June 2020

Fund financing

An opportunity for insurers

Executive summary

Innovative new investment strategy for insurers, targeting a global fund finance market of over $575 billion.[1]	Developed in close collaboration with insurers seeking to extract greater yield from short-duration assets.	An opportunity to create customisable investment strategies across tenor, geography and currency profiles.

Introduction

With typical aplomb, the world's economists have coined many colourful phrases to describe the current European interest rate environment. For example, some have likened institutional investors – and insurers in particular – to thirsty explorers desperately hunting for the oasis of yield in the middle of a barren landscape. In that context, one of the biggest headline-grabbing trends of post-Solvency II European investing has been the headlong dive into private credit. Insurers are also taking a fresh look at their existing asset base to see if they can squeeze out any additional drops of income.

One area that has received less focus is the high cash balances and money market fund investments that insurers have maintained since the run-up to Solvency II. Quite rightly, insurers are starting to ask themselves whether they really require access to liquid funds on an overnight basis to finance claims and operational cashflows. One possible answer is to look at other sources of short-dated exposure. Aberdeen Standard Investments' innovative work in the area of fund financing represents one possible solution.

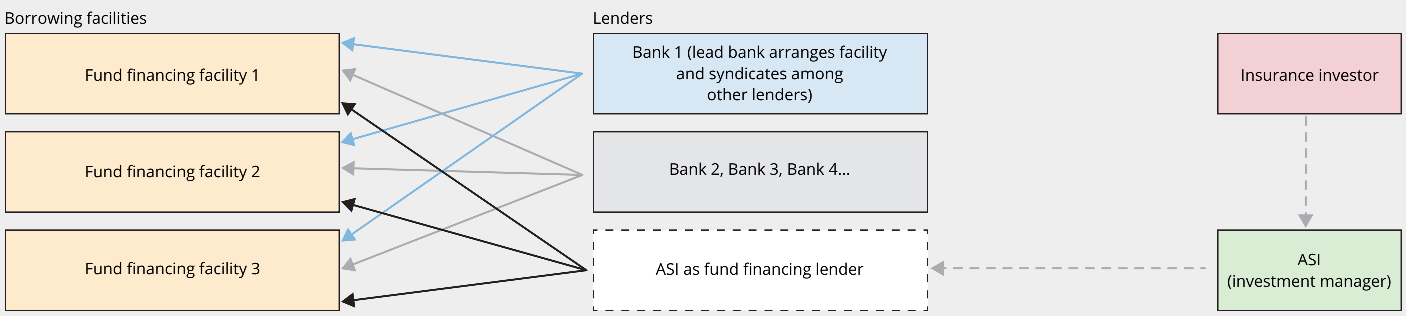
Fund financing: what is it and why is it used?

Fund financing facilities are also known as subscription lines or capital call facilities. They are credit facilities provided to certain types of investment funds during the early investment stage of a fund's life, where the lender primarily takes risk against the uncalled capital of the underlying investors. Types of funds include private equity, credit, infrastructure or real estate. There are a number of operational, as well as financial reasons, why these facilities may be beneficial to both investors and the manager/general partner of the fund during this stage. These include:

- providing managers with cash to finance investment activity within a few days rather than drawing capital from investors, which has a much longer drawdown notice period
- giving greater clarity of the timing of cash calls to help investors manage their own cashflows
- allowing cash calls to be consolidated or batched to avoid drawing down on investors too often
- a delayed drawdown from investors that can enhance IRR-based returns.

The global annual demand for fund financing is over €575 billion. We expect this to grow significantly in the coming years as fund sizes get ever bigger. A number of the world's largest banks dominate this market. Meanwhile, new banks are entering at the syndication level due to the attractive risk-adjusted returns available. Indeed, given the increasingly large size of the financing facilities, a lead bank typically syndicates the facility across a number of other banks, reducing its risk exposure. This is because banks will often have single-name credit limits, sector limits and counterparty risk to manage; syndication can assist in dealing with these. However, given that other banks represent direct competitors, lead banks are increasingly looking for non-traditional lenders to participate in their lending programmes. This is where we come in.

Performance



Source: Aberdeen Standard Investments 31 December 2018.

[1] Source: Global Legal Insights, 2020

Why is now the right time for insurance companies to enter this market?

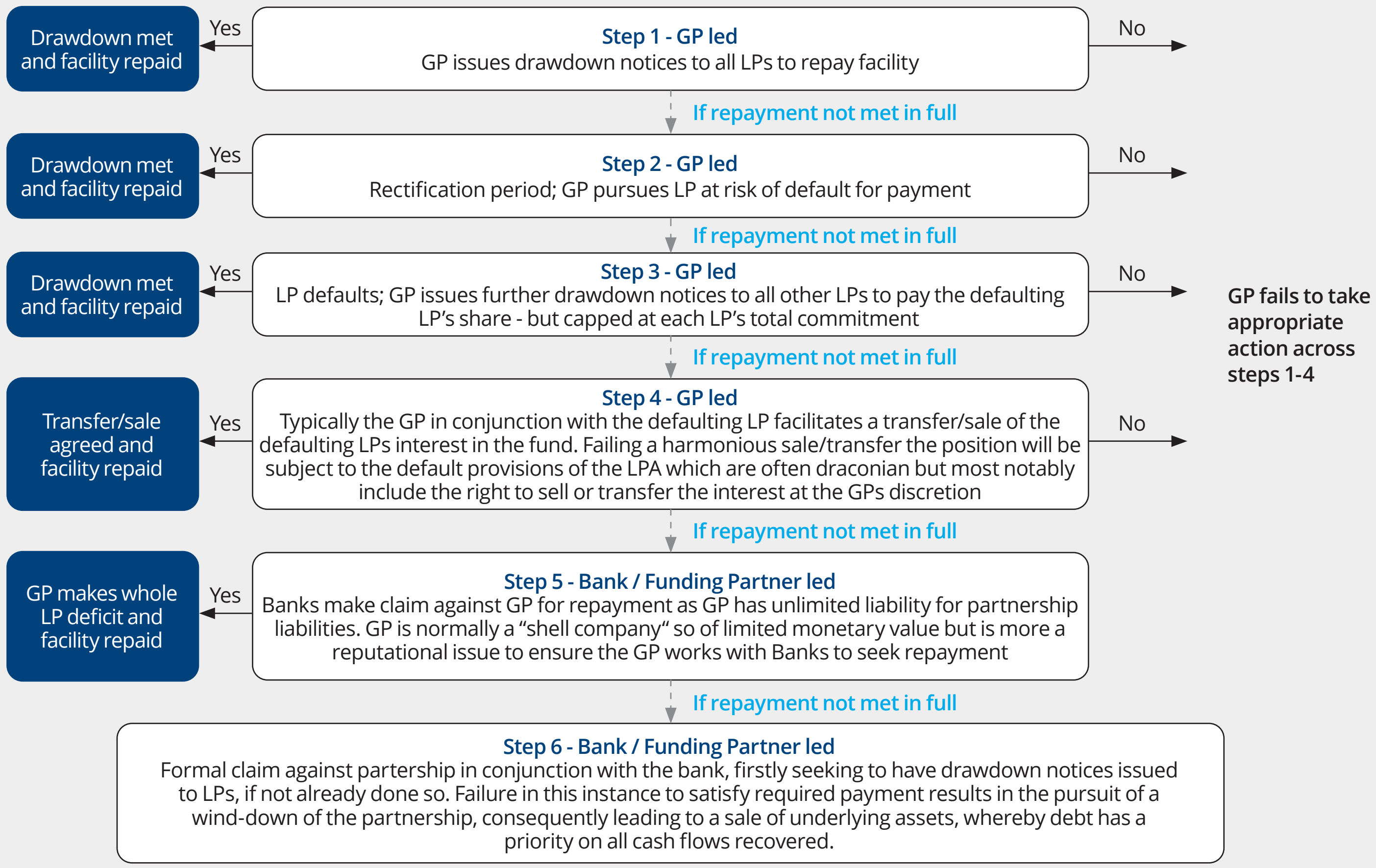
The fund financemarket has generally been the preserve of the banks. However, in the last few years, syndication requirements have become a key and increasing feature. But sourcing deals for non-banks is a challenge. Private Equity managers will usually want to work with banks that can offer them a range of banking services. This can be daunting for those not familiar with the legal documentation and the structure of funds. The complexities that are embedded within the banking and fund documentation can also be a hurdle to many. Being able to diligence the fund investors, the manager's track record and strategy will prove challenging and time consuming and then there is the ongoing cash management and monitoring of each loan.

Within our team, we have investment professionals that have worked in the funds market for over 20 years. Many have been both investors in, and providers of, these fund finance facilities while working for banks. As such, they understand and can fully articulate the risk of each opportunity. This gives us a competitive advantage in this space. ASI has also invested in over 500 private equity managers,[2] giving us in-depth knowledge of each manager.

Our strategy is well-suited to an insurer's financial objectives and Solvency II capital requirements. This is because it has:

- short duration, with individual loans running for between one and three years
- returns that are uncorrelated to credit markets
- low credit risk.
  - Loans are secured on the commitments of investors in the funds. These are typically blue-chip clients, including insurance funds, pension schemes and sovereign wealth funds.
  - Diagram 2 shows the various sources of recovery of payment for fund financing facilities.

Sources of recovery of payment for fund financing facilities



Source: Aberdeen Standard Investments 31 December 2018.
GP is general partner and LP is limited partner or the name for an investor.

It must be noted that these transactions are generally unrated, private loans. This absence of a public market rating can therefore pose a challenge for insurers, but nevertheless Solvency II does not prohibit such investments. Therefore, for standard model insurance companies, the capital charge would be the tenor of the loan multiplied by 3%.

For those clients able to take advantage of an approved internal model, the treatment can be much better. In assessing these loans as part of our investment process, we have leveraged our own internal credit ratings process. We developed this to support our wider private credit business. As such, we can help our insurance clients create bespoke credit ratings methodology for the loans.

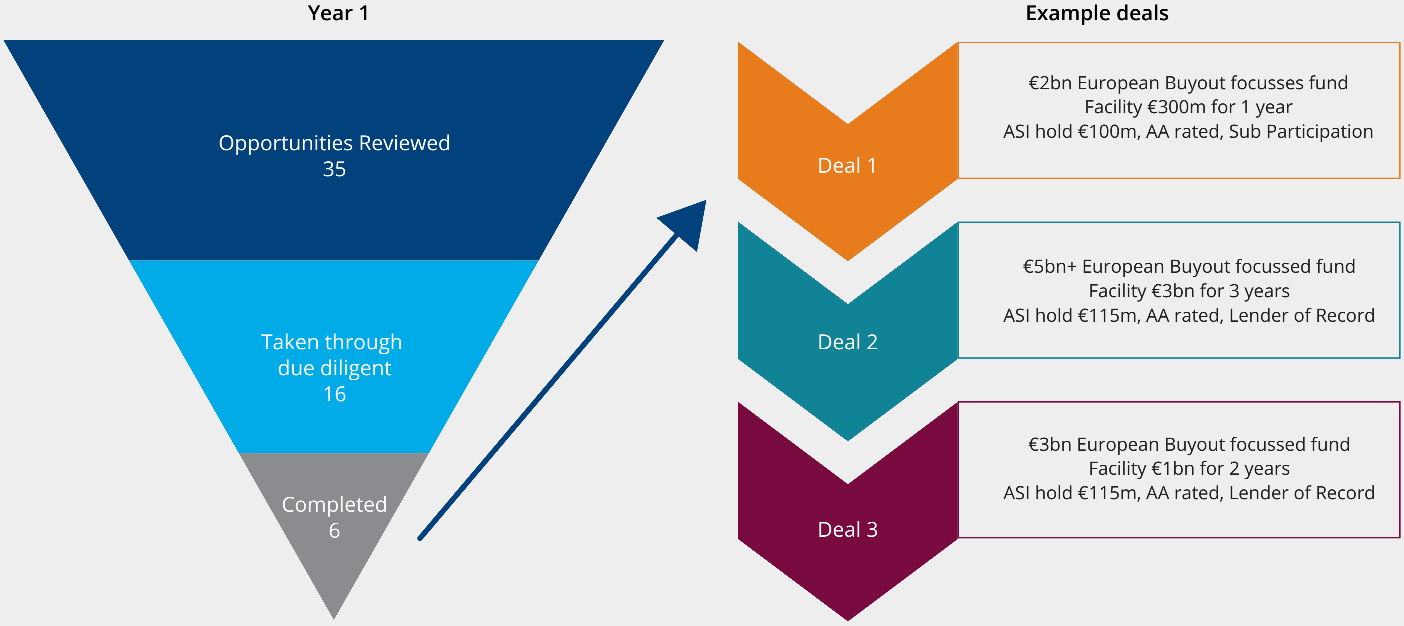
Our investment process for fund financing involves the collaboration of a number of teams across our investment management platform.

These include:

- our credit and liquidity investment teams
- those involved in currency hedging
- a number of operational, legal and structuring experts.

Crucially, we have also leveraged our private markets investment team's in-depth due diligence of private equity vehicles, managers and their investors having invested with 500 PE funds across 1000 funds globally.[2]

[2] as at June 2020



Source: Aberdeen Standard Investments May 2020.

Our approach

Shelley Morrison
Fund Manager

"At ASI, we are able to source dealflow from all the dominant banks active in this market. This means we can provide clients with different currency loans, as well as a range of tenors and pricing options, to support their specific duration or risk/return requirements. Clients also benefit from the due diligence and cashflow management capabilities of our private equity team, giving them time to pursue other yield- enhancement opportunities. We work closely with insurance companies across Europe to develop innovative solutions to support their investment challenges."

Source: Aberdeen Standard Investments, June 2020.

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