Multi-Credit: Bank Replacement

Addressee

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The paper is a revised version of Hymans Robertson's paper issued to the Investment Sub-Committee in April earlier this year. The purpose of this paper is to provide details on credit market opportunities which have, or will, come predominately (but not exclusively) from European banks deleveraging. This supports the decision to consider the appointment of a Multi-Credit manager to manage a mandate for the Fund.

Background

The level of debt in the world's developed economies grew steadily for more than a decade before the financial crisis in 2008. Although this leverage was prevalent across all sectors of the economy, it was the financial sector that was most exposed. Following the sub-prime mortgage market blow-up in the US in 2007 the systemic crisis that ensued led banks' expansion to suddenly reverse and a process of deleveraging began.

There are three ways a bank can reduce its leverage:

- they can either raise new equity, which can be costly;
- sell legacy assets held on their balance sheet, which could mean realising significant losses on impaired debt; or
- they can reduce their overall lending activity.

The third of these approaches has been the most economical and therefore the favoured approach taken by the banks to date.

This coupled with the reduction in the overall number of banks, as levels of bankruptcy and mergers increased post the financial crisis, has resulted in a lending demand and supply imbalance.

Banks now face further deleveraging pressures with new regulation being the key driver. The Basel Committee of Banking Supervision (BCBS) has revised its existing capital adequacy guidelines and, with endorsement from the G20, is now implementing the Basel III framework. The key impacts of this are an increase in capital requirements for banks, changes to the way counterparty risk is assessed and the re-rating of certain risky assets. Basel III only began to be phased in early in 2013, with the implementation period expected to last five years to January 2018.

Higher capital requirements and liquidity constraints will lead to a multi-year process of deleveraging with central estimates ranging from \$2 trillion to \$10 trillion still to come off banks' balance sheets. Banks have already begun doing this via asset disposals and term funding, but need other options.

Opportunities for institutional investors

Banks play an important role in funding the economy. In Europe, close to two thirds of corporate lending is done by the banks. In the US, by comparison only about 25% of the economy is bank financed.

The supply of debt financing has a strong bearing on the wider economy. As bank disintermediation (the withdrawal of lending) takes hold and the banking sector continues to shrink, it encourages new forms of capital market-based lending. Investment managers, both traditional and alternative, are now able to substitute banks in some areas of lending, and other more specialised areas of finance. This in turn allows pension schemes to invest in a broad range of asset classes and strategies that were previously the domain of the banks.

One may argue that capital markets participation in lending activities which were previously the domain of banks is not sustainable, and in fact reflects a search for yield in an environment when low risk assets offer little in the way of return. However in our view the bank retrenchment is resulting in a longer-term structural shift in the financial industry – especially in Europe – and going forward there will be an increase in demand for non-bank intermediaries to meet the credit needs of the economy. As long-term investors, pension funds are well placed to meet this need.

We have identified a number of asset classes and/or investment strategies that have the potential to exploit the global financial deleveraging. The major ones are summarised in the table below.

Asset Class/Strategy	Brief description	Expected return	Rating	Liquidity
Senior Secured Corporate Debt	Private or syndicated lending to sub-investment grade companies. Senior and secured on assets	LIBOR + 4.0 – 5.0% (syndicated); LIBOR + 4.5 -7.0% (private)	BB - CCC	Reasonably liquid (syndicated); 5 Years + (private)
Mezzanine Corporate Debt	Private lending to sub-investment grade companies. Subordinated to the senior debt often with an equity component	10 - 15% IRR	≤CCC	10 Years
Distressed Debt	Purchase of assets at stressed prices or securities of companies in financial or operating difficulties	15 - 20% IRR	≤CCC	5-7 Years
Senior Property Debt	Lending to property investors at the senior secured level. Properties can be either prime or high quality secondary	LIBOR + 1.5 - 6% although some debt defined as fixed rate	A	5-10 Years
Infrastructure Debt	Private lending to infrastructure projects at the senior, secured and subordinate lending	1.5 - 7% although some debt defined as fixed rate	Wide range	5-10+ Years
Asset-backed securities	Income payments from multiple underlying loans, which are then collateralised (or "backed") by a specified pool of underlying assets.	LIBOR + 0.5 - 4.0%+	AAA - unrated	Liquid, but can take time to build a portfolio as new stock limited
High Yield	Lending to large companies. Typically unsecured.	3 - 4%	BB - CCC	Reasonably liquid

Multi-Asset Credit Investing

The debt markets we have identified above provide a much wider range of higher yielding opportunities beyond traditional fixed interest investment grade bonds. These markets provide diversification by issuer and by bond type, and although correlated, markets do not necessarily move in parallel with one another.

Key attractions, given the withdrawal of bank lending and the level of current interest rates, are the additional yield that these markets can provide and the floating rate nature (i.e. coupons linked to LIBOR rather than fixed rates) of much of the opportunity set.

By using multi-asset credit mandates to access these debt markets rather than a number of discreet specialist managers, the manager can rotate assets over time to the opportunity set providing highest return per unit of risk, access to markets can be faster, and the governance burden is limited to a single manager appointment.

A number of managers run Absolute Return credit portfolios that combine the above with more traditional active bond strategies, such as duration risk and currency management. The latter is not our focus, which is very much on allocating capital to attractive parts of the capital lending market in pursuit of stable and secure yield, rather than significant levels of active trading.

The benchmark for this type of mandate is normally set as a cash plus benchmark to avoid portfolio biases, e.g. LIBOR+4% p.a. net of fees.

Managers may be expected to include investment grade bonds as a “safe haven” if the price of the asset types listed above appears high. However, we are not targeting strategies that have a persistent holding in investment grade corporate bonds, as this will reduce the target level of return.

Some managers may make small allocations to distressed debt to further enhance returns, although these are typically small given the opportunistic nature of this market. The Fund already has an allocation to distressed debt, but given it would form a small part of any multi-credit mandate and there would be a high level of stock specific diversification, we do not consider this to be of any concern.

Portfolios can be structured on a segregated basis or pooled arrangement.

A segregated mandate enables greater control around investment constraints (e.g. limit on overall rating quality) and additional flexibility (e.g. exposure to lower rated investments, Collateralised Loan Obligations (CLOs) and investment in peripheral European opportunities), thus allowing the investor to better define the target return and tailor the risk profile of the portfolio to that required.

However, pooled fund solutions provide easier implementation and on-going governance and would be less dependent upon a minimum level of investment. We are looking at a pooled fund solutions for this allocation.

Closed ended funds provide greater access to private/originated debt opportunities, whereas open ended funds typically focus solely on more liquid debt markets.

More details on some of the debt strategies are included in the Appendix.

Associated Risks

The risks associated with a multi-credit portfolio will vary by debt type, but also within each debt type there will be potential for variation in the terms of each bond. Key risks are as follows:

- Issuer or portfolio credit risk, i.e. risk of a down-grade and/or default;
- Prepayment risk, i.e. early repayment leading to a loss of the yield enhancement;
- Liquidity risk – some debt instruments are illiquid in nature (e.g. the direct lending markets, including corporate loans and real estate debt). Other elements of the market can become more illiquid under stress;
- Reinvestment risk – in the case of pooled funds, it may be that the yield benefit or discount to par price of existing investments becomes diluted if a pooled fund automatically reinvests proceeds into new bonds/loans, and where the yield on these is lower than on existing investments and, therefore, no longer sufficiently attractive. This is of particular relevance for single strategy pooled funds, where closed ended funds, such as the M&G DOF II, may be more appropriate.

Notes and Risk Warnings

The report should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the note is used by, or released or otherwise disclosed to, a third party unless we have expressly accepted such liability in writing. Where this is permitted, the note may only be released or otherwise disclosed in a complete form which fully discloses our advice and the basis on which it is given.

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix

Distressed Debt

The term ‘distressed debt’ encompasses a variety of instruments, including high yield and investment grade bonds, bank loans, private corporate lending, asset backed securities, real estate and infrastructure debt. Distressed managers target debt trading at a meaningful discount to its par value (>40%). Typically, the issuing entities are, or have been, in financial and/or operational difficulties.

In many instances investors look to gain profits by maximising recovery value post default, through undertaking a financial restructuring of the borrowing entity. Although we might expect there to be a degree of correlation with the high yield bond markets, the returns of distressed debt portfolios will be extremely security specific, depending on the success or otherwise of the managers’ restructuring activities, etc.

Senior Secured Corporate Debt (Syndicated and direct)

Senior secured lending involves lending to US and / or European sub-investment grade companies. The lending can be either through bank origination and syndicating out to the primary market or through non-bank lenders privately negotiated deals direct with the borrowers. Typically privately negotiated deals which have a limited if any secondary market offers a liquidity premium over the syndicated market which has a functioning (to varying degrees) secondary market.

Current trends suggest that lenders to the private market can expect to be paid an illiquidity premium of 1- 2% over the more liquid syndicated loans market.

In general this involves lending to midsized companies as their size prohibits them raising finance through the public high yield bond markets. The purpose of the borrowing will typically be to finance company growth, acquisitions, mergers and private equity sponsored leveraged buy outs (LBOs). As the name suggests, senior secured loans sit senior (1st lien) within an issuer’s capital structure and are secured against specific company assets. In the event of bankruptcy, senior debt will be repaid before other subordinated lenders. Historically, banks have been the dominant lender in this space. However, post Lehmans, regulation has forced banks to scale back their lending activities creating a demand for privately negotiated non-bank lenders.

Mezzanine Corporate Debt

Mezzanine debt is unsecured, subordinated, private lending to companies typically with an equity component. The debt sits subordinate to senior debt within a company’s capital structure and will often have no specific asset backing. Exposure to mezzanine debt can be through specialist funds or multi direct lending funds which will combine exposures to mezzanine debt alongside senior secured lending.

Currently funds in the process of raising capital are targeting returns of between 10% and 15% per annum, depending on the expected level of mezzanine exposure. Clearly, this return target reflects a significant degree of asset risk and an illiquidity premium. Schemes looking for a medium-term strategic diversifier from equity risk, who are willing to give up liquidity for an extended period in order to achieve a significant yield premium, could consider mezzanine as an addition to the growth portfolio.

Senior Property Debt

Senior property debt involves lending to UK and / or European commercial property investors, either on a fixed or floating rate basis. Prior to the financial crisis banks were the main source of funding in this market. However, as with other direct lending opportunities now exist for non-bank lenders. Borrowers in this market include sovereign wealth funds, listed property companies and insurance companies. The term of lending is negotiable and can vary from 4 – 10 years. The market is private in nature, with no established secondary market (at this point). As such clients need to accept illiquidity during the loan term; typically around 10 years.

A key measure of quality is the loan-to-value ratio ("LTV"), the proportion of the value of the assets on which the loan is secured equivalent to the amount of the relevant lending plus any prior claims.

The assets backing the lending can be prime properties, such as long term fully occupied office building in the City of London, or can be what is termed secondary. Typically a secondary property will sit outside the prime City of London location and will have some ability for the purchases to add value, e.g. implement a business plan to increase occupancy levels to increase rental income. Currently the senior secondary market offers c3% premium over the prime senior lending market.

In addition to the senior property debt market, there is a mezzanine property debt market, which acts like the mezzanine corporate lending market, in terms of sitting between senior debt and equity, with a correspondingly higher yield than senior debt. This is a much smaller market than the senior real estate debt market.

Infrastructure Debt

The case for investing in infrastructure debt is very similar to that for property debt – scarcity of capital should result in higher income returns than has been available in the past. Initially banks continued to lend on core infrastructure assets since the cash flows are viewed as predictable and stable.

However, regulatory changes such as Basel III is reducing lending, in particular long term lending with short-term liabilities through increased capital charges. As a result, we have started to see a wave of infrastructure debt products launch which invest at both the senior and more junior levels. This market is in its infancy, although a relatively small number of fund managers have operated in the infrastructure debt arena for over 10 years (mainly in Australia).

There is little standardisation of products. One of the attractions highlighted by infrastructure debt proponents is the inflation-linkage characteristics of infrastructure assets. However, in reality, the debt funds are not distributing inflation-linked coupons, nor does the principal invested grow with inflation.

Asset backed securities (ABS)

Although not a directly affected by the bank deleveraging in the same way, ABS pricing suffered on the back of the financial crisis, and ABS bonds offer many of the same relative value attraction of the above, and would often be included in a multi-asset credit portfolio of bonds. Hence, we include some comment on them here for completeness.

ABS are bonds which are collateralised by a pool of underlying loans which generate the cash flows from which income and capital payments on the bond are made. The source or type of the loan pools can vary, e.g. residential mortgage backed securities (RMBS), commercial mortgage backed securities (CMBS) and credit card loans. The loans are pooled in a special purpose vehicle (SPV), a company specifically set up to hold the loans and coordinate payments and which does nothing else. The SPV will usually issue a range of securities backed by the same pool of loans but carrying different levels of exposure to the risk of default in the underlying loans (and, as a consequence, different coupons). Typically bonds will be issued with maturities of between 2 and 10 years and will be floating rate over LIBOR.

The ABS universe offers a wide range of risk / return, ranging from prime RMBS (rated AAA by the public rating agencies) with current spreads over cash of less than 1% through to sub-investment grade paper offering high single digit spreads. RMBS form the bulk of most European ABS funds. The US market is of relatively limited interest in the current context. It is divided between agency RMBS, which is backed by the government and provides limited yield, and non-agency RMBS, which is mainly high-risk, sub-prime borrowing.

There are also some opportunities in European CMBS (where the diversification of underlying loans is much less than for RMBS) and ABS backed by other assets.

High Yield Bonds

These are corporate bonds, also referred to as 'sub-investment grade' bonds, as they are rated below BBB. The universe will included bonds which are rated sub-investment grade at issue and those which have been downgraded to sub-investment grade by the public rating agencies. Often the debt is unsecured, i.e. with no backing assets and sits below any senior secured debt. Typically the debt is issued with a fixed rate with terms of 5 years plus. The high yield bond market has a higher average loss from defaults than the investment grade credit market and as such pays higher coupons to compensate investors for this increased risk and the greater volatility in pricing.

The US market dominates in terms of market size (currently standing at circa $1. 2tr of outstanding debt). However, the European high yield debt market has been growing in recent years as banks have pulled away from sub-investment grade lending and currently stands at circa $350bn.

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