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Illiquid Assets

HOW IS THE NEW FINANCIAL LANDSCAPE CREATING BOTH OPPORTUNITIES AND CHALLENGES FOR INVESTORS?

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With rates at record lows around the world, and still falling in many places outside the US, the ability to generate returns is an increasing challenge for investors. While some have reacted by looking down the credit spectrum at high yield bonds or equities, others have found they can achieve their goals by harvesting the premium available in illiquid assets, says BNY Mellon.

Market and regulatory dynamics have encouraged a massive change in investors' and banks' attitudes to illiquid instruments in recent years. This is partly the result of the financial crisis and the regulation that followed, but that is not the whole story. Sophisticated investors have long appreciated the enhanced returns on offer for those willing to give up short term liquidity. Today, a growing number of investors are becoming aware of these instruments and making use of them.

Understanding the impact of regulation, however, is vital. Bank regulation has increased the cost of capital associated with loans and forced many banks to significantly reduce their balance sheets and increase the core capital they hold as insurance against losses. The result has been a banking sector with a waning appetite for holding loans.

Yet loans remain a popular financing tool for many borrowers and ensuring access to them has therefore become a politically sensitive issue. This has created a great paradox in the political debate of the day: politicians that have called for smaller and less risky banks, nevertheless they want to ensure borrowers – especially SMEs – retain access to credit.

The gradual retreat of banks from the loans market has left a vacuum that non-bank financial institutions have been eager to step into in their hunt for yield. With rates having been depressed across the western world for so long, investors have been increasingly emboldened to search for new investment opportunities.

This is a global phenomenon. There has been much talk of US rate rises in 2015, but nobody knows exactly when they will begin. Any sign of adversity on the horizon could spell further delays and when they do start to rise it will take a long time before they reach their long term average, let alone move above that level.

In Europe, while QE is not directly good news for illiquid assets, given their exclusion from the asset purchase program, the announcement does at least confirm low rates will persist for the foreseeable future.

This should continue to encourage investors into higher yielding instruments, to take on more leverage, which may not appeal to those who were caught out when the last financial crisis hit; or to investing in less liquid assets in order to reap the illiquidity premium.

THE NEW BREED OF ILLIQUID INVESTORS

The void left by the retreating banks has been filled by a number of different types of investors. Perhaps the most notable of these have been the large institutional investors, such as life insurance companies and pension funds. These institutions have the cash available to make such allocations, and the long-dated liabilities that are well matched by such long-dated assets.

Unlike fund managers or private investors, these institutions do not need their portfolios to be liquid to ensure they can quickly meet redemptions or free up cash for other purposes. More important is maximizing the yield paid on their investments and ensuring attractive risk adjusted returns. Illiquid assets often fulfil these criteria better than other investments.

Alongside the large institutional investors, hedge funds and credit managers have become particularly active as alternative lenders in the illiquid markets. Among the most sophisticated players, they have been quick to identify the significant opportunities these assets present. Decisive and cash-rich, their willingness to put capital on the table has helped many corporates raise capital while generating higher returns for themselves.

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Hedge funds may be at a disadvantage to the larger institutional players in some of the biggest and most capital intensive deals. Few have the vast reserves of capital required to finance, for example, an infrastructure project. But many have found ways around this. Their extensive connections and ability to source capital have enabled them to raise large sums of capital in tranches ready to be invested when opportunities arise, and their ability to provide mezzanine and unitranche financing solutions may afford borrowers additional flexibility and leverage. They can also be more nimble, finding it easier to take investment decisions quickly. There are advantages on both sides, and given the breadth of illiquid investment opportunities there is plenty of room for everyone.

Such financing deals were harder to arrange in the period straight after the financial crisis but are now making a comeback. Politicians have come to realize that they can play a role in reviving the loan market, particularly for mortgages, but also for credit cards, car loans and SME lending. They are again talking about the role ABS, CMBS and RMBS can play in boosting lending and revising the economy. In Europe, groups like AFME have developed new rules and codes of best practice to restore confidence among investors, and Prime Collateralized Securities (PCS) have set standards for 'prime' securities that regulators are acknowledging. In the US, the Structured Finance Industry Group (SFIG) have been driving the RMBS 3.0 initiative to develop proposed standards and define market practices for that asset class.

Accordingly, investors are once again considering structured products, whose record speaks for itself. Rating migration of Triple A rated European RMBS is very low and defaults are unheard of. The default rate on CLO notes is also well below equivalently rated corporate bonds, with CLO AAA and AA notes never having suffered a default (Source: LSTA). Such instruments offer diversification in a portfolio of bonds and loans and are naturally diversified within the asset pool by nature of their design.

However, for some institutional investors the regulatory treatment of these securities can be prohibitive, while for others, such as UCITS funds, there may be restrictions limiting their ability to directly hold certain forms of illiquid securities, i.e., bank loans. So as an investment proposition, for many institutions it makes more sense to lend directly.

Providing loans in an illiquid format on an unlevered basis offers an enhanced yield relative to the bonds on offer in today's market. But this is not the only appeal. Investors also see illiquids as a diversification play – and with good justification. There are many types of illiquid assets to choose from, each with a very different set of characteristics. What they have in common is the offer of a very different kind of exposure, with a very different returns profile, to the stocks and public bonds that dominate most investment portfolios.

WHAT ACTUALLY ARE ILLIQUID ASSETS?

Illiquid asset markets by definition receive less attention from investors than the more liquid markets of stocks and bonds, and are considerably less well understood.

The term comprises a broad stable of assets, including leveraged finance loans, real estate lending and infrastructure finance, SME loans (direct lending) and private placement note/loan issues.

An illiquid asset does not have a convenient secondary market allowing investors to quickly sell it for cash. It may be highly bespoke, (i.e. no standardization of documentation or commercial terms), having been created according to a certain set of specifications stipulated by the investor, as is often the case for over the counter (OTC) derivatives. Or the asset may be a one off with no exact comparables in the market, such as infrastructure debt.

There are as many differences between illiquid assets as there are similarities. They are rarely spoken of under an all-encompassing umbrella because the risk profile, credit stories and institutions involved, and the business practices between different types of illiquid assets, can be very different.

Each of these asset classes is populated by an almost entirely different set of institutions, with very few active in all of them. The few big institutions that do invest across them manage those investments separately, with different teams analyzing the deals. Each has its own sectoral, legal, and jurisdictional nuances that require expertise. Each is subject to its own risk factors and each requires a very different set of skills in order to succeed.

But these assets also share important characteristics. Expertise in one area can be invaluable in better understanding and managing exposures across the spectrum from an administrative perspective. In most cases the underlying asset will be a loan, usually in the form of an OTC transaction, paying a premium to the lender, which for certain types tend to be held to maturity.

Certain illiquid assets may be correlated to indices such as GDP, Euribor and Libor which provide a natural hedge against future interest rate rises and/or inflation risk. While that has been a remote concern for most investors in the US and Europe in recent times, it may become a more pressing issue again in coming years – especially if the ECB's recently announced QE program has the desired result.

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MAIN TYPES OF ILLIQUID ASSETS AVAILABLE:

LEVERAGED FINANCE

This constitutes the most widely available illiquid asset in the market. Its popularity among investors has increased steadily for many years as demand for capital outstripped supply.

In Europe, before the financial crisis, this game was dominated by the banks, which were happy to provide loans, particularly as they were seen as a good way of broadening relationships with corporate borrowers. Larger loans were syndicated between large groups of banks, each of which was happy to hold that risk on its own balance sheet, earning good revenue streams and ensuring an ongoing relationship with the borrower.

However, in the last five years new regulations relating to capital adequacy for financial institutions have made it increasingly difficult for banks to hold risk on their own balance sheets. Demand for loans remained high, but banks' ability to provide them has been curtailed.

The solution has been for banks to sell loans on to other investors, or for other investors to lend directly, cutting out the middle man. These institutions are not subject to the same regulations demanding core capital be held in liquid instruments.

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PRIVATE PLACEMENTS

These can be an attractive option for smaller borrowers as an alternative to the bank market. Where banks do still offer loans to clients they are often used as a way to win ancillary business, and augment share of the borrowers "wallet", on the understanding that the bank that extends the loan will also be considered favorably in other business opportunities. As such, it is typically the very largest and most sought-after clients that have access to the syndicated bank market.

For those outside that top echelon of borrowers, and for those with no rating, precluding them from a capital markets solution, the private placement is fast becoming the first port of call. The market has been an important part of the financing landscape in the US for years, but is relatively new in Europe – although European borrowers have been no strangers to the very international US market.

Today, Europe's embryonic, yet thriving, private placement market is positioning itself as an option for a growing number of SMEs or unrated companies without access to bank loans, despite having brands that are well known among European investors. But one day, the European market may compete with its US counterpart for the largest international borrowers.

REAL ESTATE LENDING

This lending, either for the purchase or building of real estate, is illiquid because it can be time-consuming selling such assets and the market can be relatively volatile. Real estate lending often involves syndicates of lenders, in much the same way banks have traditionally formed lending syndicates to make large corporate loans.

This has given rise to the emergence of real estate investing via fund-style structures, usually domiciled in Luxembourg, Ireland or Germany and the Channel Islands in EMEA, or outside of this in Cayman or Delaware. Such structures spread counterparty risk among a number of borrowers to reduce the exposure of any one entity, and to maximize the amount that can be lent.

Investors also take exposure to real estate via managed account platforms, which allow big originators of real estate assets to invest on behalf of their clients.

INFRASTRUCTURE FINANCE

This looks set to be one of the real growth areas of finance in coming years. The world has massive infrastructure requirements over the coming decades, yet governments all over the world are desperate to cut back on their own expenditure and reduce their deficits and the overall size of the state.

This poses a number of challenges. If governments are unwilling or unable to pay for infrastructure investment, the capital to finance it must be found elsewhere, this means attracting private capital.

Meanwhile, banks are also likely to reduce their involvement with huge infrastructure projects. The costs are prohibitively large, while repayment comes over a long period. This is incompatible with the banking sector that post-crisis regulations are creating.

This creates an opportunity for those institutional investors with long-dated liabilities – again, the pension funds and life insurance companies. These institutions have the resources to provide the large outlays of cash required for infrastructure finance, and for which repayment schedules extending out for decades are not only acceptable, but positively desirable.

The potential partnership between institutional investors with long-dated liabilities and huge, capital intensive infrastructure projects with modest but stable and long-term revenue streams has long been recognized, but has been slow to flourish. Despite being a perfect match on paper, there are considerable challenges in making the pairing work.

Perhaps the most problematic of these is the considerable risk associated with early stage infrastructure financing. Such projects are notoriously prone to cancellation, delays and cost overruns, making financing them a daunting prospect, especially for those without the experience and resources to properly assess them. However, regulators, politicians and financiers understand it is vital to find solutions to these challenges. The answer may lie in a hybrid solution, with banks providing the shorter term and higher risk financing in the construction phase, with institutional investors stepping in once the project is operational.

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BNY MELLON'S ROLE IN FACILITATING THESE TRANSACTIONS FOR CLIENTS

BNY Mellon has been at the forefront of solutions for illiquid assets for over 20 years. It provides clients with verified, independent and enriched financial data that is essential to those who invest in these asset classes. It leverages its global footprint in a similar way it does for its Global Custody clients. However, in addition to the typical asset administration and fund/SPV administration, it also provides the specialist services of loan closing, facility agent, tax administration and enhanced reporting that is invaluable to large and small clients alike.

This long history was founded in the CDO/CLO space. But when the crisis hit in 2007 the business quickly diversified to support new fund structure types, such as regulated and un-regulated funds, and Separately Managed Account (SMA) platforms that enabled investors to continue to gain exposure to such underlying assets, as well as working with the Investment Management community to find the appropriate products to meet their investment and yield objectives. Today BNY Mellon has over 1,000 vehicles (in excess of $300bn AUA) that it provides administration to across both regulated and unregulated platforms, in a wide array of jurisdictions, including those domiciled in Ireland, Luxembourg, or Cayman, and separately managed accounts (SMA's). Its largest clients outsource the administration of illiquid assets and have this delivered across the entire global platform, which enables a single desk to deliver a large single commitment into over 40 accounts.

To understand the services provided and the benefit of partnering with a global leader, the key is to understand the challenges of the asset classes involved. The illiquid assets described in this article are predominantly traded and settled OTC. The register of the investors in each security or loan is held by a network of over 300 agent banks around the world, often based in the jurisdiction of the borrower. Consequently there is a huge variance in the type of technology used and the format and availability of information from one asset type to another and from one agent bank to another.

To transform the data from these institutions into verified, independent data that can be relied upon, BNY Mellon meticulously models all assets from the underlying credit agreement for the instrument and creates a 'Security Master' on a global platform. This is then used to reconcile daily to the Agent Bank notices and the cash received. BNY Mellon processes around 70,000 notices every month and around 150,000 at the end of each quarter on behalf of its clients.

PRICING, A HOT TOPIC FOR ILLIQUID ASSETS

Pricing is a particularly hot topic for illiquid instruments. The lack of a secondary market in which such assets can be traded makes them very hard to price, presenting certain accounting challenges. It may not be possible to mark-to-market, if there effectively is no market.

Even if there is, extreme illiquidity can cause an unacceptable level of volatility in the value of the portfolio on a mark-to-market basis. It may not make sense to account for them in this way if a product is to be held for a period of years, during which time the investor has no intention of selling. Instead, such instruments need to be accounted for differently. Sometimes their price can be devised using a model, which can smooth out market volatility, or sometimes a quasi-market benchmark makes more sense.

In the regulated fund environment, via which many investors take exposure to illiquid asset classes, issuers are required to obtain prices from at least two independent sources which arrive at the same value, within certain tolerances. There are no universally agreed upon sources for this pricing data, which may be provided by models from audit firms or technology vendors, or via benchmarks to more liquid and historically comparable asset classes.

Which option is selected is often determined in large part by the jurisdiction in which the deal is taking place, and by the nature of the asset in question. A large infrastructure project is likely to come with some kind of government guarantee and its fortunes are likely to be closely linked with those of the sovereign of domicile, making a sovereign benchmark an appropriate choice, for example.

The important thing is that the pricing policy is stated clearly in the offering documents so that all sides of the transaction are clear what the process is and know what to expect. In this, and all other aspects of its clients' business, BNY Mellon stands ready to offer its many years of experience in managing and administering illiquid assets.

Whilst size, scale and global footprint are very important in the business, the true value is in the people who administer these deals at BNY Mellon. It has over 500 professionals around the world working on these structures, who need not only a deep understanding of the asset classes and the intricacies of the market, but of clients' investment vehicle structures. This results in a deeper appreciation of the hard lessons that have been learned over the years.

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