

Direct Lending Shadow Banking Risk: Consequences of Commercial Banks Retreatment from European Middle Market

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ABSTRACT

The regional bank consolidation in the 1990 and the global financial crisis 2008-2009 reshaped the global credit market broadly. This paper analyzes potential direct lending risks based on the commercial banks retreatment from the European middle market loan segment. Fundamental characteristics of the private debt market development, like the intensified competition for deals, yield compression and deterioration of creditor protections and the potential shadow banking risks are analyzed. Furthermore, the lack of market information, delayed valuations and varying investment volumes are discussed in the context of challenging monitoring. In the conclusion the paper explains the importance for the European regulators to prepare for a drawdown of the private debt market, via three lines of defense to take care of the underwriting process, monitoring loans and restructuring expertise. Finally, the paper recommends conducting research on the European private debt deal structure and underlying investments for a regulatory monitoring.

Keywords: European middle market, direct lending, shadow banking

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1. Introduction

While direct lending still plays a minor role as a financing instrument in Europe today, at the same time it has been an important financing instrument for small, medium-sized, and large companies in the US for years now. But as the European market for small and medium-sized companies (SME) is large with interesting investment opportunities, long-term investors are actively looking for private debt as an asset class in Europe (Prequin, 2023). In addition, increased regulation of banks since the financial crisis of 2007/2008 based on Basel III and IV and the investment climate with low interest rates, have gained the importance of direct lending against traditional forms of financing (Remaco, 2021a). Increasingly, medium-sized companies with capital-intensive business models such as real estate or infrastructure and growth companies with rapidly increasing capital requirements have less access to bank financing. At the same time, mid-cap bonds have lost reputation due to inflated ratings and numerous defaults. In this market environment, Europe's private debt business is in the process of closing the gap with its US competitors and it's becoming a core region for private debt. At the same time, there are early visible risks posed by aggressive new lenders and a potential late-stage business cycle. As a result of the Covid-19 pandemic, there might be more rating downgrades of SMEs in the medium term, which is why traditional lenders are acting more cautiously in this area. This results in the hypothesis that the higher unregulated activities of manager with less knowledge about underwriting, structure, and monitoring the higher the risk of market turbulences in the European direct lending market (Ruchir, 2021). In this paper, fundamental private debt characteristics are analyzed. In the first step the market development is assess in chapter three based on research information from Preqin (2020b) and BlackRock (2019). One

important finding is, that the asset class is larger now than infrastructure and natural resources combined and chances of a preliminary continuation of the growth trend are positive. Furthermore, research shows private debt investments are not standardized, with a wide range of structures, and risks arise at various points: for example, from the asset manager and the issuer. In the next step the paper examines potential market risks of European direct lending investments. To account for the relationship-based nature of direct lending and the nature of the loans that result in potential market risk the paper looks at the six key risks developed by Panossian et al. (2021). Finally, the question whether despite the still prevailing optimism in the market, regulators need to prepare for a market drawdown is answered via three potential lines of defense. The paper concludes with the findings.

2. Literature Review

Prequin (2023) examines current trends in the private debt sector and provides an overview of the key players and investment strategies. The study analyzes different regions and sectors to highlight potential opportunities and risks. The study shows that the private debt market continues to grow and remains an attractive asset class for investors, especially in an environment of low interest rates and uncertain public capital markets. The report highlights that private debt has continued to attract investor interest, with fundraising reaching a new high in 2022. The report also indicates that the private debt market has continued to evolve, with more focus on ESG considerations and the growth of direct lending funds. In terms of regional trends, North America remains the largest market for private debt, followed by Europe and Asia. Furthermore, the report provides data on the performance of private debt funds across various strategies, such as direct lending, distressed debt, and mezzanine debt. The data suggests that direct lending funds have consistently outperformed other private debt strategies over the past few years.

The potential risk of a financial crisis from the direct lending activities is the topic of a paper from Becker & Ivashina (2022). The authors discuss the importance of weak corporate insolvency rules as a driver of so-called "zombie lending." They argue that lax insolvency laws make it difficult to exit unprofitable firms from the market. As a result, these companies continue to receive loans from banks even though they are insolvent or have no realistic prospect of generating income. This leads to an increase in "zombie companies" that block the resources and capital of other more productive businesses. The authors emphasize that strict and effective bankruptcy rules are needed to clear the market of zombie companies and improve the efficiency of the economy. They call for reform of bankruptcy laws to incentivize early restructuring or liquidation of insolvent firms and minimize the negative effects of zombie lending. Pellegrini et al. (2022) examines the role of the shadow banking sector in generating systemic risk in the European financial system. The authors analyzed that the shadow banking sector continues to grow rapidly in Europe and that regulation of the sector is patchy. The paper identifies several types of risks posed by shadow banks, including liquidity risks, herding behavior, and transmission risks to the traditional banking sector. The authors propose a number of measures to minimize the risk of shadow banking activities, including introducing reporting requirements, improving transparency, and strengthening regulation and supervision. In this context, a paper from Abad et al. (2022) provides additional interesting insights on the exposures of EU banks to the global shadow banking system. The authors use network analysis to analyze the linkages between banks and shadow banks. The study demonstrates that many EU banks have direct links to shadow banks and are thus exposed to some risk. EU banks in countries with larger financial centers, such as Germany, France, and the Netherlands, are more connected to the shadow banking system. The authors also show that EU banks are linked to shadow banks through various channels, such as loan counterparties, securities financing, and

derivatives transactions. The study highlights the importance of monitoring and regulating these links to minimize potential risks to the stability of the financial system. The Global Financial Stability Board (2022) published the Global Monitoring Report on Non-Bank Financial Intermediation examines the role of non-bank financial intermediaries (NBFIs) in the global financial system, with similar results. The report analyzes that the NBFIs sector has grown faster than the traditional banking sector in recent years and now accounts for a significant share of global financial assets. However, the study also identifies risks associated with the sector's growth, such as the potential for herding behavior, liquidity risks, and the risk of transfers to the traditional banking sector. The report proposes several measures to ensure the stability of the financial system, including better supervision and regulation of the sector, improved transparency, and greater cooperation among regulators at the national and international levels. A paper from Michl et al. (2022) examines the role of shadow banks in credit creation and credit expansion via the usage of collateral. The authors show that shadow banks play an important role in credit creation, particularly through securities lending and repurchase agreements that use collateral as collateral. This can lead to an increase in the volume of credit because the same collateral can be used multiple times to secure multiple loans. However, the authors warn that this can lead to systemic risks, especially if the collateral loses value and shadow banks are forced to call back loans. The authors therefore suggest that regulators should ensure that shadow banks have sufficient capital to cover potential losses and should monitor more closely the use of collateral by shadow banks to minimize the risk of credit bubbles and systemic crises. A paper from Lee et al. (2022) examines the impact of capital regulations on the shadow financial system. The authors show that stringent capital regulations may induce traditional banks to outsource more business to the shadow banking sector, which may increase the risk of systemic crises.

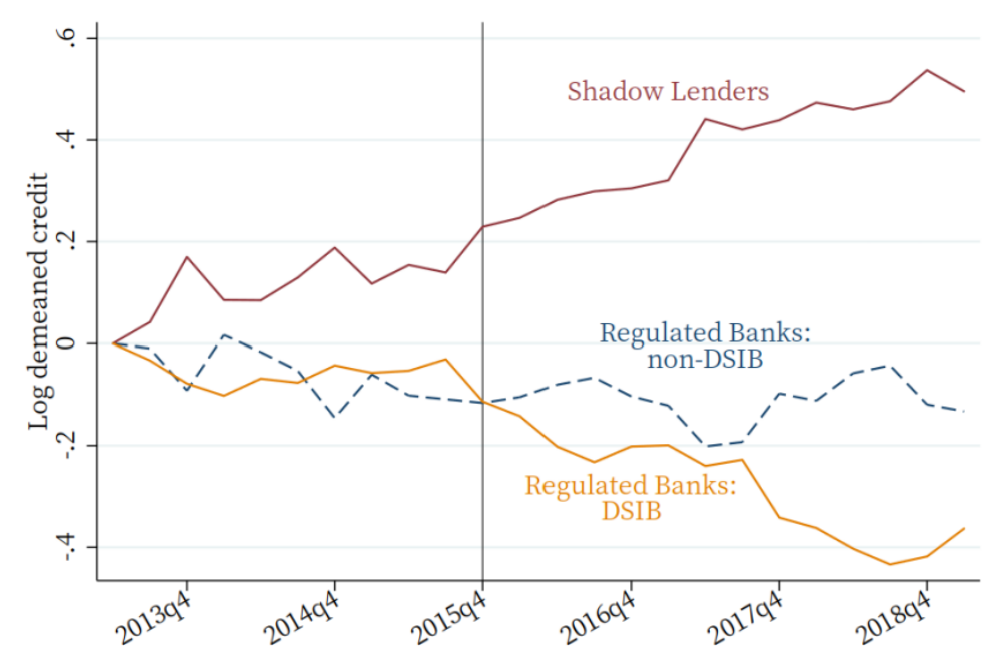


Figure 1. Substitution effect

Source: Lee et al. 2022

Figure 1 shows the changes in lending by the three types of lenders within an average firm. The amount of shadow lending increases within a firm throughout the sample period, but the increase accelerates especially from 2016Q1. The authors suggest that regulators should also consider the impact on the shadow banking sector when setting capital requirements. They also

suggest that measures should be taken to improve transparency and oversight of the shadow banking sector to minimize the risk of systemic crises.

A paper from Fidelity (2022) analyzes the increasing role of direct lending for SMEs as traditional banks increasingly withdraw from this market segment. Direct lending in this context refers to the direct extension of credit from non-bank-financed investors to companies, without the involvement of banks.

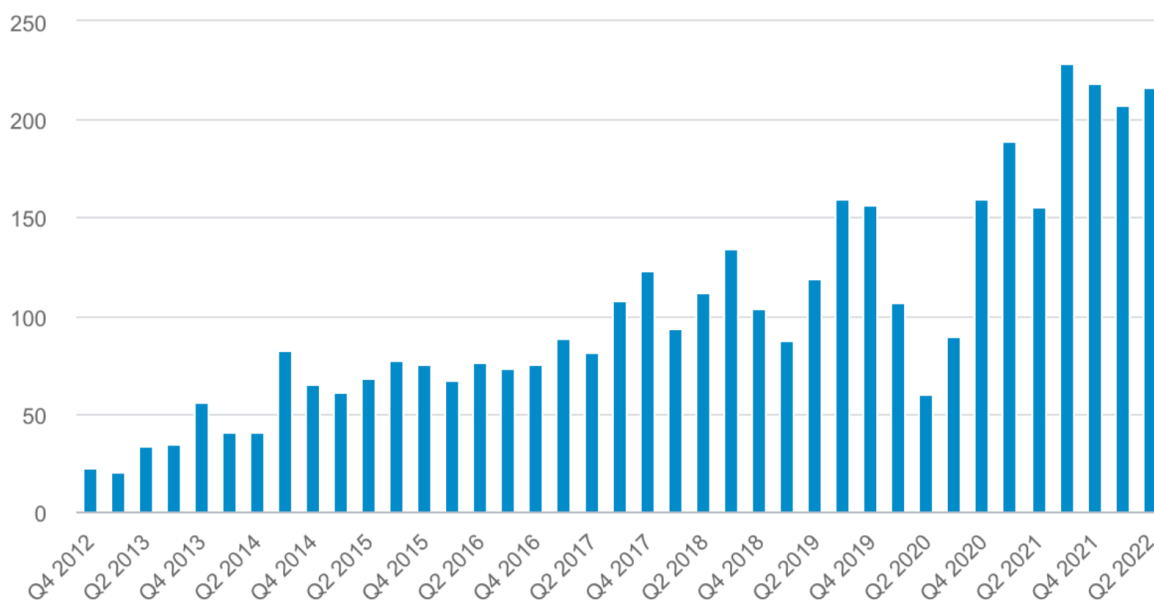


Figure 2. Deal volume private lending in Europe
Source: Fidelity 2022

Figure 2 demonstrates the significantly increasing deal volume for direct lending deals in Europe. Fidelity notes that direct lending is often quicker and easier for SMEs to obtain than bank loans and therefore represents an attractive alternative. However, there are also risks, such as higher debt and higher interest rates than bank loans.

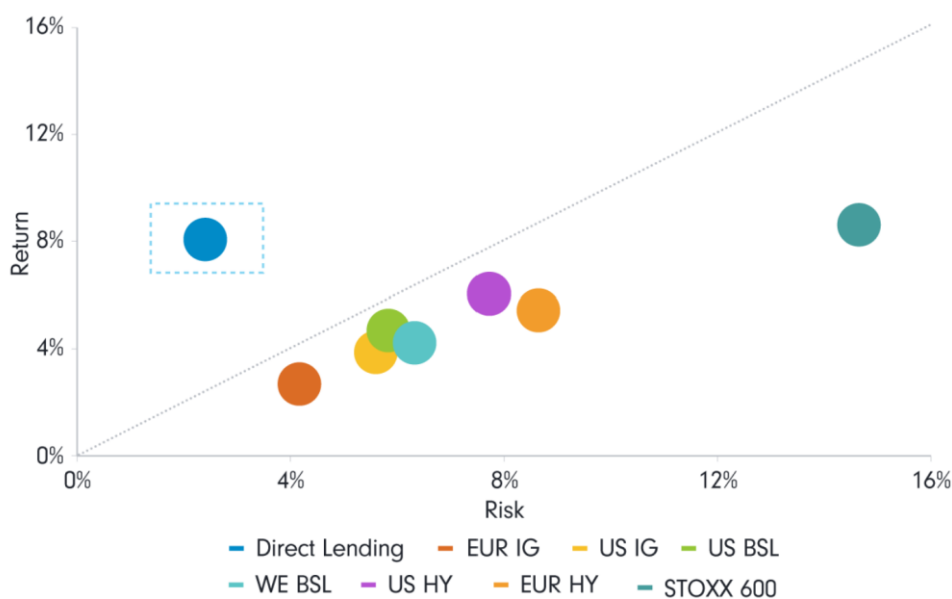


Figure 3. Direct lending risk-return profile as of December 2022
Source: Fidelity 2022

Figure 3 illustrates the premium lenders are compensated with as of December 2022. In addition, the Fidelity emphasizes the importance of carefully vetting direct lending investors and their business models to minimize potential risks.

Cooban (2023) published an article about the increased risks in the non-bank financial sector. The author argues that while the focus is on the current turmoil in the banking industry due to the COVID-19 pandemic, a bigger financial crisis may be brewing in other parts of the financial system. Specifically, the article points to the increased risks in the non-bank financial sector, such as private markets, which have grown in size and complexity since the 2008 financial crisis. These non-bank financial institutions have also been heavily exposed to risky assets, including leveraged loans and high-yield bonds, which could lead to a domino effect if there are widespread defaults. The article argues that regulators and policymakers need to pay more attention to these risks in the non-bank financial sector and take steps to mitigate them before they lead to a larger financial crisis.

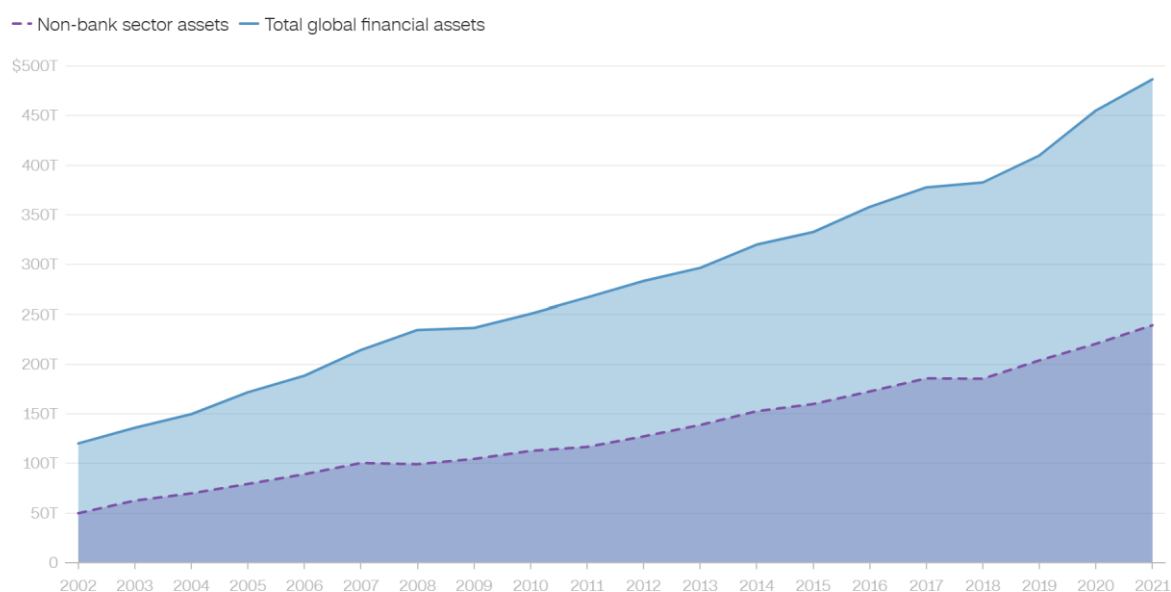


Figure 4. Illustration of non-banking assets globally

Source: CNN Cooban 2023

Figure 4 highlights that nearly half of the global assets are non-bank assets in 2021, \$239 trillion, up from 42% in 2008.

The International Monetary Fund published a paper from Cortes et al. (2023) that examines the role of NBFIs in the financial system and their increasing importance. It is emphasized that NBFIs play an important role in the provision of credit and other financial services and often offer a higher rate of return than traditional banks. At the same time, however, they are vulnerable to financial shocks and can contribute to financial system instability. It notes, that NBFIs can be a source of systemic risk during periods of heightened financial conditions, such as during the COVID-19 pandemic. The article suggests that increased regulation and supervision of NBFIs is needed to ensure financial system stability.

Macknight (2023) published an article about a potential contagion impact on traditional banks. The author examines the impact of the shadow banking contagion on traditional banks. The article defines that shadow banks may pose a higher risk to traditional banks if a crisis occurs in the shadow banking sector. The contagion could be transmitted to traditional banks if they are directly or indirectly affiliated with shadow banks or if they engage in certain business

models such as lending to shadow banks. The authors recommend that traditional banks better understand and monitor their relationships with shadow banks to minimize the risk of contagion.

Jones (2023) analyzes how regulators increase scrutiny of shadow bank exposures. The article addresses the fact that banking regulators around the world are increasingly focusing on banks' exposure to shadow banks. Given the growing importance of the shadow banking sector and the potential risks to financial stability, supervisors are concerned about the lack of transparency and the difficulty in accurately determining banks' exposure to these unregulated financial institutions. For this reason, some countries have introduced specific regulations to increase information disclosure and improve banks' risk management of shadow banking activities. Jones also mentions some of the recent events that highlight the importance of monitoring banks' exposure to shadow banks, such as the liquidity problems triggered by the COVID-19 pandemic in March 2020. Fobel et al (2023) published a report about the future of direct lending. The report provides an overview of the private credit market and analyzes trends and prospects for the future. The authors note that the private credit market has grown strongly in recent years and that this growth will continue in the future. They identify several factors driving the market's growth, including ongoing digitization, low interest rates, and continued investor interest in alternative asset classes. The authors also discuss the challenges facing the private lending market, including increasing regulation, competition from banks and other lenders, and the risk of loan losses. They suggest several measures to address these challenges, such as improving credit analysis and monitoring, adopting standards and best practices, and strengthening transparency and disclosure of information. Rothschild (2023) examines the risks of private debt investments and how they are assessed by investors and regulators. From the authors point of view, private debt investments offer high returns in the current low-interest-rate environment, but they are associated with several risks, including liquidity risks, credit risks, and regulatory risks. The authors also discuss the role of private debt investments in financing companies and the impact on capital markets. The article emphasizes the need for careful analysis and assessment of private debt investment risks by investors and regulators. The interest rate risk is the topic of a current paper from Simeone et al. (2023). The paper examines the impact of interest rate increases on the private debt market and concludes that this market remains resilient despite interest rate increases. The authors argue that this is due to several factors, including the structure of private-debt transactions, the flexibility of private-debt managers in setting interest rates, and the increasing demand for alternative investments. However, the study also indicates that there are certain areas in the private debt market that are more vulnerable to interest rate increases, such as certain types of loans and foreign currency investments. The authors therefore recommend that private debt investors and managers should strengthen their risk monitoring and risk management practices. A current working paper from Block et al. (2023) is analyzing the direct lending market in the U.S. and Europe to provide transparency on the market development. The study addresses a survey of private-debt funds to examine their investment strategies and practices. The survey examines that most funds point to the lower liquidity of their investments than traditional asset classes, such as stocks and bonds, but view this as an acceptable trade-off for higher returns. The majority of funds indicated that they invest in companies from real estate, healthcare, and energy sectors, and that they seek a high degree of diversification for the loans.

Europe: Industry preferences

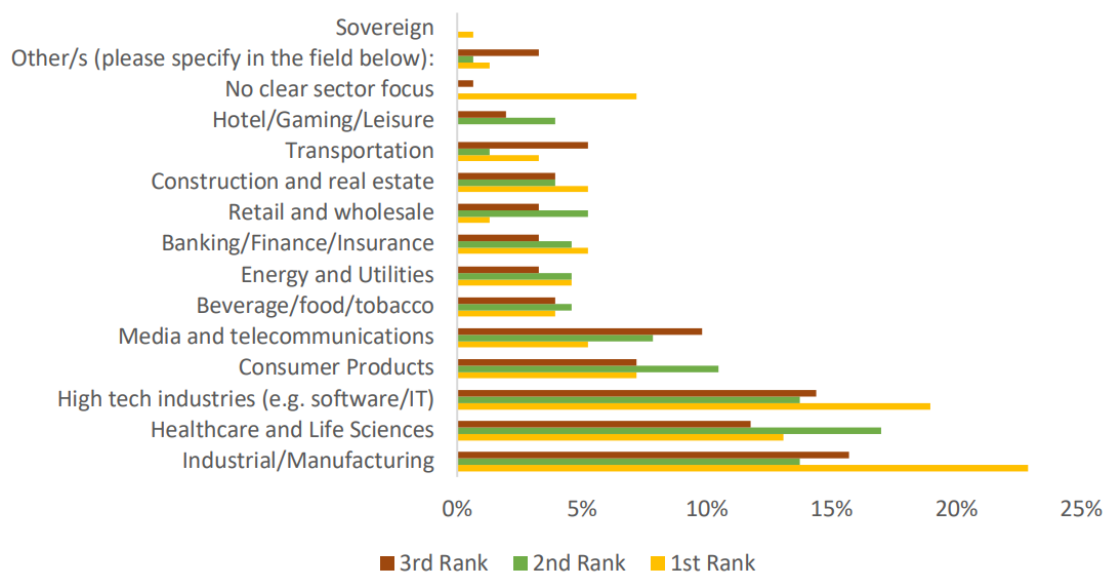


Figure 5. European industry diversification

Source: Block et al. 2023

US: Industry preferences

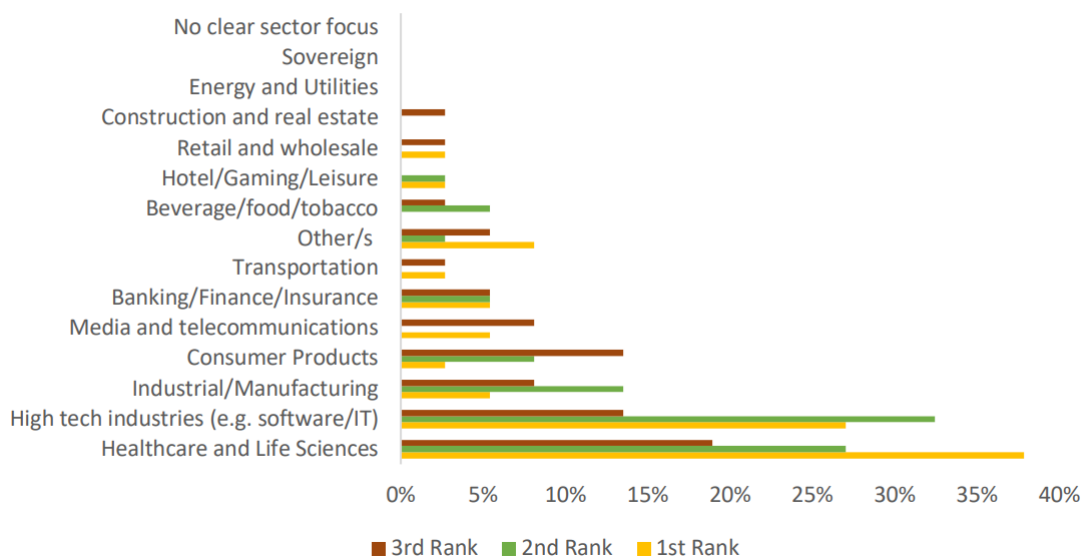


Figure 6. U.S. industry diversification

Source: Block et al. 2023

Figures 5 and 6 indicates no big differences between the allocation in the U.S. and Europe. The majority of funds in Europe and the U.S. invest in industrial, healthcare, and high-tech sectors. In addition, the survey shows that most funds use leverage to generate higher returns, with most reporting an average leverage ratio of 2:1 or higher. Finally, the survey analyzed that the majority of funds have a very positive outlook on their industry and expect the private debt market to continue to grow in the coming years.

3. Private Debt Characteristics

Based on the Preqin US research house report, the growth outlook for global private debt remains strong - despite that the market already starts from an extreme high level. In 2018, \$110 billion in new commitments for private debt market investments were made in the year until March - 17 billion less than the year before - but the flows for 2018 still surpass the previous year's level. 2018 was the fourth year in a row that direct lending investments managed to raise more than \$100 billion. Assets under management worldwide at mid-year 2018 are at US\$769 billion. This means the asset class is now larger than infrastructure and natural resources combined (Preqin, 2020a). Figure 7 illustrates the significant increase in loan volume since 1990.

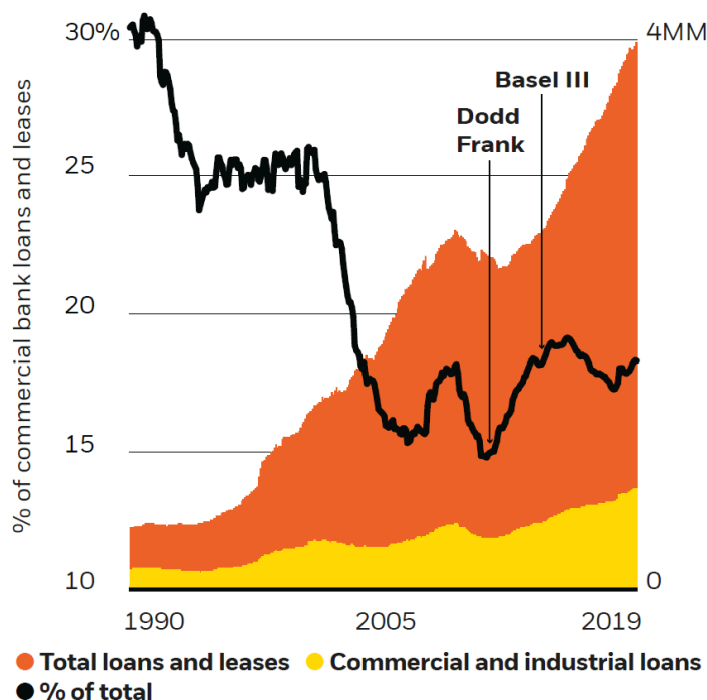


Figure 7. Commercial and industrial loans owned by U.S. banks from Federal Reserve H8 data as of June 2019

Source: Federal Reserve H8 2019

The chance of a preliminary continuation of the growth trend is positive, as investors are still below their private debt target allocation, according to Preqin, and intend to increase accordingly. Half of the investors surveyed by Preqin even plan to increase their private debt target allocation themselves. Institutional investors expect this asset class to become a core component of their asset allocation in the medium term. The flexibility of private debt as an interesting alternative for real estate and infrastructure project financing, corporate financing has gained in importance in Europe. Specialized financing, for example for ships, submarine cables, lighting systems, oil platforms or film rights are also becoming increasingly central (Preqin, 2020b). Typically, private debt exposures are collateralized or backed by guarantees. The most common are so-called unitranche (only one debt instrument for financing). In this structure of private debt, loans are granted to creditworthy companies (performing loans). Other common forms of financing are for acquisitions or for management or leveraged buyouts. Based on the capital structure, the low number of creditors and the advantageous ownership structure (the sponsor of the transaction is often a private equity company), its common practice that even in the event of a renegotiation of a loan positive return is achieved (Remaco, 2021a). In addition, usually variable interest rate of private debt provides protection against rising

interest rates. It is advantageous for the credit rating if borrowing companies have a strong product in an attractive niche market or have collateral or can offer collateral (real estate, working capital etc.). But at the same time, a lack of transparency is a serious disadvantage and measurement risk for potential market turbulences. For the most investment cases, there is little or no market data available. If the value of the assets is disclosed, it is derived from comparable transactions. Investors must therefore accept that they do not know the exact value of an investment (ESMA, 2021). Private debt as investment vehicle is not standardized and its structure varies widely. In addition, the issuer, typically has no rating - or below investment grade. As the market matures, so does investors' knowledge - which is expressed in increasingly precise requests for diversification within the heterogeneous private debt asset. Asset managers are aware of the need to differentiate themselves from the competition based on the expertise in the structuring, commitment and monitoring of loans. Investment in private debt is not standardized, and the structure varies widely, and risks arise at various points: on the one hand from the asset manager, and on the other hand from the issuer. In addition, there are specific risks inherent in the respective deal structuring. Currently, the biggest hurdles for private debt investment are the following (Remaco, 2021b):

- 1) Time and resources: Lack of time or insufficient resources, which make it impossible for investors to get a comprehensive picture of more complex investment alternatives, to carry out in-depth analysis (credit risk assessment and due diligence) and identify suitable investment solutions. Investors take a passive role after investing in a private debt fund and do not actively monitor or supervise.
- 2) Risk/return ratio: Expected returns include an illiquidity premium, which is defined as an additional return that investors are theoretically entitled as compensation for constant lower tradability, higher transaction costs and greater risk. The question is whether the risk is compensated by a corresponding return (relative value comparison vs public market equivalent) In the academic literature, illiquidity is attributed to six reasons, which can also occur cumulatively under certain circumstances (Vayanos et al., 2013).
- 3) Information asymmetries: In contrast to liquid capital market investment instruments, which are covered by rating agencies and financial institutions, less information is available for private debt. Investors must rely on the information provided by the manager.
- 4) Sustainability: Private debt investments are not listed and therefore no ESG data provider do not provide information for such investments.

The hurdles mentioned before show, that experience and trustworthiness are among the most important qualifications of private debt managers. In this context, it is evident that American managers have a longer horizon of experience than European managers (AIMA, 2018). As the market has expanded, the volume of individual deals has also changed, according to AIMA and Dechert. In the recent years, the private debt business was focused on companies with EBITDA between \$25 million and \$75 million, the so-called mid-market. However, private debt funds have recently been increasingly lending to both smaller and larger companies. Nearly a quarter of private debt managers now provide financing to companies whose EBITDA exceeds \$100 million. More than 40 percent offer private debt in relation to companies whose EBITDA is below \$25 million (Becker, 2019). Good access to traditional lenders such as banks that want or need to shrink their balance sheets and increase equity is becoming an increasingly important qualitative asset for debt managers. Bank regulation support this trend, as capital adequacy requirements are high, especially for unrated or lower-rated borrowers, which permanently supports spin-off efforts. The middle-market lending conditions were exacerbated by Dodd-Frank, Volcker and Basel III. On the allocation side, there are significant differences

between North American and European or large and small private debt managers in terms of credit segments. The distressed segment is clearly dominated by US manager: While only three percent of the assets of European private debt managers are invested in this sub-asset class, this figure is as high as 13 percent in the USA and Canada. The reasons are obvious: Americans feel comfortable in this market segment and have much more experience. In Europe, on the other hand, banks are still struggling to get their non-performing loans (NPLs) off their books. The fact that creditor protection regimes in Europe are fragmented further complicates the situation. Overall, it can be said that Europe's private debt business is in the process of closing the gap with its US competitors. Although 38 percent of capital commitments for private debt investments are still from North American investors, 31 percent are from European investors, excluding the UK, which alone accounts for a further 13 percent of commitments (Becker, 2019). Thus, Europe is becoming a core region for private debt.

4. Shadow Banking Risk of Direct Lending Investments

There are early visible risks posed by aggressive new lenders and a potential late-stage credit cycle. Risks are supported by loan structures that resemble the borrower-friendly structures of the broad-based syndicated loan (BSL) market: no covenants, virtually no amortization, and the ability of sponsors to extract dividends and transfer assets. A new class of well-funded, volume-driven, upper-middle-market lenders fund these loans, typically in partnership with private equity (PE) sponsors. These loans and the deals they support are not inherently flawed. Often, taking a secured position in the capital structure to support a sophisticated financial and operating sponsor is compelling, especially with an experienced sponsor willing to invest significant equity. However, different parts of the capital structure have economic and fiduciary incentives that do not always align. Global PE assets under management (AUM) increased to over \$3.5 trillion in 2018 (up from \$2.5 trillion in 2016), with little slowdown in fundraising. This steady increase has led to continued growth in deal flows and greater competition for deals and a larger share of PE sponsors as many new direct loan managers have entered the market. This competitive pressure has raised several issues for direct lenders, the most important is the continued rise in leverage in U.S. LBOs (BlackRock, 2019).

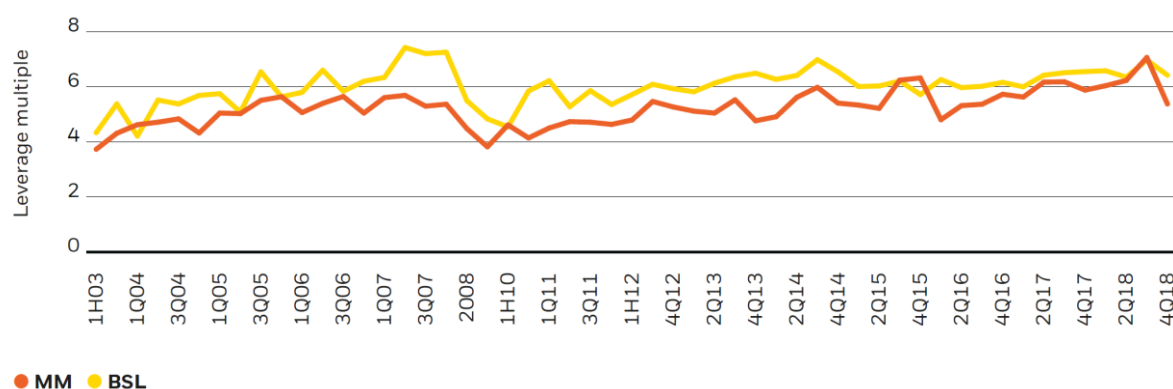


Figure 8. BSL vs MM – Debt-to-EBITDA ratio, Leveraged Loan Monthly
Source: Refinitiv 2018

In addition, the strong growth in supply is being met by rising demand from investors. This is against the background that investors currently must accept considerable duration and credit risks to achieve modest return. However, the attractive return on private debt investments is offset by low liquidity (illiquidity risk) due to the severely limited tradability. Thus, once an investment has been made, it is almost impossible to sell it at attractive prices. Furthermore, the creditworthiness of the individual borrowers, not least due to the lack of size of the

companies (EBITDA usually < EUR 100 million) and concentration risks in the business profile, the creditworthiness of the individual borrowers is often assigned to the low non-investment grade segment. This could be a problem in the coming years as the economic dislocations due to the Covid 19 pandemic could lead to a sharp increase in defaults (Remaco, 2021a). Another important parameter is the long duration of private debt investments. Due to the lack of market information, valuations and varying investment volumes over time are challenging to monitor. Moreover, objective information on the underlying investments is usually not available. Therefore, it must be examined whether the additional illiquidity is in line with the investment horizon, investment objectives and restrictions in the context of strategic asset allocation. Research has shown that the usage of a single ratio, such as net Internal Rate of Return (IRR), does not consider the complexity of illiquid investments (Reichlin & Gruber, 2019). Effectively recorded cash flows serve as a neutral basis for calculation, which is not distorted by fees or foreign currency effects. Finally, interpretation and discussion of the key figures and the resulting conclusions are central. This provides an important basis for the long-term management of illiquid investments (Reichlin & Gruber, 2019). There seems to be a positive relationship between the expected degree of illiquidity and the expected return (Ang, 2013). However, this view is biased for the following reasons:

- **Liquidity bias:** Reporting of illiquid assets not trustworthy, due to numerous biases such as survivorship bias, limited tradability, selection bias, etc. The returns of illiquid assets are too positive if the reported data are not adjusted.
- **Ignoring risks:** Illiquid investments involve significantly more risks than just illiquidity risk. It is imperative that the return figures of illiquid investments be corrected so that the risk ratios are adequately presented.
- **Lack of market indices:** There are often no index products for indices of illiquid assets. Therefore, it is not possible to invest in illiquid indices.

Risk factors cannot be separated from manager skills: Tradable and cheap market index funds in equity and bond markets allow investors to separate systematic market risk and manager skills. In illiquid markets, such separation is not possible: investing in illiquid assets is always a bet on the skills and talent of fund managers. Thus, the principal-agent theory or agency theory is of central importance. The principal and the agent have different information at their disposal. The principal's information advantage can be used in different ways either in favor of or against the principal. This information asymmetry may outweigh the advantages of illiquid investments (Reichlin & Gruber, 2019).

The bias reasons mentioned before in connection with the relationship-based nature of direct lending and the nature of the loans involved mean one's ability to properly source, underwrite, structure, and monitor an investment that result in the following potential market risks (Panossian et al., 2021):

- a. **Failure in Sourcing Pipeline:** Established managers with large origination platforms and a strong deal-sourcing pipeline have a significant advantage compared to new or small managers.
- b. **Failure in Leverage Management:** The duration of leverage is often shorter than for the underlying assets, which results in refinancing risk to the leverage. In addition, counterparties may require rapid repayment if the assessed value of the underlying companies declines—even if that decline is minimal—which can exacerbate liquidity problems in a down cycle.

- c. Due Diligence Failure: Direct lending requires extensive similar like for private equity transactions – far more than is often necessary or feasible with BSLs. Manager must have the proper staff and resources, and sector-specific expertise.
- d. Structural Investment Failure: Missing structuring expertise with narrow investment mandates may lack in flexibility needed to adapt to borrowers needs or design financing structures.
- e. Failures in Sustainable Active Management: Failures in continuous monitoring of investments, demands discipline and resources can result in late identification of problems.
- f. Restructuring Failure: Limited experience in distressed situations and challenging economic environments may lack in identification of early warning signs of distress, return a company to solid financial footing, or maximize the recovery value of an investment.

The summary of risk factors demonstrates, that the hypothesis that the higher unregulated activities of manager with less knowledge about underwriting, structure, and monitoring the higher the risk of market turbulences in the European direct lending market is correct. Therefore, despite the prevailing optimism in the market, European regulators need to prepare for a market drawdown for private debt, which would be possible via the following three lines of defense in the context of monitoring (Becker, 2019):

- 1) If the investment environment begins change, a first line of defense, is to take care of the underwriting process, to protect the loan from deteriorating market conditions, to select sufficiently stable firms, and to match the structure of the loans to corporate cash flows.
- 2) The second line of defense is to be well enough positioned in the operational infrastructure to be proactive in loan monitoring and contacting borrowers. Uploading borrower data in databases - to support risk monitoring - is a key aspect. Risk mapping and stress testing borrowers under challenging scenarios are part of a forward-looking setup as well.
- 3) The third line of defense revolves around the question of access to resources in terms of restructuring expertise. Running through various default scenarios and restructuring ideas requires capacities that younger players in the private debt market have hardly built up to date. Especially in a credit cycle that has grown old, regulators should take a close look at whether managers have access to appropriate restructuring know-how.

Overall, participants in the private debt segment are aware of a possible setback risk and preparing for it. This increases the probability that a setback is only a short-term phenomenon, but the regulator must take care of defense mechanism to avoid that a recession will accelerate the overall market risks.

5. Conclusion

This paper shows that the European credit market is reshaping since the financial crisis 2008 and 2009 based on changing middle-market lending conditions exacerbated by Dodd-Frank, Volcker and Basel III and as a result the direct lending market increased significantly. Interestingly, Europe is becoming a core region for private debt with significantly increasing investment volumes, but the regulator is not prepared for market monitoring based on the lack of information.

The bias reasons for private debt investments in connection with the relationship-based nature of direct lending and the nature of the loans involved mean one's ability to properly source, underwrite, structure, and monitor an investment result in potential market risk. Findings are, that the lack of market information, delayed valuations and varying investment volumes over time are challenging to monitor. Moreover, objective information on the underlying investments is usually not available. Investors must rely on the information provided by the manager. Therefore, risk factors cannot be separated from manager skills. Higher unregulated activities of manager with less knowledge about underwriting, structure, and monitoring can result in higher risk of market turbulences for the European direct lending market. Therefore, the aim of this paper results in the important conclusion that the hypothesis that the higher unregulated activities of manager with less knowledge about underwriting, structure, and monitoring the higher the risk of market turbulences in the European direct lending market is correct.

The important conclusion is that European regulators need to prepare for a drawdown of the private debt market, which would be possible via three lines of defense to take care of the underwriting process, loan monitoring and restructuring expertise.

Due to the increased complexity of the European private debt market and the limited data availability, this paper expresses further dedicated research on private debt manager capabilities, investment volumes and underlying companies.

The paper recommends conducting research on private debt funds to understand more about the loan structure, investment period and potential default risks caused by Covid 19.

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