Bank of England PRA

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Dear Chief Risk Officer,

# Thematic review of private equity related financing activities

The Prudential Regulation Authority (PRA) has been closely monitoring changes in the nature and scale of regulated banks' ('banks') private equity ('PE') related financing activities. Due to the size and importance of these activities to the banking sector as a whole, and their potential impact on its safety and soundness, the PRA has carried out a thematic review of banks' risk management practices in this area. As your firm was included in our study and analysis, we are bringing to your attention the findings from our review. In your role as the Senior Manager[1] (SMF4: Chief Risk Function) responsible for identifying, assessing, and mitigating risks to the business, and a source of independent challenge, we consider that you are well placed to assess how the points below relate to your business and review how they are being addressed.[2]

Assets under management within the PE sector have grown from around $2 trillion to $8 trillion over the last decade. Banks' financing activities related to the sector have

[1] www.prarulebook.co.uk/pra-rules/senior-management-functions/25-09-2023.

[2] The PRA's requirements on senior managers at banks and PRA-designated investment firms are set out in the Allocation of Responsibilities, Senior Management Functions and Conduct Rules Parts of the PRA Rulebook. The PRA sets expectations in respect of these requirements in SS28/15 – Strengthening individual accountability in banking: www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-banking-ss.

also expanded over this period. Most recently, we have seen an increase in exposures to various 'non-traditional' forms of financing linked to financial sponsors and the PE fund sector in general, such as Net Asset Value ('NAV') based loans secured against PE fund assets and facilities backed by Limited Partner ('LP') interests. This emerging trend in newer forms of financing has taken place alongside notable structural changes within markets that support banks' existing and longstanding base of PE related financing businesses. These structural changes include the growth of private credit markets and a degree of consolidation in banks that provide subscription financing credit facilities to PE funds globally.

In consideration of these market developments, ongoing geopolitical tensions, and global economic uncertainties, the PRA's thematic review focussed on the adequacy of banks' risk management frameworks that govern their PE linked financing businesses and related derivatives exposures.

As the market landscape in financing products and structures linked to the PE sector continues to evolve, banks must ensure that their risk management approach is sufficiently comprehensive and robust to control changes to the size and composition of their overall exposures, in line with requirements in the PRA Rulebook. The PRA's review identified a number of thematic gaps in banks' overarching risk management frameworks that control their aggregate PE sector related exposures.

To manage these risks effectively, and on a holistic basis, banks need to better employ group-wide risk data aggregation tools, stress testing capabilities and consolidated management information reporting processes. Boards must be fully involved in overseeing the firm-wide strategy and combined business initiatives relating to the PE sector and be properly informed of aggregate exposure trends in associated credit and counterparty risks. Boards should consider and satisfy themselves of the scale and composition of such exposures within the context of the overall risk profile of the bank. They should also take measures that ensure they are able to take a consolidated view of their exposures to other important business segments and any associated counterparty and credit risk concentrations. This expectation is in line with previous communications, for instance following our review of the failure of Archegos.[3]

**Next steps**

In the Annex to this letter, we set out our main findings that you should review and assess against your current practices. These findings include the PRA's expectations of what effective risk management requires in light of the risks identified by the review. Given the scale, breadth, complexity, and interconnectedness of multiple forms of PE

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[3] www.bankofengland.co.uk/prudential-regulation/publication/2021/december/supervisory-review-global-equity-finance-businesses.

linked credit and counterparty exposures typically entered into by banks, it is important that firms place a high priority on any necessary improvements to their risk management approach in this area. In particular, your assessment should highlight any gaps between the PRA's expectations set out in Section C of the Annex below and your internal risk and governance frameworks.

Please confirm that you have shared the output of your benchmarking exercise with your Board Risk Committee and provide this analysis, together with your detailed plans to remediate any gaps in your processes to your supervision team by Friday 30 August 2024.

If you have any questions relating to this letter, please do not hesitate to contact your supervision team in the first instance.

Yours sincerely,

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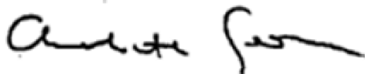

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**ANNEX**

## A. Market developments, context

- *Expansion of private credit markets and the impact on banks' PE related financing activities*[4]

1. Traditionally, banks have facilitated PE sector leverage through their role in the primary capital markets for broadly syndicated leveraged loans and high yield bonds issued by portfolio companies owned by PE funds. These forms of financing enable PE funds to make leveraged acquisitions of companies and support debt refinancing of their existing portfolio companies. These established and mature financing activities result in banks holding credit exposures to portfolio companies of PE funds in their underwriting books and high yield credit rated 'take and hold' loan portfolios[5]. However, recently, private credit funds have competed strongly with banks in the leveraged lending primary markets.
2. As private credit markets have expanded and the private credit fund sector's total assets under management ('AuM') have grown to almost $1.7 trillion, we have seen an associated increase in the provision of leverage by banks to private credit funds in the form of loan-on-loan secured financing facilities[6]. A material portion of these private credit secured financing facilities are collateralised by loans to sponsored middle market borrowers.

- *Growth in private equity AuM and consolidation of subscription financing providers*

3. In line with the growth in AuM across the PE sector over recent years, the PRA has seen an overall increase in the provision of subscription financing lines[7] by

[4] PE linked financing activities and related derivatives exposures include, but are not limited to: (1) derivative hedging contracts with portfolio companies and PE funds; (2) corporate loans to financial sponsors; (3) leveraged finance and high yield bond underwriting and take and hold positions on portfolio companies; (4) direct private credit ('PC') lending, balance sheet loans to sponsored portfolio companies; (5) secured PC loan on loan financing facilities linked to sponsored portfolio companies; (6) NAV and specific asset based secured financing for PE funds; (7) Pre IPO margin loans; (8) Listed equities margin loans and 'at-IPO' margin loan financing; (9) subscription financing lines; (10) General Partner interest financing; (11) Limited Partner ('LP') interest financing; (12) CLO warehouses and bi-lateral CLOs; and (13) other asset and cash flow based secured financing facilities to PE funds, including commercial real estate and infrastructure assets.

[5] Portfolios of leveraged loans held in the banking book, including Term Loan A, B and Revolving Credit facilities.

[6] Loan on loan secured financing facilities are credit lines extended by banks to private credit fund structures. These lending facilities are typically collateralised by a portfolio of loans entered into by the private credit fund with high yield borrowers.

[7] Subscription finance or capital call lines enable PE funds to draw on revolving credit facilities in order to support their activities prior to draw down of future capital calls on their LPs. These facilities are secured against the obligations of PE funds' LPs to make future capital contributions to the fund.

banks to PE funds, backed by future capital calls made by those funds on their limited partners ('LPs'). This increase in the total stock of subscription financing lines has recently been accompanied by a degree of consolidation of providers within the industry.

❖ *Increase in 'non-traditional' forms of private equity related financing*

4. There has been a new trend in banks providing additional, 'non-traditional', forms of leverage directly to PE funds, through secured financing facilities backed by equity investments of the PE fund. These facilities are in the form of Net Asset Value ('NAV') loans[8] or financing agreements collateralised by specific PE fund investments. These structures result in banks holding credit exposures to PE funds that are backed by collateral packages made up of PE funds' direct equity investments in their portfolio companies.
5. Banks are further engaged in other forms of collateralised and asset backed lending connected to the PE sector, including the secured financing of portfolios of LP interests in PE funds. LP interest financing also results in banks holding credit exposures that are secured by collateral pledges whose valuations are intrinsically linked to the financial performance of assets of the PE fund.
6. Collateral that underpins these different types of secured financing facility typically comprises privately held assets, often with limited secondary market liquidity.
7. In light of changing market dynamics, with demand for 'non-traditional' forms of financing structure from PE funds, secondaries funds,[9] and individual LPs growing, these secured lending exposures are likely to expand further.

## *B. The PRA's thematic review objectives*

8. Banks are typically exposed to multiple forms of counterparty and credit risks linked to the PE sector. On a combined basis, these exposures are often significant and have complex interlinkages.
9. Whilst the growth in 'non-traditional' forms of PE related financing is in its early stages, we have noted the illiquid nature of collateral underpinning these lending structures, and the continuing growth in PE linked exposures. As a result, the PRA has conducted a review to assess the adequacy of banks' risk management practices in this area. We have focussed on the independent credit and counterparty credit risk management ('CCRM') processes that support the overall expansion in PE related financing and hedging activities.

[8] Loans by banks to PE funds that are secured against the net assets of the PE fund.

[9] 'Secondaries' funds are specialist PE funds established by financial sponsors and asset managers to acquire LP interests in other PE funds in the secondary market.

## *C. The PRA's thematic review findings*[10 11]

❖ *Data aggregation and a holistic approach to risk management*

*i) Overarching risk management framework for PE sector related exposures*

10. A number of banks were unable to uniquely identify and systematically measure their combined credit and counterparty exposures linked to the PE sector within their overall risk data.
11. Banks typically enter into different forms of PE linked exposures across many distinct business lines, often located within separate parts of their group. As a consequence, individual client relationships for these activities, ranging from subscription line financing to derivatives hedging, are separately held by multiple business units. Independent credit and CCRM functions are usually aligned to product lines or organised by industry sector, counterparty type, or underlying collateral class. These typical organisational arrangements enable the development of business and risk management expertise in each respective specialism. However, despite the benefits of specialisation, a siloed approach to business, independent credit and CCRM oversight does not readily support the effective risk management of combined PE linked credit exposures generated across separate business units.
12. Whilst these various types of exposure, linked to the PE sector and entered into by banks at different points of the PE investment chain, are often legally distinct and structurally separated from one another, there are potential scenarios where the risk of loss through unforeseen credit and counterparty risk correlations may increase. High yield borrowers are typically exposed to higher interest rates and a slowdown in economic growth. Such economic conditions may adversely affect the combined credit quality of multiple portfolio companies at the same time. Alternatively, should a financial sponsor face acute operational difficulty, fraud or suffer serious reputational harm, the performance of different forms of credit and counterparty exposure linked to funds operated by that sponsor may become highly correlated.

*ii) Exposures linked to individual financial sponsors*

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[10] Indented paragraphs set out PRA expectations of firms, in each relevant area.

[11] Requirements in respect of risk management are set out in various parts of the PRA Rulebook. Firms are directed, in particular to: (i) the high-level requirements in the Fundamental Rules of the PRA Rulebook requiring firms to have effective risk management systems (Fundamental Rule 5) and to control and organise their affairs responsibly and effectively (Fundamental Rule 6); (ii) General Organisational Requirements in the PRA Rulebook to have effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems (rules 2.1 and 2.2); and (iii) Risk Control 2.1, which sets out that a firm's risk management procedures must include effective procedures for risk assessment.

13. While a small number of banks had made good progress, at a high level, in identifying and measuring their overall portfolio of PE linked credit exposures across business lines, many banks did not calculate comprehensive consolidated exposure data to measure and control combined PE credit and counterparty risks that are directly and indirectly *linked* to individual financial sponsors. These banks did not have a risk appetite framework that constrained the size of combined PE exposures linked to individual financial sponsors.

**The PRA expects banks to systematically flag all transaction and exposure data, together with relevant collateral pledges, relating to the PE sector in their trade capture and risk management systems, thereby enabling risk managers to identify and consolidate relevant counterparty and credit risk exposure information.[12] Banks should ensure that such data aggregation capabilities enable them to calculate and monitor exposures to the PE sector overall, as well as exposures linked to individual financial sponsors and individual PE funds.**

❖ *Credit and counterparty risk interlinkages*

iii) *Overlapping financial claims and collateral exposures*

14. Most banks did not have independent credit and CCRM procedures in place to comprehensively identify, measure, combine, and record risks that arise from all overlapping financial claims, liens and security interests that have direct or indirect linkages to the same underlying PE fund or related portfolio company obligor. For example, where a bank has a derivatives receivable from a portfolio company and also provides NAV financing to the PE fund that owns the portfolio company, the credit risks of both contracts are indirectly linked. The NAV financing facility is secured against a component of collateral that is effectively subordinated to the banks' own derivatives receivable claim. Where banks also provide LP interest financing to investors in the same PE fund, the value of the collateral backing this facility would, in turn, be affected, adding a further layer of complexity to credit risk analysis. Many banks do not comprehensively record these risk interlinkages in their credit analysis systems. Without full credit analysis and internal transparency, banks may underestimate their risk of loss due to overlapping and linked credit exposures should multiple PE portfolio companies suffer distress.

[12] The BCBS principles for effective risk data aggregation and risk reporting state that a bank 'should be able to capture and aggregate all material risk data across the banking group. Data should be available by business line, legal entity, asset type, industry, region, and other groupings, as relevant for the risk in question, that permit identifying and reporting risk exposures, concentrations, and emerging risks.'

**Credit due diligence procedures and management information processes should recognise and measure the presence of overlapping credit exposures, collateral pledges, and financial claims across all PE related activities where performance and recovery values of such amounts are interlinked.**

❖ *Stress testing*

15. A small number of firms had constructed stress testing frameworks that enabled a modular approach to calculating a group-wide tail event loss scenario for PE sector linked exposures on a routine basis. These modular stress tests probed the idiosyncratic risk profile of each category of PE linked exposure. The results of such stress tests were aggregated, and relevant stress loss outcomes allocated to individual financial sponsors. Other firms had not developed such comprehensive frameworks or had performed stress tests solely in the context of individual business unit portfolios or product silos and did not consider the results of these scenarios in aggregate. Comprehensive, combined stress tests, that consider potential correlations between the performance of different forms of PE related exposures and compute stress loss exposures linked to individual financial sponsors, enable firms to manage their credit and counterparty risk most effectively.

**As banks expand their activities and grow exposures linked to PE funds, it is important that they evaluate the potential for higher than previously observed default and loss correlations in periods of stress[13]. Such analysis should apply to all types of direct and indirect exposures connected to individual financial sponsors as well as to the PE sector overall. Banks should conduct routine stress testing of exposures to the PE sector as a whole, as well as PE exposures linked to individual financial sponsors. These stress tests should be modular and tailored to the idiosyncratic risk profile of different products and structures. Banks should consider theoretical scenarios and potential loss outcomes that do not conform solely to historic default rates or previously observed risk and performance correlations associated with individual products, underlying obligors, and clients. Results of these scenarios should be aggregated and allocated to individual financial sponsors and their PE funds. This information should be systematically used by independent credit and CCRM functions in assessing the size and**

[13] PRA expectations in respect of stress testing are set out in the PRA's supervisory statement (SS)31/15 – The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP): **www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss**.

**composition of overall PE linked financing activities and related derivatives exposures, as well as the appropriateness of exposures linked to individual financial sponsors.**

❖ *Board level reporting*

16. A number of banks' boards were not specifically informed of the overall scale of combined exposures linked to the PE sector or to individual financial sponsors and as a consequence, had not conducted a holistic assessment of the risks of these aggregate exposures.
17. Where banks fail to properly measure and assess the risks of their aggregate PE linked exposures, combined credit and counterparty risks to this sector may become outsized.
18. Furthermore, credit and counterparty exposure concentrations linked to individual financial sponsors may grow excessively in the absence of a defined risk appetite and effective consolidated risk measurement and control framework, which specifically governs risks linked to each of these individual parties. In the extreme event of financial malpractice at a financial sponsor, or multiple bankruptcies of a PE fund's portfolio companies, the absence of controls over the size of compounded PE credit exposures, directly or indirectly linked to that sponsor, would leave banks open to the risk of severe losses.

**Boards should be informed of the aggregate exposures linked to the PE sector and consider the overall business strategy of the group in relation to consolidated PE linked activities. Boards should satisfy themselves that the scale and composition of risk exposures linked to material financial sponsor clients, and the PE sector in general, is appropriate in the context of the overall risk profile of the bank.**[14]

[14] The PRA sets rules on the responsibilities of boards in promoting safety and soundness. Firms are directed in particular to the requirements for banks and PRA-designated investment firms set out in the General Organisational Requirements part of the PRA Rulebook. PRA expectations in respect of boards (including oversight of risk management, risk appetite, and internal controls) are set out in SS5/16 – Corporate Governance: Board Responsibilities: **www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss**.