



Financial Services Regulation Committee

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

Wednesday 5 November 2025

11.25 am

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Members present: Lord Forsyth of Drumlean (Chair); Baroness Bowles of Berkhamsted; Baroness Donaghy; Lord Eatwell; Lord Grabiner; Lord Hollick; Lord Kestenbaum; Lord Lilley; Baroness Noakes; Lord Sharkey; Lord Vaux of Harrowden.

Evidence Session No. 14

Heard in Public

Questions 152 - 161

Witnesses

I: Nathanaël Benjamin, Executive Director for Financial Stability Strategy and Risk, Bank of England.

USE OF THE TRANSCRIPT

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

Examination of witness

Nathanaël Benjamin.

Q152 **The Chair:** Welcome to the second part of today's meeting, which is the 14th oral evidence session as part of the committee's inquiry into the growth of private markets in the UK following the reforms introduced after 2008. Thank you, Mr Benjamin, for attending.

The session is open to the public, is broadcast live, and is subsequently accessible via the parliamentary website. A verbatim transcript will be taken of the evidence and will be put on the parliamentary website. A few days after the session, you will be sent a copy of the transcript to check it for accuracy. It would be helpful if you could advise us of any corrections as quickly as possible. If after the session you want to clarify or amplify any points made during your evidence or have any additional points to make, you are welcome to submit supplementary written evidence to us.

It would be helpful for the committee if you made an opening statement of the work you have been doing—obviously, the committee is aware of that—but to inform our wider audience.

Nathanaël Benjamin: Thank you very much, it is a pleasure to be with you. As you know, in the past the Bank of England and its Financial Policy Committee have highlighted the potential risks arising from the growth and the increasing complexity of private markets and features of these markets that can cause potential systemic risks, such as the extent of opacity in valuations, the extent of interconnectedness between the different actors involved in those markets, the cumulative extent of leverage across the different bits of that ecosystem, the extent of reliance on rating agencies, and the potential risk for spillovers between those markets and other, riskier funding markets used by corporates.

Those are things that we have set out, and we have done quite a lot of work to set those things out. However, there is another side to this picture, which is very important, which is that a major challenge facing advanced economies, including the UK, at the moment is an insufficient degree of productivity. Private finance can play an essential role in helping address that challenge by supporting businesses which are seeking to grow and by channelling funding towards productive investment in the real economy. There are several benefits that this type of finance brings, such as offering a very diverse range of financing to businesses, such as offering more patient, longer-term type of capital, which gives companies time to do turnarounds or restructuring. Studies have found that often there was great benefit in enhancing the performance of those businesses that were funded by the private finance ecosystem.

The ecosystem has to be a key part of the solution to improve the UK's long-term economic productivity outlook. That system of private finance has grown, which is the consequence of two things. First, the low-interest rate environment of the last decade, during which investors, in a search for higher yields, have been looking for opportunities to make greater

return on those investments. Given that building leverage was easier and cheaper in that environment, that has paved the way for a growth in private markets.

The Chair: Which in itself, of course, was the consequence of QE by the Bank of England.

Nathanaël Benjamin: This is not a feature of QE; this is more a feature of low interest rates.

The Chair: No, low interest rates were.

Nathanaël Benjamin: No, low interest rates were the main policy tool, and it is the level of interest rates that has enabled the leverage to build up, rather than QE. To your question, if there was a link between both, I would have expected to see much more presence of private finance in Japan than is the case at the moment, given that it is the jurisdiction where there has been the most QE done, and that is not the case. The level of interest rates has been the main driver of the growth of leverage.

The second factor is that before the global financial crisis, banks had taken unsustainable risks with insufficient resources and buffers to back those risks and to absorb those shocks. The result is that they incurred losses and, as a result of those risks, they cut down on their lending to protect their capital position in a way that amplified the shocks to the real economy and in a way that also put deposits at risk at the time.

Two things have happened since. First, banks, of their own choice, of their own volition, decided to shift towards a less extreme degree of risk-taking, and reforms after the global financial crisis ensured that there was a degree of capital that was matching the degree of risk that was being taken. We have seen benefits of that through the recent shocks that have been experienced by the economy—we have had conflicts; we have had a pandemic. Banks have continued to support businesses and households in the UK despite those shocks; for example, supporting up to 1.6 million households with their mortgage repayments during those periods. That has been a benefit of that system.

That has caused the banks to retreat somewhat from the riskier forms of lending, and private finance has stepped in to provide that lending. That growth would not have been possible without the banks. Banks have supported the private finance ecosystem by providing leverage to the actors—private equity and private credit. Banks have been by far the major providers of leverage to that system, and it is thanks to that provision of leverage that it has grown to where it is now.

We sometimes hear notions that banks have been disintermediated or disengaged. They have been part of the growth in that ecosystem, so it is important to recognise that. But the setup that results from that evolution is one where there is a complementarity between the lending that is provided by banks, where deposits sit on one side, and the lending that is provided by the private finance ecosystem, which is riskier. It is a

good thing for the economy to have different parts of the financial system providing different parts of lending, and for the lending to come from the bits of the financial sector that are best placed to provide it.

Having said that, to fully realise the benefits from that setup we have to answer one question, and that is that ecosystem has been untested in a downturn. It has not really experienced a downturn so far, so we do not know how it would react to a shock, whether it would act to absorb it and to self-stabilise for it, or whether it bears the risk of amplifying it. In a sense, there are reasons why there might be shocks.

For the same reason that the sector grew, because of low interest rates, now interest rates are higher and, therefore, that brings some challenge for the investors, who are now finding that a given level of return can be achieved by taking less risk. There is a question about how patient investors may continue to be or not in that current environment. Another feature is that, as you will know, there is a lot of uncertainty and risk in the global environment. The question is: what is the impact of that on trends in certain industry sectors for the corporates that have been receiving that funding?

Those are examples of challenges in the current environment and that is why it is important that we understand how the ecosystem responds to shock. That is what we are endeavouring to find out. We are working actively towards preparing a system-wide exploratory scenario where we could test that.

We are planning to say more about this by the end of the year, but that is what we are working towards. Having said that, my conclusion in a nutshell is that the reason we need to kick those tyres is because private finance tends to play such a key role in the economy.

The Chair: I will not get into a debate about why interest rates are where they are. You have placed a lot of emphasis on the level of interest rates being responsible for the growth. We have had evidence given to us that part of the reason is the impact of bank capital and liquidity requirements and that the banks have therefore sought alternative sources of income. Do you accept that that has been a factor?

Nathanaël Benjamin: I think it has been a combination of factors; one is a low interest rate environment. I do not think that we would have seen that growth without that low interest rate environment because leverage would have been too expensive to build up. That has to be one factor. There is another factor, which is some degree of risk-taking. Banks have decided, either decided or because the capital requirements were higher against that higher risk lending, to do less of it than was the case before, so it is a combination of those two factors.

The Chair: The committee has had mixed evidence on this and some pushback. Would you accept that there is a degree of regulatory arbitrage going on?

Nathanaël Benjamin: That is an interesting question. Is there regulatory arbitrage? Are there some competitive advantages for one side versus the other side? It is a nuanced picture. On the one hand, clearly, private equity or private credit players are not subject to the degree of requirements to which banks are subject. On the other hand, banks have the power to create money. They hold deposits, they hold commercial deposits, which is money, which is a power that actors in the private equity ecosphere do not have.

The implication of that is that it makes liquidity management much more complex for those actors that do not have the power to create money and that do not have access to the central bank balance sheets. There are factors that mean that some things are easier for banks to do than for actors such as private equity, so it is a balanced picture. I would not say that there is necessarily regulatory arbitrage. That is number one.

Number two, it is important to also remember that the only reason that there has been such a growth is because banks have provided the leverage to private equity and private credit players to grow that source of funding to the extent that they have.

For example, to give you an idea of the figures, from 2018 to 2024, if we think about non-bank finance more broadly, in just five years it has moved from 17% to 21% of total bank assets. The growth of that total segment has moved quite significantly in just a few years. That leverage that was provided by banks to support private equity players in growing has been a source of income, a meaningful source of earnings, for banks. So I would not quite say that there has been arbitrage. I think that it is good to have a setup whereby different parts of the sector provide different types of lending, and there are things that are easier on either side.

Q153 **Baroness Donaghy:** Good morning. We have received evidence from the Loan Market Association that bank interconnections between private debt markets, including private credits and the banking sector, are extensive. Are there specific interconnections that you are most concerned about?

Nathanaël Benjamin: I agree with this assessment. Those interconnections are important, very meaningful, and quite deep. I am happy to step through some of the main ones, but again I would say that those interconnections are needed. They are necessary because they are a symptom of banks having provided the leverage so that that ecosystem can grow and exist. They are a necessary part of the ecosystem.

However, as you say, there is a lot of interaction between the two. Banks get involved through different levels of the financing chain for private equity and private credit. They do upstream lending to the investors, to the limited partners, directly. They do midstream lending to the general partners that manage the funds, the private equity or private credit funds, against the total value of a given fund invested in private assets.

They do downstream lending directly to the companies, the portfolio companies that receive that funding.

In addition, they provide leverage to private credit funds that either compete or partner with them. They also provide financing to limited partners, secured by their own interests in the funds. There are many ways in which banks are involved. That is a focus for us. You may have seen last year that the Prudential Regulation Authority wrote to international banks, global banks, and UK banks to emphasise the importance of their ability to have an aggregate view of the totality of their exposure to that whole ecosystem and to have a good handle on their concentration to that ecosystem. That is an important part of what needs to be done.

Baroness Donaghy: There was an interesting letter last week in the *Wall Street Journal* that said that data integrity is the Achilles heel of modern lending and that some risk models are blind by design. What steps should the Bank of England should be taking to deal with that integrity and that opacity?

Nathanaël Benjamin: You are right to say that opacity is a feature generally. In terms of data visibility, I think for non-bank finance that more visibility is needed. Non-bank finance, market-based finance, covers more than just private markets. Specifically for private markets, because we supervise systemic institutions that are active in those markets, such as banks and insurers, we do have information from that. We have information from industry registers, but there are a lot of things that this does not tell us.

For example, if you look at funding coming from public markets, it is reasonably straightforward to understand where the refinancing walls for businesses, for corporates, are, when they are and how big they are. But for private markets, it is difficult to understand when the big refinancing moments are coming and how much there is to refinance. That is an example of information that we do not have. Is it comfortable? No, it is not comfortable. That is why, in part, we are preparing to do the exercises that I alluded to before, so that we can shed light on those things and understand how the ecosystem responds to shock and what the impact is on the corporates, on the businesses which are at the receiving end of all that funding.

Q154 **Lord Vaux of Harrowden:** I cannot resist biting on something that you said in your introduction, which is related to the role that private finance is taking in the real economy and driving productivity and growth, as you suggest. The traditional private equity model is that you buy an existing company or asset and leverage it up to the hilt to leverage up your returns on what can be just normal growth rather than enhanced growth. Very little investment actually goes into the company itself.

In fact, there is a long-term standard saying that you should never buy a company out of private equity or invest in a private equity IPO because, generally speaking, while they might show profitability improvements,

that is usually because they have been starved of investment and costs have been cut dramatically in the short term and performance afterwards tends to drop away very quickly.

To what extent is the private finance industry actually driving productivity and growth and to what extent is it doing more what I am describing? If what I am describing is right, what can we do to change that?

Nathanaël Benjamin: I suspect that members of the private equity industry would somewhat disagree with that statement, but that is to be expected. It is interesting. There have been research and studies on precisely that question—academic research. They tend to show that on average the performance of the businesses, of the corporates that are financed by private equity, tends to improve.

Lord Vaux of Harrowden: Before they sell it or after they sell it, though? That is the very important point. You can show improved profitability, not necessarily by a long-term productivity improvement.

Nathanaël Benjamin: That is a good question, but in a world in which productivity is not what it needs to be, those are the types of things that need to be looked at. There is also the big question about patient capital: is capital really patient, and that is the thing to test? If a shock happens, will capital still be patient? We saw some evidence of that in the global financial crisis, when, on average, private capital tended to be more patient than capital coming from banks, financing coming from banks. If that is the case, that is conducive to long-term investments. Those are features of the system that are helpful.

However, you are right to ask the question because—and we might turn to it later on—what we see is reasonably limited demand for credit or capital from SMEs generally, from businesses generally, and there is a range of reasons for that. There are some that are trying to grow. There are some businesses that are trying to grow and that are finding it difficult to grow. The things that they need, the agility of finance that they need to be able to grow, it strikes me that it is a good match with the things that the private finance industry is able to provide. To your point, there needs to be a quid pro quo in terms of how that is done, but it strikes me as something worth exploring.

Lord Vaux of Harrowden: It is interesting because most of the evidence we have heard is that while SME financing has fallen, the private finance world has not stepped into that gap. Why would that be?

Nathanaël Benjamin: You will have to ask them. We will probably say a bit more about this shortly when we share our thoughts on growth and what the financial sector generally can do to support growth in the economy. In response to a question we had from the Chancellor, this is something that we have been studying and looking into this year. It may be the case that there needs to be a bit of a setup to facilitate the arrival and the channelling of private finance to direct it to those businesses and those SMEs which need it.

The Chair: Directed by whom?

Nathanaël Benjamin: To direct financing from the private finance industry towards those businesses. The question of “Directed by whom?” is a good question. That is something that we might have a few suggestions on. For example, is there merit in considering a public/private partnership between private equity actors and the British Business Bank, perhaps? That is an example of helping get the funding to where it is needed. It is worth exploring that question.

Q155 **Baroness Noakes:** When the governor came in, he said that he had concerns about whether the banks were adding up the risks that they had across their own institutions. Following a letter to them, they were encouraged to go and look at how well they have added up the risks across, basically looking at concentration risk. If the banks have responded well to that—or perhaps I should ask whether you think that the banks have responded well to that—what are the remaining concerns? If the banks have satisfied their individual supervisors that they have their ability to look across the whole of their activities and add it up, what remaining problems are there? That would mean that those banks would not suffer under a distress event.

Nathanaël Benjamin: Correct. The difference here, to go to the heart of your question, is the impact on individual sectors, individual institutions, versus the impact on the market as a whole. What you just described will ensure that if banks have done that job of having a really good line of sight on the totality of their exposures, they themselves, systemic institutions, are resilient to shocks that might come. Indeed, we have been stress testing them, as you know well, and the results have been positive on that front.

The bit that is missing, which this does not tell you, is what the impact is of collective action across not just the banks but also the other players in that ecosystem: the private equity funds, the private credit funds that are in partnership with banks, and the insurers that are often teaming up with banks. If a shock hits, we do not know what the reaction function of the different players in the ecosystem would be and how those reaction functions would combine with each other and what the impact of all of that would be ultimately for the businesses and corporates at the receiving end of that funding. It is more of a system-wide question that still would not be answered than a bank-by-bank or banking sector question.

Baroness Noakes: In the view of the Bank, how serious is it that there would be a significant systemic risk?

Nathanaël Benjamin: That is what we are about to assess. We have set out the characteristics of the ecosystem, the types of interconnection; we just listed through them. What we do not know is how they behave under a shock, under a downturn, and that is what we will be testing.

Baroness Noakes: Or indeed whether the effect would be big enough to

cause a systemic problem.

Nathanaël Benjamin: That is what we are going to test. It may well be that we find that the combined effect of all these features is that the system is well set up to self-stabilise after a shock, to absorb it. That is what we want to test: to understand how it responds to shock; whether it impacts the value of the companies that are receiving that funding; whether, as a result, those companies have to take actions—corporate actions, for example, on employment, on investments; whether it affects the appetites of banks and other investors to continue investing in those companies and whether they risk being a drying up of financing. Those are the system-wide effects that we want to test and that have been untested so far.

Baroness Noakes: It is very much smaller in the UK than, say, in the US. Why do you think that the US has not done that?

Nathanaël Benjamin: Sorry, can you tell me again your question?

Baroness Noakes: The scale of private markets, and private capital in particular, which we are looking at, is much smaller in the UK than it is in the US, where, one would imagine, given the scale in the US, that they would have greater concerns about the likely systemic impact. However, the US authorities have not taken any particular action, as I understand it.

Nathanaël Benjamin: I would not say that. The Federal Reserve has done some quite extensive analysis on the links, for example, between insurers and private equity, and has set out a lot of thoughts on those things. I would not characterise this as no work has been done on that elsewhere—quite the contrary, quite the opposite. The Federal Reserve has done a lot of work on this.

In other jurisdictions, the ECB, the European Central Bank, has also done a lot of analysis on the impact and the extent of those issues, and the Financial Stability Board more broadly. This is on the agenda of the Financial Stability Board globally. There is a lot of interest internationally and a lot of work has been done internationally, including by our colleagues in the US.

The Chair: What have the conclusions been of that work?

Nathanaël Benjamin: That work is ongoing. The way that I would characterise it is that people agree on what the channels are, on what the risks are, what the weaknesses are, as I stepped through before—opacity, interconnectedness, and leverage.

The Chair: What is the timescale for reaching a conclusion?

Nathanaël Benjamin: The conclusion to the question of how it responds to a shock, we know what the timescale to the exercise that we will run will be. As colleagues may have said, we aim to conclude that exercise by the end of next year, but the broader work internationally is ongoing.

The Chair: The end of next year?

Nathanaël Benjamin: For our exercise. Our hope is that we are done by the end of next year.

The Chair: That timetable would suggest that you do not see an urgent problem.

Nathanaël Benjamin: Whether there is an urgent problem or not, the fact that we are doing the exercise, the fact that this topic has been brought to the top of our policy agenda in the Financial Policy Committee, speaks for itself about the importance of those issues, so I would not characterise it as you just did. The fact that we are doing an exercise will bring us the last element of the question that we do not have the answer to. I just want to give a reminder that we have already done quite a lot of work on that with a number of important participants in those markets, so we are not starting from scratch at all.

Lord Eatwell: I have a comment on what Lord Vaux was asking about productivity. We have seen an enormous increase in private capital lending. We have seen no increase at all in the rate of growth of productivity for basically 17 years since the financial crisis, so I am surprised that you think that there is a link between the two.

Nathanaël Benjamin: If you look at the amount of funding that has gone to SMEs wanting to scale up—look at the number of barriers that they are currently facing. I would not characterise it as their having had all the capital that they think they need to be able to grow.

Lord Eatwell: Quite, exactly. I agree.

Nathanaël Benjamin: There are potential reasons for that, but part of what needs to be done is to help channel this capital to it.

Q156 **Lord Eatwell:** The evidence that we received from the Loan Market Association discussed extensively the relationship between the banks and the private markets. One of the tools that was identified was significant risk transfers used by banks to sell off the risk in their portfolio, which sounds to me just like another form of credit default swap. These instruments are based on the observation of historical correlations because that is how you estimate the risk.

When a shock happens, all the correlations change, so I do not see how you can model the analysis that you are attempting to model without a real shock; in other words, I do not see how you can do it in principle, because you do not know what the correlations would be after a real shock.

Nathanaël Benjamin: That is a very good point. I agree with your point. The way to deal with that is to use a range of stresses, a range of stress tests, to reflect the fact that you do not know in advance what the correlations might or might not be. It is a good point, but I think that that is what it should lead you to.

Lord Eatwell: Would you agree with my fear, my nervousness, that the use of significant risk transfers is resulting in an inaccurate estimation of true risk, as indeed credit default swaps did in the mortgage market?

Nathanaël Benjamin: That is the risk to avoid. That is absolutely the right question to be asking, but there are ways of managing that. The way to manage that is to properly test whether the risk is properly being transferred, and under all sorts of scenarios. It is the right question to be asking.

Lord Eatwell: I always think that the problem with stress tests is, first, that the stress tests for this particular market have to be international because so many of the big lenders are international, which is very difficult to do. Secondly, a lot of the linkages in this market are invisible because they are called confidence. How do you build an analysis that takes account of these invisible linkages? What I am getting at is that there is a systemic risk here that we are not accurately identifying or estimating.

Nathanaël Benjamin: These are really good questions. If you look at the system-wide exploratory scenario that we did last year on a different topic—which was on core markets in the UK, the gilt markets, the gilt repo markets, the corporate bond sterling markets, and associated markets—we focused on UK markets, but took in all global participants in those markets so that we had a true view of everyone's behaviour in those markets.

There is a key feature of those exercises that we would also be using in this case, which is that it would be a flow test. It is not that you apply a shock and see what it tells you. It is that you apply a shock, see the reaction function of the various participants in that market and then you see whether those reaction functions are compatible with each other. For example, if someone assumes that if this happens they will get X amount of liquidity from that source, we go and ask them, "Are you going to give them liquidity?"

Lord Eatwell: The source might not be there any more.

Nathanaël Benjamin: Exactly right. What we do as part of the second round is say, "You thought that course of action was open to you. Under the scenario, it is not, because we have asked your counterparty, or because of what else we have found out, or the value of the assets since then has dropped by X%". We do a second round where we play back those collective behaviours to the participants. That enables us also to kick the tyres.

If we think some reaction functions are a bit too optimistic, we ask, "What about if that was to happen?" That two-round feature helps bring out the collective behaviour aspect of things. It is thanks to that that we were able to feed back to market participants things that they would not have found out otherwise. That is the way to deal with your very good challenge about how you tease out those behaviours.

Lord Eatwell: Would you then advance the idea that the development of collateralised loan obligations on one side and significant risk transfers on the other is creating the same environment of systemic risk in a different market now that we saw in 2007-08?

Nathanaël Benjamin: We are in a very different situation now than we were at the time, not least because banks are in a much stronger position, and we saw the benefits of that as I illustrated before in my remarks through the various shocks we experienced. That means that deposits and the core of what I would call standard lending is shielded and insulated from those riskier investments in ways that were not the case before.

Those who stand to lose from those are investors, but that is how it is supposed to work. If you take a risk, you need to accept you will be taking losses. We are in a very different situation from what was the case at the time, but we should pay attention to these features. When we see things that bring back memories, we should remember those lessons, and we should kick those tyres.

Q157 **Lord Kestenbaum:** Mr Benjamin, you have spoken often about the ecosystem. It is a word that you have used often in your evidence thus far. I assume that in this instance that it means essentially the ecosystem of capital, both investment capital and loan capital. Could you give us your view on the health of the ecosystem in this country compared with some of our global competitors?

My understanding of this ecosystem to which you refer is that if you look at some of the dynamic innovation economies around the world, such as Palo Alto, Tel Aviv and Bangalore, they have an ecosystem that makes available multiple pools of capital right across the asset classes—angel, series A, series B, growth, development, institutional and the like—all of which have different return profiles, time horizons, everything you know about an ecosystem. Does it feel to you that the ecosystem in the UK to which you refer is competitive, is more limited, is less dynamic, and as a consequence, what might one do about that?

Nathanaël Benjamin: That is interesting and a very good question. I would say two things about that. If you think about the broad ecosystem in the broadest sense of provision of funding and finance to corporates, to the real economy, I would agree with your assessment that there are things that can be improved in terms of channelling finance to where it is needed. We will be saying more in a month or so as part of our end-of-year report about what our suggestions are on this front. More work needs to be done to better channel capital to where it is needed, definitely.

The other side of this—and perhaps focusing more on private finance as one part of that broader ecosystem—is that we have a reasonably vibrant private market ecosystem in the UK. As you said, it is not as big as in the US, but it is reasonably vibrant. It is also present in the EU, much more

so than in other jurisdictions that you mentioned. It is a bit of a tale of two cities on that front. Capital is here; it just needs to be channelled.

Q158 **Lord Grabiner:** Can I ask you about what we call subprime private credit lenders? We have been told that the corporate debt market is highly competitive and that, at the top end, private credit funds get in quickly and that they are lending to investment-grade corporates. Are we seeing a growth in the number of subprime private credit lenders, do you think?

Nathanaël Benjamin: There is a global dimension to it. The situation is very different in the US from in the UK. In the UK what you describe would not be a particularly material feature. In other jurisdictions, more of that is happening. There is definitely subprime lending going on, but not necessarily via private markets. There is subprime lending happening, for example, as you saw in the US automotive sector, but in the recent cases there was a lot of press on defaults.

This was not a private credit story. Private credit was almost not involved at all in those defaults. This was more financing that was using complex structures such as securitisations or invoice financing, trade finance and so on, from multiple sources. There is definitely subprime lending happening, especially in America, but it is not necessarily only a private credit story. Having said that, part of the idea of investing in private credit is that you get higher-yielding assets and therefore you have to take more risks. Often private credit is present in a part of the funding, which is riskier, almost by structure, by definition.

Lord Grabiner: It is heartening to know that we do not have this problem here at the moment. Is a feature of subprime lending that lending standards are poorer and, if so, in what respects?

Nathanaël Benjamin: The ways in which this can happen is, for example, by having little visibility about the availability of collateral against which the lending is done—that is one example—or lending to borrowers who, under very plausible scenarios, would really struggle to repay their debt. Those are the types of features that would be exhibited by subprime lending. It is a choice by investors if they want to take those risks, but then they have to accept the losses.

Lord Grabiner: Do you think that the Bank of England has good visibility over this market, albeit that it is a small one? Do you think you have a good visibility of it?

Nathanaël Benjamin: We have general visibility via the institutions that we regulate, yes. As you know, we stress test the banks, we stress test the insurers, so in a sense we have a good sense of the extent to which these issues could threaten their own resilience, yes. Do we have good visibility about how much of that lending is happening in other jurisdictions? Not always, although there are some public registers on those things. It is a mixed picture, but it is not a phenomenon that is developing and bubbling in the UK at the moment.

Q159 **Baroness Bowles of Berkhamsted:** I was trying to think of some

simplistic approaches here, and I have two questions.

One is: what do you see in terms of trying to get more transparency around private markets so that one knows what is going on? We had some very good examples last week of people who knew what was going on with their businesses, but not everybody will be like that. What is the role of rating agencies, for example?

The other question is completely unrelated. Is there any maturity transformation going on and, if so, where?

Nathanaël Benjamin: Three questions: one is visibility, the next—let me just write it down—is rating agencies, and then maturity transformation.

To your question on visibility, at the moment we do not have the ability to look through individual sectors or individual types of companies to understand how the withdrawal of funding to those corporates could happen, and when it would have a material impact on them or not. This is back to the refinancing walls, in a sense. When are the big movements coming for those companies, and how big are those movements? We do not have visibility on that, which is not optimal.

The other thing that we do not have line of sight on is what I mentioned earlier, which is how those situations change under stress. That we do not know, and that is the thing we are endeavouring to find out.

Having said that, you are right in your observation that when we talk to private equity or private credit participants, they often say, “We have all the data we need, thank you, and we are providing very good transparency on that data to investors”, and it is true. The FCA also reviewed valuation and said that there was good practice in providing transparency to some investors. However, to your point, you often find that people who are not part of that ecosystem—like us, or like investors who are outside the ecosystem but indirectly exposed to it—struggle much more to understand where the exposures are and how the system can respond to shock. Interestingly, there seems to be general support for enhancing the degree of transparency and public data availability on those topics. I suspect this is one to watch.

That was on visibility. Your next question is on rating agencies. There has been much discussion about the involvement of rating agencies. I can be brief and set out what I see the situation to be. Typically, ratings would be used in two situations. One would be directly for private equity, for example, for acquisition financing, in cases where leveraged loans or high-yield loans are required in order to finance a deal, if the rating is required by the investor. That is one possibility. The other one is in private credit, when collateralised loan obligations are backed by private loans and when there is a demand for ratings of those CLOs. Those are typically the two ways in which the ratings are asked for.

There is a lot of need or demand for those ratings in the US and in Bermuda, for example, because for insurance regulation with the US

insurers, a rating is needed to determine credit risk capital requirements. In Bermuda, where often there is an offshoring of US insurers, it is not only to determine credit risk capital requirements, but also to determine the valuation of liabilities. There is a lot of demand for those ratings. Insurers in the US, on the whole, invest 30% of their assets in private finance, which is quite a meaningful part.

There are different types of ratings and different types of rating agencies. There are the major rating agencies. There are also some smaller, specialist rating agencies that can provide private ratings. There have been questions asked about those private ratings and the extent to which they can be optimistic in comparison with the ratings of the bigger agencies. Those questions exist.

In the UK there is also the use of ratings from rating agencies by the insurance industry as part of the matching adjustment for insurers, but more and more it is being used as a point of comparison with internal assessments made by the insurers. The situation is a bit different in the UK, and it is less widespread than overseas.

Now, clearly, one thing is the ratings, and another thing is how much people rely on the ratings. What do the ratings mean and what do they not mean? As I am sure you remember, we have seen some of these stories before in the global financial crisis. It is very important that those lessons are remembered by the various sectors. That is on ratings.

Then we move to maturity transformation. At the moment, banks do maturity transformation. That is what they do. It is part of the banking model. Generally, private finance funds are closed-ended funds and there is not the same extent of maturity transformation happening. Also, if you think that the quid pro quo that often goes with it is leverage, the extent of leverage of individual funds tends to be moderate, say 50% loan-to-value. Often, private funds compare that with banks, which are much more leveraged than they are. However, the question is not one element of the chain; it is collectively, across the entire chain. What is the full extent of leverage across all the different actors?

Back to maturity transformation: not so much. Now, that may change in a world where retail products based on private assets become much more prevalent, especially in the form of open-ended funds where retail investors have the possibility to withdraw their funds at short notice. That would be a very different situation.

Q160 Lord Hollick: I wonder whether we are being a little bit too complacent about waiting for a scenario to be published next year, relying on the fact that the banks' capital has increased significantly, because there are already early signs—and indeed the governor spoke about alarms—that the smart money is already moving to hedge against a downturn.

There was an interesting article last week in the *Wall Street Journal* headed "A Private-Credit Winter is Coming". It pointed out that, "Private credit has grown so fast that verification and audit frameworks haven't

kept up, leading to structural weaknesses across modern credit markets. There's no better indicator of market psychology"—the confidence point that came up in your discussion with Lord Eatwell—"than real-time covenant changes, which show where the smart money is quietly hedging. Right now, the smart money is fortifying against a downturn."

The early signals are quite strong signals, and if we go back to 2007-08, with the benefit of the rearview mirror, we see some of the early signals. If they are right, if this analysis is right, it is coming sooner. It is upon us. What steps could the Bank of England take to increase our level of protection?

Nathanaël Benjamin: The first thing I would say is that the Bank of England has already done a lot on the sector, perhaps more than many, in elevating the profile of those issues and ensuring that firms get prepared for the risks that come with those issues. We talked about the work that was done with banks. I could talk about the work that was done with insurers. There is a lot going on already. There are a lot of stress tests that have already happened with the banks and with the insurers, and those stress tests include their exposure to the private equity ecosystem. A lot has already been done.

There is a broader question, which you alluded to. Are we seeing the signs of broader, systemic issues? It is an important question to ask. It is an open question, but what it means is that it is very important that all of the market players who are involved in that ecosystem understand their exposure and how that can and should inform their risk management options, so that if shocks do happen in real life, the system as a whole is able to manage them and absorb them rather than amplify them.

A lot has already been done. I do not want to give the impression that we are only beginning to put a focus on that. This has happened already for several years. A lot has been done already. The final bit of the question is to test how the ecosystem as a whole, from a system-wide interaction perspective, reacts to a shock. It is absolutely the question to be asking. Now is the time for everyone to understand how they would respond and how they would manage shocks if they hit.

Lord Hollick: How do we tackle the problem of opacity? A lot of these arrangements, derivatives, financial instruments and the like, hide the real risk, which is systemic. What steps can the Bank of England or the regulators take now to shine a brighter light on what is going on? We had an example in the earlier session today where banks cannot lend because of the capital risk constraints for certain credit, and yet when it is bundled together in a fund, they can lend to it. Now, that sounds like Alice in Wonderland economics. There are things staring us in the face that look rather troubling.

Nathanaël Benjamin: One of the things we have started to do—this is a broader point about market-based finance more generally and the lack of information or data that is available—is that we have taken steps to share more of what we see with the public and with the investor community. If

you look at our past Financial Stability Report, we have started to share aggregate, market-wide positions, so that participants in broader markets such as the futures market, the gilt repo market and so on understand how they are positioned with respect to the rest of the market and understand, therefore, if a shock hits, how it will impact them.

We are deliberately investing and sharing more of the information that we see that we have, to help market participants understand better their own exposures and to help them manage their risks through the shock. We are definitely continuing to invest in that. More broadly, this is something the Financial Stability Board is very focused on, this pivot to surveillance. To show the facts more than has been the case so far is very much at the top of the agenda.

Q161 Lord Sharkey: Could I ask a little more about the life insurance industry? The BIS warned last week that the life insurance industry may be riven with hidden risks as a result of its mounting exposure to private credit. It warned, "Many of these investments are more obscure, with information hardly obtainable in common data sources", compared with publicly traded debt. It also adds a note about a reliance on private letters, which we have just discussed. Do you see any danger here?

Nathanaël Benjamin: There are clear risks to the insurance industry. I would start by saying that it is quite natural that the potential synergies between the insurance world and the private finance world are being explored. That is quite a natural thing because, on the one hand, it provides insurers with higher returns on assets and, on the other hand, it provides private equity players with longer-term financing. It is very natural that those synergies are being explored—but, to your point, that brings risk.

One of those is the risk of direct investment in assets by insurance companies. In the UK, the majority of insurance asset investments are still in fairly vanilla assets. There is a proportion of more illiquid assets that are being invested in by insurance companies. To give you an idea, these are assets such as properties or commercial real estate, infrastructure, and housing associations. Those more illiquid investments form around 10% of the matching adjustment portfolio, which is typically where you would see them in insurance.¹ That is contained. Private assets are a small part of that, in terms of magnitude. However, it is definitely something the PRA is watching very carefully, and it is subject to our stress test of the life insurance sector, very much so.

The other type of involvement of the life insurance world with private equity is what have been called funded reinsurance arrangements, whereby there has been a trend, as you know, for employers to transfer their book of annuities, to pay the pensions, to life insurers. In turn, under this funded reinsurance arrangement, life insurers transfer those

¹ Note by the witness: These more illiquid investments within insurers' matching adjustment portfolios constitute approximately 10% of total assets held by non-linked life and general insurers.

annuities to reinsurers overseas—which could be in jurisdictions such as Bermuda or the US, for example—and in turn the assets are being invested or can be invested in private, asset-backed securities, the securities that we were discussing earlier in this session. It is a long chain of travel for those assets, which are ultimately there to back the payment annuities.

The obvious question is: if something happens, if there is a shock, for example, which affects the companies that are overseas at the receiving end of that funding, how does that shock blow back and ripple back through the ecosystem? The PRA has been asking those questions and has had communications on that. It is still a small phenomenon in the UK, but it is growing and now is the time to ensure that it is done in a controlled way. It is a perfect case in point of what we were discussing earlier about the extent of reliance on rating agencies and the degree of opacity in valuation and, ultimately, who investors are exposed to. It is a very good example of those two things.

Those are the two ways in which insurers engage in that ecosystem, and that is very much part number one of our stress tests of the life insurance sector. It will also be a feature of the system-wide exploratory scenario that we are working towards.

The Chair: Mr Benjamin, thank you very much for answering these questions with such clarity. I could not help being reminded of Donald Rumsfeld's known unknowns as you answered some of these questions. There are clearly a number of known unknowns, and it is reassuring that the Bank is trying to answer some of those questions. That concludes this session. We thank you very much indeed for taking the time, and also for the very careful work that you have carried out within the Bank in recent months. We look forward to seeing the results, hopefully sooner rather than later.