Growth of private credit a “ticking time bomb”

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One of the claims of the would-be reformers of the capitalist system and its market mechanisms is that the explosive consequences of its contradictions, especially in the financial system, can be contained through oversight and regulation.

The ever-louder warnings about the growth of private credit, which has taken off in response to attempts to regulate the banking system following the global crisis of 2008, give the lie to these assertions.

This week, the *Financial Times* published a major editorial entitled “Warnings from the private credit wobble,” in which it pointed to the unmistakable signs that conditions are maturing for another crisis.

“The booming private credit sector is inspiring a rich lexicon of alarm,” it began. “For some time, market watchers have described the alternative asset class—which has grown to around $3 trillion globally—as a ‘ticking time bomb.’”

As it noted, the boom in private credit markets “has its roots in the tighter regulation placed on banks following the global financial crisis. That has channeled more credit through the less transparent and less regulated shadow banking system.”

The stated aim of the regulations, such as the Dodd-Frank Act in the US and the so-called Basel standards advanced by the Bank for International Settlements, was to introduce measures which would supposedly prevent a repetition of the 2008 crisis and the massive bailouts organized by the US government and the Federal Reserve.

But these efforts have run into a foundational contradiction of capitalism: that an economy and financial system based on private ownership, private profit and the anarchic market relations arising from it cannot, by their very nature, be subject to conscious control.

This means that attempts to contain the destructive effects of the private profit market system by closing one door means that sooner or later they will come in through another.

There has been concern over the growth of private credit for some time. But alarm bells started ringing following the collapse in September of US car parts maker First Brands and the auto lender Tricolor Holdings, both of which had taken considerable loans from non-bank financial institutions.

As the editorial noted, JPMorgan chief Jamie Dimon commented that when you see one cockroach there are likely to be more, and Bank of England governor Andrew Bailey has raised the possibility that the bankruptcies could be a “canary in the coal mine.”

At this stage, it said, while the “risks of an imminent shock appear limited,” recent warnings had drawn attention to “several troubling trends.” No doubt the editorial writers had in mind that, in 2007, emerging problems in the subprime mortgage market were dismissed as having no great consequences for the financial system, only to find 18 months later they were at the center of the biggest financial crisis since the 1930s.

Basing itself on an analysis by credit rating firm Moody’s issued last month, it drew attention to the fact that loans by banks to non-depository financial institutions (NDFIs) now account for more than 10 percent of all bank loans, three times their level a decade ago. And banks are not the only institutions involved.

“A particular concern is insurers’ growing investments in the opaque asset class, which could leave policyholders exposed if things go wrong.”

The editorial raised questions about lending standards with private capital groups “shopping” around for more favorable ratings for their investments from so-called specialist rating agencies, which have developed in the recent period, as well as worries about underwriting standards.

Describing the global economy as showing "resilience," it nevertheless remained "fragile"—how both conditions are simultaneously possible it did not explain—with uncertainty surrounding US President Trump's policies adding to the "unease."

The call from those expressing concern about the role of the private credit market, and what is universally described as its opacity, is for greater oversight and regulation.

But as the FT commented, "the [Trump] administration's push for broader financial deregulation could fuel further risk-taking just as signs of froth in both equity and credit markets are becoming harder to ignore."

The Moody's report it cited also pointed to the way in which finance capital finds a way around regulations attempting to control it in the drive for profit. It noted that the rise of private credit has altered the landscape, with banks ceding "significant lending turf to alternative asset managers on the back of more stringent regulations following the 2007-08 financial crisis."

Private credit assets under management had "tripled over the last decade, a growth rate far outpacing that of most other forms of credit."

It warned that as banks compete with non-bank lenders while financing them, "asset quality challenges may surface," and noted that the bankruptcy of Tricolor shows that "bank lending of NDFIs can result in significant losses."

The report pointed to a number of growing risks. These included aggressive growth by smaller banks weakening underwriting standards, the concentration of bank lending in a small group of private credit managers, and the inability to assess the true risk of exposure because "many private credit instruments are illiquid and opaque, and only have internally managed valuations."

A note by the Fitch ratings agency at the end of September also underscored the growing risks, noting that a shock to the financial system could reveal the extent to which the private credit sector had moved from being a niche for "sophisticated investors to an increasingly relevant component of global capital markets."

It then elaborated on what the consequences could be.

"Private credit's pervasiveness could amplify a systemic shock and impact a wide range of investors and lenders, including pension and sovereign wealth funds, banks, insurance companies, foundations/endowments, high net-worth individuals and, increasingly, retail investors. This could result in far-reaching consequences for capital formation, credit availability, consumer confidence/spending, social safety nets, national development, depositor stability and insurance availability."

What is set out in this scenario is not mere financial turbulence, but a collapse of the economy and its financial system.

The report said the agency did not "currently view the risks associated with private credit as systemic." This was largely because it was still a relatively small part of the overall financial system. But having said that, it warned that in the event of broader economic stress it would be a "meaningful transmission channel given its growth and increasing interconnectedness across various parts of the financial system."

Like all those who have probed the risk of private credit and its implications, Fitch called for close monitoring and increased oversight and transparency. But this is under conditions where the very rise of private capital has shown the capacity of finance capital to escape the effects of regulation, and where whatever control mechanisms remain are being systematically scrapped under the Trump regime.