Article Information

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The hidden risk facing Australia’s credit funds: Property values haven’t fallen, but transactions have

Australia’s private credit market is entering what may prove to be its first genuine stress cycle. While ASIC’s increased focus on private credit has attracted considerable attention, the more immediate challenge for many credit fund managers and trustees may be commercial rather than regulatory. ASIC has now identified poor private credit practices as an enforcement priority and signalled increased scrutiny of the sector. The more pressing issue is that Australian property markets have become significantly harder to transact.

When markets stop moving

Credit stress is often associated with falling asset values. However, a reduction in transaction activity can be even more significant.

Across many sectors of the property market, asset sales are taking longer, refinancing conditions are tighter and development exits are becoming less certain. For borrowers reliant on sales or refinancings to repay debt, slower transaction velocity can create substantial pressure even where valuations remain relatively resilient. This results in:

- delayed exits and extended loan maturities;
- increased workout activity;
- more judgement-based valuation decisions;
- greater pressure on liquidity assumptions; and
- heightened redemption risk.

This is particularly relevant in Australia, where ASIC’s review of the private credit market identified significant exposure to real estate and development lending.

A lack of completed transactions can also obscure emerging losses. Where there are fewer comparable sales, portfolio valuations may continue to reflect assumptions formed in more liquid conditions. Managers and trustees may therefore need to test whether valuation inputs, extension strategies and expected recovery periods remain supportable as market evidence becomes thinner.

Private credit’s first real test

Recent developer collapses have increased attention on private credit exposures to the construction and property sectors. Public reporting has also highlighted instances of redemption restrictions and growing investor scrutiny.

ASIC Chair Sarah Court recently described current conditions as the “first real test” for Australia’s private credit sector and referred to the emergence of the “first significant cracks” in the market.

Whether those cracks remain isolated or become more widespread, regulators and investors are paying much closer attention.

The regulatory risk is likely to increase where commercial stress exposes a gap between the liquidity offered to investors and the liquidity available from the underlying loan portfolio. Decisions to extend facilities, capitalise interest, defer enforcement or restrict redemptions should be made under the fund documents and supported by a clear assessment of competing investor interests.

What ASIC is likely to examine

ASIC's published commentary suggests the focus will extend beyond investment performance. Areas likely to attract scrutiny include:

- valuation governance;
- liquidity and redemption management;
- disclosure practices;
- conflicts management;
- financial reporting;
- trustee oversight; and
- governance and decision-making processes generally.

In many cases, enforcement risk may arise not because a loan underperforms, but because governance and oversight processes cannot withstand later scrutiny.

Trustees and responsible entities should also examine the quality and frequency of information received from investment managers. Reporting designed for a benign market may not identify covenant breaches, maturity concentrations, related-party issues or changes in recovery assumptions quickly enough to support effective oversight during a stressed period.

What fund managers and trustees should be doing now

As Australia's private credit market enters a more challenging phase, fund managers and trustees should ensure that both their portfolios and governance frameworks are prepared for increased commercial and regulatory scrutiny.

The current environment presents a valuable opportunity to review portfolio concentration risks, valuation and impairment frameworks, investor disclosures, trustee reporting processes, workout and restructuring protocols, and overall regulatory readiness.

Boards and investment committees should ensure that difficult decisions are escalated promptly and recorded with sufficient detail. Contemporaneous records explaining the information considered, alternatives assessed and reasons for the decision may be critical if the outcome is later challenged by investors, liquidators or ASIC.

Managers and trustees that address these issues proactively are likely to be better positioned if market conditions deteriorate further.

How Piper Alderman can assist

Piper Alderman's Funds Management and Financial Services Regulation teams advise fund managers, trustees, lenders and investors on governance, compliance and distressed asset issues, including:

- trustee and responsible entity governance;
- ASIC investigations and surveillance;
- valuation and impairment governance;
- investor disclosure obligations;
- loan workouts and restructurings;
- enforcement and recovery strategies; and
- distressed credit and insolvency matters.