

Financial Services Regulation Committee

Corrected oral evidence: Growth of private markets in the UK following reforms introduced after 2008

Wednesday 9 July 2025

10.15 am

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Members present: Lord Forsyth of Drumlean (The Chair); Baroness Donaghy; Lord Eatwell; Lord Hill of Oareford; Lord Hollick; Lord Kestenbaum; Lord Sharkey; Lord Smith of Kelvin; Lord Vaux of Harrowden.

Evidence Session No. 2
29

Heard in Public

Questions 16 -

Witnesses

I: Dr Narine Lalafaryan, Assistant Professor of Corporate Law at the Faculty of Law, University of Cambridge, and Fellow at the Cambridge Endowment for Research in Finance; Professor Ludovic Phalippou, Professor of Financial Economics at the Saïd Business School, University of Oxford.

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Dr Narine Lalafaryan and Professor Ludovic Phalippou.

Q16 **The Chair:** Welcome to today's meeting, which is the second oral evidence session as part of the committee's inquiry into the growth of private markets in the UK following the reforms that were introduced in 2008.

Thank you, Dr Lalafaryan and Professor Phalippou, for attending this meeting today. Perhaps I could begin by asking both of you if you could just sketch out for the committee how large the non-bank sector is overall, how large are private markets within it, how and from where do bank financial institutions, including private market firms, secure investment to fund their financial activity and who is primarily providing this investment. Shall we start with you, Dr Lalafaryan?

Dr Narine Lalafaryan: I am happy to go first. Thank you very much for giving me the opportunity to answer this question. The non-bank sector, otherwise known as the alternative finance market, includes a wide range of non-bank financial institutions, including insurance companies, private equity firms, private credit firms and venture capital. Non-bank financial institutions' share of total global financial assets was 49.1% in 2024. This is based on the data that was provided by the Financial Stability Board. This was an 8.5% increase from 2023. This increase is more than twice the pace of the growth of the banking sector. In 2023, the pace of the banking sector was 3.3% growth.

When it comes to the size of the non-bank sector in the UK, specifically in 2024, the non-bank market accounted for approximately 50% of total UK financial assets. Additionally, non-banks accounted for 50% of the stock of corporate lending in 2024. This data is based on various reports by the Bank of England. The situation is quite similar in the European Union. The non-bank sector doubled in size after 2008 and in 2024 accounted for over half of financial sector assets in the euro area. This is based on a 2024 study by the European Central Bank. After the global financial crisis of 2007-08 we have seen a trend of a rise of private markets, and non-banks account for roughly 50% of the market.

Within this landscape of private markets, there has been a particular rise, especially after the global financial crisis, in private equity, venture capital and, more recently, private credit. We are talking about approximately \$11 trillion—that is the size of the market—with private credit being the fastest growing asset class within the universe of these alternative investments. Just to clarify, private credit means many things, but if we follow the definition of the Bank of England, we are talking about bilateral lending between borrower and lender. This is typically arranged by non-banks. The US Federal Reserve defines private credit as debt such as non-publicly traded instruments. Again, those are provided by non-bank entities. The International Monetary Fund includes in this definition not just bilateral lending but also syndicated lending, so here we are talking about multiple lenders.

Just to clarify, this is not a new asset class, but it has been revived. In 2024, the size of the global private credit market has been estimated to be in the range between \$1.7 trillion and \$2 trillion. There are varying numbers from the Bank of England, the IMF and the Federal Reserve, but the common theme is that this is a fast-growing market. It is comparable to the leveraged loan market, which in 2023 was estimated to be roughly \$1.4 trillion, and to the high-yield bond market, so we are talking about junk bonds, and this market was roughly \$1.3 trillion. This is data provided by the Federal Reserve. The International Monetary Fund has data that shows that for about 70% of private credit deals, the borrowing company is sponsored by a private equity firm. The most recent report is by the Managed Funds Association and was published on 24 June 2025. It looks at the timeline from August 2022 to May 2024, and it shows that the UK is the second-biggest market for private credit, with loan issuance and private credit rising to 285%. This is compared to almost 500% in the United States and a 130% increase in the EU. This data also shows that, in Europe, the UK is the leader with more frequent and larger loans than EU countries.

There is a quite similar story with private equity. We are seeing an increase in this market. The British Private Equity and Venture Capital Association has data that shows that in 2024 the total amount invested by private equity and venture capital in UK businesses was £29.4 billion. This was a 44% increase compared to 2023. I think the unifying theme in this data is that private capital has grown significantly, especially after the global financial crisis and especially in the years after Covid, and it is continuing to do this.

The second theme is that the UK is the second-biggest private capital market, including for popular asset classes such as private equity and private credit.

The Chair: Could you say a little bit about why this has happened? Presumably quantitative easing is part of it.

Dr Narine Lalafaryan: There are a number of reasons for this. From a legal point of view, one of the reasons is that a lot of these trends are coming from the US. US investment funds are introducing their trends all over the world, and the UK is a market these investors find it very easy to navigate due to our legal system because it is very flexible. We also share an Anglo-American legal system and rules, and investors find it easier to invest in the UK compared to certain other jurisdictions where the legal framework is a bit more different. Credit should also be given to the expertise of a wide range of professionals who are involved in this sector, whether they are lawyers or finance professionals. The biggest reason is that US investors who drive the trends and who are the dominant investors in this market find the UK market very attractive because of the flexibility that the legal system provides.

Professor Ludovic Phalippou: I do not want to repeat. Reading your question, it is not so much about the size of non-banking financial intermediation because it is very wide. It covers trillions of dollars and all

kinds of instruments. I think what you seem to be interested in is funds that are called private credit funds, which are entities that lend directly to companies in lieu of banks. It used to be banks lending to companies, and now we have some vehicles that do the jobs of banks. We see also some institutional investors doing it directly. We see an insurance company that may make a loan. We see a Canadian pension fund lending money to Thames Water, for example. That is a changing landscape. Thames Water used to go to British banks and now can go to a Canadian pension fund for a loan. I guess this is what you are thinking about. That is much smaller, probably with around \$2 trillion of assets under management in the loan portfolio. It is important to think that most of this figure is in the US. Three-quarters of the number is in the US. The US is really where they are larger in size, but it is also where the trend started and where it is most practised.

As was just said, probably the reason the UK is the second largest is because the UK legal system and professionals in London are very similar to the ones in New York, so it is very easy for an American corporation. The largest direct lender in the world is called Ares. Ares is in the US and has opened an office in London. The head of Ares London is Blair Jacobson, a guy from Chicago who has lived and grown up in the US. He just comes here. It is very natural and very easy, so they can redeploy the same strategies as in the US here in London. So that is probably why.

Some of your questions were around whether they really help the economy and things like that. It is important to make a distinction between different players. There is this world of private capital funds. Ares is one player, and you have probably heard about Blackstone, Carlyle or these big names. These are all large private capital firms, and they provide loans. You can call Blackstone to get a loan, you can call a KKR et cetera to obtain a loan. These firms do a bit of everything, and it is important to distinguish between the ones that are called venture capital and growth capital. These firms inject capital into companies, they take a minority stake in a company and inject capital into the company. Universally, these firms are the darlings of policymakers all around the world because they just do not have enough. They want to know how to have more venture capital in the UK. They want to know how to do a Silicon Valley in France. It is always these themes that are on the table. They are the darlings.

Over about half of the market is what we call leveraged buyout, which is not a very fancy name. People do not quite like to be called leveraged buyout, even though this is exactly what they are doing. They prefer to go by "private equity" in the hope of being mixed with venture capital, who are the nice guys. Leveraged buyouts are the infamous ones. They are the ones behind Boots and Toys "R" Us and the collapse of some care homes in the UK, and so on and so forth, and Thames Water. These are the relatively infamous ones. Private credit makes these loans to companies. Most of them—two-thirds or so—are made for these leveraged buyouts. If you are going to take over Boots, Pizza Express et

cetera in the UK, most likely the provider of the debt to take over this target is going to be a private credit fund.

You seem to be interested in lending to companies. Some lending would go to the local entrepreneur who wants to borrow money, and if the bank does not give a loan, they would perhaps go to the likes of Blackstone or KKR. But that is not really the typical transaction. The typical transaction goes as follows: "I am KKR, and I want to take over Boots. I'll finance it with three-quarters of this or two-thirds of that, and I'll go to CVC or Ares to obtain a loan in order to take over that company". The controversy comes from the fact that the loan that they contract in order to take control of a company gets shuffled into the company's balance sheet. The controversy is that Boots, which did not ask for anything, is told by somebody taking control of it, "By the way, it is on you to repay everything that I had to use to take you over". That is where the controversies come from.

These questions about the usefulness of private credit and the like need also to be judged in the light of the fact that these loans are not going to the local restaurant or entrepreneur. Some are: they are expanding in that area, because as they are doing more and more lending, of course they are expanding in all kinds of areas. There will be some venture capital early-stage companies that get a loan from a small private credit fund but, as of now, it is not really the majority.

Lord Vaux of Harrowden: To be really clear, when you are investing in the big leveraged buyouts, in effect, this is not an investment in future growth; it is almost the opposite, because you are reducing the ability of the company itself to invest because it has massive debt pile within it.

Professor Ludovic Phalippou: You could put it that way. Also, these are professionals at running companies, so they might potentially bring a lot of improvements to a company. But yes, the distinction we often make is between the primary transaction and the secondary transaction. Often, if you hear an entity such as KKI—it could be any one of them—it will say that the BVCA is very good at playing with language. It might say, "We have invested this many dollars in UK businesses", but what it did was buy these businesses from someone else, so it is just a transfer of ownership. This is what it cost to buy all these UK businesses; it is not an injection of cash into UK businesses.

In relation to your question about who finances it, it used to be that mostly pension funds and sovereign wealth funds were behind it. The growth of private credit is fuelled a lot by insurance companies. None of your questions touched on that, but I think it is a big point that insurance companies seem to be doing regulatory arbitrage with private credit funds. They are allowed to leverage 10 times \$1 invested in a private credit fund, which is a fairly risky type of investment to begin with, and allowing insurance companies to have such a high leverage on something already levered is quite a wild move.

Insurance companies are the main providers of capital to private debt funds. The sovereign wealth funds and pension funds are still a big contributor to the private equity funds, and they also contribute a lot to private credit funds. Now, the new boy in the street is the retail investors who are investing in both. We now see retail investors giving money to private credit and private equity funds.

But, from a macro perspective, you can think of these as pension funds of the world giving both the equity and the debt in these leveraged buyouts, which means that, on net, they are just holding an unlevered asset—just holding the asset—but it has been sliced into many pieces, and all kinds of people, including banks, are financing all kinds of pieces, giving all kinds of credit lines et cetera in these transactions, giving loans to private credit funds which then lever extra with the bank in order to lend. The private equity funds also borrow a bit from the bank with credit lines to delay capital costs, et cetera. The banks are playing there everywhere; all kinds of financial intermediaries are there. Companies get sliced into many pieces and then there is a massive mess. But at the end of the day, from a global perspective, you just have mostly pension funds holding companies, as it used to be.

Q17 Lord Sharkey: Where does regulation stand in all that? What are your reflections on the current regulation of private markets? Do you consider that the private market should be subject to more oversight, ranging, perhaps, from greater transparency or disclosure to prudential regulation?

Professor Ludovic Phalippou: Most of the questions that your committee seems to be worried about are around whether there is a systemic risk posed by these people who act like banks but are not regulated like banks—these private credit funds—and whether, more broadly, we should be worried about private equity being so big or controlling so many UK companies and the like.

I do not think there is any systemic risk to be worried about. Investors are receiving quite a lot of information, and the broad public does not, but is that really a loss? I think so, but this could be debated. All else equal, in the UK—compared with the US—the public can get information on companies because the chambers of commerce have the accounts of all companies in the UK, including privately held ones. For example, for a study I did of private equity running care homes in the UK, I had access to all the balance sheets of all the care homes in the UK, whether or not they were private. In the US, this would not have been the case. There is quite a lot of information out there. However, it took us a lot of time because they use all kinds of structures and vehicles all over the place, and to consolidate all the information is a huge amount of work.

There could be some effort to make the information more standard, easier to aggregate and so on, even for the investors. The investors receive thousands of pages of PDF but it is very hard for them to aggregate and have an overview of what is going on and where the money goes, and some companies will not measure leverage the same

way as another does, they will not report performance the same way, and they will not do valuation the same way. There is quite a mess in the information being provided, but I do not think there is a systemic risk that you need to regulate private credit like you would with banks. But certainly, an effort could be made to standardise and clean the data.

I have long argued that we need a lot of intervention in investor protection, but it has mostly fallen on deaf ears. In the US, at one point with the Obama Administration and then the Biden Administration, the SEC made some effort on investor protection in private equity and private credit, but it was very timid. Recently, the SEC was successfully sued by the industry for overreaching, so it then had to stay away. In the UK, I have had many conversations with the FCA, which has basically always told me that it does not really care about private markets and that unless Parliament asked it to it would not really act. I always thought it was quite an emergency, and now, with retail in that space, I think it is a drama not to have strong investor protection.

We have relatively affluent people—it is not really the people on minimum wage—but they invest in private credit funds with no idea about where the money goes or all the layers of leverage that are put on it, and they do not understand the legal contracts that are behind it, which are extremely complex. That is a matter of emergency—and the insurance companies playing tricks—but I do not really see a systemic risk of banks or overpriced markets.

Lord Sharkey: The Bank of England is worried—or says it is worried, anyway—about the increase in private markets. It worries partly because of the unclear interconnectedness of the various sources. Do you share that worry?

Dr Narine Lalafaryan: I want to add to what my colleague said. I agree that, from a systemic risk point of view, there is less of a concern, but from a regulator's point of view—I appreciate that the Bank of England has already done quite a lot of work on this—it might be worth looking into this in more detail and understanding not just the interconnectedness of public markets or the bank market and private markets but the interconnectedness between different types of investors and the blurring of capital. We are seeing interconnection and blurring between not just the markets but different types of investors.

For example, post Covid, we are increasingly seeing this trend of hybrid funds, which are funds that invest in both equity and debt. Before Covid, there was a clear distinction between equity funds and debt funds, and with Covid we saw an exogenous risk, which was not really factored in in the rationale of the fund-raising of the funds. Now, some of the more sophisticated funds, the bigger players, are in a better position to come up with structures such as hybrid funds, and hybrid funds cause blurring of investors, so investors are investing in both equity and debt. There is not really that clear distinction that there used to be before between equity and debt investors, but we are also seeing an increased blurring in capital, with equity capital and debt capital. With these different

interconnections, we are seeing convergence of markets, investors and capital, which is relatively new; it did not exist before Covid; it was not really there after the global financial crisis.

From a regulator's point of view, while I appreciate that they are doing a lot of work on this, it might be worth taking a more detailed look into the interconnectedness, which is relevant not just for the UK market. It is global; when US funds invest in the UK, there is a cross-border element. From the point of view of UK banks, they are also thinking that when they originate the debt and sell it to the secondary liquid market, they need to know whether they will be able to offload the debt to US funds, for example. US investors will be interested in this.

There is another layer of interconnection here; it is not just the markets—it is markets, investors and capital. There is this great blurring phenomenon, and the blurring presents lots of possibilities, not just for the UK. It presents momentous global possibilities, but it also raises new questions. From my point of view, those questions are not necessarily regulatory; they are more about the implications of the blurring of capital, for example, when we look at our legal framework such as in corporate law, corporate governance and insolvency law. Our law has quite a distinct characterisation of equity and debt. My colleague mentioned investor protection, but I would add investor accountability, because if the investor does something wrong they must be held accountable. We have a different system: equity debt is debt. That was done for understandable reasons, including when the Companies Act was introduced. At the time, the market was very different; we did not have this type of advanced blurring, so I see this as a bigger concern, as opposed to the regulation of funds.

Q18 Lord Eatwell: I want to pick up the issue of systemic risk. I was rather surprised by the confidence that you both display that there is not a systemic risk issue. First of all, as you have both made clear, you do not know—you do not know what the connections are. The data are incredibly opaque. In those circumstances, we literally do not know what the risks are. The other point is that in Professor Phalippou's paper, for example, where he deals with this question, he says that the risks are mitigated by closed-end fund structures, but closed-end funds have liquidity problems and are typically mark to model rather than mark to market. Then when the market intervenes, very strange things can happen.

It just occurred to me that the first incident in the global financial crisis was the BNP liquidity issue in 2007 in the American markets. That was a tiny bit of the American market, but it was the spark that lit the fire. How can we be as confident as you have both been that there is not the potential spark here, when we do not actually know what all the connections are?

Dr Narine Lalafaryan: Could I clarify that, when I talk about systemic risk, the main issue is interconnectedness, if we are able to identify better how the markets, investors and capital are interconnected to each other, along with the risk exposure.

Lord Eatwell: There is an invisible connection called confidence. If there is a loss of confidence, there may be no formal transactional relationship between two financial institutions, but one can bring the other down.

Dr Narine Lalafaryan: From my point of view, I am not saying that there is not a systemic risk issue. What I am trying to say is that this new angle of interconnectedness is something that the regulators should take a look at from a systemic risk point of view. This angle brings new opportunities but also raises new questions. Many of those questions from my point of view are more on potential reforms in the corporate law framework, for example, explaining how to deal with capital that is not equity and not debt and how to hold an investor accountable or protect an investor in those situations. Maybe that should be the first step in the direction of us understanding better what is happening there.

Professor Ludovic Phalippou: Thank you for raising the point. Economists tend to be very simplistic, so maybe we are missing something—but let us try to unpack that. When there have been problems, it has usually been with a counterparty risk. Overnight banks lend to each other all the time, and if I am not sure that you have the money you pretend that you do—if you say that you have the money but nobody else believes you—we have a big problem, and the bank of Switzerland has to intervene. It is usually how it happens—that there is a counterparty that we do not trust anymore, then they freeze the lending of banks overnight, which becomes a catastrophe because we rely on that a lot. Or you have a run on the bank, like Northern Rock—we have seen it recently in the US.

Let us see what the situation is. Blackstone has lent money to Thames Water at one point, and the money comes from the Dutch pension fund, which gave the money to Blackstone, and Blackstone gave it to Thames Water as a loan. Then there may be a loss of confidence, the Dutch pension fund may want to be out of the Blackstone fund, and Blackstone will turn to it and say, “No, I’m sorry, you cannot get out”. With a closed-end fund, that is the rule—you cannot get out. What then? The Dutch pension fund will be disappointed and it may be less return than it was hoping to get. It hoped that it would not have such extreme illiquidity perhaps.

Lord Eatwell: It may write off the asset altogether, and then you are in real trouble.

Professor Ludovic Phalippou: No, but then the Dutch pension fund has to email someone like me, because I have some of my pension there, as well as others, saying, “We are very sorry, but we lost your pension”. But that is not a systemic risk in the sense of a freeze and the banks saying that they are closed tomorrow. It is not a Credit Suisse moment, where over the weekend you had to find somebody credible to take over its position. With the Dutch pension fund it is like, “Oops”. That is why I am talking a lot about investor protection. We do not see the mechanism for systemic risk, because there is no counterparty. The Dutch pension fund

has given some money to Blackstone, which has given it to someone else.

There is such a case right now, actually. Blackstone is the largest commercial real estate fund in the world, and it announced a valuation that nobody really believes: people think that it is too high. It has not changed for four years. Everybody says, "Can I be out of that valuation, please?" Blackstone turns to them and say, "I am very sorry, but you cannot". Then they are very disappointed—but that does not create any problem. It has been like that for two or three years, and nothing major has happened. It is just that Blackstone is gating people, saying, "You don't—too bad for you".

The worry that the central bank articulates about interconnectedness comes from the banks being exposed in many different ways to private equity. We can hear that worry. The private equity industry, which I have not mentioned, is quite concentrated; you have 20 different players, and behind them you may have 30 large, limited partners. So the money going to private equity is going to involve disproportionately PIF in Saudi Arabia, CPP in Canada, the Dutch pension funds and so on. There may be 30 very large providers of capital so that, if all of a sudden they say, "I'm sorry that you called for the money—I promised it to you but I am not sending it", for the banks that have given all kinds of loans with the idea that I had collateral, and now I do not have it, there is a problem. That is possible.

I am not inside the bank, so maybe the banks have not kept track very well of their concentration risk across all divisions of the bank for private equity.

The ones that I know are working with banks tell me that they have, but I cannot check; I am not a regulator and I do not have access to their systems. I have the feeling that the Bank of England is tracking it but, if it is not, it is certainly worth the Bank of England asking all the banks whether all their exposures, directly or indirectly, are to private equity funds. Most important are the underlying people, because they are exposed, in effect, to the Dutch pension fund idea and the like, so the risk is that these people do not send the money if called.

They need to know that I am exposed by \$2 million to ABP in the Netherlands, \$1 million to CPPIB in Canada and so on and to see whether I am diversified enough across types of institutional investors and that I am easy as a bank with all my positions in private equity. I think this is what they are doing but, if not, they certainly should.

Again, we do not have this overnight lending. There is an illiquid issue in closed funds; we see it with Blackstone's largest real estate. It has been like that for two or three years—nothing is happening.

Lord Sharkey: I just wonder what all this has to do with the real economy.

Professor Ludovic Phalippou: I understand that feeling. There is a lot of puzzlement, even among economists, about the usefulness of finance in general. I often make jokes. Let us take something like Debenhams. Private equity walks into Debenhams in the mid-2000s. Prior to private equity, Debenhams has no debt. They own their stores, and so the guy who owns Debenhams has the walls and the cash flows and that is it. Then private equity comes in, they take all the walls and they put it in a real estate fund. Then they issue a lot of debt and put it in a private credit fund. Then they keep some of the equity and put it in a private equity fund, and these things get sliced further and further. Then you would talk to a pension fund that would tell you, "I am extremely diversified. I have some real estate, some private equity and some private credit. I am as diversified as it gets". But you just have Debenhams.

All these finance people have sliced and diced these things with legal contracts that are super-lengthy SPVs all over the place. Jersey and Guernsey had a party; nowadays, it is more Luxembourg. You have all these intermediaries feasting on drafting these contracts and the like, and I can understand when the spectator asks, "What are you doing this for?"

At the end of the day, on aggregate, you still own Debenhams, right? If anything, you may have constrained Debenhams because of this very complex structure, which means that Debenhams cannot move with the agility that they would have had otherwise. I understand that opinion, but it is more a philosophical thought or a policy decision rather than me as a finance guy explaining how it works. I think it is legitimate to wonder about the social usefulness of finance.

On your previous points on the Bank of England, I have a couple of remarks. The Bank of England may also want to be worried about the monetary policy issue. When you are a bank, you can create money and you are highly supervised by the Bank of England. If these private credit funds are bigger lenders, they do not create any money; they just take money from these pension funds and give it to someone else. The Bank of England is therefore losing its monetary policy tools. It cannot control the supply of pounds sterling into the economy, so it could be worried about these things, and that it would be legit.

Again, the aggregation of all the Bank's positions should be a worry. I think it has it under control but, if not, we should help it. One example that might be useful is the Dutch central bank, which is the only central bank I know in the world that has taken it upon itself to do investor protection with its pension funds. The Netherlands has very large pension funds, and the central bank took the initiative mid-2010—perhaps because of some of my work—to ask for better field tracking for pension funds and releasing this information to the public, so that the public know how much is being paid to all these intermediaries for all these complex transactions and so that people with their pensions there know how much of their money pays for that. That again falls under the investor

protection type of initiatives that a central bank such as the Bank of England may want to take.

Q19 Lord Hollick: You have both explained and told us about the dramatic growth since 2008 to private credit and that the consequence is that the banks' role in providing credit to companies and institutions has diminished dramatically.

Why are the banks happy to sit by while half of their market has disappeared? What are the advantages for private credit? Is it light regulation? Is it what you just described as distributed risk, in the event, to holders in your pension fund? You seem to be very sanguine about the risks that are taken by pension funds. So why has the risk appetite changed? Why have the regulations changed? What are the drivers of this quite dramatic change over the past 17 years?

Dr Narine Lalafaryan: There is not really one answer to this question. There are certainly certain factors that have contributed to the change that we have seen and the growth in private markets. Regulation may be one factor, but I would start by saying that, in recent years, especially after the global financial crisis, we have seen an increased amount of debt and an increased amount of corporate debt. That is also in order to meet the demands of private equity.

Lord Hollick: So the demand side is important.

Dr Narine Lalafaryan: Yes, there is a supply-demand story here. I also think that, in past years, the interest rates were so low and debt was quite cheap, so companies piled up quite a lot of debt, and the funds were in a position to do that. That is one factor.

Then market changes and regulatory changes certainly also contributed to this. On the market changes, we could think about this question and say, "Well, it all started after the global financial crisis", but I would like to go a bit further back and think about the 1970s. In the 1970s, the market was the lending market; it was a very different market. We had a bilateral type of relationship between the banks and the companies, and the banks knew their customers. There was a very relational finance element there. Then, from the 1970s, when the syndicated loan market had started to gather speed, we saw more sophistication on the lender side, but also on borrower side. New market players also entered the marketplace at that time, including alternative finance providers.

Then, with the 2007-08 global financial crisis, the regulation was obviously introduced, for understandable reasons, but it had an impact on banks' ability to engage in what used to be their traditional business, which was relational finance. They are no longer in a position to engage in this relational finance.

Lord Hollick: Has their risk appetite lessened dramatically?

Dr Narine Lalafaryan: I think their risk appetite has lessened quite a lot because of the shift in their business model. They are no longer

predominantly in a position to originate this debt and then keep it until the debt matures, for example. They are now in the business of originating debt and then selling it to the secondary market—they are very much in the business of moving or trading the risk. The funds, on the other hand, predominantly originate debt and keep this debt until its maturity. They are mostly in the business of storing or owning the risk.

That is another factor in the growth of all this. I also think that, nowadays, in the higher-for-longer interest rate environment, funds probably have a bit more flexibility to deploy more flexible strategies for companies. There is more appetite on the company side to opt for private financing or non-bank financing. It is much faster to obtain it—it is speedier. It is more costly than bank financing, but there is more flexibility for companies.

This especially plays an important role in times of economic downturns. When Covid happened, funds were in a good position to step in and help companies to refinance, for example. I know that my colleague mentioned leveraged buyouts as one of the dominant strategies but, over the past few years, we have also seen refinancing as an increasing strategy. Many companies are really struggling to service their cost of debt because interest rates are so high, and funds are arguably in a better position to do this.

So it is not just about regulation. There are various factors at play here, and regulation certainly restricts banks' ability to do relational finance; they cannot really do that any more. At the same time, we are seeing in the past two years an increasing appetite for banks to partner with funds to offer private credit. One very good example of this—I think quite a successful one—is that Citibank partnered with Apollo, which is a fund. They formed a \$25 billion private credit fund in the form of a joint venture. So there is competition between banks and funds but on a certain level, especially between sophisticated players—the bigger players and the bigger funds—funds are also partnering with banks to offer this. There are some quite successful examples and others which are less successful.

Lord Hollick: On that particular example, Citibank seems to be saying that it can be more innovative and charge more—apparently, from what you are saying—if it does it through this joint venture. Why does outsourcing that sort of business make sense? What forces that?

Dr Narine Lalafaryan: I have been wondering about this question myself. It is a bit too early to say. I am not aware of any empirical data that would show what the profits for banks are. I think they are trying to participate in this market, but it is more costly. At the same time, they are thinking about how to stay a bit more competitive. I do not think I can answer this question comprehensively because it is just too early to for us to know why.

Professor Ludovic Phalippou: You said at the beginning that banks are not providing debt any more to the economy; that was your opening.

Given the conversation just before about where this debt is going and what kind of things it is financing, we may qualify the loss for the economy of a real sector with the banks not providing that to LBOs and private credit doing it instead. That said, private credit is doing more and more types of lending, so it is eating more and more of the lunch of the banks.

I have a quick advertisement—if you are interested in these questions on your way back home, I have a podcast series. The episode I recommend is the one with James Ranger, who is the head of leverage finance at Lloyds. He is a good friend. I start my talk with him by saying, “James, I’m very worried about you. You must have nothing left to do at Lloyds. These private credit guys are doing all of your work, so you must be bored. What do you do with your days?” He did take up cycling, but none the less, he said that he is very busy because he is working a lot with his private credit fund. Lloyds has a new fund with Oaktree of the type mentioned here. They give all kinds of credit lines and things like that to private debt funds, but they have retreated—or they lost—against the private credit funds on direct lending.

I did this game for an online course. I had professionals negotiating a debt package. One was negotiating with James of Lloyds and somebody else with Orla Walsh, who was a private creditor at StepStone. That happened live. James priced it like Lloyds priced it and, in my case study, StepStone was more expensive; James offered a cheaper cost and had fewer fees than StepStone. The ones acting as professionals had to choose between the two. That is insightful, because it shows very clearly why they made that choice. They went for the private credit fund. They were more expensive, but they went for the private credit fund anyway.

What is this advantage that private credit funds have over banks? Even if the banks are still trying to lend at a lower interest rate, they are still defeated by private credit.

The Chair: Why?

Professor Ludovic Phalippou: Private credit will give you what we call a single tranche. For example, if you have £10 million of EBITDA, the bank will say, “I can give you £40 million, but I need to find some people for the rest of it”.

Lord Hollick: It used to be called syndication.

Professor Ludovic Phalippou: For the £40 million, I would try to syndicate. Then I will probably sell some of it to someone—I do not know who yet or who it will end up with. If you go to private credit, say Ares, it can give you £60 million today, no questions asked, and it stays with Ares. You will not have to deal with anyone else; we are partners, and I gave you the loan. If you have a problem in three years, you come back to me. It will not be some kind of hedge fund that you do not know that ends up with your debt and you have to negotiate with. That is massively attractive for a borrower.

The other thing is that if, in three years, I want to acquire a company and James gave me the money at Lloyds, I will need to go back to James and say, "I need money because I want to acquire a company". James will say, "I've lent a bit too much right now; I'm not sure". It is a waste of time, and it is a bit annoying; it is not reliable. Ares always has money, because it just needs to call ADIA and the Dutch pension fund and it get the money I need for my add-on acquisition.

Having deep pockets and all this money that is pre-committed by investors means that private credit funds will always deliver whatever cash I want. Lloyds might or might not—who knows, in three years it may have merged with another bank and closed down its leveraged finance department, just like Royal Bank of Scotland did, so I do not have that certainty of future lending and the like. Who ends up with my debt is a big deal. If I am in a situation of distress and the hedge fund shows up and says, "By the way, I bought all your debt on secondary market, so you're talking to me", I do not know who they are.

That is why the banks really are losing. The banks did not retreat from the market. The capital requirements that have been put on them have certainly handicapped them, but not that much. They are still trying to lend even more cheaply than they can manage to, because these guys have serious natural structural advantages over the banks. So the banks retreated on credit lines, but now even these private credit funds are raising funds to provide credit lines, so they are killing the banks there. The banks keep on retreating, then they say, "Okay, I'm going to have a partnership with these guys because I know how to do lending and I have a brand at Lloyds. Maybe if I partner with Oaktree I can get the private credit benefits and I'm still alive". It costs a lot more money, so then the banks also have an additional income stream but they are shrinking.

Maybe it is a natural thing, because banks are not natural long-term lenders. They have deposits that can go out at any point in time; that is why they are so regulated. They are not natural long-term lenders. The natural long-term lenders are pension funds, sovereign wealth funds, university endowments and the like.

Lord Hollick: Sorry, you say that, but the largest part of a bank's book is its mortgage book, which is very long term.

Professor Ludovic Phalippou: They could stay as mortgage providers, although now there are some investors who are thinking about providing mortgages as well. Revolut is also thinking about offering mortgages and the like, so they may be disrupted there too. Right now, maybe they will stay on the mortgage market for a lot longer, because it is so small and they have these branches, but the banks are not really natural providers of long-term lending to corporates, when you have to sign a £100 million or £1 billion debt, and they are being destroyed by these private credit funds.

Q20 **Lord Hill of Oareford:** You just started to touch on the supplementary I wanted to ask after Lord Hollick. The banks say that the capital

requirements put in place are reducing their ability to lend to businesses—they might say to small and regional businesses in particular. You get that argument in the UK and across Europe. What do you think about that argument?

Dr Narine Lalafaryan: I would just say that there is a dramatic shift. We are speaking about smaller companies here and the funds are typically lending to smaller companies. That is the way we used to think about this, at least originally. The banks are now also competing with funds to provide money to multinational public companies, and not just what we used to call middle market companies.

A couple of years ago, companies such as AT&T, Air France and Wolfsped Incorporated went for private credit as opposed to bank financing. The reason for that is because it is faster. It is speedier to go for private credit than to put the bank package together. But it is also because many lenders, including multinational public companies, do not really mind having stricter restrictions on the type of financing that they are going to obtain, so they are very happy to go with financial maintenance covenants in their packages. Banks also now have to deal with this and, yes, the regulatory framework essentially inhibits banks' ability to offload the debt.

To add to the point that my colleague raised, and the point that was raised before about why you would choose private credit, although there is no comprehensive empirical evidence to show why many companies are going for private credit as opposed to bank financing, you could divide this into three categories: the benefits for companies, investors and society. For companies and investors, the biggest issue is that, as a company, you are not wondering who is going to own your debt within six months and whether you trust this lender.

You know that from the beginning you are stuck in this relationship. From an investor's point of view, as well as the bank's, when the banks originate the debt, they typically offload this debt to the secondary market within six months. Their primary concern is what is going to happen to me if I do not manage to offload this debt, instead of hanging debt, when there will be lots of costs imposed on a bank as a result. So this sort of liquidity and long-term investment play an important role in what banks can and cannot do. Regulation in this regard inhibits bank's ability to do this.

The Chair: Just coming back, I have a simple question. In our last inquiry, which we have just completed and was on growth and competitiveness as a secondary objective, we heard evidence from the smaller banks, particularly, that the regulatory burden and risk capital requirements, for example, made it difficult for them to lend competitively to small housebuilders but not to big housebuilders, because they kind of mark their own homework as to what the risks should be.

Professor Phalippou, you have taken something from our questions. I am

certainly interested in why the market has changed so much. If I think back to when I was a young man starting in business, I went to the bank; the bank took a look at you and decided whether you were a reasonable risk. You had a relationship with the bank and it provided that money. We hear from small and medium-sized enterprises that they cannot get that anymore. I am interested in whether that is a regulatory problem. You described how the market has completely changed, and I understand the economics of that: if I were in Lloyds—other podcasts are available—I would love to listen to your podcast.

The fundamental point is that the answer you gave on Debenhams is pretty shocking, actually. You were saying that there are all these City lawyers and people in the City making large sums of money doing something that is not particularly useful. This committee is interested in how we can get that money out into small businesses that are real and are going to create growth, jobs and opportunities. Can you help me by explaining if this a regulatory problem. If it is not, what do we need to do to fix it? There clearly is an absence of growth in the economy and any SME you talk to will tell you how difficult it is—never mind to get money out of the banks—just to open a bank account. Can you help me with that?

Professor Ludovic Phalippou: That was a tough one. The first thing to say, a bit naughtily, is that a bank will always tell you that your capital requirements are too strict. That is right by definition, because the lower those are, the more money they make. They would never argue otherwise.

None the less, it is true that post 2008, again from my earlier example, when they would have lent you £40 million and kept it on the books, now they will lend you £40 million and have to find someone to pick it up. That is easier if it is a big loan than if it is a loan to a local business. So my college endowment buys some of these loans; they are not going to buy a small loan from a local company but will buy a big one. That is true.

The capital requirement may be revisited but we need to be careful because capital requirements are a safety issue. It is how much you can lever up as a bank. You can still lend, but it is just that we relax the rules about how much you can borrow in order to lend. It is always a bit tricky to play too much with the capital requirements, but we could think of all the things that are handicaps for banks, perhaps the amount of regulation.

I have heard that, right now at ABN AMRO, 50% of the workforce works in things related to fraud and FATCA—all kinds of work that is extremely heavy. The amount of people in compliance in banks is shocking. There are very few people in compliance at Ares, Blackstone and the like. Capital requirements may be one thing, but the amount of things that the banks have to do to get the clients in is incredible. I would certainly look at all that we are asking banks to do.

We see this effect on lending. Like you were saying, you cannot really go to your local branch that much—it has probably shut down anyway—and get a loan. But my forecast is that, even with retail lending, mortgages and the like, Wise and Revolut, among others, are way superior propositions than any bank for personal banking. The puzzle to me is how a bank is even still alive in the country, when you have options like Wise and Revolut out there for personal banking. These guys are also thinking about moving towards corporate lending—Revolut in particular. For larger lending you have private credit. I would not be surprised if, in 10 years from now, retail is served by things like Revolut and Wise and companies are serviced by Ares, BlackRock, Blackstone and so on. One could try to slow down this death by having less paperwork for banks or by increasing the paperwork for the other guys to put them at a handicap.

It is certainly a strong question on what to do. On useless things, these lawyers in the City are giving a lot of money to the UK coffers, so there is some money coming back. But there are things that policymakers around the world have thought about. There have even been hearings, in 2008, about private equity and its usefulness. Things like maybe limiting the amount of debt a company can take on and limiting the tax deductibility of interest payments to avoid subsidising the use of that—these sorts of things—might go towards playing less with capital structures and focusing more on businesses.

Dr Narine Lalafaryan: I should add that, for example, many of the companies that obtain private credit financing as opposed to traditional bank financing, especially the small ones, do not have a credit rating. Obviously, if you go to a bank and you do not have a credit rating or history, you are going to be in a difficult position in getting any type of financing. For the funds, the companies do not have a credit rating; the funds engage in doing their own evaluation of what type of company it is. It is perhaps an investment-grade company or traditionally non-investment grade or a lower type of company; its credit rating is not that good. However, banks are not in a position to do this.

So the funds, typically because of the illiquid nature of their investment, are thinking about these things more carefully. They are putting in more monitoring and expertise to evaluate these smaller companies, which do not have a big track record and credit rating. Whereas the banks just cannot afford to do this, because they are in the moving business. They are not in the storage business anymore. I agree with what my colleague was saying.

Lord Eatwell: Can I follow that up? I am struck by the issue you raised about the cost of compliance and the disadvantages this may create for the banks. The banks had the advantage that their deposits are typically free. They do not pay interest on their deposits and so on. That is a big advantage that they would have over various funds. You would think it would be easier to make money if your money is free. Are you saying that the compliance issue has in a way removed the advantage that the banks always had?

Professor Ludovic Phalippou: I agree that it brings a huge cost. On this, the puzzle to me is why anybody still has money in a normal UK bank. All my money is at Wise. Right now, on a Wise deposit account you earn 4% interest. At HSBC savings it is 1%. It is quite extraordinary that the banks still manage to get away with some deposits being left with them. Look at the amount of money that went into so-called money market funds; that is how Revolut and Wise pay you 4% on your deposit. Your deposit goes into a money market fund, managed respectively for Wise by BlackRock and for Revolut by JP Morgan. They pay you 4% on your deposits because they channel your money to money market funds and they do not have all these costs.

The bank has to pay you only 1% because it puts the savings it makes on the other 3% on money market funds to earn 4%. The rest is to pay for all these compliance people at the bank, but the bank is still barely making money on retail. But as more retail money is being shifted to Revolut, Wise and money market funds, these banks are getting really squeezed. If anything, it is a puzzle why people are still leaving some money at HSBC and Barclays.

Q21 **Lord Vaux of Harrowden:** There is a question on that and another question. Revolut has a banking licence, so it is subject to the compliance et cetera, so I am curious to know why its compliance costs would be so much.

Professor Ludovic Phalippou: It is going a bit slowly in its compliance.

Lord Vaux of Harrowden: Exactly, but will that not catch up with it? More importantly, you have said a number of times that the real problem is that the banks cannot compete because they cannot hold the debt on their balance sheet. The old model of making a loan, holding it to maturity, getting it repaid and moving on has gone. Why is that? What is driving the fact that the banks cannot hold the debt to maturity, and why do they need to flip it so quickly?

Professor Ludovic Phalippou: They say it is capital requirements—that it is more profitable for them to be intermediaries rather than keeping it on their balance sheet, as it is costly for them to have it on there. It is also a bit more risky for them—if they make a loan and have \$100 million on the balance sheet and then it goes bankrupt. You do not make that much money on interest on these loans, so if something has to be written off, it can be a big deal for a bank.

Bankers typically say that it is due to the capital requirements, but they are able to do it; it is just that they prefer to flip it. Again, they are cheaper anyway, and despite that, they do not manage to win over private credit. I think it is for structural reasons. You could say, “We’re going to lower your capital requirements so that you can be cheaper, and we can lower them even more if you keep it on your balance sheet”, but they would still not have all the advantages that private credit has. So you make the banks riskier in order for them to survive a bit more, but it is unnatural for them to be there.

Lord Vaux of Harrowden: If Lord Lilley were here, he would say that it comes down to the problem of borrowing short and lending long. That is the fundamental issue.

Professor Ludovic Phalippou: Yes, exactly.

Dr Narine Lalafaryan: That is my understanding, as well. On the one hand, banks are typically only originating debt and sending it to the secondary market, and they are no longer typically involved in doing this relational finance. On the other hand, because the secondary loan markets are so liquid nowadays, there is quite a lot of competition in the secondary market, so the funds are also there buying this debt. The competition is creating positive incentives for original lenders such as banks to think more carefully about the types of packages of debt that they are originating, because if it is not a good package, the bank might not be in a position to successfully offload the debt to the secondary market. Because of this competition in the secondary market, the funds are in a better position to now say, "We are accepting or rejecting the type of debt that you are trying to send us". In a positive way that affects the original lenders' incentives to the banks to be more involved, whether through covenant packages or through the governance side of the story before they offload this debt to the secondary market. That is quite good.

Lord Vaux of Harrowden: Is this primarily commercial then, rather than regulatory?

Dr Narine Lalafaryan: Yes, I call this trend lender governance, where the secondary market, because it is so competitive and in a position to say no, creates incentives for the primary market to be more involved in originating debt, from a corporate governance point of view.

Q22 **Lord Kestenbaum:** There has been much discussion about risk in this conversation so far, and my understanding from your comments is that there is no immediate prospect, as you see it, of clear and present systemic risk. None the less, I would like to press you specifically on one aspect of potential systemic risk. I am sure you know what is coming, because thousands of gallons of ink have been spilt on the question of valuation as it applies to this asset class.

We have seen some illustrations across the market of not a collapse in but an erosion of confidence in the valuation process and valuation discipline, whether that is expressed in the eyewatering discounts to net asset value, as seen in many of the listed investment companies, or the recent spectacular falls from grace in the market, attributed in some measure to valuations. To what degree do you think the valuation challenges might collectively produce some kind of meaningful systemic risk across the asset class, over time? To what degree does there seem to be the potential for some kind of collusion of interests in maintaining the current discipline across professional advisers, private equity funds, the investment professionals who work in those funds and the ability to raise further capital, which is in large measure attributable to the value

that is placed on those funds? Is it impenetrable as a consequence of the potential collusion of interests, or, should I say, alignment of interests? If you say, "No, this is a real issue that requires meaningful intervention", what kind of intervention might that be and from whom?

Dr Narine Lalafaryan: I could say that the valuations, price discovery mechanisms and ownership structures of assets within non-bank finance are quite opaque, but I think my colleague is in a better position to comment on this because it is not really my area of expertise.

Professor Ludovic Phalippou: Valuations are off, in particular for some products like venture capital and real estate, where we see on secondary markets that nobody really believes them. We are a bit closer in LBOs. We think they are off in private credit because of a massive increase in interest rates, and then we do not see much default, despite the fact that the cost of debt has doubled on average. Most loans from private credit were made pre the increase in the interest rate, when the cost of the loan was only 5% or 6%. When the interest rate goes up by 5%, the loan typically goes up by 5%, because most of the time it is floating—although some people may have bought insurance—so then the cost of the debt is 10% or 11% a year, which is massive. They have this massive debt and pay 11% interest on it. The private credit that has lent it says, "Everything is cool. We have no default. People are just paying". But we know that is not quite true, with the delays in payment; there is lots of trouble, and, as you say, there is a bit of a collusion with everyone saying, "Let's keep it. Let's extend and pretend". That is what it is called.

None the less, again, this can lead to a lot of disappointment among investors, but I do not see how that becomes a freezing of the economy such as we have when banks stop wanting to lend to one another overnight and the like. I do not see that mechanism, which could be because I do not know enough. Also, in 2008, when there was the big crisis, people were saying that we should stop market discovery, stop the market trading every second, try to freeze everything and just say, "There's no price discovery. Let's try to sort things out first". Here, in a sense, you do not have price discovery, so that puts you in a position where you will not have a sudden crisis or things like that. Again, you will have disappointed investors, but I do not see a sudden crisis. We see it with the BlackRock real estate fund and many funds that are publicly traded. They trade at a discount and you either accept that or you do not, but, that said, you may be disappointed that you are facing such a discount. That is life. You have lost money on your investment, but that is how it is.

Economists should never make predictions, mostly because they are wrong, but I ventured to make one recently. I am writing a full paper on it. I believe that the industry will face a large number of lawsuits at some point, which will trigger regulation intervention by the SEC, the FCA, et cetera—unless, somehow, the UK Government decide to intervene beforehand. That is my prediction. I do not know when it will happen, but I foresee that it will happen at some point.

I will give an example. Retail investors put money into a semi-liquid vehicle that is doing private credit—you can put your money into a vehicle that lends private credit to companies. When you sign, you may not realise it but there is a condition that says, “You cannot sue me for the wrong NAV. I will give you a valuation—correct or not—and you are withdrawing your right to sue me for this”. Right now, it is going through and it is fine, but at some point, somebody will go to court and say, “I am not sure you are allowed to prevent me from suing you for lying to me”. There are some laws above that.

You will see a series of lawsuits on valuation, especially with some illiquid funds; on hidden fees; and on all kinds of things that people were not informed of. At some point, the SEC and the FCA will say, “We may need a lot of investor protections in that space because we are protecting them a lot in public markets, where things are fairly transparent, but here we are telling them that it’s an open bar and whatever goes—these are consenting adults, so we’re not touching anything”.

That is unless you want to front-run this as a Parliament or as a Government by saying, “We’re not going to wait for the lawsuits then have reactive regulation. We’re going to anticipate that and ask, a bit like the Dutch did with their central bank, to have stricter rules around valuations and the like, but with a mindset of investor protection”. Perhaps you will at the same time avoid a bigger financial crisis but, again, I do not see a freezing of the economy because the valuations are wrong.

Dr Narine Lalafaryan: I want to add something briefly to the lawsuit part of the story. There is a lot of discussion about what is happening and why we are not seeing big funds in the courts and litigation in this area. It will come at some point, but I think that the lawyers advising on these types of deals are carefully helping their clients navigate these waters. Although there may be lawsuits on valuations, as far as I am aware, they are settled behind the scenes. The things that we will see be litigated or have lawsuits will be issues such as a fund employing a very aggressive strategy, being alleged to be a shadow director in a company or destroying a company. We will see this at some point, even with very sophisticated Wall Street funds, because these trends come from the US. It is not aware of how our legal system works, and there are quite big differences when it comes to that side of the story—how the US and the UK work.

I am aware of cases where there was a settlement and it did not go to court. The fund was alleged to be a shadow director with huge implications. It was really big, but I do not expect there to be a big wave of lawsuits because they are sophisticated investors who have very good teams of people advising them. I agree with you: it is not so much about the regulatory side as it is about them being involved in companies and what they are doing, both positively and negatively, for the company.

Q23 Lord Vaux of Harrowden: On valuations, obviously, we are talking about mostly private assets. Ultimately, valuation is a subjective

question, depending on the methodologies and so on that you can apply. As a result, you tend to see valuations moving upwards quite quickly and downwards quite slowly, when there are reasons to move valuations. Does the fee structure of these funds tend to push them that way? Is the old traditional 2% fee on assets under management, plus 20% over 8%, or whatever it might be, pushing? Is it an incentive for the funds to overvalue, in effect, and to hold values at a higher level than they should?

Professor Ludovic Phalippou: One of the characteristics of private market fee structures is that they are not based on NAV because nobody really believes in it. If you based them on NAV, you would have so much discretion on your own pay that nobody would really accept the contract. The fees are based on the idea that, when you exit, we count the cash and then we share—

Lord Vaux of Harrowden: The 20 over eight thing.

Professor Ludovic Phalippou: Exactly. The management fees tend to be based on how much capital you have committed and how much of what you gave is still on the ground, and not on NAV. However, there is a very recent trend of fees being based on NAV, especially with retail investors. Again, that is because retail investors do not understand that it is unacceptable to set a fee on NAV; a retail guy would not know that. No institution would accept that, but retailers do not know. This is another good example of needing investor protection even more badly now that retail people are in, as compared to before. Protections for institutions were needed before but now, with retail, it is amazing. This is a very good example of where somebody basically sets up their own pay and retail just pays. Eventually, it will lead to lawsuits.

Q24 **Lord Eatwell:** There are two issues that I would like to address, but I want also to comment on the jaw-dropping sentence in Professor Phalippou's paper, which says that highly leveraged care homes experience double the death rate compared with those with lower leverage. Gosh, that is a systemic risk: death.

Professor Ludovic Phalippou: We need to define systemic risk. It is a dramatic risk.

Lord Eatwell: There are two serious things that I want to ask. First, Dr Lalafaryan, you rightly said that, in the mixture of finance, which you call "chameleon", this becomes highly relevant at bankruptcy because of the difference between equity and debt. However, you seem to leave out the fact that it is highly relevant for taxation. For example, as we know, when you have differential taxation, the Modigliani-Miller theorem does not apply. I was puzzled about that. I wonder about the extent to which fiscal aspects—they are, after all, governmental, as is regulation—are driving part of the development of private markets, as you discussed them.

Dr Narine Lalafaryan: I completely agree with you that the phenomenon that I call "chameleon capital" covers various areas, including tax and accounting. I am not a tax law expert, so I do not want

to say anything about tax law; I am sure that there are people who are qualified to talk about tax law much more than I am. I agree with you that this is a big issue but my main concern is that, if we look at this from a bankruptcy and corporate law perspective, we have very isolated treatment of equity and debt and of what happens if you have an investor—

Lord Eatwell: I understand that. As a committee, we are concerned because of the general argument about a lack of equity investment in the UK, compared with relying on debt, because of the favourable fiscal situation.

Dr Narine Lalafaryan: We should definitely look into that. I have a separate paper looking at chameleon capital in distress and the bankruptcy implications of this, but I wonder whether we should think about this more carefully. It opens up lots of new questions about how we look at equity and debt in the context of important areas such as investor accountability, investor protection, directors' duties and controlling investor duty. There are rules for equity and debt, but corporate law provides very few rules to protect creditors; most of it is in insolvency. What if we have someone who is an investor—either a parallel investor or someone who is an equity investor today and a debt investor tomorrow, or the other way around? In this way, they are influencing the company in various positions, but the law does not provide an adequate response to this.

Lord Eatwell: Thank you. Several times this morning, people have mentioned “relational lending”, where there is a relationship in some sense. A caricature of modern banking is that relational lending has disappeared: you lend on the basis of an algorithm and you have no idea who your bank manager is. There is the image of the little town bank manager who used to hold your hand, so to speak, in business things; I do not know whether it is true but there is certainly an idea that this has disappeared.

Famously, Handelsbanken, which is becoming quite successful as a banking institution in the UK, pursues relationship lending. It is mostly to the high net worth, but it is relationship lending; it is a sort of private bank for the masses. If the banks moved back to that sort of model, would they recapture the lending market from the private investors?

Professor Ludovic Phalippou: That is a question of the strategy for private banking; my wife is a private banker. It might work, but that is the entire business model of private banks: you build this relationship, and if somebody needs advice, they can call you any time, et cetera. But it is true that it is not profitable for people below a certain amount of income. Revolut has a project doing this sort of private banking for the masses. Perhaps it will succeed, but I do not know what the odds are.

Lord Eatwell: If you have an account with Handelsbanken, for example, you also have the mobile phone number of your manager.

Professor Ludovic Phalippou: It is quite amazing that nowadays we think of that as a miracle, when it used to be that the manager would know your parents and everything. Perhaps that will save them; it is possible, but I do not know. For business lending, we are talking about relatively large sums of money, and the sorts of relationship we are talking about are more along the lines of Ares going to Air France and saying, "I will always be there for you. We signed a deal and if you need more money within two years, I will give you it. I am credible because I have all this capital that is committed to me, so there is no problem with me lending more to you if you satisfy the following criteria". That is what has become of relationship lending.

I will make a quick remark regarding what you said about wanting more equity, not debt. Again, it is very important to distinguish between the primary and secondary markets. If somebody comes to the UK and buys Manchester United with only equity, that is not helpful. They are just buying out the previous owner—whether they use only equity or a mix of debt and equity, it does not change anything. What makes a difference is if it is a primary transaction, where somebody comes in, such as the Qataris in Paris, and says, "Look, here is several billion".

Q25 **Lord Smith of Kelvin:** You have both downplayed the chances of systemic risk. Going back only a few years—I am not talking about 17 years ago—some words were said in political circles and bond market yields went up, values came down and a number of pension funds suddenly discovered that they were very big on bonds like they might have been big on private equity, especially ones in Scandinavia. We suddenly discovered that, and it had a major effect. The Bank of England had to step in and put up very big money. That was a systemic risk. It went away—it was not like 2007, 2008 or 2009—but I put it to you that there is a risk there somewhere, if a lot of these pension funds are in these other areas now, with part equity, part fixed debt and in quite high-leverage vehicles and so on.

We also seem, from what you are saying, to be moving to an absolutely free banking market, because if we loosened up a bit in banks they would not have all these compliance people, so they would be able to lend again. Can you just repeat what you said? I heard that we should ease regulation on existing, regulated people and should not regulate these new vehicles any more than we need to. I am just saying that I think there is still a systemic risk there somewhere.

Lord Eatwell: If I may just supplement that, one image we have had, on exactly the issue that Lord Smith is talking about, is that risk is like a balloon. You have squeezed a bit of the balloon, in the banking bit, but the balloon—the risk—has just grown up elsewhere.

Dr Narine Lalafaryan: My position on this is that we do not know enough about this market to be able to say that we need to regulate it. That is why my suggestion is to better understand the interconnectedness that I mentioned between not just the markets but investors and capital. This is really important, as is interconnectedness

between the UK banking sector and private markets, and global interconnectedness, because there is a lot of traffic between the US and the UK across the Atlantic.

At this stage, my answer would be that we just do not know enough about this market. There is not a lot of comprehensive empirical data to show that there is systemic risk. I completely agree with the point that one might say that you squeeze the balloon and you give it to the other players in the market, but we do not have enough empirical data to be able to credibly say that there is systemic risk. We are starting to get more empirical data that shows the interconnectedness and exposure between the markets, investors and capital. I keep repeating myself, but it is important to look not just at this one circle of interconnectedness, which is between the markets, but at the interconnectedness between investors and capital.

Professor Ludovic Phalippou: Pension funds in the UK have some 3% or 4% of their assets in private equity and private debt. It is not a large amount of money, unlike bonds, which is about half or 40%. When there was this big problem in the bond market, we were talking about very large sums of money for the pension funds, and it was down to the Government to decide whether they wanted to bail out the pensioners. But it did not freeze the economy, even if the Government had said, "Too bad, you lost your pension". It could have been a scandal.

It is important to bear in mind that the pension funds have very little in private markets—US has probably one of the largest amounts, at 25% or 30%. It is not large amounts of money, and the odds that it would go to zero are pretty extreme. What happened in the bond market involved meaningful amounts of money. Here, the chance that there will be a meaningful loss is low.

I repeat, however, that it is different in insurance. Insurance companies have been piling up private credit and leveraging up positions on private credit. What we have not mentioned so far is that private credit funds often borrow themselves in order to lend, so have layer after layer of leverage. Insurance companies are sitting on top of a lot of layers. What could happen is this: if there was a natural disaster in the UK, people would go to the insurance companies, which would not be able to service the claims because they had piled up these private credit funds, the valuations were wrong, they would not be able to withdraw, the liquidity was not what they anticipated, they had all these layers of debt, et cetera. The UK Government would then have to step in and say, "Sorry. You have an insurance claim. I think it is important that we pay, so we will pay instead of the insurance company".

That could be a major concern. That is why insurance companies have these capital requirements where, usually, there is a strong regulator to make sure that they can pay what they promise. With private credit, a number of insurance companies are in a situation where it is not clear at all that they can pay what they have promised. It may be worth thinking about that, rather than the pension fund or the bank situation.

Regarding the idea that the risk is going somewhere, a book by a Harvard professor linked every financial crisis to a debt overhang—if there is too much debt at one point in time, there is a financial crisis. Put differently, no financial crisis has ever occurred without a massive, unprecedented amount of debt, but that has been built into the system. We have extraordinary amounts of debt. If you go to any business and work out all the different structures of leverage on top of that business, you will see a massive amount of debt. There has been a massive increase in interest rates that should have been enough to collapse everything, but it did not, probably because these private credit funds are quite flexible—they can pretend, they do not need to mark to market, et cetera.

The question of the fragility of the economy is legitimate, but then we are talking about how we limit the amount of leverage that any business takes on. To go back to the care home paper that I wrote, during the first wave of Covid, before anybody got any government help, there were twice as many deaths per resident in PE-owned care homes. But the paper also shows that some care homes that were not held by private equity were equally highly leveraged, and they had twice as many deaths as well. If you just looked at ownership, you would say, “Look at these evil private equity people. They have all these deaths on their hands”, but if you really look at it, you see that it is leverage. Yes, all private equity puts leverage, but there are also non-private-equity people who put leverage.

If you are interested in that question, which is an important one indeed, think about how to limit leverage in an economy. How do you limit the deductibility of interest payments and so on? It is not trivial at all. You probably need international co-operation, and the definition of leverage is not that easy, et cetera. There is a law in Europe, which I think is also the case in the UK, that no company can lever more than six times EBITDA, but there is no law on defining EBITDA exactly; you can define it in the way you want and then get the leverage you want. So it is not easy to implement, but that could be a noble pursuit and then you have to think hard about how to de-risk the economy in general by not encouraging these people to pile up on debt.

Dr Narine Lalafaryan: I will briefly add that many funds go for this chameleon capital, which creates equity that looks a lot like debt, exactly for those reasons: they do not want to show debt on their balance sheet. That is why they create chameleon capital.

Q26 The Chair: Just before I call Lord Hill, another committee that I chaired—the Economic Affairs Committee—published a report almost four years ago on quantitative easing, which we described as “a dangerous addiction”. Am I wrong to conclude that the impact of quantitative easing has in part been responsible for this huge growth, because it held down interest rates? We now have the problem of how to resolve the short-term high interest rates, which the Government are paying, and everything else. Could you say something about the impact of quantitative easing in creating this growth?

Professor Ludovic Phalippou: I was always a big critic of quantitative easing, so I am glad that you also tried to stop it. I think it was a drama. Its first impact was to create massive wealth inequalities by allowing whoever had assets to borrow at 0%, to release capital this way, et cetera.

The Chair: I am sorry to interrupt you, but it is also relevant to the whole issue of valuations.

Professor Ludovic Phalippou: Exactly—these valuations were inflated and people were able to cash out on these inflated valuations by borrowing if they could. But that was only people with assets; the people who had rotten assets could even have central banks buying their rotten assets from them at a better price than the real market value. It was really a direct subsidy for the wealthiest people—the asset owners. That was quite dramatic for society in general.

On private markets, a thesis that has been pushed by two researchers at Harvard called Ivashina and Lerner is that quantitative easing is primarily responsible for the growth in private market funds—private equity and private credit especially—because there was this perception that everything is zero: the bond market would give you zero, so you would not make any money without bond markets. Somehow there was the same perception with public equity, then people turned to private markets because they thought that they were the only ones that would give any sort of decent returns. Therefore, we should put our money there.

We saw many pension funds in different countries reasoning that way, as well as sovereign wealth funds saying, “We need a decent rate of return on our sovereign wealth funds or pension funds. The only way that could happen is with private markets”. So there was this belief built in that was accelerated by quantitative easing, because it was in your face that you would have zero or even negative interest rates if you left it in bonds, so the money had to leave the bond market and go to something like alternatives.

There is good evidence to think that a lot of capital flows into private markets were triggered by quantitative easing. It grew already in the 2000s before quantitative easing. There was a fair growth; it went from about \$1 trillion to \$6 trillion in 2007, so private markets have grown without quantitative easing. Venture capital grew in the 1990s without it. Post 2010, we saw a number of institutions shifting and, whenever they justified it, they often brought in the argument that the only way for them to hope for a return was private markets, especially for fixed income like insurance companies.

If I am insurance company, I am asked to hold a lot of fixed income. It has zero or negative interest rates. There is no way I can survive with this, so my only hope is to put it in private credit funds that deliver 10%. This may be fake debt, because a lot of it is equity in disguise, is highly levered et cetera, but the regulator lets me get away with it, so I am just

going to pile up on private credit like mad. This again makes for an extremely risky situation for insurance companies. Quantitative easing has created a lot of drama on that front as well.

Q27 Lord Hill of Oareford: Can I just check that I have understood the broad drift of what you are arguing? It is that these developments that you have very eloquently described are not of themselves increasing systemic risk; that there is no discernible effect on the availability of capital into the system, particularly at the large end—and some of these developments perhaps make that more efficient, because the cost might be higher, but it is done more quickly and there is more availability; and that there is no immediate need to rush to regulation. You made the point that investor protection may be something one needs to look at and a point about information. Is that a fair summary of what you are arguing?

On the gap that the development that you described might leave, you said that banks have been caught between the pincers that we have spent a lot of time on—private markets and then Monzo/Revolut. Is there likely to be a gap in the availability of capital for smaller businesses? Do you have any thoughts on how that might be filled?

Dr Narine Lalafaryan: The summary that you presented is my understanding of how we should approach this question. On the small and medium-sized companies and the gap, we see sophisticated players that were already in private markets before the global financial crisis and new players. Those sophisticated markets are not necessarily interested in funding certain smaller companies that have no credit rating, so the question is whether the new players that are coming in now—it is a booming market—are in a good position to provide this type of financing. They do this, but I have certain concerns about how they do this.

Within this universe of private credit markets, there are so many different types of private credit funds. The hybrid funds that I mentioned are the most sophisticated ones. My worry is mostly about the new players that are funding the smaller companies, because the bigger players are no longer interested. The upper-middle market has actually gone up; it is not 50 million now, but at the much higher end. The sophisticated players such as Ares are more interested in funding AT&T and Air France. That is a concern and I agree that we need to think about it more carefully. If there are any risks, they come from those new players that do not have enough expertise, unlike the bigger ones that have already been in the market for longer.

Professor Ludovic Phalippou: If, as was mentioned earlier, small businesses have difficulty getting lending at the moment—I am not familiar with that, but if they do—we cannot blame it on private credit. It is up to the banks to lend. Does one have in mind that Lloyds is making so much money with private equity lending that, out of the goodness of its heart, it uses some of its profits to lend to small businesses for the fun of it or for the benefit of society? It may do, but I have difficulty in believing that model. If banks are retreating from lending to small

businesses, we need to study compliance issues, onboarding clients and all these things.

Lord Hill of Oareford: Briefly on Europe and the EU, at the very beginning you had some statistics that showed that some of these trends are common, but Europe has traditionally been more reliant on bank financing for its economy. How do these trends affect the ability of the European economy to fund itself?

Dr Narine Lalafaryan: It is a great question and it is also relevant to us in the UK because, if we think about it from a legal point of view, all these trends are coming from the US. US investment funds are bringing what I call their own legal trends and legal customs. Continental Europe is affected more than us because its legal framework—I am an expert in corporate law—is quite different. It has more constraints to welcoming this type of financing. There are lots of innovative trends, including things like liability management exercises, which these funds are doing and which are much more difficult to do in continental Europe because of its legal system, compared with the UK, where we are a bit more flexible.

That is the reason why we also see the statistics that I gave. In continental Europe, the market is much smaller because there is a bit more resistance, but the resistance is not necessarily because of regulation; it is because the corporate system there is actually quite different.

Professor Ludovic Phalippou: There is not much private credit outside. Continental Europe does not have that much but we see some in Turkey, as well as in emerging markets. The legal aspect is difficult because these private credit funds have very complex structures, so they cannot easily deploy in eastern Europe and the like. Banks are very present in Europe; in France, the Netherlands, the Benelux countries, et cetera, you can still go to a bank.

Lord Hill of Oareford: The legal systems in the 27 countries are still different.

Dr Narine Lalafaryan: Yes. That is the reason why the US funds ship their trends to the UK. London is the first global hub where these trends are being tested, redefined and amended—and, sometimes, rejected. London plays a very important role in all these legal trends and whether or not we accept them.

From my point of view, the bigger question—these are the things I worry about a lot—concerns the corporate legal trends that the funds are bringing from the US, which are not fit for our legal system. London is doing a very good job but there are lots of important questions that are unanswered, and we often do not see litigation here until things go really wrong.

Q28 **Lord Vaux of Harrowden:** I want to go back to something that you said at the very beginning. You described venture capital as “the good guys”.

A lot of what you have said since gels with my own experience as someone who has been through the entire private equity cycle being owned by private equity. I am on record describing it as parasitical, frankly; I do not see that it adds any value at all.

How true or fair is it to say that, in terms of the returns you get from, basically, leveraging up—that is really where this came from back in the late 1990s or whenever, when pension funds could not leverage; its genesis was in it being a way of getting leverage into pension funds effectively—the growth in private equity has driven the fact that venture capital is constrained? How can we encourage investment into primary growth, rather than secondary growth, and financial engineering?

Professor Ludovic Phalippou: I would recommend a book called *Boulevard of Broken Dreams*; I like the title. It was written by Josh Lerner and it goes through all of the initiatives in the world by Governments who wanted to create more venture capital. The title suggests the answer.

It is always a bit tricky when you want to subsidise. The returns on venture capital have been decent-ish—there are good players, and they are usually welcome everywhere—but it is not easy to make money with these young, early-stage entrepreneurs. This is a very difficult question. I will be careful about the subsidy to venture capital. If they have decent returns, they will have money.

It is hard to test whether LBOs have heat in them, but venture capital has grown quite a lot. It was quiet in the 2000s because people were still traumatised from the 1990s. It took them 10 years to forget; that is usually what it takes in finance. Venture capital has done extremely well over the past 10 or 15 years—it has gathered a lot of money—but, right now, its valuations are not really believable. So we think that it has less than what it says it does, but there is now quite a lot of money in venture capital.

Again, it is the same thing with private credit. Most of the money is in the US and in China. China has as much venture capital and growth capital as the US. The UK is tiny compared to that, and the rest of Europe is smaller yet, so it is not easy for the UK. Because of Brexit, it is out of the EIF in Luxembourg. That was a big hub for venture capital investments and a conduit for stimulating EIF investment in venture capital funds in Europe. In providing a lot of capital for growth and venture, as well as lots of advice, it helped to play quite a big role. However, the UK has gone out of the EIF, and we have some direct evidence that that has hurt the UK venture capital industry quite a bit.

Baroness Donaghy: I am still reeling from the phrase that it is not clear what the distinction is between investment and debt. As an individual, if I did not have that distinction, I could lose my house, presumably. Are these the hybrid funds that you were talking about earlier?

Dr Narine Lalafaryan: I was talking about hybrid capital and hybrid funds.

Q29 **Baroness Donaghy:** On the implication of that—of there being confusion in what seem to me to be two opposite things—surely, going back to Lord Kestenbaum’s question, the risks inherent in that must be great.

You have both made some very useful suggestions. The first is that we should make a more standardised information system so that we have better information about things such as valuation. You have also suggested certain possible reforms in corporate law. We heard later about the issue of limiting leverage. I am not sure how we would do that as a committee—because that is what the committee is about: making recommendations on improving a system.

You referred, I think, to insurance company debt as being another area that could be looked at. It seems to me that there is quite a limit in what we as a committee can do to extract or make recommendations about some of those areas. Do you have any others? Some of those areas are political, in particular tax; one of the questions that was asked, I think, was on whether the taxation system is the difference.

I do not yet have a clear idea of what we could do to make a difference. Can we learn from anywhere else—any other jurisdictions? It does not seem that clear to me that we can learn anything.

Dr Narine Lalafaryan: I think we potentially can on the corporate legal reforms. That is the reason I started my research in corporate law—I think it should provide the first answer before we look into insolvency law and tax law. I am also aware of discussions about potential reforms to Section 172 of the Companies Act on directors’ duties. We could integrate these chameleon capital issues into that discussion on how we treat equity and debt in corporate law, and the questions on investor accountability and investor protection. Equity and debt have a very disintegrated and isolated approach in our legal system, and things are really blurring. This legal trend is also in the US. That would be my first humble suggestion.

Baroness Donaghy: Is there a reference that we can use for the statement you just made?

Dr Narine Lalafaryan: In my chameleon capital paper, I discuss this post-global financial crisis significantly and post-Covid evolution, explain what the open-ended legal questions are for both equity and debt, and how we could make reforms to directors’ duties but also introduce new notions on controlling shareholders or debt holders—because if they do things wrong, that is hugely problematic.

To my knowledge, the only legal mechanism in UK company law that has an adequate response to what I coined as chameleon capital is Section 251 of the Companies Act on shadow directorship. This is because, if you are a shadow director, you are held accountable, but the definition of a shadow director is a person—it does not really matter whether you are an

equity holder or debt holder—as long as you are in control of the company. If you interfere and do something wrong, you will be held accountable. This should really drive the story about chameleon capital, because it could be used for opportunistic behaviour.

Baroness Donaghy: Can we use that extract from your paper as part of the evidence?

Dr Narine Lalafaryan: Absolutely—it is in the last section on the implications of chameleon capital. There are many implications, but I had to narrow down the scope of the paper. The biggest argument in that paper is that this is about control. It does not really matter whether you are an equity holder or debt holder; many of these credit investors are running the company and they are heavily involved in corporate governance, with positive and negative implications. But our legal regime does not really think about creditors in that way, from a corporate law point of view. When it is insolvency, insolvency law comes in. But things have happened before now, so we might want to think about this in more detail.

The answer the question about what we can learn from the US and the EU, not that much. The biggest worry for me, as a lawyer, is that these legal trends are coming from the US, as I mentioned. Legal trends or customs are being shipped from New York, and London is the first hub where we are testing these things, but we are also explaining certain European constraints to our American counterparties.

In a way, US funds are rewriting the global law of debt. I have a new working paper with my colleague from Harvard Law School, Jared Ellias, looking specifically at this question: how US private credit funds, private equity firms and venture capital bring in their own ideas. Some of them work really well for us, but others do not—whether it is for our corporate law, insolvency law, tax law or other things. From my point of view, the question is more on the legal side and less about how we need to regulate the funds. I am not saying that we should not, but it is too early to be able comprehensively to say how we should regulate them.

Professor Ludovic Phalippou: I am sorry that, as an academic, I can explain to you why everything is very complex but I am pretty hopeless at telling you what to do. But I have written notes on the questions that were asked, and I am happy to send them to you and to add a section on possible policy implications.

To give you an idea about how complex things are, we talked about the limitation of leverage and things like that. The more you borrow, the higher the interest you will pay on the debt. If you load up a company with 90% debt, you will probably pay a 15% interest rate. HMRC, for example, has a rule that says, “If you show me a debt that is at more than 8% interest, you can call it whatever you want, but I do not call it that, so the interest will not be tax deductible”. Given that the discussions are very good and the UK does the right thing, above 8% of interest is not tax deductible, so that discourages a high debt. All you need to do is

to have a shareholder in the corporate structure located in Luxembourg. Luxembourg accepts up to 15%, on which you deduct your interest, because they consider it like that. All you need to do is to have a shareholder at that stage in your corporate structure located in Luxembourg—or Jersey, where they probably have something similar.

It is extremely hard for one country, without extreme co-ordination with others, to implement anything that would make a big difference. That is the difficulty, and everybody is there, so there is no one you can really learn from because everybody is facing those kinds of issues. I would only encourage strong co-operation. I am happy to add a paragraph on possible implications for you, but the power of one nation is limited even with the best will, because it is a big co-ordination issue.

The Chair: On that note, we can conclude the evidence session. We are very grateful to you, Dr Lalafaryan and Professor Phalippou, for what has been a fascinating set of exchanges and for the papers you have provided for us. It would be great to have your notes. The committee members will now put wet towels on their heads and think about the implications of what you have told us this morning. Thank you very much.