PRA Issues Thematic Review of Private Equity Related Financing Activities: What It Means for Fund Finance Providers

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On 23 April 2024, the Bank of England's Prudential Regulation Authority ("***PRA***") issued a letter to bank chief risk officers ("***CROs***") detailing findings from its 'thematic review of private equity related financing activities' [1].

This review was conducted due to the PRA's concern that, as the private equity ("***PE***") sector has grown over the last decade, so has bank exposure to all types of financing provided to this sector. The PRA specifically referred to the increase in bank exposure to what it calls 'non-traditional' forms of financing to PE funds, namely subscription-line facilities (i.e., facilities secured by the capital commitments of investors), and NAV loans secured against a fund's net asset value. The PRA also noted the growth of private credit markets and consolidation in the number of banks that provide subscription-line facilities to PE funds globally.

Why now?

The PRA has acknowledged the exponential growth of PE over the last decade, so why is this review coming now? Over the last 2 years, the UK has seen an increase in inflation caused partly by prices rising due to demand outstripping supply during the covid pandemic, and also by the disruption to supply chains caused by Russia's invasion of Ukraine, which impacted food and energy prices. The Bank of England's response was to increase interest rates in an attempt to slow inflation. In turn, banks' liquidity decreased as their cost of funding rose with interest rate hikes and capital adequacy requirements meant that they became more selective about how they deploy their balance sheet. This recent liquidity crunch has prompted PE sponsors to look for more debt options than they previously may have needed when fundraising was easier, and all the while this has happened in a high interest rate environment. Ultimately, the PRA's concern is that if banks aren't carefully monitoring their overall exposure to PE across all product areas, then any shockwaves in the PE market could cause severe losses to the banks. In its letter, the PRA urged banks to conduct routine stress testing of exposures to the PE sector as a whole, as well as exposures linked to individual financial sponsors.

Review findings

The aim of the PRA's review is to ensure that banks' risk management policies and procedures are comprehensive and robust enough to deal with their overall exposure to the PE sector, in accordance with the PRA Rulebook[2].

The PRA's review identified weaknesses in the current risk management frameworks that banks employ in order to control their exposure to the PE sector and outlined the following improvements

1. better use of group-wide risk data aggregation tools, stress testing capabilities and consolidated management information reporting processes;
2. 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; and
3. 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.

   These findings are set out in full in Section C of the Annex to the letter.

Next steps:

In its letter, the PRA called for banks to compare the PRA's findings and expectations for effective risk management against such bank's current practices. By **30 August 2024**, each CRO must confirm to the PRA that they have provided to their respective Board Risk Committees and supervision team (i) a copy of the PRA's expectations, together with the findings of their benchmarking exercise (highlighting any gaps between their current risk frameworks and the PRA's expectations), and (ii) detailed plans of how to remedy any gaps in their processes.

Conclusion:

While some may see increased regulator attention on PE as a cause for concern, the fact that the PRA are monitoring the growth in, and exposure to, the PE sector should provide comfort that UK banks will be well positioned to avoid any PE-related banking crisis. The PRA's recognition that fund finance products have grown enough to warrant specific mention also shows how far the fund finance industry has come in the last decade, from a fairly niche product to a tool regarded as almost essential in order to effectively manage fund liquidity.

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[1] A copy of this letter can be found here: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2024/thematic-review-of-private-equity-related-financing-activities

[2] A copy of the PRA Rulebook can be found here: The Bank of England PRA | Prudential Regulation Authority Handbook & Rulebook (prarulebook.co.uk)
