

The rise of private credit markets: A threat to financial stability?

Category: Private sector,Uncategorized

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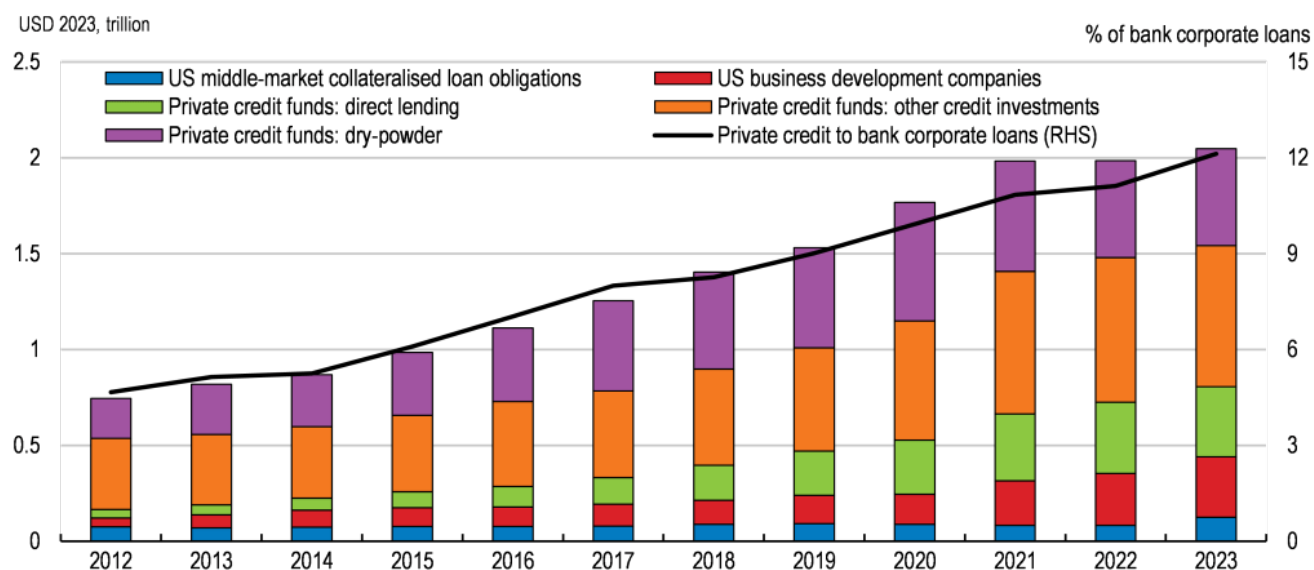
By Caroline Roulet.

Private credit has become an important source of financing

Private credit is a form of non-bank financing to firms, mainly through specialist funds that raise long-term capital from end-investors and offer long-term floating-rate loans to middle and smaller sized companies without access to capital markets or bank credit. End-investors such as pension funds and insurance companies value private credit for a number of reasons, including portfolio diversification, confidentiality, and potentially higher returns. Regulatory compliance costs could also be lower, although this varies by type of end-investor.

The latest OECD Economic Outlook documents the rapid expansion of this form of financing since the Global Financial Crisis and analyses the potential risks to financial stability. Private credit markets reached USD 2 trillion globally in 2023 (Figure 1). This was equivalent to 12% of bank loans to non-financial corporations, up from 5% in 2012. Private credit is very diverse but primarily US-focused, though is now also expanding rapidly in Europe and Asia.

Figure 1. Private credit continues to rise in advanced economies



Note: Business development companies (BDCs) are SEC-regulated, closed-end or publicly traded investment companies that must invest 70% of their assets in US companies valued under USD 250 million. Middle-market collateralised loan obligations (CLOs) are a segment of the US CLO market backed by senior secured loans to smaller companies that are originated in either public or private markets. Dry-powder is unallocated or unused capital maintained as cash reserves or liquid assets for future investment. Data are expressed in USD trillion adjusted by the 2023 US consumer price index and as a share of bank loans to non-financial corporations in advanced economies. See note of figure 1.25 in the December 2024 OECD Economic Outlook for further details.

Source: Houlihan Lokey; International Monetary Fund (IMF) Financial Soundness Indicators database; Pitchbook; and OECD calculations.

The expansion of private credit markets raises potential financial stability risks

The growth in private credit has become a matter of interest for central banks and other regulators due to the relative lack of visibility of the market and the underlying risks, and

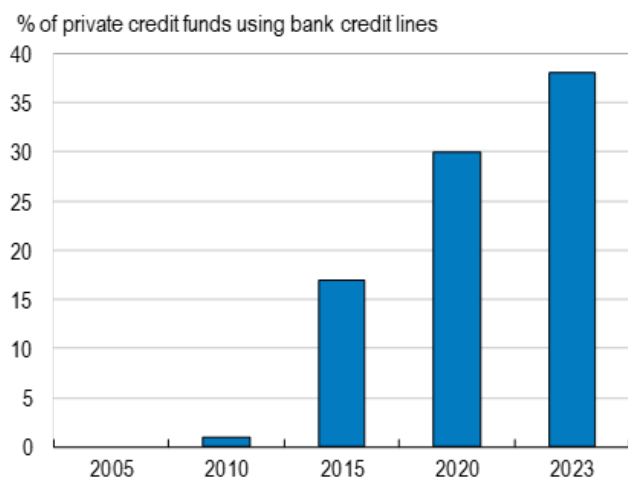
the extent to which private credit funds are interconnected with other financial institutions, not least banks.

Losses by private credit providers could quickly spread to banks. Private credit funds rely increasingly on secured credit lines from banks, with these collateralised by private loans (Figure 2, Panel A). Private capital funds (such as private equity funds) have also become major investors in financial instruments that transfer risks from bank loan portfolios (so-called “credit risk transfers”). This generates risks for both private capital funds and banks if either credit quality deteriorates or if funds’ large end-investors are unable to provide the capital they have committed to.

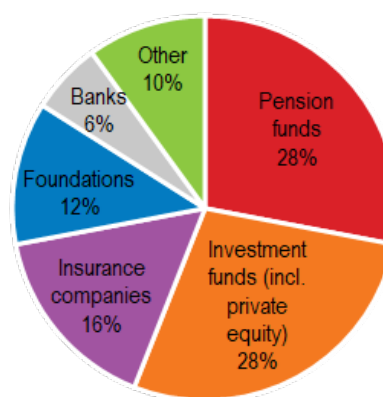
Private credit funds are also directly interconnected to private equity funds and institutional investors (Figure 2, Panel B). For instance, large private capital funds often manage both private equity and private credit portfolios. Also, private credit funds often provide credit to companies wholly or majority-owned by private equity funds. Consequently, vulnerabilities in one segment of the private financing industry will likely spill over to the other. Liquidity pressures could also arise for end-investors, including insurance companies and pension funds, if there are unexpected capital calls by private credit funds. Such risks are more likely due to the rising amount of committed but so far uninvested capital by end-investors (so-called “dry powder”), frequently held as cash reserves by private credit funds. In the United States, systemic risk warnings are increasing due to insurers’ private credit exposures (Fournier et al., 2024). In Europe, the difficulties of an Italian insurer (Eurovita) illustrate similar risks (AMF, 2024).

Figure 2. Interconnections between private credit funds and the financial system are growing

Panel A. Banks increasingly finance private credit funds



Panel B. Pension funds and insurers are major investors in private credit funds



Note: In Panel B, credit lines to private credit funds are not included in banks' investments, and data are as of June 2022. Source: MSCI (2023), Blackrock (2023), and OECD calculations.

More broadly, the lack of transparency in private markets is a concern. Multiple layers of leverage from borrowers to funds to end-investors are a potential source of financial instability, with risks of liquidity shortages triggering fire sales and simultaneous deleveraging. Although most private credit funds are unleveraged, some use derivatives for leverage (Federal Reserve, 2023). Some private credit funds also permit redemptions, which increases their liquidity risk.

The recent deterioration in credit quality is a further source of potential risk. A heavier debt service burden for private credit borrowers has led some to delay repayments by adding interest coupons to the loan principal. Refinancing risks are also raised, especially for the most fragile borrowers, because around 50% of the outstanding loans of US private credit funds are due to be reimbursed within three years (Cai and Haque, 2024). With defaults among highly leveraged non-financial corporations rising, there are risks that losses on private credit loans could rise sharply. Such loans are often to firms in economic sectors with low collateralisable or tangible assets and hence low recovery rates in the event of business failure.

Private loans are non-traded, which hinders proper valuation by investors and monitoring by regulators. Credit risk assessments are also uncertain in the absence of clear regulatory standards and could result in losses being underestimated. In the event of a severe shock, a rapid loss of confidence could trigger margin calls in derivatives used by private credit funds, adding further to liquidity pressures from redemptions, with risks that distressed funds default with losses for end-investors. Many liquidity management tools at private credit funds have yet to be fully tested in severe scenarios. While divestment and fire sale risks seem low at present, close monitoring is needed given significant data gaps about the sector and its often limited prudential or conduct oversight. Greater transparency in regulatory reporting would close data gaps and enable better assessment and management of risks by private credit funds and end-investors (EBA, EIOPA and ESMA, 2024; IMF, 2024). Regulatory assessments and stress-testing of end-investors should also take appropriate account of their exposures to other non-bank financial institutions (Acharya, Cetorelli and Tuckman, 2024).

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Stepping up structural reforms to improve Egypt's business climate

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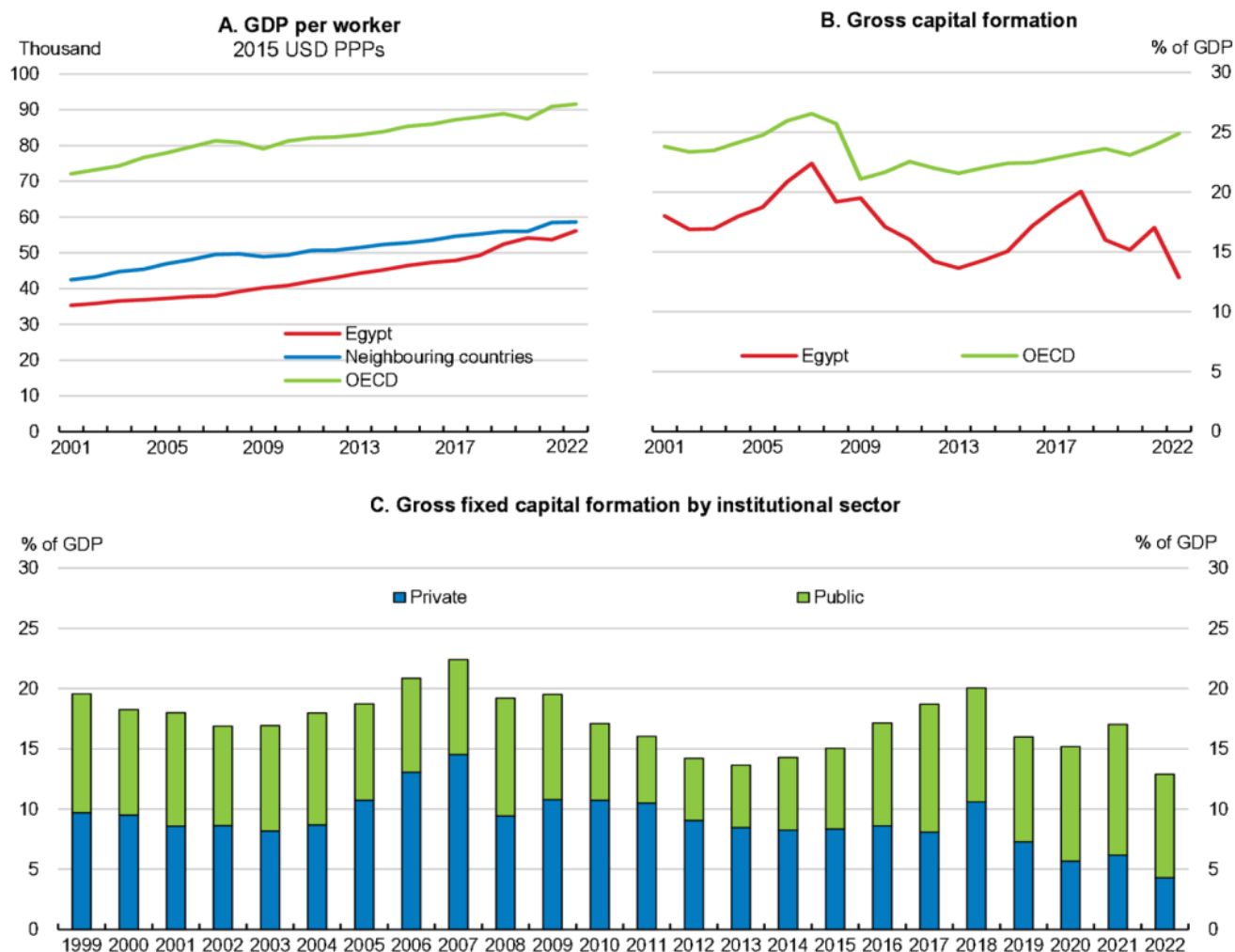


by Ania Thiemann, Economist and Competition Expert,
Competition Division.

Egypt's challenging business climate is holding back productivity and therefore also living standards. Labour productivity is still far below the OECD average (Figure 1), with low overall investment and a declining share of private investment in the total. Low investment in innovation, and research and development (R&D) also contributes to low productivity growth, as Egypt spends less than 1% of GDP on R&D. Market mechanisms, such as business entry and exit, and growth of the most efficient firms, appear to be weaker than in many similar emerging markets. Underlying these facts are deep-seated structural causes that impede market competition, investment and efficient resource allocation. These barriers stifle the country's potential for long-term sustainable growth and restrict the development of a robust private sector. To ensure sustainable economic growth, as set out in Egypt's National Structural Reform Programme, thorough policy reforms are required that can boost market competition.

Regulatory and trade barriers, as well as a dominant state presence need to be addressed to revive private sector activity.

Figure 1: Low output per worker is related to low investment



Note: Data for Egypt in all three panels refer to fiscal years (from July of indicated year to June of the following year). Neighbouring countries refer to Algeria, Israel, Jordan, Lebanon, Morocco, Tunisia and Türkiye.

Source: IMF, World Economic Outlook database – October 2023; OECD, National Accounts database; Ministry of Planning and Economic Development; and OECD calculation.

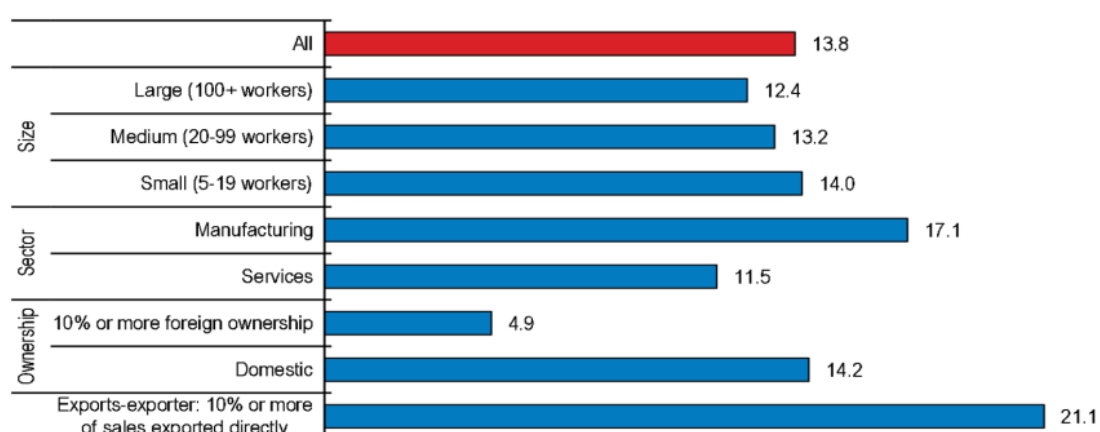
Removing regulatory barriers to enhance market entry and expansion

A central and long-standing challenge is the heavy regulatory burden that acts as a barrier to market entry and expansion,

while also promoting informality. Complex and lengthy processes for obtaining business licenses and permits during the post-establishment phase constrain both domestic businesses and exporters (Figure 2). Despite recent reforms, the administrative load remains heavy, stifling Egypt's business dynamism compared to regional and global averages, with comparatively low entry and exit rates. Moreover, overall regulatory quality remains low, reflecting lengthy and opaque decision-making processes and implementation.

Figure 2: Business licensing is a constraint on domestic businesses and exporters

Percentage of firms in Egypt identifying business licensing and permits as a major constraint, 2020



Note: Share of respondent firms out of 3075 firms surveyed.

Source: World Bank, Enterprise Surveys.

To support a more dynamic private business sector, Egypt needs to streamline its business registration and licensing processes. Licensing requirements can be replaced by online registration in most cases, while a more efficient on-line application system would speed up processes. A new online platform for business registration was opened up in 2023, but difficulties remain with local permits. Simplifying procedures and reducing bureaucratic hurdles can encourage new business formation and attract more investment. Additionally, improving the transparency of administrative procedures would also

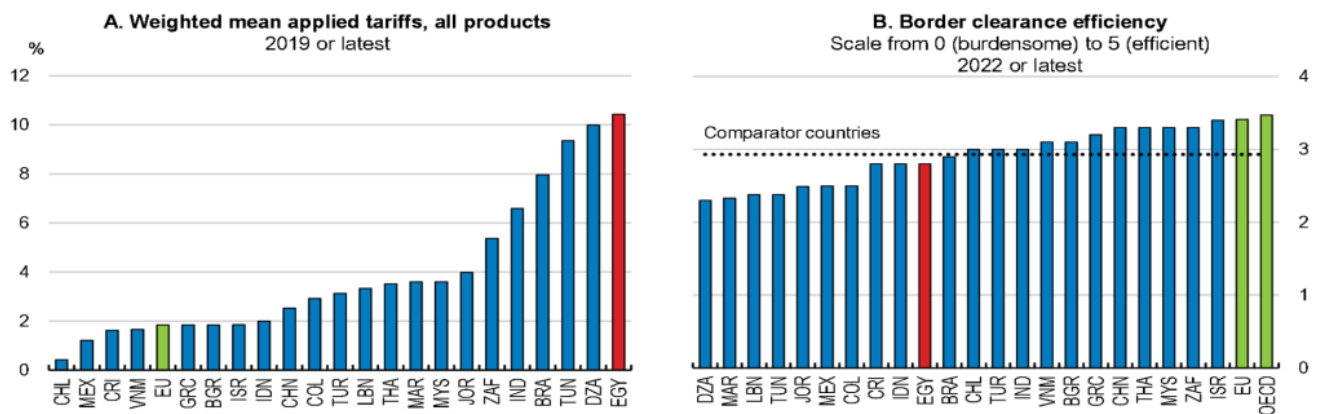
reduce opportunities for corruption, which is a crucial step towards creating a fair and competitive market landscape.

Strengthening competitive pressures through trade and investment

High tariff and non-tariff barriers to trade mean that the Egyptian market remains relatively insulated from global competition. Such trade restrictions limit the country's integration into global value chains and reduce the spillover benefits of foreign technology and know-how, which are essential for boosting productivity.

Liberalising trade policies and reducing tariffs can enhance Egypt's competitiveness on the global stage. The creation of the National Single Window (*Nafeza*) to support external trade, should help speed up customs procedures. Border clearance has improved but remains comparatively slow (Figure 3). To support faster import release, the authorities are working on a new risk management system, which should speed up processes by reducing the number of inspections to those selected by the risk matrix. However, Egypt should also simplify its tariff regime, as tariffs remain high and unwieldy, with particularly high tariffs for agricultural products, and for products that compete with Egyptian manufactured goods (with tariff rates of 40-60%), in a system with 7 850 tariff lines. Foreign traders whose products already meet domestic standards should not have to preregister their products, and import licences could be replaced by a simple registration with the customs authorities, as is the case in Europe. A more open and predictable trade regime would benefit domestic businesses and investors, as well as supporting more inward foreign investment. This in turn would facilitate the transfer of technology and expertise, thus foster productivity growth.

Figure 3: High import tariffs and slow border clearance are hampering trade



Note: In Panel A, data for the countries presented refer to 2019 except for Thailand (2015), Tunisia (2016), Israel (2017), Mexico (2018), Jordan and Malaysia (2020). Weighted mean applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. When the effectively applied rate is unavailable, the most favoured nation rate is used instead.

Source: World Bank, World Development Indicators; World Economic Forum (2019), Global Competitiveness Index 4.0.

Reducing the state's footprint in the economy

State-owned enterprises (SOEs) play a significant role in Egypt's economy, to the detriment of competitive market conditions by crowding out private sector activity. The government's recent steps to level the playing field, though commendable, need to be more comprehensive and sustained. Over-reliance on SOEs in various sectors, such as utilities and transport, but also in manufacturing, prevents private enterprises from competing on an equal footing. Privatisation and divestment of SOEs should be pursued more aggressively to reduce the state's dominance in the market. This move will not only improve efficiency but also stimulate private investment. The OECD's guidelines on privatisation could serve as a valuable framework for Egypt in this regard.

Further actions to support private businesses: Access to finance and digital diffusion

Access to finance remains a significant hurdle for many businesses in Egypt. Banks overwhelmingly prefer to lend to the government, leaving private enterprises, especially small and medium-sized enterprises (SMEs), with limited financing options which hampers business expansion and innovation. Enhancing financial inclusion by opening up the banking sector to competition, notably by FinTechs with Open Banking regulation, can mitigate this issue. Policies aimed at improving the creditworthiness of SMEs and developing a robust microfinance sector will also support private sector growth. Improving digital financial services could play a critical role in this transformation.

Digital inclusion is key to boost productivity and competitiveness. However, Egypt lags behind in terms of digital infrastructure, and adoption by SMEs. The legal framework for digital business models needs significant improvement to allow for dematerialised businesses to expand. Investing in digital infrastructure and fostering a regulatory environment that supports digital innovation are therefore crucial steps to create a more vibrant business sector and help enhance overall economic efficiency.

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