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FINANCIAL & PROFESSIONAL RISKS

# Private Credit - Risky Business?

*Question: which asset class has seen the most growth (17% per annum) since 2008's Global Financial Crisis (GFC)?*

*Question: which asset class is approaching USD 3 trillion assets under management?*

*Question: which asset class is considered an established peer of the more traditional equity and debt markets?*

*Answer: private credit.*

*With the US leading the charge and European and AsiaPac markets also on the up, this article outlines the basics of private credit, including its impact on the Financial Institutions (FI) underwriting space.*


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As explored in RPC's recent article [Private credit, increasingly public problems | RPC], private credit is essentially: "commercial loans extended by traditionally non-bank financial institutions". A nascent market at the turn of the century, it picked up speed after the GFC, and continued to strengthen during the COVID era, and is now very much in vogue.

This is thanks to commercial borrowers being less able to access traditional bank loans, more relaxed financial regulations and potentially superior investment returns. Supply and demand is higher than ever, with the larger banks also now competing in this space, alongside more traditional institutional investor vehicles.

### The Economic Risk

Sounds too good to be true? Global regulators are certainly looking proactively at the industry, which generally exists outside the scope of prudential regulation (which governs the traditional banking system). As a result, regulators are looking to strike a balance between supporting the economy and innovation but also getting ahead of any systemic financial issues. Concerns include:

- The development of a secondary trading market and opaque portfolio valuations potentially masking poor performance: remember the sub-prime crash?
- The use of Payment in Kind (PIK) notes: these allow debtors to defer repayments (at extra cost) avoiding default.
- More traditional lenders being double-parked: both lending to the institutional investors and having their own lending skin directly in the game.

### The Underwriting Opportunity

With risk comes opportunity and this certainly extends to the FI underwriting arena, where theoretically every risk is writeable at the right price and with suitable policy terms and conditions. When evaluating private credit risks, relevant factors might include:

- Is the client an established cross-cycle player?
- Portfolio diversification: e.g. across a good mix of industry sectors?
- How is lending financed: fund investors, balance sheet or are the loans packaged and sold in the secondary market?
- How are conflicts of interest managed and how are these communicated?
- Portfolio performance - including notable borrowers, industry sectors, "at risk" or borrowers in default (e.g. any PIKs, forbearance or restructuring)?
- Any recent claims history, valuation, audit findings or compliance concerns (such as adherence to regulatory guidance in the industry and/or territory)?
- Scenario stress-testing, both against private credit and similar historical data-sets?

### Policy Response

Whilst FI policies are not written to be a financial backstop to failed investments, coverage is often triggered as a result of the decisions/acts which lead to that failure:

- Lender negligence (e.g. a failure to conduct adequate borrower due diligence or valuation oversights).
- Investor claims for fiduciary breaches (e.g. a failure to diversify) and misrepresentations (such as to the risk profile of an investment portfolio).
- Actual or perceived conflicts of interest.
- Borrowers countersuing to contest recovery/default proceedings.
- Fraud: e.g. non-existent/mis-valued/multiple-pledged collateral.
- And, as global regulators sharpen their attention, expect an uptick in investigations and enforcement actions to mitigate against a repeat of the GFC.

### Euclid Perspective

As the prior RPC article highlights: *"private credit is not the one-size fits all, low-risk and high-reward panacea that its most enthusiastic proponents promote".* At Euclid we understand that but, as alluded to above, with risk comes opportunity, for both our commercial partners and insurers. Euclid's appetite is focused on clients who demonstrate robust risk management and transparency in their approach to exposures - through diversification, rigorous due diligence, and expert delivery. Working with our broker partners to understand each prospective client's business model, funding structure, and approach to compliance, we are able to tailor coverage to the specific risks inherent in the fast evolving private credit industry.