# The PRA's thematic review of private equity related financing activities in the UK

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Late last month, the PRA published a *Dear CRO* letter which sets out the main findings of its thematic review into UK regulated banks' private equity (***PE***) related financing. This was published together with a speech on PE financing by Rebecca Jackson, executive director for the PRA's Authorisations, RegTech, and International Supervision Directorate. Citing "the scale, breadth, complexity, and interconnectedness of multiple forms of PE linked credit and counterparty exposures" and concerns around the potential impact on the "safety and soundness" of the banking sector, the PRA's focus is on ensuring that banks' risk management practices are sufficiently comprehensive and robust. The PRA's letter therefore highlights perceived gaps in banks' risk management frameworks for this area and sets out its expectations against which banks must review their current practices.

**Why the PRA is interested in PE financing**

Banks are exposed to the PE sector in a variety of ways and as such, the PRA expects banks to have adequate risk management frameworks governing PE linked financing business. Regarding the risks, the PRA has noted that in the last decade or so, PE markets have changed significantly, noting three main developments.

- The first is that the PE sector itself has grown significantly over the last decade: the PRA notes that assets under management within the PE sector have grown from around $2 trillion in 2012 to around $8 trillion in 2023.
- The second is that banks' financing activities have expanded and become increasingly complex over this period. Historically, banks' financing of the PE industry typically focussed on the "downstream" level, i.e. the provision of loans and bonds through the capital markets to portfolio companies owned by private equity funds. However, the PRA notes that over the past decade there has been an increase in "upstream" lending which involves direct recourse to the investors in (and managers of) funds, and well as "midstream" lending to the funds themselves.
- Finally, there has also been a growth in private credit funds, which simultaneously raise financing from banks and compete with them to provide leverage to the PE industry. The PRA notes its concerns that whilst competition has a role to play in ensuring that borrowers can access the funds they need, it may also affect the price and quality of the offering in the market in a less positive way.

**Gaps in banks' risk management frameworks**

The gaps identified by the PRA in banks' PE-related financing risk management frameworks are:

1. A number of banks were unable to uniquely identify and measure their combined credit and counterparty exposures linked to the PE sector as a whole, and to individual financial sponsors.

2. Lacking procedures to comprehensively identify, measure, combine and record risks that arise from overlapping financial claims, liens and security interests that have linkages to the same underlying PE fund or related portfolio company obligor. In particular, banks may therefore underestimate their risk of loss due to overlapping and linked credit exposures should multiple PE portfolio companies suffer distress.
3. A failure to conduct routine, bespoke and comprehensive stress testing for PE-related exposures.
4. Lacking adequate board level engagementwith PE-related exposures.

**PRA's expectations to address the gaps**

In light of these gaps, the PRA set out a number of expectations for banks to improve their practices in this area. At a high level, these involve banks employing better group-wide risk data aggregation tools, stress testing capabilities and consolidated management information reporting processes, with greater board-level engagement across the piece. To elaborate further, measures banks should be taking include:

Measuring risk

- Systematically flagging all PE transaction and exposure data, as well as relevant collateral pledges, in trade capture and risk management systems. This should enable risk managers to consolidate relevant counterparty and credit risk exposure information, and enable them to calculate exposures to the PE sector overall as well as to individual financial sponsors and PE funds.
- Enabling credit due diligence procedures and management information processes to measure overlapping credit exposures, collateral pledges, and financial claims across all PE activities (where performance and recovery values of such amounts are interlinked).

Stress testing

- Implementing comprehensive stress testing across bank-financed PE businesses, which considers the potential for higher than previously observed default and loss correlations during periods of stress, for all exposures linked to the PE sector.
- Applying such modular and tailored stress testing to all direct and indirect exposures connected to individual financial sponsors as well as the PE sector overall.

Board-level engagement

- Ensuring boards are informed of aggregate exposures to the PE sector and assess how the overall business strategy of the group fits into its 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.

*Next steps*

The PRA now expects CROs to:

- Review and assess the findings against current practices, highlighting any gaps between these expectations and their internal risk and governance frameworks and prioritising necessary

improvements to the risk management approach; and
- provide the output of the CRO benchmarking exercise, along with detailed remediation plans, to their PRA supervision teams by 30 August 2024.

**Conclusion**

Whilst the PRA's thematic review was focussed on the banks within its remit, this is another example of increasing regulatory attention towards the private capital sector. We expect further regulatory scrutiny of the sector in the near future, both in the UK and abroad, and will be following these developments closely over the coming months.