What changed post-crisis?

► What are institutional investors looking for when they make indirect investments through funds or securitisation vehicles?

Text Christian Behring — Illustration Stina Fisch

In its early days the fund industry catered almost exclusively to retail investors. These were predominantly individuals looking for higher yielding alternatives to the traditional savings products offered by their banks. Expectations towards product development were relatively low and the challenges of a successful distribution effort were well understood.

During the last 20 to 25 years the industry saw institutional investors, such as insurance companies, public and private pension funds and even banks, emerge as a new and rapidly growing client group. This group, however, is not homogenous and their driving motivation to invest indirectly (through funds or securitisation vehicles) rather than directly has shifted over time and become ever more complex.

INVESTOR CONSIDERATIONS

Operational aspects are important, besides tax (e.g., the treatment of interest vs. capital gains) and accounting considerations (e.g., consolidation rules and different jurisdictional GAAP standards). The investor needs to assess whether there is a capacity to service and monitor the investments in-house or if it is more efficient to outsource these, especially in the case of more complex and illiquid assets; he would then need to compare the costs of the different solutions.

Meanwhile, an external solution will have to ensure that the same reporting standards the investor would utilise for his in-house investments are met. In the case of more complex and illiquid asset classes, outsourcing can be the only way for investors to get access to this asset class, and thus to diversify their investment portfolio. This is particularly true for smaller entities operating within the framework of a larger group, which may gain access to pooled investments through an external vehicle.

Finally, regulatory aspects also have an effect in the decision-making process of institutional investors. This is so because these rules can prohibit the direct holding of certain asset types. Hence, in order to make said assets permissible, a repackaging of these may be necessary (e.g., insurance companies investing into corporate loans either through securitisation or fund vehicles).

POST-FINANCIAL CRISIS

The trend towards indirect investments by institutional investors gained momentum in the last ten years up until the global financial crisis of 2008 and 2009. Since then, prominent cases like the Madoff scandal, the bankruptcy of Lehman Brothers, and the gating and liquidation of many hedge funds have all heightened the investors' focus on certain aspects concerning ("meaningful") risk management, valuation policies, fund governance and asset protection. As a consequence, institutional investors have begun to scrutinise not only the key portfolio manager involved with a fund or securitisation product, but also the supporting control mechanism, as well as the operational and risk management infrastructure which must take into account risks stemming from fraud, counterparty and liquidity risk. Investors increasingly demand that qualified directors represent their interests on the boards of investment vehicles, making sure to adhere to proper conflict of interest policies. Moreover, the jurisdiction in which a fund or securitisation vehicle is incorporated matters more and more - both from a sovereign credit risk perspective, as well as pertaining to the limitations imposed by the jurisdictional tax, legal and judicial system. Not surprisingly, there has been a growing preference for onshore jurisdictions rather than offshore ones. However it is noteworthy that not all onshore jurisdictions are created equal.

Over the course of the past years, many factors were thought to have caused the financial crisis; in our view, the trend towards indirect investments, particularly in illiquid product categories such as real estate, mortgages and corporate loans in conjunction with implicit short-term leverages, are common denominators worth emphasising.

Further to the above, the central pillars of new financial regulations, which are being rolled out today as a direct response to the crisis, seem to support this view. Both in the US and Europe, the principal goal is to ban, limit or further regulate indirect investments by institutional investors, with an emphasis on banks and insurance companies.

One of the central themes of the new set of regulations, commonly know as the "Volker rule", is to prohibit US banks from investing in "funds" whose definition is sufficiently broad to include hedge funds, private equity funds,

"The underlying trend has not only remained intact but has in fact continued to grow strongly through the crisis."

Christian Behring
Partner, Behring, Khan & Co.

as well as certain securitisations such as collateralised loan obligations.
The European legislator's core mission, expressed through the Alternative Investment Fund Managers Directive, has been to extend the scope of a mutual fund type of regulation to all types of funds that are primarily sold to institutional investors, regardless of their specific structure or underlying asset class. AIFMD key concepts, such as the requirement for risk retention for securitisation investments or the appointment of a depository, are directly aimed to remedy conflicts of interest and the potential of fraud, something that less transparent and complex indirect investment structures inherently are more prone to than simple direct investments.
Other regulatory "innovations" such as EMIR, FATCA and Solvency II, amongst others, either contain new reporting and transparency rules to fund and securitisation rules or extend existing rules for the first time to all types of investment vehicles.
Interestingly enough, while these developments are reshaping in many aspects the ways in which institutional investors invest indirectly, the underlying trend has not only remained intact but has in fact continued to grow strongly through the crisis.
In recent years, both in Europe and the US, closed-ended fund structures have seen an exponential growth and are increasingly expected to fill the funding gap that is left behind by post-crisis undercapitalised or still deleveraging banks. Additionally, as Europe still considers the securitisation market as one of the principal villains of the crisis, running off asset backed securities and CLO structures are being replaced with regulated loan funds. In times of zero interest rates, and in search of earning a complexity and illiquidity premium, there will remain an unbroken institutional demand for the underlying assets of these structures.

CONCLUSION

The continuing growth and demand for indirect investment opportunities, combined with the regulatory tsunami that is engulfing the fund industry's participants (including its investors), sets very high standards for an effective product development and successful distribution effort.
Professionals involved in these activities not only need to understand the multi-faceted requirements and objectives of the investor universe, but they must also have, at a very minimum, a general knowledge about the market, operational, regulatory, tax, accounting and reporting requirements. ◄