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Private Credit – Overvalued or value creator?

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25th September 2019

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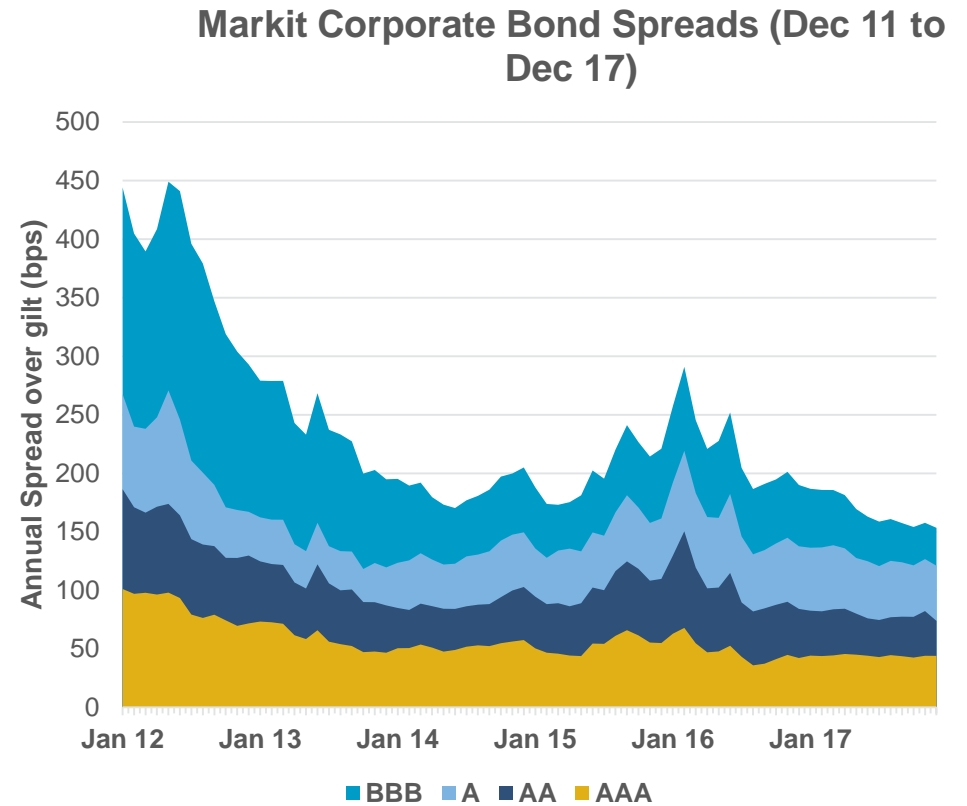
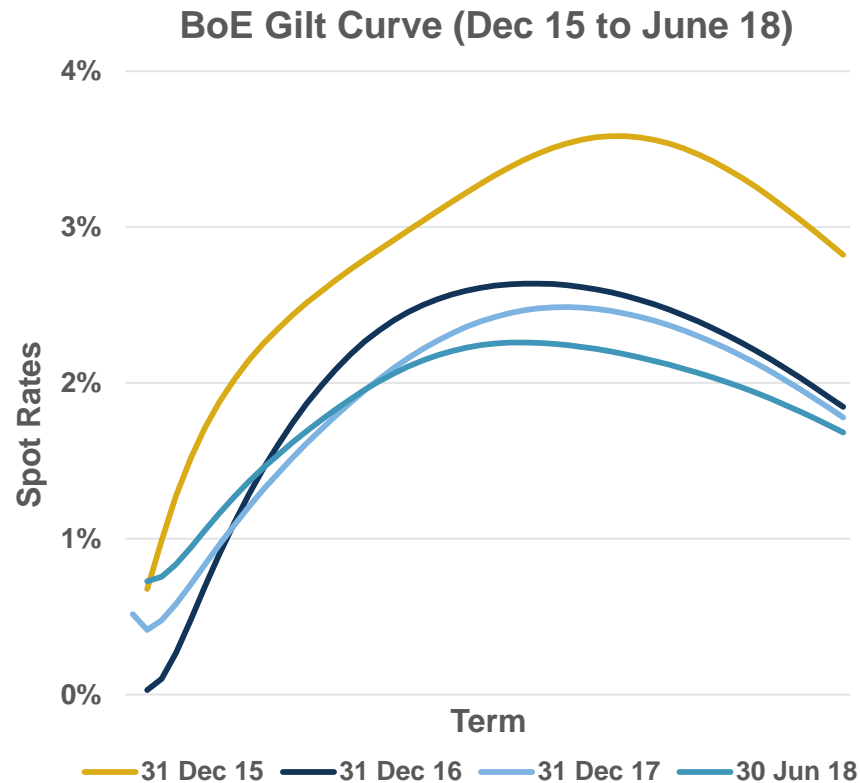
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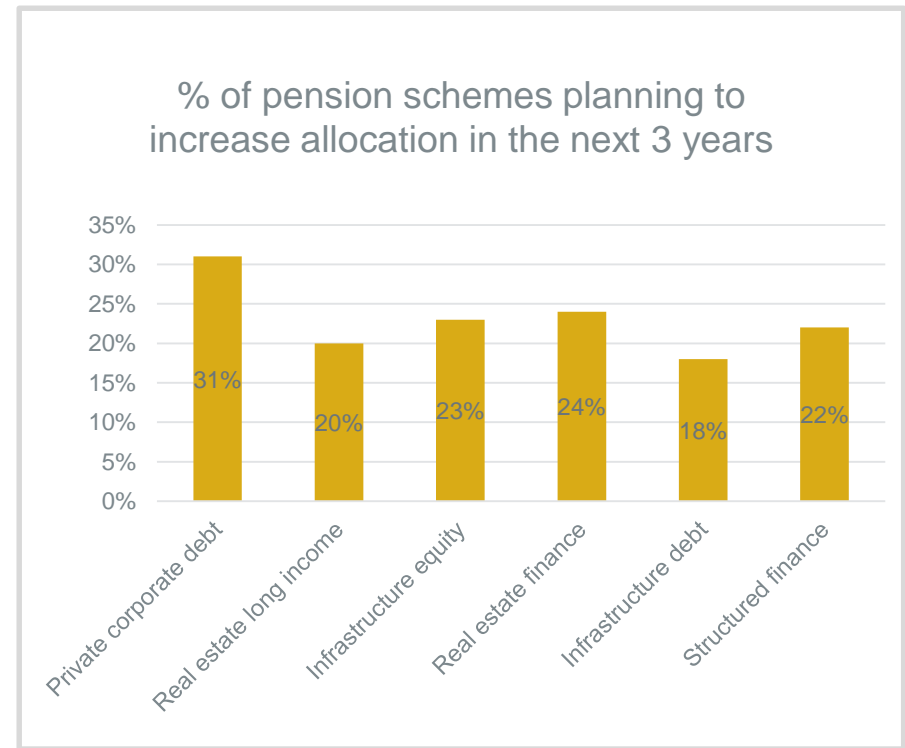
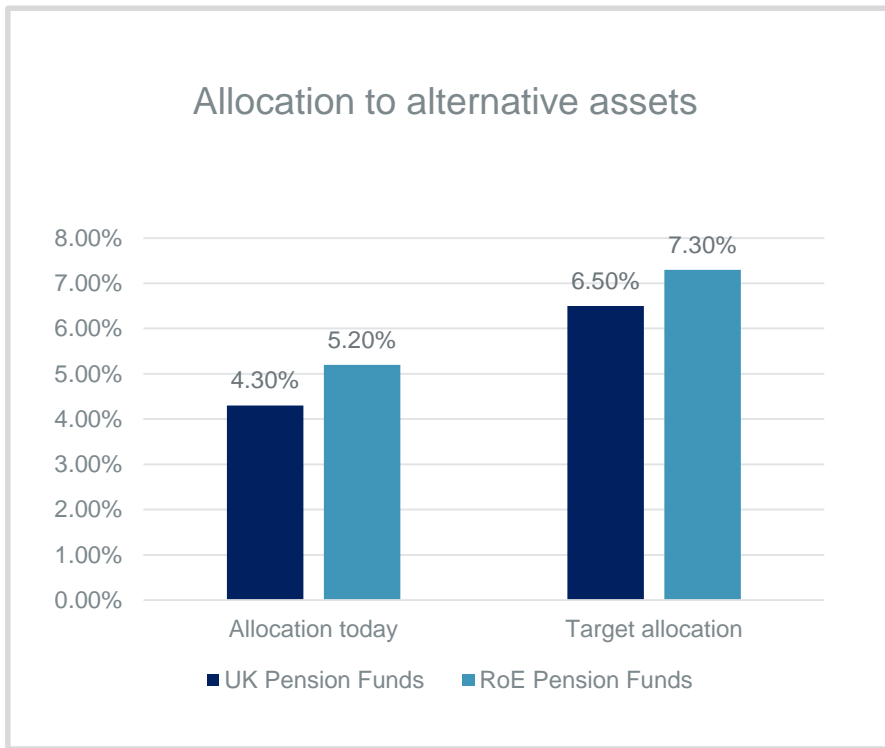


Introduction

Long term yields fall further and credit spreads stay low...



...so pension providers broaden their horizons



Source: Aviva Alternative Income Study 2018

The scale of the illiquid asset opportunity..

Suffolk Pension Scheme invests £60m in greenfield infrastructure.

The M&S Scheme, British Coal Staff Superannuation Scheme and the Mineworkers Pension Scheme have each invested in solar assets via Greencoat.

CoE Pensions Scheme has said it plans to invest 20% of it's £2bn return-seeking pool in infrastructure assets.

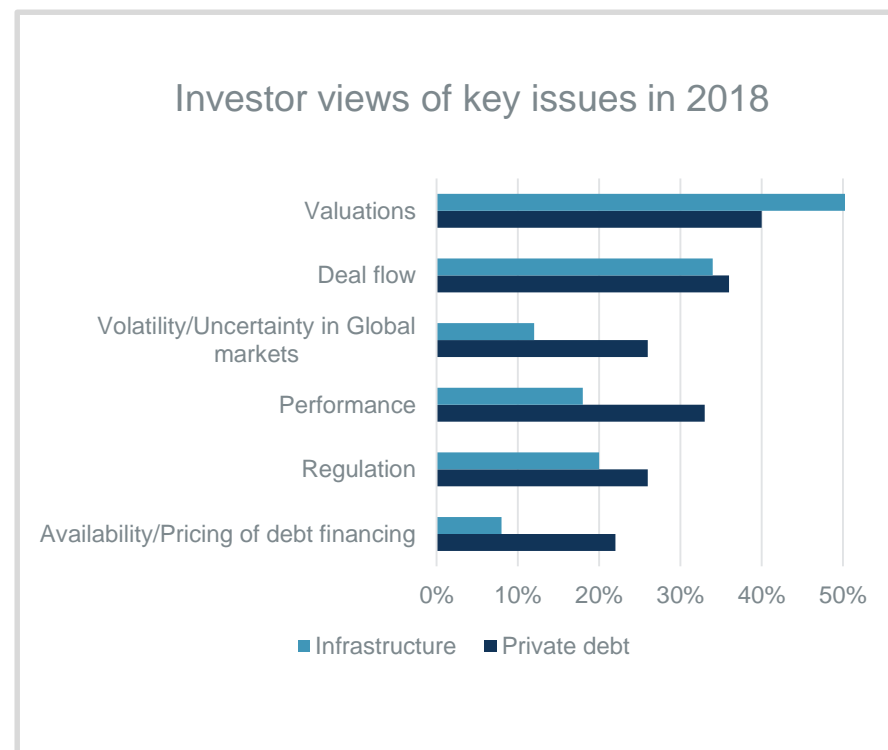
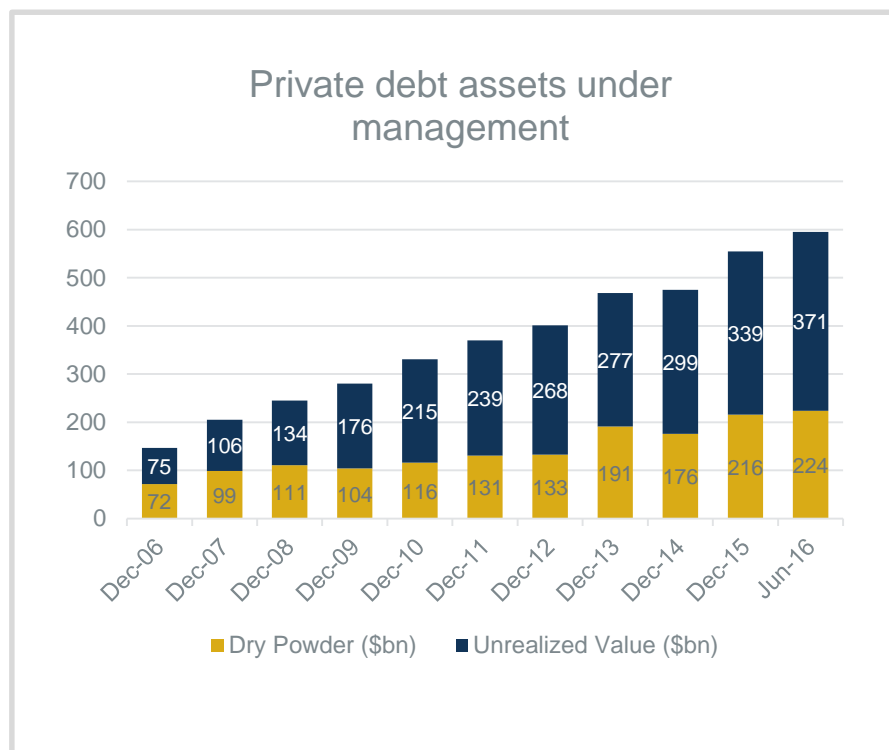
Lambeth Council Pension Scheme has invested £42m in build-to-rent projects.

NEST is challenging the asset management industry to innovate in order improve DC schemes' access to private credit.



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The flood of capital into private credit has driven down returns



Source: Preqin



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But are they diving in too fast?

“Pension trustees may have different reasons to want to gain exposure to illiquid assets.”

“Where trustees [are considering] changing their scheme’s investment strategy to include assets with less liquidity, [trustees should] make sure they have the necessary skills, expertise and appropriate governance arrangements for the complexity of their scheme’s investments, so the risks are properly managed.”

tPR has also committed to provide further guidance on..

“how trustees’ investment strategy can include assets with long-term investment horizons, such as venture capital, infrastructure and other illiquid assets in a diverse portfolio.”

[Source – “Pension funds and liquidity” – The Pensions Regulator blog]



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Potential opportunities

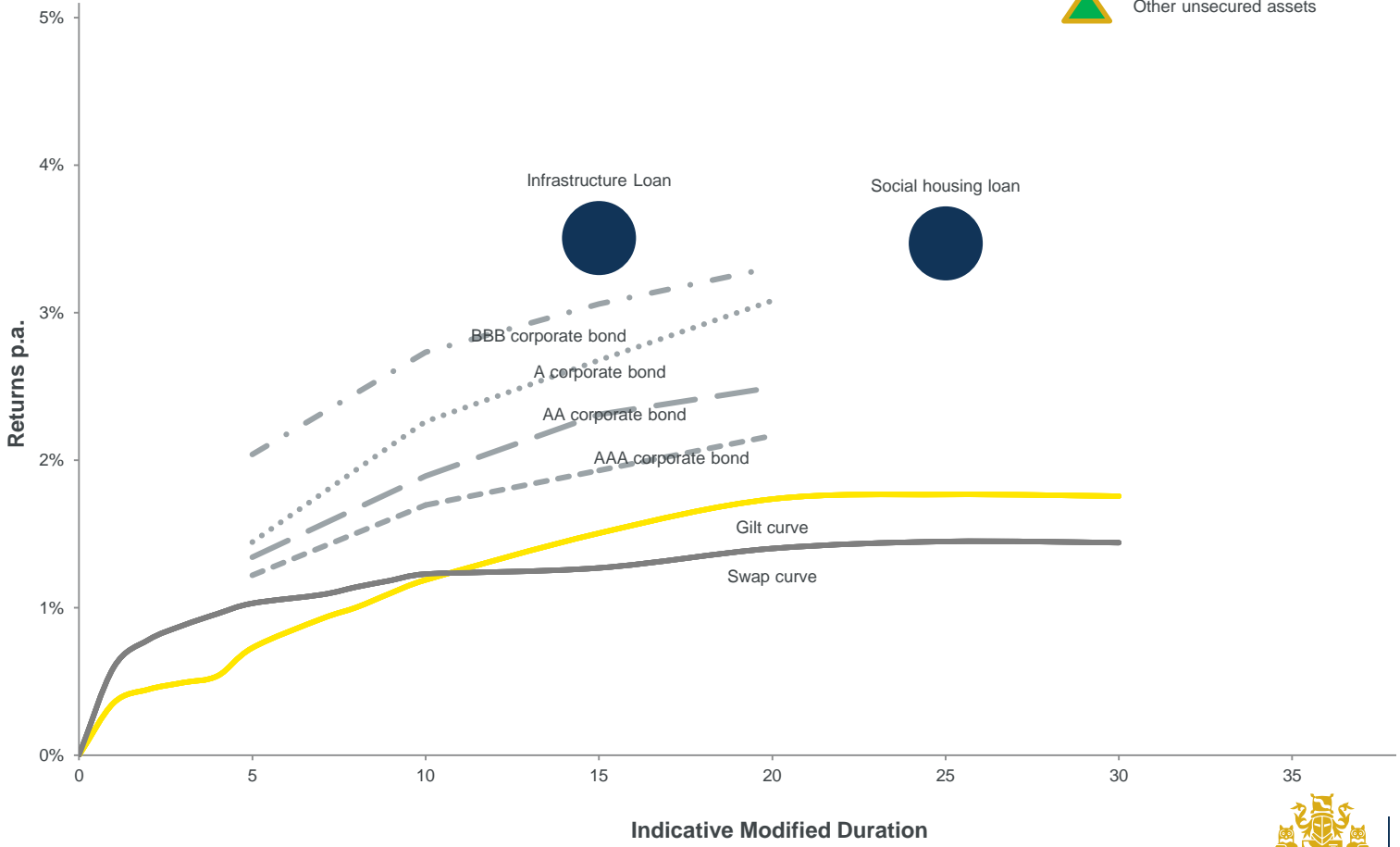
What might be considered alternative?

Type of investment	Examples	Key features
Infrastructure	Social infrastructure, economic infrastructure, energy (including renewables)	Loan to a project; no security; highly illiquid
Real estate backed	Residential & commercial lending, social housing, student accommodation, equity release, ground rent	Formally secured on a property; highly illiquid
Other asset backed	Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing	Formally secured on real assets; often highly structured
Other unsecured	Private placements, SME lending, high yield, overseas (including emerging market) debt	Unsecured; most closely related to corporate bonds
Other	Private equity, hedge funds, insurance linked securities	Various risk / return profiles

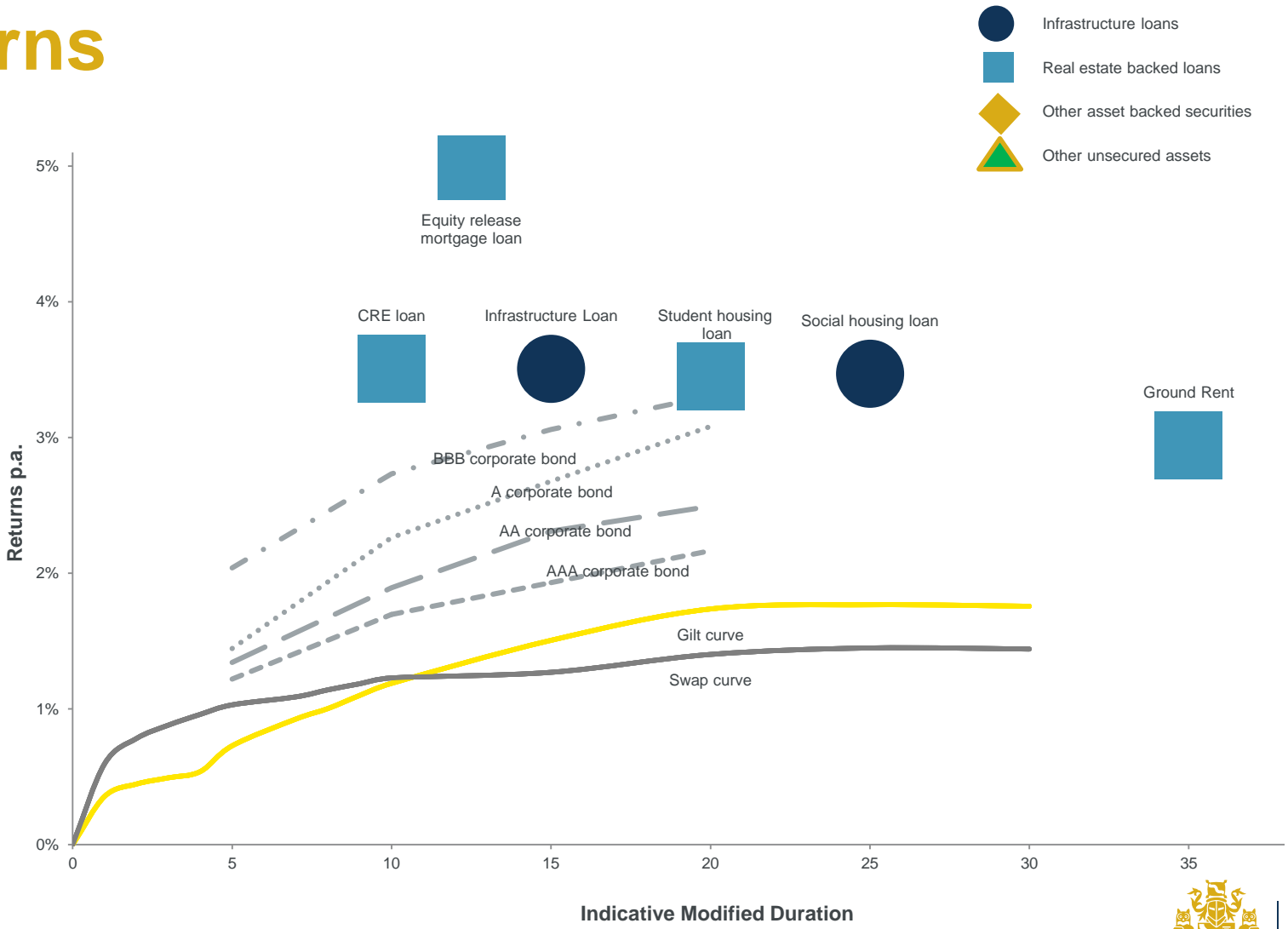


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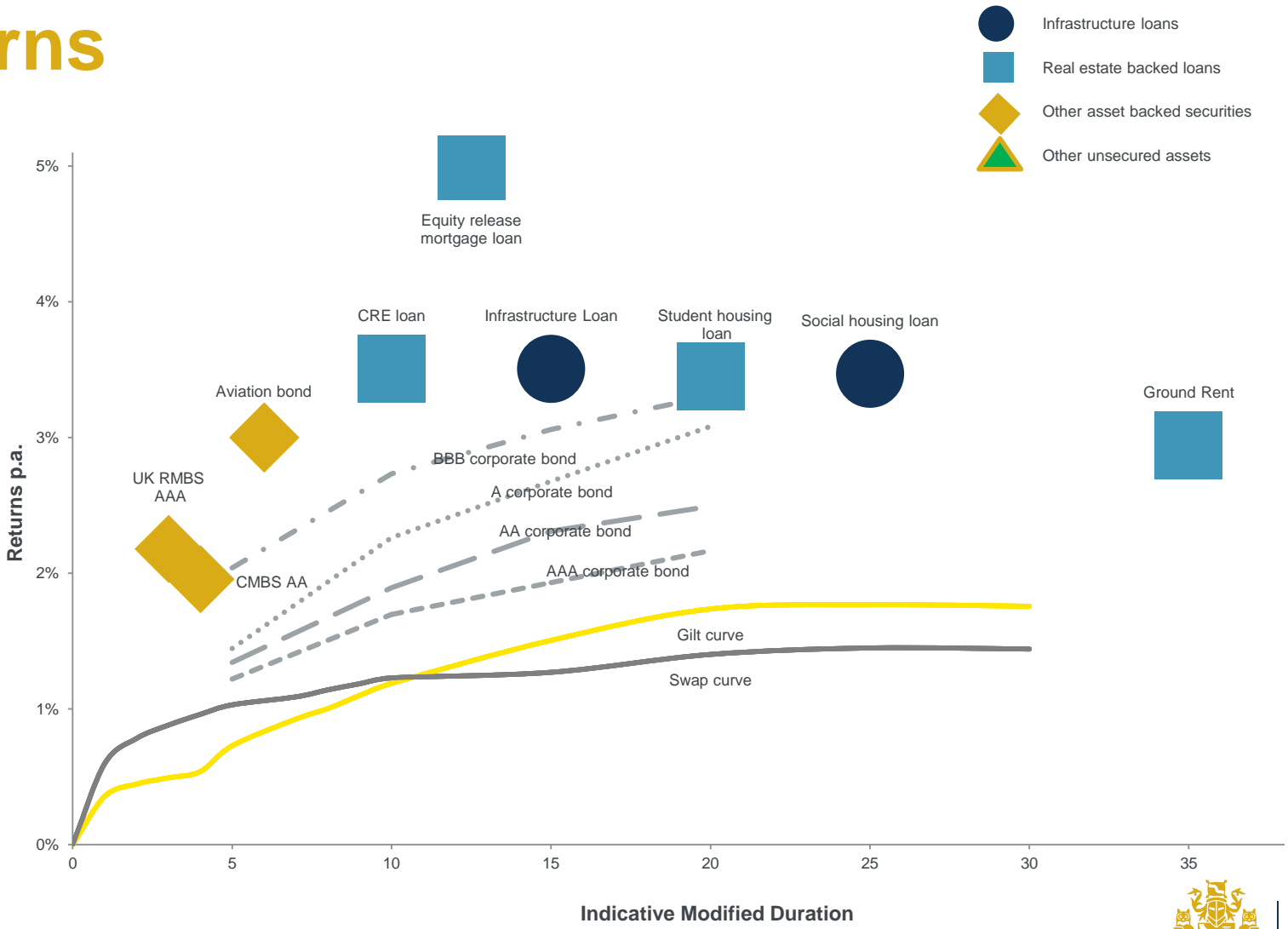
-  Infrastructure loans
-  Real estate backed loans
-  Other asset backed securities
-  Other unsecured assets



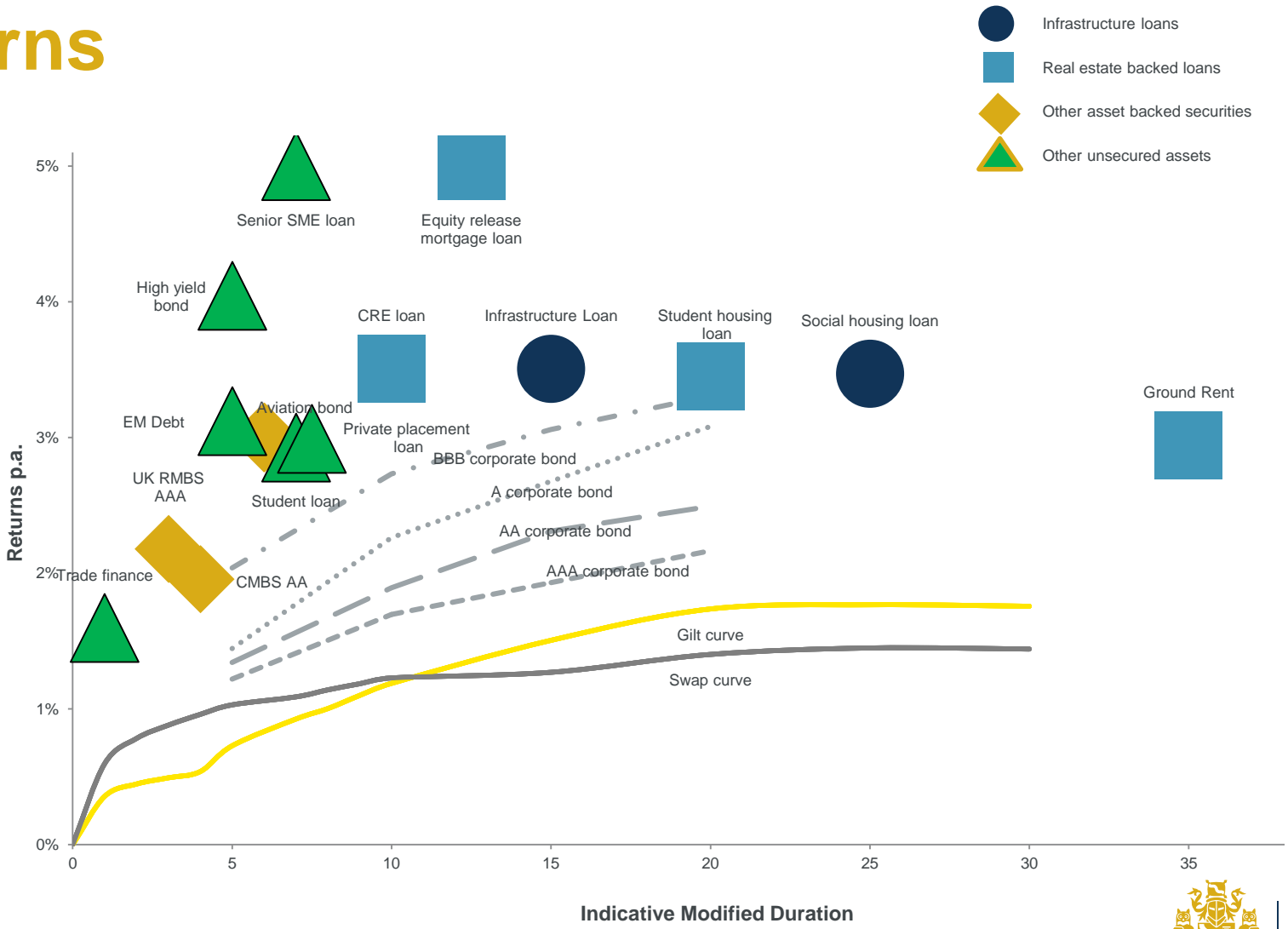
Returns



Returns



Returns





Challenges and constraints

Challenge 1 – how do I get hold of one?

- Unlike corporate bonds or equities, a pension scheme generally can't buy non-traditional assets easily. It could buy one through:
 - Pooled fund
 - Securitisation
- If I find one, can I price it?
- And perform a credit assessment?



Challenge 2 – Do I need to retain liquidity?

- Liquidity requirements need to allow for:
 - Benefit payments
 - Collateral requirements
 - De-risking strategies
- 56% of UK pension schemes are cash flow negative¹
- Increased uncertainty around cash flows as a result of pensions freedoms
- Private credit funds offer increased liquidity compared to directly holding assets

[¹Source – Mercer's European Asset Allocation Report 2017]



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Challenge 3 – How do I manage when things change?

- As the pension scheme has a relationship with the borrower (potentially through an intermediary), terms can be changed either contractually or on a discretionary basis through:
 - Changes in borrower circumstances
 - Borrower optionality
 - Variations (or changes to loan terms)
- As such, pension schemes may wish to:
 - Hire expertise in house
 - Utilise investment management (or credit insurance) expertise
 - Outsource all management



Summary of challenges

Type of investment	Examples	Pricing Transparency	CF certainty	Ability to source	Ongoing mgment
Infra-structure	Social infrastructure, economic infrastructure, energy (including renewables)	Low	High	Medium	Complex
Real estate backed	Residential & commercial lending, social housing, student accommodation, equity release, ground rent	Low	Medium	Medium – difficult	Complex
Other asset backed	Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing	Medium - High	Medium	Easy	Simple
Other un-secured	Private placements, SME lending, high yield, overseas (including emerging market) debt	High	High	Easy	Simple
Other	Private equity, hedge funds, insurance linked securities	Low	Low	Easy - Medium	Medium





Final thoughts

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- Consideration of alternative assets will be key in meeting funding targets and long-term aspirations
- Pension Schemes should continue to evaluate non-traditional opportunities, being aware of the potential benefits as well as the challenges



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