Analyse, Assess and Address – Regulatory focus on Private Equity

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The Second Quarter of 2024 saw a series of publications by the Bank of England (BoE), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) on potential risks the private equity (PE) sector poses to the regulated sector. This article draws out the key themes in these recent developments before examining what it means for those impacted, including PE firms, PE owned financial services businesses, and lenders.

Regulatory engagement with industry sectors tends to follow an analyse, assess and address model – regulators gather information about the sector, assess what that tells them about risks to their objectives and then take steps to address what they consider to be the most significant risks.

Systemic nature of the industry

On 22 April 2024, Nathanael Benjamin, Executive Director for Financial Stability at the BoE, delivered a speech on macro-risks arising from regulated firms interaction with the PE sector. In that speech he set out three major concerns that the BoE has from a macro-prudential perspective:

1. **Impact on systemic institutions** – it is difficult to understand financial sector exposures to PE as there is limited public data on those exposures. Consequently, the BoE is concerned that the risk management processes for lenders and other large financial institutions properly take account of risks attached to funding provided by banks and other lenders to PE firms.
2. **Impact on interlinked markets** – there are significant interlinkages between players in the private equity ecosystem, and an overlap between the public and private markets. In a stress, it is not clear how these linkages and overlaps might interact, leading to potential for spillover effects from one to the other, and potentially into the real economy.
3. **Impact on real economy and employment** – a shock to PE sector could limit access to funding leading to impacts to the real economy. It is difficult for the BoE to assess the scale of this due to a lack of transparency in valuations and data about PE in the corporate sector.

The BoE followed this up with clear references to the risks it sees arising from Private Equity in its June 2024 Financial Policy Committee meeting. In its record of that meeting, it referred to supervisory work being undertaken by the PRA and FCA (for which see below) and put down a clear marker that it would come back to the issue of Private Equity once that work had concluded.

The BoE’s primary concern appears to be to avoid an unexpected issue arising in the PE sector akin to the problems with Liability Driven Investments following the mini-budget proposed by former Prime Minister Liz Truss in 2022. At that time, a crisis in the markets, coupled with an increasing interest rate environment driven by rising inflation, exposed weaknesses in liability driven investment strategies adopted by pension funds, leading to significant problems for pension funds and real world impacts right across the economy.

The BoE’s intention here appears to be to seek to de-risk the potential for impacts on the wider economy arising from stress in PE sector both by having lenders pay greater heed to risks posed by lending, and by making sure that the regulators themselves have a better line of sight on the implications of stress in the PE market for the regulated sector as a whole.

Lenders to PE firms

On 23 April 2024, Rebecca Jackson (Executive Director of Authorisations, Regulatory Technology and

International Supervision at the PRA), delivered a speech on PE financing and risks to regulated sector. The speech lays out the findings of a recent thematic review launched by the PRA in August 2023 into private equity-related financing activities and the adequacy of banks' risk management frameworks. The broad thrust of the PRA's conclusions were that:

1. **Lenders to PE firms find it difficult to monitor PE exposures** - only a very small number of banks are able consistently to aggregate data in a manner that is appropriate to their exposures to the PE sector. The PRA identified gaps – some of which the PRA found to be significant – in most of the risk frameworks that it assessed.
2. **Correlations may arise between risks in certain scenarios –** There is a significant risk of correlations occurring between the risks to which lenders to PE firms are subject. Correlations or linkages between risks (for example between risks in a PE fund and its portfolio companies, or a sponsor and a PE Fund) could lead to the risk profile of PE-related lending increasing significantly in an uncontrolled way over a relatively short period. The PRA gave the example of malpractice at a financial sponsor or the bankruptcy of multiple portfolio companies over a small period causing risk correlations to increase significantly, with the result that liquidity evaporates, leaving banks open to severe, unexpected losses.
3. **An overall lack of sophistication in banks' approach –** The PRA found that a lack of Board engagement and inadequate or non-existent stress testing carried out by banks in relation to PE-related lending, led to increased risk that banks could be exposed to unexpected, and significant, losses arising from PE lending.
4. **Significant improvements are needed quickly** – The PRA's conclusion from its thematic work is that improvements are clearly needed, and need to happen quickly. There is a clear regulatory expectation that this should happen now, not later.

Building on the concern expressed by the BoE, the PRA's primary driver is – as one might expect – improving the ability of the banking sector to understand, monitor and respond to risks arising from lending to PE firms, particularly given the level of funding that has been provided to the PE sector in recent years when interest rates were relatively low. As banks are forced by the PRA to improve the sophistication of their risk management practices in relation to PE lending, it possible that PE firms experience greater levels of scrutiny from lenders during the investment lifecycle.

Valuation questions

Alongside the matters raised by the BoE and PRA, in its Dear CEO Letter for the Asset Management and Alternatives sector of 1 March 2024, the FCA took the opportunity to register its concerns around valuation practices for private assets. The FCA noted a trend toward a higher proportion fund assets being held in private assets, which are often difficult to value robustly and reliably across all market conditions.

As a result, the FCA noted that it would be conducting a multi-firm review of the valuation of private assets, focussing on looking at valuation practices and including personal accountabilities, governance, information provided to Boards, and the oversight provided by Boards.

Nikhil Rathi, the CEO of the FCA, was at pains to point out in a subsequent interview that he was not wholly convinced that the PE sector poses the level of systemic risk the BoE is concerned about. But he did note that more data was required to understand the level of risk posed by the PE sector. He recognised that there were risks, but said in the interview that he did not think that *"…we should go into overkill regulatory mode where we put leverage limits on all of this activity…"*

While this is a helpful indication, the work being done by the FCA into valuation practices does suggest that the regulator is looking to understand whether firms ought to be doing more to govern

the valuation process effectively. Further guidance from the FCA on this area is likely.

Given the concerns expressed by the PRA about banks' ability to assess and monitor risks arising from PE lending, any conclusions the FCA forms about weaknesses in valuation practices may well feed back into the PRA's work to enhance the sophistication of banks' risk management frameworks. And the BoE has clearly indicated that it will come back to this topic in a future meeting once that work has concluded.

What does all this mean?

It is relatively rare for all three regulators – the BoE, the PRA and the FCA – to be speaking at the same time about a particular issue. As such, the PE sector is likely to remain of regulatory interest. On the plus side, the regulators clearly understand the importance of the sector in driving much-needed investment to companies across the UK, not just in the financial sector.

Even so, the BoE's intervention may well lead to a more joined up approach from the PRA and FCA towards the PE sector. The current regulatory interest could manifest in increased day-to-day supervisory intensity in a number of areas, including:

- increased focus on risk management within lenders, leading to changes to risk management processes when lending to PE firms, as well as increased transparency during the funding lifecycle;
- increased regulatory focus at the level of PE firms on how the assets are valued on an ongoing basis, with a particular focus on governance and accountability;
- the regulators assessing portfolio companies that are themselves in the regulated sector to see if leverage at investor level could lead to the regulated firm's safety and soundness being undermined in a stress scenario;
- the potential for a greater regulatory focus on Boards and their approach to looking at these risks at all levels; and
- a focus on the role and behaviour of investor directors on Boards of portfolio companies that are regulated entities, including how they manage the inherent conflicts of interest that come with the role, and how they calibrate the level of their involvement to make sure they do not cross the Non-executive/Executive Director divide.

Conclusion

The breadth of the regulators' powers (coupled with their ability to intervene both at the PE company and at regulated portfolio company level) gives them a powerful set of tools to analyse, assess and address issues arising at all levels in the PE sector.

At the moment, the regulators appear firmly in the "analyse" phase, thinking broadly about the issues arising in the sector that could affect their regulatory objectives. This suggests that urgent industry-wide intervention is unlikely in the immediate future. However, the renewed focus on the sector is likely to lead to an increase in supervisory intensity over time, as the regulators move through to the "assess" and "address" phases.

A strategic approach to identifying potential regulatory issues before they arise, dealing proactively with regulatory engagement, and addressing emerging risks both at PE firm and portfolio company level, will therefore remain important to minimise the risk of regulator overreach into the sector.

We advise a number of PE firms across all sizes and sectors and are aware this is a topic of interest

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in the industry. We and our regulatory team are seeing increasing numbers of questions around how firms can best manage this focus and what they can be doing to anticipate further potential developments.

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