Jon Moulton's Diary

The Bank of England is right to worry about private equity

Veteran financier Jon Moulton has been involved in buyouts, turnarounds and venture capital since 1979 with firms such as CVC, Permira, Apax, Alchemy and, most recently, Better Capital, where he has been the chair since 2009

Last month, the woman in charge of banking (and a lot more) at the Bank of England, Rebecca Jackson, gave a speech on "Private Equity Financing". In summary, the BoE is getting concerned at the scale, complexity and increasing risk levels in the use of debt by and around private equity.

It brought back a fond memory of 2006 when the Great Financial Crisis (GFC) of 2008 was in advanced incubation. I was honoured (the first and last time) to be invited to a "risk breakfast" at the Bank of England. I cannot remember what was covered but it had nothing to do with the coming disaster. What I did do was sketch out how a Collateralised Loan Obligation (that multiple layered debt animal, the CLO, which was shortly to be famous) worked to the then deputy governor who was unaware of them and their mechanics.

A few weeks later, I mentioned this educational session at an event I was speaking at. Unknown to me the BoE was in the audience – as was the FT. A few hours later, a PR man from the BoE called me. He was clearly concerned that the BoE might lose public credibility. He remarkably asked that I withdraw my statement that I had explained CLOs on a serviette to the deputy governor. I immediately agreed and he was obviously pleased. I then explained that I was happy to correct the story – it was a menu.

He was less happy at this.

Anyway, the GFC contained ingredients that certainly echo the more recent developments in private equity.

- Rapid growth in new forms of debt.
- GP loans, net asset loans, commitment facilities, loans against future carried interest etc and the products that these facilitate such as extension funds.
- New entrants lending at higher risks. Silicon Valley Bank.
- General weakening of covenant and other protections, Cov-lite loans.
- CLO and similar structures with incentives to lend quickly and in volume.
- Conflicts downplayed. Such as loans to GPs (on friendly terms – even non-recourse) who borrow from the same banks that provide fund and investor debt.
- Poor collateral . Use of cheerful venture capital valuations, pro forma financials and the like.
- Dangerous cross-linkages where, for example, a firm is both a GP in a fund and an organiser, even an investor in, CLOs that provide funds to investors, portfolio companies, investors and themselves. Credit funds, often sponsored by major PE firms, regularly play in these more exciting corners of the debt markets.
- Complex structures.

This is not an exhaustive list!

The GFC should remind people of the way that simple mortgage lending to subprime got out of control. Valuations of properties were being done from aerial photographs – pictures that were, in the more careful lenders, done in late afternoon.

Why late afternoon? The shadows enabled them to estimate the number of storeys in a building.

Some of the biggest names in PE today were heavily involved in sub-prime and its aftermath.

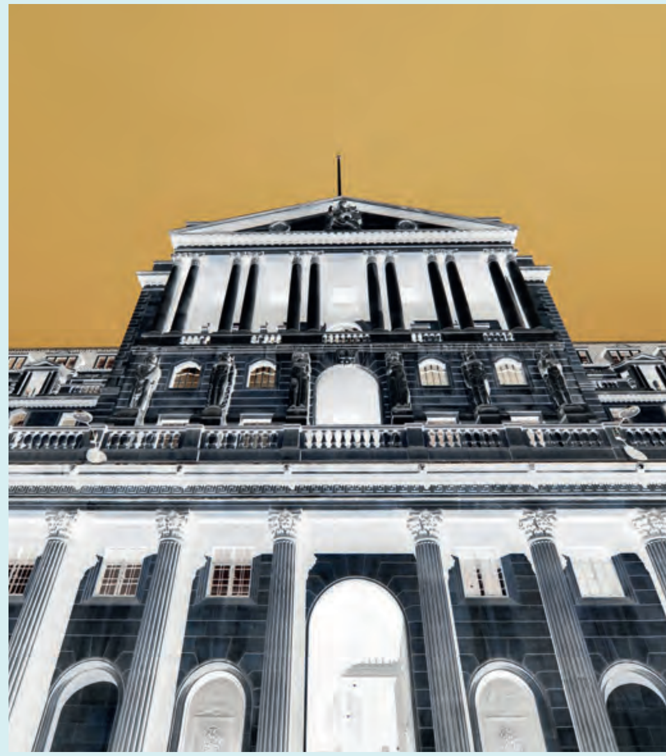
The BoE's recent findings amount to an unsurprising view that banks have mostly so far failed to measure these complicated risks. You can add the reality that often they often don't understand the interrelated risks. Domino failure is a clear possibility. Also, its not just banks, other forms of capital market actors are as important. Indeed, maybe more so.

The BoE is critical of the lack of holistic (not a clarifying adjective!) assessment by banks, a lack of stress testing (which would have to be very clever to reflect the assorted correlations!) and, politely, the understanding of the banks' boards as to what is going on.

I totally agree that the Bank is right to worry about this complex and fast-growing world. Early action in 2006 would perhaps have saved massive grief in the GFC.

Its substantial supervision that's needed – setting up committees is not going to cut it. Ms Jackson has a really significant and difficult job.

See page 23 for more on regulation



The Bank of England must take action on the risks to banks arising from private equity to prevent a financial crisis

Getty Images

'Some of the biggest names in PE today were heavily involved in sub-prime and its aftermath'