

Issue 30 – June 15, 2026



Detecting Borrower Stress Before Defaults

Insights Engine | Credit Research



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Executive Summary

As borrower stress becomes more selective, credit research is shifting from financial-statement review to sector-led surveillance, liquidity tracking, covenant analysis, and early-warning intelligence.

*"Transparency is more limited.
Valuations may lag reality.
Underwriting standards have
weakened."*

Sarah Breeden

Deputy Governor for Financial
Stability

Bank of England

Credit research is moving from backward-looking financial statement review to forward-looking risk intelligence.

Borrower stress now often appears first in sector conditions, liquidity pressure, covenant headroom, refinancing access, and business-model weakness before it reaches EBITDA, leverage, defaults, downgrades, or portfolio marks.

U.S. credit conditions remain resilient at the headline level, with banks still profitable and asset quality generally favorable, yet risk is becoming more concentrated across commercial real estate, consumer-linked sectors, leveraged borrowers, software credit, and lower-rated issuers.

For investors, private equity firms, investment banks, and credit research teams, the key question is no longer only whether a borrower can repay today. The sharper question is where stress may appear before markets force recognition.



\$13T

Rated U.S. Corporate Debt

\$6T

Debt Maturing by 2030

\$44B

Direct Lending Issuance

\$80B

Q1 Bank Net Income



Sector Signals Lead Financials

Credit risk often moves through sectors before it becomes visible in borrower financial statements

Credit research is becoming more forward-looking because financial statements are no longer the first place stress appears. Revenue, EBITDA, leverage, and interest coverage remain essential, but they are backward-looking indicators. The stronger credit view now begins with sector research, industry analysis, macro trends, and market intelligence.

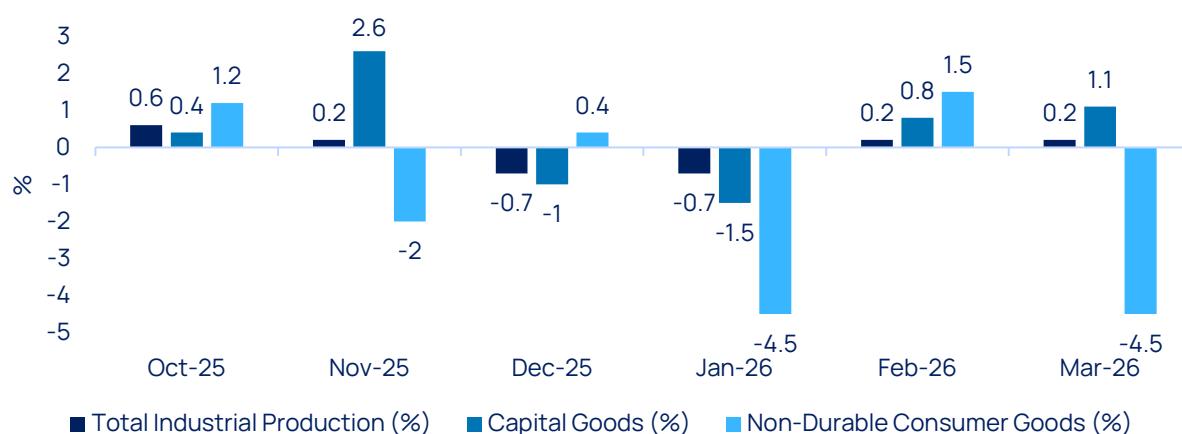
If end-market demand weakens, refinancing costs rise, customer spending slows, inventory builds, or pricing power fades, borrower stress is already forming before it reaches reported numbers. This matters in the current credit cycle because headline banking data still looks resilient.

The U.S. banking industry generated \$80.5 billion of net income in Q1 2026, while asset quality remained broadly favourable. But beneath that stability, weakness continues to appear in specific credit pockets, including commercial real estate, consumer-linked borrowers, leveraged companies, and lower-rated issuers. U.S.

The borrower's financial model should not be the starting point; the borrower's operating environment should be. Sector demand, margin pressure, refinancing access, regulatory change, customer behaviour, and competitive disruption give a more comprehensive view of future repayment capacity than historical statements alone.

Industrial Recovery Masks Persistent Consumer Weakness

Capital goods rebound contrasts with repeated consumer weakness, signaling uneven sector credit risk across borrowers



Source: European Commission



Liquidity Shows Stress Early

The earliest borrower stress signal is usually shrinking liquidity flexibility, not immediate default risk

Liquidity is becoming the most important early-warning indicator in credit research. A borrower can still report acceptable EBITDA and leverage while its actual repayment capacity is weakening. The pressure usually appears first in cash conversion, receivable days, inventory build, supplier stretch, revolver usage, working-capital drag, interest burden, and declining free cash flow after capex.

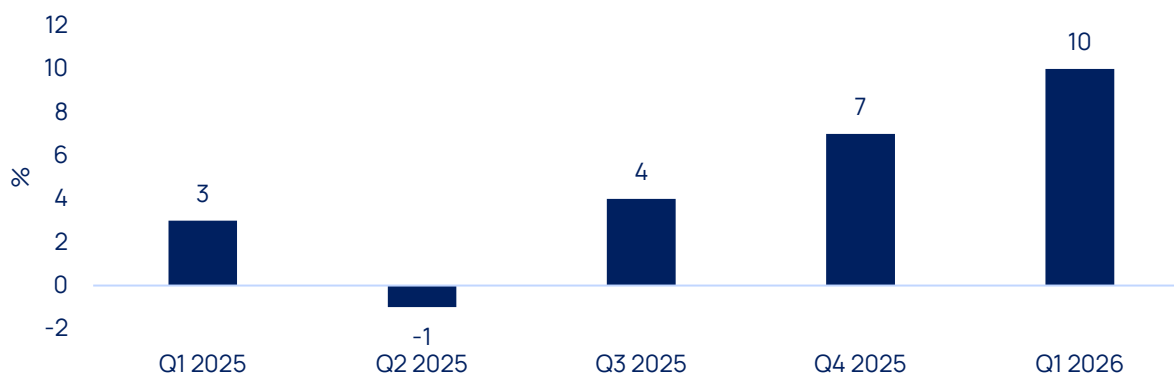
This is where credit analysis moves from “is the company profitable?” to “how much time does the borrower really have?” Current lending conditions reinforce this shift. Banks reported tighter standards for commercial and industrial loans in Q1 2026, with higher premiums on riskier loans, tighter covenants, and stronger collateral requirements.

This signals for credit research teams because tighter lending conditions reduce borrower flexibility even before a formal credit event occurs. When refinancing becomes harder, liquidity runway becomes a stronger predictor of stress than accounting profitability. For PE portfolio monitoring, debt advisory, and credit portfolio management, should be dynamic, not quarterly.

Credit teams need to track cash burn, short-term maturities, covenant cushion, revolver availability, sponsor support, and refinancing probability under multiple scenarios. The key question is not whether the borrower can service debt today, but whether it can survive the next refinancing window without value leakage, covenant pressure, or forced restructuring.

Credit Tightening Signals Rising Borrower Pressure

Bank lending standards tightened sharply into 2026, reducing refinancing flexibility and exposing early borrower stress



Source: European Central Bank

Covenants Map Downside Control

Covenant pressure reveals lender control, borrower flexibility, and downside risk before defaults occur



Covenants are becoming central to modern credit research because they reveal risk before it appears in defaults, downgrades, or valuation marks. In a low-rate environment, many borrowers benefited from loose documentation, flexible EBITDA adjustments, broad debt baskets, limited maintenance tests, and borrower-friendly amendment terms. That structure worked when liquidity was abundant. It becomes more fragile when refinancing costs rise, lenders tighten standards, and weaker borrowers need more time.

The scale of refinancing risk makes covenant analysis more important. Rated U.S. corporate debt stood at about \$13.07 trillion at the start of 2026, with roughly 47% maturing through 2030, implying nearly \$6.1 trillion of refinancing exposure over the period. Globally, rated corporate maturities are expected to peak near \$2.95 trillion in 2028. The issue is not only the size of the maturity wall; it is the coupon reset. Much of the debt maturing between 2026 and 2028 was issued at lower coupons than today's refinancing

cost which means weaker borrowers may face higher interest expense even if revenues remain stable. This is why credit research must go deeper than headline leverage. A borrower with 5.0x leverage and tight covenants may be safer than a borrower with 4.0x leverage, weak documentation, aggressive EBITDA add-backs, and multiple ways to layer debt ahead of existing lenders. Covenant headroom, EBITDA adjustment quality, restricted payment capacity, asset-transfer flexibility, lien baskets, maturity clustering, and amendment history all matter.

For investment banks, private equity firms, lenders, and credit investors, covenant research should become a practical control map. It should identify where lenders have protection, where sponsors have flexibility, where collateral leakage can occur, and where refinancing pressure may force negotiation. In the next credit cycle, the most valuable credit research will not simply calculate leverage; it will explain who controls the downside when stress begins.

Risk Intelligence Replaces Reports

Credit research is becoming continuous borrower surveillance, not periodic financial review

The future of credit research is not more periodic reports; it is continuous risk intelligence. Investors, lenders, PE firms, and investment banking teams need borrower surveillance systems that combine financial data, sector indicators, liquidity trends, covenant monitoring, refinancing calendars, market pricing, and qualitative business-model risk.

The objective is to detect borrower stress before it becomes a default, downgrade, restructuring, or portfolio mark. This is especially important as credit risk becomes more interconnected. Direct lending issuance slowed to \$44.76 billion for the three months ending May 2026, down sharply from Q1, while software-related loans underperformed the broader leveraged loan market.

This shows why credit research must now monitor not just leverage, but also borrower behaviour, investor liquidity, asset-class flows, and sector disruption. In software and technology, AI is turning credit risk into a business-model durability question: recurring revenue is no longer enough if customer retention, pricing power, or product relevance weakens.

The winning credit research model will combine sector intelligence, borrower-level analysis, covenant tracking, and early-warning analytics. The output is not just a credit memo. It is a risk dashboard, watchlist, refinancing heatmap, and decision-ready view of where stress may appear next.

Credit research is entering a surveillance era. Financial statements still matter, but they are no longer enough. The highest-value insight now comes from detecting stress through sectors, liquidity, covenants, refinancing risk, and borrower behavior before credit markets force recognition through defaults, downgrades, or valuation marks.

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