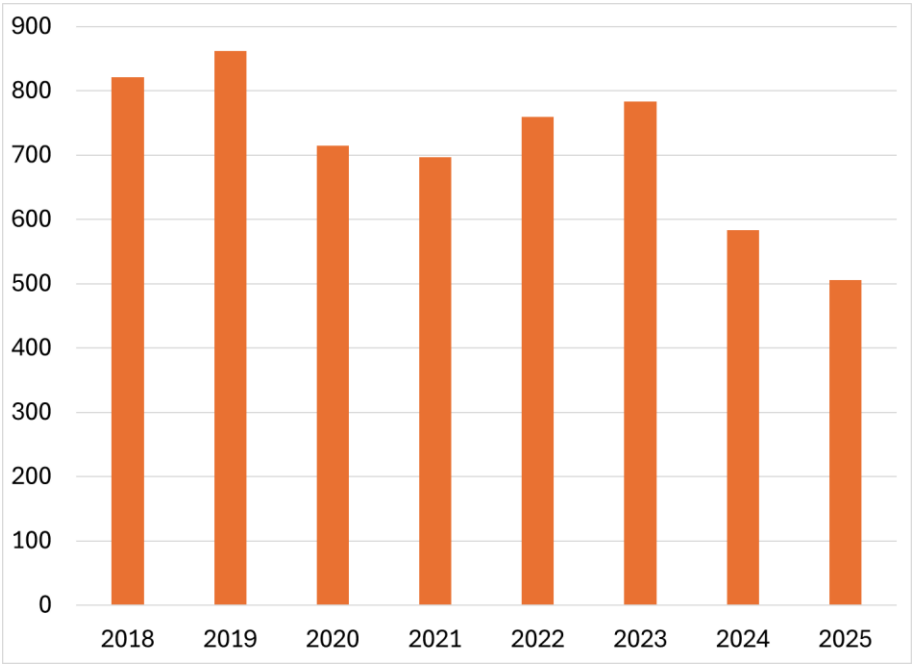
Source: Federal Deposit Insurance Corporation

Figure 16. Mission-Critical Staff Departures as a Percent of Total Staff



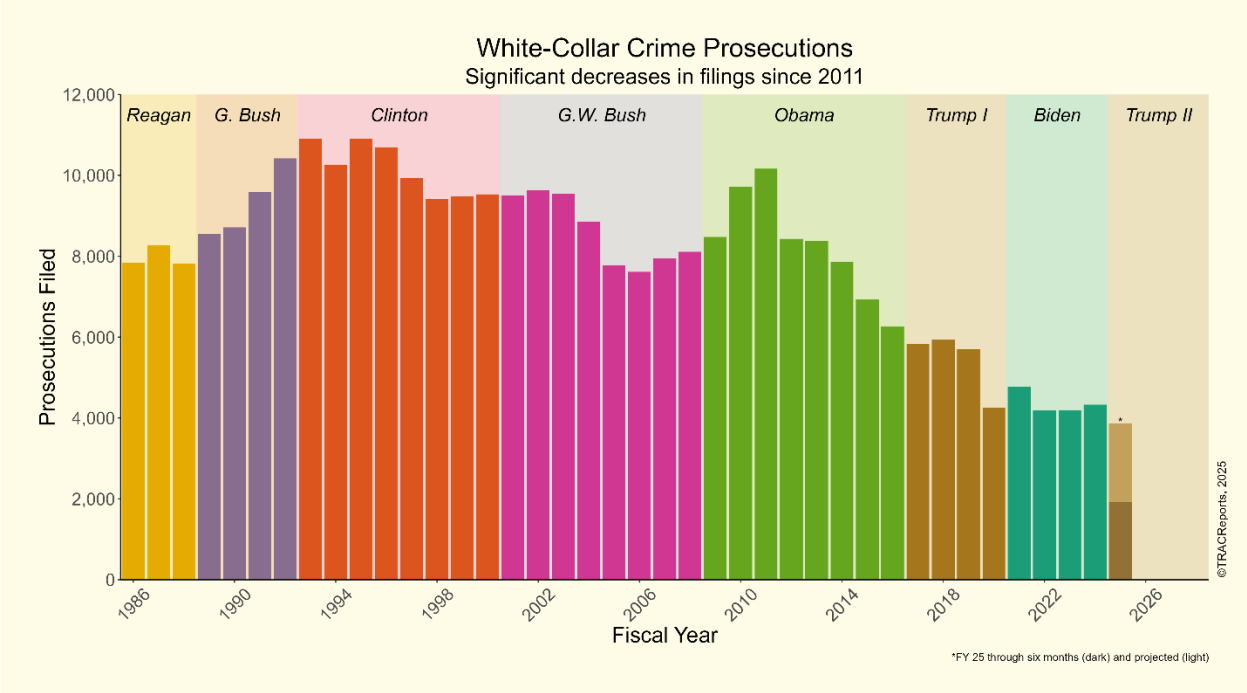
Source: Securities and Exchange Commission

Figure 17. SEC Enforcement Actions



Source: Huffman and Jindra (2025)

Figure 18. White-Collar Crime Prosecutions



Source: Transactional Records Access Clearinghouse (2025)

WHAT NEXT?

Private markets commonly involve the use of Ponzi finance, i.e., credit-constrained businesses rely on the ability to refinance the principal and interest service on their private debts. This, in turn, relies on the continuous growth of asset prices to justify additional refinancing given a loan-to-value ratio. Currently, there are signs that the reliance on Ponzi finance in private markets is growing as well as spreading beyond private markets. The underwriting of private debts increasingly incorporates the availability of interest refinancing, money managers' portfolio strategies have become more dependent liquidating assets in smoothly working financial markets, and the interdependence of private equity funds, private debt funds, banks and money managers is rising. The push for the retailization of private markets creates a temporary solution to deal with refinancing and liquidation pressures, but also feeds an asset-based Ponzi process by passing the buck for holding financial instruments tied to private markets to a broader segment of the financial sector. This is only sustainable temporarily, given that rising leverage, more securitization, more continuation, more resecuritization and recontinuation, a rising share of level 3 valuation, a rising share of interest PIK, the growing use of synthetic PIK, and the loosening of underwriting standards can only go so far to sustain a net inflow of new participants. Unfortunately, all of this is currently encouraged by a regulatory environment that believes in the self-cleansing properties of markets through competition (markets punish bad actors), in shareholders' pressures on management to get rid of fraud, in market-driven disclosure of information, and in self-reporting of fraud for a free pass.

As the process of fragilization continues, default rates may remain low and steady because the recognition of payment difficulties is deferred by seemingly favorable market conditions, that allow refinancing and liquidation at rising asset prices to proceed smoothly via PIK debts, continuation, recontinuation, securitization, and resecuritization. High yields are obtained by participants who entered early and, potentially, the next entrants if the Ponzi process continues. Ultimately, however, the accumulation of weak underwriting, mounting refinancing pressures, loose credit rating, inflated asset valuation, and embedded leverage generate such a fragile financial structure that a crisis produces losses that pierce through any capital and liquidity buffers. Equity buffers will crumble and liquidity will evaporate, as refinancing channels close

and real and financial assets tied to private markets need to be liquidated en masse to meet debt commitments. A significant mark down of level 3 valuations, and a large downgrade of credit ratings, will feed a debt-deflation process that may spread to other markets as interdependencies grow during the period of stability. As such, although BDCs and other financial vehicles are structured in such a way that they have large buffers of equity, these buffers provide a false sense of safety. This is all the more so that liquidity and capital buffers are procyclical. Leverage is rising among BDCs, covenants are weakening and being bypassed (e.g., synthetic PIK), and participants in private are bypassing capital regulation via credit rating inflation, securitization (RNF, CLO, etc.) and off-balance-sheet innovations such as JVLF. Banks such as JP Morgan, Barclays, and Citigroup have started to implement financial strategies to profit from a fallout of private market funds via credit default swaps on Apollo, Ares, and Blackstone funds (Platt et al. 2026).

Private markets may not yet be a source of systemic risk, but, given the previous trends, regulators should put a brake on current practices. Regulation needs to move beyond a passive/sea-wall approach to financial regulation that merely adds new capital and liquidity requirements, merely provides more information to market participants (or, worse, lets market forces decide what information should be provided), and focuses on profitability as a key measure of economic health. Given the high short-term profitability of a Ponzi process and the risk of losing market shares if one does not participate, market forces do not incentivize self-correction of financial practices that increase the risk of financial instability. Instead, herd behaviors and *fuite en avant* becomes the norm, and the goal of each participant is to make the process continue as long as possible, with the hope that one will come out unscathed when the process unravels. As Mr. Prince, former CEO of Citigroup put it: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” (Prince in Nakamoto and Wighton 2007)

Instead of a passive approach, federal and state agencies must have a nimbler and more proactive regulatory framework centered around the regulation and monitoring of underwriting, valuation, and credit-rating practices. The goal is to rein in and contain the use of Ponzi finance, especially asset-based Ponzi finance, through the regulation and monitoring of new financial practices. The

role of regulators is to go against the grain and stop the growth and spread of financial fragility early, even if Ponzi finance may sustain highly profitable economic activities, may temporarily improve economic welfare (e.g., improve homeownership rate) and problems are currently small and contained (low default rate, etc.). Ultimately, the soundness of private markets relies on the operational income-generating capacity of credit-constrained businesses. The role of regulators is not to eliminate Ponzi finance, but rather to ensure private market deals involve underwriting based on a careful analysis of expected operational income and expect length of refinancing needs, the availability of sufficient collateral to meet unexpected losses, and sound ratings and valuations of private-market instruments. Regulators should also reduce the conflict of interest within private funds that incentivize hiding problems and validating inflated level 3 valuation through the use of special purpose entities. Such a regulatory approach would incentivize lenders to ask "*how* will you repay on time?" instead of merely "will you repay on time?" Repayment based on the direction of asset value is less creditworthy given probability of default. Portfolio strategies based on such repayment practice should be discouraged.

Finally, private markets involve taking risky long-term illiquid positions that require patience and an entrepreneurial mindset. Together, the trend toward retailization and the accommodation for higher liquidity preference are challenging the foundations of such a financial model. They create a short-term portfolio-management mindset that promotes high return through leverage and the liquidation of private-market positions. The retailization of private markets will lead to a rapid inflow of funds far beyond the needs of the small-and-medium enterprises that are currently considered to be creditworthy. This will incentivize further loosening of underwriting as new deals must be found and competition increases within private markets and with banks and public markets. Given the fundamental contradiction between the purpose of private markets and the desire to engineer liquidity in order to grow them, regulators need to intervene. Regulators should limit access to private markets to money managers with the ability to judge the risks involved, with a portfolio-management mindset geared toward patience and the operational success of the business enterprises, and with liquidity and financial buffers large enough to sustain expected and unexpected losses.

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