

Tokenization and Private Credit: How Well do Worlds Collide?

I. TOKENIZED DEBT – WHAT IS IT AND WHY DOES IT MATTER NOW

Financial markets are entering a new chapter in how capital moves. Private Credit has emerged as the largest real-world asset (RWA) segment moving on-chain, signaling a structural shift in how credit markets may operate in the future. While traditional debt markets rely on banks and intermediaries to create and trade debt instruments, blockchain technology now enables those same obligations to be fractionalized, tracked, transferred, and settled digitally.

At its core, a blockchain is the infrastructure where these digital transactions take place, while a token is a digital representation of a fraction of a loan or bond. For example, a \$10 million loan could be broken into 100,000 tokens worth \$100 each. Token holders are connected through smart contracts, which automate their entitlement to the loan's cash flows—both interest and principal—without the need for manual reconciliation or intermediaries.

Critical to note, here and throughout the piece, is the presence of contract risk. A contract must be both structurally and technologically sound to be recognized and enforceable in court. Otherwise, claims during bankruptcy may face transfer delays or disputes—similar to those seen in traditional bankruptcy proceedings.

To summarize, tokenized debt is the digital conversion of traditional lending into on-chain assets that can be traded, transferred, or held. The real innovation, however, lies not in the digital wrapper itself, but in how this structure could reshape credit markets. From recovery processes to collateralization, regulatory treatment, liquidity, and transparency—the mechanics that define risk and return in private credit may look very different in a tokenized future.

Now is a critical time to examine these implications. The regulatory conversation around the “retailization” of private credit is accelerating. From U.S. policy discussions on expanding access through retirement accounts (e.g., 401(k)s) to large institutional initiatives from BlackRock, KKR, and Goldman Sachs Asset Management, to name a few, the signals all point in one direction: private credit—and its risks—are on the path toward broader public allocation in the foreseeable future.

MARKET COMMENT

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II. VALUE DRIVERS AND MARKET DISCUSSION

A. Traditional vs. Tokenized Recovery

When an asset is tokenized and moved on-chain, the benefits are clear: efficiency, transparency, and speed. But one thing doesn't change — credit risk. If a borrower defaults, a blockchain won't erase the underlying economic reality. That's important, because too often tokenization is sold as a cure-all, when in fact it's an upgrade to the plumbing, not a rewrite of credit fundamentals.

So the real question is: where does tokenization create value in debt markets? In my view, the most compelling answer lies in how defaults and recovery pathways behave when things go wrong.

Take a traditional bankruptcy. Creditors and borrowers file under Chapter 11 or 7 — let's use Chapter 7 as the example. The process is familiar: bankruptcy court, asset liquidation, repayment of lenders according to the waterfall. Straightforward in theory, but in practice, painfully slow. The gap between filing and repayment is full of delays — legal proceedings, servicing decisions, and administrative costs — leaving investors waiting in uncertainty while recovery value gets chipped away.

This is where a blockchain changes the equation. Smart contracts are immutable — once coded, the rules can't be bent. That matters. It means when a bankruptcy trigger hits, collateral can be frozen immediately and liquidation can begin without waiting for a judge or a trustee (given the appropriate structure and technology, as mentioned above). The waterfall is executed automatically, with proceeds distributed to token holders pro rata. Fewer intermediaries, fewer fees, less value leakage.

The result isn't a world without defaults. It's a world where defaults are faster, cleaner, and less destructive to value.

B. Overcollateralization

Overcollateralization is a long-standing market practice, born out of experience: in credit markets, value doesn't always erode slowly and visibly—it can disappear almost overnight in a downturn. To guard against this, lenders and structured credit vehicles began requiring collateral cushions of 120–130% of the loan amount. This practice reassures investors who, above all, care about one thing: the certainty that their principal and interest will be repaid. An overcollateralized structure acts as that buffer, signaling that value will remain intact even when macroeconomic turbulence rattles the underlying assets.

Tokenization challenges the need for such heavy buffers. Two forces shift the equation: radical transparency and automated enforcement. With smart contracts, all loan terms, covenants, cash flow waterfalls and necessary legal specifications are encoded into the blockchain—visible, immutable, and binding. When default triggers occur, collateral can be frozen and liquidated instantly, with proceeds distributed to token holders based on pre-agreed rules. This significantly reduces and in some cases, eliminates much of the legal wrangling, time delay, and “value leakage” to intermediaries that plague traditional recoveries.

The implication is powerful: if recovery speed and certainty improve, markets may demand less overcollateralization. For borrowers, that translates directly into lower capital costs; for investors, it means the potential for greater efficiency without necessarily sacrificing downside protection.

C. Regulatory Capital Question

This brings us to the question of regulatory capital charges. The decision drivers are well known: probability of default, loss given default, and exposure at default. However, there is a factor that doesn't show up in the formula directly and still weighs heavily on outcomes: the time taken to recover value. In traditional markets, recovery timelines stretch from months to years, not weeks, and in private credit the illiquidity and opacity of transactions push regulators to assume worst case scenario. The result? Higher capital charges in private markets compared to their public counterparts.

Tokenization directly challenges the need for such heavy buffers. How? Because it attacks the friction points head-on: recovery timelines, recovery costs, and illiquidity. Consider the cost of recovery: in every default, the order of claims becomes a legal battle, fees pile up, and the present value of recovery deteriorates as time drags on. With tokenization and proper contract language, smart contracts can automate distribution, lock in terms, and remove layers of intermediaries. This means fewer leaks in value, faster outcomes, and cleaner recoveries.

Add to this the transparency of on-chain reporting and the operational risk reduction from automated execution, and the case for lower capital charges becomes stronger. Regulators may not rewrite the rules overnight, but the trajectory is clear: as more assets move on-chain and the efficiency of tokenized structures proves itself, private debt capital charges could begin to converge toward those applied to rated, traded instruments in public markets.

D. Liquidity & Transparency

To build on the discussion, two themes have consistently surfaced in comparing traditional private credit with its tokenized counterpart: Liquidity and Transparency. Traditional private credit deals are highly bespoke — custom negotiated, structurally complex, and long-dated (often 4–7 years, sometimes longer). While that model offers control and pricing power for GPs and allocators, it imposes opacity and illiquidity on LPs and other investors. These qualities are manageable when yields are strong and defaults are low, but they become pain points when, not if, cycles turn. Illiquidity carries a real cost when an LP wants to exit early, exposures need real-time monitoring, portfolios need rebalancing, or systemic volatility distorts valuations.

Tokenization reframes these challenges through the lens of transparency. The fundamentals of credit risk remain unchanged, but the operational risk of the transaction shifts. Fractionalization and smart contracts build an environment where capital can move with greater efficiency, traceability, and trust. This evolution may compress the traditional illiquidity premium but could just as easily give rise to a transparency premium — where investors pay up for clarity and speed.

III. KEY CONSTRAINTS

Of course, while Private Credit tokenization remains the largest on-chain RWA and continues to grow, there are still key constraints limiting broad adoption. The ones worth watching most closely are:

- 1. Regulatory Adoption** – Clear frameworks are needed before institutions can scale exposure with confidence.
- 2. Legal Enforceability** – Tokenized contracts must hold the same standing in court as traditional agreements.
- 3. Rigidity of Contract Structure** – Automation creates efficiency, but overly rigid terms may limit flexibility in workouts or restructuring.
- 4. Technology Risk** – Smart contracts and custody infrastructure must prove resilient against security breaches and operational failures.
- 5. Interoperability** – Current platforms and chains remain siloed, and seamless interaction has yet to be achieved, limiting liquidity and scale.

Beyond these, the second-order challenge is cultural. Regulation may set the rules, but adoption depends on a mindset shift within the private credit industry itself. Even with all the efficiencies tokenization introduces, without willingness from incumbents to rethink how deals are structured, serviced, and exited, we won't see the critical mass needed to showcase the value.

That shift, however, is already underway. We're seeing digital-native asset managers enter the market, alongside partnerships between established private credit players and fintech innovators. For allocators, the responsibility will be to ensure rigorous measurement and risk management across portfolios—because what can't be measured can't be managed. As tokenized assets grow, that discipline will be critical not only for investor confidence but also for sustaining regulatory support around on-chain adoption.

The question that now remains is less about if tokenization has a role, but what needs to fundamentally change in the infrastructure to scale adoption and accessibility across both allocators and investors.