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BNP PARIBAS
ASSET MANAGEMENT

CHAIR

NEIL HOLMES
Director, Client Consulting UK & Ireland

Neil joined bfinance in early 2018 to focus on the insurance market. He has has a long career in the banking and asset management industries, including 20 years covering insurance clients. Neil has also worked for Conning Asset Management, Credit Agricole Corporate and Investment Bank, Fortis Bank and Barclays.

PHILIPPE DELOFFRE
Head of Real Estate Debt, BNP Paribas Asset Management

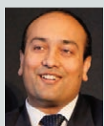
Philippe is head of real estate debt in the alternative debt management team. He joined in March 2017 from Acofi, where he was head of CRE debt funds. Previously he worked at CBRE, where he set up the debt advisory business for France. He began his career at a structured finance banker for Commerzbank and then for ABN Amro.

KAREN AZOULAY
Head of Infrastructure Debt, BNP Paribas Asset Management

Karen is responsible for the infrastructure debt division in the alternative debt management team. She joined the firm in April 2017 from SCOR Investment Partners, where she was infrastructure manager from 2012 and developed the infrastructure debt strategy. She has also worked at Dexia in project finance.

RUSSELL LEE
Head of Client Solutions, Legal and General Retirement

Russell's team leads on product innovation as well as tailoring solutions to specific client needs. They work with pension scheme sponsors, trustees, and other insurers who wish to remove or reduce pension risk from their balance sheets. He has led a number of landmark transactions and has worked in structured finance and banking.



PRASUN MATHUR
Head of Shareholder Investments, UK & Ireland, Aviva

Prasun joined Aviva in October 2016 where is responsible for leading on the development and execution og investment strategy for the UK life shareholder business - this includes the £57 billion (and growing) annuity bank. Prior to joining Aviva, he headed up ALM strategy for Phoenix and has also worked for HSBC.

GARETH SUTCLIFFE
UK lead investment advisory team, EY

Gareth is the UK lead for EY's investment advisory team, which advises financial institutions and asset managers. Gareth has 17 years of experience across private equity, consultancy and insurance investment strategy and treasury. In addition, he also has a wealth of experience in a number of illiquid asset classes.

PRIVATE DEBT FOR INSURERS

CHAIR: What are the challenges faced by insurers in the private debt market? My company bfinance is seeing more and more interest in private debt as an asset class, as insurers are looking for opportunities for extra yield and diversification. In order for it to be properly executed, does this require strong expertise, and as asset managers and insurers, how are you tackling that?

LEE: I think the short answer is yes it does require strong expertise. You require that extra knowledge in order for your regulator to actually allow you to invest in those assets. Yes, you can have an outsourced model, but the assets are hard to come by, and so it feels like there is a need to have an in-sourced, in-house knowledge of these asset classes. But it's not just about the traditional asset management approach. It is also about understanding the way that the capital works for these deals particularly around pre-payment risk and all the technical details. Also I think it is about the sell-structuring capability, the ability to work early in the process and not just being an end-taker. It makes a big difference if it's a triple-B or single-A asset under firms' internal models, for example.

CHAIR: For an ideal in-house team, what sort of people are you looking to recruit?

LEE: I guess a bit of everything. People who have got a background in securitisation are useful. Also people who have worked in banking, and who know about the origination of the assets. Then it is about having the people who have got the technical knowledge around the asset class, because you don't want to lose sight of the economics around if it is a good deal or if it is a bad deal.

MATHUR: I think private debt is the flavour of the day. There are a lot of economics to be delivered on the public debt side, and we're working on that as well. Private debt is increasingly a focus for the regulator. The asset manager can only be liable for the investments they make on our behalf from a financial conduct perspective. The asset owner is ultimately responsible from a Prudent Person Principle (PPP) perspective. We need to clearly demonstrate our ability to collectively (across asset manager and owner) manage the asset from a downside risk perspective (including internal ratings, workout, etc). There is a strong requirement for us to build capability to ensure that credit underwriting is happening appropriately by the asset owner. Further, we're always on the hunt for interesting opportunities to diversify through deepening existing capability or newer markets. We spend a lot of time enabling these opportunities.

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CHAIR: So, it sounds like you're using a mix of building up an internal team as well as still using external expertise as and when you find it?

MATHUR: Yes. So, I think we have to, because in order to invest in a private debt asset, you need to start out with the origination expertise, and the necessary contacts to be able to generate those opportunities. Then, once you've acquired the assets, one needs ongoing capability to manage the asset over a long duration, which could be 50 years or even longer in a lot of instances. That requires good infrastructure to be build. You really need to know where your resource constraints are, and delegate responsibilities across asset owners and managers accordingly.

CHAIR: So, if I can turn to the asset management side, Karen, how have you found your interaction with insurers? Are you finding that they are making you work harder in terms of helping them originate, manage, and also understand the asset?

AZOULAY: I would say that, compared to a few years ago, insurers are now very well-educated on the private debt market. Having said that, they clearly understand that to be able to invest directly they need to have the internal capabilities to deeply understand the asset class and the overall risk. There needs to be a team able to originate transactions, and then assess the underlying credit quality of each asset, with processes in place in order to monitor transactions. This clearly means a lot of resources are needed internally, which is why, for insurers, they often find it appropriate to outsource this externally.

CHAIR: So, you need access to quality assets, and we've concluded that you're going to probably need assistance in that until you build up your own capabilities. But I get the feeling there's always going to be a need for a bit of assistance.

LEE: The UK is a limited market and very property-dominated. We like

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property but there is a concentration risk. And as the opportunity set here on the annuity side is £2 trillion-worth of liabilities, most of which are probably going to end up with insurers, that's an awful lot of money to be invested if the allocation to illiquid assets is close to even 50 per cent of that. It might be more, and that's a huge amount of lending. If you don't have the asset management capabilities there, it takes a long, long time to build it.

CHAIR: How do L&G go and source assets? From a current market perspective, are there very attractive assets out there, or are they not so attractive anymore? What's your current view on sourcing them and making sure they're the right assets for you?

LEE: There are still some very attractive assets out there and it is still essential to make the price work. Have yields and spreads come in this year? Yes, they have, even while the liquid markets have been going a little bit wider, the illiquid credits have been coming in a bit tighter. You have more and more competition for those assets, and probably no let-up in that because pension schemes, the large ones in particular, are looking to allocate in that asset class. Soon, everyone will be competing in the UK for the same asset classes.

CHAIR: Prasun, are you getting pressure from above, shall we say, to invest in assets like private debt as well?

MATHUR: I don't think pressure is the right word. I'd say that the business case for going into private assets is very strong, and so there is a desire for us to go for such assets instead of a push from above. I think we are reasonably well-agreed that it's a very important part of the investment strategy to go into private assets for multiple reasons - security being one of them and being rewarded for the illiquidity premium the other. I think there are two sides of the balance sheet, the capital side and the return side, and these private debt assets actually support you on both sides of the balance sheet. They typically have a lower capital requirement, and they typically offer a higher return for it as compared to public debt assets. From just a risk-return perspective, because of that double whammy, it makes a compelling case as long as the credit underwriting is good. In theory, even if the illiquidity premium is not there, the risk-adjusted return may still be. That's what is attracting a lot of cheap money in these assets. Reporting metrics incentivise you differently. IFRS, more focused on the best estimate risk-adjusted return, whilst Solvency II metrics that bring in 1 in 200 risks into the equation. Subject to credit underwriting, investment decisions are usually a question of what metric the organisation is more focused on.

SUTCLIFFE: I think, for listed firms where you're effectively promising the market a certain amount of IFRS return in dividend, then if you promise that it will go up next year, the escalator of dividends, then you've got to get that return from somewhere. The asset side is one of those places.

CHAIR: From the asset management side, there has been a drive to source new assets which will see a greater

demand over supply. How is that developing? Concerning infrastructure, there has always been a feeling that there's a small supply relative to demand. Are you having to cast your search further afield? How are you helping the insurers?

AZOULAY: We know there is an illiquidity premium between 100bps to 150bps depending on the credit cycle. We see our role as optimising the relative value on a transaction basis. We create value on the debt side by choosing the transaction that would offer the best relative value. We have a proactive sourcing through our existing network, thanks to the track record we have had for many years in the market, and through the relationships we have with banks, financial and industrial sponsors and financial advisers. It is also about having structural capabilities in the team in order to be able to better assess the credit quality of the transaction and have an influence on the terms. When you combine the geography, the sector, the contractual and regulatory frameworks, and which financial structure you would expect from a specific type of transaction, then you can optimise relative value on a transaction basis.

CHAIR: But, at what stage are you engaging the insurance company to understand the limitations on what they can invest in depending on structure and capital?

AZOULAY: The insurance companies that invest through a fund have to share the same investment guidelines. Some insurance companies might be willing to invest with very specific investment criteria in terms of underlying risk, geographies or sectors. The benefit of being part of a private debt platform is that we are able to provide tailor-made solutions for each investor that may have specific needs.

CHAIR: Russell, at what stage are you looking to be engaged? Or, are you finding that those who are sourcing assets for you are much more mindful of your potential needs?

LEE: It's a balance, isn't it? So, you have a limited team working within the insurance company, looking at the opportunity.. So, you need to have the right balance because, if everyone comes to you really early with a half-baked deal, then that's not a good use of your time. At the same time, if people don't engage you early, then you lose the opportunity to craft a deal structure that is optimal from an insurance perspective. So, I don't think it's an easy thing to answer. I think there's a need for insurers themselves to increase the number of people they have looking at these opportunities and who are engaging with the asset originators, because it feels that insurers can't have their cake and eat it.

CHAIR: Prasun, do you think the insurers now hold the whip hand, and are starting to move the dial? One of the other things I'm interested in is how Solvency II friendly they are? Do you feel that you have a particular set of circumstances, and can influence asset managers in finding appropriate assets? Or do you think it's just still early days, as Russell said?

MATHUR: We can certainly influence. I think one of the key drivers for our ability to influence is the size of the

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ticket that you can write, and that often is a barrier to entry as well. If you can write, let's say, a £250 million cheque for an infrastructure transaction, that carries a lot more weight than a £25 million ticket, and that opens more doors for you, especially in private debt. It can help you structure a deal.

Are we extracting the best risk return in a competitive market? I think we can do more to extract more value. One of the easiest examples that I have when it comes to extracting value is getting access to inflation. Take bulk purchase annuities as an example. A large proportion of the bulk purchase annuities market is inflation-linked. So, naturally, we have a strong desire to invest in inflation-linked assets, and if there are private credit assets in the UK that have revenues that are inflation-linked, we want them to structure debt that is sized to the inflation revenues that they have. This is where banks have not necessarily been as aligned as institutional investors, where banks typically try and structure deals as fixed liabilities coming out of the borrowing vehicle. They provide inflation swaps as a hedge for their revenue stream, whereas we are natural takers of that inflation-linked revenue stream. We always try and influence the quantum of the inflation linkage that comes out of the debt, because that, to us, is good credit risk management and for us, we are a natural home for those revenue streams.

DELOFFRE: Well, it's a two-way process. On one hand, considering the recent lending market as an example, you would probably see that the European market is not growing back. Opportunities are increasingly attractive as the banking system retrenches and seeks the support of institutional investors. One certainly can sense that Basel IV is already creating more room for alternative lending platforms. On the other hand, as the cycle is maturing and the opportunities for investors are changing, especially for those who are largely exposed to equity real estate in their home market. Are we seeing more buying pressure from alternative lenders, and how does that affect margins? Overall, my assessment is that the impact is quite limited. The European market, as it is a bank dominated market, has shown fewer signs of the buying pressure affecting loan risk metrics and returns. In the UK the competition is still moderate, despite a pick up since Q2 this year, and loan margins are under control. There are opportunities in both currencies, but my perception is that the insurance sector is not really willing to go ahead of the curve and take more risk in order to secure their investments. In that, institutions are aligned with traditional lenders.

LEE: One of the risks for insurers is just the cliff risk in terms of rating downgrades. It's all very well having attractive new triple-B yields, but you've much higher balance- sheet risk, because if it falls to double-B then your capital requirements increase significantly. That kind of risk makes insurers want more of a cushion before they invest. That's just really to do with Solvency II. It's very ratings-based.

AZOULAY: I think at least for infrastructure, my impression is that investors first began investing in this asset class as an alternative to

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government bonds with PPP-type of transactions. As they became more and more educated they began investing in more complex strategies, so taking more risk, but most of them still in a secure debt environment. Some of them may be willing, currently, to invest in mezzanine, but the market is still relatively small in terms of volume at this stage. Generally speaking, I would say that as the market is dominated by banks, the influence of institutional investors is still limited in terms of margins. However there are some sectors where institutional investors are bringing a lot of liquidity which is putting downward pressure on margins. The off-shore wind market is a good example. Back in 2012, very few investors were able to consider this sector in their investment strategy, however in today's market offshore wind transactions are being commoditised. As a consequence, their margins decreased by around 100bps to 150bps in 3 to 4 years. So, in some sectors, the large amount of liquidity coming from investors may indeed affect the price and margins.

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Solvency II

CHAIR: From a broader private market, private debt perspective, how Solvency II-friendly are the assets out there at the moment that you could potentially invest in? And if, under Solvency II, they're not fit for purpose and they don't truly reflect the risk, how is the regulator viewing this?

MATHUR: Up until 2015, before the advent of Solvency II, insurers were investing in assets that they felt were suitable to back the liabilities that they thought they had, and those assets had characteristics which were a lot more flexible as compared to post-2015 Solvency II era. Up until 2015, UK insurers spent a lot of time divesting assets that were not Solvency II-efficient. After 2015, the effort has been to get back into those assets again, in one shape or the other. It's basically recovering what you lost as a consequence of going into Solvency II, and getting back to the same playing field that you had pre-Solvency II. Insurers and financial engineers are always finding ways of structuring and securitising to make them Solvency II-efficient, and that's where that capability, that requirement from an insurance perspective, comes very much in handy as Russell was saying from a resourcing perspective. A clear example of that technology being put to work are the equity release mortgages that insurers have traditionally invested in. They were deemed to be Solvency II-inefficient, and the PRA supported structuring them and securitising them to make them Solvency II-efficient. Whilst it's not considered obvious to the PRA that you could use the same technology for other assets, there are examples of other MA inefficient asset classes that have gone through the same regulatory approval process successfully. If an asset feature is not efficient in the Solvency II space, then structuring them is a path that a lot of insurers are increasingly taking, with varying levels of success.

CHAIR: You're saying that you're having to adapt to the Solvency II regime, rather than getting the Solvency II outline to change? The second point, granted, takes a while.

MATHUR: Yes, but the ABI and other working parties engage with the regulators to influence the Solvency II outline as well.

CHAIR: Is the regulator looking to help the insurance world?

SUTCLIFFE: The regulators have changed the approach to infrastructure, and there is a review that the European regulators go through every two years around Solvency II and figure out if they might like to change it.

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They've also started going through a process of consulting and changing the rules around securitisation. Lots of financial services markets are interested in having a better-functioning securitisation market. I suppose it is a bit slow, but there is a gradual shift.

LEE: You have the PRA, and you have the insurers with their internal models. You have got a limited number of people in the insurers and a limited number of people in the PRA. Approaching the PRA and saying I'd like to change my internal model, that's quite a process in itself.

CHAIR: Are we seeing that the interest or the ability to structure some of the private debt assets is a good defensive mechanism against the risks in the cyclicality of the financial markets?

DELOFFRE: I think what's interesting about these assets is that basically the cycle component of the property debt is very much connected to property liquidity and banking liquidity, because of the medium-term nature of this type of debt. As a private debt instrument, real estate debt is uncorrelated to the financial markets and does not show volatility. Given that real estate senior debt is highly structured and monitored, and as it is backed by tangible assets with long term value, one can appreciate that it is immune to the cycles.

AZOULAY: I agree with that. Infrastructure is usually seen as resilient to economic cycles, and it's uncorrelated to traditional asset classes. This is due to the fact that those financings are structured in a standalone basis, taking into account defensive features. The favourable Solvency II capital treatment compared to corporate debt, is explained by the fact the debt is secured through an exhaustive security package and set of covenants. So, the structuring protects the asset class itself, and that's why it's resilient to economic cycles.

CHAIR: Prasun, are those some of the factors involved in the ultimate decision to invest in these particular assets?

MATHUR: Yes, to some extent. I think different private debt assets behave differently from cycle perspectives. Real estate behaves is more cyclical, whilst Infrastructure is less exposed to GDP cycles. The risk side is equally important - in fact, even more so from a credit cycle perspective. One could carry on investing in different assets as long as the underwriting criteria is not compromised.

ESG

CHAIR: Let's have a look at ESG. I think it's probably fair to say that ESG's becoming more mainstream within investment thinking and decision-making. In the private debt world how much ESG thinking is there? How are the asset classes adapting to ESG? I think the interesting bit for me is, is it E, is it S, or is it G that investors view as important? Are we seeing any innovations coming in to make assets more ESG-friendly within your particular sectors?

AZOULAY: We have the same approach within the private debt platform, and actually we have put a strong ESG policy in place. The first step is based on BNP Paribas' group exclusion policy, with specific sectors excluded such as coal or mining. We have taken this a step further by including ESG in the investment process, with an ESG assessment based on an internal taxonomy provided by our internal ESG team. A taxonomy is a sector mapping. So, on each sub-sector, we would have a certain level of due diligence specific on ESG, and that would be based on the due diligence package we have before investing in infrastructure debt assets. Then, the last step of this policy, going even more further down the road, consists in having mandated an independent expert who is able to assess the environmental and climate impact on the portfolio, and on each transaction.

DELOFFRE: Historically, real estate lenders used to rely on a property environmental survey. It was the responsibility of the property owner to make sure the remediation to pollution was financially covered during the loan life. Debt managers have changed this paradigm and gradually it has contributed to raise

awareness on sustainability and we ensure properties now comply with ESG principles. At BNPP AM we fulfil an ESG assessment in the same way we do credit and real estate assessments, with a view to capture the extra value out of property debt strategies. Our approach combines bespoke qualitative and quantitative requirements that go beyond the acceptance of a property environmental label such as BREEAM, or the property benchmarks such as GRESB. The good news is that there is gradually a consensus that ESG is creating value to property owners, occupiers and lenders. Our mission is to give investors access to this benefit.

CHAIR: So, from an investor point of view, Russell, I'm assuming you have strong ESG policies in place?

LEE: We do. If you look at Legal and General overall, and the way we deploy our shareholders' funds through Legal and General Capital into things like under-supply of UK housing or urban regeneration, there's a strong social ethos there around deploying capital. We want to do good in local communities. At the same time, you're delivering value for your shareholders. That's very much a part of the ethos. Then, in terms of the environmental side, you want those houses to be built to the most efficient, highest possible standard. So, there's the lending opportunity, but also the question of who are the people coming into these houses? Is it later living? Is it someone who's already a policyholder and a customer of ours? You have to think about all sides of the experience.

CHAIR: I suppose the interesting thing with ESG is that it was often conducted on an exclusion basis. Now, we also have investors interested in impact investing.

MATHUR: We think ESG is really important. We've done a lot of work together with Aviva Investors. Aviva Investors has been one of the leaders in thinking about ESG broadly, and not necessarily just in private markets. There are so many angles to this. One is the regulatory aspect of it, where the regulators are trying to come up with a consistent framework that it can deploy industry-wide, for demonstrating ESG in your investments. That's much-needed. What's missing right now is a consistent framework. That ESG data needs to be captured when you actually invest in assets. The second area is how ESG fits in from a fixed-income perspective? A lot of research on ESG has been done purely from an equity perspective. How fixed-income players do the ESG assessment and influence when actually investing is quite important. We encourage more research on this subject. The research does suggest that E, S, and G, all three, contribute differently in fixed income. You may have negative screening for, say, E and S, but a lot of positive screening for the G, as an example.

SUTCLIFFE: I think there's clearly a groundswell of opinion that sees this as a very positive in all sorts of areas, but how does it manifest itself? A framework may be the best way to at least benchmark it, for want of a better phrase.

DELOFFRE: From a fixed-income perspective it has probably taken seven to 10 years to get the ESG initiative to come to a quite standardised and assessable framework that benefits investors. I believe that in private debt we may revisit the question in just a few years.

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