



EU stamps authority on private credit

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LONDON, Mar 5 (LPC) - European regulators are finally taking a tighter grip on the lightly regulated private debt market, putting in place a major set of rules to minimise systemic risks posed by the fast-growing asset class.

One of the key focuses under the new rules outlined by the Council of the EU last month was leverage restrictions.

The amount of money that credit funds can borrow will be capped, with the ceiling for a closed-end fund set at 300% of net asset value. It will tighten to 175% for an open-ended fund with a redemption mechanism which can be accessed by retail investors.

In addition, regulators will restrict the sale of an entire loan position, despite most credit funds currently holding loans on their books until maturity.

Under the new rules, credit funds are required to retain a minimum 5% of a loan's notional value for up to eight years or until the loan's maturity. The idea is to avert moral hazard and maintain the general credit quality of loans originated by credit funds.

"If there is a deterioration in the risk associated with the loan, as prudent risk management, you can still sell the loan," said Yannick Arbaut, a Luxembourg-based partner at Allen & Overy.

"The new rule here is the legislators want to make sure that you don't have actors that originate loans, don't care about the credit quality and then sell them off."

Other measures address risk diversification, such as the requirement that the value of a loan to a single borrower cannot exceed one-fifth of a fund's capital.

The new rules highlight that the private credit market, which is opaque and illiquid in nature, is attracting regulators' attention following a boom in recent years.

The asset class in Europe, including the UK, grew at an aggressive 21% compound average growth rate over the past decade to US\$460bn assets under management as of June 2023, according to a recent Moody's report. That exceeds a 14% growth rate in the US.

Credit funds have also expanded their offerings, from writing direct loans to companies for their private equity buyouts to funding day-to-day operations for investment-grade companies.

"The private credit funds market has grown hugely and therefore it's appropriate for the regulators and lawmakers to consider whether the regulations should be adapted accordingly," said Rahul Manvatkar, investment funds partner in London at Linklaters.

"If the funds are over levered, then that has the potential to increase systemic risk."

Such concerns have not only been raised by the EU regulators, but also in the UK. Late last year, the Bank of England warned that private credit and leveraged lending could face a sharp revaluation due to a worsening macroeconomic outlook.

"The European legislators want to avoid what they call systemic risk if borrowers become unable to repay these loans," said Adrien Timmermans, investment funds' counsel at Linklaters, Luxembourg. "And that could lead to a domino effect resulting in a much broader impact for the financial market as a whole."

Softer version

Credit analysts say the leverage cap is unlikely to have a material impact on the market given the majority of funds have utilised leverage to a limited extent.

"We do not expect the rules will hinder the growth of the direct lending market, especially considering the fact that the sizable portion of the market is either unlevered or leverage sitting below the proposed leverage caps," said Alexandra Aspioti, senior analyst, financial institutions group at Moody's Investors Service.

Lawyers echoed the view and suggested the rules are softer than market players might have feared.

"There was an initial discussion at one point that a credit fund needs to be structured as closed-end and it can't be open-ended. But that has been softened now," Arbaut said.

"The principle is credit funds should still be closed-end, but they can be open-ended if you can demonstrate you have proper liquidity risk management systems and a redemption policy in place. I think the burden of proof is higher now for evidence to show to your regulator that it's appropriate for your fund strategy to be open-ended."

The new rules are expected to be published in the EU Official Journal in the next few months, and once published, EU member states will have 24-month to implement them into national laws.

Despite expectations of only a mild impact, some hope regulators are careful not to become overzealous.

“The reality is that all funds have a direct responsibility to their LPs (limited partners). And if it gets something wrong which it shouldn’t have, the LPs can choose not to invest again,” said Aymen Mahmoud, co-head of the London finance, restructuring and special situations group at McDermott Will & Emery.

“A natural responsibility lies [there].”