Boards, Policy & Regulation | Regulatory Oversight

Private credit ties to banks deepen in Europe as default risk rises

By **Naomi Rovnick** and **Sinead Cruise**

March 14, 2024 6:34 AM GMT · Updated 4 days ago

[1/2] Road construction workers carry out work outside the Bank of England in the City of London financial district in London, Britain, February 13, 2024. REUTERS/Isabel Infantes/File Photo *Purchase Licensing Rights*

Summary Companies

Most new European funds use 'sub-line' debt -data

European regulators seeking insight on bank exposures

Private lending may mask corporate distress, sources say

LONDON, March 14 (Reuters) - Europe's private credit funds are increasingly borrowing from banks to boost their performance, fuelling concerns about the wider risks posed by this interconnectedness.

A record 80% of new European private credit funds borrowed from banks via 'subscription lines' in 2023, funding that allows them to lend before tapping their investors for cash, MSCI Private Capital Solutions research shared with Reuters shows.

Subscription lines are used by some credit funds to enhance returns, a separate MSCI study found. MSCI studied pools that were set up recently because funds are most likely to use subscription lines when they start operating.

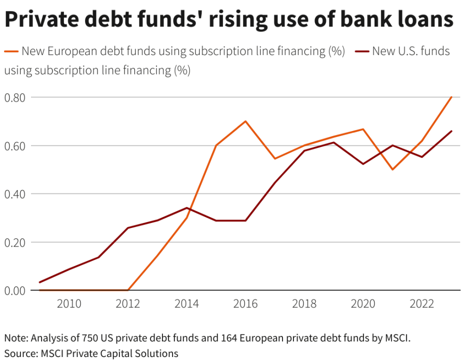
Regulators including the Bank of England (BoE) are already probing potential risks posed by lenders' exposure to credit funds, which are loosely regulated and typically finance firms that struggle to borrow directly from banks or in bond markets.

The boom in so-called shadow banks has also raised the alarm among some financiers, who point to the possibility of new asset bubbles that could undermine financial stability.

"Increasing engagement in the private credit domain ... brings them (banks) closer to the sector's inherent risks," said Chris Naghibi, Chief Operating Officer of First Foundation Bank.

Some private credit funds are also adding leverage to their loans, maximising returns but at the same time magnifying potential losses, more than 20 industry sources told Reuters and some fund filings showed.

These moves come as corporate distress in Europe has reached its highest level since the start of the COVID-19 pandemic.

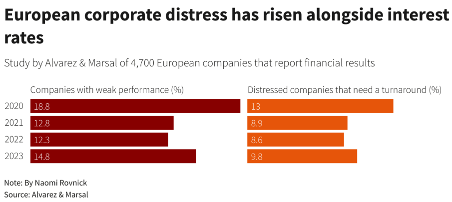


Reuters Graphics

FLEXIBILITY

European private credit funds, while a fraction of the size of bank lending, now have $460 billion under management, UBS estimates. Their growth coincides with an economic slowdown that is adding to concerns that private lending may be delaying decisions to restructure businesses.

Since such funds are not obliged to publish detailed information on their loans or the bank leverage they deploy, beyond informing their own investors, it is hard for regulators and bank investors to know if credit fund lending is going sour.



Reuters Graphics

A recent Bank of England (BoE) study noted that private credit market participants have so far reported minimal defaults versus the wider market of lending to riskier borrowers.

Ratings agency S&P Global expects defaults by European speculative borrowers it covers to reach 3.75% by June.

"Everyone is asking why we aren't knee-deep in corporate restructurings by now," said Peter Marshall, co-head of European restructuring at investment bank Houlihan Lokey.

More than a dozen sources told Reuters that private credit funds were able to avert some defaults with flexible lending, sometimes employing complex refinancing structures.

Deloitte estimates that almost seven in 10 European private debt deals has only one lender, meaning it has sole control over the terms offered and interest rates charged.

Some funds, said Patrick Marshall, head of fixed income for private markets at Federated Hermes, were altering loan terms like covenant headroom to kick stress "into the long grass".

"But what is going to happen is that (loan) recoveries are going to be lower too," he said.

Alvarez & Marsal managing director Chris Johnston said some funds worked with company owners to avoid crystallising a loss.

Payment-in-kind facilities (PIKs), where firms roll up interest payments to be paid in later years, were seen in 3.5% of 167 direct lending deals across six European countries in the last quarter of 2023, credit intelligence provider Reorg found.

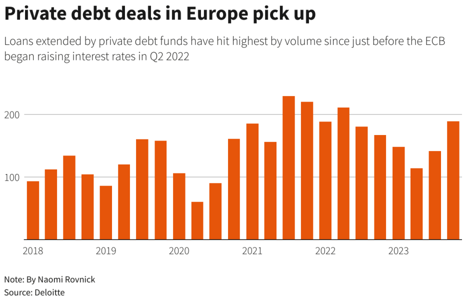
That was almost double the 1.9% of deals involving PIKs in the first quarter of last year, Reorg said.

Separately, a fifth of European private credit deals in the final quarter of 2023 were debt refinancings that extended loan repayments, Deloitte found, the highest proportion since 2020.

"That is helping to push out the day when there is a reckoning with the higher cost of debt," said Andrew Wilkinson, senior restructuring partner at law firm Weil Gotshal.

Feedback

Banks can also extend maturities, but are obliged to reflect this across reportable data, such as metrics on loan quality and estimated credit loss, against which they must make provisions.



Reuters Graphics

CONTAGION

Marshall of Federated Hermes said U.S. and Asian investors also sometimes asked European funds to add leverage, a practice already common in the U.S.

Ares Management Corporation (ARES.N) said last month its Ares Capital Europe VI fund had raised 11 billion euros in equity and would have more than 16 billion euros of investable capital, including anticipated leverage.

While access to leverage did not always mean it would be deployed, sources said such structures could unwind quickly during times of market stress.

"There could be some kind of contagion event where a fund cannot renew its short term debt and is forced to call capital from (its) investors," said Keith Crouch, executive director in MSCI's private capital unit.

Private debt funds were now "part of the banking ecosystem," said Marshall at Federated Hermes, adding further regulation would be "not a bad thing".

> Get a look at the day ahead in U.S. and global markets with the Morning Bid U.S. newsletter. Sign up here.

Reporting by Naomi Rovnick and Sinead Cruise; Editing by Elisa Martinuzzi and Alexander Smith

Our Standards: The Thomson Reuters Trust Principles.

Read Next

Boards, Policy & Regulation
Uber to pay $178 million in Australia taxi class action settlement
ago

Business
Google Malaysia apologises for misquoting ringgit exchange rate
8:23 AM UTC

Technology
Turkey moves against Meta over Threads-Instagram data sharing
8:00 AM UTC

Business
Julius Baer cuts 2023 executive bonuses after Signa losses
7:43 AM UTC

Feedback