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The Regulators' Approach to the Private Credit Market

Presented by Claudine Salameh, Partner and Jason Gaitz, Senior Associate

What is Private Credit?

1

Provision of Credit by Non-bank Lenders

Credit typically provided to small and mid-sized businesses



2

Forms

Can take various forms e.g. loans, bonds, notes, private securitisations



3

Terminology

“Private credit” often used interchangeably with “private debt”, “direct lending”, “alternative lending” or “non-bank lending”



Typical Features of Private Credit

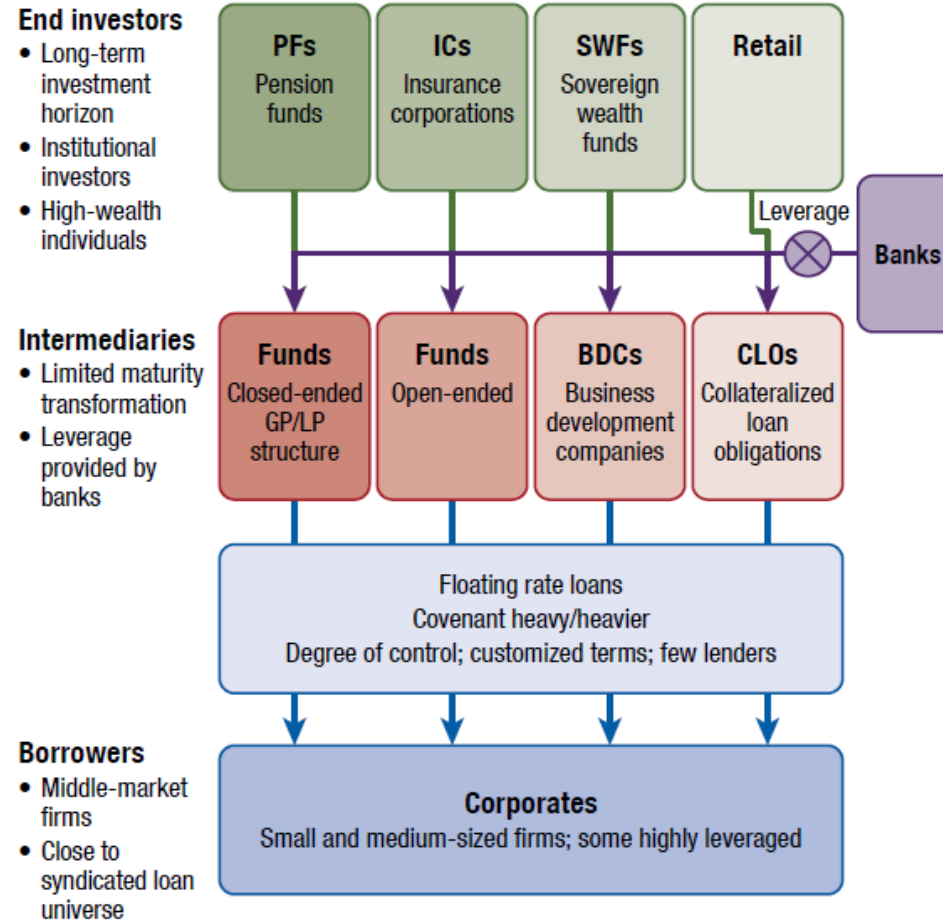
- 1 Generally illiquid and held to maturity in a closed-end fund
- 2 Typically secured and issued with floating rate agreements
- 3 In Australia, the lending vehicle is usually structured as an unlisted and unregistered unit trust
- 4 Longer investment horizon with contractual term typically being five-eight years

Examples of types of private credit loans

- 1 Asset-based Finance:** Entities borrowing money secured against the value of assets they own
- 2 Cash Flow Finance:** Loan made to a business is secured by the company's expected cash flow
- 3 Infrastructure Debt:** Financing of long-term infrastructure where repayments are funded by cash flow of the completed project
- 4 Real Estate Finance:** Provision of credit secured against an underlying real estate asset

Structure of Private Credit

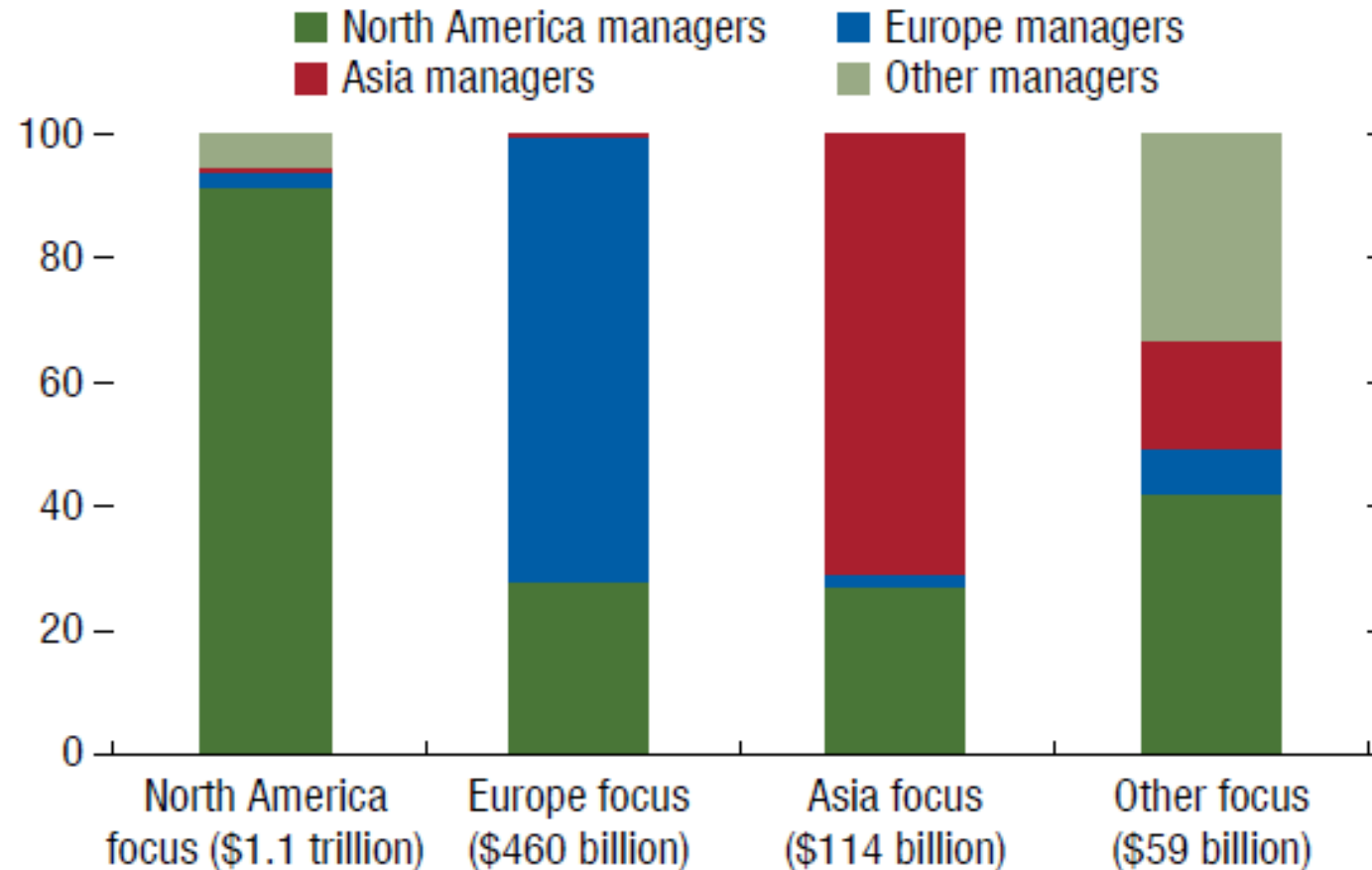
Private Credit, End Investors, and Borrowers



Source: IMF staff.

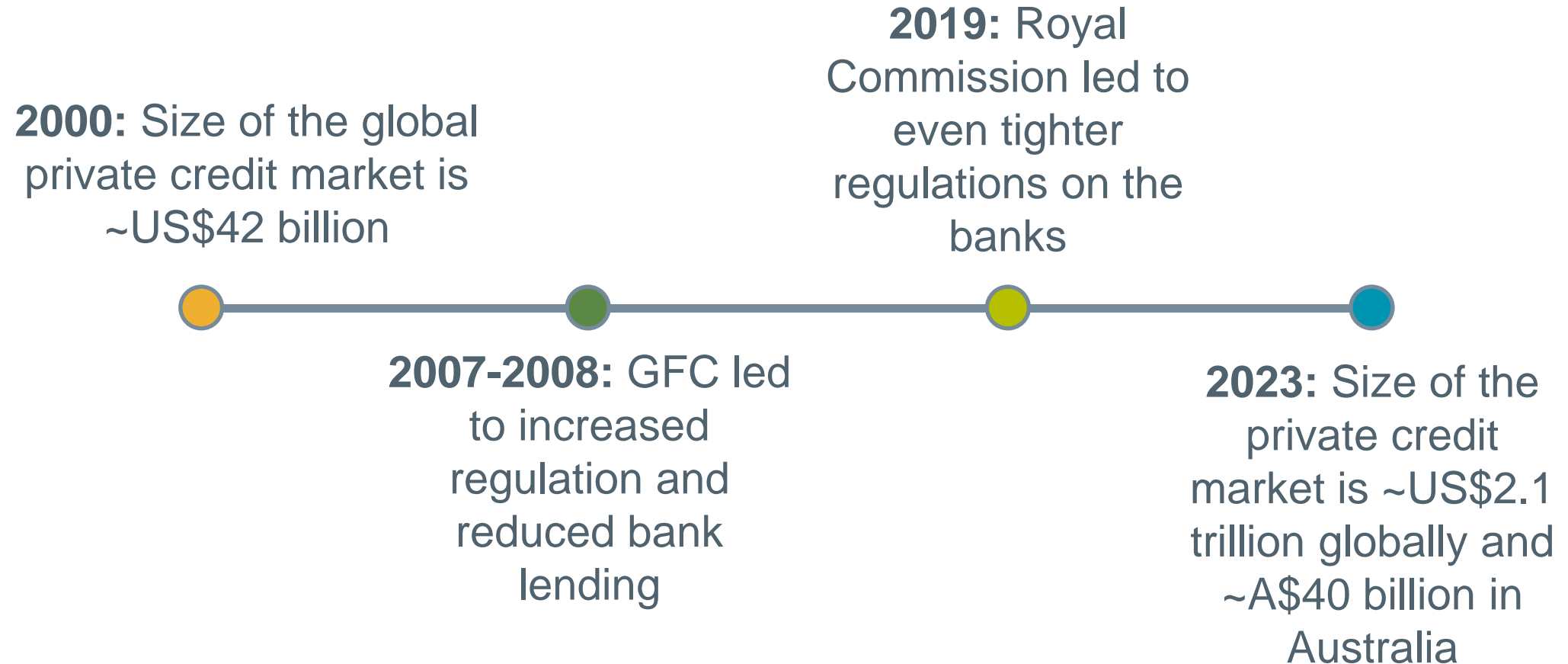
Geographical Focus

3. Geographical Focus of Private Credit Funds' Managers
(Percent, as of June 2023)



Source: IMF (2023)

Timeline of Growth in Private Credit



Why the Remarkable Growth in Private Credit?

- 1 Relatively light regulation of private credit compared to banks
- 2 Low interest rates until 2022 saw investors search for alternative high yield investment strategies
- 3 High costs of disclosures and compliance of traditional bank lending relative to private credit
- 4 Creditor friendly insolvency regime in Australia

Benefits of Private Credit

1

Investors

Increased diversification and stable returns which are typically higher than government bonds



2

Borrowers

Access to credit, bespoke agreements, greater flexibility (including in times of distress), fast transaction turnaround and longer maturities



3

Economy

Private credit can be beneficial for economic activity, innovation and growth by providing finance where traditional means fall short



Risks of Private Credit

1

Lack of Transparency and Opaqueness

Fewer reporting obligations than publicly listed or registered funds, so there is limited information for investors/regulators to assess risk



2

Liquidity Risks

Private credit funds can manage cash flow risks by adopting a closed-end structure, but investors may be vulnerable to capital calls



3

Unreliable Valuations

Private credit assets are valued infrequently, which can be exploited in a downturn scenario



4

Conflicts of Interest

May arise at several points throughout the lifecycle of a private credit fund and at different levels of the fund structure



Risks of Private Credit Cont.

5

Default Risk

Some uncertainty as to how private credit will respond to higher interest rates and inflation



6

Leverage

Private credit relies on the use of leverage, but investors have limited visibility



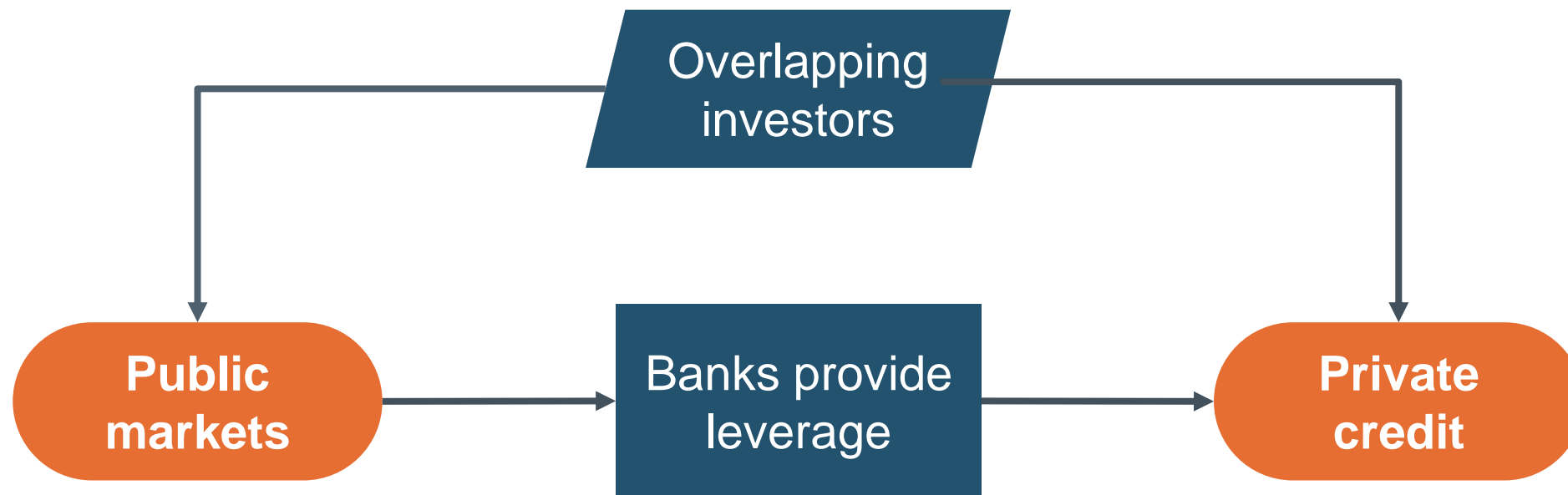
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Retail Investors

Risk of private fund managers seeking to attract retail investors who may require higher disclosure and regulation



Potential Risk Transmission to Public Markets



Does Private Credit get Enough Credit for all the Credit it Gives Borrowers?

'Marking their own homework': Inside Australia's \$200b unregulated private credit boom

Credit products are being launched a mile-a-minute, promising plenty of returns buoyed by high rates. But behind the euphoria, there's plenty of disquiet.

— **Exclusive**

APRA puts major super funds on notice over 'opaque' private credit

— **Opinion**

This is where the next financial crisis could emerge

Borrowing costs have risen, and private equity managers have been having difficulty selling portfolio companies. Yet institutional investors have an ever-growing appetite for illiquid alternative investments.

Magellan co-founder Chris Mackay lambasts private credit in tirade

Overseas Regulatory Response

1

United States

SEC has implemented measures to enhance transparency and competition in the sector, including stronger reporting requirements



2

European Union

Enhanced disclosure requirements, implemented limits on funds' use of leverage and placed restrictions on fund structure



3

United Kingdom

Increased oversight of private funds eg Financial Conduct Authority carried out review of valuation practices for private assets



IMF's Regulatory Recommendations



Approach

Encourage authorities to take a more proactive and supervisory regulatory approach



Reporting

Enhance reporting requirements for private credit funds and their investors



Liquidity

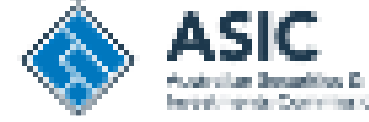
Address liquidity and conduct risks in funds that may be faced with higher redemption risks



Cross-border

Strengthen cross-sectoral and cross-border regulatory cooperation

The Australian Regulatory Response



- 1 One of ASIC's strategic priorities is to drive consistency and transparency across markets and products
- 2 ASIC will be undertaking an examination of, and reporting on, the growth of private markets
- 3 ASIC has launched a dedicated private markets unit
- 4 Query whether the industry may benefit from new regulatory guidance from ASIC e.g. in relation to disclosure, conflicts of interest and fee structures

The Australian Regulatory Response: APRA and Treasury



- Heightening supervision of superannuation funds' investments in unlisted assets
- Increased supervision of unlisted asset valuations
- Currently investigating liquidity management at large super funds



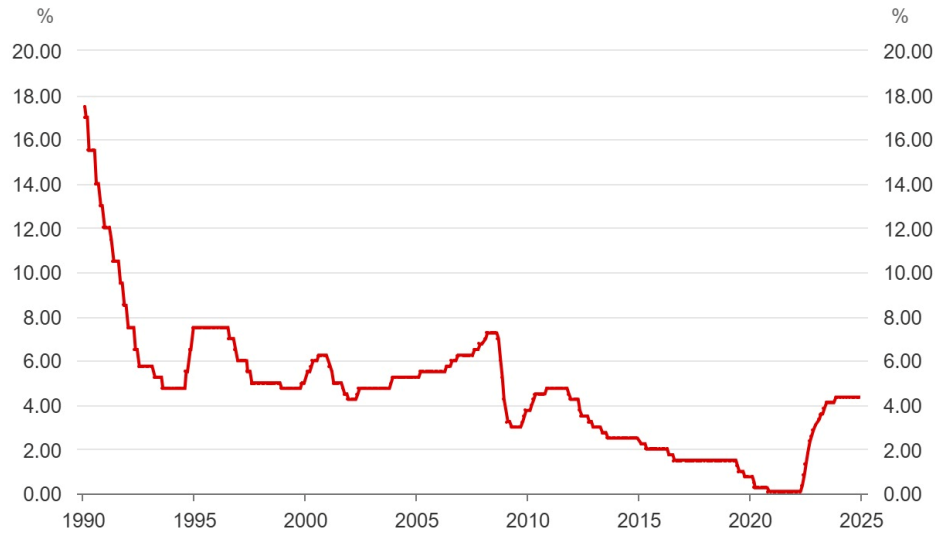
Australian Government
The Treasury



- Reviewing the regulatory framework for managed investment schemes, which are one form that private credit funds can take

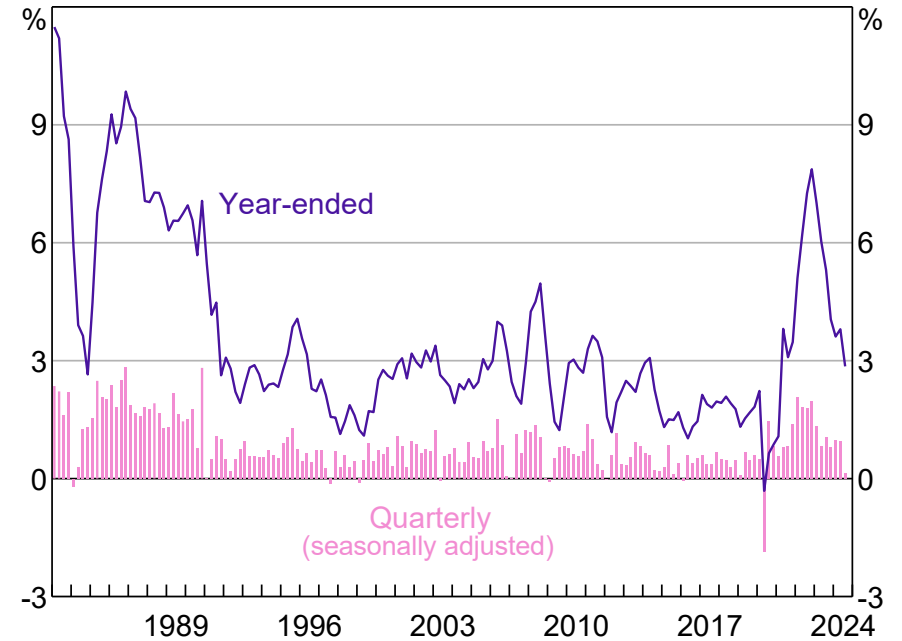
Emergence of Financial Distress and its Implications

Graph of the Cash Rate Target



Source: RBA

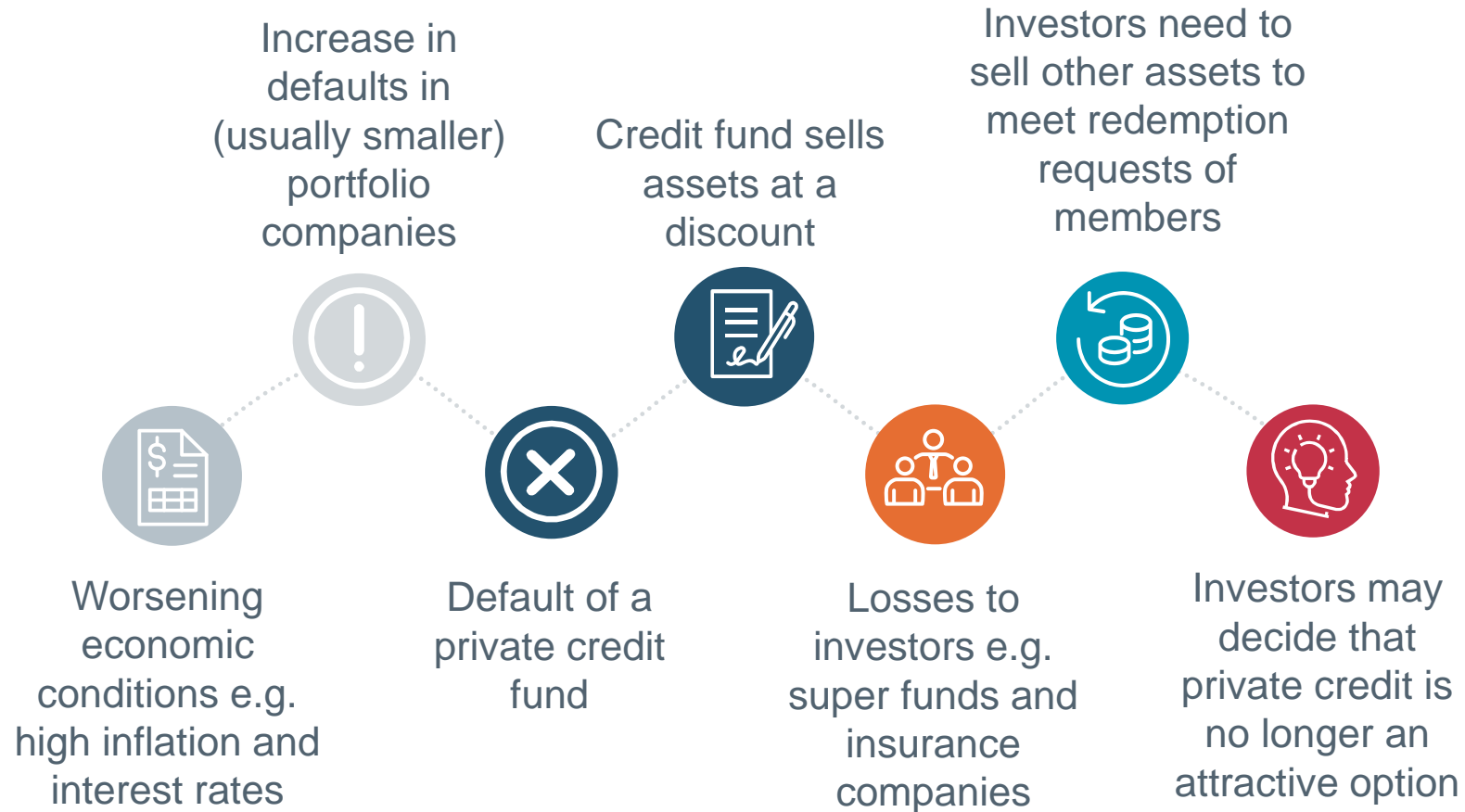
Consumer Price Inflation*



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000.

Sources: ABS; RBA.

Emergence of Financial Distress and its Implications



Insolvency Processes During Financial Distress

Formal Insolvency Processes



The appointment of administrators, liquidators and/or receivers and managers etc. may occur at the portfolio company level or the private credit fund level.

Informal Restructuring



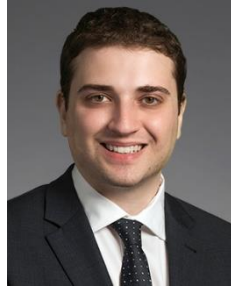
The flexibility of private credit may allow portfolio companies to negotiate forbearance or standstill agreements.

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