KEY POINTS
- Private credit (PC) is a subset of, and should not be considered synonymous with, non-bank financial intermediation.
- Many of the concepts discussed in relation to systemic risk (risk of runs, liquidity stress or maturity mismatch) are generally absent in PC.
- There is a question of whether the UK's and EU's regulatory architecture, borne out of the 2008 global financial crisis, is best equipped to regulate PC from a systemic risk perspective.

Spotlight

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Private credit: exploring systemic risk concerns and regulatory architecture

The regulation of private credit (PC) is firmly in the regulatory spotlight, as part of a broader focus on non-bank financial intermediation (NBFI). This Spotlight article explores whether PC features the risks typically associated with NBFI, and whether the regulatory architecture in the UK and EU is appropriate to address any such risks.

WHAT IS NBFI AND HOW DOES PRIVATE CREDIT FIT WITHIN ITS RUBRIC?

Private credit (PC) is often discussed in the same breath as non-bank financial intermediation (NBFI). However, the two concepts are not by any means synonymous. Given that regulatory policy needs to be precise about what risks it seeks to address, it is vital to understand the distinction and overlap between the two terms.

NBFI

At a high-level, NBFI refers to financial activities and institutions that operate outside of the traditional banking system; NBFI is currently estimated to represent about 50% of global financial assets. There are various market participants active in NBFI – investment funds (private equity (PE) funds, hedge funds, venture capital funds, etc), pension institutions, (re)insurance companies, money market funds, cryptoasset firms, and others. NBFI is arguably a more appropriate and neutral term compared to its predecessor, "shadow banking", as a means of describing such activity. Confusingly, the term NBFI is sometimes used by policymakers and regulators to refer not only to non-bank financial *intermediation*, but also non-bank financial *institutions*, highlighting the inchoate nature of this discussion.

PC

PC is a subset of NBFI and refers to direct lending activities (mostly by PE and hedge funds) typically to small and medium sized businesses that are sub-investment grade. That said, in recent times PC lending has also expanded to large corporate borrowers, who may prefer PC to the syndicated loan market or bond markets because of the private and customised nature of PC.

As with NBFI, there is no one legal definition of PC, and so it will be important to monitor how policymakers and regulators seek to define the sector over time.

WHY HAS PRIVATE CREDIT GROWN?

PC has grown exponentially since the 2007-2008 Global Financial Crisis (GFC). According to the Bank of England (BoE) Financial Stability Report (December 2023), PC grew from around $0.5trn of outstanding market-based corporate debt globally in 2015 to $1.8trn in 2023. That said, PC is still small relative to outstanding investment grade bonds ($32trn), leveraged loans ($4.6trn) and high-yield bonds ($3.4trn). Whilst PC has grown globally, there are disparities in its role in financing in different economies. For example, in the US 70%+ of financing comes from the non-bank sector (including public bond markets and PC), whereas in Europe the inverse is true, with 70%+ of financing coming from bank lending.

There are two main reasons for the growth of PC over the past 10-15 years. First, following the GFC, banks considerably scaled back lending due to weakened balance sheets. At the same time, higher capital requirements imposed in the aftermath of the GFC (the aggregate common equity Tier 1 capital ratio of major UK banks rose from 4% at end-2007 to 14.6% at the end of 2022) meant banks were disincentivised to lend, particularly to the sub-investment grade sector. As a result, PC saw the opportunity to step in and lend to businesses that could not, or would not, obtain bank financing.

Secondly, over a decade of near zero interest rates (from 2009 to 2022) meant that returns on government and corporate bonds were unattractive to institutional investors. Such investors, seeking more yield, turned to alternative investment products, including PC funds (PCFs).

More generally, there is a tendency for private companies to look to PC for financing, rather than the public bond markets. For example, portfolio companies owned by PE funds have tended to look to the PC market to finance deals as a result of the certainty of financing and flexibility, with the added benefit of not having to bear the costs and make disclosures associated with syndicated loans or public markets generally. Large companies are also attracted to PC for some of these same reasons.

WHAT ARE THE CONCERNS OF POLICYMAKERS?

Concerns regarding financial stability and systemic risk have traditionally focussed on areas such as leverage, liquidity and maturity transformation (with associated risk management and asset fire sale concerns), and the linkages of firms with other parts of the financial system including concentration risk.

The GFC featured elements of all of the above concerns, particularly in relation to exposures of banks, since banks typically operate with high leverage. Bank runs are also the product of a maturity mismatch between assets and liabilities; however, PCFs do not typically feature significant amounts of leverage. In addition, PCFs are typically closed-ended, with seven-to-ten-year lock-up periods – there is no maturity or liquidity mismatch and thus no risk of a run on PCFs, unlike with banks and their depositors.

That said, policymakers are considering whether liquidity stress in PCFs could arise, particularly as fund structures evolve. For example, some PCFs now feature semi-liquid evergreen structures – these are hybrid fund structures with no fixed end date, that offer investors liquidity via fund subscriptions and redemptions. However, evergreen PCFs still typically feature lock-up periods (say, three years) to match the approximate maturity of the relevant underlying loans. Policymakers will be looking at liquidity profiles closely as fund structures evolve further, including into open-ended fund structures.

Some changes have already been introduced, with a view to addressing some of the above issues. In the EU, the Alternative Investment Fund Managers Directive has been significantly amended as "AIFMD2" – amongst other things, AIFMD2 recognises loan origination as a core activity of alternative investment fund managers (AIFMs), but introduces leverage limits for loan origination (175% for open-ended funds and 300% for closed-ended funds), as well as requiring that loan originating funds be closed-ended unless the AIFM can demonstrate that the fund's liquidity risk management system is compatible with its investment strategy and redemption policy. Indeed, Recital (13) of the AIFMD2 text notes that "…it is necessary to address the potential micro-prudential and macro-prudential risks that loan origination by AIFs could pose and spread to the broader financial system".

Policymakers are also concerned with the increased interconnectedness between PC and the traditional banking sector. PCFs and banks are increasingly entering into partnerships – PCFs are able to access the banks' origination capabilities particularly in specialty finance, while the banks are able to stay close to the sector as they develop their own private credit arms, providing fund financing and product distribution, as well as arranging collateralised loan obligation transactions. Separately, PCFs are often interconnected with PE funds, since many managers of PCFs also manage PE funds; banks have significant exposures to PE funds through financing of PE funds' portfolio companies (and PCFs are themselves lenders to such portfolio companies). Finally, policymakers are interested in the interconnectedness of PC with the insurance sector (which itself has a role in the NBFI sector), given that some large PCF complexes include (re)insurance companies that provide some of the capital for such PCFs to then make loans.

Furthermore, PCFs and private companies receiving such financing are not subject to public disclosure; as a result, policymakers are concerned that there could be regulatory gaps. Price discovery is lacking, and so it is difficult for regulators to assess the potential impact of significant losses of PC lenders, borrowers and investors to the rest of the financial system.

In May 2023, the US Federal Reserve published its view that "financial stability vulnerabilities posed by private credit funds appear limited", based on information gleaned from Form PF, the confidential reporting form for certain US Securities and Exchange Commission (SEC) registered investment advisers to private funds. However, in February 2024, the SEC adopted amendments to Form PF, requiring more detailed information, including in order to facilitate the Financial Stability Oversight Council's (FSOC) monitoring of systemic risk in the private fund industry. In the EU, AIFMD2 has also increased the amount of detail required under Annex IV (which is similar to the SEC's Form PF as a systemic risk reporting tool).

IS THE CURRENT UK/EU REGULATORY ARCHITECTURE WELL-EQUIPPED TO REGULATE PC?

The current financial services regulatory framework in the UK and EU has been designed around making banks safer, and was borne out of the GFC. However, policymakers are now having to contend with the fact that the NBFI sector controls twice the amount of assets of the banking sector. In the UK, more than half the total stock of corporate debt today is in the form of non-bank loans or debt securities (BoE, Bayes CRE Lending Report).

The question therefore is whether the current regulatory architecture is well-suited to address systemic risks posed by NBFI and thus PC, if any.

UK

Prior to the GFC, the UK Financial Services Authority (FSA) was the single regulator for all financial services business in the UK, irrespective of type and size, and from both prudential and conduct perspectives – this is referred to as a "unified" or "integrated" model of regulation. The FSA was established under the Financial Services and Markets Act 2000 (FSMA) itself as a reaction to the highly complex system of self-regulatory organisations that existed at the time; it brought together predecessor organisations including the Securities and Futures Authority, the Investment Management Regulatory Organisation and the Pensions Investment Authority, together with the Banking Supervision division of the BoE.

After the GFC, the UK government shifted the regulatory system to a "twin peaks" model, under which the Prudential Regulation Authority (PRA) (a subsidiary of the BoE) is responsible for prudential supervision for banks, insurance companies and systemically important investment firms, while the Financial Conduct Authority (FCA) is responsible for market supervision, conduct supervision, as well as the prudential supervision of firms not supervised by the PRA. The Financial Policy Committee, within the BoE, acts as the UK's macroprudential authority; it is tasked with ensuring that emerging risks and vulnerabilities across the financial system are identified, monitored and effectively addressed. The twin peaks model has also been adopted in Australia, the Netherlands, Ireland, and Belgium, to name a few.

PCF sponsors (being private fund managers) are exclusively regulated by the FCA rather than the PRA. As noted above, the FCA is responsible for the prudential supervision of firms not supervised by the PRA – in this regard, the FCA supervises regulatory capital and remuneration requirements for UK AIFMs under the UK's implementation of the AIFMD (UK AIFMD), and for UK investment firms under the Investment Firms Prudential Regime (IFPR). However, the FCA's prudential role under the UK AIFMD and IFPR relates to customer protection; that is, ensuring that investment firms are appropriately capitalised in order to carry on business for their customers. The FCA does not have responsibility for monitoring or managing systemic risk.

In June 2023, the BoE launched its system-wide exploratory scenario (SWES), which is expected to conclude in Q4 2024. The SWES aims to improve the BoE's understanding of the behaviours of banks and NBFI entities during stressed financial market conditions.

Should the BoE or PRA determine that PC represents a threat to financial stability and that

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PCF sponsors be subject to new regulation, there is no mechanism for them to impose new rules directly on such sponsors since they do not have supervisory authority over such sponsors (the PRA can of course impose conditions on banks and insurance companies in their interactions with PCFs). Instead, the FCA would need independently to consider the risks posed, and how to address such risks in a manner consistent with its statutory objectives and perimeter under the FSMA.

The above is not to suggest that a shift back to the unified system under a single regulator (like the former FSA) would necessarily be better in terms of dealing with the supposed risks of PC. Indeed, the FSA itself was seen to be lacking as a regulator; it was accused of focussing on conduct of business issues at the expense of prudential oversight. In the aftermath of the GFC, the House of Commons Commission concluded that "the FSA was not so much the dog that did not bark as a dog barking up the wrong tree". However, co-ordination between the BoE/PRA and the FCA would be paramount if the regulation of PC risks is to be managed effectively.

EU

In the EU, there are two layers of regulation applicable to financial institutions – those regulations that apply to financial institutions across all 27 EU member states, and those that apply only to Eurozone banks.

Each member state has one or more national regulators (some operate a unified model while others operate a twin peaks model like the UK). At a pan-EU level, the European Supervisory Authorities (ESAs) (comprising the European Banking Authority, European Securities and Markets Authority, and European Insurance and Occupational Pensions Authority) work primarily on providing guidelines and harmonising financial supervision in the EU by developing the "single rulebook" for regulation. Separately, the European Systemic Risk Board (ESRB) is responsible for macro-prudential supervision of the financial system in the EU. Although not part of the European Central Bank (ECB), the ESRB works closely with the ECB; indeed, the President of the ECB is also the Chair of the ESRB and the ESRB is based at the ECB's offices.

The ECB has carried out work examining the key linkages between banks and the NBFI sector, and has proposed measures (in its Financial Stability Review) for NBFI market participants in relation to leverage and margin for liquidity management. However, the ECB only directly regulates Eurozone banks, and not NBFI market participants (whether in the Eurozone or elsewhere). The ECB can thus influence the activities of banks that are exposed to PC, but not PC firms themselves (unless they are owned by Eurozone banks).

The ESRB and ESAs do not supervise individual financial institutions (that is the purview of the national member state regulators). It is up to the European Commission to propose EU legislation to address any regulatory gaps. To that end, the European Commission published in May 2024 its macroprudential review for credit institutions and the systemic risk relating to NBFIs. And, as noted above, steps to regulate leverage in PCFs have also been taken under the new AIFMD2 loan origination rules.

COMPARISON WITH THE US

The US regulatory system is highly complex, but in relation to PCF advisers, the primary regulator would be the SEC. The SEC is fundamentally a conduct regulator, and not a prudential regulator – indeed, unlike the UK FCA which imposes regulatory capital requirements on fund managers, the SEC does not impose any net capital requirements on investment advisers.

However, unlike the UK and EU, the US appears to have a system that can result in the direct supervision of PC firms from a systemic risk perspective.

Established in 2010 under the Dodd-Frank Wall Street Reform and Consumer Protection Act, FSOC is charged with identifying risks to the financial stability of the US; promoting market discipline; and responding to emerging threats to the stability of the US financial system.

One of FSOC's key powers is to designate systemically important institutions, resulting in such entities being subject to supervision by the Federal Reserve (the central bank of the US) (the Fed). In April 2023, FSOC voted unanimously to adopt a new framework for designating NBFIs under the Fed's supervision.

So in the US, at least, there is a framework where individual PC firms (and their consolidated groups) can be directly supervised by a central systemic risk regulator, in a way that does not quite exist in the UK and EU. That said, the FSOC framework was established as a result of the GFC, with a focus on "too big to fail" institutions. Given PC amounts to only 7% of corporate debt in the US, it will be interesting to see which, if any, PC firms are considered, under the new designation framework, to be systemically relevant. It will also be interesting to see how the Fed, which is a banking supervisor, might approach the question of how to regulate PC – will it seek to impose bank-like capital requirements on the PC sector? As argued above, PC does not pose the same risks as banks; it is institutional investors' money at risk and runs do not occur on PCFs.

CONCLUSION

As the PC sector continues to grow, policymakers rightfully should seek to get a clear understanding of the potential risks that might arise from, for example, the failure of a large PC firm or broad failure of borrowers to repay PC lenders. However, proportionate and precise action needs to be taken in response to careful analysis of emerging risk, without choking markets that provide an important source of alternative funding. Apart from the bodies mentioned above, it will be important for international bodies including the Financial Stability Board and the International Organisation of Securities Commissions to work together to review the data and develop globally consistent NBFI policy outcomes. ■

Further Reading:

- Private credit continuation funds: a developing frontier for secondary transactions? (2023) 11 JIBFL 745.
- The growing emergence of competitive tension in the liquidity market (2022) 11 JIBFL 729.
- Lexis+® UK: Journals: JIBFL: LMA Defaulting Lender provisions in today's growing non-bank loan market.