Regulators look out for trouble

  

Guest comment by **Aymen Mahmoud**, **Riley Orloff** and **Matthias Weissinger**

In both the US and Europe, regulators are taking a keen interest in private debt. But do they have a distorted view of the asset class's risks?

It's no secret that direct lending markets are growing at a remarkable pace. As investment managers look to provide their investors with stable risk-adjusted returns, the flight of capital to private credit has taken it to upwards of $2 trillion and the product offering has evolved into the most sophisticated general lending product in the leveraged finance markets.

Coupled with the contraction of balance sheet bank lending and the associated complexities that have impacted the broadly syndicated market post-global financial crisis, the lending markets had a hole that private credit has filled perfectly. Even the 'GFC' vernacular has become commonplace when describing the economic consequences of 2007 and 2008 and the oft-cited 'credit crunch' terminology is now largely forgotten.

But the improper use of credit was a significant cause of the GFC, and the absence of credit is possibly the most far-reaching consequence. Credit became the poster child for regulation when things turned sour – and rightly so. People didn't understand what the banks were doing. Obfuscation around collateralised debt obligations and collateralised loan obligations was so rife that films like *The Big Short* were able to caricature the events leading to the GFC so that the average person with no links to the markets could understand them.

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Disbelief at how 'bad actors' were acting without proper regulation may be found in that film: "I'm going to find moral redemption at the roulette table." And so to private credit. History's lesson appears to be that where a lot of profit has been generated and where a lot of money is deployed, regulators will need to step in to avoid repeating the GFC's impact. But are the two situations alike, or are regulators looking for trouble in the wrong place? Are they better served applying their regulatory oversight elsewhere?

What is driving regulation?

As we entered 2024, we saw increased chatter around the regulation of private credit (and private equity), propelled either by the meteoric growth of these sectors or by their relative slowdown since 2021. What have regulators been focused on? Is their focus global or more localised/supranational and is there risk of imbalance? And why now?

Are there systemic issues facing the global economy that are underwritten by private credit or private equity that we weren't aware of? Are the general public and retail investors as exposed to private credit and private equity markets as they were to the bank lending industry in the GFC? If the answers to

at least some of these questions are not singularly compelling, then it seems the case for regulation in what is largely an egalitarian economy is predicated on a fear of market disorder caused by the destabilisation of an extremely private enterprise.

The current proposed regulations are best split into two. In the US, you have non-depository financial institution regulations (the US proposals). In Europe, there is the Alternative Investment Fund Managers Directive (the EU proposals).

The US proposals note that loans to non-depository financial institutions (ie, lenders to private lenders) have risen from $56 billion in 2010 to $786 billion in 2023. Their focus is on asset managers with upwards of $10 billion of total assets, and the output of the US proposals centres around reporting.

Institutions above the threshold are required to undertake reporting covering items, such as loans to credit funds, loans to private equity and reporting around unused commitments. These reporting requirements don't create regulatory requirements in themselves. Instead, they help regulators intervene where they believe reported indices suggest problematic or unsafe conduct.

The EU proposals also focus on the leverage taken on by lenders rather than on how much lending there is to a particular business, arguably because this granularity would be too broad-brush. However, aren't the underlying assets of any asset manager the appropriate metric of their financial health, just as the underlying financial health of an individual enterprise is determined by its assets and liabilities? The EU proposals aim to cap leverage at closed-end loan origination alternative investment funds (ie, credit funds) at 300 percent of their net asset value, with open-end funds capped at 175 percent.

Unhelpful commentary

Commentary from stakeholders supporting the EU proposals (the same who saw no problem with AAA ratings of subprime mortgages for extended periods) is raising concerns the sector poses a risk to financial stability because of vulnerability to macroeconomic shifts. This is the same industry that provided liquidity following the GFC and the advent of the leverage lending guidelines, which created a lending vacuum due to vulnerability to macroeconomic shifts.

Many remember the leveraged lending guidelines imposed in 2013, which discouraged exposure lending at certain leverage levels. While they didn't hold legal force, investment banks were careful not to fall outside of the guidance. Those rules drove borrowers to the wider capital markets rather than to more institutional relationship lending. Companies were largely at the whim of the emotions of those markets, unable to transact during periods of macroeconomic uncertainty, despite their own solid business fundamentals.

The absence of 'willing' lenders was joined by the absence of 'able' lenders. Able, that is, to explain to public shareholders the acts of defiance from US regulators. That very regulation helped the private credit industry accelerate its growth spurt, but also helped many companies and drove a significant number of economies where the credit underwriting decision was made analytically and not in a regulatory vacuum. Without those private credit funds, economic growth, job losses and innovation may have slowed for a decade or longer.

The leveraged lending guidelines were rendered defunct under the Trump administration and have not resurfaced in form or substance before the US proposals. It may well be that history is indeed the right teacher for credit markets, but the lesson is perhaps not the under-regulation leading to the GFC. Perhaps it's the 'one size fits all' approach to regulation that we ought to be wary of, in case it slows progress at a time when it's needed. ■

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