

PIK Away: Are BSL CLOs More Structurally Sound Than BDCs?

PIK (payment-in-kind) loans have gone from a niche feature of subordinated debt to a defining characteristic of the business development companies (BDC) market. PIK refers to debt instruments that defer cash interest payments, instead adding those non-cash deferred payments to the accumulating debt balance, with the expectation that borrowers will repay the full amount at maturity. As PIK balances have grown, investors should be asking a question that too few are: what exactly is keeping PIK in check? In broadly syndicated loan (BSL) CLOs, the answer is clear. In BDCs, it largely isn't. In this month's blog, we explore a key differentiating feature between BDCs and BSL CLOs. PIK is sharply limited in BSL CLOs by the terms of their indentures. By contrast, BDCs are structured freely to (i) allow purchases of PIK debt and (ii) hold high concentrations of PIK assets as compared to materially tighter constraints in BSL CLOs. Before we dive into the differences, let's dive further into what is meant by "PIK" and why it can be considered concerning. PIK is a financing arrangement in which, rather than paying interest in cash, a borrower rolls that interest into its outstanding debt balance – effectively borrowing the interest from itself and increasing its outstanding debt balance owed. PIK loans, therefore, are loans with this highly borrower-friendly feature. We believe PIK is particularly concerning as it can be an early sign of stress for borrowers who are unable to meet their cash interest obligations¹ and, as discussed below, puts BDC investors more at risk.

The BDC PIK Problem, By the Numbers

According to J.P. Morgan's April 2026 BDC PIK report, PIK loans across the 30 BDCs they track totaled approximately \$46.9 billion in 4Q 2025, representing 15.36% of the portfolios – a figure they expect to climb further as elevated short-term rates and sluggish deal activity continue to pressure borrowers. More concerning is the quality of what's inside. Loans marked below 90 cents on the dollar (what we might call "bad PIK") stood at 1.99% in 4Q 2025, up from 1.52% in 1Q 2025 and, when combined with non-accruals, totaled about 4.05%.² We believe this number deserves attention, and may worsen given Q1 2026 valuation pressure, particularly in software (see our February Clarion Credit Snaps "Attack of the Bots" for more on the AI Software scare). Cash-to-PIK conversions can also function as shadow defaults — situations where lenders grant PIK relief to borrowers who would otherwise be in breach of their payment obligations.³ Some market participants believe that if these amendments are treated as stress events, the implied shadow default rate could be closer to 6%, well above the ~2% headline figure⁴, and public BDCs, perhaps not

¹ S&P Global Ratings, "BDC Assets Show The Prevalence Of Payments-In-Kind Within Private Credit", as of December 12, 2024.

² J.P. Morgan Research, "BDCs: PIKing into PIK", as of April 14, 2026.

³ Octus, "Shadow Defaults, 'Bad PIK' Signal Cracks in Private Credit", as of February 20, 2026.

⁴ TCW Private Credit, "The Big PIK-ture", as of August 18, 2025.

surprisingly, are now trading at the largest discount to book value since the post-COVID recovery — a sign that investors are demanding a higher risk premium for exactly this kind of exposure.⁵

Why BDCs are Structurally Prone to PIK Accumulation

The growth in PIK reflects how BDCs are structurally set up. Lending to middle-market and private credit borrowers with several financing alternatives gives those borrowers negotiating leverage, and fierce competition among direct lenders has normalized PIK as a feature of standard unitranche deals.⁶ The result is an industry where PIK allocations are approaching 15% of portfolios with no mandated ceiling. This creates a meaningful liquidity problem as BDCs must distribute at least 90% of taxable income to shareholders. When PIK income exceeds roughly 10% of total income, a mismatch emerges between cash received and cash that must be paid out as dividends.⁷ To bridge that gap, BDCs have the option to issue new equity (potentially dilutive) or take on more leverage⁸ — neither of which we believe is a clean solution.

BSL CLOs: Where Structural Discipline Lives

BSL CLOs handle PIK very differently. We've seen standard indentures permit a PIK limit of up to 5% - a basket small enough to ensure the CLO portfolio continues generating the cash required to pay its liabilities. Moreover, deferring or PIK obligations are ineligible collateral — a manager simply cannot purchase a loan that is already fully deferring interest.⁹ And if a loan does carry PIK, it is usually required to have a minimum cash pay component — typically the benchmark interest rate plus a minimum spread.¹⁰ This ensures the loan continues to contribute to the overall interest cash generated from the CLO collateral. This is a strict, document-level prohibition enforced by rating agencies, and not specific to certain CLO managers. Because CLO interest waterfalls depend on the portfolio generating actual cash interest, material PIK exposure could trigger interest coverage (IC) and overcollateralization (OC) test failures, mechanically diverting cashflows from junior tranches to senior noteholders. That self-correcting mechanism provides a structural backstop that doesn't exist in BDCs. The BSL CLO investor base — the dominant buyer of syndicated loans — reinforces this further as they frequently lack the mandate to invest in non-cash-paying instruments, which is another reason why the BSL market has been unwilling to replicate private credit's PIK flexibility even under competitive pressure.¹¹

⁵ PIMCO, "Private Credit's Other Lanes Still Offer Value", as of March 6, 2026.

⁶ White & Case, "Private Credit Leans on PIK Flexibility in Competitive Market", as of June 18, 2025.

⁷ iCapital, "Painting a PIKture", as of February 12, 2025.

⁸ Octus, "BDCs Reliant on Spillover Income to Support Dividends in Declining NII Environment", as of December 9, 2025.

⁹ Barclays, "Broadly Syndicated Loan (BSL) CLO Primer", as of January 22, 2021.

¹⁰ 9fin, "CLOs Take Their PIK", as of January 6, 2025.

¹¹ White & Case, "Private Credit Leans on PIK Flexibility in Competitive Market", as of June 18, 2025.

Beyond PIK specifically, BSL CLOs impose hard limits on CCC-rated assets (typically 7.5% of the portfolio), with OC test haircuts applied once that threshold is exceeded.¹² Issuer concentration limits and industry diversification requirements add further structural guardrails. BDCs have none of these mechanical constraints — exposure levels are governed solely by manager discretion.

The Bottom Line

BSL CLOs have something BDCs lack: strict structural limits on PIK enforced by the indenture, the rating agencies, and the investor base. Deferring obligations in CLOs are substantially constrained. Coverage tests create automatic consequences if cash income deteriorates. Concentration limits prevent sector crowding — particularly topical in software — that has amplified BDC PIK risk. BDCs operate on managerial discretion. But discretion is a weaker protection than structure, particularly in a competitive market where lenders may be more incentivized to accommodate borrowers. The BDC data is starting to show exactly what happens when the market doesn't build in limits.

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¹² Yield Book, "An Introduction to CLOs", as of June 2021.

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