



Financial Services Regulation Committee

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

Wednesday 10 September 2025

11.40 am

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

Evidence Session No. 7

Heard in Public

Questions 74 - 81

Witness

I: Apostolos Gkoutzinis, Partner in Corporate Finance, Securities and Leveraged Finance, Milbank LLP.

USE OF THE TRANSCRIPT

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

Examination of witness

Apostolos Gkoutzinis.

Q74 **The Chair:** Welcome to the second part of today's meeting, which is the seventh oral evidence session as part of the committee's inquiry into the growth of private markets in the UK following reforms introduced after 2008. Thank you, Mr Gkoutzinis, for attending. Would you like to make an opening statement before we go on to questions?

Apostolos Gkoutzinis: Lord Chairman, thank you very much. I am a partner at the firm of Milbank. I have been practising in international financial markets and corporate finance for over two decades. I ran the firm's capital markets practice in Europe.

For the purposes of your work here, maybe it is relevant to say that I do a lot of work in this sector. I am not exclusively a private lending lawyer and maybe that is an advantage, because I can see private lenders but, at the same time, I can see public markets, the leveraged finance market, the commercial banking market, the international, European and American bond market. I have perhaps an interesting breadth of practice that may be useful to your committee.

I might add that, after this intellectual celebration by Lord King, I was just reminding myself that Aristotle in his *Rhetoric* advises people such as me who follow brilliant speakers to ask for sympathy from the audience, so I would table a request for sympathy after this wonderful presentation of all these issues in financial markets.

About the private lending market, very quickly—perhaps in 30 seconds—I will hit some of the points that may be relevant, certainly for somebody such as me, and perhaps helpful for the committee. It is a very large, very significant market and it is growing. It is remarkable how quickly it is growing. Last year, my team and I did the largest leveraged buyout in Europe and it was funded entirely by direct lenders. This was unheard of even 24 months ago.

A few weeks ago, a major private lender in the UK financed the largest private lending transaction into a UK nuclear power plant. Again, having a nuclear power plant financed in the direct lending market, and not in the normal syndicated, regulated bond market, is quite remarkable. It is a very large, growing market.

The second point is that it is a very diverse market. It is very important, if I may suggest, for the work of the committee to focus perhaps on understanding all the facets of that market, from the SME lending to some of the largest asset managers in the world, which are bigger than the largest banks. I am not going to name any names today, but the statistics are accurate that the three largest asset managers in the US are larger by a factor of three than the three largest investment and commercial banks in the US, if you put them together, by measure of assets.

It is a very diverse market, from the very smallest to the very large. It is a very creative market, consistently looking to innovate. Every time I say to my team, "This doesn't work. We are never going to see this. It's impossible. This is never going to work", two weeks later I read in internal memos that some direct lender has come up with a structure that, two weeks earlier, I was advising people was never going to work. The level and pace of innovation is incredible.

I would dare to say that the level of innovation in products, target markets and types of financing in the primary sector is limited only by the imagination of these people and, of course, the regulatory standards. Anything that can happen is happening or will happen in this sector. It is a very competitive market. That is not a free comment. Competition in these markets drives underwriting standards and selection of deals. As the funds are motivated to win business, allocate more capital and win the competition, you can imagine that they are also occasionally motivated to be more flexible in their underwriting and risk standards than more heavily regulated financial institutions.

Finally, it is important to say a word about London. London is the premier centre of innovation in this space. It is the centre of innovation for the whole European and local capital markets ecosystem. London is the largest centre of direct lending outside New York. London is the largest direct lending centre for the rest of Europe and the Middle East.

I was having a nice discussion with Mr Cook in preparation for this meeting and I was making this point: when we are talking about direct lending in the UK, are we talking about direct lenders as they support businesses and borrowers in the rest of the country, as they support the national economy as lenders to UK businesses, or are we talking about direct lenders in London as they expand and finance growth and investment in the rest of Europe and LBOs of private equity funds in the rest of Europe?

London has both and direct lenders in the London market do both. That is just to give a few notes and perhaps trigger some reactions. I am all yours and I hope I can be helpful to your work.

The Chair: When, every day, you say, "This is not going to work", is that because you think there is too much risk involved or because you think practices have changed, in a way, due to innovation or market pressure?

Apostolos Gkoutzinis: It is the latter. I have to assume that, statistically, there may be some lawyers in the room. We all see it. In all areas of the practice of transactional law, you know the parameters, the guidelines and the practices of your clients and you know the overall scope within which they operate, how they are motivated, how they are funded and how they compensate their best people. Of course, you have your experience of having dealt with them in previous transactions.

With all that information, sometimes you are bold enough to say, “I don’t think this is going to work”. Of course, it is legal. We are not talking about illegal activities.

The Chair: No, I am talking about risk.

Apostolos Gkoutzinis: Exactly, so we take all of this and we say, “This is not going to work”, but then, because of the competition, because of the drive, hunger and thirst for winning deals and hitting profitability targets—this is a very competitive market—they move the goalposts and come up with better structures while, at the same time, trying to mitigate risk. I would not say that they disregard risk in innovating.

The Chair: We have had mixed views on the extent to which the interconnections between the banking sector and private markets represent a systemic risk to our country’s financial stability. What do you think about that?

Apostolos Gkoutzinis: It is a very interesting point. I would say, as a starting comment, that a lot of work needs to be done—and I would certainly be very grateful for data and analysis on this—as to what these interconnections actually are. There are various levels where one can see that. The direct lenders compete with the banks. That is one level. I do not know whether competition is connectivity, but one angle you can see is that they compete with the banks for business, for opportunities to lend to private equity sponsors, corporates or listed companies, et cetera.

They collaborate with them. I have done many deals where the capital structure—the funding needs of the company—requires financing products of different priorities. The banks are very happy to come and provide financing on a secure, first-priority basis. It is a little safer, but not as lucrative. Then the capital structure requires additional financing on a subordinated basis, which is a little riskier, but more lucrative on a risk-reward basis. The direct lenders will come and take that position.

Then they will have an intercreditor agreement, so direct lenders and banks together regulate how they will manage the exposures of this. In that scenario, they are not competing; they are collaborating. They are coming together to find a solution for their mutual benefit. Often, the direct lenders help the banks.

Again, drawing from my practical experience—I am not going to name any names—I have done lots of deals, some of them with very significant listed companies, with strategic value for the UK economy, because of the sector—either government contractors or in other strategic sectors—where the banks, for whatever reason, wanted to exit that risk. It was the banking system’s decision that it needs to either exit this particular risk exposure or reduce it. Who comes in to step in and buy that credit? It is the direct lenders. They have come in and supported the banks in exiting safely from their particular credit exposures.

When we talk about these links, it is not one link; it is not two links. Maybe, if we have time here, we can probably come with other examples of how the systems are interconnected. Another one, just thinking now, off the top of my head, is the personnel. There is a flow of people from the commercial bank to the direct lenders and vice versa. Unfortunately, it is probably mostly one way, from the commercial or investment banks to the direct lenders.

The flow of people is enormous. It is not going to be long before a lot of the cultures and traditions of the commercial banks are cross-pollinated and then adapted to the cultures, traditions and practices of the direct lenders. Right now, there is an enormous flow of people at all levels, right to the top, from the commercial banks into the private lenders.

The Chair: Is it because they get paid more?

Apostolos Gkoutzinis: There is a serious point. Of course, that cannot be discounted. I have lots of friends who have done this move and, yes, this was a good motivation. How should I put it diplomatically? Another one was perhaps the level of rigidity, bureaucracy or the hierarchical structures that stifle individual performance within the commercial banking sector, the shackles of which people wanted to get out of. That is a big part of that. This is a thoughtful remark. I have seen it and I have experience with friends.

Q75 **Lord Sharkey:** It has been suggested to us that the valuations that private credit and private equity firms provide on the funds they manage and the assets they own do not, in fact, reflect their true, intrinsic value or it is very hard to tell whether they do. What are your reflections on that?

Apostolos Gkoutzinis: The way I would put it is perhaps, if you allow me, a little different. The managers, the portfolio and credit managers, have a very good view of the intrinsic value and what the risk is. Perhaps you are referring to the book value that they show to their investors. Whether there is a discrepancy between the two, we will never know. That is the hallmark of the private lending market: the fact that information is less transparent. There is no public disclosure requirement.

There is also a regulatory angle. Because these positions are not traded securities in the legal sense, the normal disclosure and transparency rules of listed securities do not apply. It is simply a private relationship with the investor. The investors in these funds are normally family offices, pension funds, insurance companies, university endowments.

Lord Sharkey: Banks.

Apostolos Gkoutzinis: Yes, of course. They do have the tools to examine and there is a real informal process of moral suasion, I would say, outside the confines of the law and the legal documents. If you are the largest investor in a credit fund and you see that this book value that you get on your quarterly statement has not really moved in the last two years, even though the market has moved up and down, et cetera, the

pension fund will probably take the portfolio manager out to lunch and they will probably get, on a one-to-one basis, feedback on what is going on.

I would not necessarily suggest that investors are powerless. The investors in some of these funds are some of the most powerful people in the financial markets and they do have the mechanisms to get to the bottom of it but, yes, because of the way that the disclosure rules and accounting rules work for these types of private investments, there is a risk that book values are not moving with the mark-to-market value.

At the same time, in defence of book value in these instances—and to make a more integrated argument—this can also be in an advantage. In a volatile market, where the market values of traded securities change because of something that President Trump just tweeted and that wipes 10% of the value off the security without really any change in the intrinsic value of the probability of repayment, the direct lenders will say that the fact that we are not really susceptible to this volatility, can take a long-term view and are not forced to adjust valuations is a good thing.

There is a lot to be said about that, but I have given some of my thoughts. The law is against fraud and accounting fraud of all kinds. One cannot discount the possibility that, in some fringes of the financial system, that is occurring, but it has never been my experience with the top-end funds that I work for. They are incredibly focused, as institutional cultures and structures, on being very transparent with their clients. They do not publish these results, necessarily, by portfolio, because they do not have to, but privately with their investors they are incredibly motivated to be as transparent as they can be.

Q76 Lord Hollick: An issue of concern to the committee is to understand the interconnectedness between traditional banks and private finance, particularly from the point of view of systemic risk. My understanding of funds generally is that the investors take the risk. You invest in a credit fund; it goes belly up; you write it off.

Apostolos Gkoutzinis: You are very correct.

Lord Hollick: In that sense, there is not a systemic risk. Then you think about the relationship that the banks themselves have with these funds. Are they lending to the funds? Are they investing in the funds? I was intrigued by a comment that Jamie Dimon made. He says, "Private credit is a recipe for financial crisis". He clearly takes rather a dim view. He then says, "However, I have decided to invest £50 billion in private credit, to swoop in strategically and profit if there is a meltdown". He is playing it both ways.

What is the real risk to the banking system from the tremendous growth of private finance?

Apostolos Gkoutzinis: The honest answer is that we do not know, but we can analyse the flow of risk. Perhaps we can identify where the potential flow of risk is. We do not know who precisely is investing and by

how much in the private lending industry. Clearly, a very wealthy family office can withstand the failure of a fund. Of course, they are not going to enjoy it, but it is not a systemic problem.

It is a question of size. Could an insurance company, with significant funds allocated to a direct lender, withstand the failure of that direct lender? If the insurance company is doing its concentration risk analysis and its liquidity and asset allocation analysis properly, probably it can, but often financial crises are created by human error. It is entirely possible that there is some risk issue there in the sense that a pension fund, an insurance company or other financial sources of capital, which are regulated themselves, perhaps make wrong allocations and suffer losses. It is a question then of degree and scale, in terms of how significant that can be in the sense of systemic risk.

I do not have a definitive answer, but it is interesting to at least raise the question of whether the competition that is unfolding for asset accumulation and asset allocation in the credit markets could perhaps lead to the deterioration of underwriting standards. If that were to happen in the pursuit of additional asset allocation, and if banks were to follow, that may be an issue. That is a worthwhile area of examination to focus on.

They are very fast. They are very ingenious. They are very talented. I am just thinking on my feet. Could they put the banks at a disadvantage if all the good deals, the good credit, the best companies, the most talented business plans, the most accretive technology and software business plans go that way and then the banks are left trying to finance less exciting, lower-quality credits? It is possible.

I do not know if that is within your definition of systemic risk but, in a broader sense, it might be. The banks, 20 years ago, had the entire economy to lend to. Now they are getting a lot of competition and these competitors are quite successful at identifying the best opportunities, much more quickly than the banks. Maybe that is an area of concern. For the borrowers themselves, it is a good thing.

In financial markets, there are never solutions; there are always trade-offs. What may be a source of issues for the banks may be a good thing for the borrowers and the shareholders, who have more ample capital and more entrepreneurial capital to draw from. I do not know whether I am helping. Systemic risk in the sense of what Lord King used to worry about as the Governor of the Bank of England, in terms of a complete meltdown, a collapse, is a question of scale. We are not there yet, but who knows what will happen? For sure, these institutions are getting larger and larger.

Q77 Lord Eatwell: As the whole structure of financial engineering develops, one area that seems to be growing in private markets is credit risk transfer. This I find disturbing, since it has echoes of credit derivatives in financial markets. It is disturbing because the true risk of investment strategies is distorted. With credit derivatives, people thought that

investing in mortgages was as safe as investing in United States treasuries, which it was not.

Is the growth of credit risk transfer and other engineering possibilities distorting the perception of true risk? If so, that is where systemic risk comes from.

Apostolos Gkoutzinis: It could be. It is very complex. It is a lot more complex than some of the structures from when I was a not-so-young associate. I was an associate in 2008 and I remember very well some of the ideas we were doing. Some of the structures today are even more opaque, complex and sophisticated.

As you know very well, financial people and attorneys do not go for complexity for the sake of it. They are usually trying to avoid other issues. Complexity is simply the by-product of trying to achieve too many conflicting objectives at the same time. There is the risk of misunderstanding risk because of complexity, lack of transparency and the absence of public financial information. Your point is valid.

Lord Eatwell: Just suppose that there is a significant, large private lender. You referred to the asset management companies in the United States. Let us suppose one of those goes bust. For some reason, it loses an enormous amount of money. What would the ramifications of that be?

Apostolos Gkoutzinis: It would depend on why it went bust. Was it internal fraud? That is a non-systemic event. Was it because it was too heavily exposed to a particular sector of the economy? It would be unlikely that it would be the only one going bust. Was it specific to that company, meaning a consequence of a culture of lax underwriting and legal standards? Again, after sorting out the original mess that any insolvency is bound to leave behind, the market will largely move on.

For some of these largest funds with hundreds of billions of dollars under management, clearly, they have hundreds of portfolio companies. The portfolio companies losing their biggest supporter is going to be very unsettling. This goes to the earlier question about whether the banks are lending to them. Yes, but we do not know how much. This is real work that can be done by the appropriate regulatory agencies.

The banks are lending against the investor commitments, for example. The banks are lending against the net asset value of portfolio companies. These transactions are not public. We do not even talk about them internally. They are very sensitive. Our firm is involved in these transactions. We know them well. The banks are lending. An insolvency, yes, would expose the banks to the relevant risk, if they are lenders.

They are trying their best to cover their exposures. They take collateral. The collateral is over privately held positions. They are not listed positions that are highly liquid. There may be questions as to the value of that collateral in a systemic event, when there is a race to the court for people to get paid. Yes, it is definitely one of the areas of risk, where risk can potentially flow into the regulated financial system.

Q78 Lord Lilley: I am still not clear really where the money comes from and what its term structure is. To what extent does it come from banks? In that case, they are perhaps providing a service to the banks. The banks hand over some money to one of these private investment companies because they think it has the expertise to handle it better than the bank can do itself, but it is still an exposure of the bank.

The essence of a bank is that it borrows short and lends long. It converts short-term savings into long-term investments and that is why we allow it. To what extent do these private market investments convert short-term savings into long-term investment? If they do, why are they not classified as banks and are they not vulnerable should people want their money back before the investment has matured?

Apostolos Gkoutzinis: We have the world's leading expert in banking regulation in Professor Lastra. They are not classified as banks because they do not accept deposits. Their liabilities to their investors are not short-term liabilities, primarily. Let me answer your first question and we will take it from there. I must admit, I am not aware of regulated deposit-taking commercial banks being primary investors in direct lending.

They definitely lend money against the value of investments that the funds are making, but I am not aware of circumstances where we set up a fund to make credit investments, let us say, in the defence sector and we go out to raise money, and we go to a bank and say, "Would you give us £100 million, so that we can convert that into investments?" I am not aware of banks being primary investors in the returns. In the secondary market, I made my comment that they regularly participate.

Where is the money coming from? It is coming from rich individuals and families, philanthropic or university endowments, pension funds, insurance companies and privately held companies. Treasurers in non-listed entities, if they feel very comfortable about the liquidity profile, may allocate. It also comes from sovereign wealth funds.

I do not have statistics but, anecdotally, just by looking at the deals that we are doing at the firm, one of the widest avenues of primary investment in direct lenders in the UK must be the Middle East—the Gulf states, the UAE, Kuwait, Saudi, with sovereign wealth fund money—and further away, in Singapore, Taiwan and South Korea. They diversify. All these people used to buy government securities. They were also putting money into private equity. Now they have this great, amazing asset class that returns better on an adjusted risk basis than some of the other alternative investments. They get a lot of government money, not directly from Ministers of Finance, but through the sovereign wealth funds arms of those states. This is a good universe of participants in this market.

This is the point I made earlier: the only limits are creativity and dogma. For everything I say, there is an exception but, normally, we are looking at five to seven years. Maybe they go to 10 years. They do not cash

invest. Nobody is cash investing. They are just signing a commitment that says, "When you need to lend money to a company, I will give you the portion of my commitment".

There is usually a deployment period. Let us call it three to five years. For the first five years, they hand out the cheques. They collect some interest payments and then they hope to get the capital back over time. They also make money on fees. They charge commitment fees, ticking fees and various others, so it is not just interest that they earn.

They hope to return the money back to their investors I think across a seven-to-10-year horizon, but there are exceptions. For infrastructure, if you want to finance a nuclear powerplant, seven to 10 years is a very short period. There are some others. There are always exceptions.

Looking at the investor in the fund, that is an illiquid investment, because you commit and there will be a legally binding investment period, let us say, of five years, so you need to be good on your commitment for the next five years. What tends to happen is that you get a notice in your email that says, "This is a call notice for a drawdown next week. Can you please send me 50% of what you committed?" You need to have the cash available for that.

Lord Grabiner: That is the private equity model.

Apostolos Gkoutzinis: That is correct. There are lots of similarities. There are differences, but there are also similarities. For the investor in these funds, it is an illiquid investment, but they do not care, because the returns are great so far. Because they spread it around to so many funds, as they are spreading and they are rolling around the whole market, some of the funds are deploying, but some of the other funds are returning capital. There is a constant recycling. It never stops.

Q79 **Lord Grabiner:** I just want to ask you about your practice. I am interested, but I do not want to hear the names of the clients. Typically, what happens? You are instructed for a fund, are you?

Apostolos Gkoutzinis: We have a very diverse practice. We are instructed either by the funds or by their private equity sponsors to represent the private equity sponsors. In very large transactions, there may be a banking tranche and a direct lending tranche. We may represent both. We have separate teams. One team will represent the bank. The other team will represent the direct lender.

Lord Grabiner: The money is, so to speak, invested by the outside, well-heeled financier. It might be a Middle Eastern entity. It might be a sovereign wealth fund. It might be a wealthy family office. Whatever it may be, they will create a pot.

Apostolos Gkoutzinis: That is correct.

Lord Grabiner: That pot of money will then be available to be invested in individual enterprises.

Apostolos Gkoutzinis: That is very correct.

Lord Grabiner: In the private equity model, the private equity fund, as you say, is an illiquid investment from the perspective of the investor in the private equity pot and that party is looking at getting out in five to seven years or whatever.

Apostolos Gkoutzinis: That is correct.

Lord Grabiner: Leaving aside that structure, there is also a big private lending part of the market, is there not?

Apostolos Gkoutzinis: When I refer to private lenders, I refer to credit funds that perform the direct lending function. I am not referring to deposit-taking institutions that give private loans.

Lord Grabiner: Are those lenders in the business just of lending or are they in the business of becoming partners of the particular venture that they are lending to?

Apostolos Gkoutzinis: That is an excellent question. There are all sorts of models. One term that we use on the more adventurous, riskier, distressed side of the market is loan-to-own funds, where they see that a business is particularly underperforming and is going to default on the credit, and they think that they can put better managers in and provide additional capital to turn the business around.

They give an appropriately priced loan on the expectation or the certainty that it may default, so they can acquire the equity and become controlling shareholders. Then they will put in additional working capital and capital expenditure capital to develop the business and have a return on their original investment. To answer your question directly, there are funds that have a lending strategy, but they pair that strategy with an equity strategy, a mezzanine strategy, a convertible strategy or with strategies to team up with other, similar institutions to control.

Oftentimes, they see an opportunity for what we call roll-up investments, particularly in industries that are very segmented and somebody consolidating the industry is likely to make a lot of money. Because the industry is quite segmented, they go on to do further acquisitions and start building up the portfolio. All these strategies are possible and the market has a lot of specialised funds that will do exactly what you described.

Lord Grabiner: We do not have any figures and there is simply not enough known about it, but do you know what the comparative sizes of these markets are?

Apostolos Gkoutzinis: I do not have the figures but, anecdotally, by far the largest portion of the market is for loans or bonds that are senior secured, high quality and sub-investment grade in rating. By the way, a very important element of this discussion is the credit rating.

Again, there are always exceptions, but this market is not typically dealing with the investment-grade part of the world, like the super high-quality credits. They do not need the direct lenders. They do not create the attractive returns that the direct lenders would be interested in, so this market is what we call the leveraged market, the sub-investment grade market or the high-yield market. It is credits of lesser quality.

In that space, the overwhelming majority of direct lenders are targeting senior secured, safe, first-ranking type structures. The minority will look into alternative structures, all the way to the distressed funds, which is a niche market in and of itself. Because of the complexity of making distressed investments, the difficulty and the legal skills that are required within the portfolio managers, distressed funds are probably a quite distinct part of that universe. It is very difficult.

We can all understand it, on a human level. If you are programmed to look for high-quality, riskless types of lending, it is very difficult to switch off and all of a sudden try to see where you can find the substandard company to invest in, in the hope of defaulting and acquiring. That is why it is quite a distinct part of that market.

Lord Grabiner: That is a specialism. They are sometimes called vulture funds, are they not?

Apostolos Gkoutzinis: I have heard of that, yes.

Lord Grabiner: They are sometimes called other rude words as well, to the same effect. Thank you very much.

Apostolos Gkoutzinis: They get bad publicity but, all joking aside and if you will allow me to be philosophical for a second—

Lord Grabiner: You are Greek, so you are entitled to be.

Apostolos Gkoutzinis: I am also proudly British as of five years ago. There is a space for them as well. I have done amazing deals with companies that have a terrible balance sheet, but fundamentally good business plans and good people. They were over-levered, so had terrible financial balance sheets, but underlying good products and services. Because the balance sheet was unsustainable, the commercial banks would not lend to these people.

The so-called vulture funds would lend, and then what happens? I have a particular company. Two years later, it turned itself around with the help of the vulture fund. The vulture fund made a lot of money, because it took a risk position when nobody was going to touch that company. Then the company went on to the stock exchange. It raised equity capital and additional financing, and now it is one of the most successful European companies in the sector. There are success stories in that space.

Lord Grabiner: Is it that big banks do not have the professionalism or the talent to spot that potential? Is it that it is a marketplace they are not interested in, because it is too risky, they will make more money from

deposits and there are other people out there who specialise in identifying potential, who are prepared to back their judgment?

Apostolos Gkoutzinis: There are many reasons. It is not a question of professionalism or talent. There is a regulatory aspect. Professor Lastra will give you all the technical aspects but, as a practitioner, how I see it, capital regulation, risk-weighted asset regulation and the Basel guidelines, in effect, move lending decisions away from the sub-investment grade market.

Commercial banks have become, effectively, a utility. That is an exaggeration, but there is some truth in it. In the commercial sector, they are incentivised, through capital regulation, to avoid sub-investment grade credits, but some of the largest and best companies in the world started life as sub-investment grade and worked their way up. We do not want to mention each and every one of them, but there are lots of regulatory and supervisory guidelines that provide incentives, motivations or instructions to the banks to avoid the sub-investment grade sector, or that allow them to lend to the sub-investment grade sector but with parameters that are, for good reason, quite strict.

The key word here, to me, is flexibility. The advantage that the funds have is that they are not bound by these parameters, whether it is leverage guidelines, risk concentration parameters or industries. It is a good question for the committee to ask: if the direct lender charges 5% and the bank is charging 3%, why would any borrower go to the direct lender?

But there are real advantages as to why you would do that. One of them is the flexibility, for example, to lend more, over the cash-generating capacity of the borrower. There is higher leverage, which some of the banks will not do. Another reason why these funds are more competitive is that they can commit for longer. I remember a deal in Norway, which was a takeover under the local takeover panel rules, and, from the moment that we announced the offer until we could close the offer, if you added up all the local stock exchange regulations and this, that and the other, it was going to be about 18 months to close.

The stock exchange regulation required us to have committed financing on the first day, so that investors would have the certainty that we had committed financing all the way to the end. There is no bank on the street that will give you an open-ended commitment for 18 months, but the direct lenders did it.

The Chair: This might sound a bit of a naive question, but what you are really describing here is regulatory arbitrage, is it not?

Apostolos Gkoutzinis: Professor Lastra was my PhD supervisor. She knows that I do not like labels. I want to see the substance. When we label things, we run a risk. It is regulatory arbitrage, yes, in the sense that they can go in places where other competitors, for valid reasons, cannot go. In that sense, the answer is yes. I am not suggesting it is a

bad idea. It is all about trade-offs, at the end of the day, as I said. The regulatory phenomenon is all about trade-offs. There are no solutions.

You can let the commercial banks lend with eight times leverage, as opposed to four times, but, if they start losing money left, right and centre and depositors are getting worried, you have another type of problem on your hands. It is all about identifying, in a proportionate manner, the aim of regulation. What is the risk that you are regulating against? Then you have to decide the priorities. We cannot have them all, in regulation or in life.

The Chair: Professor Lastra has just passed me a note saying, "Yes, it is regulatory arbitrage". Do you agree?

Apostolos Gkoutzinis: I do not know. Regulatory arbitrage almost has a bad connotation to it.

The Chair: I am just simply saying that the banks have these regulations, so they cannot do these deals. Other people in the private market are doing it because they are not covered by the regulations, so the effect of the regulation is to push—

Apostolos Gkoutzinis: It is definitely part of the strength. In other words, if you were to say tomorrow that we take the bank regulatory book and apply it to the direct lending market, it would have a major impact. There is no question about it.

The Chair: Of course, they are deposit takers and there are other issues.

Apostolos Gkoutzinis: Yes, absolutely.

Q80 **Baroness Donaghy:** Just briefly, it all sounded very exciting and very thrilling, and a race that I would like to be involved in. You said, "The only limit is the imagination of people".

Apostolos Gkoutzinis: There is also the law. I am a great believer in the law.

Baroness Donaghy: You have answered my first question. It appeared to me, on the sub-prime market issue around 2008, that that was not about imagination. That was people behaving like sheep.

Apostolos Gkoutzinis: Or crooks.

Baroness Donaghy: Crooks and sheep, yes, or crooked sheep. It seemed to me that it is possible to convince oneself that a trend is going to carry on bringing in those bucks to satisfy the investors and will lead to something akin to a disaster. The role of this committee is to find out whether there is a possibility that such a situation might arise that destabilises our financial system.

Apostolos Gkoutzinis: That is an excellent question. It is possible. Every market phenomenon has the inherent capacity of planting the seeds of its own destruction. If you will allow me another general

comment, the monetary and financial history of the world is full of such incidents. There is, at the same time, the risk of going the other way and, by bad regulation or untimely regulation, destroying a very valuable market.

The direct lending market is a valuable market. It is not an opportunistic market. If one looks at it, it came out precisely because there is an underbanked sector of the economy. There are sectors of the economy or types of business plans, especially in capital-intensive industries, that start life and do not generate enough free cash flow until years after they have spent money developing technologies, building plans and doing great things.

There are lots of areas of the UK, European and global economy that are presently underserved by the regulated banking business. I am not putting any moral or critical judgment on that. It could be for very good reasons, but the private lending business, outside all those reasons that make the banks hesitant to go to certain places, plays a very valuable role.

My country of origin—because I regard the UK as my country and Greece also as my country, but let us call Greece my country of origin—had a terrible financial crisis 10 years ago. It has restored the health of the local banks. It has put in a lot of systems and controls to ensure that bad loans and non-performing loans, as they call them—NPLs—do not happen again. The banking system is healthy, but what is going on in the expansion of credit in the economy?

Huge swathes of the Greek economy—small businesses, medium-sized businesses—just because an owner, 10 years ago, was involved in a business that had a non-performing loan, are now excluded from the banking sector. They are completely outside. The direct lending funds are starting to come in to find worthwhile credit stories to support and you can see that, again for good reasons—no moral judgment—the banks are either reluctant or unable to do that.

There is definitely a risk of throwing the baby out with the bathwater if you overdo it in relation to regulatory intervention. Regulators and central banks are always worried about shadow systems that are outside the scope of their monitoring capacity. I am not in daily contact with regulators, but I am sure that this market makes a lot of people in the regulatory apparatus nervous.

I can assure you, as much as I spend my practice and career working with these executives and institutions, that, for the most part, they operate a valid, worthwhile function. Their clients are looking out for them. They are looking to do deals with them for a reason.

Baroness Donaghy: Are you claiming that this is, in any way, helping small and medium-sized businesses?

Apostolos Gkoutzinis: That is still a very small part of that sector. If SME is a significant focus of this committee, a lot more work needs to be done. Having seen some efforts, maybe that personal experience would be helpful. I have tried to do a direct lending deal with a mid-market fund—not one of the giants, a much smaller fund—and an SME. It is very difficult and I realised in the end why it is so difficult. It is not law. It is not tax. It is not structure.

These SMEs are very personalised. Typically, it is a family business. They treat the business pretty much like the bank account of the family. There are no systems and controls. The credit fund just could not get comfortable with the absence of systems, controls and proper governance, which is to the credit of the credit fund. It could not get there, even though the returns were quite juicy, because it was just not comfortable that there were no accounting systems.

It is just tough to lend to the SMEs. My estimation is that, if you get a lot of real-life evidence from the SME sector, corporate governance, accounting controls and proper internal systems and controls could be a big issue.

The Chair: I am conscious of time. Lord Hill, did you have one last question?

Q81 **Lord Hill of Oareford:** Yes, a brief one. You have described, in answer to the Lord Chairman, a situation in which you think regulation has had an effect in creating some arbitrage. You used the phrase that banks are a bit more like utilities. Here is a growing sector, growing extremely quickly. What is the regulatory change that regulators could make to the private credit market that would worry you most about its continued growth and success?

Apostolos Gkoutzinis: It is an excellent question. I have not thought of it. At a very practical level, although this is going more into politics, so it may be another sphere, overtaxing these funds would drive them away from the United Kingdom. They are very sensitive to overall levels of taxation and they are very mobile. Regulation is not going to kill this industry, but you could kill it with a bad tax law overnight.

Any type of regulatory intervention that included specific, quantified ratios and quantified rules on asset allocation, underwriting standards, transaction structures, overall leverage limits—anything that would directly affect the product that they design and offer—would have a significant impact.

Lord Sharkey: What about transparent valuation of the underlying assets?

Apostolos Gkoutzinis: If you applied the rules of listed securities to private investments in these funds, that would be a transformative change.

The Chair: Transformative in what way? Do you mean in a bad way?

Apostolos Gkoutzinis: No, not necessarily, but it would change it. There are advantages and disadvantages. It is down to preference. One size does not fit all. Mark-to-market accounting does not necessarily have overwhelming advantages or overwhelming disadvantages versus historical book values.

For my personal savings, I like public markets because, as a person, I am risk averse. I come from a modest background. I want to make sure that I press a button and I know how much my investment is worth. I take that risk of perhaps lower returns for the benefit of the transparency, but others are less risk averse. They like the long-term nature of these investments and with the long-term nature of that goes perhaps the more insensitive valuation methods.

The Chair: On that note, can we thank you? That has been absolutely fascinating and you have led us through a very complicated situation. It was of great value to the committee.

Apostolos Gkoutzinis: I hope it was helpful. Thank you very much. It was really a privilege.