Bank of England warns of private equity dangers

Financial policy committee raises fears about transparency and asset valuations

Ben Martin, Banking Editor, The Times — Thursday March 27 2024

The Bank of England has sounded its strongest warning yet about the threat to financial stability posed by the $8 trillion private equity market as buyout firms and the companies they own wrestle with higher interest rates.

In a sign of officials' growing unease, the Bank's financial policy committee said in its latest quarterly update that it was carrying out a closer review of the risks lurking in the private equity industry, which grew rapidly in the period of ultra-low rates that followed the 2007-9 financial crisis.

The committee also cautioned that financial markets more broadly are too optimistic about the extent of future rate cuts by central banks, raising the likelihood of a sharp sell-off if policymakers disappoint investors.

Buyout firms typically use debt to finance the acquisition of businesses, and this model has come under pressure as borrowing costs have risen sharply since late 2021. Officials at the Bank cautioned on Wednesday that these risks "need to be managed carefully", not least because of the opaque nature of asset valuations and overall leverage levels in private markets, which are making it difficult for regulators to assess the potential threat.

The exposure of banks that lend to the industry is also being scrutinised, as are private equity-owned companies that seek to offset the pressure they face from higher rates through refinancing deals such as "amend and extend" transactions. These refinancings could "add to corporate debt burdens" at companies that are already deemed to be riskier borrowers because of the leverage resulting from their buyouts.

"Finance for riskier corporates could be particularly vulnerable to a significant deterioration in investor risk sentiment," the committee said.

The Bank will examine all of these risks further in the coming months and will publish the findings of its review in June.

Michael Moore, the chief executive of the British Private Equity & Venture Capital Association, which represents the UK's private capital industry, insisted that the buyout model had been "tried and tested" in previous periods of turmoil: "Private capital has been an important part of the UK economy for over 40 years, showing its resilience through different economic cycles."

Central banks around the world have rapidly lifted borrowing costs to tame inflation, with the UK's base rate having been increased to a 16-year high of 5.25%. Yet expectations are now growing that policymakers in the UK, US and Europe will soon push through a series of rate cuts. This optimism has caused markets to rally.

Rising prices have "pushed measures of risk premia further below historical averages across a number of asset classes", the committee said, meaning that valuations in markets are becoming increasingly stretched.

"These moves, in a challenging risk environment, suggest that investors are putting less weight on risks to growth or to the path of interest rates necessary to bring inflation back to target sustainably," the committee cautioned. This in turn has increased the risk of "a sharp correction in a broad range of asset prices and a widening in credit spreads" since the final quarter of last year.