



# AI in Private Credit

Underwriting, Covenant Surveillance, and the Monitoring Gap

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Abstract

Private credit now finances a meaningful share of the corporate economy while disclosing less about itself than any comparable asset class. Moody's expects assets under management to pass \$2 trillion in 2026 and to approach \$4 trillion by 2030. Artificial intelligence arrived quickly on the origination side of this market: PwC's 2026 survey of more than 120 credit portfolio managers found that 54 percent are most likely to apply AI in underwriting. Only 16 percent treat AI-enabled portfolio management, including monitoring, as a current priority. That 38-point spread is the monitoring gap, and it has opened at a bad time. Covenant-lite structures grew from 4 percent to 21 percent of private credit deals between 2023 and 2025, caps on EBITDA add-backs are disappearing, payment-in-kind interest converts cash signals into silence, and the Proskauer default index has risen for three consecutive quarters. This paper examines why AI deployment concentrated in underwriting, what covenant erosion does to a lender's information position, and why covenant surveillance is now the highest-return application of AI in private credit. It sets out a four-layer surveillance architecture (document, data, signal, judgment) that replaces the static credit file with a continuous one, and the behavioural guardrails that keep automated monitoring from breeding automated complacency.

Keywords

AI in private credit, direct lending, covenant surveillance, portfolio monitoring, covenant-lite, EBITDA add-backs, payment-in-kind interest, early warning systems, business development companies, credit agreement extraction, automation complacency, private credit defaults

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## 1. Introduction: An Expensive Asymmetry

Private credit firms spent the past two years wiring AI into the front of the credit lifecycle. Data rooms are summarised by machine. Credit agreements are parsed in minutes. First drafts of investment committee memos increasingly come from models. In PwC's 2026 global survey of more than 120 credit portfolio managers, 54 percent said underwriting is where they are most likely to apply AI (PwC, 2026).

The same survey contains a second number that deserves more attention than it has received. Just 16 percent of managers regard AI-enabled portfolio management, monitoring included, as a current priority. The industry automated the stage of the credit lifecycle where work was already most disciplined, most reviewed, and most expensive per decision. The stage that runs for the following five to seven years, across hundreds of borrowers, on lagged quarterly data, was left as it was.

That choice has a cost, and the cost is rising. Proskauer's default index for senior-secured and unitranche loans reached 2.73 percent in the first quarter of 2026, its third consecutive quarterly increase (Proskauer, 2026a). Downgrades have outpaced upgrades in KBRA's direct lending universe for two full years (KBRA, 2026). The collapses of Tricolor and First Brands in late 2025 were frauds rather than cycle casualties, but they were above all failures of information: double-pledged collateral and poorly disclosed off-balance-sheet financing that came to light only as the companies failed (Cambridge Associates, 2025).

Underwriting decides what risk a fund takes. Monitoring decides how long the fund carries risk it never meant to take.

This paper proceeds in seven parts: the state of the market, the underwriting build-out, the parallel erosion of covenant protections, the anatomy of the monitoring gap, the reasons it exists, an architecture for closing it, and the guardrails that keep the fix from creating new failure modes.

## 2. A Larger, More Concentrated, Less Visible Book

Start with scale, which is harder to establish than it should be. The Financial Stability Board put global private credit between \$1.5 trillion and \$2 trillion at the end of 2024, with the United States accounting for roughly \$1 trillion (FSB, 2026). Moody's expects assets under management to exceed \$2 trillion during 2026 and to approach \$4 trillion by 2030 (Moody's, 2026). MSCI, counting business development companies and other vehicles, already places the market near \$3 trillion (MSCI, 2026). The estimates disagree because the market's boundaries are unclear, and that disagreement is itself the finding: no one, including the official sector, can fully see this asset class from outside.

The composition is shifting as fast as the total. Growth is moving toward asset-backed finance, evergreen and semi-liquid fund structures, and retail capital (Moody's, 2026). Each of these channels tightens the market's liquidity promises while the underlying loans stay illiquid, which raises the price of stale information. The FSB warns that valuations perceived as stale create a first-mover incentive in stress, with investors exiting before marks catch up to reality (FSB, 2026).

Concentration has shifted too. Lending to software-as-a-service businesses grew from about \$8 billion in 2015 to more than \$500 billion by the end of 2025, or 19 percent of direct loans, and a third of private credit funds hold SaaS exposure (BIS, 2026). When software equities fell almost 30 percent between October 2025 and February 2026 on fears that AI would disrupt SaaS business models, BDC

shares fell about 10 percent on average, discounts to net asset value deepened, and BDCs with high software exposure underperformed their peers by roughly 5 percentage points (BIS, 2026). AI now sits on both sides of the trade: it is the new tool inside the lender's workflow and the new threat inside the borrower's income statement.

Supervisors have noticed. The FSB's May 2026 report concludes that private credit remains untested at its current size and sector concentration, and that data challenges hinder effective monitoring by authorities themselves (FSB, 2026). The Bank of England has launched a system-wide exploratory scenario covering private markets (Moody's, 2026). When the official sector concedes it cannot watch a market from outside, the watching falls to the people inside it.

### 3. Where AI Went First: The Underwriting Build-Out

Adoption on the buy side moved from experiment to infrastructure in roughly eighteen months. SimCorp's 2026 survey of 200 buy-side executives found 70 percent of firms using AI in the front office, against about 10 percent merely exploring it a year earlier, and the share of respondents naming private markets as the largest opportunity for technological innovation jumped from 27 percent to 51 percent over the same period (SimCorp, 2026).

Inside private credit, the mature applications cluster where outputs are grounded in documents and can be checked by a human: data room summarisation, document extraction, covenant analysis, transaction-level cash flow analysis, fraud and know-your-customer screening, and workflow automation (PwC, 2026). Investment committee memo generation, term sheet drafting, structuring benchmarks, and legal clause review are advancing behind them. Autonomous credit approval remains, sensibly, nowhere in production.

The payoff is real. PwC finds that firms pairing AI with human underwriters review more deals with the same headcount and catch more risk issues earlier than peers running manual processes (PwC, 2026). Nothing in this paper argues against the underwriting build-out. The argument is about what was built second, and so far has not been.

Underwriting went first for understandable reasons. The work is bounded: a deal has a data room, a deadline, and a defined output. The benefit lands on the fee-earning side of the firm, where budgets live. And capability is easy to demonstrate, which matters commercially: Edelman Smithfield's 2026 survey found that 100 percent of limited partners consider it important that managers demonstrate AI capability across sourcing, diligence, value creation, or operations when making allocation decisions (Purkess, 2026a).

An underwriting model is a photograph. The borrower it depicts begins changing the day the loan funds. Watching that change is a separate capability, and the survey data says most firms have not built it.

### 4. The Thinning Tripwire: Covenants in 2026

Private credit's original bargain traded illiquidity for control: tight documentation, maintenance covenants tested quarterly, and direct information rights. The maintenance covenant doubled as a free early-warning system. Every quarter the borrower had to prove compliance, and a miss forced a conversation while enterprise value remained to protect.

That bargain is being renegotiated structurally. Proskauer's review of more than 450 private credit deals found covenant-lite structures rising from 4 percent of deals in 2023 to 21 percent in 2025, with 91 percent of those involving borrowers above \$50 million of EBITDA, and well-positioned sponsors extracting covenant-lite terms for borrowers as small as \$30 million (Proskauer, 2026b). The share of deals capping EBITDA add-backs for non-recurring items fell from 66 percent in 2023 to 39 percent in 2025. Incremental free-and-clear debt baskets of at least 100 percent of EBITDA appeared in 81 percent of deals, up from 64 percent a year earlier. Average closing leverage rose to 5.1x against permitted capacity of 6.3x, while spreads compressed from 6.8 percent in 2023 to 5.6 percent.

Add-backs corrode a lender's information position. Because covenant EBITDA includes projected cost savings and merger benefits, reported leverage understates economic leverage. The FSB notes that private credit borrowers carry more debt than the roughly 4x typical of leveraged loans, that adjusted figures put true leverage closer to 7x, and that research on leveraged loans shows projected EBITDA behind add-backs misses its targets most of the time (FSB, 2026). A leverage test run against a number padded with promised improvements is a tripwire mounted a foot above the floor.

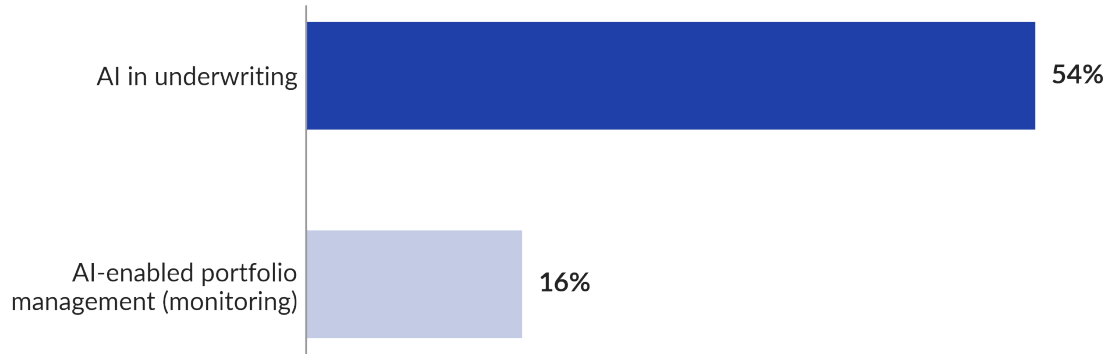
Payment-in-kind interest removes a different signal. PIK income at the fifteen largest listed BDCs grew 20 percent year over year to \$1 billion in the twelve months to March 2025, reaching 8.7 percent of total interest income (PitchBook LCD, 2025). Across credit estimates reviewed by the FSB, about 12 percent of loans carry PIK features, half of them toggles the borrower can switch on mid-life; a study of US BDC loans found toggle exercise associated with a 1 to 2 percentage point higher probability of delinquency in the following quarter, against an unconditional base of 3 percent (FSB, 2026). PIK is often rational capital management. It also deletes the most honest datum a lender receives: cash that arrives or does not.

The net effect is a shift in where safety comes from. Information rights survive, and even covenant-lite private credit documents retain springing covenants on revolvers and reserved lender protections (Proskauer, 2026b). But a right to receive monthly financials produces no safety on its own. With fewer automatic tests, surveillance moves from the document to the lender's own analytical effort, exactly as portfolios grow past the point where human reading can keep up.

## 5. The Monitoring Gap

Define the monitoring gap as the distance between how fast portfolio risk now moves and how fast portfolio information arrives and gets processed. Its mechanics are mundane. Borrower financials and compliance certificates are typically due within 45 days of quarter end. Valuations update quarterly, a cadence the FSB describes as adequate in normal market conditions but less so under stress (FSB, 2026). The fastest-reporting managers deliver marks about 30 days after quarter end, and the benchmarks built on those marks publish roughly 50 days after that (MSCI, 2026). A deterioration that begins in the first month of a quarter can be four to five months old before it forces itself onto an investment committee agenda.

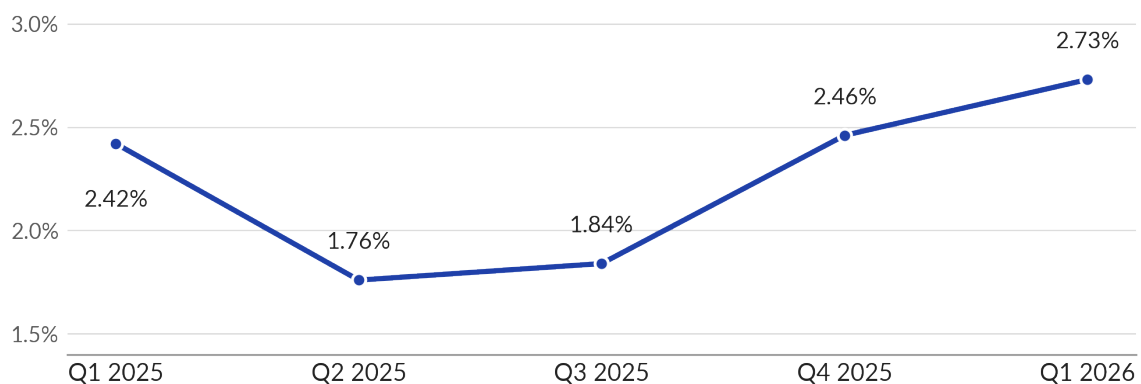
Against that lag, the survey evidence on AI priorities reads as a structural imbalance.



**Figure 1.** Share of credit portfolio managers prioritising AI by function. Fifty-four percent are most likely to apply AI in underwriting; 16 percent treat AI-enabled portfolio management, including monitoring, as a current priority. Source: PwC Global Private Credit Survey 2026 (more than 120 respondents).

What information does flow is noisy. Moody's Analytics reviewed more than 6,000 positions across 34 listed BDCs and found that, for loans entering portfolios at a discount, around three quarters of the observed deviation from par reflected entry pricing rather than any later movement in value (Purkess, 2026b). The same loan can carry different marks at different lenders, a dispersion academic work ties to information asymmetry across lending relationships (Jang & Kim, 2025). An allocator reading headline marks is mostly reading noise; only loan-level surveillance separates entry pricing from real deterioration.

Reported defaults understate stress for a related reason: intervention happens upstream of the default statistic. Lincoln International found the size-weighted covenant default rate in its direct lending universe rising from 2.4 to 2.9 percent in the first quarter of 2025, and notes that the restrained headline level partly reflects amendments that pre-empt or waive defaults, alongside elevated PIK interest (Lincoln International, 2025). KBRA's forward-looking default monitor counted 81 borrowers in payment default or surviving only on sponsor and lender support at the end of 2025; a quarter of its assessed borrowers cover interest at less than 1.0x; and multilevel downgrades nearly tripled quarter over quarter as sponsor support was withdrawn in several names (KBRA, 2026). Deterioration in this market accumulates behind support structures and then resolves abruptly.



**Figure 2.** Proskauer Private Credit Default Index, senior-secured and unitranche loans, Q1 2025 to Q1 2026. The Q1 2026 reading covers 697 loans representing \$189.2 billion of original principal. Source: Proskauer Rose LLP.

Tricolor and First Brands belong in this section rather than in a chapter on fraud. Both were idiosyncratic, and both spanned public and private lenders alike (Cambridge Associates, 2025). But the mechanism in each case was informational: obligations pledged twice, financing structured off balance sheet and disclosed poorly. The managers who avoided the losses did so through deeper ongoing diligence, abnormal-margin checks, and scepticism about management credibility. Monitoring quality already separates outcomes in this market. It is simply not yet systematised.

The market's new structure raises the stakes. Evergreen vehicles and retail capital mean stale marks now interact with redemption windows, and the IMF has long warned that managers in opaque credit markets face incentives to defer loss recognition until it arrives all at once (IMF, 2024), and its October 2025 assessment adds that growing retail interest in private credit stands to amplify credit downturns (IMF, 2025). The monitoring gap used to be a credit problem. In a semi-liquid wrapper it becomes a franchise problem.

## 6. Why the Book Lost the Race for Attention

The economics point one way. Origination earns fees and carries careers; monitoring is a cost centre until the quarter it becomes the whole firm. Budgets follow revenue, so the tooling followed the deal team.

The psychology points the same way, and it is worth being precise about the mechanisms. Sustained human vigilance degrades quickly when signals are rare, a finding replicated in watch-keeping research since the 1940s; a performing book offers years of nothing. Commitment plays its part: the professionals reviewing a loan are often the ones who underwrote it, and evidence of trouble argues with their own prior judgment. Salience finishes the job. A live deal is vivid and deadline-driven; borrower number 137's late management accounts are neither.

The data was a real obstacle too. Borrower reporting arrives as PDFs and spreadsheets in whatever format each company's controller prefers. Covenant definitions are deal-specific, a customisation the FSB links to reduced pricing efficiency and wider dispersion in marks (FSB, 2026). Normalising that by hand across 150 names was uneconomic, so quarterly sampling was a rational design for a human-only system.

AI removes the economic excuse. Reading every reporting package on the day it arrives used to require headcount no fund would pay for; it now requires software the underwriting team already licenses. What was a constraint has become a choice. Choices, unlike constraints, get priced by investors.

## 7. Covenant Surveillance as an AI Problem: The Continuous Credit File

Monitoring work is document-grounded, repetitive, and verifiable, which is precisely the profile of work where current AI performs dependably; PwC's own maturity map draws the same boundary (PwC, 2026). The deployment target should be to retire the static credit file, assembled at close and revisited quarterly, and replace it with a continuous one. Four layers make that concrete.

The first is the *document layer*. At close, extraction models convert the credit agreement into a structured, versioned record: covenant definitions and test levels, step-downs, baskets and their capacities, add-back caps, reporting obligations and deadlines, PIK terms and toggle conditions. Every

amendment triggers re-extraction, and the amendment history itself becomes a tracked signal, since amendments are where stress hides from default statistics (Lincoln International, 2025).

The second is the *data layer*. Each borrower deliverable is ingested on arrival and mapped to the agreement's defined terms rather than to generic accounting lines, because covenant EBITDA is a negotiated definition, not an accounting fact. The system maintains a running ledger of add-backs taken against add-backs realised, which over time reprices the leverage a lender believes it holds (FSB, 2026).

The third is the *signal layer*, with three families of output. Deterministic covenant mathematics tracks headroom levels and trajectories, projected test dates, and basket usage, replacing pass/fail snapshots with direction and speed. Anomaly detection works within and across borrowers: margin trends against sector peers, working capital swings, revolver draws, and reporting latency, since late financials are one of the oldest behavioural distress signals in lending. External overlays complete the picture: sector spread movements mapped to portfolio exposure, and concentration views of the kind the BIS built for software lending, held as a continuously refreshed fact about the fund itself (BIS, 2026).

The fourth is the *judgment layer*. Signals route to named owners with severity tiers and escalation deadlines. Investment committees review exceptions and trends rather than reporting packets, and management tracks two metrics that barely exist in the industry today: time from borrower event to firm awareness, and time from awareness to action.

Consider what this changes in practice. A borrower exercises a PIK toggle, gross margin compresses for a second consecutive quarter, and management accounts arrive late twice. No covenant has tripped; under a covenant-lite document, none will. As a pattern, this is a watch-list entry months before the file would otherwise surface, while the full menu of responses, from a sponsor conversation to amendment pricing, is still open. The toggle alone, on the FSB's evidence, marks a meaningful jump in next-quarter delinquency risk (FSB, 2026). The pattern is what the quarterly cycle structurally cannot see.

Feasibility is no longer the objection. The extraction stack a firm uses in diligence handles surveillance documents, which repeat monthly in similar form, and the marginal cost of reading the next package approaches zero. PwC's finding that AI lets teams review more deals with the same headcount applies with greater force to the book, where the reading is more repetitive than any data room (PwC, 2026). PwC's own view of the next stage matches this paper's:

*"In our view, the next stage of evolution will be the combination of better data, better monitoring, and more active asset management underpinned by agentic AI to increase efficiency and control across the end-to-end process." (Erich Butters, in PwC, 2026)*

## 8. Keeping Judgment in the Loop

Automated surveillance has failure modes of its own, and they are behavioural before they are technical. The first is automation complacency: when the system is usually right, humans stop checking it. The countermeasures are structural rather than exhortative: sampled human re-verification of extractions, periodic blind review of randomly selected credit files, and audits of dismissed alerts. An earlier paper in this series, *Combating Automation Complacency*, treats these mechanisms in detail.

The second is alert fatigue. A surveillance system that cries weekly gets dismantled within a year, informally first. Thresholds need tuning by severity, duplicates need suppression, and alert volume itself

belongs on the governance dashboard.

The third is misallocated trust in the other direction. Machines should compress time to awareness; people keep the decisions. Workout strategy, sponsor relationships, and amendment negotiation stay human, and the division should be explicit and documented. Limited partners are alert to exactly this point: they expect concrete evidence of AI capability without overstatement of its role in investment decisions (Purkess, 2026a).

Last, confidentiality is a design requirement, not an afterthought. Borrower financials are private information, and surveillance systems must run on architecture that keeps them out of public model training entirely.

## 9. Conclusion and Recommendations

Covenant erosion removed the market's automatic tripwires in the same period that defaults turned upward, software concentration deepened, and semi-liquid structures tied stale marks to redemption windows. Against that backdrop, the industry's AI investment flowed almost entirely to origination. The 38-point spread between underwriting and monitoring priorities is the most expensive open position in private credit, and closing it is cheaper now than it will ever be again.

For managers, the working agenda is as follows:

1. Treat the credit file as a living asset. Extract every credit agreement into structured form at close, and backfill the existing book starting with the largest exposures and the weakest interest coverage.
2. Move surveillance cadence from quarterly to continuous. The trigger for analysis should be the arrival of a borrower deliverable, an amendment request, or an external signal, never the calendar alone.
3. Track headroom trajectories and add-back realisation, not pass/fail covenant status. Direction and speed carry the information; the snapshot does not.
4. Treat PIK activation, amendment requests, and reporting latency as first-class credit signals with defined owners and response deadlines.
5. Hold portfolio concentration views (sector, sponsor, reference rate, PIK share) as continuously refreshed facts, reviewed whenever they move, in the spirit of the BIS software analysis.
6. Measure time to awareness and time to action as management metrics, and report them internally with the same discipline as deployment and returns.
7. Build complacency countermeasures in from day one: sampled re-verification, blind file reviews, and audits of dismissed alerts.
8. Tell limited partners what was built. AI capability is now an allocation criterion, and monitoring is the least crowded place to demonstrate it.

Private credit promised investors patient capital and close borrower relationships. The first half of that promise survives any cycle. The second half has become a technology question as much as a relationship one, because closeness at portfolio scale is now a function of what a firm's systems read

and notice. The lender who notices first keeps the most options. That has always been true. What changed is that noticing first is now an engineering decision.

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Dr. Leigh Coney is the Founder and Principal Consultant of WorkWise Solutions. His doctoral research examined how humans interact with emerging technology, and he has spent over a decade working at the intersection of AI, behavioural science, and organisational design. His work focuses on decision making in high stakes environments, with particular attention to why sophisticated AI systems fail to achieve adoption and how governance and deployment systems can be designed to account for human cognitive and social dynamics.

Dr. Coney advises private equity firms, family offices, private credit funds, independent sponsors, and investment banks on AI strategy, governance design, and psychology informed change management.

This paper is part of an ongoing research series on responsible AI adoption in financial services. Previous publications include *AI for Roll-Ups: Standardizing Operations Across Acquired Companies* (Q2 2026), *Helping Portfolio Companies Deploy AI: A General Partner's Operating Partner Playbook* (Q2 2026), *Agentic AI Governance in Private Equity* (Q1 2026), and *Combating Automation Complacency* (Q1 2026).

## About WorkWise Solutions

WorkWise Solutions builds secure, purpose built AI systems for private equity, venture capital, family offices, private credit funds, and investment banking firms. The firm specialises in zero retention AI architecture that ensures proprietary deal flow and portfolio data never train public models.

WorkWise's approach is grounded in a core insight: most AI implementations fail because of broken workflows and poor adoption strategies, not because of the technology itself. Every engagement integrates behavioural science and organisational psychology into the technical design, so that AI systems become a durable part of how investment teams actually work.

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