Insights From the PRA's Thematic Review of the Treatment of Risk in Private Equity Financing

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On 23 April, the UK's banking regulator, the Prudential Regulation Authority ("PRA"), published a **letter** to Chief Risk Officers setting out the results of a thematic review of private equity related financing activities.

Given the grown of assets under management in the private equity sector from around £2 trillion to £8 trillion over the last decade, with a commensurate increase in related bank financing activities, the PRA has taken a look at banks' risk management practices. Of particular interest is the treatment of financing that the letter characterises as 'non-traditional', including NAV and subscription financing, as well as structural market changes that have resulted from the growth of private credit markets. Given these changes, alongside geopolitical uncertainties, the PRA has looked at risk management frameworks and control structures for aggregate PE exposures, and has made a number of findings. The letter asks banks to assess these against current practices and put in place any necessary improvements to risk management that were highlighted as a result of this benchmarking exercise.

Thematic Review Findings

The PRA's review focussed on independent credit and counterparty credit risk management or 'CCRM' processes, and it raises the following expectations for review:

- *Data aggregation and a holistic approach to risk management:* the PRA's expectation is that all transaction and exposure data, along with collateral pledges, relating to the PE sector should be captured thereby enabling risk functions to identify, measure and consolidate counterparty and credit risk exposure information on a sector and individual sponsor and fund level.
- *Credit and counterparty risk interlinkages:* here, the PRA's expectation is that overlapping credit exposures, collateral pledges and financial claims where performance and recovery values are interlinked should be subject to due diligence and management information processes that recognise and measure the risk that arises out of these linkages.
- *Stress testing:* the PRA wants to see routine stress testing of sector and individual financial sponsor exposures performed in a modular way and "*tailored to the idiosyncratic risk profile*

of different products and structures." In keeping with other pronouncements on stress testing, the PRA also wants to see a move away from using historical default rates and previous risk patterns, and the use of higher than previously observed default and loss correlations.

- *Board level reporting:* In keeping with their findings on data aggregation, the PRA wants to see Boards being informed of aggregate exposures linked to the PE sector in order that Boards may satisfy themselves that the scale and composition of these exposures fit within the overall risk profile.

Next Steps

Banks should provide the PRA with confirmation that they have shared the output of the benchmarking exercise with their Board Risk Committee, and provide their analysis of their CCRM process benchmarked against the letter's findings together with detailed plans to remediate any gaps identified with their PRA supervisors by 30 August.