

Major global bank takes a private credit hit

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The disclosure by the major global bank HSBC last week that it had suffered a \$400 million loss as a result of the collapse of the UK lender Market Financial Solutions (MFS) in February has sent out a warning about the opacity of the connections between the banking system and the rapidly growing private credit market.

MFS was a bridging lender providing short-term finance at a high interest rate which allowed homeowners to buy a new property before their current one was sold. It collapsed when it was discovered that it had engaged in major fraud in which assets were pledged as collateral for multiple lenders simultaneously.

The shortfall in funds has been estimated to be £930 million and banks, including Barclays, Santander and Jeffries, took an immediate hit. The loss for Barclay's was estimated at £228.

HSBC maintained that it had not lent directly to MFS. Its connection to the MFS failure—a result of its fraudulent operations—only emerged three months later when it recorded a \$400 million “fraud-related” charge in its quarterly earnings report. HSBC's ties to the failed MFS were via the private credit fund Atlas SP, set up by Apollo Global Management.

The HSBC loss was regarded as significant by financial markets and led to a 6 percent fall in its shares when it was revealed.

It highlighted a wider danger pointed to in a report by the Financial Stability Board (FSB), a global finance watchdog, released earlier this month. It noted that while direct bank lending to private credit was “relatively small,” amounting to less than 0.5 percent of their assets, it warned that a “web of interlinkages may create challenges for banks in effectively managing their direct and indirect risks.”

Regulators have been concerned that banks are so keen to obtain higher profits from the private credit boom that they do not have a clear understanding of the extent of their exposure. As the Bank of England deputy governor, Sarah Breeden, told an *Financial Times* (FT) conference last month there were various levels of lending by the

banks, of different types. “That is a layer cake,” she said, “and the banks don't really add those up.”

Moreover, the supposed regulators have no real idea of what the level of banks' involvement might be. FSB secretary-general John Schindler has acknowledged that the supposed watchdog cannot even put a precise figure on the size of the private credit market.

Pointing to both the dangers and the lack of knowledge, Andrew Bailey, the Bank of England governor and FSB chair, wrote in a comment piece in the FT that there were “significant interlinkages” between private credit, the banks, insurance companies, private equity firms and that these “multiple layers of leverage” required “deeper scrutiny.”

In an assessment of the HSBC revelations, the FT noted that its exposure “underlines investor jitters about the influx of private credit lenders and whether they may have eroded underwriting standards, with the potential for defaults to ripple across the financial sector.”

The FSB also drew attention to the influx of so-called retail investors, wealthy individuals rather than institutions, into private credit. They have been actively courted by the funds seeking ever more cash with which to secure profit.

According to the FSB, the share of assets under management sourced by retail investors has risen from virtually zero to 13 percent over the past decade. But there is a difference between institutions and retail investors. Institutions tend to invest longer term while individuals want quick access to their money if problem signs emerge. But the investments by private credit are in longer-term, relatively illiquid assets, not easily turned into cash at a profit, they can only provide for limited redemptions of investors' funds.

The FSB said this situation “could increase potential vulnerabilities related to liquidity mismatches” because notwithstanding disclosures “retail investors may not fully understand the illiquidity of the asset class, which may amplify redemption requests during stress episodes.”

It is not quite a run on the banks, but mass redemptions

could turn into the credit market equivalent. A recent article in the Murdoch-owned *Australian* said the decisions by some major funds, including Apollo and Blue Owl, “to invoke contractual withdrawal limits” marked the “most significant liquidity crisis in alternative credit since the global financial crisis.”

Inflation and the rise in interest rates, generally tightening credit conditions, have focused more attention on the private credit market after it grew at an exponential rate in the period of ultra-low interest rates which prevailed from 2009 to 2022.

One of the practices under scrutiny is the selling of assets by private equity investors. The modus operandi is to buy assets in the expectation they will be able to be sold at a later point realising a profit, after some “restructuring”—above all reductions in labour costs—has been carried out.

But the rise in interest rates has tended to lower the market value of such assets and made them harder to sell at a profit. Consequently, an increasing number of private equity firms are using what are known as continuation vehicles.

These are new funds set up by the original fund to which the assets are then sold, avoiding the necessity to bring them to the open market where they would register a loss. Another advantage is that this practice also generates valuable fees.

One might well wonder how such practices are even legal. But they are becoming increasingly used. The Institutional Limited Partners Association, which represents some of the world’s biggest pension and sovereign wealth funds, has estimated that last year transactions with continuation vehicles amounted to one fifth of all buyout exits.

This kind of trade is rife with conflicts of interest because the entity selling the assets is on both sides of the transaction, leading Neal Prunier to tell the FT that they should be called “conflict vehicles,” noting there was “increasing and growing” concern among the financial backers of the private credit funds.

Last year there were more than \$100 billion worth of sales into continuation vehicles, up from \$70 billion the year before and just \$7 billion or less a decade ago.

Insurance companies have been one of the major backers of private credit because they cannot obtain a sufficient rate of return from their traditional operations in the public market.

This has brought a warning from the former Apollo risk manager, Chak Raghunathan, who told the FT in an

interview that some insurance companies would not be able to manage policy holder funds in a downturn.

He noted that assets and liabilities had to be matched in time but there was a risk of policy holder withdrawals from insurance firms. This could lead to a situation where firms were forced to sell illiquid assets “in a market that’s going down.”

In 2011, the Senate report on the 2008 financial crisis found that it was the “result of high-risk, complex financial products; undisclosed conflicts of interest; and the failure of regulators, credit rating agencies and the market itself to rein in the excesses of Wall Street.”

Senator Carl Levin, chairman of the subcommittee, which carried out the investigation, said it had found “a financial snake pit rife with greed, conflicts of interest and wrongdoing.”

No one, however, was prosecuted for what was clearly criminal activity in many cases. Goldman Sachs, for example, sold financial products which it knew were going to fail. The Obama administration took the decision that, having bailed out the financial system on the basis that it was too big to fail, it also determined that those responsible were too big to jail.

The outcome of the Senate investigation was the Dodd-Frank Act which imposed some limited restrictions on the financial operations of the banks. But it is in the very nature of finance capital, rapacious in its never-ending search for profit and willing to use all means necessary to achieve this objective, that it found ways around these attempts at containment.

And one of the means developed was the growth of the private credit, which may be as large as \$3.5 trillion, and which is starting to exhibit some of the features which characterised the financial system prior to 2008.



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