Creditreform
Rating Agentur

Loan Funds as an Alternative Form of Investment

High demand for low-risk investments and outsourcing of credit risks - two sides of the same coin?

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Management Summary

1. Creditreform Rating has recorded four trends leading to the Asset Based Finance segment (ABF) taking on a more prominent role in outsourcing credit risks than it has in the past: (i) regulatory requirements; (ii) the tension between risk-aversion and search for yield; (iii) high demand for long-term financing; and (iv) political will.

2. Loan funds are a form of investment through which banks can outsource credit risk and institutional investors can gain access to investment opportunities. In this form of investment, a vehicle for investment is created – the loan fund – which primarily invests in illiquid assets rather than tradable loans or assets. The loan fund is financed either by investor equity or bond issues.

3. The loan fund segment has become increasingly dynamic in the last few years. This became evident in our analysis of the number of European loan funds and their target volumes; the number of real estate loan funds started in Europe since 2011 has seen a substantial increase. At the same time, the targeted fund volume has increased significantly. The target volume of the 81 real estate loan funds issued to date amounts to a total of €31.9bn. A similarly dynamic development took place in the European market for loan funds in the infrastructure segment. As of mid-2014, the European market includes a total of 42 infrastructure loan funds with a target volume of approx. €12.6bn.

4. The complex structure of the loan funds poses a challenge in the evaluation of investment-related risks, thus justifying the demand for ratings. Creditreform ratings are used in the context of outsourcing credit risk via loan funds, as they provide an analysis of the potential and existing risks at various levels of the loan funds' structure, thus providing a significant increase in transparency.

5. We expect financing for the European real economy, particularly for infrastructure assets and commercial and residential real estate, to shift increasingly towards capital market-based financing. Considering its inherent potential, alternative forms of financing such as loan funds may play a significant and sustained role for European refinancing markets in future. In our view, the favorable conditions and growth potential in the areas of infrastructure and real estate indicate positive prospects, in particular for the future of loan funds. In addition, loan funds were not immediately affected by the immanent regulatory changes for structured financing, as there is no tranching process. Thus loan funds are an attractive form of investment in two respects. While institutional investors in a low interest environment are able to satisfy their demand for solidly collateralized debt instruments of good credit standing, loan funds offer banks the opportunity to refinance their financial assets and to release regulatory capital.

6. What is particularly relevant for loan funds, in our view, is the EU Directive for Alternative Investment Fund Managers - the AIFM directive - which was implemented in German national law through the Kapitalanlagegesetzbuch (KAGB). In addition

to comprehensive organizational requirements and concrete provisions for risk and liquidity management, the KAGB contains in particular capital requirements for managers of alternative investment funds.

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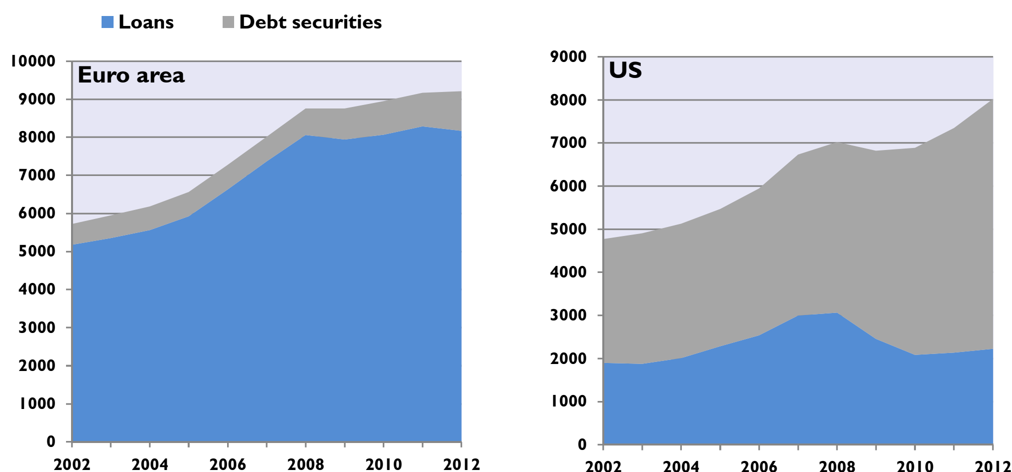
1. The development of European capital markets

Funding structure of non-financials

The economy in the euro area as a whole as well as in Germany has traditionally been shaped by a bank-based system of financing. As a result, external financing of European non-financial enterprises is characterized more strongly by bank loans than by capital market-based financing. By contrast, in particular enterprises in the USA obtain financing primarily via the capital markets. A look at fig. 1 shows that the structure of debt financing has not seen any significant change in the past decade. In 2012, the analysis of non-financial enterprises in the euro area shows a credit volume of €8.166bn, compared to €1.045bn financed by debt securities.

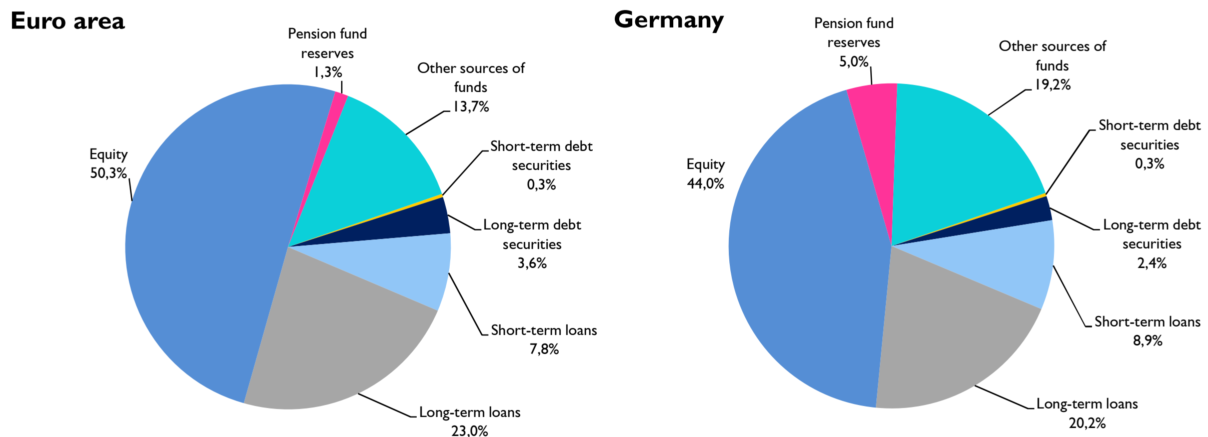
Figure 1: Debt financing of non-financials



Source: Eurostat, Board of Governors of the Federal Reserve System, own calculations
*) Shown in € bn (EA-17) and US$ bn (US), US: Nonfinancial Corporate Business

The dependence upon loans in the euro area becomes clearer upon examination of the capital structure of the non-financials. Nearly one third of the total liabilities of enterprises in the euro area consist of short and long-term bank loans (30.7%). In Germany, the proportion of loans in the balance sheet total is, at 29.1%, only slightly under the figure in the euro area (see fig. 2). If one focuses exclusively on debt, the predominance of loans becomes even more evident. Thus in the euro area as a whole as well as in Germany, approximately four-fifths of debt finance is provided by banks (euro area: 85%, Germany: 79%). On the other hand, only approx. 26% of debt finance in the United States is accounted for by bank loans.

Figure 2: Capital structure of non-financials



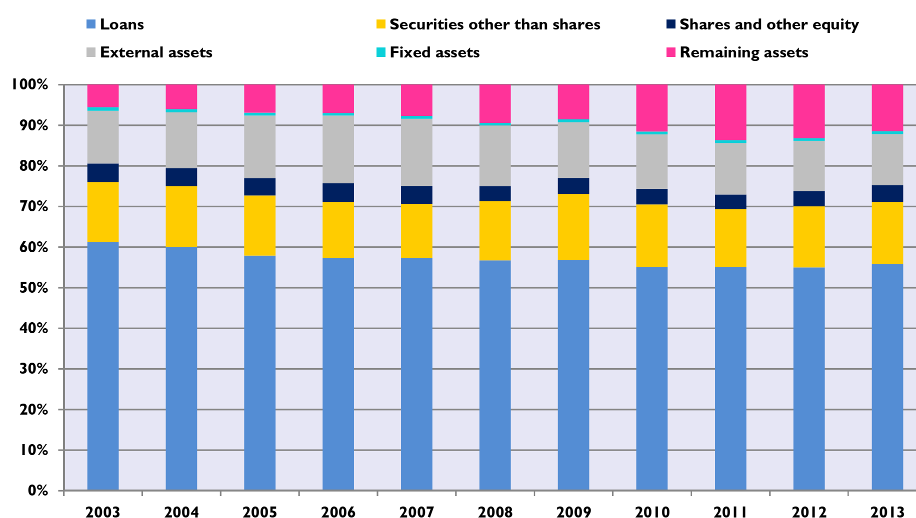
Source: Eurostat, own calculations

*) in %, as of Dec 13, unconsolidated financing and monetary assets account for non-financial corporations

The asset side of the banks' balance sheet

The aggregated balance sheet of banks in the euro area shows that no fundamental change has occurred with regard to the structure of the assets side since 2003 (see fig. 3). It is, nevertheless, remarkable that the proportion of loans has diminished over the last decade. Thus the proportion of loans dropped from 61.2% in 2003 to 55.8% in 2013. At the same time the proportion of external assets has decreased in the last few years 12.7%, having been at 16.5% in 2007.

Figure 3: Structure of the asset side of the bank balance sheets in the euro area

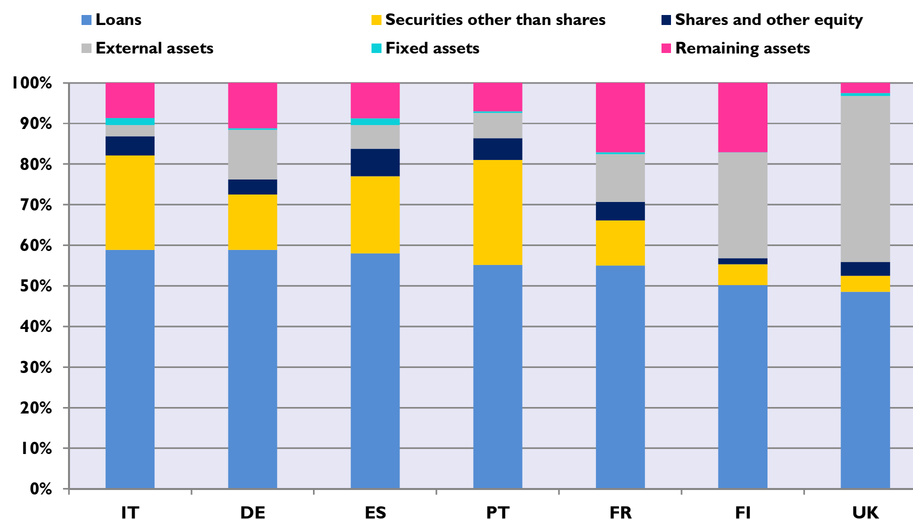


Source: ECB

*) = External assets = with respect to residents outside the euro area

There are nevertheless national differences with regard to the structures of the asset side of the balance sheet (see fig. 4). Thus the proportion of loans is lowest in economies such as the United Kingdom (48.5%) and Finland (50.2%), which show a predominance in market-based financing. In Germany (58.8%) and in the southern European economies (IT: 58.8%; ES: 58.0%), the proportion of loans is noticeably higher.

Figure 4: Asset side of bank balance sheets in selected countries

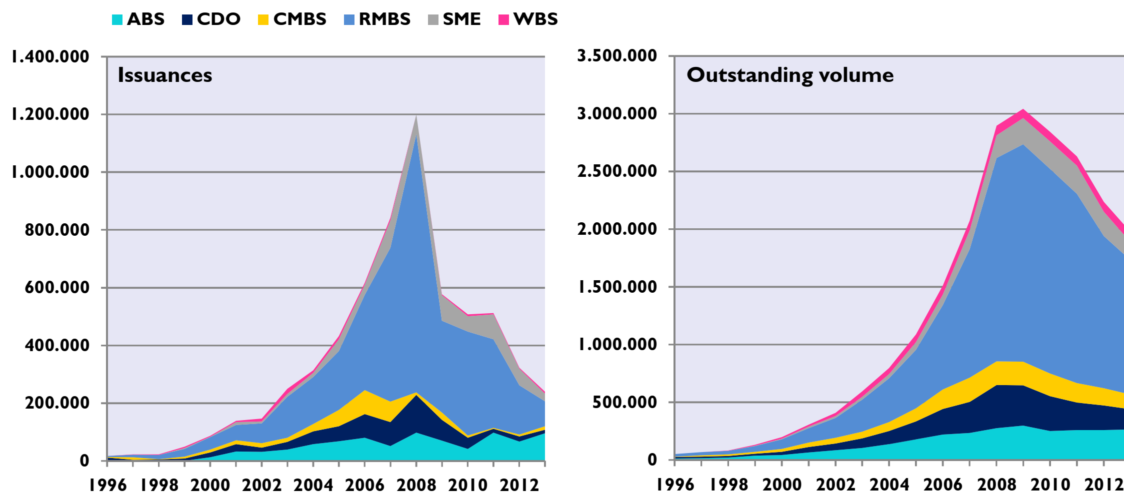


Source: ECB
*) As of Dec 13, external receivables with respect to residents outside the euro area or abroad (UK)

Securitization market

The European securitization market grew substantially ahead of the financial crisis and peaked in 2009 at an outstanding volume of US$3.065 trillion (see fig. 5). Since then, the market in Europe has dwindled significantly. At the end of 2013 the outstanding volume amounted to only US$1.981 trillion. This substantial decrease is primarily attributable to the Residential Mortgage-Backed Securities (RMBS) segment. Between 2009 and 2013, the outstanding volume of RMBS fell by approx. US$720 bn to approx. US$1.162 trillion. In relative terms, the Collateralized Debt Obligations (CDO) segment, whose outstanding volume fell by almost half from US$349 trillion to US$175 trillion, took the most dramatic downturn. The Asset-Backed Securities (ABS) segment was, at US$265 trillion, the second largest segment in the European securitization market at the end of 2013 (2009: US$298 trillion).

Figure 5: Securitization market in Europe (in US$ trillion)

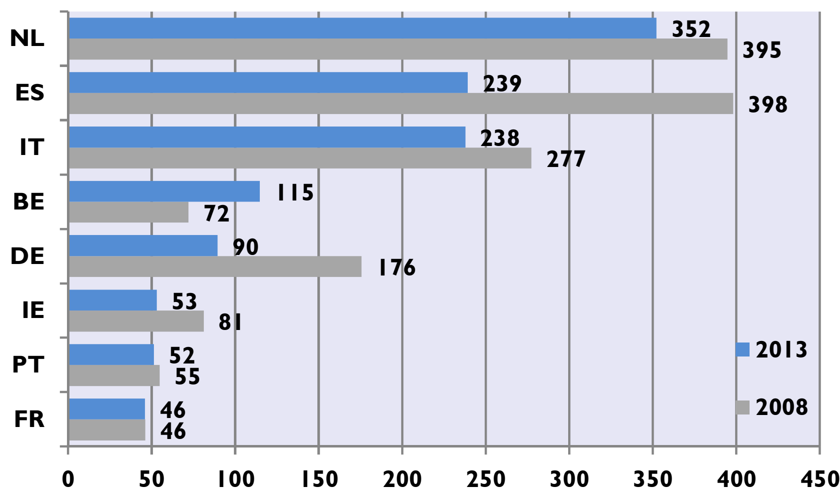


Source: SIFMA

The securitization market in Europe is relatively small compared to that of the U.S. The US securitization market has shown a visible decline since 2007, when it peaked at approx. US$11 trillion. However, the US market was five times the size of its European counterpart at the end of 2013 with an outstanding volume of approx. US$10 trillion. The issuance activity in the United States since the financial crisis has remained relatively strong in 2013 the issuance volume amounted to approx. US$2.200 trillion. In Europe, issuance of securitizations has declined massively since 2008. While the issuance volume was at approx. US$1.2 trillion in 2008, in 2013 it was at a volume of only approx. US$240 bn. Before the financial crisis, issuances were placed for US$845 trillion (2007) and US$620 trillion (2006).

In a national comparison, the German securitization market has in particular declined significantly (see fig. 6). In 2006, the volume of outstanding securitizations was US$176 bn; in 2013 it had declined to only US$90bn. The volume in Spain decreased to a similar extent, where a decline of 40% to US$239 trillion was registered. The decline in the Netherlands was relatively low, with a drop in volume from US$395 trillion to US$352 trillion. On the other hand, the securitization market in Belgium has grown - from US$72 trillion to US$115 trillion. The greatest market activity in Europe continues to be in the United Kingdom. While the UK securitization market has contracted significantly, the outstanding securitization volume amounted to US$570 bn in 2013 (US$952 in 2008), which corresponds to a market share of approx. 29%.

Figure 6: Outstanding securitizations in 2008 vs. 2013 (in US$ billion)



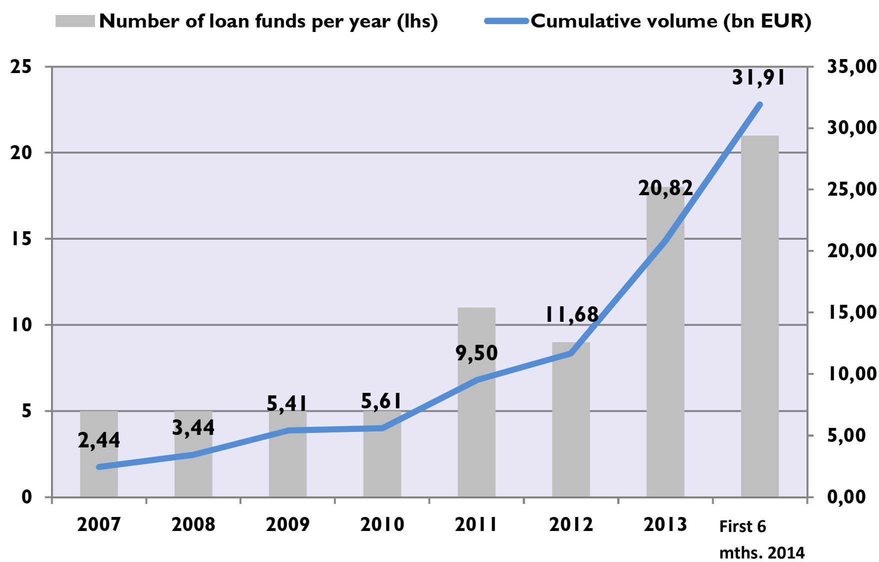
Source: SIFMA

Asset-based finance – loan funds

However, the loan fund segment has become increasingly dynamic in the last few years. This became evident in our analysis of the number of European loan funds and their target volumes. Thus the number of real estate loan funds started in Europe since 2011 has seen a substantial increase (see fig. 7). While five mortgage loan funds were started per year in 2007-2010, in 2011 and 2012 that number had already risen to eleven and nine funds, respectively. What is remarkable is the significant increase in issuance activity in the last one and a half years. In 2013 nearly as many loan funds were issued (18) as in the two previous years. In the current year (up to June 2014) the number of funds has already reached 21. At the same time, the targeted volume of loan funds rose significantly. In 2011 and 2012 the targeted volume was in total €3.9bn and €2.2bn respectively. By contrast, the volume in the first six months of 2014 alone amounted to €11.1bn - having been at €9.1bn in 2013.

A similarly dynamic development was seen in the European market for loan funds in the field of infrastructure (see fig. 8). In 2012, the number of infrastructure loan funds started had nearly doubled to six. This level was maintained in 2013 with a total of seven funds, until the current year, when twelve loan funds were registered alone in the first six months. As of mid-2014, the European market includes a total of 42 infrastructure loan funds with a target volume of approx. €12.6bn (placed and securitized by third parties), whereby the market grew substantially, especially due to the dramatic increase in 2012 (€3.6bn) and 2013 (€4.2bn).

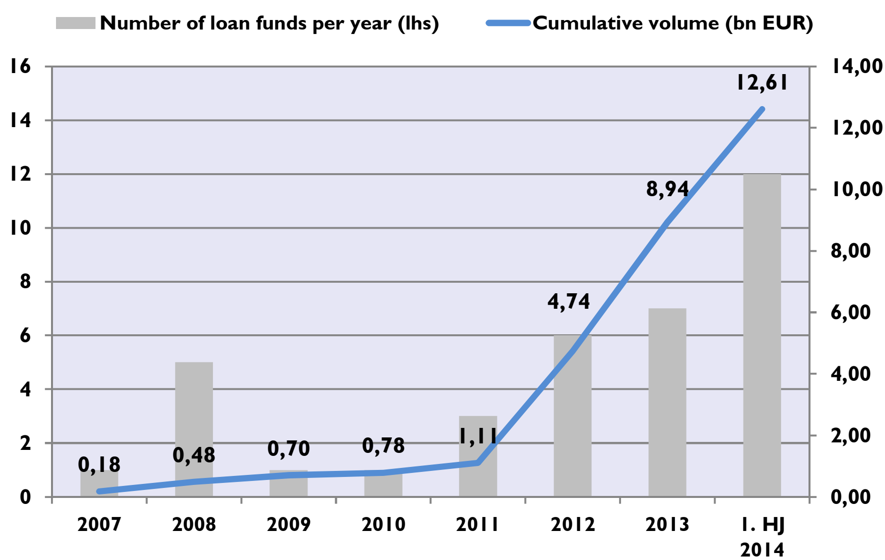
Figure 7: Real estate loan funds in Europe



Source: Preqin, own calculations

*) Volume includes placed loan funds and funds in the placement stage

Figure 8: Infrastructure loan funds in Europe



Source: Preqin, own calculations

*) Volume includes placed loan funds and funds in the placement stage

2. Impulses for the outsourcing of credit risk through asset based finance

The developments in the banking sector are still characterized by the efforts of banks to adjust their business model. In particular, the deleveraging of banks has led to radical changes in the financing field. In the wake of the shift from debt to equity financing, the banks are noticeably reducing their risk-weighted assets. Creditreform Rating has recorded four trends leading to the Asset-Based Finance segment (ABF) taking on a more prominent role in outsourcing credit risks than in the past: (i) regulatory requirements; (ii) the field of tension between aversion to risk and search for yield; (iii) high demand for long-term financing; and (iv) political will.

Regulatory requirements

European banks are subject to increasingly strict regulation. Due to the implementation of Basel III, the banking sector is subject to stricter requirements related to the quality and quantity of capital. In the course of this, banks in Europe are endeavoring to scale back their assets and increase their equity base. Accordingly, the capitalization of European banks has improved markedly; already banks exceed on average the minimum requirements for core tier I capital (CT1) which is primarily comprised of subscribed capital and reserves. At the end of 2013, the share of risk-weighted assets covered by CT1 was an average (median) of 12.4% - a noticeable increase from June 2011, when the core capital ratio of the Group 1 banks averaged approx. 10%. In September 2014, the European Banking Authority (EBA) published for the first time the CT1 ratio as of 31 Dec 2013 in its Basel III monitoring report, assuming full implementation of the Basel reform package. Due to the change in the definition of capital, the ratio of tier 1 core capital would fall from 12.4% under current rules to 10.1% under the CRD IV framework (after the transitional arrangements have expired). Group 2 banks would have an average core capital ratio of 10.3% (fully-implemented CRD IV package) - 13.2% under current rules.[i]

The improvement in banks' capital ratios was achieved by the reduction of risk-weighted assets, which is more pronounced than the reduction of total assets. According to calculations made by the Bank for International Settlements, approximately half of the increase in the CT1 ratio is accounted for by the reduction of risk-weighted assets.[ii] By means of a combination of asset sales and a replacement of high-weighted loans with safer ones, banks have reduced their exposures with high risk weights. This development was accompanied by a decline in lending to the business sector and by a stagnating number of loans granted to private households.

In our view, ABF will constitute a valuable support for the deleveraging process for banks; the increased use of instruments such as loan funds enables banks to outsource credit risks from its balance sheet, thus reducing their capital requirements and financing costs. Proceeds resulting from the sale of assets can be used for new business or to pay down debt. They also simultaneously create, by selling their assets, new investment opportunities for participants in the financial market who find themselves faced with insufficient investment opportunities.

Tension between search for yield and risk aversion

Institutional investors, particularly insurance companies and pension funds, seek forms of investment which yield high returns. The current interest rate environment, as well as the monetary policy measures, has led to a decrease in the yields of asset classes such as government bonds, and the monetary policy of the most important central banks remains expansionary. The interest rate of the European Central Bank (ECB) was lowered on 4 September 2014 to 0.05%. In addition, the ECB announced that it wanted to buy loan securitizations (ABS papers) and covered bonds starting in October. With regard to the future, the ECB has repeatedly stressed that it will maintain the present high level of accommodation with regard to its monetary policy and that key interest rates will remain at the current level for a prolonged period of time.[iii]

At the same time, risk aversion on the part of institutional investors has risen markedly in the past few years, leading to an increasing search for low-risk, 'safe' alternative investments ('flight to quality'). While the yield spread between asset classes such as government bonds and riskier assets such as corporate bonds have widened, this is not in accord with the aim of strengthening its aggregate capital position and reducing risk-weighted assets with a high risk-weight.

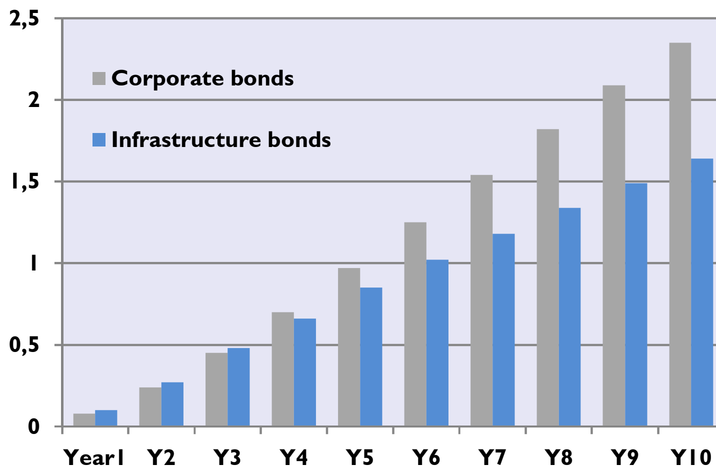
Banks as well as insurance companies thus find themselves in a field of tension in which they are to generate higher yields. Banks - for whom interest is an important source of income - are experiencing difficulties due to the fact that their interest margin has fallen in the current interest rate environment, and many insurance companies are faced with the challenge of not being able to service guarantees, should yields from their investments continue to fall due to the current market developments. On the other hand, the banking and insurance sector is faced with increased capital requirements under Basel III and Solvency II. This causes investment forms offering a high level of investment security in addition to relatively high yields to be correspondingly attractive. This brings alternative investment

forms such as loan funds back into focus, which is based on assets in the areas of real estate or infrastructure.

High demand for long-term financing

Long-term ABF portfolio investments are particularly attractive because they offer the opportunity to diversify financial instruments and to achieve relatively high yields. Additionally, in the best case, stable and predictable cash flows can be realized over a long period of time - even in times of economic tension. Also, the bonds' credit risk subsides more quickly in the course of time than is the case with other forms of investment, e.g. corporate bonds (see fig. 9). Moreover, in the event of default, higher recovery rates and liquidation proceeds can be achieved.

Figure 9: Cumulative default rate of investment-grade bonds (in %)



Source: Bank for International Settlements

In addition to this, there is an enormous demand for long-term financing in the European Infrastructure market in particular. The European Commission estimates the investment needs for infrastructure networks in the areas of transport, energy and telecommunications for the period from 2014 to 2020 at approx. €1 trillion.[iv] Economists at the European Investment Bank (EIB) assess this forecast as definitely too low and in their conservative forecast assume an investment demand of €8.4 trillion until 2030, which would correspond to an annual investment demand of €470bn.[v] Considering that public authorities in Europe are plagued by heavy debt and the European banking sector has considerably restricted lending, the financing gap which has opened up needs to be filled by other stakeholders, in particular institutional investors and alternative forms of financing. The latest research carried out by the Bank for International Settlements on the challenges for infrastructure financing also indicates that alternative forms of

financing will take on a key role, as they make investments in the infrastructure segment accessible to a broader group of investors and enable access to the financial resources of the capital markets.[vi]

Political will

In this context, the revitalization of markets for high-quality securitization products (including ABF) is increasingly becoming a topic among political decision-makers in Europe. Thus the EU Commission notes in March 2013 in its Green Paper on the long-term financing of the European economy in March 2013 that, due to the declining role of banks in granting long-term loans, new demand for the channeling of financing in long-term investment is being created, which will open up new opportunities for market-based financing.[vii] In its communication to the European Parliament and Council, the Commission finally outlines a schedule for long-term funding in March 2014 and speaks in favor of the development of capital market solutions.[viii]

The endeavors of the EU commission, to create a new type of fund - the European Long-term Investment Fund (ELTIF), move in the same direction. Such funds are to promote investments in long-term assets. In order to ensure that an ELTIF is based on long-term assets, a minimum of 70% of its capital must be invested in ‘eligible’ assets; these include assets such as infrastructure, real estate, ships, aircraft, or shares in other ELTIF. At the same time, 30% of the capital can be invested in other assets. On the other hand, an ELTIF may make not engage in short selling nor invest in commodities or financial derivatives.[ix]

Furthermore, the Europe 2020 Project Bond Initiative, a joint project of the EU and EIB, underlines the political will to revive European capital markets.[x] The Project Bond Initiative aims to stimulate investment in the infrastructure areas of transport, energy and telecommunications, whereby institutional investors are to be more intensively involved in debt financing.

3. A basic structure for loan funds

ABF is equally attractive for borrowers and long-term investors. Fundamentally, institutional investors can thus diversify the exposure resulting from the underlying assets with regard to sectors, geographical orientation, and liquidity preferences. From the perspective of investors, ABF provides investment opportunities in asset classes in which they need not invest directly and individually. At the same time, ABF offers a high degree of flexibility concerning the preferences of investors with regard to maturity, coupon, effective yield and risk. For banks, ABF provides a possibility for risk transfer and regulatory capital relief. The amount of regulatory capital relief depends here on the reduction of risk-weighted assets, which in turn depends on the parameters of the loan fund. At the same time, high-quality securities can be created in the course of these transactions for the collateralization of further debt financing. In the following, we will elaborate on the loan fund as an ABF instrument as opposed to traditional securitization.

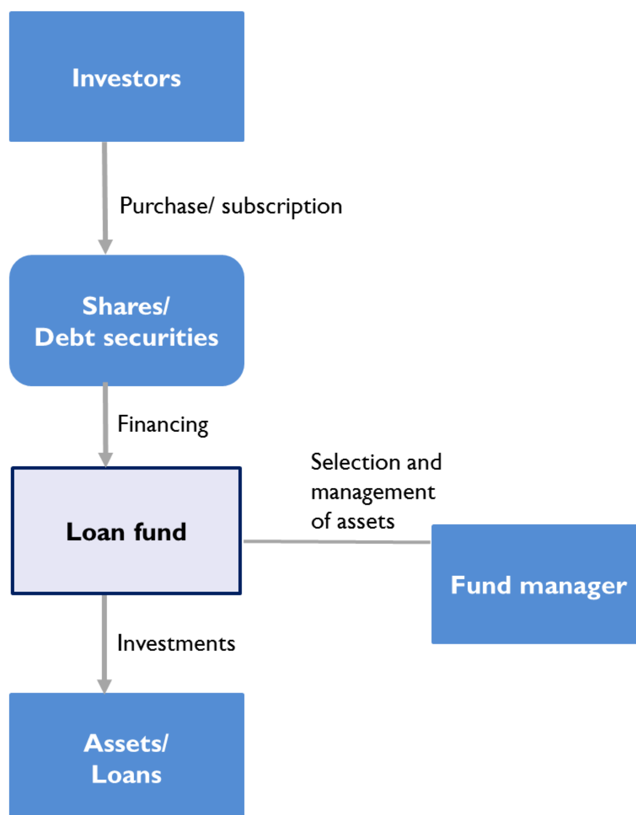
One type of investment that provides institutional investors with access to the aforementioned investment opportunities are loan funds. In the case of this investment instrument, an investment vehicle is established - the loan fund - which usually invests primarily in illiquid and non-tradeable assets. The spectrum of assets is broad, ranging from commercial real estate, hotels, and residential real estate to transport such as ships and aircraft to infrastructure assets. The Infrastructure Asset class is very multifaceted. Investment objects can be divided into the sectors of Transport (road and rail networks), Communication (e.g. cable networks), Energy (power plants, gas & oil networks, etc.), and Public Utilities (water, sanitation).

However, no fixed structure regarding the parameters of this investment instrument has emerged as yet. Usually, a Fund Manager will assume responsibility for investment decisions as well as the subsequent supervision of the projects, in the course of which he is responsible for the monitoring of assets, portfolio management, and for transaction and risk management. This so-called Alternative Investment Fund is designed as a closed-end fund.[xi] The loan fund is financed either by means of equity in the form of shares or via the issuance of debt instruments (see fig. 10).

Fundamentally, there are two major differences between loan funds and asset-backed securities. On one hand, the number of assets in which the loan fund invests tends to be much lower than with an ABS pool. In particular, there is no slicing into tranches in a loan fund structure. Accordingly, there is no order of payment ("waterfall structures"), so that in

the case of default on underlying assets, there will usually be no cascade of payments. In the case of a simple ABS structure, the equity tranche is the first to be affected by losses, followed by the mezzanine tranche and, finally, the senior tranche. This is not the case with loan funds, where shares are subject to a pari passu provision. In the case of loan portfolios, however, it can happen that e.g. the individual underlying loans each have a different order of payment.

Figure 10: Exemplary presentation of a loan fund / portfolio structure

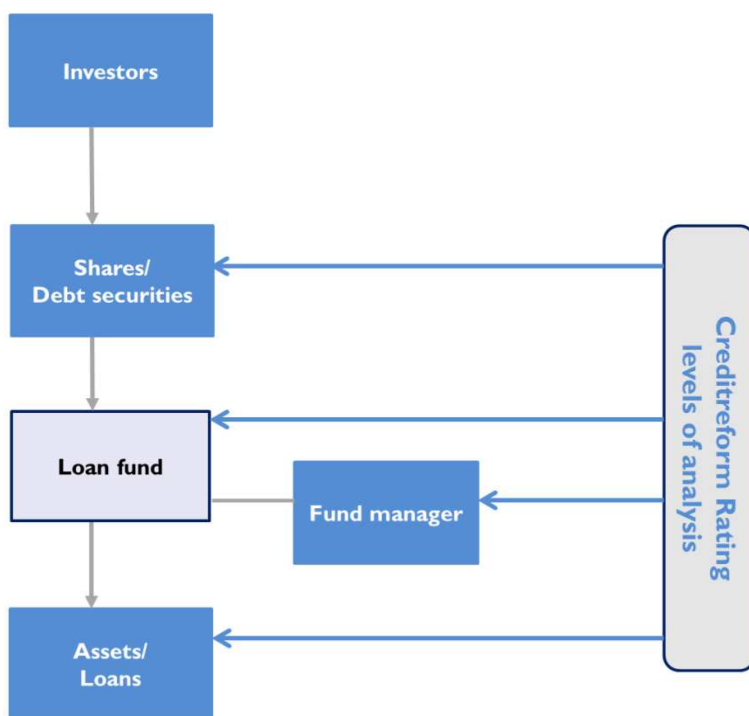


Source: own research

4. Creditreform rating as an important element in the process chain

The complex structure of loan funds poses a challenge in the evaluation of investment-related risks, thus justifying the demand for ratings. Thus Creditreform Rating plays an important role in outsourcing credit risk via ABF instruments such as loan funds, as we carry out an analysis of the existing, future, and potential risks at various levels.

Figure 11: Levels of analysis in the context of loan fund structures



Source: own research

A look at fig. 11 shows that Creditreform ratings increase the transparency of complex financial instruments and can therefore facilitate investment decisions in the areas of infrastructure, real estate, etc. Here, several levels of analysis are included as part of the rating process, whereby the analyses of individual levels is always carried out with a view of potential and significant risks which might jeopardize business operations, the immediate servicing of debt securities, or the repayment of invested capital.

Creditreform rating carries out a detailed analysis at the level of the securities issued of the transaction structure, issuance terms and conditions, legal structure, and the quality and intrinsic value of the underlying securities. The ability of the issuer to fully service its interest payment and

repayment obligations depends decisively on its liquidity, which is generated from interest income as well as from repayments and returns on the part of debtors under the purchased loans. Thus the economic success of the bond is determined to a large extent by the economic development of the loan portfolio and loan fund, which is in turn dependent upon the economic development of the individually acquired financing and its debtors, as well as upon the underlying assets.

In view of this, the loan portfolio or loan fund underlying the issue is of central importance to the issuer as a cash-generating unit. In the context of evaluating the loan fund, Creditreform Rating evaluates the investment strategy, anticipated cash flows, and yields in addition to the structure of the fund, portfolio, and terms and conditions. In this context, the Fund Manager undergoes a qualitative assessment. Assessment criteria are i.a. the track record with regard to deal sourcing, the quality of the loan selection, and the investment process.

In order to render loan funds more transparent, we also analyze the underlying securities separately, thus contributing to the identification of high-quality assets for the pool of receivables. Here, in addition to the creditworthiness of the borrower and intrinsic value of the assets, we focus on cash flow stability and anticipated performance. Risks related to covenants as well as industry-related risks also play an important role in this context.

Frequently there are 'blind pools' underlying the loan funds or loan structure, i.e. the concrete investment objects are unknown at the time of issuance. Creditreform Rating creates scenario-based cash flow models based on which we then carry out analyses of Monte Carlo simulations in order to evaluate, using stress scenarios, the coverability of the debt instruments by the loan portfolio or underlyings. The aim of such a cash flow model is to evaluate, in various stress scenarios, the effects of the loan portfolio or underlyings on the coverability of the debt securities. Usually we employ additional risk-oriented, weighted, scenario-based loan-to-value analyses in order to examine whether the ascertained revenues would be sufficient for fully servicing the issuers' entitlements and thus the creditor's claims in the case of enforcement.

5. Prospects for loan funds in Europe

The market for loan financing in Europe is subject to significant changes. In the face of tougher capital requirements for banks by Basel III, many banks have noticeably reduced their traditional lending business. The focus is increasingly on the acquisition of further investors and the successful structuring of financing. At the same time, restricted lending on the part of banks in Europe coincides with a large number of loans which require refinancing.

Accordingly, we expect financing for the European real economy, particularly for infrastructure assets and commercial and residential real estate, to shift increasingly towards capital market-based financing. Given their inherent potential, loan funds can play a significant and sustainable role for European refinancing markets in future. While institutional investors in a low interest rate environment are able to satisfy their demand for solidly collateralized debt instruments of good creditworthiness, loan funds offer banks the opportunity to refinance their financial assets and release regulatory capital.

Currently, regulatory plans for structured finance are being discussed and there are reasonable grounds to believe that the regulatory actions are still being carefully weighed and that there will be no prohibitive impact on the further development of structured finance markets. Thus the ECB has already announced concerns that the proposed capital surcharges being discussed do not sufficiently distinguish between qualitatively superior and inferior financial instruments and that the historical development of the ABS has not adequately been taken into account.[xii] Nevertheless, within the field of financial regulation, structured financing transactions are an issue still under construction.

By contrast, loan funds initially remained unaffected by the regulatory changes, as there is no tranching process. In accordance with article 4 number 36 of Directive 2006/48/EC, a transaction or structure in which the credit risk associated with an exposure or a pool of exposures is tranched is considered to be securitization.[xiii] Loan funds are thus an attractive form of investment in two respects. On one hand, they can cover the high demand by institutional investors, insurance companies, and pension funds for low-risk investments. On the other hand, it enables banks to outsource credit risks.

What is particularly relevantsignificant for loan funds, in our opinion, is alone the EU Directive for Alternative Investment Fund Managers - the AIFM Directive (AIFMD), which was implemented in Germany in 2013 by

means of the German Kapitalanlagegesetzbuch (KAGB). In addition to comprehensive organizational requirements and concrete provisions for risk and liquidity management, the KAGB contains in particular capital requirements.[xiv] Accordingly, an Alternative Investment Fund Manager must, according to § 25 of the KAGB, have a minimum initial capital of €300,000 inasmuch as it is an internal Alternative Investment Fund Manager, and €125,000 if it is an external Alternative Investment Fund Manager. In addition, an Alternative Investment Fund Manager must have additional own funds of at least 0.02% of the amount by which the value of the managed invested capital exceeds €250m if the value of funds managed by the Alternative Investment Fund Manager exceeds €250m. Furthermore, a capital requirement is provided in order to cover potential professional liability risks arising from business operations pursued by the Alternative Investment Fund Manager.[xv]

In our view, the favorable conditions and growth potential in the field of infrastructure and real estate indicate positive prospects, in particular for the future of loan funds. This alternative form of investment is an appropriate and certainly complex instrument for covering the need for long-term financing. However, instruments such as loan funds require a high degree of expertise in selecting, structuring and for the ongoing management of the investments. In this context, market participants such as Creditreform Rating will play a pivotal role in increasing transparency and enabling improved risk assessment.

Endnotes

[i] European Banking Authority (2014): Basel III monitoring exercise - results based on data as of 31 December 2013, 11.9.2014.

[ii] Cohen, B.H. (2013): „How Have Banks Adjusted to Higher Capital Requirements?“, BIS Quarterly Review September 2013, Bank for International Settlements.

[iii] European Central Bank (2014): Monthly Bulletin August 2014.

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[vii] European Commission (2013): Long-term financing of the European Economy, Green Paper, COM(2013) 150 final, 25.3.2013

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