Private credit debt funds: a regulatory perspective

Key regulatory and risk management considerations for Hong Kong managers of private credit debt funds in the current market conditions

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The rise of private credit

Historically, private credit funds had played a limited role prior to the global financial crisis, often as the provider of the final portion of financing, taking the highest level of credit risk in typical tiered capital structures.

Following the global financial crisis, private credit funds have increased their activity significantly. These funds are now often the sole provider of debt financing on a transaction, stepping into the shoes of the role that banks played pre-global financial crisis.

While the market for private credit in Europe is maturing, demonstrated by the sheer number of private credit funds that are now active in Europe, there remains significant potential for the growth of private credit in Asia, demonstrated by several large private credit fund raises in the region.

The growth of these funds across Asia and specifically the rise of Hong Kong fund managers raises questions around the wider compliance and regulatory framework for private credit funds, and the applicability of the existing SFC regulations for fund managers.

The economic impact of Covid-19 presents additional challenges for private credit funds. Given the significant changes to market conditions, fund managers are expected to reassess their risk policies and measurements and reporting methodologies in order to ensure they comply with regulators' expectations for effective risk-management control techniques and procedures.

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Focus areas for private credit funds

The Fund Manager Code of Conduct ("FMCC") issued by the Hong Kong Securities and Futures Commission ("SFC") sets out expectations for the risk management control techniques and procedures to be adopted by all licensed or registered persons acting as fund managers.

Fund managers are required to implement adequate risk management procedures in order to identify, measure, manage and monitor appropriately all risks including market risk, liquidity risk and operational risk.

Risk Management Framework	
• Policies & Procedures • Risk Identification • Risk Measurement • Risk Limits • Risk Monitoring & Reporting	**Market Risk** **Liquidity Risk** **Issuer & Counterparty Risk** **Operational Risk**

There are specific requirements on **issuer and counterparty credit risk**, a particularly worthy area of focus for private credit funds. These require the creation and maintenance of an effective credit assessment system to evaluate the creditworthiness of the fund's counterparties and credit risk of the fund's investments.

Liquidity risk is another area of focus for private credit funds. Fund managers are required to set and enforce concentration limits, establish and regularly monitor measures of liquidity risk mismatches, and regularly conduct assessments of liquidity in different scenarios, including stressed situations, to assess and monitor the liquidity risk of the funds accordingly. These liquidity risk management policies need to be appropriate given the specific nature of each fund under management, and this raises additional challenges for managers who may be managing other types of fund apart from private credit funds.

Covid-19 presents particular challenges for many sections of the economy in which private debt funds have made investments. **The FMCC requires fund managers to reassess the adequacy of funds' risk policies, risk measurement and reporting methodologies when there are significant changes to relevant market conditions that impact the fund's risk exposure.**

Impact of Covid-19 on private credit funds

The economic and social consequences of the coronavirus pandemic are manifold:

- Loss of economic performance due to reduced workforce of the companies and restrictions imposed by the authorities
- Increased costs for transport and logistics or restrictions on the transport of goods
- Consumer and investment behaviour restrained in the overall economy
- Restrictions on international trade and travel
- Bottlenecks and cascade effects due to multiple international linkages and concentration on only a few key producers

These raise a number of implications for the effective risk management of the credit exposures taken by private credit funds:

- Re-assess appropriateness of exposure/concentration limits
- Evaluate the impact of the pandemic on creditworthiness at investment and portfolio level
- Assess short and medium-term scenario on the investment portfolio, including effects on key KRIs
- Re-calculate credit risk provisions
- Evaluate the effect on the valuation of collateral (mainly real estate)

How KPMG can assist you

Our Financial Risk Management team have extensive experience in advising financial institutions in Asia on the assessment of credit risk and the systems, processes and tools available to manage this risk on an ongoing basis.

We have also advised a number of fund managers on the implementation of appropriate risk management and control techniques to ensure compliance with the SFC's FMCC requirements.

Our assistance can take the form of:

- Performing an independent assessment of the appropriateness and adequacy of existing risk management procedures and compliance with the SFC's FMCC requirements;
- Advising on the creation of a holistic risk management framework for private debt fund managers;
- Assisting with the allocation of roles and responsibilities;
- Drafting policies and procedures;
- Reviewing existing systems and processes to manage issuer and counterparty credit risk in light of the significant changes to market conditions;
- Assisting with the establishment of new and revised systems and processes to manage relevant risks, including issuer and counterparty credit risk;
- Advising on the calculation of credit risk provisions (including under IFRS 9);
- Advising on the establishment of appropriate risk measurement methodologies, including credit risk and liquidity risk measurement methodologies and templates;
- Designing and implementing risk limit and stress testing frameworks; and
- Designing and implementing risk monitoring tools and reports.

Relevant experience

- KPMG conducted gap analyses on the policies and procedures of a number of fund managers against the revised FMCC issued by the SFC, and provided recommendations to allow the clients to address any gaps in their risk management policies and procedures.

  Deliverable: A gap analysis report identifying gaps in relation to the revised FMCC requirements.

- KPMG advised a fund manager on their liquidity risk management framework and compliance with FMCC liquidity risk management requirements. We designed and implemented risk measurement tools together with related policies and procedures. Specific measurement methodologies were designed for a wide range of funds including a number of private credit funds.

  Deliverable: A report with recommendations around process or control improvements for risk management, as well as related policies and measurement templates.

- KPMG assisted a fund manager by designing appropriate scenarios and guidelines/templates for performing liquidity stress testing and assessing the impact for each scenario. Funds under management included private debt funds.

  Deliverable: A set of liquidity risk management tools (Excel-based) with a user manual

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