Interplay between banking and private credit – a Hong Kong regulatory perspective

In our podcast *Out of the shadows: The growing regulatory spotlight on private capital*, we explored the increasing noise we hear from regulators regarding the impact of and potential for private capital to pose systemic risk. Some call for increased scrutiny, while others have cautioned against a rush to over-regulate.

Heightened regulatory focus – both on banks' exposure to private capital, and on private capital activities – reflect two sides of the same coin. Below, we share our perspective from Hong Kong, focusing on the implications for banks and private capital, particularly private credit.

Banking perspective

No consensus on regulation, but a growing topic of discussion

Regulators are examining banks' exposure to private capital, though no clear regulatory consensus has emerged yet. While the issue is regularly raised, there remains debate over whether, how and to what extent regulation is necessary.

Private capital is on the local regulatory radar

In April 2024, the Hong Kong Monetary Authority (***HKMA***) issued a research memorandum titled *The Financial Stability Implications of the Private Credit Sector in Asia-Pacific* (***HKMA private credit research***). Earlier, in November 2023, the HKMA issued a similar memorandum: *The Financial Stability Implications of Private Equity for Emerging Market Economies* (***HKMA private equity research***). Note that the views and analysis contained in the research memoranda '*do not necessarily represent the views of the HKMA*.'

While no further public updates have been released by local regulators (in their supervisory capacity), these memoranda clearly indicate that private capital no longer flies under the local regulatory radar.

HKMA: systemic risks in APAC have 'remained contained so far'

The HKMA private credit research concluded that '*the systemic risks in the PC* [i.e. private credit] *sector may have **remained contained so far**. Nonetheless, some developments may warrant further monitoring as they may evolve and increase the vulnerabilities. These include the trend of launching open-ended PC funds and the growing popularity of new* [private credit] *funds that use credit lines*.' The HKMA private credit research came to this conclusion for the following reasons:

'*First, the total asset size of PC funds remained small as compared to non-bank financial intermediaries (NBFIs) or banks in the region. Second, the liquidity mismatch risks of these funds were low, as most of them were closed-ended. Third, these funds' leverage and usage of bank credit lines did not seem to be particularly high. Fourth, the contagion risks from the PC sector to other financial institutions (FIs) appeared to be limited, as major PC investors in the region such as pension funds, insurance corporations and asset managers on average allocated a small share of their assets to the PC sector.*'

Increased monitoring, reporting, stress testing, and potentially a thematic review?

Of note is the following ***qualification*** in the HKMA private credit research in respect of their sampling data: '*Our sample cannot provide a complete picture of the usage of leverage and subscription credit lines by PC funds, as the data is available for only around 20% of them.*' The research uses '*data commonly employed by other central banks and international organisations*' and is said to be sourced from Preqin.

Similarly, the HKMA private equity research flagged that '*unexplored areas remain due to **data gaps**, especially on the size of leverage employed by PE funds and their interconnections with other sectors in the financial systems that can also give rise to systemic issues.*'

At the global level, the IMF's *April 2024* *Global Financial Stability Report* also highlighted the potential risks from banks' direct exposures to private credit, cautioning that concentrated exposure in certain banks could pose threats:

'*Potential risks to financial stability arising from direct exposures of banks to private credit currently appear to be contained. Banks are one of the primary providers of leverage to private credit firms, yet their aggregate exposure remains low…Credit risks to banks are also mitigated by the secured nature of the loans. However, the **lack of data** does not allow ruling out the possibility that some banks exhibit concentrated exposure to the sector.*'

In our view, a logical regulatory reaction to this observation will be to focus efforts around monitoring and information gathering around banks' private capital related activities. This could translate to increased activities in the areas of (i) reporting, through regular returns and disclosures, or specific information requests, (ii) increased dialogue with relevant stakeholders and market participants, (iii) stress testing, and (iv) thematic reviews.

We think any regulatory response will look at banks' private capital related activities as a class, rather than to single out private credit related activities.

What to consider for banks?

One would assume existing regulatory frameworks for disclosures, reporting, credit risk management and regulatory capital should, if robustly implemented, already address the risks of bank exposure to private capital.

However, banks should ensure their practices are fit for purpose and maintain active dialogue with regulators, particularly in business lines that serve private capital clients, such as prime brokerage and private banking.

Credit risk transfer activities

Hong Kong licensed banks engaged in cross-border or intragroup credit risk transfer activities using private capital exposure as underlying assets (eg subscription line financing), should be mindful of the HKMA's Supervisory Policy Manual Module CR-G-12 Credit Risk Transfer Activities, which outlines the HKMA's risk management expectations. This applies to both locally incorporated licensed banks as well as the Hong Kong operations of foreign banks.

Private credit perspective

Is lending regulated?

It should be of no surprise to the market that depending on their risk appetite, business nature, territorial nexus, transaction structures, and regulatory status, private credit firms have found ways to become comfortable in light of the regulatory ambit of Hong Kong's Money Lenders Ordinance. This is in particular noting from the legislative history, policy intent, regulatory framework, and operative provisions of Hong Kong's money lenders regulatory regime that it could not have been tailored to and cannot quite cater to the needs of private credit funds, which are a relatively modern invention.

As a result, regulators could begin reevaluating whether the current framework adequately addresses private credit activities, potentially through the lens of existing banking and securities regulatory regimes.

Are you appropriately licensed, exempted, or robustly structured to comfortably fall outside the existing regimes for your activities?

The Securities and Futures Commission's (***SFC***) *January 2020 circular* on their licensing requirements for private equity firms and family offices should now have reached the inboxes of firms managing private capital in the region.

Although there is no equivalent circular for private credit managers, unlicensed firms should be mindful that, other than lending, private credit activities may include margin lending, securities dealing or advisory activities, corporate finance advice, fiduciary roles and intermediation activities which may require a license.

Whilst for each of these activities, different houses will have varying interpretations of the applicable regulatory regimes, now may be an opportune time to reassess whether existing legal and regulatory positions remain defensible, especially in light of the evolving regulatory climate.

For licensed houses, it may be worthwhile building into the rolling review framework an assessment of private credit activities from a licensing perspective - to avoid any incremental growth in business and activities inadvertently triggering licensing requirements in light of the ever-expanding types of regulated activities.

Anything new for regulated houses?

For regulated firms, the focus remains on **reporting**, **transparency**, and **investor-protection**.

In October 2024, the SFC issued *a circular* identifying deficiencies in private fund manager's conduct and announcing that it would:

'*commence a **thematic on-site inspection** of asset managers managing private funds to detect any material breaches or non-compliance*';

and

'***step up its disciplinary actions** and impose harsher penalties against similar or persistent misconduct to send a strong deterrent message to preserve the integrity of our market and instil confidence in the investing public*'.

Regulated firms should assess which entity or business (licensed or otherwise) their private credit lending activities fall under, as regulators hold broad and significant audit powers to review regulated activities being undertaken with a Hong Kong nexus.

As regulators intensify scrutiny of banks, houses should understand how their information could indirectly be aggregated (with other houses') and disclosed to regulators. Dialogue with bankers could help to clarify the nature and extent of such disclosures and their implications.

Evolving risks in a changing market

Complaints from disgruntled counterparties and investors, market attention, and reputational damage - these are all issues and risks that are aside from but equally important to - and would feed into - the risks of regulatory scrutiny. Risks emanating from these issues are often projected when the market is in a downward cycle, with volatile market conditions.

Whilst we remain of the view that regulatory considerations should never be made in vacuum, assessing and documenting the current approach in light of the wider climate may help to tackle legal and regulatory risks that are starting to dawn.

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