Moody’s rating agency warns of “systemic risk” in private credit

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Stock markets continue to soar—Wall Street has reached new record highs this week—on the back of the cheap money provided by the Fed and other central banks but there are warnings of increasing dangers in what has become a growth area of the financial system.

The ratings agency Moody’s has issued a report that the private lending industry, which has grown to $1 trillion, was posing “systemic risks” as a result of its “explosive” growth.

“The mounting tide of leverage sweeping into a less-regulated ‘grey zone’ has systemic risks,” it said. “Risks that are rising beyond the spotlight of public investors and regulators may be difficult to quantify, even as they come to have broader economic consequences.”

The private credit market began to expand after the global financial crisis and its growth accelerated after the massive $4 trillion intervention by the Fed in response to the March 2020 crisis at the onset of the pandemic. It has provided a source of profit for investors who are seeking to increase their returns above those obtainable in the stock and bond markets.

Reporting on Moody’s findings, the *Financial Times* said, “leveraged buyout groups” had been “particularly active users of the industry, weaving private equity and private credit closely together in a debt-laden ecosystem.”

The head of leveraged finance research at Moody’s, Christina Padgett, said: “Private equity’s business model relies on leverage. We have become accustomed to leverage in the institutional loan and bond market. Now we are seeing a higher degree of leverage among smaller companies.... At the moment that is fine because interest rates are low but it introduces a higher degree of risk going forward.”

Moody’s is not alone in sounding a warning about the increased risks flowing from private credit. In a report published earlier this month S&P Global said private debt had emerged as a “new frontier for credit investors as they search for yield” with the market growing tenfold in the past decade.

“The growing investor base, a lack of available data, and the distribution of debt across lending platforms make it hard to know how much risk there is in this market—and who holds it.

“The expansion of the investor base could lead to heightened risk in the market if it leads to volatile flows of money into and out of the market,” it said.

Private credit is by no means the only potential source of instability.

In 2008, the epicentre of the financial crisis was the major banks and finance houses which were bailed out by the government with the provision of trillions of dollars of cheap money by the Fed. Regulations were introduced to strengthen their capital base, which supposedly were designed to prevent a repeat of the financial meltdown.

But there has been criticism that deregulation introduced by Fed chairman Jerome Powell has significantly weakened even those limited measures.

The criticisms came into public view during a Senate banking committee hearing at the end of last month when Massachusetts Democrat senator Elizabeth Warren told Powell she would not support his renomination as Fed chair, describing him as a “dangerous man.”

Warren said there were multiple instances where the Fed had relaxed financial regulation.

“Over and over, you have acted to make our banking system less safe. And that makes you a dangerous man to head up the Fed, and it’s why I will oppose your renomination,” she said.

Warren, who has described herself as "capitalist to the bone," is no opponent of finance capital and Wall Street. Her support for tighter regulation arises from the fear that another crisis on the scale of 2008, or possibly even larger, will lead to a deep-going economic crisis and the eruption of massive social struggles by the working class.

Warren's criticisms received little support in the financial press at the time and there is general support for Powell's reappointment which is under discussion in the Biden administration.

But this week the *Financial Times* chose to publish an opinion piece by Dennis Kelleher, the president of Better Markets, an advocacy group for tighter regulation and control of the banking and financial system.

Kelleher began by stating that Warren's description of Powell was "accurate" and the deregulation he had supported over the past four years had "undermined the financial stability of the banking system," moving "the US closer to future financial crises and bailouts funded by taxpayers, as happened in 2008."

He said Powell's actions had weakened regulations covering five areas: capital requirements, supervisions, proprietary trading, living wills to allow stricken banks to be safely unwound and the amount of liquid assets held by banks that are easy to sell.

Each of these rules had been significantly weakened, leaving the regulatory framework impaired and "materially reducing the resilience of the banks." Deregulation had also made it harder for "regulators and the public to know the actually condition of the banks, making crisis planning and mitigation more difficult."

He cited a dissenting opinion from Fed governor Lael Brainard on stress test changes which "gave a green light for large banks to reduce their capital buffers materially."

Banks with assets of between $250 billion and $750 billion were no longer subject to rules applicable to "systemically important banks" despite some "still being large enough to cause systemic issues and contagion" and as a result "have much less confidence that any large bank can withstand a crisis."

He said bans on proprietary trading—when a bank engages in financial activity on its own behalf rather than obtaining a commission from a client—had been weakened which encouraged "risk-taking and even gambling-like behaviour."

"Not only did Powell's Fed allow banks to engage directly in more of these types of activities, but they were also enabled to do more of it indirectly through investments on venture capital and loan finds, some of which have been shown to be unstable and unsafe."

At present the vast accumulation of debt and financial assets is being sustained by ultra-low interest rates. But this regime is now coming under great pressure because inflation, far from being "transitory," as maintained by Powell, is increasing at rates not seen since the 1970s.

The Fed seems almost certain to indicate it will start winding back its $120 billion per month asset purchases, probably early next year, when it meets next week. Powell has said that in his view it is "time to taper." But he has insisted it is not time to raise rates because he is all too aware that such a move could trigger a landslide on the mountain of fictitious capital and debt which the policies of the Fed have created.