Skadden | The Capital Ratio

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Bank of England Highlights Concerns With Private Equity Financing

The Bank of England's Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) recently delivered a series of speeches[1] raising their concerns about the evolution of private equity financing and the banking sector's exposure to the private equity industry. On 23 April, the PRA released a Dear Chief Risk Officer letter outlining the findings of the PRA's thematic review into private equity financing activities (the CRO Letter and, together with the FPC Speech and the PRA Speech, the Publications).

The Publications are part of increasingly broad scrutiny by the UK financial services regulators of private equity firms. The Financial Conduct Authority (FCA) is also currently reviewing the valuation of assets in private markets, which will focus on governance procedures and discipline over valuations. The review's results are expected later this year. However, the FCA has not yet announced further rules for private credit firms. By contrast, we note that the EU's AIFMD II will introduce new rules specifically for private credit firms, as discussed in our prior Skadden publication.

In this edition, we will examine the key points in the Publications and next steps required for banks.

Market trends in the private equity industry

In discussing the PRA's concerns, the Publications described the growth in the private equity industry occurring over the last decade and, as a result, the changes in the financing of the industry. Assets under management (AUM) within the private equity sector have grown from $2 trillion to $8 trillion in that time, fuelled by a period of low interest rates. The banking sector's exposure to private equity also has grown significantly.

In previous years, funds usually were not leveraged at the fund level, with banks providing "downstream" financing through the capital markets for syndicated leveraged loans and high-yield bonds issued by the fund's portfolio companies. In recent years there has been a growth in "upstream" (investors and fund managers) and "midstream" (funds that own portfolio companies) lending. Upstream and midstream lending often involves complex structures such as "Net Asset Value loans" (NAV loans) that are collateralised by specific fund investments and the secured financing of portfolios of limited partner (LP) interests in private equity funds. As a result of this growth, the PRA has stated that private equity funds are now highly leveraged vehicles.

The change in approach to private equity financing has been partly because of investors seeking alternative ways of generating returns from private assets as — from a relative perspective — public equity capital markets remain historically weak for both primary and secondary offerings worldwide. The increased desire from LPs to sell their fund interests in secondary markets has seen the formation of "secondary" funds to purchase

[1] On 22 April, Nathanaël Benjamin of the Bank of England's FPC delivered a speech to Bloomberg where he discussed the growth of private equity, its contribution to market-based finance and the concerns that the FPC had with such contributions (the FPC Speech).

On 23 April, Rebecca Jackson from the PRA delivered a speech at UK Finance focusing on the PRA's concerns regarding the adequacy of banks' risk management processes regarding private equity financing (the PRA Speech)

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these interests, which often require leverage to meet targets. "Continuation" funds — which are set up by a sponsor to purchase, and then potentially restructure and spin off, assets from another fund that the sponsor manages — have also grown in popularity as an alternative exit strategy. Investors in continuation funds have increasingly sought leverage against their capital commitments.

Additionally, there has been a significant increase in the use of private credit funds as an alternative source of lending for the private equity sector. The PRA estimates that private credit markets have expanded to a total AUM of $1.7 trillion. These private credit funds raise financing from banks before competing directly with them to offer a diverse range of leverage options, particularly to portfolio companies. Sponsors, seeking to capitalise on this growth, are establishing their own private credit funds that lend to the portfolio companies of other sponsors or — subject to the clearing of conflicts of interest — to companies they want to add to their own portfolio.

Review of bank exposures to private equity financing

The emergence of more complex financing arrangements and private credit funds has increased the banking sector's exposure to private equity not just in terms of scale, but also in complexity and interconnectedness of such exposures. This increase in exposure prompted the PRA to carry out a thematic review to assess the adequacy of banks' risk management processes. The review focuses on the independent credit and counterparty risk management (CCRM) processes as they apply to private equity financing and hedging activities.

Identification of exposure to private equity sector

The PRA found that numerous banks were unable to identify and systemically measure their combined credit and counterparty exposures linked to the private equity sector within their overall risk data due to private equity-linked exposures occurring across separate business lines. As client relationships are held by separate business units, consequently this means that credit and CCRM functions are aligned to product lines or organised by industry sectors, counterparty types or underlying collateral class. While this enables business and risk management expertise per specialism, this siloed approach means that there is no overarching risk management framework that can assess exposures to the private equity sector holistically. Even where banks have identified their overall private equity-linked credit exposure, such data often did not measure combined private equity credit and counterparty risks directly and indirectly linked to individual financial sponsors.

The PRA expects banks to systematically flag all transaction and exposure data, as well as relevant collateral pledges relating to the private equity sector in their trade capture and risk management systems. Such data aggregation must enable banks to monitor their exposure to the private equity sector as a whole, as well as exposures linked to individual financial sponsors and private equity funds.

Review of linked credit exposures

Further, the PRA found that most banks did not have independent credit and CCRM procedures to identify, measure, combine and record risks comprehensively arising from overlapping financial claims, liens and security interests over direct or indirect linkages to the same underlying private equity fund or portfolio company obligor. One example in the report cites a bank that has a derivatives receivable from a portfolio company, but also provides NAV loans to the private equity fund that owns the portfolio company.

The PRA expects banks to establish credit due diligence procedures and a management information process to recognise and measure overlapping and linked credit exposures (*e.g.*, when multiple portfolio companies are under financial stress).

Stress testing

The PRA found that only a few firms had created stress testing frameworks, which would enable a holistic view to calculating groupwide losses for private equity-linked exposures on a routine basis. The stress tests' results were aggregated and did not allocate stress loss outcomes to specific financial sponsors. The PRA believes comprehensive and combined stress testing is required to enable banks to manage their credit and counterparty risk effectively.

The PRA expects banks to evaluate the potential for default and loss correlations to the private equity sector in periods of stress that were higher than previously observed. Such stress tests should apply to all types of exposures, both to individual financial sponsors and to the private equity sector overall. The stress tests are expected to be modular and tailored to the specific risk profile of different products and scenarios, considering potential loss outcomes that do not align solely to historical default rates or previously observed risk and performance correlations.

Board level reporting

Lastly, the PRA found that numerous bank boards were not specifically informed of the overall scale of exposures to the private equity sector or to individual financial sponsors, and consequently had not conducted a holistic assessment of the risks from these aggregate exposures. The PRA is concerned that this failure means that combined credit and counterparty exposure to private equity will become outsized.

The PRA expects boards to be informed of the aggregate exposures to the private equity sector and consider the business strategy of their groups regarding their overall private equity-linked activities. The boards should satisfy themselves that the scale and composition of risk exposures is appropriate in the context of their own risk profiles.

Next Steps

The PRA expects chief risk officers (CROs) at banks to review the letter's main findings and consider the scale, breadth, complexity and interconnectedness of private equity-linked credit and counterparty exposures as a high priority matter. Consequently, CROs will be required to assess their risk framework against their key findings above and report back to their board risk committees. Further, the analysis' results will need to be shared with the bank's supervisory teams at the PRA by 30 August 2024.

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