hedgeweek special report
www.hedgeweek.com
April 2013

Investment opportunities in debt fund strategies

Sponsored by
BNP Paribas Securities Services

CLOs are set to deliver significant returns in 2013

A good time to be a direct lending manager

Calibrating capital costs under Solvency II

In this issue...

03 Investment opportunities in debt fund strategies
By James Williams

10 CLO 2013 Outlook: Good opportunities for significant returns
By James Williams

13 Alcentra: CLO funds were the 'stand out success story' in 2012
By James Williams

16 A good time to be a direct lending manager in Europe
By James Williams

19 Solvency II: Look-through treatment will help calibrate capital costs
By James Williams

hedgeweek

Publisher

Editor: James Williams, james.williams@globalfundmedia.com
Sales Managers: Simon Broch, simon.broch@globalfundmedia.com;
Malcolm Dunn, malcolm.dunn@globalfundmedia.com
Head of Events: Katie Gopal, katie.gopal@globalfundmedia.com
Chief Operating Officer: Oliver Bradley, oliver.bradley@globalfundmedia.com
Chairman & Publisher: Sunil Gopalan, sunil.gopalan@globalfundmedia.com
Graphic Design: Siobhan Brownlow, siobhan.brownlow@globalfundmedia.com
Photographs: iStockphoto; Stock.xchng
Published by: GFM Ltd, 1st Floor, Liberation Station, St Helier, Jersey JE2 3AS, Channel Islands **Tel:** +44 (0)1534 719780
Website: www.globalfundmedia.com

Investment opportunities in debt fund strategies

By James Williams

Prior to the global financial crisis the ability for European corporates to finance themselves via leveraged loans was dominated by a prevalence of collateralised loan obligations (CLOs): in 2007, at its peak, the CLO market bought up two thirds of the USD166billion of leveraged loans issued that year, according to ratings agency Standard & Poor's.

Banks would originate leveraged loans through a syndication process, whereby they and a number of other investors – including other banks and CLO managers – would each commit capital, and thereby diversify the risk. The CLO manager would repeat this process, investing in multiple loans by raising money from global institutions on the capital markets to create the CLO vehicle. The loan pool would then be sliced and diced to create a series of different layers or tranches – for example from AAA to BB – to provide income streams of varying risk; the more risk an investor wanted, the lower down the capital structure they would go to receive higher interest.

It was this ability for CLO managers to raise money on the capital markets and provide the necessary liquidity for banks to continue originating loans – just as they do with mortgages – that oiled the wheels of capital markets.

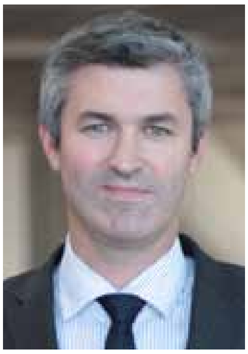
But since 2008 things have changed. Europe's CLO market has dried up considerably, although it is far from finished. Just this year, a few deals have emerged which suggest that there are some green shoots of recovery – the US CLO market meanwhile continues to recover strongly – but what is evident is the number of new players entering the loan space.

Whereas previously institutional investors – traditional asset managers, pension funds, insurance companies – would invest in loans via CLOs, increasingly they are looking to invest directly or via third party asset managers. This new set of actors is playing a key role in providing credit to corporates who increasingly find that their banks are simply not willing to lend anymore.

This is because of tighter banking regulation under Basel III requiring banks to reduce and strengthen their balance sheets. The simultaneous reduction in bank lending and CLO activity has changed the European landscape; one where debt funds now co-exist with CLOs, and where alternative managers and CLO managers are starting to converge.

As Simon Perry, Head of Business Development, EMEA, at Alcentra, one of the world's leading asset managers, explains: "We are raising more new capital from pension funds and insurance companies into unlevered vehicles: either segregated managed accounts, open-ended funds, or in the case of the Alcentra European Floating Rate Income Fund, which launched last year, a closed-ended listed fund that issues shares on the London stock exchange."

BNP Paribas Securities Services ("BNP Paribas") has reacted quickly to this evolving market. It has long been a leading provider of loan portfolio administration services, and has long had a fund administration service for private equity managers. Now, given that alternative managers are investing in loans as a new asset class, the firm is ideally placed to leverage its expertise in both areas.



Hugh Stevens, Head of Private Equity and Real Estate Services at BNP Paribas Securities Services

Debt Fund Administration Services

Hugh Stevens is Head of Private Equity and Real Estate Services at BNP Paribas Securities Services. He notes that the debt funds market has evolved rapidly in recent years. Whereas the early focus was on distressed debt opportunities, there is now a range of debt fund strategies including leveraged loan funds, infrastructure debt funds and real estate debt funds. All of which require specific structuring.

Cross-border structures

Investment opportunities for fund managers in the secondary market are not always straightforward. Managers have to pursue global market opportunities to effectively invest the fund's capital. Factor in that fund raising remains challenging and the result, says Stevens, is that managers need to consider cross-border fund structures – this could be an offshore master/feeder structure to allow multiple investor types, or a European QIF or SIF regulated fund structure.

For most managers setting up a new debt fund, this can be a daunting task.

"Managers are realising that they need service providers that understand the requirements of investors in different markets, the regulatory requirements in different fund domiciles and understand the accounting treatment for investments made across multiple markets. It's a complex process," says Stevens.

"We have a strong cross-border distribution capability in UCITS funds and what we're starting to see is emerging interest in AIFMD-compliant funds," notes Stevens. UCITS is the gold standard for European mutual funds and has become highly popular with Asian investors. Cross-border distribution of UCITS is now commonplace. "If AIFMD-compliant funds gain the same brand recognition with investors in Asia then we'll have a situation where those fund sponsors in Asia will require a strong European partner," adds Stevens.

Regulation: a help and a hindrance

Without doubt, regulatory change is one of the key drivers behind Europe's growing debt fund market. For banks, under Basel III the need to increase their tier one capital ratios is forcing them to deleverage and divest their riskier assets. By pulling back on their lending activities, a significant funding gap has opened up.

"We've had the financial crisis, we've had the reaction from the regulators, and now we need to digest those rules. Regulation has resulted in banks having to raise their capital ratios. They're not lending in the same way anymore and that creates a tsunami of refinancing risk; the European market will evolve, but it'll be a gradual process," comments Oern Greif, Head of Debt Market Services at BNP Paribas Securities Services.

Stevens expands on the point: "If you look at the European real estate market, lending is around EUR2.5trillion. In the past this was predominantly provided by banks and partly through the securitisation industry via CLOs. If banks are pulling back from providing that lending, and the CLO market is subdued, you can understand where that funding gap is coming from."

Debt funds are now helping plug part of that gap and are being helped by some government initiatives aimed at creating more liquidity for real estate distressed debt. For example, Ireland's National Asset Management Agency (NAMA) was established in 2009 to buy up toxic loan assets from financial institutions.

This is prompting private fund sponsors to get more involved but as Stevens stresses, the flipside to this is that, as funds become more like banks, banking regulators are becoming more interested. A newly launched debt fund, could find itself having to operate under both fund and banking regulations.

"As a firm, we bring together our knowledge, our history and our experience of operating both in a regulated bank environment and a regulated funds environment. The fact that we have experience on both sides is a clear value-add for our clients."

For new fund sponsors, it is important to know that against this regulatory backdrop they have a counterparty that will adapt and administrate the fund throughout its lifecycle despite continuously changing regulations.

"For our asset manager clients based outside Europe, we understand the difficulty in coordinating contact with multiple European regulators. For these clients, we are the partner who can keep them ahead of the changing regulatory environment; a partner who really understands the cultural requirements of the regulator in each market, particularly Europe," notes Stevens.

Given the complexity of setting up multiple fund structures, there are two key elements to BNP Paribas's loan fund administration solution that appeal to its clients:

Cross-location co-ordination: If a sponsor chooses different providers in each country then the sponsor has to provide co-ordination of all the cash flows, all the information flows, between the different locations. As investment opportunities become more geographically diverse it's harder to provide that co-ordination and keep investors satisfied.

"We provide a single point of operational contact for our clients. For example, if the sponsor is located in London but the fund requires a regulatory filing in Luxembourg, our team in London will co-ordinate with our team in Luxembourg to ensure the regulatory filing takes place.

"Some clients have existing funds with specialist providers in different locations. They might have a boutique administrator in Jersey, one in Ireland, etc. They end up sitting between all these different providers and it's not a comfortable place to be. Having offices in 33 global locations allows BNP Paribas to cover all the key locations within a fund structure."

Cross-function co-ordination: In addition to fund administration, BNP Paribas also provides loan administration and investor servicing. All three components of the service are integrated. That's not necessarily a common offering in the market. Often a firm will support fund administration and require the client to undertake some loan servicing themselves or find an additional specialist provider.

"Our clients do not suffer from this problem. We offer a complete solution for investor servicing, fund servicing and asset servicing," says Stevens.

As well as this vertical support structure, the BNP Paribas solution runs horizontally, supporting the fund at each stage of its evolution. Stevens and his team work with clients during the structuring of the fund, help with investors' operational due diligence, fund raising, closing the fund, servicing the fund through the investment phase, and then assisting with liquidating the fund when it reaches the end of its life.

This "matrix" solution developed by BNP Paribas has put it in a leading position to support a range of clients including securitisation issuers, private equity managers, asset management firms, insurance companies and banks in the burgeoning debt fund market.

Fund administration components

Corporate administration: This involves looking after the companies involved in the structure. BNP Paribas sets up the company, introduces independent directors, runs the board meetings, administers board resolutions and provides accounting and regulator filings.

Fund accounting: All fund NAVs are calculated, typically on a monthly or quarterly basis, though some funds are priced daily. "We meet with the auditors, set up the audit schedule, keep the books and records of the fund and then at year-end produce the financial statements. When the fund closes we run the payments waterfall, calculate the payments due to investors, receive the investor subscriptions and track the accounts – all cash flows in and out of the fund – through the fund's lifecycle," notes Stevens.

Fund performance: A fund administrator uses specialist systems and fund performance analysts to provide clients with a range of performance and risk analytics: for example, performance attribution analysis to track the sources of fund over or under performance. For closed ended funds, as the manager has some control over the timing of cashflows, the performance is expressed as an internal rate of return calculated to industry guidelines against all historic cash transactions since inception of the fund.

Compliance: A depositary will be required for any fund distributed in Europe or by a Europe-based manager starting from July 2013 onwards. Many European funds are already required to appoint a depositary, however, new regulations – the Alternative Investment Fund Managers Directive (AIFMD) – extend the requirements significantly. For example, depositaries will now be required to keep records to verify ownership of fund assets for any controlled entity within the fund structure. For a debt fund, depositaries must hold financial assets in custody and also supervise and keep records of any loan assets that cannot be held 'in bank'. "It's a due diligence process, making sure the fund has legal entitlement to those assets. Our systems must also monitor cash transactions to ensure the rules of the fund are being adhered to," says Stevens.

Clearly the regulatory and structural complexities of setting up a loan fund are substantial, but equally as complex is the administration of the underlying assets making up a portfolio – that is, the loans themselves. They come in many different guises, and unlike bonds and equities, have myriad characteristics that require sophisticated administration.

Loan Administration Services

Oern Greif focuses on the asset side of the debt fund equation, and has over 20 years' fixed income experience, the last decade of which has been spent at BNP Paribas Corporate and Investment Bank (CIB). Greif notes that securities services are becoming "immensely relevant" both to issuers and end investors as the debt fund market evolves.

The firm's approach, he says, has been to profile the opportunity in loan funds but also to stress that "we are experts in loan administration, how the underlying collateral looks. Although loan funds are relatively new, we anticipate that they will grow in number. The dovetail between loan servicing and loan fund servicing is quite elegant."

For new entrants, the prospect of overhauling their internal operations to accommodate loan administration is both costly and potentially burdensome. The inherent complexity of loans requires a sophisticated operational framework. Each loan requires interest rates to be calculated, principal to be redeemed and a plethora of reports to be produced.

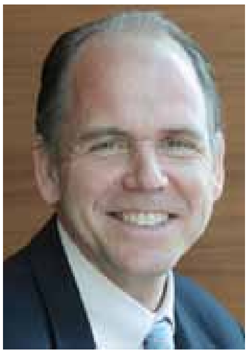
Over the years, BNP Paribas has developed its expertise in the administration of leveraged loans. Today, the firm services billions of loan assets in approximately 350 active loan facilities on a daily basis - and as more new managers enter the loan fund space, that figure continues to rise.

Three client categories

BNP Paribas splits its client-base into three categories. Firstly, there are the banks and corporates; the traditional lenders and borrowers of loans.

As banks reign in their lending activity, a second client group has emerged: namely the asset owners, the big pension funds and insurance companies wishing to put their money to work. However, unlike banks these institutions are not natural lenders and as Greif explains: "They don't typically have credit procedures to underwrite loans as banks would, they don't necessarily have the back-office instruments to calculate the principal or monitor whether loan covenants have been breached: they either have to build that infrastructure internally or outsource it.

"The easiest fix is to invest in a fund structure rather than being a direct lender."



Oern Greif, Head of Debt Market Services at BNP Paribas Securities Services

"Regulation has resulted in banks having to raise their capital ratios. They're not lending in the same way anymore and that creates a tsunami of refinancing risk; the European market will evolve, but it'll be a gradual process."

Oern Greif, BNP Paribas

This has created a third client group which BNP Paribas refers to as "credit managers": alternative asset managers including private equity/real estate and hedge fund managers.

"They are what we call post-crisis CLO managers. We interact with all three: banks and corporates, asset owners, and alternative managers. The funds themselves come in many different varieties depending on tax and funding, jurisdictional issues, etc. Although they can be individually tailored they all essentially do the same thing: provide a fund vehicle to investors that wraps together loans, which are the collateral we service on a daily basis."

Loan servicing – a robust solution

Prior to the financial crisis, BNP Paribas was already an active administrator in the CLO space. The motivation for doing so was due to a clearly perceived gap in service levels both in terms of how investors were supported, and the CLO managers themselves. The firm's CLO team was established to meet that gap explains Stuart Draper, Senior Sales Manager, Client Development, Debt Market Services at BNP Paribas Securities Services.

"It goes back to basics (with respect to the loan service model). Firstly you've got to be responsive. In the CLO days, trades had to be checked before they were executed, and that check and response capability was in the hands of the collateral administrator. We became very successful in doing that, supporting a wide variety of debt structures, and built up a good book. Since 2009 the European CLO market has slowed, so we've had to adapt accordingly as debt funds have emerged in parallel."

The second basic element is flexibility, whether it is for loan reporting, or the way in which relationships with managers are built. After all, every manager has different needs when it comes to their desired methodology of loan assessment.

BNP Paribas is in a prime position to support this burgeoning market. Within the securities services business, its experience in servicing loans means that the infrastructure is firmly in place. As Draper says: "We have a robust solution in place that needs to be driven and that's why we are utilising it to leverage the debt fund opportunities that we've been seeing." Equally, BNP Paribas Investment Partners, BNP Paribas' asset management arm, has had teams of managers very active in the space from early on.

According to Draper, sponsors of debt funds typically come in two flavours:

- **The ex-CLO manager**: someone who is already familiar with loan structures and who already has their own legacy CLO infrastructure still in place. "That's when we can assist managers to establish a fund in a consultancy capacity."
- **The alternative asset manager:** someone who may have a track record in funds but not in loans as an investible asset class.

"The expanse of structures that loans can hold is wide and can sometimes come as a surprise to these managers who think 'Wow, I actually need a lot of infrastructure in place here'. They may not know how long they're going to be in this space because of the nature of the alternatives sector dipping in and out when managers see value. In such circumstances we not only do traditional collateral administration services for the fund, and monitor the portfolio, but also provide services to the investment adviser who may lack the internal administration tools needed to manage these loans," notes Draper.

Stuart Draper, Client Development at BNP Paribas Securities Services

"Since 2009 the European CLO market has slowed, so we've had to adapt accordingly as debt funds have emerged in parallel."

Stuart Draper, BNP Paribas

Reporting is the cornerstone

BNP Paribas has invested heavily in two key areas: pure administration, and granular reporting. Loans are sophisticated instruments but their method of settlement is not – typically a trade +10 settlement cycle – and is still highly paper-based. This can be challenging for managers as there's often a myriad of defined deadlines. What BNP Paribas has done is build a loan administration team of individuals from the buy-side and the sell-side; in particular those with agency experience. This has helped create a well-rounded team capable of navigating any issues that arise in the loan market.

"There's a huge variety of instruments: term loans, delayed draw loans, revolvers, mezzanine, first and second lien loans: all of which have slightly different characteristics and different ways of being administered. You need a robust system to do that. Also, PIK (Payment in Kind) conventions vary from jurisdiction to jurisdiction, so sometimes managers need our assistance understanding the concepts of how the underlying documentation and resultant cash flows will work," says Draper.

Not surprisingly, loan reporting is a massive challenge for managers and represents a cornerstone of the firm's loan service business. The analytical system used to monitor a portfolio and create reports has been constructed so as to provide bespoke deep-level reporting for managers, and consolidated summarised reporting for investors.

Explains Draper: "The quality and consistency of reporting needs to be high because loans have more characteristics per se than classic fixed income or equity instruments. Our bespoke reports, accessible on-line, give managers top line details such as NAV, etc, but we're also supplementing this through granular reporting at the asset level.

"Our reporting architecture allows our team to update reports in accordance with requests from both the managers and their investors, incorporating more (or less) data. Ultimately, we want to ensure that the reports are visually appealing and high quality. Our ability to slice and dice data enhances transparency, which our clients demand." ■


By your side in a complex world
Sell-side, buy-side or issuer, at BNP Paribas Securities Services, dealing with complexity is our speciality.
We can help you find your way.
BNP PARIBAS
SECURITIES SERVICES
The bank for a changing world
securities.bnpparibas.com
BNP Paribas Securities Services is incorporated in France as a Partnership Limited by Shares and is authorised and supervised by the ACP (Autorité de Contrôle Prudentiel) and the AMF (Autorité des Marchés Financiers). BNP Paribas Securities Services' London branch is subject to limited regulation by the Financial Services Authority for the conduct of its investment business in the United Kingdom and is a member of the London Stock Exchange. BNP Paribas Trust Corporation UK Limited and Investment Fund Services Limited are wholly-owned subsidiaries of BNP Paribas Securities Services, incorporated in the UK and are authorised and regulated by the Financial Services Authority. Details on the extent of our regulation by the Financial Services Authority are available from us on request.

CLO 2013 Outlook: Good opportunities for significant returns

By James Williams

The CLO market enjoyed a resurgence of sorts in 2012 with approximately USD50billion in new issuance, overshadowing the paltry figure of around USD13billion in 2011. Much of this CLO activity remains in the US, where major players such as Dallas-based Highland Capital Management LP – the largest US CLO manager by AUM (approximately USD14billion) – and New York-based BlueMountain Capital Management continue to originate deals.

Currently, Highland manages 21 CLOs. Over the course of 2012, BlueMountain successfully issued two CLOs representing USD1billion of issuance according to Bryce Markus, Managing Partner and Portfolio Manager: "Both of these transactions were broadly syndicated to global institutional investors. We have already launched our first CLO of 2013 and expect to issue as many as four CLOs this year."

As well as managing CLOs, these managers are increasingly tailoring their needs to institutional investors by running CLO funds, which invest in the CLOs of other third-party managers. Funds such as those managed by GSO Capital Partners International out of London are providing compelling returns, and as Markus adds: "In our absolute return vehicles, we continue to see strong demand from institutional investors, many of whom have looked to diversify their credit exposure through the use of alternative investment strategies."

Josh Terry, Managing Director and Head of Trading at Highland, says that investor demand is strong right now "for pretty much all tranches of CLOs. We've seen AAA-rated securities already come in at 10 to 15 basis points this year so there's been quite a strong rally in the liability side of the capital structure in 2013."

2010 and 2011 were characterised by market volatility, which is ultimately the main enemy of CLO creation: without new CLO paper coming to market, funds are restricted to the secondary market. However, 2012 proved more benign and Terry postulates that 2013 could be even better, with USD75billion of CLO issuance.

CLO managers are perfectly placed to construct funds because of their innate knowledge of the loan markets.

"Being a loan investor in our absolute return funds gives us a deeper understanding of the loan market, which we believe makes us a better CLO manager. Similarly, being a CLO manager gives us additional perspective on the market, which makes us a more skilled investor in loans and third-party managed CLOs," explains Markus.

Terry says that when investing in other managers' CLOs the whole process is fundamentally driven: "We are unique in the sense that we have the capability to look at the underlying portfolio of loans that a CLO manager has selected and say 'Okay, we know this percentage of loans very well, we think this percentage is going to be downgraded, this percentage will default', and based on our underlying knowledge of the portfolio we can make an assessment of where we want to be in the capital structure of that CLO.

"Then we analyse the structural characteristics of the deal and finally we look at the manager; that's our last consideration because we have the ability to look at the loan portfolio, monitor it, and if it deviates away from our expectations then we have the ability to sell our positions into the market."

Mark Moffat, Senior Managing Director at GSO concurs, adding: "The important thing for us is that it all starts with a fundamental knowledge of the corporate loans backing the CLO. If we're comfortable with the loan portfolio we then perform due diligence on the manager and make sure we're satisfied with their credit process, resourcing, and the structure of the transaction itself."

When you consider that each CLO will typically have around 120 companies within it, the complexities of understanding the portfolio, what the quality of loans is like in each tranche, etc, makes for a long and detailed investment process in any given CLO fund.

Bryce Markus, Managing Partner and Portfolio Manager at BlueMountain Capital Management

"A typical fund for us will hold about 30 positions across 20 or so different managers. The majority of a portfolio will be in BBB, BB-rated securities and equity positions," confirms Terry.

Most CLO fund portfolios hold between 30 and 80 different investments in anything up to 70 CLOs. Rather like a Russian doll, a CLO fund is uniquely layered and diverse; something that investors no doubt appreciate.

"A fund that invests in a portfolio of CLOs can look through more than 1,700 different companies. We would tend to focus, given the returns that we are looking to generate, at the bottom of the CLO capital structure on CLO income notes and CLO lower rated mezzanine investments: BB, B-rated investments.

"Currently, we see the default outlook in the US as being relatively benign and therefore the risk/return balance at that end of the capital structure is more attractive," comments Moffat.

From a performance perspective, CLO funds seem to be delivering compelling returns. It's not unheard of for some to generate annual returns in excess of 50 per cent, although high single digit to mid-teen returns are a more approximate average.

"Our positions in CLO equity and BB tranches delivered strong performance for a number of our funds as the loan default rate remained low, cash flows to the equity tranche remained strong and increased demand from investors drove yields lower. While we believe asset spreads will tighten in the coming year, we expect liability spreads to follow suit, resulting in an attractive return profile for CLO equity investors," says Markus.

Highland launched its CLO Value Fund I back at the end of 2008. It was expected to mature in 2014 but when the market rebounded much quicker than expected the fund ended up being monetised at the end of 2009, providing a rather healthy 138 per cent gross return to investors; that is not typical of most CLO funds but it illustrates their potential to deliver quick returns if market conditions are favourable.

"Typically, a blended portfolio of both primary and secondary CLO debt tranches – say BB and BBB – might deliver an overall return profile of mid to high single digits, on average.

"However, when you take into account that average dollar prices are close to 90 cents on the dollar in the current market, the likelihood of some spread tightening over the next couple of years could drive the investment closer to par, or the likelihood your secondary investments could be redeemed earlier than modelled and pulled to par more quickly, means that returns in the neighbourhood of 10 to 15 per cent are possible.

"2012 performance was, for us, strong across the board and our outlook is attractive for 2013 as well," says Terry.

Markus believes that currently, the opportunity set for CLO investors has shifted away from 2005-2007 vintage CLO paper to new issue CLOs. This move, he says, has been driven by the rally in spreads over the course of 2012 and the fact that the limited supply of vintage CLO paper in the secondary market has meant that "holders are less inclined to sell. On the new issue front, we believe CLO equity continues to be attractive as investors can achieve mid-teen returns (on a loss-adjusted basis) for secured corporate credit.

"Additionally, while subordinated tranches of the CLO capital structure rallied over the course of 2012, the AAA slice remains approximately 10 basis points wider than post-crisis, making this an attractive investment for some investors."

While returns are clearly attractive in CLO funds, they aren't without risk. As mentioned, Highland's CLO Value Fund I was able to close early on a fast market rebound. But that's not always the case. Historically, this is an asset class that has gone through periods of illiquidity. Investors have to be comfortable in the knowledge that such an investment might not always deliver on time and that liquidity could deteriorate in the underlying collateral – the bank loans – at a certain point.

"There are two categories of risk for investors to consider: fundamental risk and technical risk. On the fundamental side the risk is that the default rate and loss rate in the underlying collateral is above what's expected in the investment. On the technical side, it goes back to liquidity. You have to be comfortable with some potential mark

Josh Terry, Managing Director and Head of Trading at Highland

"The market right now is characterised by short duration investments. The secondary market is mainly comprised of CLOs that are entering their reinvestment periods this year and in 2014. So mark to market volatility should be somewhat muted."

Josh Terry, Highland Capital Management

to market volatility and periods of illiquidity when you invest.

"However, the market right now is characterised by short duration investments. The secondary market is mainly comprised of CLOs that are entering their reinvestment periods this year and in 2014. So mark to market volatility should be somewhat muted," says Terry.

Managers like GSO Capital Partners invest in the lower, riskier end of the capital structure which might not necessarily suit every investor but Moffat confirms that presently the firm is discussing managed account solutions with some clients:

"If an investor wants solid BBB, A-rated securities then we can create tailored managed accounts at those specific rating levels. Alternatively, someone looking for a higher return-type of product could choose to invest directly into one of our funds or we could create a bespoke managed account for them in those lower rated tranches. We are seeing increased interest from investors wanting to make a single large investment in structured credit."

As a new asset class, CLO funds are a palatable option for investors who may still have some reservations about investing directly into securitised products. But Markus adds a final word of caution:

"Over the past six months, CLO spreads have rallied significantly. Depending on the fund's mandate, there could be concerns about managers "reaching for yield". Separately, given the limited supply of CLO paper, it may be challenging for some larger funds to ramp up and invest all of their capital efficiently." ■

Alcentra: CLO funds were the 'stand out success story' in 2012

By James Williams

Alcentra is one of the world's leading asset managers. With a focus on sub investment-grade corporate credit it has built a strong 11-year track record in secured loan investing. It has USD16billion in assets under management, including some USD9billion in European assets.

Whereas historically European asset managers would gain access to loans by raising capital and creating a CLO, in recent times the use of fund structures has become more common. Certainly, CLOs are still used – last November saw Alcentra close its USD406.5million Shackleton II CLO, bringing the total number of CLOs on its US platform to 15. But as the banks remain wary of lending, leveraged loan funds are gaining prominence.

Last year saw Neuberger Berman launch the NB Global Floating Rate Income Fund. Alcentra did likewise with the introduction of its LSE-listed Alcentra European Floating Rate Income Fund, which invests in the secured loans and high yield debt of primarily European corporates. This emergence of listed loan funds even prompted Joseph Lynch, a Chicago-based managing director at Neuberger Berman Fixed Income LLC, to say that they "could be the new version of CLOs for European investors".

Today, Alcentra is becoming increasingly active, not just in secured loans, but other areas of fixed income including CLO funds, stressed/distressed debt and direct lending.

"In 2009, it was very hard for companies to re-finance in the loan market because the banks were being very conservative, CLOs were less active in the market. All the liquidity was in the high yield bond market so people tended to go down that path.

"The senior secured loan market, however, has caught up. Loans have some attractive characteristics relative to bonds: they have strong covenant structures, low default rates, high recovery rates. Particularly now, when the high yield bond market has had such a tremendous run over the last 18 months, we think the relative value is in the loan market," explains Simon Perry, Head of Business Development, EMEA, at Alcentra.

To tap in to increased investor appetite for loan funds, the firm has built a range of solutions as a function of investors' tolerance for liquidity.

"We are raising more new capital from pension funds and insurance companies in to unlevered vehicles: either segregated managed accounts, open-ended funds which trade at a net asset value, or in the case of the LSE-listed European Floating Rate Income Fund, a closed-ended fund that issues shares on the stock exchange," adds Perry.

The open-ended fund is 80 per cent weighted towards senior secured debt with the other 20 per cent in cherry picked subordinated (junior) debt. The portfolio is comprised of 60 individual loan positions held in companies across 26 market sectors. The average yield to maturity is more attractive for loans in Europe compared to the US – around 7.15 per cent versus 5.60 per cent – but Perry notes that there are good arguments for both markets:

"The US loan market is deeper and more actively traded. Essentially, the US is good in terms of corporate backdrop, not so good for returns, while in Europe potential returns are higher but you've got to be more selective about where you're investing.

"We think there's a strong argument for being active in both markets and keeping a close eye on relative value between the two."

Investors should expect to earn returns of between 7 and 10 per cent over a three-year timeframe, but Alcentra's flagship European Loan fund – an open-ended monthly liquidity loan vehicle – went beyond that for 2012, returning just over 12 per cent.

The only problem is that growing popularity could make loan funds unwitting victims of their own success. With significant money coming in, says Perry, it puts pressure on new issue spreads, and, potentially deal terms. "In the US we've seen that translate into a tightening of spreads and an increase in the prevalence of covenant-light deals."

Simon Perry, Head of Business Development, EMEA, at Alcentra

CLO funds produce significant returns

This has prompted Alcentra to cast its net into other exciting areas of the fixed income market. And if one considers raw performance alone, 2012 proved particularly fruitful for the firm's secondary CLO funds, both of which are open-ended structures. As Perry mentions: "The stand out success story of 2012 is what happened in the structured credit space.

"We focus purely on CLOs and currently have two funds: one of which focuses on the mezzanine part of the capital structure, the other which focuses on first-loss tranches. Both of those funds generated around 40 per cent returns for 2012, which was quite phenomenal."

That may not necessarily translate into 2013 with Perry estimating a 20 per cent return opportunity. The benefit of investing in a first-loss equity tranche of a CLO is that most of the return comes from current income on the underlying asset, and this, according to Perry, "is a little more sustainable. Having said that the strategy is more sensitive to any upticks in default rates or downgrades."

Direct Lending and stressed/distressed debt

Due to the issue of tightening spreads in primary loan issuance, Alcentra is also looking at investment opportunities in direct lending and stressed/distressed debt.

One of the key advantages of the direct lending market is that the volume of investor demand is much less: after all, these are not broadly syndicated transactions but private deals. It's a much smaller universe, allowing managers like Alcentra to maintain yields and deal terms more effectively.

The flipside to this is that because only one or a handful of lenders are involved in loan origination, there isn't any secondary market liquidity. Such strategies therefore favour investors who are less constrained from a liquidity perspective.

"This is an area where middle market companies are starved of access to finance because of the way banks are pulling back on the back of increasing regulatory capital constraints. As this is a less liquid market you have to access it through longer lock-up fund structures (e.g. closed-ended GP/LP fund structures), so it really only suits investors with a longer investment horizon."

To illustrate Alcentra's growing interest in direct lending, at the end of 2012 it was one of four managers selected by HM Treasury to manage direct lending funds under the Business Finance Partnership.

"We launched and closed a GBP200million fund at the end of 2012. That fund is aimed at lending to middle market corporates across the UK. We are currently raising funds for a second fund that will be more European-focused."

As for stressed/distressed debt situations, this is a potentially interesting opportunity over the near-term in light of the fact that there are a number of companies, who, because of more challenged businesses or leveraged balance sheets, have failed to secure refinancing in the capital markets. These companies face a maturity wall in 2014-2015 and this should create attractive pricing in the secondary market from distressed sellers.

"We are targeting returns of 10 to 15 per cent in that strategy. There are opportunities to find debt trading at 70 to 80 cents on the dollar. You may be buying something on a yield of 12 per cent but if there is an opportunity of an earlier exit through refinancing that yield could potentially be boosted to a 15 or 17 per cent return," suggests Perry.

Administrative challenges

Given the variety of investment opportunities that Alcentra is pursuing in fixed income, the administrative burden when it comes to managing loan fund portfolios can be substantial. Segregated managed accounts require granular reporting on every loan position, while the firm's LSE-listed fund requires a daily NAV: these are far from simple exercises.

According to Stuart Medlen, Executive Director and Global Head of Transaction Management at Alcentra, there are three separate areas that need to be considered when administrating loan funds: pricing, loan settlement, and general loan administration.

That market vendors such as Markit and Thomson Reuters have, over the last five years, been growing the number of dealer quotes they receive for their pricing services has, says Medlen, allowed managers to price their loan portfolios more efficiently.

"That's been a clear development in Europe and has allowed for a lot more visibility within the loan asset class," says Medlen, who illustrates the point by adding: "Historically, the CLO market did not have a pricing element needed in loans as there is today. It then evolved with the introduction of managed account structures which had a mark to market element and perhaps monthly NAVs. Now, at the end of the scale you have vehicles like the Alcentra European Floating Rate Income Fund that prices the NAV on a daily basis."

This pricing function played a key part in the fund's board deciding to choose BNP Paribas as its administrator.

"We viewed them as the best-equipped administrator to cope with what is a new type of vehicle. The fact that BNP Paribas can produce a daily NAV that is published on the LSE is the most important thing for us. It sounds simple, but there are a lot of administrators that struggle to provide this. Most provide a T+10 turnaround so moving to a fund with daily pricing is quite a big leap."

Another challenge is loan settlement. This is particularly true of Europe which has a lot of idiosyncratic jurisdictional complexities. Alcentra has a strong in-house settlement team to ensure that loans are settled quickly and efficiently. Even though loan settlement has decreased steadily over the last few years to around 30 days it's still nowhere near as fast as the bond market.

Having said that, the process in the US is a lot smoother because its market is homogenous.

Says Medlen: "At the moment the US market is looking to move to a straight-through processing model. Once a loan looks more like a bond from a settlement time and efficiency perspective that would be a clear advantage to attract new investors to the asset class. Hopefully, in the not too distant future, the majority of US loans should begin settling STP and some European loans should follow suit thereafter."

The third challenge is general loan administration. Unlike bonds, which have a defined interest, collection period, and investors know exactly what income flows they're going to get, that's not the case for loans. Contracts roll over, they can be monthly, quarterly and are typically linked to Libor (floating rate loans). Factor in potential defaults, Payment in Kind (PIK) interest and there are a lot of unique areas within loan administration.

"It was important for us that they had a dedicated loan administration system that could help us do our daily reconciliation quickly," says Medlen, who added that having a partner within the same time zone was also vital.

"Finally, the corporate secretarial part of the BNP Paribas offering is something we found attractive. Being a Guernsey vehicle and a London-listed fund means that there are a lot of reporting requirements. We wanted an administrator that had done this before and was well aware of all the LSE's reporting requirements. It's quite unusual for a loan fund to be listed, after all." ■

A good time to be a direct lending manager in Europe

By James Williams

"Now is a good time to be a direct lending manager. We view what's happening in Europe as a secular shift in the structure of its market. Whereas it was once 90 per cent dominated by banks, increasing institutional capital is beginning to balance things up," comments Mike Dennis, managing director and co-head of Ares Capital Europe LP (ACE).

ACE is the European private debt lending arm of US firm Ares Management, a USD56billion alternative asset manager specialising in credit.

Quite how far European institutions will penetrate the capital markets remains to be seen. It's unlikely that Europe will end up like the US, where approximately 80 per cent of capital is institutional, but Dennis is adamant it will play an increasingly important role: "The shift has only really just started."

To provide some context, in Europe the direct lending capabilities of private equity and hedge funds is estimated to be around EUR3.5billion, Jeremy Ghose, head of buyout firm 3i's debt management unit, told Reuters. By comparison, the banks held EUR4.7trillion of outstanding loans at the end of 2011, according to the ECB.

But change, however insubstantial, is certainly afoot. Ares Capital Europe is in the process of closing its second fund this quarter, and has a long-term plan to launch more funds thereafter. Just last month, Legal & General announced a GBP120million 10-year debt facility to Bruntwood, a UK commercial property company. This is Legal & General's second real estate financing deal, following the GBP121million loan issued to UNITE Group in April 2012.

"We want institutions to play a bigger part in the direct lending market going forward. A small number of institutions won't provide the depth of liquidity required long term, so we are encouraged to see more firms entering the direct lending space. You can't do it with a handful of players as the liquidity won't be deep enough. Intermediate Capital Group are currently trying to raise a senior loan fund so it'll be interesting to see how they do," says Dennis.

Mike Dennis, Managing Director and Co-Head of Ares Capital Europe LP (ACE)

"We want institutions to play a bigger part in the direct lending market going forward. A small number of institutions won't provide the depth of liquidity required long term, so we are encouraged to see more firms entering the direct lending space."

Mike Dennis, ACE

Ares Capital Europe: A European vanguard

Ares Management LLC, headquartered in Los Angeles, was established in the late 1990s. It currently runs the largest Business Development Company (BDC) in America, Ares Capital Corporation: a USD6.3bn Nasdaq-listed specialty finance company providing debt financing to approximately 153 US middle-market companies.

In 2007, Ares decided to extend its direct lending expertise into Europe. The firm already had a European presence, having established a CLO business in 2006. However, unlike the US, its European vehicle – Ares Capital Europe Ltd – is only open to private investors.

Explains Dennis: "The public markets in Europe aren't yet ready for listed direct lending vehicles. We raise private money from investors – sovereign wealth funds, pension funds, insurance companies, etc. We have offices in London, Paris, Frankfurt and Stockholm and have around 25 dedicated professionals. We were one of the first direct lending private debt funds to launch in Europe."

Since 2007, ACE has managed to put EUR1.5billion of capital to work and is invested in more than 50 European middle-market companies. The strategy, in essence, is to originate loans and lend to companies with an EBITDA of between EUR5million and EUR75million. It provides a mixture of senior, unitranche and mezzanine debt to help companies fund leveraged buyout activity, refinance themselves or help achieve growth targets. To clarify, unitranche debt combines senior and subordinated debt in one instrument and is often used for LBO purposes.

Dennis says that typically each loan has a five- to six-year maturity. Their size varies anywhere between EUR25million and EUR200million. The fact that the portfolio of loans held in ACE is so diversified is, in Dennis's view, one of the firm's core competitive advantages:

"What we say to investors is that if you manage your strategy across the balance sheet – that is you invest in senior debt, unitranche debt and mezzanine debt – in a blended strategy, we fundamentally believe you can deliver 10 to 12 per cent unlevered net returns each year. Compared to current returns available from fixed income and/or equity on a risk-adjusted basis, that's pretty attractive."

Not only is the portfolio geographically diverse (50/50 split between UK and Europe) but sector diverse. Add in that each tranche of debt works out to be roughly 33 per cent of the portfolio, and the fund has just as familiar a construction as a standard bond fund; but with the benefit of added yield.

The first fund was more of an evergreen fund than a typical GP/LP structure, and could have continued to raise capital, but Dennis points out that the firm had reached a point in its development where it made sense to launch a second fund: one that will, in fact, use a GP/LP structure.

And the reason for launching is simple: investor interest in direct lending is building.

"The capital raising exercise has been really successful so far, we've really expanded the LP base. The level of interest in private debt and direct lending is significant. Given that we've already invested EUR1.5billion over the last four years in the first fund, we'll be expecting something similar in this second fund. There's certainly been a re-balancing of allocations to credit and direct lending strategies have benefited," says Dennis.

The name of the second fund is Ares Capital Europe II.

There are other reasons, aside from attractive risk-adjusted returns, for why investors are beginning to favour direct lending funds. Firstly, it helps that ACE's investment strategy is to lend first and second lien senior debt i.e. at the top of the capital structure, where risk is that much lower.

Then there's the overall approach to investing. For a firm like ACE, this is very much a long-term business. They're in it for the long haul. This reassures both the companies they lend to and their investors.

"LPs ask us "Is this just a short term opportunity given the current market dislocation?" That is, raise a fund, invest in it for a couple of years and then move on to a different strategy. Well, if we're lending money to a company over a four-, five-year period we can't just pack up our bags within a couple of years because we've made the returns we were looking for. That would be counter-productive for us as a business.

"For distressed debt strategies buying secondary market assets, I think that is a tactical two- to three-year trade. But in terms of establishing an institutional lending business as Ares has, this is a long-term strategy and one that will see us continue to launch funds going forward," asserts Dennis.

Trust is a huge part of direct lending. After all, most companies are used to dealing with banks to get their loan arrangements, not third party asset managers. Once a deal is arranged, it sets the tone for a strong ongoing relationship between the manager and the firm. Getting it right from the outset is crucial.

"At the beginning we had to ensure that companies trusted us. It helps that a lot of our team are ex-bankers. Our whole approach is to originate the deal, execute the transaction, and then manage the portfolio. We're there from start to finish, and this helps foster trust. This is absolutely a relationship play," says Dennis.

Aside from relationship building, any serious direct lending firm needs to have sufficient "skin in the game". That's why firms like ACE, International Capital Group and others have invested heavily in their infrastructure. It takes time and commitment – attributes that any institutional investor would take succour from.

A great deal of emphasis is placed on rigorous due diligence when selecting the right companies in which to invest. In this regard, ACE is in a favourable position. The Ares platform, with USD56billion in assets, has relationships with around 1,500 companies globally. In Europe, this is a huge advantage when performing due diligence on a target company, with Dennis noting that "it is uncommon for us to have no platform knowledge of the company, or the sector in which it operates".

"We take a forensic approach to due diligence to ensure we're lending to the right companies. Credit is quite an asymmetric asset class in that if you get it right, you'll earn, for example, 10 per cent annualised, but get it wrong and you could end up losing money. To be successful you have to have a thorough due diligence process, which we do," explains Dennis, adding:

"Unlike banks, which take a cookie cutter approach to loan origination, we assess the risk of a company on a case by case basis. The debt structure and pricing that we put in place is very specific to the risks we identify in that company. In the banking market you've got a pretty tight band of pricing for companies. We don't tend to follow those rules. We price the individual risk of every company we lend to."

The whole focus of Ares Capital Europe Ltd, and indeed the imminent second fund, is to invest purely in performing companies.

"There are direct lending strategies out there that focus on special situations, distressed debt. But Ares Capital Europe is very much a performing loan strategy."

If Dennis's expectations of more institutional players entering this space are realised, direct lending in Europe could be on the cusp of something much bigger. For institutional investors looking for diversified strategies, that's an exciting prospect. ■

Solvency II: Look-through treatment will help calibrate capital costs

By James Williams

Solvency II is an EU-wide piece of regulation which aims to introduce stronger rules on capital adequacy and risk management for insurance companies, and ultimately increase the protection of the final beneficiary. The Directive represents a major change in the way that insurance companies will operate because at its heart lies a requirement to focus far more exclusively on the assets being held on the balance sheet, and the inherent risks they represent.

Previously, insurance companies used to focus on liability risk assessment but the '08 financial crisis has prompted regulators to ensure that greater risk management and governance within firms are in place to avoid systemic risk. The new regime will apply to all insurance firms with gross premium income exceeding EUR5million or gross technical provisions in excess of EUR25million. Like the banking regulation, Basel III, the essence of Solvency II is to ensure that firms have adequate capital requirements to withstand a market shock.

"Under Solvency I a life insurance firm would have 70 per cent of its global risk and capital requirements just on liability risk. Under Solvency II, that is now only 25 per cent, with up to 70 per cent of total risk applicable to the market (i.e. on the asset side). This is quite a dramatic change. Now, life insurers really need to focus on asset risk," comments Maxime Gibault, head of the insurance company client segment at BNP Paribas Securities Services.

The Directive was due to come into effect on 1 January 2013 but implementation has since been delayed until 2015 for reasons that will be explained later. Omnibus II, aimed at defining all the rules of the Directive, is, however, expected to be ready by 1 July 2013.

The upshot of this is that whilst most of Europe's biggest firms have been getting their internal risk management and governance controls in place, the imminent threat of Solvency II has somewhat receded.

Nevertheless, the capital adequacy component of the Directive is compelling and causing insurers to re-assess the assets they invest in from a cost and risk budgeting perspective. Under Solvency II, a capital charge of 39 per cent will apply for global equities (and 49 per cent for other equities), and a charge of 25 per cent will apply to holding direct real estate investments. Debt-related instruments could, potentially, be cheaper, at 15 per cent.

Although not as powerful a catalyst for change were the Directive to be introduced this year, capital costs are to some extent influencing insurers and prompting them to look more closely at debt funds as an alternative asset class.

"Whilst Solvency II generated a lot of sound and fury a while ago, my impression is that it has gone off the boil to a certain extent. Implementation now appears to be quite a long way down the track but as a behavioural driver, under Pillar I the capital cost for debt is less than it is for equity investments. In terms of turning insurance companies on to debt investments, that is a motivating factor," comments David Williams, partner at Simmons and Simmons.

Three pillars to Solvency II

Pillar 1 is a quantitative pillar, requiring the insurer to use every type of methodology to monitor all potential risks being taken and to then calculate the capital requirements for each of those risk exposures.

Pillar 2 is the governance pillar. On top of the capital requirement calculation, a governance element also needs to be put in place. This is to ensure that everything is done to mitigate every type of risk being taken. The internal process of risks and solvency is known as ORSA: Own Risk and Solvency Assessment.

Pillar 3 is the reporting pillar, which can be split in two: one piece relates to private reporting and is required by local regulators. The other piece is public reporting, which details the strategy of the insurance company, the risks being taken, and the

Maxime Gibault, Head of Insurance Company Client Segment at BNP Paribas Securities Services

"This is the most important piece of regulation to have ever effected insurers. Even though the final set of rules are yet to be fully defined it definitely changes the focus of their responsibilities."

Maxime Gibault, BNP Paribas

amount of capital being immobilised.

BNP Paribas Securities Services recently conducted a client study. It found that while insurers were advanced in terms of preparing for the Directive's quantitative requirements under Pillar 1, some 60 per cent of insurers were yet to address the requirements on public and regulatory reporting.

Calculating the capital costs

When it comes to the calculation methodology there are basically three options available: insurers can either use the standard calibration methodology based on a set of risk factors established by the EU regulator, the European Insurance and Occupational Pensions Authority (EIOPA), use their own internal risk model, provided it has been approved by their national regulator, or use a combination of both.

There are two levels of capital requirements that need to be determined from the calculation methodology. As Gibault explains: "These include a Solvency Capital Requirement (SCR) and a Minimum Capital Requirement (MCR), which is a percentage of the SCR. If an insurer were to fall below the MCR, the local regulator could stop them from operating to protect the final beneficiary.

"This is the most important piece of regulation to have ever affected insurers. Even though the final set of rules is yet to be fully defined, it definitely changes the focus of their responsibilities."

But insurers who are thinking of diversifying into debt funds face a catch 22 situation. As a new asset class, debt funds, per se, have not been taken into consideration under Solvency II. There remains significant confusion as to how such instruments would be treated using the SCR assessment. Gibault elaborates on the point:

"It's actually a bit of a contradictory situation. There is a huge need for financing real estate projects; last year France required EUR100billion for real estate and EUR160billion for infrastructure, so there was huge demand. The duration of those debt loan investments is significant which sits well with the liability objectives of the insurer, so they are a perfect match in terms of duration and yield.

"However, even though insurers are interested in those types of investments, they don't exactly know how they will be treated within their Solvency Capital Requirement assessment. It's still early days for these investors with respect to diversifying into debt loan funds."

It's for precisely this reason that EIOPA have delayed the introduction of Solvency II as they seek to iron these creases in the standard calculation.

What the regulator needs to ensure is that insurance companies do not get put off from investing in securitisations through CLO funds, or in the bonds of long-term infrastructure projects, because of fears of overly punitive capital costs. Tim Wilkins, a senior consultant at Towers Watson, told Risk.net: "A 10-year securitisation rated AAA attracts a higher capital charge than a junk bond."

Another commentator was quoted in the press as saying that current Solvency II calibrations "vastly overstate the risk of many securitisations and make it almost impossible to invest in this asset class".

The "look-through" methodology

One way to overcome the potential complexity of holding debt fund investments could be for insurance companies to allocate capital into segregated managed accounts. This would give them full transparency, and favourable liquidity terms.

But there is another option, which the regulator will likely apply within a funds context, and that is something referred to as a "look-through" treatment of collective investments.

"A debt fund will invest in debt instruments – real estate loans, securitisation interests, etc, but may itself be a corporate vehicle that issues shares to its investors. The general intention of Solvency II is to "look-through" the fund vehicle to the underlying assets in order to calculate the necessary risk capital. Previously, there had been concern as to how the look-through provisions would operate, but the most recent technical specifications have given some helpful clarification as to the need to search for "economic substance"," says Williams.

Polyanna Deane, partner at Simmons & Simmons, adds additional context by confirming that a sliding scale of capital charges will apply to corporate bonds, asset backed securities and different tranches of structured credit products such as CLOs, depending on credit rating and duration of the debt investment:

"For example, it is currently proposed that a top-rated corporate bond of any duration will attract a capital charge of 0 per cent and a top-rated structured investment with a maximum duration of six years will attract a capital charge of seven per cent. However, a top-rated re-securitised structured product with a maximum duration of three years will require a capital charge of 33 per cent, making it potentially less attractive to an investor than the 25 per cent charge for holding real estate directly, but more attractive than an investment in unlisted equities, private equity or hedge funds as they attract a capital charge of 49 per cent."

"However," stresses Deane, "we still don't have the final rules on this."

Transparency will be key

This look-through treatment will allow insurers to see exactly what's in a debt fund (or any fund for that matter). Gibault adds that by using either the standard model or their own internal model it would at least enable an investor to arrive at an estimated SCR: "Having that look-through capability is the only way they can rate and assess the cost of the investment. We assessed a standard portfolio debt fund with a six-year duration, and based on our look-through assessment the cost of capital was only 17 per cent."

The transparency aspect represents a challenge to both insurers and fund managers alike.

Williams says that one of the challenges for fund managers is to ensure that they can "deliver the transparency that the investor needs, not least so that they can meet their internal and external disclosure requirements". This might, he says, limit the choice of managers: "Those that already have significant institutional infrastructure will be better placed compared to a smaller player entering the debt fund space for the first time."

Equally, the ability for insurers to diversify into debt funds and direct lending will depend on their having an internal infrastructure in place to forensically assess each position. This might necessarily favour the biggest insurers.

"What is already happening is that the biggest insurers – AXA, Alliance – are engaging in direct loan activity with corporates. I don't know where the market is going to be in 2016 but for sure we'll continue to see direct lending to corporates and infrastructure projects.

"Ultimately it will depend on the individual insurance company, but also on the final rules of the directive," comments Gibault. ■