Concerns over private credit deepen as war on Iran intensifies

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Concerns about the stability of private credit and its potential for triggering a financial crisis via its connections to insurance companies has reached the top level of the US financial system.

Last week the US Treasury announced that it would initiate a series of meetings with domestic and international insurance regulators starting this month and continuing into the summer. This would "allow participants to survey recent market events, emerging risks, risk management practices and outlooks for the sector."

Central to the concerns in the Treasury is the rapid, largely opaque and unregulated growth of private credit and its intertwining with insurance companies, which have turned to private credit to try to boost their returns, as well as with banks which have financed them.

The head of JP Morgan Chase, Jamie Dimon, who last October warned of "cockroaches" in the financial system following the failure of two companies backed by private credit, has again pointed to emerging dangers in his annual letter to shareholders issued yesterday.

"I do believe that when we have a credit cycle, which will happen one day, losses on all leveraged lending in general will be higher than expected, relative to the environment," he wrote. He said inflation could lead to a rise in interest rates, which would act "like gravity" on almost all asset prices, leading to a "flight to cash."

The rise and rise of private credit is one of the most significant changes in the financial landscape since the 2008 global financial crisis. The global private credit market has expanded from around $500 billion in 2008 to about $3.5 trillion today.

Much of this expansion has come from the efforts of US-based life insurance firms, together with others, to increase their returns under conditions where traditional investments in government bonds and blue-chip equities have proved to be inadequate. There have been moves in the other direction as well with private capital moving into insurance.

The Treasury announcement has come in the wake of a series of events which have shaken the private credit system and called into question its stability. Last October two auto-connected firms, Tricolor and First Brands, collapsed revealing connections to private credit. This was followed by the default in February of the UK non-bank mortgage lender Market Financial Solutions which was funded is part by private credit.

Most significant has been the wave of redemptions from private credit funds as investors seek to get their money back from some of the biggest names in the sector, including Blue Owl, BlackRock and Apollo among others, as their managements seek to restrict the withdrawal of funds.

Last Thursday Blue Owl revealed that it was hit with what the *Financial Times* called a "mammoth increase in redemption requests in the first quarter," as investors tried to pull out a total of $5.4 billion.

The withdrawal requests amount to 41 percent of Blue Owl's $3 billion technology fund and 22 percent of its $36 billion private-credit fund. Pointing to trends across the sector the *Wall Street Journal* reported that investors had "pulled more than $11 billion out of private-credit funds over the past two quarters."

The *Journal* said that Blue Owl, something of a startup on Wall Street, had become a "poster child for private credit, and its troubles raise new questions about how fund managers can weather prolonged outflows." It noted that its larger fund, Blue Owl Credit Income, was one of the biggest in the industry.

Blue Owl's co-president Craig Packer issued a statement that while market perceptions had driven activity, "fundamentals across our portfolio" have remained "resilient." There was a "disconnect between the public dialogue on private credit and the underlying

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trends in our portfolio," he said.

Such statements are always issued because otherwise, as in this case, there would be a run on the company. While there may well be an element of herd-like behaviour in the seeking of redemptions, the concerns over private credit do express real issues.

Chief among them is whether the vast investments which have been made in financing software firms, with large amounts of debt, are going to heavily impacted by developments in AI, which are undermining the profitability of their business models.

After the levels of redemptions were revealed last week, only a fraction of which will be met because of restrictions imposed by the firm, shares in Blue Owl, described by the *New York Times* as "once the hottest name in private credit," fell by 7 percent, bringing the decline to more than 47 percent so far this year.

The financial risks arising from the explosive growth of private credit have now increased with the US war on Iran and its flow-on effects through inflation not only in oil but across commodity markets, pressures on already stretched government finances and the prospect of interest rate rises, according to a report by the Bank of England (BoE) at the start of the month.

The report of the central bank's Financial Policy Committee (FPC) said while the financial system had been resilient so far, the shock of the war "will weigh on growth, increase inflation and tighten financial conditions."

"This is likely to interact with vulnerabilities previously identified by the FPC in sovereign debt markets, risky asset valuations and risky credit markets, notably in private credit."

It noted that many sovereign debt markets, where government bonds are bought and sold, have been "characterised by a relatively high use of leverage by a small number of hedge funds pursing similar strategies across jurisdictions."

The similarity of the strategies employed meant that all the heavily involved hedge funds react in the same way to an adverse event increasing the risk of what the BoE report called a "disorderly unwind of positions causing a jump to illiquidity in core markets."

This is what happened in the freeze of the US Treasury market in March 2020 when no buyers could be found for US bonds for a number of days requiring a massive intervention by the US Federal Reserve to the tune of around $4 trillion.

The report made clear that because of the interconnectedness of financial markets and the involvement of a small number of major hedge funds a crisis could start anywhere and then spread everywhere.

"Should investor sentiment on the sovereign debt outlook deteriorate abruptly, the role played by a small number of leveraged hedge funds in global bond markets meant that stress in one major sovereign bond market could spill over to the others."

On the issue of AI, the report noted that it had the potential to raise productivity and promote long-term economic growth but pointed out that valuations for US technology companies focused on AI remained "particularly stretched." What it called "AI repricing," that is a fall in the market valuation of these companies, "could transmit widely throughout the financial system and impact the real economy."

"The conflict in the Middle East posed additional threats to AI company valuations, given the energy-intensive nature of the supply chain for key components and the operation of data centres. In addition, supply chain disruption for key input chemical elements and materials could similarly act as a bottleneck on the buildout of infrastructure capacity."

The report highlighted the extent of growth of private credit markets and warned that they had not been tested by "macroeconomic stress at their current stage."

It said concerns about "opacity, valuation methodologies and asset quality deterioration amplified by structural liquidity mismatch [a reference to the desire by investors to have short-term access to their funds which are tied up in long-term investments], were central to recent redemption episodes."

The report concluded that the UK banking system and by implication that of other major economies had the capacity to support households and businesses "even if economic and financial conditions were to be substantially worse than expected."

But as the saying goes: They would say that wouldn't they.

The evidence in the market and from the BoE report itself is that they are a growing number of potential triggers for a major crisis, the danger of which has been heightened by the war on Iran.

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