IMF warning over growing private credit market

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Financial markets ponder the question of when the US Federal Reserve might start to cut interest rates and go back and forth, on an almost weekly basis, over the question of the timing, frequency and size of the reductions. At the same time, however, potential sources of turbulence within the financial system are building up.

One area of concern is the $2.1 trillion private credit market, which has rapidly expanded since the global financial crisis of 2008, rising six-fold. It was the subject of analysis in one of the chapters of the International Monetary Fund's *Global Financial Stability Report* prepared for its spring meeting next week.

There are three methods by which corporations, industrial and financial, can obtain finance. The traditional method is to secure a loan from a bank. Another, if the corporation is large enough, is to issue bonds, which are then traded on the market.

The third, and most rapidly expanding, is private funding by financial institutions which has proved to be attractive because of the higher rate of return that can be obtained.

The first two methods are subject to some scrutiny, either through bank regulation or, in the case of bonds, by activity in the market.

But the private credit market is very opaque and would-be regulators and authorities responsible for maintaining the stability of the financial system have little idea what is going in this area.

The conclusions of the analysis on this market contained in the report were summarised by its authors in a blog post yesterday.

After noting its rapid expansion—in the US its market share is almost equal to that of syndicated loans and high-yield bonds—they pointed out that pension funds and insurance companies had eagerly made investments that, though illiquid, offered higher returns.

The lack of liquidity, that is the ability to rapidly turn assets into cash, is not a problem under conditions of stability. But that can quickly change if there is volatility and a rush to get into cash.

Private corporate credit had created significant economic benefits for corporations seeking long-term financing, the authors said.

"However," they continued, "the migration of this lending from regulated banks and more transparent public markets to the more opaque world of private credit creates potential risks. Valuation is infrequent, credit quality isn't always clear or easy to assess, and it's hard to understand how systemic risks may be building given the less than clear interconnections between private credit funds, private equity firms commercial banks, and investors."

In other words, the supposed guardians of the financial system are largely in the dark as far this rapidly expanding, and increasingly important area of the market is concerned.

They concluded that immediate financial risks appear to be limited. But then, as if aware that such statements are often made on the eve of a crisis, added a rider.

"[G]iven that this ecosystem is opaque and highly interconnected, and if fast growth continues with limited oversight, existing vulnerabilities could become a systemic risk for the broader financial system."

They indicated some of what they termed "fragilities." Companies that tapped the private credit market tended to be smaller than companies that took out loans or bonds and this made them "more vulnerable to rising interest rates and economic downturns."

The rise in interest rates by the Fed is already having an effect, with the IMF's analysis showing that in this market "more than one-third of borrowers now have interest rate costs exceeding their current earnings."

Furthermore, a kind of risk-increasing spiral has been set in motion.

"The rapid growth of private credit has recently spurred increased competition from banks on large transactions. This in turn has put pressure on private credit providers to deploy capital, leading to weaker underwriting standards and looser loan covenants —some signs of which have been noted by supervisory authorities."

Such vulnerabilities did not yet pose a risk to the broader financial sector, the report's authors said. But they could if they continue to build and come to the surface in a severe downturn in which "credit quality could deteriorate sharply, spurring defaults and significant losses" that would be hard to assess because of opacity.

Regulators may find themselves trying to play catch up when a crisis develops because "severe data gaps make monitoring these vulnerabilities across financial markets more difficult and may delay proper risk assessment by policymakers and investors."

A column by financial analyst Mohamed El-Eiran in the *Financial Times* (FT) this week, approached the issue of financial instability from another angle.

When he started his career in investment management, he wrote, he was taught to design investment portfolios with a solid foundation "with a much smaller and opportunistic and tactical top"—a reference to more speculative and short-term operations.

"In other words, construct a durable structure that could mostly resist unsettling market volatility and navigate economic and geopolitical shakes."

But today this "once reassuring construction" appears to have become completely inverted as a "shrunken and secular and structural base now has to support a larger and opportunistic tactical top."

El-Erian pointed to a situation where speculation and the placing of large bets on the "next big thing," in the present situation artificial intelligence, allows markets to power ahead.

"Momentum is now well recognised as a factor that allows investors to ride remunerative waves that will break at some point, but not just yet."

Higher growth rates in the US, at least above the stagnation in Germany, Japan and the UK, as well as dovish signals from the Federal Reserve on interest rates, "have enabled markets to brush aside a host of worries be they political or geopolitical."

However, as he noted: "Unlike the pyramids of Giza, this narrow-base/ broad-top construction is unstable."

Another sign of financial instability is the rapid increase in the price of gold. After trading for many months at around $2,000 per ounce, it underwent a major spike in March, rising by 19 percent, with indications that it will continue as it reached another record high yesterday closing at near $2,400.

The surge has left analysts scratching their heads as to the proximate cause with possible factors such as the anticipation of interest rate cuts by the Fed and rising geopolitical tensions being cited.

But the overall sentiment has been one of mystification. As an article in the FT put it in March, when the surge began "longtime market watchers [have been] struggling to explain what has been one of the yellow metal's most curious rallies."

In the past when there has been a significant rise in the price, there has been some significant risk event, but on this occasion, there has been "no significant shift in current events."

An article published in Bloomberg this week was no clearer, offering a range of possible explanations including central bank worries about the use of the dollar as an economic weapon, bets that an interest rate cut by the Fed is imminent, traders drawn to gold because it is going up, or fears of continued inflation or a hard landing for the economy.

All of these factors may be playing a role. But gold is not simply another commodity whose rise and fall can be explained by immediate market factors. In the final analysis under capitalism it is the money commodity, the ultimate store of value.

For a long period, since US president Nixon removed the gold backing from the US dollar in August 1971, the world has operated on the basis of the dollar as a fiat currency. Unlike gold, the dollar does not have intrinsic value and has only been able to function as world money because it is regarded as being backed by the economic power of the US state.

This has provided the US with considerable advantages, enabling it to run up debts to finance domestic spending and its endless wars and bloated military spending in a way not possible for any other country.

However, the US debt mountain has expanded at an increasing rate in the past several years, is now virtually equivalent to its GDP and is predicted to rise even further in coming years. It is increasingly being recognised as unsustainable, leading two credit rating agencies to downgrade its rating.

In the final analysis, the surge in the gold price, which has been fuelled not least by central bank buying by China, but other central banks as well, could well be sign that the long developing debt crisis in the US, on top of all the other vulnerabilities in financial markets, is coming to a head.