

Not-so-private questions – speech by Nathanaël Benjamin

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Speech

Good morning, all. I am delighted to be here today to discuss a very important topic: private equity. I will step through the growth in the market, its important role in supporting companies to access finance, and the emergence of different players in that ecosystem. I will also explain why I have concerns about certain aspects of the developments in private equity and interconnected markets. That is something I have spoken about before,¹ and which the Bank of England's Financial Policy Committee (FPC) – of which I am now a member – has been highlighting in recent communications.²

Shining a light on the current dynamics in the private equity market is crucial at this juncture, given the important role the sector plays for the real economy. Indeed, making sure that the financial system evolves in a way that is conducive to safe and sustainable financing practices is essential for durable economic stability and growth in the UK. It is important for the FPC to consider both its primary and secondary objectives in the round: financial stability as well as supporting the government's economic policy to achieve strong, sustainable, and balanced growth. And with that combined lens, in a sense, financial stability is a means towards the ultimate goal of promoting the good – the welfare – of the people of the UK for the long term. As I embark on my role within the FPC, this will be a key area of focus for me. And in my opinion, private equity is perhaps the most material case at the moment that demonstrates the importance of this combined lens.

That is because recent developments in that market have the potential to disrupt the supply of funding to real economy companies in a stress. And to cause systemic institutions – such as banks – to experience significant and correlated losses on their exposures linked to private equity. These dynamics, as well as exogenous shocks, could all be amplified by vulnerabilities in this sector, such as opacity and interconnectedness across institutions and markets. So this is typical financial stability ground. That's why we care.

How does the growth of private equity contribute to market-based finance?

Market-based financing³ in the broadest sense has grown significantly over the last decade. Half of the funding for UK businesses now comes directly from financial markets

¹ See: ['Yesterday's logic' – speech by Nathanaël Benjamin](#), Bank of England

² See: [Financial Policy Summary and Record of the Financial Policy Committee meeting on 13 March](#), Bank of England

³ Market based finance is made up of markets (eg, equity, debt, and derivatives markets) and different kinds of investment funds, insurers, intermediaries like broker-dealers, and market infrastructure like central counterparties.

and non-bank financial institutions. Rather than from banks, as was the case traditionally. Since the end of 2007, market-based finance has made up almost all of the net increase in lending to UK businesses.

Private equity consists of funds which use pools of capital, largely from institutional investors, to invest in non-publicly-traded companies. They are one part of the system of market-based finance that has grown particularly rapidly. During the era of low interest rates, investors have turned to private equity as they sought returns. Also, they have been attracted to the perceived benefits of investing in unlisted, and therefore less liquid, assets. They can focus on total return in the absence of short-term earnings targets associated with public markets. And they get greater control over the companies.

Globally, assets under management in the private equity sector have increased from around \$2 trillion in 2013⁴ to around \$8 trillion in 2023⁵ (**Figure 1**). In comparison, the public equity market is around \$100 trillion.⁶ And the size of the private credit market, part of the wider market-based finance ecosystem, stands at about \$2 trillion.⁷

This has been accompanied by a movement of people away from banks to the non-bank sector, including private equity. So people who used to work for banks are now competitors, or clients, of banks, often in sectors such as private equity.



Source: McKinsey, Preqin, and Bank Calculations

⁴ Joyce, 2020, [Future of Alternatives 2025: Private Equity AUM Will Top \\$9tn in 2025](#), Preqin, accessed 10 April 2024

⁵ McKinsey, 2024, [McKinsey Global Private Markets Review 2024: Private markets in a slower era](#), accessed 10 April 2024

⁶ Slok, Agarwal, and Shah, 2024, Apollo Global Management, [Trends in private markets going into 2024](#), January 2024, accessed 10 April 2024

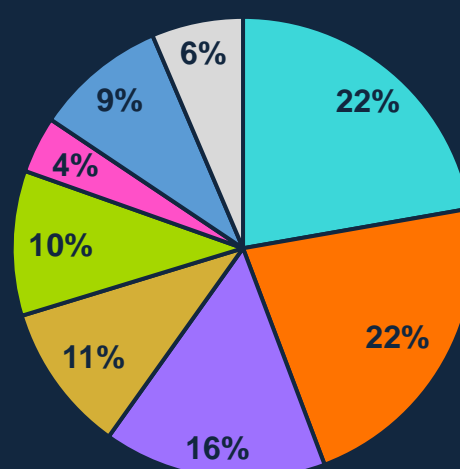
⁷ See: [Financial Stability Report - December 2023](#), Bank of England

The sector plays a crucial role in funding UK businesses, with around £250 billion actively invested in UK companies via private equity. Notably, companies in ‘software, communications, IT, and media’ sectors, as well as ‘commercial products and services’, particularly benefit from private equity funding, with each receiving around 22% of all private equity fund investments (**Figure 2**). Additionally, companies in ‘consumer goods, hospitality, and retail’ sectors receive around 15% of private equity’s total financing.

Figure 2: Almost a quarter of private equity fund investments in the UK are directed to companies in software, communications, IT and media

Sectoral distribution of private equity investee companies in UK

- Software, communications, IT and media
- Commercial products and services, and other business/non-financial services
- Consumer goods, hospitality, and retail
- Semi-conductors
- Health and pharmaceuticals
- Transport and Utilities
- Financial sector
- Others (including energy and agriculture)



Source: Pitchbook and Bank calculations

Given this picture, it is clear that the sector plays an important role in supporting employment in the global and UK economies. A report by the British Private Equity and Venture Capital Association and EY estimates that in 2023, UK businesses backed by private equity and venture capital employ 2.2 million workers (of which 1.9 million are private-equity-backed only), collectively earning £75 billion.⁸ Furthermore, suppliers to these same businesses employ an additional 1.3 million workers. Overall, this is comparable to the entire education sector’s workforce.⁹ So private equity affects a material part of the UK’s workforce. In turn, this employment will support consumer spending.

The growth in private markets is definitely contributing to greater competition within the financial sector. And the resulting diversification in the sources of financing available to

⁸ See: British Private Equity and Venture Capital Association and EY, 2023, [Economic contribution of UK private equity and venture capital in 2023](#), accessed 10 April

⁹ According to the Office for National Statistics employment data by industry, there are around 3.5 million people employed in the education sector in the months of October to December 2023. See: Office for National Statistics, [EMP13: All in employment by industry: People \(not seasonally adjusted\)](#), released 13 February 2024

corporates is clearly a good thing for the economy. For example, some evidence suggests that investment by companies backed by private equity held up by more than their peers during the global financial crisis.¹⁰ Indeed sustained financing to businesses and to productive finance assets – including in times of stress – is important and can, in turn, support investment by those businesses, which is a crucial driver of productivity growth. Private equity investment is also more than just financing. It can contribute to the productive use of capital in the economy, with sponsors using their experience of working with a variety of businesses to improve underperforming companies.

So the prominence of the private equity sector both within the financial system and for the real economy is significant. But with that comes a responsibility for the sector to ensure that its growth happens safely and sustainably.

What makes up the private equity ecosystem?

There are many players in the private equity ecosystem, each with a different role to play. Please bear with me as I make introductions.

First, there are **financial ‘sponsors’** (sometimes called ‘general partners’) who manage the private equity funds, and typically make money via management fees and carried interest. There is a lot of diversity here. But while there are still many small sponsors, the market is starting to become more dominated by larger sponsors than before. According to McKinsey, the top twenty-five fund managers accounted for 47% of private equity fundraising in 2023, which is the highest share in a decade.¹¹ Sponsors are also increasingly sophisticated. Their activities are becoming more complex. At one end of the spectrum you find single strategies, focussing on buy-out activities. But at the other end you find multi-strategies, competing in lending activities, and active in the private credit, commercial real estate, infrastructure, and insurance spaces, for example. Not only has their product portfolio expanded, the largest of these sponsors are also operating globally.

Second, there are **‘limited partners’**, who are the investors into the private equity funds. And these include insurers, pension funds, foundations, or wealthy individuals. However, and conversely, there is also a trend of large private equity sponsors gaining control of institutional investors, such as insurers and reinsurers, in order to access more stable funding sources.

¹⁰ Bernstein, Lerner, Mezzanotti, 2019, [Private Equity and Financial Fragility during the Crisis in The Review of Financial Studies](#), *The Review of Financial Studies*, Volume 32, Issue 4, Pages 1309–1373

¹¹ McKinsey, 2024, [McKinsey Global Private Markets Review 2024: Private markets in a slower era](#), Accessed 10 April 2024

Third, **banks** also play a crucial role by providing leverage throughout the ecosystem. They provide and facilitate 'downstream' lending to companies owned by private equity funds. They do 'mid-stream' lending to the private equity funds themselves. And they have 'upstream' exposures where there is recourse to the limited partners. The private equity industry is an increasingly important source of revenue and credit risk for banks, which see significant opportunities there.

Fourth, **private credit funds** also participate by lending substantially and directly to companies owned by private equity funds, thereby competing with banks, while receiving credit from banks as well. Moreover, private equity sponsors are often establishing their own private credit funds to compete actively with other private credit funds that lend to the companies they seek to own. Private credit markets have been in focus recently. Earlier this year, my colleague Lee Foulger used the FPC's approach to assessing financial stability risks in the non-bank sector to set out how the higher interest rate environment may impact private credit markets.¹² And the IMF Global Financial Stability Report published recently also assesses vulnerabilities and potential risks to financial stability from corporate private credit.¹³

And finally, last but certainly not least, there are the **companies themselves** that are owned by private equity – as well as financed by other mechanisms such as leveraged loans, or bond issuance. Notable names like Merlin Entertainment, Wagamama, and Hovis fall into this category. But private equity investments are often directed into small and medium-sized companies, managed as a portfolio by the private equity sponsors.

As you can see, the ecosystem is becoming increasingly complex and interconnected. That requires careful navigation and underscores the importance of efforts to understand these interlinkages more thoroughly.

Why am I focusing on this now?

So now that I have presented the main players in the private equity ecosystem, let me turn to the dynamics we're observing between those players.

The strong growth and attractive returns of the private equity asset class over the last ten years has occurred during a period of low interest rates. However, since the start of 2022 interest rates have increased substantially. And markets are not expecting for the foreseeable future a return to the low levels seen in the recent past. So the sector is now facing challenges.

¹² See: [Non-bank risks, financial stability and the role of private credit – speech by Lee Foulger](#), Bank of England

¹³ IMF 2024, [Global Financial Stability Report, The Last Mile: Financial Vulnerabilities and Risks](#)

These challenges fall into two categories. **Firstly, the difficulties that the highly-leveraged companies backed by private equity face in the higher interest rate environment. And secondly the consequences of a lack of exit opportunities for private equity fund investments.** Private equity is particularly vulnerable to this given its extensive use of leverage, and the illiquid nature of its investments. I will step through these challenges in turn.

First, higher risk-free interest rates have **increased funding costs**, creating a more challenging environment for highly-leveraged corporates everywhere. Those sponsored by private equity are no different. Indeed, it has been a generally less accommodating market for those real-economy companies to repay and roll over their debt. Many companies sponsored by private equity use leveraged loans or private credit loans to finance themselves. And these loans tend to have a floating rate. So much of the higher interest rate costs have already been passed through to them. Default rates on these leveraged loans have also started to increase, and may rise even further, which could impact credit spreads negatively, and in turn translate into even higher funding costs. This would make it more costly for the companies concerned to refinance themselves in the future.

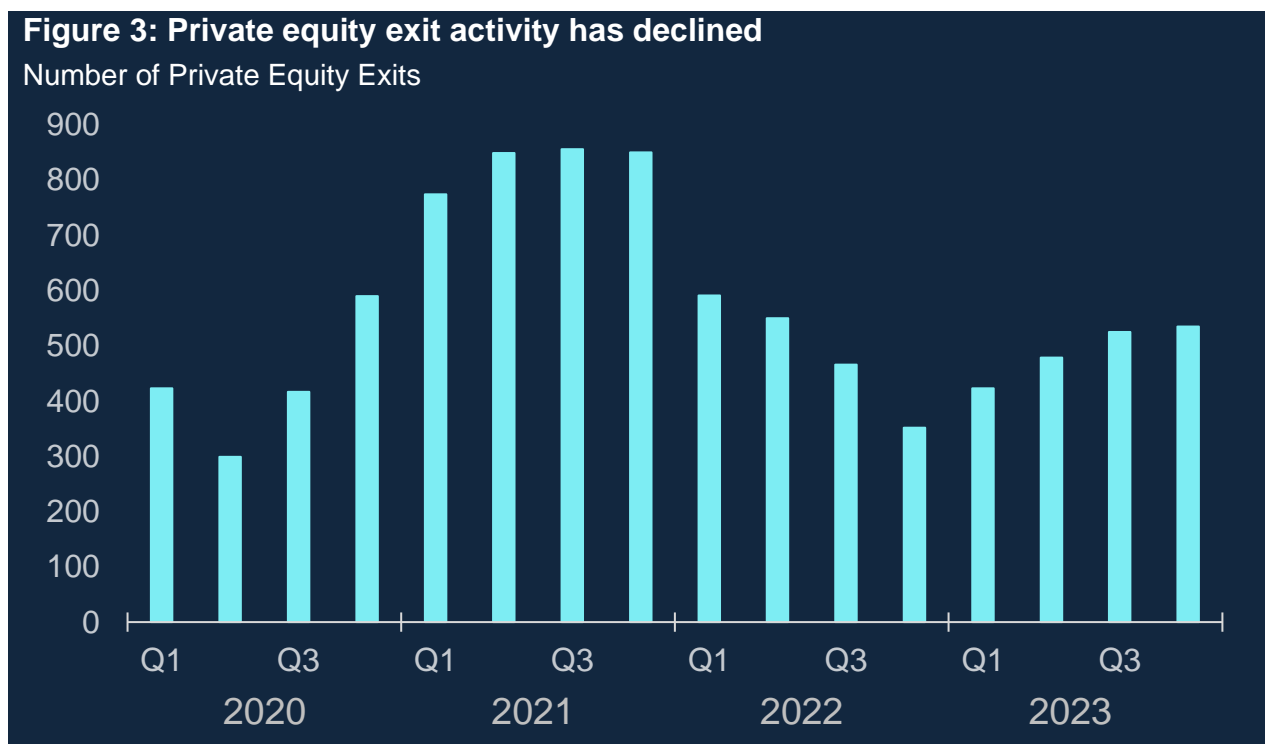
Some companies sponsored by private equity have turned to refinancing solutions which delay crystallisation of risks. That includes 'amend and extend' or 'payment in kind' agreements. While these agreements can help smooth through the stress, the risk is that the impact of higher rates is simply delayed, and an extension gives false comfort, increasing credit losses in the future. It is therefore important that there is high-quality risk management as debt is extended, and sponsors may also be called upon to inject equity.

So these are undeniably challenging times for a number of companies financed by private equity – in the same way as for most corporates who are highly leveraged. And a crucial question for us is the extent to which that in turn leads them to cut back on investment and especially employment. And how that impacts systemic institutions or markets.

But the challenges don't stop here for the private equity sector. Private equity funds have the additional challenge of the drying up of traditional exit routes for their investments via the capital markets, leading to difficulties in achieving the return on capital sought by limited partners. Those pressures are particularly relevant in an environment where a given level of return can now be achieved by investing in less risky and more liquid assets. This has increased pressure on fund valuations in secondary markets and encouraged the emergence of new forms of leverage, which I'll now turn to.

Because of the higher funding costs and lower earnings multiples, sponsors are reluctant to sell their investments into this market, and investors are reluctant to buy. Sponsors have often used an initial public offering (an IPO – when the shares in a company that is owned privately are sold to the public for the first time) to sell down their private equity fund

investments. But the IPO market has been weak globally, and in 2023, global IPO proceeds were down around 80% compared to their peak in 2021.¹⁴ Partly reflecting this, exit activity has declined significantly (**Figure 3**).



Source: S&P Global, Preqin, and Bank Calculations

The depression in exit activity has put pressure on limited partners in two key ways. Firstly, sponsors are unable to return capital to their investors. And so the length of time that the limited partners' capital is locked up in funds is increasing. Secondly, some limited partners have found themselves above their target allocations towards the private equity sector.

Faced with these challenges, limited partners have looked to sell their holdings or "interests" in secondary markets. And the increased supply of limited partner interests in the secondary market has put downward pressure on the prices that they can demand for selling their interests. So there is downward pressure on valuations in secondary markets. In a recent report, Jefferies noted that while pricing in the secondary market overall had improved due to rising public valuations globally, only 1% of limited partner interests were priced above the net asset value of the company portfolio, whilst many older interests were trading at discounts of 25% or more.¹⁵

So it seems some people have been stuck. And this has catalysed the development of new types of leverage. Private equity "secondaries" funds have been established to purchase the increased supply of limited partner interests. These funds, in turn, often

¹⁴ PWC 2024, [Global IPO Watch 2023 and outlook for 2024](#), Accessed 10 April 2024

¹⁵ Jefferies 2024, [Global Secondary Market Review](#), Accessed 10 April 2024

require leverage to meet return targets. In addition, for some time sponsors have been creating “continuation funds” to restructure and spin off the ownership of selected sponsored companies, thereby providing an exit opportunity on their investments. New investors in continuation funds in turn may look for leverage against their capital commitments. And we have also seen additional forms of leverage being sought in the form of secured financing against portfolios of existing limited partner interests in private equity funds.

We are also observing a trend towards private equity funds themselves seeking leverage, backed by the entire net assets of the fund. This is a way for sponsors to generate additional liquidity, in some cases reflecting pressure to finance dividend pay-outs to investors, to repay portfolio companies’ debt, or to purchase new fund assets.

These loans are in the form of net asset value financing (“NAV financing”). While NAV financing has been present for many years, 17Capital – a financier of private equity investors – projected a seven-fold increase in NAV financing from \$100 billion to \$700 billion by 2030.¹⁶ As the providers of NAV facilities have recourse to the assets of the private equity fund, and these assets are leveraged themselves, this has been termed “leverage on leverage”. You can see why.

Banks are major providers of these new kinds of leverage. But they are increasingly joined by private credit funds. While the range of providers brings greater competition to the sector, it can also increase the risk profile for lenders in the market. So there are natural questions about the risks of these financing arrangements, and the growth in kinds and quantity of leverage, or ‘leverage on leverage’, throughout the ecosystem. And I cannot resist pointing out the ironic contradiction in banks on the one hand worried about the threat from non-bank players, but on the other hand keen to help them leverage themselves up. There are also questions about the liquidity of the underlying collateral, particularly in a stress. Indeed, the types of collateral used to secure these forms of financing are illiquid, being private assets, which are hard to value. Or collateral can be portfolios of limited partner interests which involve hundreds of individual fund investments, which may be challenging to unwind.

Why do we worry?

So what?

Well, the dynamics I have just described speak for themselves. And it is not hard to work out that naturally they cause us concerns related to the financial system as a whole.

¹⁶ 17Capital, 2023, “[Why 2022 was another record-breaking year for NAV finance](#)”, accessed 10 April 2024

Macro-financial vulnerabilities

The developments I described are **set against a backdrop of opacity and are resulting in growing interconnectedness.**

First, the opacity: there is a lack of transparency about the degree and kinds of leverage (and “leverage on leverage”) entering the system. Moreover, private asset valuations are more opaque than public markets because assets are marked manually on a quarterly basis, by the sponsors, which is much less frequently than public equivalents. That is, they are not ‘marked-to-market’. This can have benefits: opacity around valuations can smooth things through a period of uncertainty. But there are material risks. As my colleague Lee Foulger has **highlighted**: “opaque valuations could increase the chance of an abrupt re-assessment of risks or sharp and correlated falls in value, particularly if further shocks materialise”. But it could also put pressure on the portfolio companies themselves. If a shock happens, sponsors may need to deleverage and rebalance their exposures to meet the debt repayments or demands for dividends from limited partners that I have just described. This could lead to sponsors selling their portfolio companies to meet these demands. If this happened, the opacity throughout the system could get in the way of appropriate risk management and cause a procyclical reaction. In other words, it could amplify any initial shock. And otherwise healthy companies might need to be sold at steep and unnecessary discounts.

Now let me turn to the interconnectedness: as is obvious from the time it has taken me just now to attempt to describe comprehensively who’s doing what, the environment is becoming increasingly complex and interconnected. Banks find themselves exposed to various parts of the private equity ecosystem. That includes through lending to private equity sponsors and funds, to limited partners, to the companies under private equity ownership, and they are competing with private credit funds. Pension funds and insurance companies invest in private equity sponsors, and conversely they are sometimes owned by private equity, most significantly at a global level. But in the UK there is also an increased exposure to the private equity ecosystem through the growth in the use of cross-border risk transfer in the insurance sector, known as funded reinsurance, a topic that has been touched on by my colleagues.¹⁷ There are also significant interlinkages between private credit markets, leveraged lending, and private equity activity.¹⁸ This intricate web of connections adds to the notable lack of transparency, making it difficult to assess financial stability risks.

As set out in recent publications, **our approach to assessing risks in market-based finance** is to focus on how vulnerabilities could affect systemic institutions, systemic

¹⁷ See: **CP24/23 – Funded reinsurance**, Bank of England

¹⁸ See: **Non-bank risks, financial stability and the role of private credit – speech by Lee Foulger**, Bank of England

markets, and the provision of vital services, such as credit. And as you can see, we worry about all three of those things in the specific case of private equity. To spell it out:

First, the impact on systemic institutions: understanding financial sector exposures to private equity is difficult given limited public data. But we have previously noted the substantial activity which banks are undertaking in relation to the private equity sector. Investors such as insurers and pension funds appear to be less exposed. But as with banks, a shock or a significant deterioration in the macro-outlook could result in correlated losses on their private equity investments and debt linked to private equity. My colleague Rebecca Jackson will tomorrow set out our views on risk management in relation to banks' activities in private equity. The extent to which these institutions manage their counterparty risk and credit concentrations competently – and the extent to which they understand their correlated exposures – is key for financial stability. We've warned about this before a number of times.¹⁹ It remains particularly true in the case of private equity. But it is important that all the players in the ecosystem, not just banks but also sponsors and investors, have robust risk management frameworks.

Second, the impact on interlinked markets: there are significant interlinkages between players in the private equity ecosystem, with overlap between public and private markets. In a stress, behaviours of sponsors, banks, and investors may interact, leading to the potential for spillovers between private and public markets. For example, common players may respond to a stress by reducing future investment into private-equity-concentrated industries, or by selling assets, with potential impacts on high yield and leveraged loan markets.

And third, the impact on the real economy and employment via the provision of finance, in what we call vital services: with many UK companies (large and small) reliant on private markets for financing, a shock to this sector – driven by investor losses and/or a decreased appetite for private assets – could limit their ability to access the financing they need. Which could lead to cutbacks in investment and employment. We are continuing to evaluate these risks. But to be honest, in the same way as there is a lack of transparency in valuations, more generally data about the impact of private equity on the corporate sector is scarce and it is difficult to assemble the overall picture.

Conclusion: What is the role of the FPC?

While we cannot predict the future, we expect that private equity will continue to grow in size and complexity, adding to the already complex ecosystem I have described. Indeed, many financial institutions we speak to have strategic plans to grow their activities related to private equity. That trend is positive as it diversifies sources of financing, bringing

¹⁹ See: ['Yesterday's logic' – speech by Nathanaël Benjamin](#), Bank of England

greater opportunities for businesses, and ultimately employment and growth. And the competition between banks and non-banks at play here is a very positive sign of a healthy and innovative financial sector. But that needs to happen in a safe and sustainable way. The opacity, complexity, and interconnectedness of the sector have made assessing its developments difficult, but it also means that it is all the more important.

These developments could pose risks to financial stability through several transmission channels – systemic institutions, systemic markets, and through the provision of funding. So far, the majority of private equity demand globally is outside the UK. But a crystallisation of risks in other jurisdictions could easily spill over to UK institutions and corporates. The private equity sector plays a big role in channelling finance to UK corporates, and as a provider of services and employment. Those corporates employ many people. So it is important that we assess how a disruption to the provision of finance can impact them. In addition, we will look to monitor the impact on systemic institutions and markets, given their role in underpinning a stable financial system.

The Bank of England's Prudential Regulation Authority is focused on ensuring that the banking sector's risk management practices keep pace with the evolution in the market. And that banks are adequately protecting themselves in case things go wrong. There will be more on that tomorrow from my colleague Rebecca, where she will explain the results of the PRA's thematic review of banks' exposures related to private equity. The Financial Conduct Authority is also carrying out a review of valuation practices for private assets.²⁰ That includes examining the personal accountabilities for valuation practices, governance of valuation committees, the information reported to boards about valuations, and the oversight by relevant boards of those practices.

Ultimately, as a macro-prudential authority, the FPC's role is to understand and respond to risks as appropriate. We seek to spot where private and public interests diverge. And we want to ensure that developments in the private equity sector happen in a safe and sustainable way, where the forward-looking interests of households and businesses are protected for the long term.

So these are the questions we are asking. What is the impact of the dynamics in the private equity sector on UK corporates, and on the rest of the financial system? How might this all play out in times of stress? If some players feel they have been patient so far, what happens if they become less patient?

We will examine these questions through a combined lens of our primary and secondary objectives of financial stability and sustainable growth. That combined lens is essential to

²⁰ Financial Conduct Authority, 2024, [Portfolio letter: Asset Management & Alternatives Supervisory Strategy - interim update](#)

promote the good – the welfare – of the people of the UK for the long term. We will publish a further assessment of these risks in our June 2024 Financial Stability Report.

Thank you.

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