Wharton UNIVERSITY of PENNSYLVANIA PUBLIC POLICY INITIATIVE

publicpolicy.wharton.upenn.edu

ISSUE BRIEF
VOLUME 7
NUMBER 7
OCTOBER 2019

How Regulators Can Help Smooth the Credit Cycle

Author: Christina Skinner[1]

Readily available credit is key to financial stability and, ultimately, economic expansion. Businesses and households everywhere need access to credit to spend and invest in ways that fuel the real economy.[2]

However, banks—the usual source of credit in the economy—lend procyclically.[3] In fact, procyclical lending appears to be an unavoidable consequence of a big bank's balance sheet and its regulatory constraints.[4] In contrast to banks, there are certain kinds of investment funds—specifically, private credit or debt funds—that operate with a different set of strategic priorities and operational constraints. The core claim of this Issue Brief is that certain private funds are structured and incentivized to supply the economy with a countercyclical source of credit, turning on their credit 'spigots' precisely when banks are likely to turn theirs off, by pulling back from lending.[5] As such, these private investment funds have the potential to make the economy more resilient by helping to smooth the credit cycle—by making downturns in the financial cycle less prolonged and less severe. Despite the role that private investment funds can play in steadying the economy, many policymakers remain suspicious, especially in light of longstanding concerns about shadow banking. But regulatory or legislative efforts that allow more investment to flow into the private debt industry potentially could help promote economic stability, not endanger it.

SUMMARY

- Certain alternative private funds that invest in debt or credit have the potential to play an important role in promoting financial stability, as they are structured to supply the economy with a countercyclical source of credit, precisely when banks are likely to pull back from lending.
- Despite the benefits to economic resilience, however, the development of a robust market for nonbank credit has generated concern among some financial stability watchdogs, reflecting long-standing distrust about the shadow banking sector. This Issue Brief outlines the rationale for why regulators and legislators should be thinking of ways to allow more—not less—investment to flow into the private credit/debt market, to mitigate future economic downturns.
- In particular, the brief argues that certain private credit/debt fund investments should be made accessible to retail investors, and recommends possible avenues the SEC could pursue—i.e., amending the definition of an accredited investor and expanding exemptions under Regulation D—to enable that to happen.
- In addition to fostering a countercyclical source of credit, such a deployment of the SEC's rulemaking power also stands to have the ancillary benefit of promoting broader financial inclusion.

SNAPSHOT OF THE PRIVATE DEBT AND CREDIT FUND INDUSTRY

Certain kinds of public investment funds, like mutual funds and ETFs (which are regulated by the SEC under the Investment Companies Act of 1940), are not the subject of this Issue Brief. Rather, we are examining a type of alternative investment fund: private funds that invest in debt or credit, which are excluded from the definition of an investment company under the 1940 Act.[6] These private funds principally invest in credit assets by making loans, buying loans, or buying corporate bonds.

In general, private credit or debt funds can supply or support credit in three main ways: (1) by lending directly;[7] (2) through mezzanine funds, in which a fund makes private loans that are subordinate to a senior secured loan, but senior to equity; and (3) through distressed debt funds, which buy the debt of companies with imminent covenant defaults.[8] For context, the private debt sector was booming for the first eight to nine years after the crisis.[9] In 2017, 42% of institutional investors surveyed by Preqin, the data firm focusing on alternative assets, had planned to commit more capital to private debt funds in 2018.[10] Preqin's study of 136 private debt funds showed $107 billion was raised by funds closed in 2017.[11] In total, private debt assets under management (AUM) were $638 billion, as of June 2017.[12] (For context, the private debt industry quadrupled between 2006 and 2016). And some market analysts have predicted that the industry will have $1 trillion AUM by the year 2020.[13]

Generally speaking, the growth of alternative funds over the past decade can be explained by events from the financial crisis of 2008, and the resulting migration of financial activity from banks to asset managers. The losses suffered on banks' balance sheets, combined with heightened regulatory requirements, prompted many large banks to deleverage and/or retreat from certain capital markets activities. Asset managers then seized credit-investment opportunities where banks were forced to pull back.

The largest asset managers that engage in these private debt alternatives include private equity companies, like Blackstone, KKR, and Carlyle, as well as traditional asset management companies, like BlackRock, and hedge funds such as Bridgewater and the Man Group. Investment in these funds is usually limited to "accredited" or "sophisticated" investors, which are investors that meet a certain income or educational thresholds.[14] Accordingly, private fund investors tend to be institutions, such as pension funds, insurance companies, nonprofits, endowments, or sovereign wealth funds.

The principal reason why these funds have potential to support economic resilience is because they are naturally incentivized to lend in a countercyclical direction. For one, these funds likely have an aggressive and sometimes risk-seeking strategy that is a function of their investors' appetite for diversification. A private fund's strategy will be opportunistic—meaning that it is contrarian in many cases—that is, countercyclical. Where the strategy is long-term in nature, the fund will tend to invest in assets that are distressed but quite likely have fundamental value to recover. Moreover, these private funds have the freedom to pursue their strategic objectives at the fund level. Because they lack the balance sheet constraints of a bank (i.e., regulatory capital rules), private funds can more readily raise and then deploy capital in down times and after economic shocks.

The stability of their funding

NOTES

1 This Issue Brief is based on Christina Parajon Skinner (2019), "Nonbank Credit," https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3325167.

2 Cindy M. Vojtech, "Post-Crisi Lending by Large Bank Holding Companies," FEDS Notes, July 6, 2017.

3 John Armour et al. (2016), *Principles of Financial Regulations,* p. 49 (noting that banks' "core asset class"—loans— "rise and fall with the economic cycle").

4 Simon H. Kwan (2010), *Financial Crisis and Bank Lending* (Fed. Reserve Bank of San Francisco, Working Paper Series 2011).

5 Madison Marriage, "More Asset Managers Become Shadow Banks," *Financial Times,* June 21, 2015.

6 Many private fund advisers register with the SEC on Form ADV and provide information about the funds that they manage via Form PF, however. See, e.g., U.S. SEC, *Private Fund Adviser Overview.*

7 In 2016, the approximate market size of 'plain vanilla' direct lending was $350-500 billion in the U.S. and about $90-120 billion in Europe. *See* Bfinance (2017), *Direct Lending: What's Different Now?* Available at https://www.bfinance.com/insights/direct-lending-what-s-different-now/.

8 Dechert LLP (2017), *Financing the Economy 2017: The Role of Private Credit Managers Supporting the Economy Forward,* pp. 11, 24.

9 Preqin (2017), *Quarterly Update: Private Debt Q1 2017.*

10 Preqin (2018), 2018 Global Private Debt Report, p. 14.

11 *Id.*

12 *Id.*

13 Dechert, *supra* note 7.

14 *See* 17 C.F.R. §§ 230.501(a), 506(b)(2)(ii) (these are provisions of "Regulation D" of the Securities Act of 1933).

15 Typically, these additional provisos to the LPs' investments

source is also a key feature. Unlike a bank, these private funds tend to have locked-in capital, which allows them to deploy their capital in periods of downturn, without the possibility of flight. This nearly eliminates "run-risk." Notably, premier alternative funds are increasingly using structures to secure capital for even longer periods of time.[15] Finally, on a corporate level, a substantially large asset management institution typically has a flexible business model, giving it the latitude it needs to raise fresh capital for a new fund and in pursuit of any opportunity—regardless how esoteric—that presents itself. These firms operate a range of distinct funds that can support credit markets during downtimes and in a range of different ways.

Many of these funds have patient capital that stands *ready*—and *hungry*—to seize opportunities during moments of downturn. To be sure, this is profit-maximizing behavior on the fund's part, to serve its and its investors' financial interests. But at the same time, this behavior provides a social good to the extent it helps restore health to the credit markets.

EXAMPLES OF PRIVATE DEBT AND CREDIT FUNDS PROMOTING SOCIAL GOOD

1. STIMULATING GROWTH IN TIMES OF DISTRESS

For some years after the crisis, global energy suffered from a capital imbalance where financing demand for corporate projects greatly exceeded available bank funding. In practice, a private debt fund may, for example, lend to an energy company so that it can build a renewable energy plant after an economic downturn, at a time when very few banks could. In such a scenario, not only does the loan stimulate economic growth, but it also enables add-on economic benefits associated with the creation of innovative and energy-conserving infrastructure in society.[16]

2. HEALING BANK BALANCE SHEETS

In another example, debt funds might invest in a bank's nonperforming loan (NPL) portfolio, thereby helping that bank repair its balance sheet so that it can eventually return to full-steam lending. Not only can these investments help clean up weak banks, but they can also provide a salve for healing the weakened aspects of otherwise functional banks. A steady stream of asset manager NPL investment should in theory make the down phase of a credit cycle much shorter and much shallower than it otherwise would be.[17] Recently, funds have been financing their NPL investments through securitization, helping to stimulate that market, which was devastated by the crisis.[18] Since the bottoming out of the securitization market may have made the credit cycle bumpier by crimping credit liquidity, funds' financing of credit investments through securitization is a social good to the extent it serves a credit-cycle-smoothing role by supporting funds' NPL acquisitions.

NPL investing promotes economic resilience in several other important ways, too. For one, it may reduce the number of foreclosures in the real economy. Investment funds are likely to have greater incentives and capacity (than banks) to salvage the NPLs. Typically, the fund will purchase the NPL portfolio at a discount of somewhere between 25% and 50% of the loans' face value, acquiring the portfolio on an investment thesis that the fund could deploy its capital markets structuring expertise to work out a more profitable arrangement, which is likely also to be more borrower-friendly.

NOTES

are referred to as "evergreen" fund structures. In such funds, returns are "recycled back" into the fund rather than distributed to the investors.

16 BlackRock, *What Is Private Market Debt* (undated).

17 The industry expects that investment funds are likely to continue acquiring NPLs. Major funds are still eager to invest, and new stores of NPLs are expected to come online from banks in China, Ireland, and India.

18 "Loan Buyers Drive Europe MBS," Asset-Backed Alert, June 2, 2017 (on file with author).

19 Amin Rajan (2015), *The Rise of Private Debt as an Institutional Asset Class,* p. 6.

20 In 2015, the ten largest asset management firms active in fixed-income had $1.98 trillion in bond holdings, as compared to $921 billion in 2008. David Oakley & Barney Jopson, "Asset Managers Push into Bonds Prompts Regulatory Scrutiny," *Financial Times,* (June 2, 2015).

21 *See,* e.g., Mark Vandevelde, "How the Biggest Private Equity Firms Became the New Banks," *Financial Times,* Sept. 19, 2018; *see also* Office of Financial Research (2016), *2016 Financial Stability Report.*

22 OFR, *supra* note 18 (explaining that "[u]nderstanding the incentives that drive these [shadow banking] activities and the potential risks and vulnerabilities they may create for financial stability is central to the OFR's work.").

23 FSB (2017), *Assessment of Shadow Banking Activities,* p. 3-5.

24 *See, e.g.,* Iris H. Chiu & Iain MacNeil eds. (2018), *Research Handbook on Shadow Banking: Legal and Regulatory Aspects,* p. 7.

25 *See, e.g.,* John C. Coffee, Jr. (2011), "Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight," 111 Columbia Law

3. KEEPING MARKETS LIQUID

Apart from this role in supplying countercyclical credit and investment, asset managers can provide other credit-related services to financial markets at times when banks cannot. For example, some of these institutions' entry into corporate bond trading helps sustain that market's liquidity. According to 2015 market research, investors reported that it then took seven times longer to liquidate their bond portfolios as it did in 2008.[19] But there, too, asset managers filled the credit void, in that case by acting more like traders. The size of their fixed-income holdings enables some asset managers to replicate the market-making that banks used to do, thereby sustaining liquidity in those debt markets, even during times when banks are stressed. This can further help to flatten (i.e., smooth) the credit-cycle curve.[20]

CURRENT STATE OF REGULATION

Despite these benefits to economic resilience, the development of a robust market for nonbank credit has had some financial stability watchdogs worried.[21] Their concerns largely echo longstanding regulatory efforts to identify financial stability risks inherent in nonbank credit intermediation and, more broadly, in the so-called shadow banking sector.

More specifically, prudential regulators in the U.S. and globally have dedicated considerable resources to tracking and mapping shadow banking activities, especially and including among investment funds. In the U.S., for example, this work was at one point central to the Office of Financial Research's (OFR) work.[22] On the international level, the Financial Stability Board (FSB) was monitoring the shadow banking world for several years (of which these funds are a key part).[23] Collectively, these efforts led to a mainstream view that some segments of this sector should be more tightly regulated.[24] (Regulatory data on private funds—and private credit funds—remains sparse.)

The extent to which private credit intermediation can in fact enhance the stability of the financial system has not been fully explored in this regulatory conversation and debate. Attending to the downturn of the financial cycle is an important—yet underdiscussed—aspect of financial stability regulation. Indeed several theories of financial economics suggest that the downturn of a financial cycle—not just the upturn—presents "systemic risk."[25] Because financial stability regulation is mostly focused on "leaning against the winds"—that is, putting the brakes on the upturn of the financial cycle—there is some question of the efficacy and sufficiency of the regulators' tools for addressing the inevitable downturn. Stated very simply, how can the regulator help the economy to recover? Private credit intermediation can play an important role in stymying a spiraling or sluggish economy.

On that view, supporting or facilitating private credit intermediation could be seen as a legitimate and worthwhile pursuit of "macroprudential" regulation.[26]

POLICY PROPOSAL: OPEN ACCESS FOR RETAIL INVESTORS

Using regulation to impact the allocation of capital across the financial system—specifically, with the goal of increasing the amount of countercyclical capital at work during economic downturns—may ultimately be more effective and efficient than relying solely on other kinds of time-varying tools, like the countercyclical capital buffer ("CCyB"). While regulators

NOTES

Review, pp. 795, 797.

26 Macroprudential regulation is principally concerned with systemic risk. For a comprehensive treatment of systemic risk and countervailing macroprudential policies, see generally Xavier Freixas, Luc Laeven & Jose-Luis Peydro (2015), *Systemic Risk, Crises, and Macroprudential Regulation.* Thus far, the chief macroprudential tool for tinkering with the financial cycle is the chief among them being the countercyclical capital buffer (CCyB). It is said to be a "time-varying" tool because it can be leveled-up or leveled-down by macroprudential authorities like the Federal Reserve. Regulator limits on loan-to-value or debt-to-EBITDA ratios are two other related tools.

27 *Cf.* Pepper Hamilton LLP (2017), *Going the Distance, The Expanding Life Cycle of Private Equity Funds,* p. 12.

28 *See* Dodd-Frank Act § 941 (amending section 15G of the Exchange Act), 79 Fed. Reg. 77,602, 77,611, 77,613 (Dec. 24, 2014).

29 Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11,251, 11,252, 11,262 (Mar. 16, 1982).

30 *See* SEC (2013), *Investor Bulletin: Accredited Investors,* p. 1-2, available at https://www.sec.gov/files/ib_accreditedinvestors.pdf (explaining the term accredited investor).

31 SEC (2015), *Report on the Review of the Definition of Accredited Investor.*

32 *See* Christina Parajon Skinner (2017), "Regulating Nonbanks: A Plan for SIFI Lite," 105 GEO. L.J. 1379 (making this argument in the context of the FSOC designation process.)

33 Jeff Cox, "Hedge Fund King Ray Dalio: Middle Class Needs 'Wealth Transfers' to Bridge Income Gap," *CNBC,* Oct. 23, 2017.

may wish to raise the CCyB to make the upturn of a financial cycle less steep, regulatory or legislative efforts to allow more investment to flow into the private debt industry could serve to mute future downturns.

To date, however, macroprudential regulators (like the Fed) do not themselves have the tools to facilitate the flow of capital into the private credit and debt fund sector. Such regulatory intervention would require modification to the existing securities law framework that governs private fund investing.

The primary recommendation of this Issue Brief is that securities regulation should be designed to facilitate the flow of capital into the market for private, nonbank credit. In particular, private credit/debt fund investments should be made accessible to retail investors—which would thereby increase the base of countercyclical capital available for these funds to deploy during economic downturns. (One notable benefit of this approach to financial-cycle-management is that it takes the burden off regulators to toggle regulation alongside predictions about the financial cycle—as is the case with the CCyB. Instead, modifying the securities law around private fund investing would permanently make the investment channel to private debt funds wider, which would work in all future financial cycles.)

To be certain, investor protection measures would be critical to any initiative to allow retail investors to invest in private funds. In particular, it would be important for the SEC to have the ability to siphon the flow of retail investment into only those private credit and debt funds that were structured suitably. There are (at least) three structural features which regulators should consider in determining whether a private debt/credit fund is structured suitably.

1. LIQUIDITY

While illiquidity is helpful to the fund's stability, there is some tension, on this point, with the interests of retail investors. The average retail investor may not be able (or should not attempt) to withstand a ten-or-so year lock on his or her investment. Innovative funds, however, could likely find some way to structure around this challenge. For example, some structure might develop that would permit existing retail investors to trade their interests in the fund with those investors wishing to enter the fund but who had missed the original window for investing. A similar market currently exists among institutional investors. To maintain stability, however, the fund would have to ensure that any trading-out of share positions were always matched with buying in, precisely to avoid any possibility of a sudden decrease in capital (similar to a run).

2. FUND MANAGER INCENTIVES

It is reasonable for policymakers and academics to advocate for regulatory checks on managerial exuberance or, stated differently, for sufficient 'skin in the game.' Yet managers of these funds are already usually required to clear a hurdle of profit and performance before receiving incentive fees. Also, they have strong reputational incentives to invest in high-quality credit. Poor quality investments—those that are too risky or too sloppy—will dissatisfy investors, diminish the institution's reputation and, consequently, its ability to raise future funds.[27] For that self-preserving reason, asset managers naturally tend to have more 'skin in the game' with their credit investments than, for instance, banks.[28]

3. EDUCATION

A range of fintech platforms now offer meaningful investor advice and education—often targeted to retail investors—that could improve these investors' ability to 'fend for themselves' in private debt markets. There are a number of ways that market authorities, like the SEC, could incentivize such innovation as a means of opening alternative credit and debt investments to the retail investor. The definition of accredited investor could, for instance, be keyed or scaled to the use of such fintech platforms, which might in turn incentivize alternative funds to pay some fee to these platforms for their service in supplementing any additional disclosure obligations. Regulators could also, on a more general level, promote fintech innovation simply by not suppressing it—taking a "sandboxing" type approach that allows new technological products and services to develop with some latitude before they are regulated as new forms of investment advice.

POLICY IMPLEMENTATION

The final issue to consider is how best to operationalize this new framework. Two possible avenues are (1) amending the definition of an accredited investor and (2) expanding the exemptions in Regulation D. In 1982, the SEC developed Regulation D, which included the term "accredited investor."[29] Accredited investors are defined as individuals that meet a certain income or net worth threshold. Many institutions qualify as accredited investors as well, though under a separate set of standards. The intent in developing the definition of and criteria for an accredited investor was to include in private markets only those who could "bear the economic risk" of investing in unregistered securities.[30] The SEC, however, has the legislative delegation from Congress to change this rule.

The Dodd-Frank Act requires the SEC to review the accredited investor definition every four years. In 2015, the SEC considered (but did not ultimately recommend) "scaling" the definition (e.g., along with funds' voluntary disclosure of additional information), as a well as "a more flexible approach" involving "a contextual evaluation of an investor's attributes with respect to a particular offering" (i.e., accrediting investors for some offerings, but not others).[31] In practice, this would not be the ideal modality of regulation. Invariably, sorting funds into regulatory winners and losers is bound to create friction between regulator and industry, along with unanticipated costs.[32]

Alternatively, the commission could expand the exemptions in Regulation D. Specifically, the SEC could add a category of exemption to the existing Rule 506 of Regulation D for offers and sales of any dollar amount, irrespective of investor-type (accredited or sophisticated), where the private fund (i) is a credit or debt fund and (ii) can demonstrate or self-certify certain structural criteria concerning its liquidity management systems, incentives programs, and approach to investor education. One possible downside to this approach is its feasibility; it is unclear how such proposed rulemaking would be publicly received, given its relatively niche scope.

The outcome of this approach would be to expand the amount of capital that private debt funds could access and have available to deploy in countercyclical ways, while at the same time giving the SEC the power to *ex ante* establish which kinds of funds would be suitable for retail investors. Importantly, the SEC would not be responsible for making case-by-case decisions about which funds could access retail capital. Instead, the SEC would use its rulemaking power to set across-the-board criteria for funds' eligibility to accept retail investments.

Finally, it bears noting that an ancillary benefit of this proposal is broader financial inclusion. As the wealth gap in America continues to widen, leveling the opportunities for investing—between those in the top 40% of income and those in the bottom 60% of income—could have a meaningful impact on bridging that gap, and supporting middle- and low-income households' ability to save for homes, education, and retirement.[33]

CONCLUSION

Countercyclical credit is a social and economic good. Facilitating the flow of investors' capital into those non-bank credit and debt funds that are structured stably would better serve economic resilience than relying solely on the existing macroprudential tools. Private, nonbank credit helped smooth the credit cycle after the 2008 financial crisis—through countercyclical lending and credit-investment and by otherwise supporting credit-market liquidity. Increasing the amount of this kind of patient capital in the financial system—relative to that in banks (as deposits) or in open-ended funds (as redeemable shares)—could improve the resilience of the economy and, as such, bolster financial stability. Moreover, giving retail investors access to private investment opportunities would also serve the socially desirable goal of greater financial inclusion.

ABOUT THE AUTHOR

CHRISTINA SKINNER, JD

Assistant Professor of Legal Studies & Business Ethics,
The Wharton School

Christina Skinner's research interests lie at the intersection of law and global financial markets and institutions. She has particular expertise in financial stability. Her scholarship examines a range of questions concerning the structure of legal frameworks that are designed to address emerging risks to financial stability—especially and including risks emerging outside of the banking sector; risks in the fintech space; and risks in connection with the debt cycle. Related to this work, she also studies conduct and culture in global banking institutions. Professor Skinner's work is international and comparative in scope, drawing on her several years of experience as an academic and regulator in the United Kingdom. She is or previously has contributed to policy working groups at the Financial Stability Board and the U.K. Banking Standards Board.

Prior to joining the faculty at Wharton, Professor Skinner served as legal counsel at the Bank of England, in the Financial Stability Division of the Bank's Legal Directorate. Her work there focused principally on matters of bank resolution, financial market infrastructure, and macroprudential policy. Previously, she was an Academic Visitor at the University of Oxford, Faculty of Law and a Visiting Fellow at the London School of Economics, Law Department. From 2014-2016, she was a post-doctoral fellow and lecturer in Law at Columbia Law School.

Professor Skinner received her J.D. from Yale Law School, and an A.B. from the Woodrow Wilson School of Public and International Affairs at Princeton University, with a concentration in international economics. She received certificates of proficiency in European Politics and Society, and Spanish Language and Culture.