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Re-risking the balance sheet, allocations to illiquids grow

*A panel of **BNY Mellon** industry experts offers an insight into the evolving European insurance industry, with a focus on illiquid investment*

Paul Traynor: What forces are driving insurance firms' investments in illiquid instruments?

Heneg Parthenay: Solvency II is a big factor, but there are other drivers, such as the prevailing low-yield environment and balance sheet deleveraging by banks. Solvency II incentivises insurers to invest in fixed income, but it's not just government bonds that are treated favourably from a capital perspective – loans with fixed or floating rates also benefit.

The current economic environment should also be considered. Interest rates have been at historic lows in the Group of Four developed economies for an unprecedented period. Finding yield has become extremely difficult. Insurers can pick up yield by investing in high-yield bonds, but they may increase both default and liquidity risk as banks reduce their willingness to hold inventory. To get paid for taking 'classic' illiquidity risk, investors have sought opportunities arising from banks' desire to shift new loans off their balance sheets, in line with capital regulations.

Approximately 20% of the US loan market is now disintermediated. Europe is going fast from a lower base. Typically, banks still originate the loans, but insurers and other investors take the risk off the bank balance sheet and onto their own via the syndicated loan market and structured credit, harvesting the illiquidity premium. This makes sense from a capital perspective and offers yield without adding default risk.

Pre-crisis, the 'originate and distribute' model worked because the securitisation market was fully functioning. In the US it has recovered, while in the UK and Europe the more esoteric submarkets, such as commercial mortgage-backed securities or collateralised loan obligations, are not yet at pre-2008 levels. Institutional investors are funding loans directly, via structures that are simpler and cheaper than securitisation deals: the insurer receives the premium the bank used to pay through securitisation, and the more complex the loan, the more the insurer is being paid in terms of the illiquidity premium. But you have to be able to analyse the risk. With a commercial mortgage deal, for example, you are betting on only one or two assets, so you need strong real estate expertise to assess accurately the real value of the asset used as collateral. If you do not have that expertise in house, asset managers like Insight Investment can originate the deal, negotiate the documentation and analyse the underlying risk.

But you can harvest the illiquidity premium even with short maturity instruments. As well as classic long-dated infrastructure debt or commercial real estate debt, other options might include five-year secured loans or 12–24-month bridging loans. Shorter-maturity loans are more likely to be floating rate, which might be the smarter investment if, as widely anticipated, policy rates start to rise.

The Panel

Paul Traynor, Head of Insurance Services – International, BNY Mellon
Paul.Traynor@bnymellon.com

Heneg Parthenay, Head of Insurance, Insight Investment
Heneg.Parthenay@InsightInvestment.com

Brian McMahon, Managing Director, Asset Servicing, BNY Mellon
Brian.McMahon@bnymellon.com

Liz Fitzgibbons, Vice President, Senior Sales Manager, EMEA, BNY Mellon
Elizabeth.Fitzgibbons@bnymellon.com

Paul Traynor: Although less attractive from a capital perspective, what illiquid equities investments are interesting to insurers?

Heneg Parthenay: Solvency II hits public equity investments with an effective 39% capital charge and other types of equity with a 49% charge. Against this backdrop, most insurers will only invest in private equity for reasons of diversification. Insurers might also venture into equities in search of long-term exposure to segments offering inflation protection, such as utilities or other companies with significant exposure to the price of commodities, including oil and mining companies. Because of their long-term horizons, insurers will be weighing the long-term benefits of inflation protection against the capital costs incurred. Again, equity exposure will always be marginal compared to fixed income.

Paul Traynor: Do different types of insurer have a significantly different approach to investing in illiquid assets?

Heneg Parthenay: Long-dated assets are most suited to life insurers, but long-duration liabilities should not be a barrier to investment in short-dated instruments. Short-maturity illiquid assets are a good alternative to asset-backed securities (ABS) that are penalised by new capital rules. If you can assess the value of a loan book, but you cannot access it via ABS, then you may decide to invest in the loan book directly or through syndication. Shorter-dated liability owners, such as non-life insurers, might take this direct lending route. Their allocation to the asset class will be based on an analysis of their liquidity situation, under normal and stressed conditions, to make sure that they will not have to divest from their portfolio as forced sellers.

Because of US regulatory constraints on investment in unrated instruments, European and UK insurers are more attracted than US counterparts to illiquid investments at this stage. But the mechanisms to access such instruments are still being established. There is supply and demand, but there is work to be done on the mechanisms in the middle to help them meet each other. Demand must be pooled to give enough capacity to the supply side.

Paul Traynor: Through what structures are insurers currently accessing illiquids?

Brian McMahon: Depending on the size of the investment, the insurer might potentially look for a segregated or managed account mandate or a co-investment vehicle, in the form of a regulated fund. A firm looking to invest substantial terms in illiquid debt might, for example, use a securitisation vehicle with a single investor behind it. As well as the balance-sheet benefits, this enables cash to be deployed quickly and has a fairly straightforward operating structure. Alternatively, if you're willing to commingle assets, you might look at a fund with a partnership structure, either offshore or onshore, depending on regulatory factors. For example, the recent German investment ordinance, introduced in February, imposes certain criteria for German insurance companies wishing to avail themselves of quotas on private equity or alternative investments.

Liz Fitzgibbons: Illiquid investments span the whole gamut from infrastructure debt to real estate to syndicated loans and direct lending small and medium-sized enterprises bilateral funding platforms. Operationally, all of those assets function differently in terms of risk profiling, reporting, pricing methodology, etc. Much depends on the size of the insurance firm and of the investment, from a structuring perspective, as Brian says. Recently, we've found a preference for managed accounts, partly due to the transparency these offer on the underlying characteristics of each individual loan item sitting in their portfolio, for Solvency II reporting purposes.

Paul Traynor: How can insurers get out of an illiquid investment at short notice?

Brian McMahon: Insurers go into these investments with their eyes open, expecting to hold for the long term. If they're investing in an infrastructure or real estate fund – be it debt or equity – there are different types of investment vehicle available, depending on whether the priority is income or the longer-term pay-off. Most funds typically have pretty robust criteria on potential partnership exits. There are secondary markets, but exits are uncommon.

There are many different ways of gaining exposures. Investors can come into debt or equity directly, while some insurers and pension funds go in purely as an limited partner-type play, investing in a range of funds to get an exposure to multiple underlying assets. While the traditional fund structuring in this space has been through closed-ended funds, there are some new fund trends coming through, with funds being structured to allow for redemptions under certain criteria, or with certain restrictions. Such funds therefore operate more like an evergreen fund.


Paul Traynor


Heneg Parthenay

Heneg Parthenay: Under the new regulatory framework, insurers must assess their liquidity needs in both normal and stressed market environments. In their liquidity plans, insurers will always avoid reliance on less liquid assets, which means in practice that they are very unlikely to get out of illiquid investments before maturity and even less likely to get out at short notice.

Paul Traynor: How are illiquid instruments priced?

Brian McMahon: Valuation sources and methodologies differ across the range of illiquid instruments. Overall, the accounting rules for the fund – which are typically International Financial Reporting Standards (IFRS) or local generally accepted accounting principles – will dictate how the valuation is achieved. Because IFRS is based on fair value, the first step is to look at the net present value approach to determine whether or not amortisation cost and impairment are appropriate. In parallel, rules under the Alternative Investment Fund Managers Directive (AIFMD) require the appointment of an external valuer or establishment of an independent valuation committee. For tangible assets such as real estate, there is a wide group of vendors that can provide third-party valuations, but most asset managers have established a valuation committee to provide input on how the asset has performed, to check the initial investment assumptions remain valid, and to provide a net present value calculation, after future cash flows.

Liz Fitzgibbons: Illiquid instruments are not, by definition, hard to price. Unless you're going into the very distressed end of the market – which insurers tend to avoid – it will be possible to access pricing through vendors that can provide valuation. In addition, there are robust systems in place to support

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Brian McMahon

Liz Fitzgibbons

established pricing methodologies. Insurers and their managers are able to formulate mark-to-model metrics using the economic interest and liquidity characteristics of each specific asset to determine pricing if needed.

Brian McMahon: As well as capital value, income has to be tracked by monitoring any investment structure's distribution policies and accounting rules. Under IFRS, buying assets at less than par value will have an impact on the increments being recognised within the fund. If the income distribution policy is not set up appropriately, the investor could encounter an accounting or distribution problem. At BNY Mellon, we model the cash flows, waterfall calculations and distribution to avoid such unforeseen consequences.

Heneg Parthenay: For the most part, these assets are held to maturity by insurers, but they still need to be valued at fair value for IFRS purposes. This means insurers must talk to their auditors to ensure the accounting policy reflects the real economics of the deal, but valuation should not drive the structure of the investment. It's also important to remember that the valuation represents the price a buyer will pay in the secondary market, whereas the economic value for the insurer, which will hold the asset to maturity, has more to do with the regularity and quality of the income and the probability of the principal to be paid back at maturity.

Liz Fitzgibbons: With over-the-counter (OTC) illiquid investments, one is dealing with different services to ensure the interest is being calculated and paid correctly. You might be dealing with master services or primary services in the real estate space, or facility agents in the syndicated debt market. One needs to understand the underlying asset to ensure the cash flows are correct on a continual basis, taking into consideration rate reset and rollover dates, for example. Overall, the aim is to make the experience of investing in an illiquid instrument such as a loan as similar as possible for the insurer to investing in a bond.

Paul Traynor: What are the challenges of safekeeping these illiquid assets?

Liz Fitzgibbons: Varying levels of documentation and negotiation are required to fit certain types of illiquid assets into predetermined structures. If an insurer appoints a third-party investment manager, this party would take responsibility for the negotiation and documentation; but, if the insurer retains more control over the process, a corporate trust service provider like BNY Mellon could assist them with issues such as trade certification, dealing with agent banks, setting predefined settlement dates, etc. For every loan purchased, we would provide a full trading pack, with each line item correctly held in safekeeping, which is a fundamental requirement to allow them to be forward sold. We provide a full-vault, low life-cycle management system, which supports the administration required for loan and pricing documentation.

Brian McMahon: These assets are not 'in custody' assets. These fund structures are often subject to AIFMD, and as such a depositary must be appointed. The functions of the depositary have three main elements: cash monitoring; safekeeping; and oversight. The funds often have a mixture of liquid and illiquid positions. The depositary must ensure such liquid positions are safekept, while performing regular checks on evidence of assets and title as part of their duty of care.

Heneg Parthenay: Safekeeping is important for illiquid assets because it provides security on the income generated by the assets, which is less of an issue for listed assets. As such, the service provided is far more important and extensive here than in a typical custody environment.

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Contact

BNY Mellon
One Canada Square
London E14 5AL

www.bnymellon.com

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