

First Brands Group's collapse –
Policy Recommendations to Reduce Systemic Risk

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“Improve transparency, strengthen oversight, and enhance market discipline”

First Brands Group's (FBG) collapse, while rooted in firm-specific missteps, has raised broader concerns about **systemic risk** in credit markets – particularly the fast-growing *private debt* or “shadow banking” sector. Regulators and policymakers can draw lessons from this case to prevent similar situations from causing wider financial instability. Below, we outline policy recommendations that aim to *improve transparency, strengthen oversight, and enhance market discipline* in areas highlighted by the FBG episode:

1. Expand Regulatory Oversight to Private Credit and Non-Bank Lenders: FBG's financing web involved hedge funds, specialty finance companies, and other non-bank creditors that operate outside traditional bank regulation. As private credit plays a larger role in corporate finance, regulators should **extend regulatory oversight** to cover significant non-bank lenders and the funds that invest in leveraged loans. This could involve:

- **Systemic Risk Monitoring:** Designating large private credit funds or financing vehicles as systemically important (if their distress could impact the broader market), which would subject them to stress-testing and risk management standards. Even if each fund is small relative to banks, their *collective* growth (over \$1.7 trillion in assets, comparable to the leveraged loan market) and interconnectedness call for attention.
- **Disclosure of Exposures:** Requiring non-bank lenders to report large exposures and risk concentrations to a central authority. For instance, in FBG's case, a single mid-sized company accumulated exposures across many funds and banks. Regulators (e.g., the Financial Stability Oversight Council) should have sight of when a corporate borrower becomes heavily financed by multiple private sources. **Monitoring such concentrations** can help identify “too-connected-to-fail” linkages before they unravel.

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- **Standards for Valuation and Liquidity:** Private credit assets are often illiquid and not mark-to-market regularly. This can increase investor complacency. Regulators might require periodic valuation reviews or impose *capital buffers* on entities with illiquid loan holdings. A lack of market pricing in private credit means losses surface with a lag. Ensuring that fund managers and their investors maintain adequate buffers for potential loan losses will reduce the odds of a panicked run or “fire sale” contagion if one borrower fails.

2. Enhance Transparency and Disclosure of Off-Balance-Sheet Financing: A glaring issue in FBG’s case was the opacity of its true debt. Policymakers should mandate **improved disclosure standards** for supply chain finance, factoring, and similar arrangements. Concretely:

- **Accounting Rules Enforcement:** International and U.S. accounting bodies have recently introduced new rules requiring companies to disclose supplier finance program details (e.g. amounts outstanding, impact on liquidity). Regulators should ensure these rules are rigorously implemented. Auditors must be vigilant that companies like FBG cannot simply bury billions in payables to third-party finance companies without proper footnotes. If FBG had been public, ideally its financial statements would have flagged the more than USD2 billion in payables subject to finance programs, alerting investors and rating agencies.
- **Extend Disclosure to Large Private Issuers:** While public companies now face stricter requirements, large private firms (which may issue debt under Rule 144A or use syndicated loans) should *also* be subject to key disclosure obligations if their debt exceeds certain thresholds. Policymakers could require that any company with, for example, more than USD1 billion in debt provide quarterly public updates of its financial condition (perhaps via SEC filings or bank regulatory reports), including off-balance sheet commitments. The goal is to **level the playing field of transparency** – the public vs. private distinction blurs when the credit risk ultimately ends up with pension funds, insurance companies, and banks throughout the system.
- **Central Registry for Collateral and Factoring:** To combat the risk of fraud (e.g., duplicate invoicing), regulators could explore a registry for pledged receivables or financed inventory. Similar to how UCC-1 filings in the U.S. record security interests, a more accessible digital registry could help lenders check if a receivable has already been factored elsewhere. While implementing this across private transactions is challenging, high-profile failures like Carillion (UK, 2018) and Greensill (2021) have demonstrated the need for transparency in supply chain finance. At a minimum, financial institutions should **share information on suspected abuses** with regulators promptly (as occurred with Tricolor’s double-pledging of auto loans, which triggered a federal investigation).

Greater transparency serves as an early warning system, it reduces information asymmetry and enables market discipline. When assets are not marked to market and disclosure is poor, problems become “surprises” that can cascade unexpectedly. By shining more light on corporate borrowing and off-balance-sheet financing, regulators can allow investors to price risk more accurately and react in a measured way.

3. Strengthen Corporate Governance and Risk Management Expectations: The FBG case reveals that internally, the company lacked sufficient checks on risk-taking. Regulators and policymakers can encourage better governance in highly-leveraged firms:

- **Independent Board Requirements:** For private companies above a certain size, authorities could require the establishment of an audit committee or a minimum number of independent directors. While direct regulation of private boards is unusual, it could be tied to access to public debt markets or to certain safe harbors. For example, a stock exchange or the SEC might mandate that any issuer of publicly traded debt (even 144A) attest to basic governance standards. An independent board earlier at FBG might have scrutinized the off-balance-sheet maneuvers or insisted on slower growth – potentially preventing the worst outcomes.
- **Enhanced Auditor Scrutiny and Whistleblower Channels:** Regulators could work with the Public Company Accounting Oversight Board and equivalent bodies internationally to issue guidance that auditors should closely review **supplier financing, leasing, and related-party transactions** at firms with high leverage. Encouraging external auditors to be skeptical of “implausible” metrics (as FBG had) can surface issues sooner. In addition, whistleblower programs might be extended to private company employees/contractors, incentivizing reporting of misleading financial practices at large private firms.
- **Creditor Involvement and Covenants:** Lenders themselves are a key line of defense. Regulators can promote the use of covenants or monitoring in loan agreements even for private credits. For instance, bank regulators might require banks arranging leveraged loans or providing warehouse financing to CLOs to prefer structures that include information rights and covenants. Academic research on debt shows that maintenance covenants can trigger timely intervention in struggling firms, improving outcomes for creditors and possibly the firm. The trend toward cov-lite has weakened this early intervention mechanism. Policymakers could highlight this in guidance and even consider **capital charges for banks holding cov-lite loans** due to their higher loss given default. Inadequate creditor protections in cov-lite loans could amplify economic shocks. Re-emphasizing the importance of prudent covenants (or alternative protections) is thus a systemic risk issue, not just a contractual one.

4. Improve Early Warning and Intervention Frameworks: Once a firm like FBG starts to wobble, the goal should be to manage the distress in an orderly way to avoid spillovers. Several policy ideas emerge:

- **Enhanced Surveillance by Regulators:** Regulators could integrate data from large lending institutions, rating agencies, and market prices to detect if a medium-sized corporate is experiencing distress that could have knock-on effects. For example, a sharp drop in loan trading prices (FBG’s first-lien loan going from 100 to 36 cents) could trigger a closer look by regulators at who holds those loans and what exposures exist. This is analogous to how regulators monitor unusual movements in bank credit default swaps or counterparty exposures.

- **Facilitating Out-of-Court Restructurings:** Often, a swift out-of-court workout or exchange can prevent a disorderly default. Policymakers can foster legal environments that favor **pre-packaged bankruptcies or voluntary restructurings**. In the U.S., for instance, safe harbor provisions for certain financial contracts sometimes impede a coordinated workout (credit default swaps might trigger upon formal default, discouraging a quiet restructure). Examining these rules to see if they can be adjusted to encourage restructuring agreements *before* liquidity is fully exhausted could be beneficial. The goal is to avoid value destruction – for instance, FBG had to file Chapter 11 on an emergency basis to make payroll, a chaotic scenario that could have been smoother if creditors had acted a few months earlier when troubles became apparent.
- **Debtor-in-Possession (DIP) Financing Support:** In systemic crises, authorities have at times supported DIP financing to ensure companies can reorganize rather than liquidate. While FBG did obtain a USD1.1B DIP from its lenders, one can envision scenarios where multiple firms failing could strain DIP capacity. Policymakers should be prepared (perhaps via central bank liquidity lines or guarantee programs) to backstop critical DIP lending if a wave of corporate defaults threatens to freeze the restructuring process – provided implementation of sufficient regulation. This ensures that fundamentally viable operations (like FBG’s ability to continue supplying auto parts) are maintained, reducing real-economy damage and job losses even as financial claims are reorganized.

5. Address Incentives in the “Shadow Banking” Chain: A systemic lesson from FBG is how risks can migrate from a company to the financial sector. Wall Street’s search for yield led many participants to FBG’s debt – from *Jefferies* packaging invoice loans, to *UBS* and *Norinchukin* investing in leveraged loan tranches, to *Morgan Stanley* clients indirectly exposed via a fund. Policymakers should evaluate whether incentives are properly aligned in this chain:

- **Risk Retention and Skin-in-the-Game:** For arrangers of deals, ensure they retain some risk or perform due diligence akin to what’s required in public markets. After the 2008 crisis, regulations forced securitization sponsors to retain some exposure to discourage shoddy underwriting. A similar principle could apply to private credit arrangements. If *Jefferies* had more skin in the game than a small fund investment, it might have been more cautious about how FBG was using invoice finance.
- **Transparency to End-Investors:** Pension funds and insurance companies investing in private credit funds need better disclosure of underlying asset quality. Regulators of those institutional investors can push for look-through reporting. An investor should know if a fund’s assets are concentrated in one sector or reliant on potentially fraudulent receivables. Had end-investors been aware that FBG’s EBITDA was artificially boosted by aggressive payables financing, they might have questioned the risk earlier. Increasing the information available to ultimate asset owners improves capital allocation efficiency and can reduce herding into risky assets.
- **Macroprudential Tools:** Consider calibrating **countercyclical capital buffers** or other macroprudential tools to account for private credit growth. For example, if credit to corporates outside the banking system is growing fast (as it was in recent years, with direct lending assets under management doubling in a short span), regulators could signal

caution or require stress testing portfolios against downturn scenarios. This is analogous to monitoring mortgage credit growth in the shadow banking system. The aim is to prevent a buildup of many FBG-like cases hidden across the economy.

6. International Coordination and Information Sharing: FBG's creditors spanned the globe (U.S., Europe, and Asia). In our interconnected markets, a collapse can have *cross-border ripple effects*. Regulators should strengthen channels for sharing information about troubled borrowers and dubious financing schemes. For instance, if U.S. authorities investigate a case of invoice double-pledging (as with FBG and Tricolor), informing regulators in other jurisdictions can prevent the same practices from being used elsewhere or alert foreign investors to risk. Bodies like the Financial Stability Board could include *non-bank corporate credit* in their systemic risk assessments, much as they do for bank lending and open-end funds.

Moreover, given that entities like **Norinchukin (Japan)** and **UBS (Switzerland)** were involved in FBG's debt, it underscores that even a mid-size U.S. industrial firm can create losses in foreign financial institutions. Thus, *harmonizing best practices* – such as guidelines on supply chain finance disclosure or common reporting templates for large exposures – would help close regulatory arbitrage gaps.