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EU regulates private credit funds: a step too far, or in the right direction?

Gaia Freydefont February 29, 2024 11:04 PM

Some fear over-regulation, others welcome level playing field

Private credit specialists are debating the likely impact of the first set of regulations that will govern this new market in the European Union. Some fear regulatory over-reach, while others believe the rules are proportionate, even positive.

The European Council and Parliament this month approved the final text for amendments to the EU Alternative Investment Fund Managers Directive II (AIFMD II). Among other things, it will impose limitations on private credit funds' use of leverage and seek to create a level playing field for credit fund regulation across Europe.

After political agreement was reached in November, AIFMD II is expected to enter into force by the second quarter of 2026. Over the next two years further legislation will clarify its implementation, prompting more discussion.

“This regulation has gone a bit too far,” said Aymen Mahmoud, co-head of the London finance, restructuring and special situations group at US law firm McDermott Will & Emery.

“Some credit and private equity funds these days have a listed aspect, which is allowing retail money to access this market," Mahmoud added. "Those businesses are no more risky than any other listed business, which is not subject to the regulation. We are not comparing like-for-like with 2008 where consumer deposits and private equity or direct lending money is coming out of the same pot.”

Others argue direct lenders have little to worry about, because they tend not to use leverage substantially.

“Actually, on balance, credit funds would probably see the proposals as a positive. in terms of the EU playing field,” said Simon Crown, financial regulation partner at Clifford Chance in London.

‘Ceiling for very tall people’

The directive caps the leverage private credit funds can apply. But most are not “structurally leveraged and [they] are almost all closed-ended”, said Steven Haywood, investment funds counsel at McDermott Will & Emery in London. He predicted “business as usual”, with no material change resulting from the rules.

“Is this actually going to be a problem? My understanding is that no, these are ceilings for very tall people,” echoed Crown. “Most [funds] are going to be fine in terms of the amount of leverage they deploy. I think it has carved out a space, but people are playing well within it already.”

At the end of 2022, the average leverage applied by hedge funds was 160%, according to another private credit fund lawyer, and for other alternative investment funds, including private credit, it was 110%.

The directive imposes a 175% cap where funds are open-ended, or 300% where they are closed-ended. In other words, most private credit funds are already playing within the rules.

The lack of an obvious need for the regulation is therefore causing confusion.

“Part of the difficulty in understanding where this is coming from is that most funds are not multiplying up what they are lending out, they’re just lending out what they’ve taken in from their own investors,” said Haywood.

Sophisticated players

Market participants also argue private credit funds and their investors are grown-ups who can look after themselves.

“[Private credit funds] are ultimately solidly backed in terms of funding,” said Haywood. "Essentially, private credit is not a CLO business, the asset class is different. It is increasingly mature in its risk assessment of borrowers."

The argument is that the managers of these funds have a very strong incentive to choose creditworthy investments. Ultimately, the manager's job is to return the principal to investors in the fund, ideally with a return.

“There is an inbuilt ability to make very safe judgements about what's going on,” said Haywood. “These are very sophisticated investors, investing in very sophisticated products, [and] everyone should and does understand the risks associated with them.”

It is not clear that the risks to consider in private credit are unique to this sector. On the contrary, some consider the asset class less risky than others, according to Haywood.

“In fact, it couldn’t cause a problem in the financial system, unless there was some huge macro event in any case, which meant that all of these investments went bad,” Haywood added. “It’s difficult to see how it poses a risk, beyond a risk that already exists in other asset classes, such as private equity, and in many ways, this is less risky.”

The market is not experiencing problems at the moment, and although many have long warned that a credit downturn was on the horizon, there had not been enough evidence to justify new rules, said Mahmoud: “We haven't really seen the wave of credit fund restructurings that so many predicted, suggesting that the underwriting quality from these credit funds is actually better than expected.”

Great power, great responsibility

Other market participants believe that while some of the rules may be unnecessary now, they may not be if the sector keeps growing at its current pace.

“I think it is pre-emptive,” said Crown. “It's not saying 'there is a market problem, and this is how we need to fix it'. It's saying 'we want to open up the market to these guys a bit and it is prudent to put some controls in place so that they don't morph into the sorts of problems which we've seen elsewhere.'”

The number of private credit funds has “exploded over the past 10-12 years”, turning this into a mainstream asset class, said Haywood.

“Funds are now seen as a significant financing provider for the real economy, next to public bodies and banks, and financing through private credit funds has materially increased over the past decade,” said Arnaud Cagi-Nicolau, global private equity and investment funds partner at White & Case in Luxembourg.

Market participants have warned for years that private credit and direct lending have never been through a credit crunch, and a shake-out could be expected, when they did.

“When someone is looking at [private credit] through a risk lens, they will say, ‘We've got a very new asset class and it's kind of exploded', but where is the risk exposure? Where are the risks to the financial system in this?” said Haywood.

The risk to the financial system is the *potential* for a credit downturn on the scale of the 2008 financial crisis, market participants argue.

“The problem is [there is] a long history of there being economic problems where you have uncontrolled provision of credit,” said Crown**.**

Direct lending has created a new source of credit which has grown spectacularly. In any such situation, bitter memories of the past return.

“What they're saying here is: ‘asset managers, you can play more in this space, but we know from bitter experience how this can go wrong, and therefore, some of those controls that banks have got used to, such as concentration risk limits and skin in the game rules, are going to apply to you too'," said Crown.

No one likes anything to become very powerful, very quickly, either.

“In some jurisdictions, the banking lobby will not be massively keen on credit funds having a broader role to play,” said Crown. “And therefore, putting these controls in place was one of the ways of getting them comfortable.”

As any financial instrument is more widely adopted, the impact it can have if it comes crashing down grows, and the regulator is being prudent about that.

EU harmonisation

One of the most market-friendly aspects of the new directive is creating an EU-wide regulatory environment for private credit funds to operate across the bloc, removing friction for private credit.

“The regulatory framework for private credit funds in Europe has been fragmented until now, with some countries authorising loan origination activities and others prohibiting, mainly based on national banking monopoly rules,” said Cagi-Nicolau.

A troublesome French law, for example, says that only banks can lend.

"As long as you comply with the controls in [the directive] — the concentration risk limit, the leverage limits, the skin in the game requirements — then you're going to have a much broader and level playing field," added Crown.

"The new rules take advantage of the AIFMD review, and AIFMD II will offer great opportunities for credit fund managers operating in Europe by creating a harmonised framework that allows alternative investment funds to extend loans, providing legal certainty and creating a level playing field for loan origination activities," said Cagi-Nicolau.

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