Advocacy Group Calls for Checks on Private-Equity Debt (The Wall Street Journal)

By Chris Cumming | WSJ Pro  
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A group urging tighter controls on Wall Street wants U.S. authorities to scrutinize the market for high-risk corporate debt, a lightly regulated sector private-equity firms depend on to finance their deals.

The amount of risky corporate debt outstanding -- including high-yield bonds, leveraged loans and private direct loans -- has passed an estimated $5 trillion, according to a report issued Tuesday by Americans for Financial Reform, a financial-reform group in Washington, D.C.

This debt is typically used by heavily leveraged or riskier companies, many owned by private equity. Americans for Financial Reform asked regulators and Congress to strengthen oversight of this market and require lenders and borrowers to provide more information about their activities.

Andrew Park, senior policy analyst for hedge funds and private equity at Americans for Financial Reform and the author of the report, estimates the volume of leveraged loans and high-yield debt outstanding has roughly doubled since 2008, while the volume of direct-lending debt has increased from virtually zero to an estimate of more than $1 trillion.

Still, the opacity of risky corporate debt -- from lack of reporting requirements to widespread use of adjustments in calculating the debt -- makes it hard to put a precise number on it, or to quantify the effect of the debt on an individual company, said Mr. Park.

"The fact is that there is no good way to understand how indebted companies actually are," he said. "We have guesses and estimates based on the data out there, but there is no standardized way to look at it."

Private-equity firms and leveraged lenders have long disputed the idea that the growing market for riskier corporate credit is a threat. They note default rates remain relatively low -- a long-term average of 4.1% for speculative-grade credit, according to ratings agency Moody's Investors Service -- and argue nonbank lending fills a void created by banks pulling back from riskier loans following the 2008 financial crisis.

The American Investment Council, the largest trade group for private equity, said in a 2021 paper that nonbank lenders help the economy remain stable by stepping in when other lenders are pulling back.

Private-credit firms "play an important role in stabilizing volatile credit markets and smoothing credit cycles by investing in companies that would otherwise contract or go bankrupt," the group wrote.
Because these lenders use lower leverage and "are not interconnected in the same manner as banking institutions," they present less risk of triggering a systemic crisis across the financial system, the group added.

Still, over the past year as the Federal Reserve has raised interest rates, concerns have grown about how this mountain of riskier corporate debt will perform, particularly during a recession. Default rates remained at the relatively low rate of 2.3% as of September 2022, according to Moody's. But a slowdown in debt issuance made 2022 a slow year for private-equity deals, and spurred more firms to turn to the largely unregulated private-credit market.

For Mr. Park, it is not just the volume of outstanding debt raising concerns, but how the debt is used. His report says this risky corporate debt is far more often used for financial transactions than for investment.

Between 2014 and 2019, just 3% of leveraged loan proceeds were used for corporate purposes such as investing in the business or organic expansion, the report said, based on an analysis of lending data. Meanwhile, 51% of proceeds went to refinance existing debt, 38% for acquisitions, including leveraged buyouts, and 8% for dividend recaps, a controversial financial strategy in which a company takes on debt to pay its owners.

To get a better handle on risky corporate credits, the report recommends the Treasury Department issue guidance to make it easier to designate firms – including private-equity firms and hedge funds – as systemically important financial institutions, and for Congress to make the $1.5 trillion leveraged lending market covered by securities law.

"Our regulations and laws are completely outdated to deal with leveraged lending. A lot of the rules were written in the 1990s when these markets were a fraction of the size they are today," Mr. Park said.

Americans for Financial Reform is a coalition of groups including advocacy organizations and labor unions that has worked closely with some progressive policy makers and regulators on Capitol Hill. The group was closely involved in several major financial-reform efforts, including the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

More recently, the group helped spearhead efforts to promote the Stop Wall Street Looting Act, the 2019 proposal by Sen. Elizabeth Warren (D., Mass.) and others to more tightly regulate the private-equity industry. The proposal ha so far failed to gain traction in Congress.