Alternative Investment Management Association

The European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London
E14 5AA
UK

Submitted electronically via the EBA website at: http://www.eba.europa.eu/

19 June 2015

Dear Sir/Madam,

AIMA's response to the EBA Consultation Paper EBA/CP/2015/06

The Alternative Investment Management Association Limited[1] (AIMA) welcomes the opportunity to submit its comments to the European Banking Authority (EBA) on the Draft EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395 para. 2 Regulation (EU) No. 575/2013 (CRR) (the 'Consultation Paper').

We welcome the consideration that the EBA is giving to the potential risks that could arise from institutions' exposures to shadow banks from both a micro-prudential and a macro-prudential perspective. However, as our members are generally not institutions that will be subject to the guidelines, we do not have comments on the approaches that institutions should take to develop internal policies for monitoring and setting limits on individual and aggregate levels. However, in this response we would like to raise our strong objection to the proposed definition of 'shadow banking entity'. In particular, we strongly disagree with the EBA's comments in the Consultation Paper that all undertakings for collective investment in transferrable securities (UCITS) that are money market funds (MMFs) as well as all alternative investment funds (AIFs) should be included within the scope of the definition of 'shadow banking entities' and consider that institutions should not automatically be obliged to place limits on their exposures to these types of funds. We set out our detailed response to the questions raised in the Consultation Paper in Annex I to this response, which relate to the following issues:

- **Shadow banking activities:** Whilst we recognize that the EBA has included some activities which may be considered to be bank-like activities within the guidelines, the list of activities set out as an initial filter is far too broad and fails to analyse how particular activities may pose 'shadow banking' risks to institutions that are setting limits in accordance with the CRD IV. The list of activities should be limited to include only deposit taking/lending activities and we consider that there should be an additional filter to determine whether an entity is engaging in these activities to a material extent or not. We would suggest that an amendment should be made to the definition of 'credit intermediation activities' set out in the draft guidelines so that the focus remains on bank-like activities, such as deposit taking, which are not subject to adequate regulation;

- **Funds:** We strongly disagree with the EBA's comments that all AIFs and UCITS that are MMFs should be considered to be 'shadow banking entities' and consider that funds that do not engage in bank-like activities should be outside of the definition of 'shadow banking entities'. We agree that UCITS that are not MMFs should not be categorised as shadow banking entities. However, we consider that it is inconsistent to include AIFs which are not MMFs within the

[1] As the global hedge fund association, the Alternative Investment Management Association (AIMA) has over 1,500 corporate members (with over 9,000 individual contacts) worldwide, based in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors.

definition, as most credit strategies that can be carried out in a UCITS can be replicated in an AIF. AIFs which are not MMFs are likely to have better liquidity alignment than a UCITS and is therefore likely to raise less concerns from a shadow banking perspective than a UCITS which is not an MMF. We therefore consider that both AIFs and UCITS which are non-MMFs should be excluded from the definition of shadow banking entity. As further support for our contention that not all funds should be included within the scope of the shadow banking entity definition, we set out in Annex II to this response a paper which AIMA produced in 2012 which explains why hedge funds are not shadow banks. We also set out in Annex III AIMA's paper which explains why we consider that asset managers in the non-bank lending space are beneficial to the real economy and how they employ responsible risk management techniques which would mean that they do not raise shadow banking concerns and hence should not be assessed as shadow banking entities;

- **Developments in the area of shadow banking:** Article 395(2) of the CRR requires the EBA to take into account "developments in the area of shadow banking and large exposures at the Union and international levels". We would therefore encourage the EBA to take into account the work of the Financial Stability Board (FSB) in this area which did not designate any types of funds as automatically being shadow banking entities. The EBA should follow the FSB's approach and adopt guidelines which focus more on activities than entities;

- **"No fire-sale" provision:** In the EBA's discussion of the principal and fall-back approaches, (although not in the wording of the actual guidelines themselves), the EBA states that "the portfolio must be adjusted" if the exposure limits that are applied by an institution are lower than its current exposures. This implies that institutions may need to sell or transfer assets or otherwise abruptly reduce their exposures in order to comply with the relevant limits when the guidelines enter into force. If AIFs are included in the definition of shadow banking entities, this may lead to institutions having to transfer their investments and/or reduce their counterparty exposures to such AIFs. We would therefore propose that the EBA should include a "no fire-sale" provision in the guidelines in order to prevent a situation where institutions are forced to divest assets or reduce exposures immediately (which might cause significant market disruption, which the EBA's proposals are designed to avoid); and

- **Increased information from fund managers:** The guidelines impose a number of obligations on in-scope institutions which are likely to require them to obtain additional detailed information from shadow banking entities to whom they have exposures. We are concerned that effectively requiring the disclosure of detailed information by investment fund managers in order to facilitate institutions' compliance with these requirements in respect of exposures to AIFs is likely to be impractical and might require the disclosure of detailed financial or other proprietary information to institutions who may well be competitors in other contexts. In addition, certain information may be highly sensitive or subject to confidentiality restrictions. We therefore consider that the EBA should limit the extent of information that a credit institution or investment firm which is taking an exposure to a shadow banking entities will be required to collect.

We hope you find our comments useful and would be more than happy to answer any questions you may have in relation to this letter.

Yours sincerely,

Jiří Król
Deputy Chief Executive Officer
Global Head of Government & Regulatory Affairs

Annex I

AIMA's response to the questions posed in the Consultation Paper

Q 1: Do you agree with the approach the EBA has proposed for the purposes of defining shadow banking entities? In particular:

- **Do you consider that this approach is workable in practice? If not, please explain why and present possible alternatives.**
- **Do you agree with the proposed approach to the exclusion of certain undertakings, including the approach to the treatment of funds? In particular, do you see any risks stemming from the exclusion of non-MMF UCITS given the size of the industry? If you do not agree with the proposed approach, please explain why not and present the rationale for the alternative approach(es) (e.g. on the basis of specific prudential requirements, redemption limits, maximum liquidity mismatch and leverage etc).**

We strongly disagree with the approach the EBA has proposed for the purposes of defining shadow banking entities. In particular, we do not consider that all UCITS which are MMFs and all AIFs should be included as 'shadow banking entities' *per se*, but that institutions should be required to look at the activities that are being carried out by entities which are potentially carrying out credit intermediation activities. We also consider that the activities that are scrutinised in this context should be limited to only those activities that are bank-like and which are not already subject to adequate regulation.

Shadow banking activities

In the Consultation Paper, the EBA states that the proposed guidelines aim to capture entities that "pose the *greatest risks* both in terms of the direct exposures institutions face and also the risk of credit intermediation being carried out *outside the regulated framework*" (Emphasis added). However, there does not appear to be any materiality thresholds reflected in the guidelines and it is also unclear whether the guidelines focus solely on bank-like activities carried out outside a regulated framework.

The proposed guidelines seek to define 'shadow banking entities' as an undertaking that: (1) carries out one or more 'credit intermediation activities'; and (2) is not an excluded undertaking. The guidelines then define 'credit intermediation activity' as "bank-like activities involving maturity transformation, liquidity transformation, leverage, credit risk transfer or similar activities", and considers that entities carrying out one or more of the activities listed in the following points of Annex 1 of the CRD shall be automatically regarded as carrying out credit intermediation activities:

- 1 (taking deposits and other repayable funds);
- 2 (lending);
- 3 (financial leasing);
- 6 (guarantees and commitments);
- 7 (trading for own account or for account of customers in specified forms of financial instrument);
- 8 (participation in securities issues and the provision of services relating to such issues),
- 10 (money broking); and
- 11 (portfolio management and advice).

i. Un/Under-regulated bank-like activities

Whilst we welcome the consideration being given to activities that may pose shadow banking risks, we note that the list of activities is far broader than the activities that would traditionally be understood to be 'bank-like'. Whilst we recognize that the EBA has included some activities which may be considered to be bank-like activities within the guidelines, such as taking deposits and lending, we consider that the list of activities should be limited to include only those activities which are genuinely bank-like.

We also note that the list of activities would capture a vast amount of institutions that are adequately regulated to carry out these activities or which pose little risk from a shadow banking perspective. We would therefore welcome consideration being given to the regulation of these activities by other pieces of legislation as well as mitigating factors which may mean that an entity carrying out one or more of these activities is not un/under-regulated and would not pose shadow banking risks to a CRD IV institution.

ii. Consistent application

We also note that the proposed definition of "credit intermediation activities" in the guidelines is extremely broad. This results partly from the use of general and vague concepts such as "maturity transformation", "leverage" or "credit risk transfer" which are not clearly defined. In the absence of clear, technical definitions of these terms, we are concerned that there could be inconsistent application across the EU and potentially these could be read far more broadly than the EBA intended.

iii. Materiality

The approach set out in the draft guidelines also places no emphasis on those entities which pose the greatest risk or are outside a regulated framework.

In addition, the cross-reference to the specific activities in Annex I of the CRD IV Directive is also very wide because taken literally, it would appear to capture any type of entity that carries out those activities even once, and even outside the context of the financial markets. For example, an ordinary commercial company which made a loan to an employee or director could be said to be engaged in lending (i.e. the activity listed at point 2 of Annex I of the CRD IV Directive). Since such a company would not be an "excluded undertaking" as defined in the guidelines, it would appear to constitute a shadow banking entity for these purposes. This would mean that an institution which had an exposure to such a company (e.g. through investment in that company or through that company being a counterparty to a transaction with the institution) would need to set an individual exposure limit in respect of that company and include the exposure to that company in the institution's aggregate limit. Potentially, this could greatly increase the number of entities deemed to be shadow banking entities, subject only to the exclusion of *de minimis* exposures which are less than 0.25% of the institution's eligible capital and therefore, on the drafting of the guidelines, do not constitute an "exposure" for these purposes.

The list of activities from Annex I of the CRD IV Directive is clearly not intended to be an exhaustive list of the activities that could constitute credit intermediation activities – this is because the guidelines state that these shall "include *at least* those listed in [the relevant paragraphs of Annex I of the Directive]" (Emphasis added), implying that other activities which do not fall within those paragraphs of the Annex may still be caught.

We think that this definition is therefore currently far too wide (and potentially much wider than even the EBA intended) and we would therefore support a general amendment to the definition of "shadow banking entities" that would limit its scope by reference to whether the "credit intermediation activities" constitute the principal activity of the entity. This would have the advantage of excluding entities which engage only in minor or peripheral "credit intermediation activities" (as defined) and which could not reasonably be considered to add to any systemic risk. We think this is preferable to amending only the specific drafting of the list of activities from Annex I of the CRD IV Directive because it is otherwise possible that entities could be brought back within the definition due to the other generalised "credit intermediation activities" such as "maturity transformation" or "leverage".

Funds

i. Hedge funds are not shadow banks

The Consultation Paper notes that some activities carried out outside the banking sector can have beneficial effects as regards the financing of the real economy and fostering growth, but also identifies the following concerns regarding shadow banking, as well as seeking to explain both the micro-prudential and macro-prudential risks:

- Run risk and/or liquidity problems.
- Interconnectivity and spillovers.
- Excessive leverage and procyclicality.
- Opaqueness and complexity.

These are not concerns which are particularly apparent in AIFs or UCITS which are hedge funds. In order to support of this assertion, in the first quarter of 2015 AIMA surveyed a number of its members regarding the redemption, liquidity and leverage profile of their flagship hedge funds and the risk management processes used in relation to those funds (the 'AIMA Survey'). We received 80 responses to the AIMA Survey, which represented total global hedge fund assets under management ('AUM') of approximately US$400 billion or just over 13% of the estimated total global hedge fund AUM of US$2.9 trillion.[2]

The responses to the AIMA Survey indicated that the average levels of financial leverage is 2.8x, with relative value arbitrage employing the highest levels of financial leverage and event driven strategies employing the lowest levels of leverage. The responses also revealed that more than 75% of the funds surveyed offer redemptions on a monthly, quarterly or annual basis, with only about 16% of funds offering redemptions on a more frequent basis. Almost half of the funds surveyed impose a notice period for redemptions (with almost 70% of this sample permitting monthly redemption). 41% of the funds surveyed offer a notice period of 31-90 days, with all but one of these being funds permitting redemptions on a monthly or quarterly basis.

Finally, nearly all hedge funds are capable of imposing one type or another of a redemption restriction either as part of a normal course of business or in order to address stressed or otherwise exceptional market conditions.

This survey data is broadly consistent with a number of other industry, academic and official studies on hedge fund leverage and redemption profiles and shows that, in comparison to other business models in the financial sector, the hedge fund industry's risk profile is rather benign. The relatively low levels of leverage combined with relatively infrequent redemptions and long notice periods suggest that whatever cause for concern there may be in this area can be mitigated by hedge funds and their managers naturally by reason of the business model features and design. As further support for our contention that not all funds should be included within the scope of the shadow banking entity definition, we set out in Annex II to this response a paper which AIMA produced in 2012 which explains why hedge funds are not shadow banks. We also set out in Annex III AIMA's paper which explains why we consider that asset managers in the non-bank lending space are beneficial to the real economy and how they employ responsible risk management techniques which would mean that they do not raise shadow banking concerns and hence should not be assessed as shadow banking entities.

ii. AIFs and UCITS

The EBA states in the Consultation Paper in relation to funds that:

> "at this stage…the EBA proposes to include all MMFs within the scope of the definition of shadow banking entity. As such, all funds would be considered as falling in the scope of the definition of shadow banking entities except if they are non-MMF UCITS (and third country firms subject to equivalent requirements). All MMFs (being UCITS or AIFs), all AIFs and unregulated funds would fall in scope."

We agree that UCITS that are not MMFs should not be categorised as shadow banking entities. However, we disagree that all AIFs and all UCITS which are MMFs should *automatically* be deemed to be shadow banking entities. In particular, we consider that there is no reason to include AIFs which are not MMFs within the definition, as most credit strategies that can be carried out in a

[2] Press release, Hedge Fund Research, *Hedge Funds Conclude 2014 With Inflows As Investors Position For Volatility* (20 January 2015).

UCITS can be replicated in an AIF. AIFs which are not MMFs are under an obligation to ensure that the liquidity of the investment strategy, the liquidity profile and the redemption policy are consistent.[3] As UCITS are obliged to provide bi-monthly liquidity as a minimum, regardless of its underlying investments, UCITS are subject to detailed rules on diversification and concentration as well as liquidity management and stress testing to meet redemption requests which address concerns the EBA raises with shadow banks in the Consultation Paper. An AIF which is not a MMF is therefore likely to pose less risk from a shadow banking perspective than a UCITS which is not an MMF. We therefore consider that, as a minimum, both AIFs and UCITS which are non-MMFs should be excluded from the definition of shadow banking entity.

iii. Regulation of AIFs and UCITS

We note that in developing the guidelines the EBA is required by Article 395(2) of the CRR to identify shadow banking entities "which carry out banking activities outside a regulated framework". Leaving to one side the question of whether an AIF or UCITS is carrying out "banking activities", it would be disingenuous to suggest that AIFs and UCITS operate "outside a regulated framework".

Whilst AIFs are not directly regulated at the EU level, under the Alternative Investment Managers Directive (AIFMD), AIFs are indirectly subject to a robust set of prudential regulatory standards which include: leverage monitoring and reporting rules, authorisation requirements, extensive transparency requirements and reporting rules, valuation rules, safekeeping of assets by a depository, conduct of business rules, remuneration requirements, own funds and professional indemnity insurance rules. UCITS are subject to many similar requirements under the UCITS Directive.

In the EBA's Report to the European Commission on the perimeter of credit institutions established in the Member States (the Report), the EBA reported that the majority of Member States had no concerns to note on "the prudential requirements imposed under the AIFMD and the UCITS in light of the bank-like activities which may be carried on by entities within the scope of those measures." The Report notes that the AIFMD and the UCITS Directive "set out a stringent organisational framework for investment managers, together with risk and liquidity management requirements. Further, the segregation rules and the requirement to entrust assets to the safekeeping of depositaries provide additional safeguards." The Report noted that only two competent authorities indicated concerns and that:

> "Of those competent authorities who indicated concerns, one pointed out that the recent debate on loan origination by legal persons managing alternative investment firms (AIFMs) and alternative investment firms (AIFs) [*sic*]. The prudential requirements for AIFMs under the AIFMD do not include credit risk as such so if the management firm (and not the AIF itself) was lending this would not normally be captured in the same way as for a CRR institution. Although there is no evidence to suggest this is currently a material risk, the carrying on of such activity without adequate prudential requirements in place could pose risks. Of course there is a need to strengthen capabilities in long term financing but we should also be wary that origination of loans is a core competence of the banking sector that requires specific expertise, e.g. in the evaluation of credit worthiness, loan servicing etc. Second, as regards lending by AIFs, there is nothing to stop AIFs carrying on such activity and capital requirements are not applied to an AIF. Again, there is no evidence to suggest this a material risk at this time but the issue might warrant further consideration. The other observed that there has been non proper EU-wide consideration of the type and magnitude of prudential risks of firms carrying on depositary business (whether or not they are credit institutions or some other form of entity). Consideration could be given to exploring the risks to which depositaries might be exposed and, in turn, the risks they may pose in order to determine whether or not there is a case for further harmonised prudential requirements."

As neither of these concerns appears to be material and would not be applicable to all AIFs or all UCITS we do not consider that all AIFs and all UCITS that are MMFs should automatically be

[3] See Article 16 of the Alternative Investment Managers Directive (AIFMD).

considered to be "shadow banking entities". We would therefore suggest that an amendment be made to the definition of 'credit intermediation activities' so that the focus remains on bank-like activities which are not subject to adequate regulation.

iv. The draft guidelines

We note that unlike the Consultation Paper, the draft guidelines themselves do not expressly state that they apply to all AIFs (or other residual categories of unregulated funds). On the face of it, this is slightly at odds with the EBA's statement above. The only direct reference to investment funds is in the negative scope definition of "excluded undertakings" (paragraph 6 of the draft guidelines) which specifically carves-out non-MMF UCITS funds and third country funds that are equivalent to non-MMF UCITS funds. This implies that non-UCITS funds are potentially within scope, but it does not state that this is automatically so. We consider that this would be a preferable approach to automatically including all AIFs and UCITS which are MMFs within the scope of the definition of shadow banking entity, without analysing the activities that are being carried out by that fund.

Developments in the area of shadow banking

Article 395(2) of the CRR also requires the EBA to take into account "developments in the area of shadow banking and large exposures at the Union and international levels" in order to issue guidelines that set "appropriate aggregate limits to such exposures or tighter individual limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework." In order to set these limits, the EBA should therefore take into consideration, amongst other things the recent work of the Financial Stability Board (FSB), in particular their *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*. In that document, the FSB stated in relation to the entities that were assessed by work stream 3 (WS3) (i.e. (i) credit investment funds; (ii) exchange-traded funds (ETFs); (iii) credit hedge funds; (iv) private equity funds; (v) securities broker-dealers; (vi) securitisation entities; (vii) credit insurance providers/financial guarantors; (viii) finance companies; and (ix) trust companies) that:

> "WS3 observed a high degree of heterogeneity and diversity in business models and risk profiles not only across the various sectors in the non-bank financial space, but also within the same sector (or entity-type). This diversity is exacerbated by the different legal and regulatory frameworks across jurisdictions as well as the constant innovation and the dynamic nature of the non-bank financial sectors. Together, these factors tend to obscure the economic functions conducted by these entities, and hence to complicate the evaluation of the regulations that do or should apply to them. WS3 therefore developed an economic function-based (i.e. activities-based) perspective for assessing shadow banking activity in non-bank entities.
>
> The economic function-based perspective allows the extent of non-bank financial entities' involvement in shadow banking to be judged by looking through to their underlying *economic functions* rather than *legal names or forms*. Furthermore, this approach is forward-looking in that it will be able to capture additional types of entities that conduct these economic functions generating shadow banking risks."

We consider that the EBA should take into consideration these comments of the FSB when developing their guidelines under Article 395 of the CRD IV. In particular, we consider that the EBA should not label all AIFs and all UCITS which are MMFs as 'shadow banking entities', regardless of the economic functions that those funds fulfil. This would create a dangerous precedent which cannot be found in any other shadow banking workstream on either the European or international level and is inconsistent with the activities-based approach that is being taken by the FSB.

"No fire-sale" provision

In the EBA's discussion of the principal and fallback approaches, (although not in the wording of the actual guidelines themselves), the EBA states that "the portfolio must be adjusted" if the exposure limits that are applied by an institution are lower than its current exposures. This implies that institutions may need to sell or transfer assets or otherwise abruptly reduce their exposures in order to comply with the relevant limits when the guidelines enter into force. If AIFs are included in the definition of shadow banking entities, this may lead to institutions having to transfer their investments and/or reduce their counterparty exposures to such AIFs.

We would propose that the EBA should include a “no fire-sale” provision in the guidelines in order to prevent a situation where institutions are forced to divest assets or reduce exposures immediately (which might cause significant market disruption, which the EBA’s proposals are designed to avoid). We think that this language could be modelled on the securitisation “no fire-sale” provisions in the AIFMD Level 2 Regulation.

Increased information from fund managers

The guidelines impose a number of obligations on in-scope institutions which are likely to require them to obtain additional detailed information from shadow banking entities to whom they have exposures. These include:

- Identification of the individual exposures to shadow banking entities and all potential risks to the institution that result from them;
- Application of the internal risk management framework, with analyses of the business of each SBE performed by risk officers;
- Inclusion of risks arising from SBE exposures in the institution’s ICAAP and capital planning;
- Identification of interconnectedness between shadow banking entities themselves and between shadow banking entities and the institution using a “robust process”; and
- The need to obtain and analyse a range of information about the shadow banking entities in order to qualify for the more flexible principal approach.

We are concerned that effectively requiring the disclosure of detailed information by investment fund managers in order to facilitate institutions’ compliance with these requirements in respect of exposures to AIFs is likely to be impractical and might require the disclosure of detailed financial or other proprietary information to institutions who may well be competitors in other contexts. In addition, certain information may be highly sensitive or subject to confidentiality restrictions. We therefore consider that the EBA should limit the extent of information that a credit institution or investment firm which is taking an exposure to a shadow banking entities will be required to collect.

Q 2: Do you agree with the approach the EBA has proposed for the purposes of establishing effective processes and control mechanisms? If not, please explain why and present possible alternatives.

No comment.

Q 3: Do you agree with the approach the EBA has proposed for the purposes of establishing appropriate oversight arrangements? If not, please explain why and present possible alternatives.

No comment.

Q 4: Do you agree with the approaches the EBA has proposed for the purposes of establishing aggregate and individual limits? If not, please explain why and present possible alternatives.

No comment.

Q 5: Do you agree with the fallback approach the EBA has proposed, including the cases in which it should apply? If not, please explain why and present possible alternatives. Do you think that Option 2 is preferable to Option 1 for the fallback approach? If so, why? In particular:

- **Do you believe that Option 2 provides more incentives to gather information about exposures than Option 1?**

- **Do you believe that Option 2 can be more conservative than Option 1? If so, when? • Do you see some practical issues in implementing one option rather than the other? 6. Taking into account, in particular, the fact that the 25% limit is consistent with the current limit in the large exposures framework, do you agree it is an adequate limit for the fallback approach? If not, why? What would the impact of such a limit be in the case of Option 1? And in the case of Option 2?**

No comment.

Annex II

The role of Credit Hedge Funds in the Financial System: Asset Managers, Not Shadow Banks

Alternative Investment Management Association

The role of Credit Hedge Funds in the Financial System: Asset Managers, Not Shadow Banks

Research Committee

March 2012

Table of Contents

1. Introduction

The term "shadow banking" was first coined by Paul McCulley of PIMCO in August 2007 to describe a large segment of financial intermediation that is derived outside the balance sheets of regulated commercial banks and other depository institutions, the implication being that such organisations are engaging in bank-like activities out of the sight of regulators, creating unmonitored risks to the global financial system.

In November 2010 the G20 requested that the Financial Stability Board (FSB) in collaboration with other international standard setting bodies develop recommendations to strengthen the oversight and regulation of the shadow banking system. One of the key challenges for policy makers is to first define and understand the scope of the term "shadow banking". This paper argues that that credit hedge funds which have been at times included in the shadow banking complex and hedge funds in general should be considered part of the asset management sector , not the banking industry and as such should not be considered part of any shadow banking discussion.

In part 1 of this paper we deconstruct the term shadow banking arguing that it is a misnomer for several reasons. Crucial distinctions between the key functions of a traditional bank and that of hedge funds and other non-bank financial institutions will be highlighted. Part 2 offers an overview of the credit hedge fund universe, splitting it into four key investment strategies. We argue that hedge fund strategies are extremely diverse and constantly changing over time. The majority of these do not involve a focus on the fixed income or credit markets and hedge funds generally do not engage directly in credit transformation. Further, we discuss that hedge funds (and credit hedge funds) are not large users of leverage; offer unique liquidity terms for its investors and in doing so provide considerable advantage of enabling its investors to customise their asset mix more precisely to their liability profile. This reduces significantly any asset/liability mismatches that may occur and boosts investment returns.

Part 3 of the paper considers the questions posed by the Financial Stability Board's task force (April 2011) as to what extent shadow banking (and in this case we look at the perspective of credit hedge funds being included in this definition) is involved in credit intermediation, maturity transformation, liquidity transformation and credit transformation. We show that hedge funds' liquidity and maturity profiles as well as their leverage are such that they do not pose significant risks to the financial system. No hedge fund is sufficiently large, leveraged complex or interconnected that its failure or financial stress would cause such severe disruption. Hedge funds individually or collectively are therefore not systemically important and can be seen as a stabilising (additive to overall market liquidity) as opposed to a destabilising element of the financial system.

1.1 Definition of shadow banking / Explanation as to what money creation is and how it works.

Deconstructing the definition of shadow banking and how this reference is not an appropriate label for hedge funds.

In their *Federal Reserve Bank of New York Staff Report entitled* '**Shadow Banking'** Pozsar, Adrian, Ashcraft and Boesky (2011) critically note *'We use the label "shadow banking system" for this paper, but we believe that it is an incorrect and perhaps pejorative name for such a large and important part of the financial system.*'

Indeed, the term shadow bank, originally coined by Paul McCulley, is a misnomer for several reasons.[1] First, the term seems to have caught on in the financial press partly due to the fact that it conjures up opaque or nefarious activity without precisely defining it. The implicit connotation is that such organisations engage in bank-like activities out of the sight of regulators, creating unmonitored risks to the system.

[1] 'Finance: Shadow boxes' by Brooke Masters and Jeremy Grant, Financial Times, 2 February, 2011

Second, the definition used in the above report is very broad and ignores one of the key functions of traditional banks that distinguish them from other non-bank financial institutions such as hedge funds, namely, *multiple deposit creation*.

Pozsar, Adrian, Ashcraft and Boesky (PAAB, 2011) define shadow banks as follows: "*Shadow banks are financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees,*" (Federal Reserve Bank of New York Staff Reports). Though non-banks and traditional banks may share some of the above functions, this definition ignores key differences between banks and non-banks.

One of the reasons why traditional banks are important is that they are part of the money supply process (Mishkin (2007)).

The money supply process includes (a) the central bank, (b) banks (that is depository institutions), (c) depositors and (d) borrowings from banks. A central bank, such as the Federal Reserve controls the monetary base through open market operations and extension of discount loans to banks.

An individual bank can make loans up to the amount of its excess reserves, thereby creating an individual amount of deposits. However, the banking system as a whole can create a multiple expansion of deposits, because as each bank makes a loan and creates deposits, the reserves find their way to another bank, which uses them to make loans and create additional deposits. In a simple model, a narrow definition of money is linked to the monetary base through the so-called monetary multiplier. The money multiplier is a function of the currency ratio set by depositors, the excess reserves ratio set by banks and the required reserve ratio set by the central bank.

Hence, an important insight from the above discussion is that non-banks such as hedge funds are not involved in the money supply process through multiple deposit creation.

Not only are hedge funds not banks since they are not depository institutions, but hedge funds do not even fulfil all the criteria of the shadow banking definition criticized as being unhelpful in the Federal Reserve Bank of New York Report. Hedge funds are part of the asset management industry – not the banking industry. They do not take deposits, do not undertake maturity transformation or benefit from implicit or explicit taxpayer guarantees, for example. It may therefore be more helpful to label institutions such as hedge funds as non-banks rather than shadow banks.

PAAB(2011) describe shadow banks as being '*interconnected along a vertically integrated, long intermediation chain, which intermediates credit through a range of securitization and secured funding techniques such as ABCP, asset-backed securities, collateralised debt obligations and repo*'. However, hedge funds play only a subordinated role in this six step chain that consists of (1) Loan Origination, (2) Loan Warehousing, (3) ABS Issuance, (4) ABS Warehousing, (5) ABS CDO Issuance, **(6) ABS Intermediation** and (7) Wholesale funding. PAAB define credit hedge funds as being active in (6) ABS Intermediation. In this sense they are similar to other non-bank ABS investors such as pension funds, insurance companies, and sovereign wealth funds.

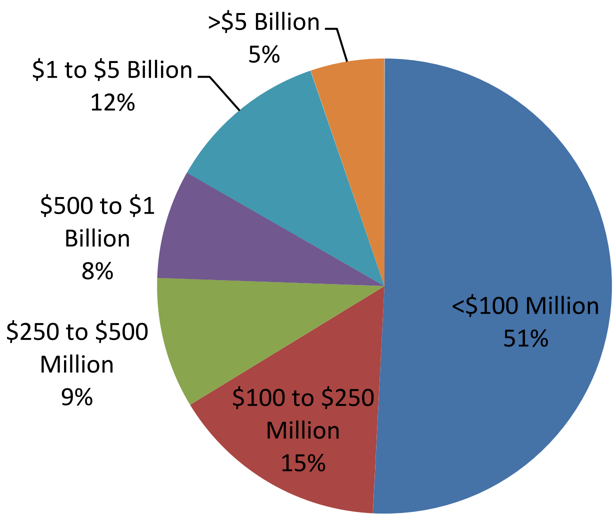
Moreover, credit hedge funds are not involved in all forms of credit intermediation. PAAB define credit intermediation as consisting of credit, maturity and liquidity transformation. Credit hedge funds are not involved in credit transformation which is defined as the enhancement of the credit quality of debt issued by the intermediary through the use of priority of claims. If hedge funds match the liquidity terms that they provide to their investors with the liquidity or maturity of the assets that they hold then they are not engaging in a maturity transformation (the use of short-term depositions to fund long-term loans) either. For example, direct lending by credit hedge funds is now done primarily through long lock-up private equity style vehicles. To the extent that most hedge funds are not traded on a liquid secondary market, most of them do not fulfil liquidity transformation functions either, even though this is in principle possible.

As PAAB note, hedge funds do not benefit from any official public sector enhancement such as deposit insurance. Activities with indirect and implicit official enhancements include asset management activities like bank-affiliated hedge funds and money market mutual funds.

2. Hedge Funds as Part of the Asset Management Family

According to the Boston Consulting Group (BCG) report 'Building on Success – Global Asset Management 2011', the value of professionally managed assets grew 8% to $56.2tr in 2010. The BCG report divides these assets into retail ($22.9tr) and institutional AuM ($33.5tr). The retail asset management industry consists of mutual funds ($10.6tr), unit-linked insurance ($2.4tr), unit-linked pensions ($5.2tr) and private banking ($4.5tr) while the institutional asset management industry consists of insurance ($7.9tr), pensions ($18.7tr) as well as corporations ($2.4), nonprofits ($1.3tr), governments ($1.9tr) and banks ($1.1tr). The above asset management organizations may invest in hedge funds. As a result the two groups may overlap. According to Hedge Fund Research[2], the global hedge fund industry as of the end of 2011 was measured at approximately $2trillion[3]. These assets were split among 7,409 diversified funds resulting in an average size of a hedge fund being $275m. Note, however, that the largest 5% of hedge fund firms control over 60% of the assets so this average is skewed by a large number of small funds. It is important to consider that 95% of hedge funds manage less than $5bn[4].

Chart 1: Distribution of Hedge fund Industry Assets by Number of Firms in Q2 2011



Source: HFR, Inc. Global Hedge Fund Industry Reports

Credit hedge funds make up approximately one quarter to one third of the global hedge fund industry and fall into several categories (see also Section 3 and Annex 1).

[3] Hedge Fund Research, Sept 2011 (www.hedgefundresearch.com)
[4] Bank of America Merrill Lynch Q2 2011 Hedge Fund Industry Overview

The credit hedge fund universe

Credit hedge fund managers employ a diverse range of investment strategies, ranging from direct corporate lending to the trading of complex derivatives. A common feature that exists throughout these strategies is the acceptance of credit risk on behalf of the borrower. This credit risk has asymmetrical qualities relative to other market risks in that the upside of the risk is bounded by the return of capital at a future date at par. Traditionally, the focus of these investment strategies has been on corporate credit, but recent global events have meant that sovereign credits have also become part of the opportunity set that credit hedge fund managers invest in.

The classification of credit hedge fund managers into distinct investment categories has not been treated uniform across hedge fund index providers or by the managers themselves. For example, there are many hedge funds that refer to themselves as "event-driven", a term which can refer to several distinct types of investment strategies involving both equity and credit instruments. The best way to understand credit hedge funds is to look past the name, past the assigned hedge fund index classification, and through to the actual activities performed. The list below divides the credit hedge fund universe into four investment types:

1. Relative Value Credit
2. Long-short Credit
3. Macro Credit
4. Fundamental Credit

The impact on and the relationship to the financial system on each of these investment types differs, often significantly. Whereas Fundamental credit managers are most likely to execute "near-bank" activities such as lending, the use of prime brokerage leverage by Relative Value and Macro managers entails a different set of market and regulatory concerns.

2.1 Relative Value credit managers:

Overview:

Central to the investment strategy of relative value credit managers is an analysis of price differentials between bonds and related assets (simultaneously buying and selling the different securities) to establish whether one is over or under-valued in relation to one another.

Positions are taken because of mispricing based on historical and/or expected future relationships. These can be within a single company's capital structure (debt and equity) or between two separate companies' capital structures. These credit hedge funds can be more commonly grouped under the following published hedge fund indices, "relative value arbitrage", "credit arbitrage", "long short credit", and "fixed income-corporate". Often mixed with other strategies, they can be found also within "fixed income arbitrage" and "convertible arbitrage", although they have differing characteristics.

Relative Value credit managers invest in bonds, including convertibles, credit default swaps (CDS) on bonds and to a smaller degree, equity. The investment strategy practiced involves owning one instrument (going long) while short selling another one in a ratio which they believe optimises the risk/return of the trade. The financial instruments traded have a higher weighting towards derivatives, in particular CDS and CDS indices but may also include equity options and indices. CDS are usually investment grade or crossover, but not exclusively (they may also include sub-investment grade). Cash instruments may include corporate bonds or bank debt (less frequently), including sovereign bonds. Sub-strategies include "capital structure arbitrage", "curve trading", "index basis trading", "volatility arbitrage", "credit correlation", "index arbitrage", and "intra-capital arbitrage".

Considerable fundamental analysis is used to determine whether mispricings exist, using methodology similar to that used by fundamental credit managers but usually not as detailed in scope. Quantitative models are also used to highlight anomalies in relative valuations, although positions are not taken on the basis of altered mathematical relationships alone. Model outputs are used as signals only and fundamental credit research is undertaken to determine what factors may have caused the change in conditions and whether they are expected to continue.

Investment Horizon:

Typically, the investment horizon for a relative value trade ranges from 2-6 months (positions are generally not held for any longer unless the investment thesis holds or the position has been re-evaluated),often tied to an event (e.g. such as an earnings announcements) which is expected to realign value.

Exiting from these positions relies exclusively on secondary markets, unlike fundamental credit managers, who may receive a distribution of cash outright. Relative Value managers may be impacted from the same event as the fundamental credit managers, such as a restructuring, but are not as directly involved. For example, they might hold a bond position but would not be on the creditor committee negotiating on behalf of bondholders.

Portfolio investments are generally in the most liquid instruments in the credit space; and very often the entire portfolio can be liquidated (all positions in the portfolio sold out) within a week under normal trading conditions. Turnover in such a portfolio is relatively high; with 100% of the portfolio usually turned over every two to four months. Less liquid (or longer term) investments may also be held, but these usually comprise less than 5% of the fund's total NAV (with most funds having very strict investment limits) ranging from 10% to 20% of NAV. The fund's terms often state limits for less liquid instruments or Level III (FASB)[5] assets, as well as provide for side pockets in the event of illiquidity.

Leverage:

Market exposure is typically net neutral from a risk or beta perspective[6], and some leverage may be used to optimise returns on the particular trade. Notional leverage[7] can be high, with a maximum gross notional exposure of 3 to 6 x NAV (a magnitude of three to six times the total of the fund's NAV); the average being around 4 times NAV. On a risk-adjusted basis, gross leverage is significantly lower, usually 1 to 2 times NAV, while the investments long exposure is often less than 1 times the fund's NAV. The difference between risk-adjusted and notional exposure is due to derivative instruments, which can limit maximum loss.

The use of derivatives also skews the apparent positioning of Relative Value managers as they may appear to have a net short exposure on a notional basis. This happens because short positions are taken in higher quality credits, which tend to have a lower beta to market moves, while longs, are in lower quality credits, which have a higher beta. Managers position the portfolio sensitivity to be "beta-neutral", which often requires a larger amount of short positions need to be held. Short positions are frequently held in CDS, which mean that the actual risk is a fraction of the notional amount[8].

Investor Liquidity:

Investor liquidity is usually quarterly with 90 days' notice. Some funds have a one-year lock, which may often be waived for a penalty of 3% to 5%. There may be investor gates for redemptions above

[5] Assets whose fair value cannot be determined by using observable measures, such as market prices or models. Level 3 assets are typically very illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. In addition to Level 1 and Level 2 assets (both of which have more accurate fair values), Level 3 assets must be reported on by all publicly traded companies as of 2008.

[6] Exposure varies over a credit cycle and managers may be marginally long or short biased (+/-40%), measured on a risk basis

[7] Notional = market value of exposure

[8] Some mark-to-market risk is assumed if the position is not fully funded and broker leverage is used

a certain amount, usually 25% (calculated at the fund level, investor level or both via a trigger mechanism).

2.2 Long-short credit managers

Overview:

Long-short credit managers are similar to relative value credit managers, but are differentiated by:

- A focus on fundamental mispricing over structural/quantitative mispricing, and
- A preference for sub-investment grade debt positions.

Their portfolios tend to be more directional, are usually longer-biased, with the "carry/yield" (the return from holding the asset) playing a more important role in expected returns. Among the most common investment strategies employed include taking outright[9] long or short positions based on event-driven themes and/or perceived mis-valuations. Pure relative value trades usually make up less than one-third of portfolios in credit hedge fund managers who trade the strategy. Many of these managers often only have experience investing in long–only high yield instruments and are more comfortable trading in cash bonds tending not to use CDS indices or single names except for hedging purposes.

Positions that these managers are likely to invest include bank debt as well as bonds, both of which could be non-performing. Depending on the liquidity target of the same managers, funds may hold stressed and distressed [10] positions, although these are usually in the large names which have several very liquid instruments available to trade (e.g. TXU, Lehman Brothers).

Long investments are predominantly held in sub-investment grade credits, while shorts positions usually include investment grade or crossover names[11]. Short positions are often expressed via CDS, although many managers intentionally look for cash shorts to minimise synthetic vs cash mismatch (basis risk), having learnt the lessons of 2008. Many funds retain some overweight CDS exposure in notional terms within the short book which can result in total notional CDS exposure being higher than total notional cash exposure[12]. However, significantly lower leverage usage than pre-2008 means that the risk of destabilising the fund via the unwinding of a similar trade is also lower.

Leverage:

Leverage usage is lower than for relative value manager, with gross notional exposure ranging between 1 to 4 times NAV and averaging around 2 times NAV. As is the case with Fundamental credit managers, gross long exposure is usually less than 1 times NAV. On a risk –adjusted basis, the risk-adjusted net exposure[13] ranges between 0.6 and 1 times NAV (+100% to -60%).

Investment Horizon:

Typically, the investment horizon of a long-short credit manager is approximately three to six months, but some positions may have a longer expected holding period, perhaps as much as several years. As per the case of the relative value manager, ease of liquidity of the portfolio is imperative. The relevant manager must demonstrate that its investment positions can be fully liquidated within a short period of time (usually within one month and no longer than three months

[9] Positions are taken outright, without a specific offsetting trade
[10] Stressed credits are considered to be those that have not yet missed a coupon payment date nor filed for bankruptcy, in contrast to distressed credits
[11] Crossover credits straddle between investment grade and high yield. Managers delineate credit quality grades according to several factors, including current spread levels, relative debt/EBITDA ratios, and historic price ranges. They are generally dismissive of agency ratings
[12] For example the ratio of notional CDS exposure to notional cash exposure could be 3:2
[13] Risk-adjusted exposure is lower due to derivatives' usage, as with Relative Value credit managers

even under stressed conditions). The average turnover of such an investment portfolio is approximately in the range of three to nine months.

Investor Liquidity:

Investor liquidity is usually quarterly with 90 days' notice and may also carry a one-year lock up[14]. Some managers waive this lock for a penalty (charged on exiting the fund) of 3% to 5%, although this option is less common than with Relative Value credit managers. Investor "gates" are increasingly common, where investor redemptions are limited above a certain amount, usually 25%, either at the fund level, investor level, or both. In the latter case, the investor gate is triggered once redemptions at the fund level reach a certain threshold. Managers often reserve the right of discretion vis-à-vis implementation of the gate even if the threshold is triggered, in particular if the underlying market liquidity is available. In the post-Lehman Bros. crisis period, it appeared[15] that Long-Short credit managers were less inclined than Relative Value managers to use the gate once triggered, possibly because leverage being used was lower, cash bonds made up a greater portion of the portfolio and ISDA counterparty triggers were therefore less relevant.

Long-short credit funds can be found in hedge fund published indices alongside Relative Value managers, where they are more commonly grouped under "fixed income-corporate", "convertible high yield", "credit arbitrage", long short credit", "fixed income arbitrage" and "credit".

2.3 Macro credit managers

Overview:

An important point to note is that discretionary macro trading is a distinct hedge fund strategy and the use of the term "macro" does not imply that macro credit managers fall within this sector. Instead it refers to credit managers who take a top-down approach to invest in their portfolio rather than the more popular bottom-up approach employed by the majority of credit hedge fund managers. Their top down focus leads them to take positions that have a heavier focus on larger scale or quantitative mispricing in industries, asset classes and geographic regions, rather than positioning based largely on specific company fundamentals (central to the bottom up investment strategy). For example, in 2010-11 these managers actively traded long and short exposure in European banks and sovereigns based on top-down views. As with all credit managers, they also conducted fundamental research before taking positions.

Another characteristic of Macro credit managers is that portfolios tend to target risk neutrality combined with "convexity", i.e. option-like trades, imbedded in the portfolio, which should produce outsized returns if certain events or realignments occur. These can be both macro as well as sector or company related. This means that there can be a heavier emphasis on indices and options, and there is a greater focus on the most liquid credit instruments and derivatives (CDS and CDS indices). Portfolio turnover can be high, on average 100% of the portfolio turns over every one to two months.

Leverage:

Fund leverage employed by macro managers is similar to that of the Relative Value credit managers, but notional leverage can persist at higher levels: gross notional ranges at 3 to 6 times NAV, the average being around 4 times NAV. On a risk-adjusted based, the range of leverage employed is between 1 to 2 times NAV.

Investor Liquidity:

[14] The agreed period of time during which investors' money in the hedge fund is committed and cannot be withdrawn. The length of lock-up period may depend on the quality and reputation of the fund, as well as the liquidity of the underlying investment portfolio.
[15] This is an observation only, without empirical evidence

As with the terms on offer from the relative value credit managers, investor liquidity is typically quarterly (every three months) with 90 days' notice, although some funds have shorter liquidity terms, as short as monthly with 30 days' notice.

2.4 Fundamental credit managers

Overview:

While perhaps more commonly recognised (via hedge fund data vendors) as "event driven", "special situations" and "activists" or "fundamental value" investors, fundamental credit managers are value investors. For classification purposes, some funds end up being grouped in equity buckets rather than credit ones because their investment focus includes all parts of the capital structure, including equity. In addition, when these funds participate in a restructuring, they can receive equity as settlement of a debt obligation.

Leverage:

Fundamental credit managers are generally "long-biased" in their investment outlook, which means that they take very few short positions to offset risk[16]. These long positions generally total less than 100% of their fund's capital (the remainder being cash), while short positions (i.e. short sales) are usually put on together as a "macro" hedge against large market downturns. These short positions are typically taken in equity and credit indices such as the S&P 500, Russell 2000, DJ CDX.NA.IG Main, DJ CDX.NA.HY, or iTraxx Europe.

Investment Horizon:

The investment horizon of a fundamental credit manager is typically long term, (generally 24-36 months) and may in some cases be extended longer. By way of comparison, stylistically they range between Private Equity funds and Specialist Lending companies. Like Private Equity, fundamental credit managers buy because the perceived value of the investment is considerably less than that implied by the price. Managers usually target a 20-30% Internal Rate of Return, depending on the perceived risk of the investment. However, while, private equity funds invest in the shareholders' equity of its going concern (firm being invested in); credit hedge funds target companies in financial distress and buy their debt, with the expectation that they could receive the equity of the company[17] should a restructuring or liquidation of the company occur[18].

Credit hedge funds will often buy this debt from banks who have had to sell positions where the firm (subject of financial distress) would have (i) breached its lending covenants (ii) risks of lending to the same company has increased beyond their (or that of the regulators tolerance levels). Unlike Private Equity funds, these debt instruments may still trade, and may even be extremely liquid. Returns on the investments are generated as a consequence of specific company events (event driven) such as the balance sheet restructuring of the financially distressed firm, a trade sale, a public offer of the firm, or court-ordered plans for reorganisation (bankruptcy related court orders).

Similar to Private Equity funds, Fundamental credit managers may become "activist" investors. These investors deliberately set out to acquire a sufficiently large quantity of stakes in the firm's capital structure (debt or equity) allowing them to wield enough influence that the company often must listen to them (by holding blocking positions in either the equity or debt of the capital structure). Activist investors may choose to negotiate directly with the company or indirectly. Often they may be motivated by ethical concerns, and may canvass for change in the management

[16] Risks would include short term mark-to-market volatility of a long-term position, or undesired residual exposures within an investment, e.g., exposure to a subsidiary within a company.
[17] Hedge funds would look to receive some combination of cash, equity, and new debt, depending on the invested instrument and health of the company.
[18] In the event of a company bankruptcy, debt holders will always get paid out ahead of equity shareholders as a matter of priority in a bankruptcy situation of a company.

of the firm or its operations. Activist credit funds often become involved in a company's financial and/or its organisational restructuring. Several of these types of hedge funds hold board seats on companies in which they have significant holdings.

Corporate lending is also an activity carried out by fundamental credit hedge fund managers who act as lenders of last resort to companies in cases where access to more traditional means of bank lending is either (i) unavailable (when a company is undergoing a restructuring) or (ii) more expensive.

Often this lending activity is tied to a company's restructuring. For example, hedge funds may provide bridge financing to a company that has already declared bankruptcy in order that it may continue to function as a going concern, a bank would not normally have a mandate to supply this kind of financing.

Some hedge funds have become specialist lenders to other borrowers who find it difficult to source loans from commercial banks. These are typically small- and medium-sized companies who have had to meet higher hurdles as banks have tightened their lending practices. As with other Fundamental credit strategies, Direct Lending and Specialist Lending hedge funds are not large users of leverage. However in lower interest rate environments, some of these managers have set up term funding lines in order to obtain marginal gearing, usually extending no higher than 50% of equity.

Credit lending hedge funds have long investment horizons, ranging from 12 months to 5 years or longer. The funds' underlying investments are structured as loans with some having equity warrants attached. Managers may also invest a small amount in the equity of a borrower directly as part of their commitment. A typical lending arrangement would have the following characteristics:

- Non-callable for the first year
- Call typically at 102-103 (ie, penalty for early repayment of 2-3 points)
- Final maturities of 5-7 years, with average duration of 2-3 years
- Either fixed or floating interest rates, depending on market conditions
- Upfront fees of 1-2.5 points

Investor Liquidity:

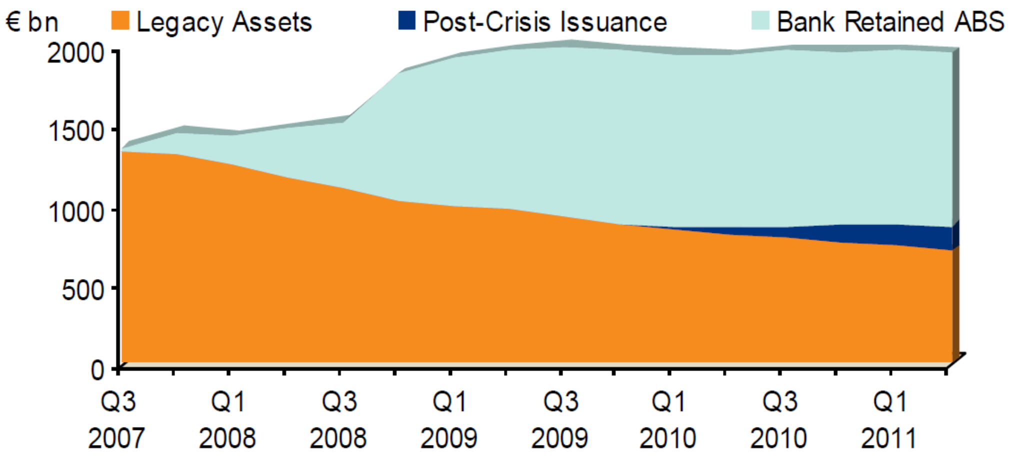
Within the Credit hedge funds universe, fundamental credit strategies have the most stringent investor liquidity limits, ideally matched to the liquidity of the underlying funds' investments. Many of these funds have investor liquidity of two years or longer with additional investor protection from redemptions (in the form of gates), should a large part of the fund be redeemed simultaneously. In the last few years there has been an increase in funds using a private equity structure; synonymous with a lengthy investment horizon, and built-in redemption periods. During periods of heightened fund illiquidity and/or unusually investor redemption pressure, credit hedge funds have the ability to "gate" and or "side-pocket" investor cash. As such, credit hedge fund managers can take (and have taken) time to unwind their portfolios, a position hedge fund investors have accepted.

3. Involvement of hedge funds in direct lending and asset backed securities

In this section we look at the extent to which credit hedge funds are involved in maturity transformation, liquidity transformation, and credit transformation in the area of direct lending which is complementary to hedge fund strategies that were described in the previous section. The objective is to attempt to quantify the extent of that activity in order to understand whether it should be accounted for in any systemic risk concerns.

Policymakers might consider select hedge funds as contributors to maturity/credit transformation because of direct lending strategies or through the chain of credit intermediation in purchasing Asset Backed Securities (ABS) on behalf of their clients (who are mainly institutions such as pension funds). While such transformations may occur in the small subset of credit hedge funds involved in direct lending, special situation "loan to own" strategies or through ABS positions, credit hedge funds only account for approximately 1% of non-bank credit intermediaries as indicated by the FSA. Further, it is estimated that direct lending activities and ABS only account for a small subset of this total. As illustrated below, a dominant majority of ABS has been retained by banks and new issuance since 2008 remains very low. Legacy assets in European ABS are held by a variety of non-bank credit intermediaries of which hedge funds make up a small percentage. We do not view this exposure as systemically significant.

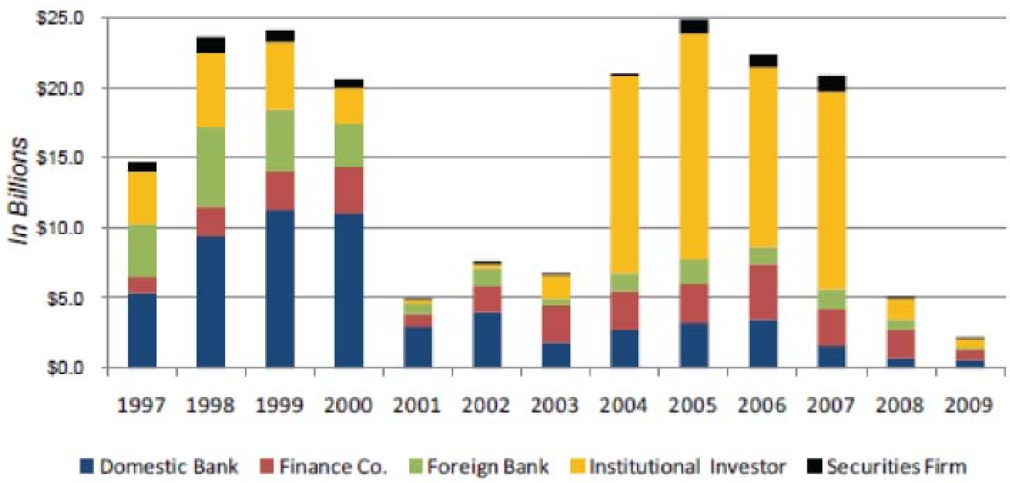
Chart 2: European Asset and Mortgage-Backed Market



Source: RBS Global Banking and Markets.

Since 2008, the degree to which credit hedge funds have employed direct lending as an investment strategy has diminished considerably. Most funds that are still involved in this practice are structured as private equity vehicles rather than hedge funds. This structuring ensures that the liquidity profile of their underlying assets matches that of the relevant finance vehicle. We estimate that only a small number of large alternative investment firms (as measured by assets under management) have small private equity style funds (with a drawdown structure and 5 year lock-ups to take advantage of a funding gap in the middle market). These funds do not use leverage and are generally small in size ($500m-$1,500m committed capital). Prior to 2008, middle market companies received financing from commercial banks, finance companies, CLOs and specialized hedge funds. Chart 3 below illustrates the volume of US direct lending to middle market companies; a proxy for overall direct lending, (as companies greater than $50m EBITDA tend to access the high yield market). One can observe the size of this market is small and continues to shrink, with past annual issuance reaching as high as $25bn, but more recently tracking closer to $5bn (against a background of new industry regulations and other similar pressures being imposed on commercial banking lending activities).

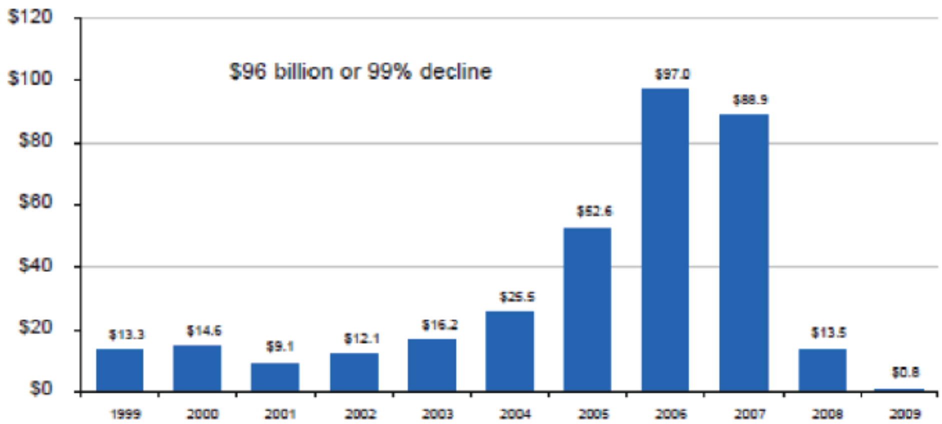
Chart 3: Total New Issue Middle Market Volume (Sub-$50m EBITDA Companies)



Source: Standard and Poor's (Leveraged Commentary and Data)

Further, the Collateralised Loan Obligation (CLO) market, which in the past supplied both middle market loans and larger syndicated bank loans, remains largely shut down (see chart 4 below) with little loan origination stemming from these vehicles. The overall leveraged loan market is flat in the US and shrinking in Europe as companies opt for issue high yield bonds instead.

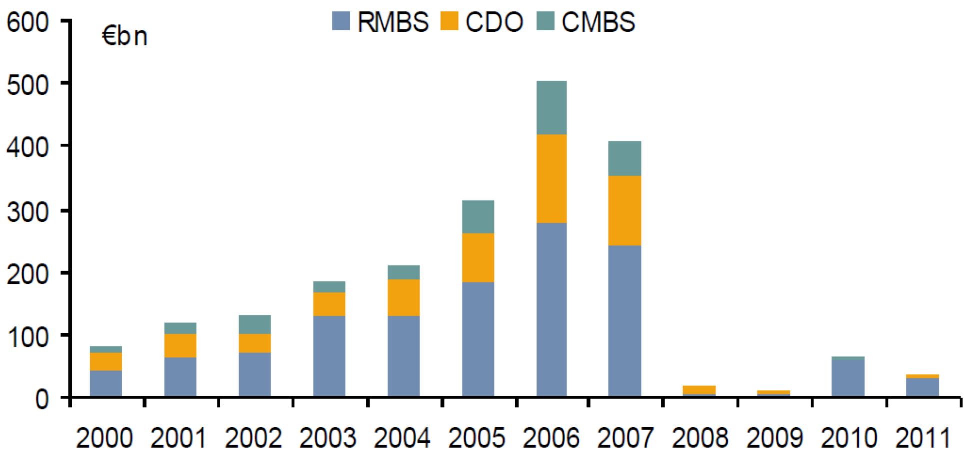
Chart 4: CLO Capacity by Year (1999-2009)



Source: S&P's Leveraged Commentary and Data (January 2010)

Asset backed securities such as RMBS, CMBS and CDOs contributed to growth in credit markets until 2008. Since then, securitisation has been very limited as indicated in chart 5 below. Hedge funds may invest in securitised products but do so on an opportunistic basis to take advantage of mispriced risk. Again, we regard the magnitude of credit hedge funds' role as a component of the credit intermediation chain to be too small to be systemically significant.

Chart 5: Securitisations of Mortgages and Leveraged Loans



Source: RBS Global Banking and Markets.

So are credit hedge funds and hedge funds in general systemically important 'shadow banks'?
According to the Financial Stability Board, the key drivers of systemic risk are size, interconnectedness, and leverage of financial institutions. In the shadow banking discussion, the importance of credit, liquidity and maturity transformation plays an important role. This section seeks to address these issues from the hedge fund perspective.

Hedge Funds ability to manage the liquidity profile:

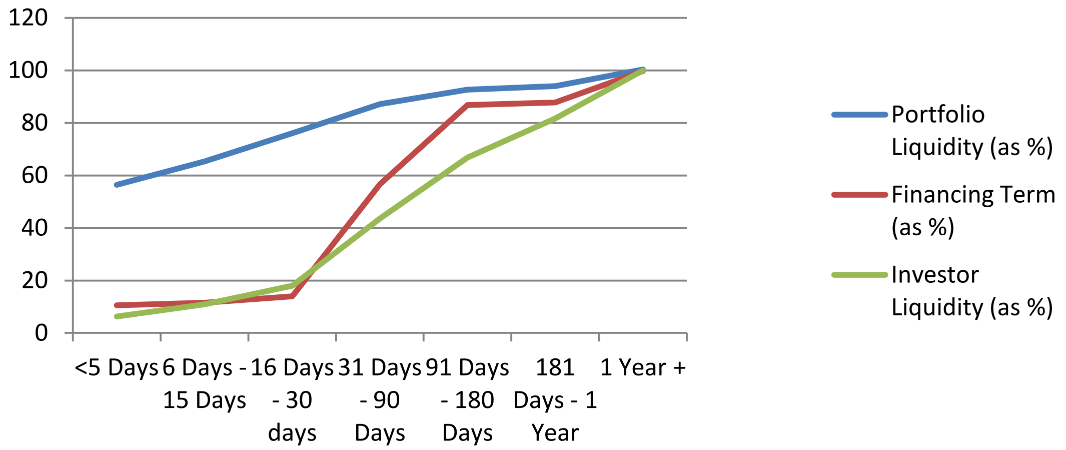
The most recent survey published by the FSA shows that the hedge fund liability profile is opposite to that of a bank, i.e. the funding maturity is longer than the liquidity of the risk portfolio. The sources and the terms of hedge fund borrowings are also a relevant factor. The latest FSA survey found evidence that the hedge fund industry is becoming less reliant on short term funding:

"*Portfolio and Investor liquidity largely remains unchanged relative to the April 2010 Hedge Fund Survey. In contrast, the term of financing has been "pushed out" in aggregate, with a reduction in short-term financing of between 5 and 30 days and an increase in financing terms of 31 to 180 days. By pushing out the financing terms, hedge funds have potentially reduced the risk of a sudden withdrawal of finance from their leverage providers (usually prime brokers)*"[19]

The graph below shows that assets of hedge funds could normally be liquidated in a shorter time frame than the period after which their liabilities (to investors and finance providers) would become due. Assets held by hedge funds could naturally be contractually long in maturity. For individual hedge funds as well as for the entire financial system, the risks involved in this maturity transformation, for both individual hedge funds and the whole financial system are mitigated by market liquidity only to the extent that markets can justifiably be assumed to remain liquid during stressed conditions.

[19] FSA Hedge Fund Survey, April 2011, http://www.fsa.gov.uk/pubs/other/hf_survey.pdf

Chart 6: Liquidity transformation in hedge funds



Source: Financial Services Authority, Hedge Fund Survey 2011

As we have highlighted in section 2, hedge fund structures are also designed to deal with stressed market conditions and are normally able to restrict investor redemptions through gates, side-pockets, suspensions or as otherwise allowed by their various fund offering documents. Maturity/liquidity transformation in hedge funds should therefore not be subject to systemic risk concerns to the same extent as those for financial institutions or structures whose liability profiles are short term.

Another factor that one should consider is the alignment of investor expectations, with regard to the underlying liquidity of investments within a hedge fund. The annual survey of hedge fund investors produced by Deutsche Bank[20] underscores this important feature of the hedge fund market (ref Table 1 below). Investors routinely accept long initial lock-up periods whereby the invested funds cannot be redeemed before the lock-up period expires. Indeed, the vast majority of hedge fund investors also accept quarterly or longer redemption periods.

Table 1: What is the longest lock-up that you will accept on new hedge fund investments?

No lock up is acceptable	10.10%
Less than 6 months	6.00%
Less than 1 year	7.00%
1 years soft lock up	15.90%
1 years hard lock up	18.80%
2 years soft lock up	13.70%
2 years hard lock up	9.60%
3 years soft lock up	4.00%
3 years hard lock up	3.60%
3 or more years	5.10%
NA/Prefer not to answer	6.30%

Source: Deutsche Bank Alternative Investment Survey 2011

[20] The 2011 annual survey conducted by Deutsche Bank included respondents from 528 hedge fund investors that collectively manage more than $1.34 trillion in hedge fund assets under management.

Chart 7: What liquidity do you require? Historical

Source: Deutsche Bank Alternative Investment Survey 2011

Leverage:

The FSB note states that leverage built up within the shadow banking system can also amplify procyclicality. As mentioned previously in section two, the use of leverage within hedge funds is modest, and indeed far lower levels of leverage are employed within the hedge fund industry than those employed by banks. In its most recent report (July 2011), the UK FSA estimated that the use of leverage by hedge funds managed from the UK remains largely unchanged in the aggregate (at approximately 2 or 3 times its net equity) compared with banks which are currently leveraged around 15 to 30 times their equity (down from as high as 40 or even 60 times prior to the crisis).

Empirical analysis collected via a recent academic study on industry leverage further supports this position. According to the study, an estimate of the leverage ratio employed by investment banks from December 2004 to December 2009 was 14.2 (times net assets), with a peak of 40.7 recorded in 2009, while the estimated leverage employed across the entire financial sector was 9.4 times. By comparison, during the same period, the study reported that the average leverage factor used across the hedge fund industry was 2.1 times, (hedge fund leverage peaked at 2.6 and bottomed out in October 2009 to 1.5).

A more recent analysis published by Hedge Fund Research Inc, (see table 2 below) reported that hedge fund industry leverage declined in the last 12 months, from 1.27 times to 1.1 times investment capital. Similar academic studies and hedge fund surveys carried out by various regulatory jurisdictions all conclude that the hedge fund industry has consistently employed relatively low levels of leverage.

Table 2: Standard Leverage

Standard Leverage	Q1 2010	Q1 2011
All SM Fund Weighted	127%	110%
ALL SM Asset Weighted	239%	216%
Fund Size: <= 50 MM	108%	106%
Fund Size: 50-200MM	117%	107%
Fund Size: 200-500 MM	145%	131%
Fund Size:500M - 1B MM	173%	158%
Fund Size: > 1B	203%	189%

Source: HFR, Inc 2011 Hedge Fund Leverage Report

The relative size and systemic importance of the hedge fund industry:

Hedge Funds are significantly smaller players in the context of the broader financial market. Recent estimates of the size of the hedge fund industry reported total hedge fund assets under management of approximately $2 trillion, whilst the global banking industry is now estimated to total in excess of $100 trillion in assets under management. We estimate that there are only two very large hedge fund firms that would qualify as Systemically Important Financial Institutions (SIFIs) under the Dodd-Frank criterion (where institutions with over $50bn of assets are deemed as systemically important), with the largest of these hedge fund advisers managing assets equal to approximately 3% of the entire hedge fund industry. Further, many hedge fund managers provide multiple hedge fund offerings; the result of all this being that the total size of assets managed by the hedge fund industry is even less concentrated when looking at asset concentration on a fund by fund basis. This dispersion of assets reduces the risk that the failure of any one hedge fund or fund adviser would create systemic risk due to a lack of substitutes.

Size of the credit hedge fund industry:

Using the criteria set out in section 2, we estimate the proportion of credit hedge fund assets being within a range of approximately 25%-35% of the total of all hedge fund assets under management, or approximately $630 billion. Please see Annex 1 for a breakdown of the estimated total of the hedge fund universe and the estimated proportion relevant to credit hedge funds.

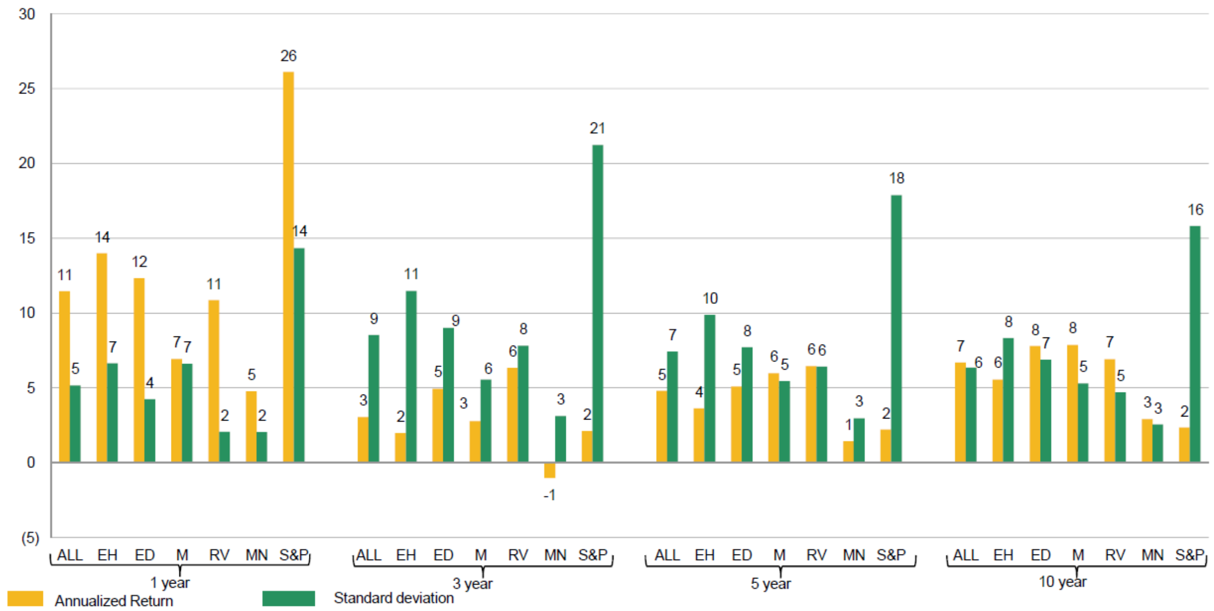
The movement of assets to the hedge fund industry should not cause additional concern either, as it is gradual (consensus forecasts of industry growth estimate total AUM to reach $2.25 trillion in 2012). Moreover the hedge fund market is both well managed in terms of risk and subject to increasing oversight by regulators, including under the new AIFMD (although for many years hedge funds have already been required to be registered with the UK's FSA) and the Dodd-Frank Act. During the financial crisis, hedge funds frequently closed and liquidated in an orderly manner as evident from chart 10 in annex 1, but there was little or no impact on the system and there was no burden placed on the taxpayer. In a March 2011 report, the UK FSA remarked that "risk-taking by non-banks may be less concerning because non-banks are more likely to be able to fail without damaging the wider sector and economy. For example many hedge funds fail each year without causing systemic problems".[21]

[21] Prudential Risk Outlook 2011, Financial Services Authority (Section B4) http://www.fsa.gov.uk/pubs/other/pr.pdf

Risk: Volatility:

Hedge fund returns are significantly less volatile than equity returns, meaning hedge funds as a group tend to be significantly less risky than a diversified portfolio of stocks as represented by the S&P 500. According to analysis from Morgan Stanley (see chart 8 below), the standard deviation of hedge fund returns in all strategies (ALL) ranges from 5-9% versus S&P 500 range of 14-21% across 1, 3, 5 and 10 year periods. Credit hedge funds bucketed under Event Driven (ED) and Relative Value (RV) range from 5-9% while Equity Hedged strategies are slightly higher at 7-11%. By this measure, investing in the S&P 500 carries approximately twice the risk of investing in hedge funds.

Chart 8: Annual returns and Standard deviations as of June 2011



Source: Hedge Fund Research (June 2011), Morgan Stanley Prime Brokerage

4. Conclusion

Credit hedge funds are part of the asset management community and exist to serve pension funds, endowments, unions, family offices and other investors; they are not 'shadow banks'.

First, hedge fund asset managers do not operate in a 'shadow'. They are or will shortly be subject to strict regulation in all major jurisdictions around the world. EU hedge fund managers are currently regulated on the basis of domestic Member State regulation but will shortly be subject to increased and harmonised regulatory scrutiny following the entry into force of the new Alternative Investment Fund Managers Directive (AIFMD). Similar regulations will apply for US hedge fund managers pursuant to the Dodd-Frank Act. Importantly, all major jurisdictions are introducing a detailed and mandatory systemic risk reporting regime which is based on the template created by the International Organization of Securities Commissions (IOSCO)[22].

The level of regulation and oversight of the hedge fund industry should ensure that if there were to be a build up of systemic risk in the hedge fund sector, competent authorities should have all the available data and tools to contemplate appropriate intervention.

[22] A summary of the existing regulatory framework for hedge fund managers in Hong Kong, Singapore, USA and Europe is outlined in Annex 3.

Second, hedge funds are not banks. There are well-established differences between hedge fund managers and banks:

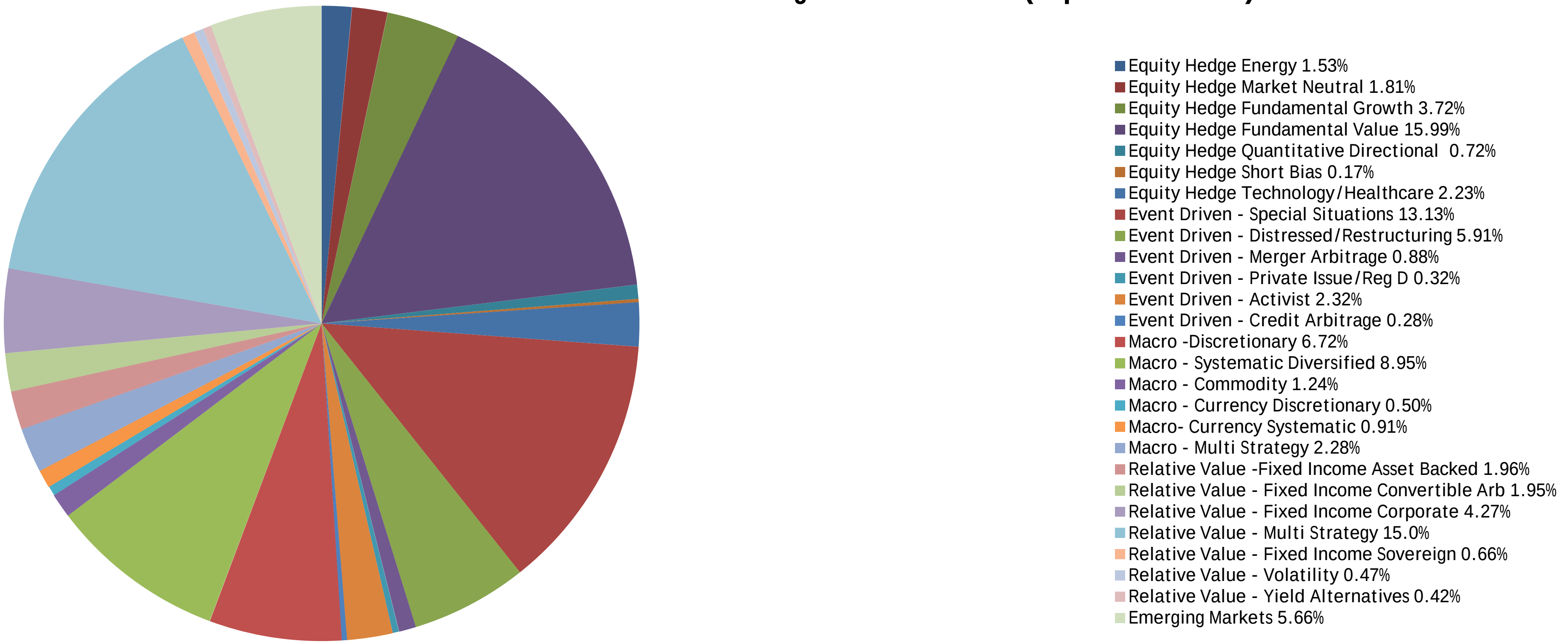
- Investors in asset managers seek particular risk exposures (bank depositors or money market fund investors generally do not seek exposures to bank loans, trading portfolios or other risk portfolios);
- Hedge funds can control, manage and change their liquidity profiles ex-ante by aligning their redemption policies with the liquidity profiles of the funds and ex-post by potentially limiting or even suspending redemptions (and therefore lengthening their liability profile) depending on the market liquidity situation;
- Hedge funds create bespoke liquidity conditions for particular funds or even groups of investors which then match the liquidity profiles of the invested instruments (managed accounts, single investor funds);
- Hedge funds do not offer a guarantee, or do not hold themselves out in such a way as to give an impression to guarantee the redemption of the original investment at par or at a pre-specified time;
- The absolute majority of the hedge fund investor base is now composed of sophisticated institutional investors.

We therefore do not believe credit hedge funds or hedge funds in general should be considered part of the complex called the shadow banking sector because they are:

- adequately regulated
- subject to extensive reporting to competent regulatory authorities
- small in size in relation to the rest of the financial system
- consistently employ low levels of leverage
- do not engage in any significant sense in credit, liquidity or maturity transformation
- do not play a large role in the credit intermediation process.
- are not in need of government support – safe to fail not too big to fail.

Annex 1

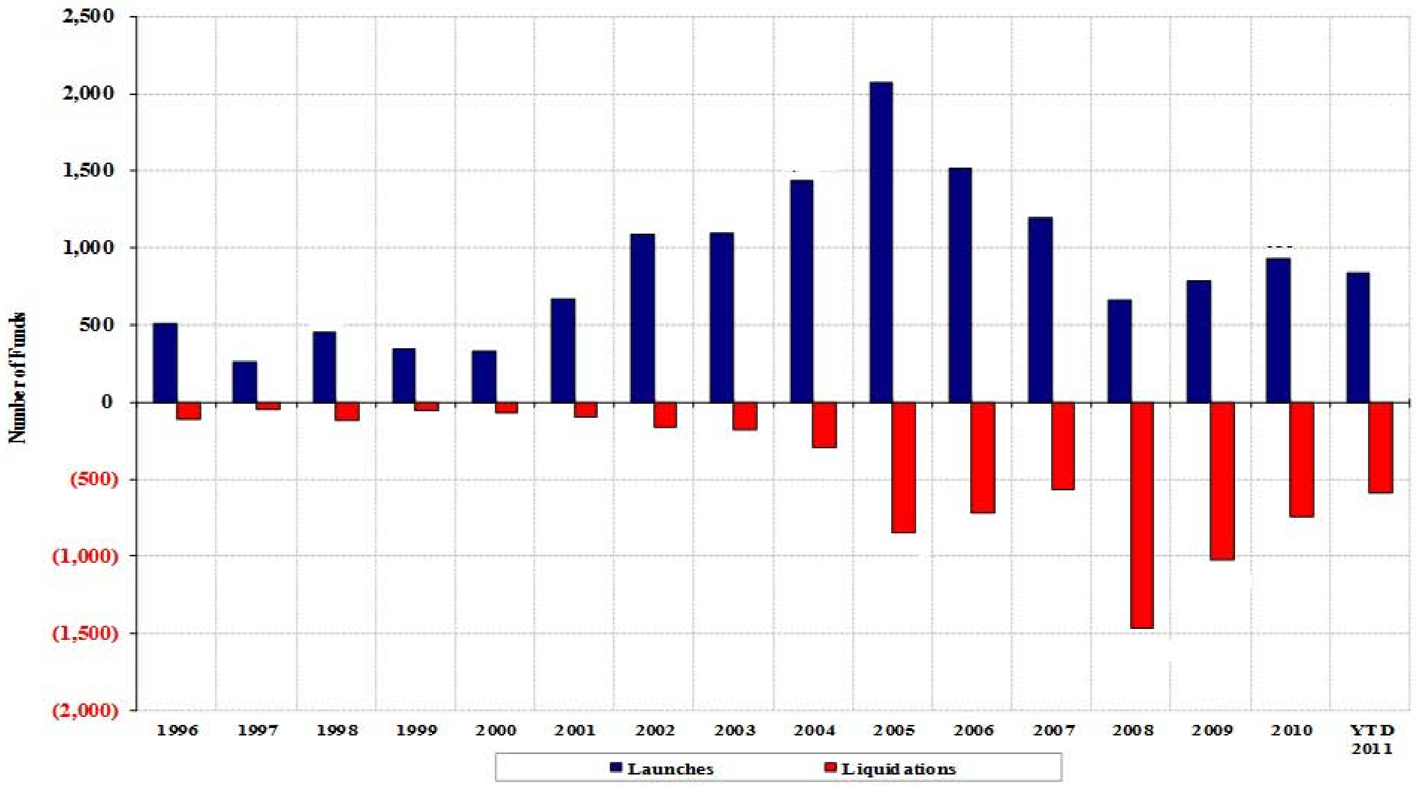
Chart 9: The Global Hedge Fund Universe (September 2011)



Source: HFR Inc. HFR Global Hedge Fund Industry Reports

Note: Our best estimate of the credit hedge fund universe as per our guide in section 2 and 3 above is made up of estimates of total hedge fund assets under management derived from Event Driven (Special Situations, Distressed/Restructuring, Merger Arbitrage, Activist, Credit Arbitrage) and Relative Value Fixed Income (Fixed Income Asset backed, Convertible Arbitrage, Fixed Income Corporate and Fixed Income Sovereign) hedge fund strategies.

Chart 10: Launches and Liquidations of Hedge funds (1996- September 2011)



Source: HFR, Inc. HFR Global Hedge Fund Industry Reports.

Annex 2
Redemption strategies

There are a variety of strategies potentially available to hedge funds for handling redemptions requests and requests for payment. Such strategies may include:

- **Reliance on a 'lock-up' or 'lock-in' period**: Requires that new investors agree to a minimum period of time during which their money invested in the hedge fund is committed and cannot be withdrawn. The length of lock-up period may depend on the quality and reputation of the fund, as well as the liquidity of the underlying investment portfolio. Some funds may allow investors to redeem during a lock-up period if they pay a penalty (redemption fee), for example 3% to 5% of the amount of capital they are seeking to redeem.

- **The alteration of provisions as to redemption notice periods, redemption dates, or their frequency:** Redemption requests are conditioned upon a requirement to give notice (generally 45 to 120 days) to the manager that the investor wishes to redeem all or a portion of its capital account on the given redemption date. These notices are generally irrevocable once delivered and are unconditional.

- **The suspension of determination of the hedge fund's Net Asset Value (NAV), along with a suspension of subscriptions and redemptions:** Redemptions may be refused if the fund manager reasonably believes that the NAV of the fund investments cannot be fairly ascertained, the redemption or realisation of the fund's investments cannot, in the managers opinion, be affected at normal prices or normal rates of exchange, or if there are negative tax consequences of the redemption.

- **The suspension of the date of payment of the redemption proceeds:** Full suspensions or other restrictions can be imposed at the manager's discretion or subject to certain preconditions.

- **The imposition of a 'gate' on redemptions:** This mechanism is used by hedge fund managers to limit the percentages of capital that can be withdrawn on the fund's scheduled redemption date, or to delay or suspend withdrawals altogether where there is a possibility of a "run" on the fund's capital. Redemption gates are often imposed at the discretion of the fund manager to investors, for any reason, from removing any but a portion of their original stake in a fund over a period of time or delay the payment of redemption proceeds to investors. Other gates are drafted as non-discretionary mechanism exercisable only in specified circumstances.

- **The creation of a 'side pocket' or a special purpose vehicle ('a synthetic side pocket') for illiquid investments:** Under this strategy, the hedge fund creates a special purpose vehicle (SPV) to which it conveys the hedge fund's illiquid assets in return for shares or security interests, thereby separating illiquid assets from other more liquid assets. It then transfers those shares or security interests to its redeeming investors as payment 'in kind' of the redemption price that is owed to those investors. The SPV would liquidate the illiquid assets at some point in the future, when market conditions are more favourable and it is able to do so, and then distribute the proceeds to the SPV's shareholders or beneficial owners. A type of account used in hedge funds to separate illiquid assets from other more liquid investments. Once an investment enters a side pocket account, only the present participants in the hedge fund will be entitled to a share of it. Future investors will not receive a share of the proceeds in the event the asset's returns get realised. Investors who leave the hedge fund will still receive a share of the side pocket's value when it gets realized. Usually only the most illiquid assets, such as delisted shares of a company, receive this type of treatment, because holding illiquid assets in a standard hedge fund portfolio can cause a great deal of complexity when investors liquidate their position.

In addition to the alternatives described above, a fund manager may also be able to use strategies such as the restructuring of the hedge fund or voluntary or compulsory liquidation of the hedge fund.

The availability or suitability of any of these strategies will depend on the terms of each hedge fund as further outlined in the governing documents, and the facts and commercial considerations of each particular case.

Redemption restrictions may be declared during:

a) any period (other than ordinary holiday or customary weekend closings) when any market is closed which is the main market for a significant part of the investments, or when trading thereon is restricted or suspended;

b) any period when any emergency exists as a result of which disposal by the fund of investments which constitute a substantial portion of its assets is not practically feasible;

c) any period when for any reason the prices of a material portion of the investments of the fund cannot be reasonably, promptly or accurately ascertained by the fund;

d) any period when due to conditions of market turmoil or market illiquidity it is not possible, in the opinion of the Directors, to determine the fair value of a substantial portion of the assets of the fund;

e) any period when remittance of monies which will, or may be, involved in the realisation of, or in the payment for, investments of the fund cannot, in the opinion of the Directors, be carried out at normal rates of exchange;

f) any period when proceeds of the sale or redemption of the Shares or Management Shares cannot be transmitted to or from the fund’s account;

g) any period when the business operations of the Manager, the Investment Manager, the Administrator (or any delegate thereof) in relation to the operations of the fund are substantially interrupted or closed as a result of or arising from acts of war, terrorism, revolution, civil unrest, riot, strikes or acts of God;

h) any period when, in the reasonable opinion of the Investment Manager the realisation of assets by the fund to fund redemptions would result in unreasonable losses to the fund; and

i) any period when a conclusive valuation of the fund is not possible for any other.

Alternative Investment Management Association

Annex 3

Regulatory framework - Authorisation and reporting requirements for hedge funds and hedge fund managers

Country	Authorisation requirements - Hedge Funds	Authorisation requirements - Hedge Fund managers	Reporting requirements in relation to competent authorities
United States	Hedge funds may either be authorised or non-authorised. Authorised hedge funds pursuant to the Securities Exchange Act of 1934 may offer its interests to any number of investors while non-authorised hedge funds may only offer its interests to certain investors. Authorised hedge funds are under she supervision of the Securities & Exchange Commission ('**SEC**').	Hedge fund managers may register with the SEC under the Investment Advisers Act 1940. Hedge fund managers that make use of futures and options to execute trades are also obliged to be registered by the Commodities & Futures Trading Commission. Under the newly adopted Dodd-Frank act, hedge fund managers/advisers will be obliged to register with the SEC or the CFTC.	Authorised hedge fund managers are required to report, *inter alia*, fund's holdings of financial instruments and risk measurement. Under the Dodd Frank Act the U.S. regulatory agencies have broad powers to request regular reporting requirements from hedge fund managers and advisors. This will likely include data about their size, risk exposures and leverage. The reporting regime is likely to be based on the IOSCO template.
EU	Fund structures and establishment remains in the domain of national law of EU Member States.	National European legislation pertaining to hedge fund managers is being replaced with the newly adopted Alternative Investment Fund Managers Directive. All hedge funds with assets under management of more than 100 million euros will have to be authorised by Member State competent authorities.	Managers will have to report a large set of data about themselves, their size, strategies, their risk exposures and leverage to their respective competent authorities. The reporting regime is likely to be based on the IOSCO template.
France	Hedge funds (except for contractual funds) are subject to authorisation requirements by the Autorité des marchés financiers ('**AMF**') pursuant to the French Monetary and Financial Code.	Management companies are authorised by and placed under the supervision of the AMF.	Hedge fund managers are required to report, *inter alia*, key information as to holdings and exposures of hedge funds.
Hong Kong	Hedge funds sold to the public in Hong Kong are subject to authorisation requirements by the Securities and Futures Commission ('**SFC**') pursuant to the Securities and Futures Ordinance ('**SFO**') and the SFC's Code on Unit Trusts and Mutual Funds.	Any asset management activity conducted in or from Hong Kong, whether in relation to a retail or a privately placed fund, or other forms of securities and/or futures contracts management, requires the fund manager/adviser to obtain a SFC licence pursuant to the SFO.	Hedge fund managers are required to report, *inter alia*, key information as to holdings and exposures of hedge funds.

Germany	Hedge funds are subject to authorisation requirements by the Bundesanstalt für Finanzdienstleistungsaufsicht ('**BaFin**') pursuant to the German Investments Act.	Hedge fund managers are subject to authorisation requirements pursuant to the German Banking Act.	Hedge fund managers are required to report, *inter alia*, key information as to holdings and exposures of hedge funds.
Singapore	Hedge funds are subject to authorisation requirements by Monetary Authority of Singapore ('**MAS**') pursuant to the Securities and Futures Act ('**SFA**').	Hedge fund managers are subject to authorisation requirements pursuant to the SFA.	Hedge fund managers are required to report, *inter alia*, key information as to holdings and exposures of hedge funds.
Luxembourg	Hedge funds (UCITS or non-UCITS) are subject to authorisation requirements by the Commission de Surrveillance du Secteur Financier (**'CSSF**') pursuant to the part II of the act of 20 December 2002 (**'UCI Act 2002**') or the act of 13 February 2007 ('**SIF Act 2007**').	Hedge fund managers are subject to authorisation requirements by the CSSF pursuant to UCI Act 2002 or SIF Act 2007.	Hedge fund managers are required to report, *inter alia*, key information as to holdings and exposures of hedge funds.
Sweden	Hedge funds (UCITS or non-UCITS) are subject to authorisation requirements by the Finansinspektionen (**'FI**') pursuant to the Swedish Investment Funds Act (**'LIF**').	Hedge fund managers are subject to authorisation requirements by the FI pursuant to the LIF.	Hedge fund managers are required to report, *inter alia*, fund's holdings of financial instruments and risk measurement.
United Kingdom	Hedge funds may either be authorised or non-authorised. Hedge funds that are regulated must comply with the provisions of the FSA Handbook. Under the UK regulatory regime, hedge funds are typically non-authorised.	All UK based hedge fund managers must be authorised and, once authorised, then regulated by the Financial Supervisory Authoirty ('**FSA**') pursuant to the Financial Services and Markets Act 2000.	Authorised hedge fund managers are required to report, *inter alia*, fund's holdings of financial instruments and risk measurement.

Annex III

Financing the Economy - The role of alternative asset managers in the non-bank lending environment

Alternative Investment
Management Association

Financing the Economy

The role of alternative asset managers
in the non-bank lending environment

www.aima.org

Contents

Foreword from the AIMA Alternative Credit Council

I am delighted to introduce on behalf of the AIMA Alternative Credit Council (ACC) our new paper, "Financing the Economy." This research comes at a very important time – as alternative credit funds and the use of non-bank finance becomes increasingly prominent across all aspects of lending.

Non-bank finance is very much part of the mainstream in the US and funds that provide direct lending tend to operate largely in the US. Outside of the US, bank deleveraging in Europe is creating an opportunity for institutional and private investors to expand direct lending to a range of sectors, and there are plenty of new approaches and structures emerging.

Increased activity from capital markets as opposed to lending through traditional bank lending channels has produced material benefits. Included among these are increased market liquidity, a greater diversity of funding sources and a more efficient allocation of risk among investors.

Non-bank lending can greatly mitigate the systemic risk associated with direct lending by banks. Levels of leverage used by funds in their portfolios are close to negligible. Alternative credit funds, typically, are investing on behalf of sophisticated investors who understand and can absorb potential losses. Unlike bank depositors, these investors cannot instantly withdraw their capital, given funds tend to be closed-end in nature. Finally, alternative funds are often specialists in dealing with stressed and distressed assets so complexity is something they are prepared for. Rather than selling assets and collateral in a panic, they are capable of expertly managing default situations.

Amidst historically low interest rates, a dearth of true yield opportunities from investing in fixed income is hampering the ability of pension funds to deliver on their basic objectives. Consequently in recent years, the appetite of institutional investors for private debt exposure has developed aggressively, as the risk-adjusted returns on offer make this one of the most attractive investment strategies of recent years.

Governments acknowledge the need to develop a more diversified lending market in Europe and the role of non-bank lenders in doing this. In its recent Green paper on Europe's long term financing situation[1], the EC argues that the reverberations of the financial crisis provides an important opportunity to diversify Europe's credit markets. Further it confirmed that, in order to truly revive the economy, it will be necessary to improve the blend and overall resilience of different funding sources.

Removing structural barriers to entry in the lending market will increase diversity of supply of credit, boost the resilience of the financial system and drive better outcomes for consumers and businesses.

AIMA's Alternative Credit Council was established in late 2014 to provide general direction to AIMA's executive on developments and trends in the alternative credit market. We hope that our combined work will help ensure a sustainable future for this essential sector. Our collaboration starts with this research, which is now the third paper in a series of work that explores the thesis that facilitating greater capital markets, and by association, hedge funds enhances economic growth for the long term. The research is ultimately for the benefit of both policy-makers and market participants, and continues AIMA's commitment to improving the industry for practitioners and investors alike.

Stuart Fiertz, Chairman
AIMA Alternative Credit
Council and President
Cheyne Capital.

1 European Commission. "Green Paper: Long Term Financing of the European Economy." March 2013

Introduction

The source of funding for the real economy matters. Capital market financing contributes more to economic growth than bank lending by creating opportunities and an economic environment that fosters better economic management and investment in risky but often innovative projects. AIMA's own research[2] has shown that growing combined stock and bond markets by one-third could fuel a long-term real growth rate in per capita GDP of approximately 20%, as stock and bond market liquidity allows for cost-efficient re-allocation of capital across industries. We've decided to go further and look at various components of the capital markets. We examined the role of activist funds in the equity space and have now turned our gaze to the debt markets.

Private debt strategies have grown dramatically in popularity in recent years buoyed by both increased investment from investors into these funds as well as increased demand from smaller businesses for alternative sources of funding.[3]

Across Europe's lending landscape, a quiet revolution is taking place in the way companies secure their finance. Amidst tighter banking restrictions and subsequent overall reduced levels of bank lending, the past two years has seen a significant rise in alternative asset managers jumping in to bridge the financing gap via non-bank lending. These alternative lenders consist of a wide range of non-bank institutions with different strategies including private debt, mezzanine finance and distressed debt. Hedge funds have also increased their exposure to this sector through a variety of investment strategies that can be termed "alternative credit", which include but are not limited to direct lending, private debt, securitisation and capital relief.

As of the end of 2014, figures for Europe reveal over 350 transactions have been completed by 36 alternative lenders in just over 2 years.[4] Deal flow has continued to grow, as the volume of deals done by direct lending funds in Europe

2 Capital Markets and Economic Growth, Long-term trends and policy challenges, AIMA (2014).

3 We define private debt as investments in or strategies related to loans (whether by funds themselves or bought on the secondary market); private debt securities (securities privately placed with or issued directly funds or a group of funds, including forms of private securitisations); other instruments with debt or hybrid debt characteristics used for the financing of companies or projects by asset managers. Further, we consider distressed debt investments, mezzanine financing, real estate and infrastructure financing as well as other forms of opportunistic and short term lending such as bridge financing to all fall within the definition of private credit.

increased 43% between 2013 and 2014. It is estimated that there are now around 40 active direct lending funds (up from 18 reported in 2012) and a further 81 new funds out in the market looking to raise £50bn. Increasingly, banks are also teaming up with alternative lenders to provide more flexible structures and there remains a strong role for them in the new lending environment.

Indeed, some of Europe's largest institutional investors are helping to bridge the financing gap for the SME[5] (Small and Medium Enterprise) sector by investing in alternative credit funds or taking a more direct approach and doing it for themselves. Direct lenders enjoy a growing credit portfolio across a wide range of businesses as well as providing support to a broad variety of infrastructure projects.

Arguably, the role of non-bank finance is never more important than today. A recent survey[6] by the European Central Bank showed that mid-market corporates continue to report a reduced supply of bank loans for the fifth consecutive year, while access to direct bank finance for SMEs is increasingly difficult. In contrast, the AUM of US loan funds has tripled since June 2012 while growth has been even faster in the EU with AUM rising fivefold over the same period (albeit from a lower base).

Private debt financing today accounts for approximately 6% of the total estimated funding for SMEs. Given bank lending to SMEs is likely to continue to decline, funding from the private debt industry as an overall percentage of total SME funding in the European Union could reach levels of between 15% – 20% within the next five years.*

Alternative credit hedge funds, and the wider hedge fund industry, are part of the wider asset management sector, not the banking industry and as such should not be included in any part of the shadow banking discussion. Hedge funds must be authorised and are the subject of strict regulation across all major financial jurisdictions. Further, they are subject to significant micro-prudential operational standards and organisational requirements such as conflict of interest and conduct rules, the protection of client assets as well as prudential regulations on liquidity and risk management.

In this latest research piece, we explore the development of private debt investment and the increasingly important role asset managers are playing as participants in non-bank finance. To help us in our understanding of this area, we conducted a global survey among a variety of alternative credit participants throughout late 2014.[7] The objective of the survey was to gather information about the funds and managers who participate globally in private debt and to contribute to the debate around asset management involvement.

Special thanks are due to AIMA's Alternative Credit Council for its support in the production of this paper. We hope that this publication will help to improve understanding of the private debt sector and be considered a trusted source for you to learn more about this increasingly influential area of capital market development.

Jack Inglis, AIMA CEO

4 Deloitte Alternative Lender Deal Tracker which tracks primarily mid-market deals across Europe with up to €350m of debt.

5 The category of micro, small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual turnover not exceeding €50m and/or an annual balance sheet total not exceeding €43 million.

6 April 2014, Survey on the access to finance of small and medium sized enterprises in the Euro area, ECB.

7 We are grateful for the support received from Simmons & Simmons in drafting the questionnaire for this survey.

* Source: AFME's Bridging the Growth Gap Report, Preqin, AIMA private debt survey.

Demographics of survey participants/ methodology

Asset management firms that participated in this survey account for assets under management (AUM) of approximately $530bn (using the midpoint of the provided AUM response ranges).[8] Using the same methodology, these managers allocate approximately $85bn to private debt investment strategies.

The majority of participating firms in the survey are located in the UK or North America, which are considered to be the two most developed regions for private debt investment (figure 1).

The full spectrum of asset management firms are represented including traditional asset managers, private equity firms and hedge funds (figure 2). Just under half of the respondents are hedge funds or fund of hedge funds investing predominantly in fixed income and credit (figure 3).

While firms of all sizes are represented in this survey, the average respondent (credit lender) is a medium to large asset manager holding a significant investment in private debt. Over 55% of the responses are large asset management firms (with $5bn or greater in AUM – figure 4) while 50% allocate $1bn or more in AUM to alternative credit strategies (figure 5). Smaller firms (with $500m or less in AUM) are also well represented in this survey.

8 If a manager chooses a response option of between $20bn and $50bn in AUM, it is assumed they have $35bn in AUM.

Figure 1: Headquarter locations of participating firms

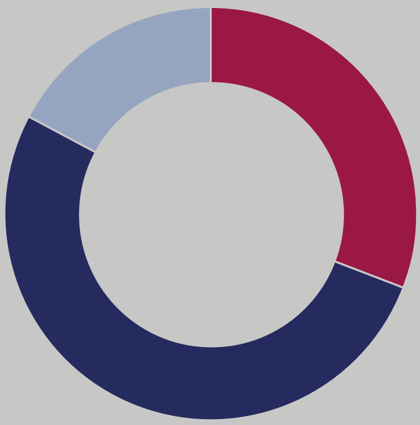


Figure 2: Investment classification of participating firms

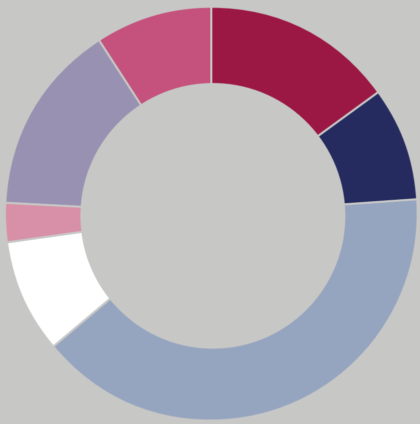


Figure 3: Primary strategy of participating hedge fund firms

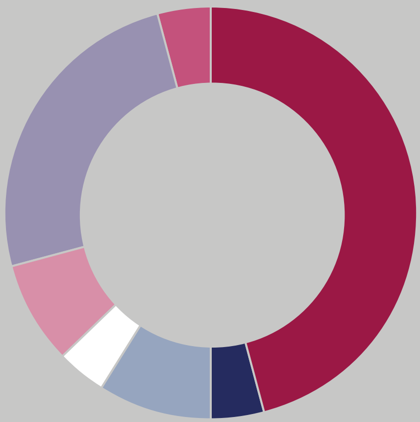


Figure 4: Distribution of participating firm AUM

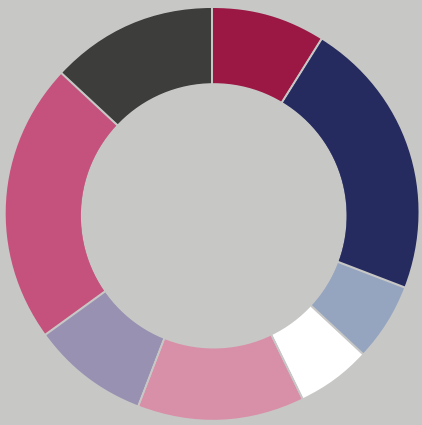
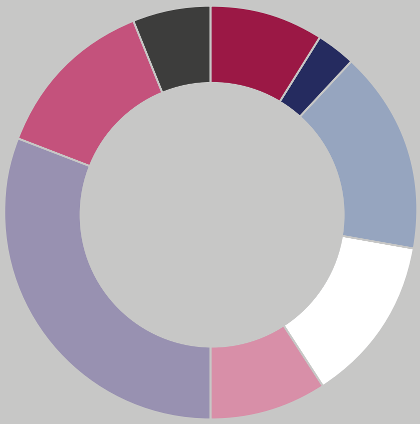


Figure 5: Distribution of AUM mandated for alternative credit investment



* %s on graphs are rounded up and thus may not always aggregate to 100%

Key findings from the survey

1 Asset managers are playing an increasingly crucial role in financing the real economy

The global financial crisis and subsequent bank reform has led to a diminution of capital and reduced lending opportunities available to the private sector. Arguably nowhere has this dearth of lending been more challenging than in the European lending market. In stark contrast to the US lending market where 80% of all corporate lending is carried out in the capital markets (through the issue of equity or bonds), almost the same percentage of the total of European lending is bank financed.[9]

Among the borrowers that are particularly feeling the brunt of forced bank retrenchment are the small and medium sized enterprises (SMEs) that have traditionally relied on banks for investment. While many firms have started to issue bonds (high yield, investment grade) as a way of raising finance, this alternative only applies for larger companies as capital markets do not have the appetite for buying into bonds where the size of the firm is comparable to an SME.

Amidst these restrictions, the alternative lending market continues to grow, and direct lending (non-bank finance) is fast becoming a permanent feature of the lending market. These alternative lenders consist of a wide range of non-bank institutions with different strategies including private debt, mezzanine finance and distressed debt.

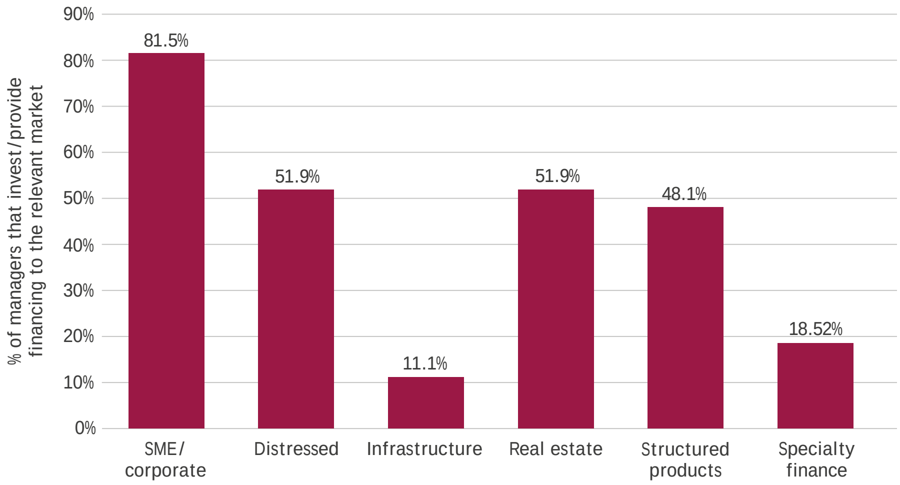
Hedge funds have increased their exposure to this sector through a variety of investment strategies that can be termed “alternative credit”, which include but are not limited to direct lending, private debt, securitisation and capital relief.

Adding support to this opinion, over 80% of the managers in this survey are lending to SMEs and their equivalent or larger corporates (figure 6).[10] The ECB estimates that SMEs account for 99.8% of all businesses and for 66% of all employment in the EU, while in the U.S an estimated 200,000 SMEs employ 65% of the work force.[11] Over 50% of managers surveyed are investing in distressed debt and providing finance to struggling companies that would otherwise likely fail.

82%

of managers surveyed are lending to SMEs

Figure 6: Private debt markets that managers participate in

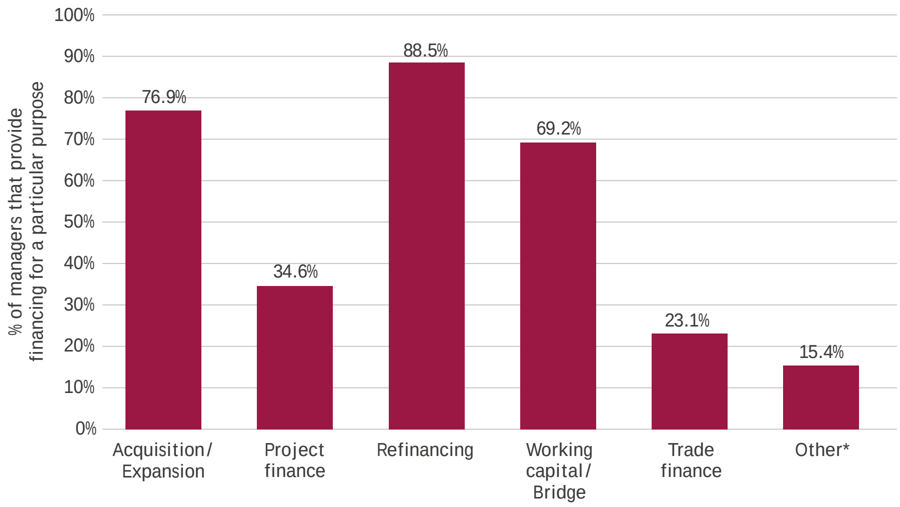


9 EIF, “Institutional non-bank lending and the role of Debt Funds”, Working Paper 2014/25

10 In the EU, the category of SME is defined as enterprises with fewer than 250 persons and an annual turnover not exceeding €50m and/or an annual balance sheet not exceeding €43m (Article 2, Annex of Recommendation 2003/361 EC)

11 United States. Census Bureau. Washington: GPO, 2007. Print.

Figure 7: **Purposes of financing**



*Other includes responses such as restructuring finance and pre-IPO finance.

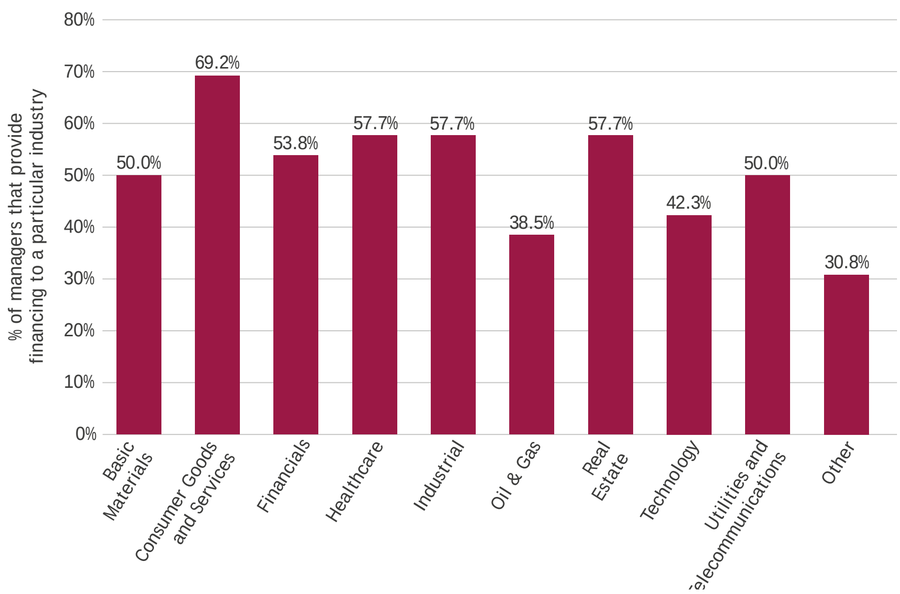
95% of the managers surveyed provide financing for acquisition/expansion or refinancing purposes while 77% provide financing for both purposes (figure 7). Purposes of financing relevant to borrowers such as access to bridge financing (short-term cash for the maintenance of operations) or as a means to improve their working capital (acquire inventory or pay off accounts payable) also rate very highly among their reasons for seeking capital in the absence of bank support.

M&A activity is expected to deliver an even higher volume of transactions in the coming years, as firms look to invest large volumes of dry powder, which will further fuel demand for un-constrained and bespoke debt which favours alternative lenders.

95%

of the managers surveyed provide financing for acquisition/expansion or refinancing purposes

Figure 8: **Manager industry preference**



The managers polled are active in providing finance across a variety of industry sectors. One of the more popular industries that managers lend to is the consumer goods and services industry (figure 8). This particular industry is vital to the performance of an economy as consumption is typically responsible for more than 50% of a country's GDP. In the UK, for example, household consumption expenditure accounted for 65% of GDP in 2013.[12] Traditionally these industries have relied on borrowing from the banking sector. But, as banks have moved out of lending to this area, it is notable that direct lending has become a prominent borrowing alternative, and is fast becoming a permanent feature of the lending market.

The target transaction size by managers participating in the survey is typically below $100m with the range of preferred investments between $25m-$100m (figure 9). These transaction sizes are indicative of companies that are considered too small for the public corporate bond market as most new issuances tend to be in excess of £100m.

Managers are generally providing finance to borrowers (who have an EBITDA) of $25m or less. This is highlighted by 50% of the responses in figure 10 below, adding further support to the opinion that asset managers are financing companies that are too small for public bond financing.

Figure 9: Managers' target transaction size

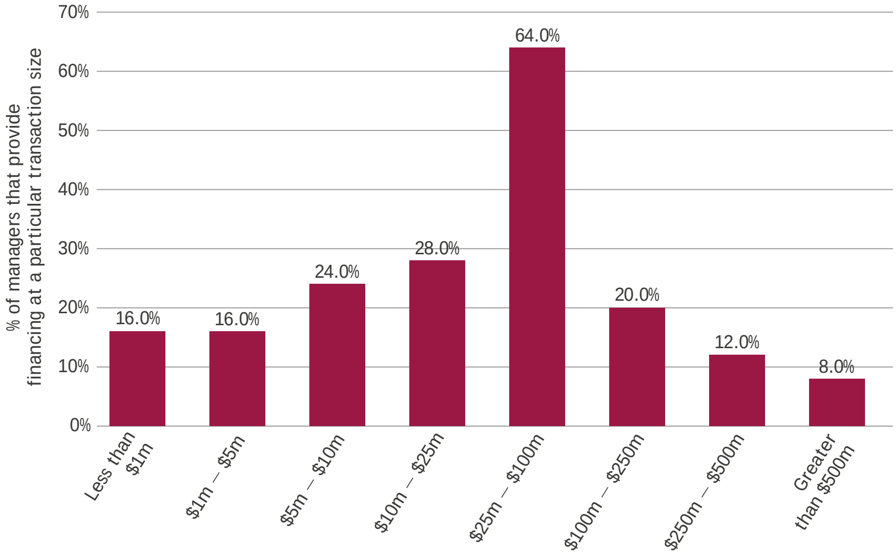
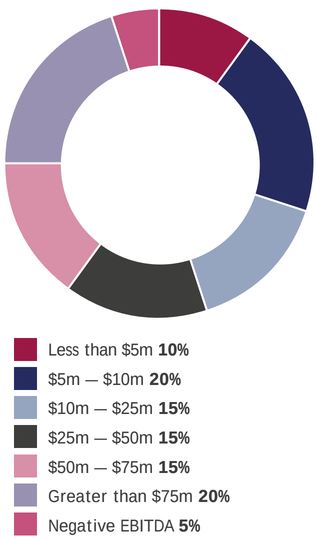


Figure 10: The average size of the borrowers by EBITDA



Financing terms are being extended to companies in multiple regions although a bias exists with the UK, USA and Western Europe the most popular regions, likely supported by a favourable climate for direct lending. 76% of respondents provide financing to UK-based companies (figure 11). It has been suggested that European mid-sized businesses will need to raise $3.5 trillion in debt over the next five years,[13] while EU banks will need to reduce their asset base by $2.6 trillion. It is thus vital that asset managers continue to extend financing to companies in the key economies of the EU.

12 Data taken from the World bank (2013)

13 The Squeezed Middle, June 2013, S&P

Figure 11: Where the managers provide financing (most popular locations)

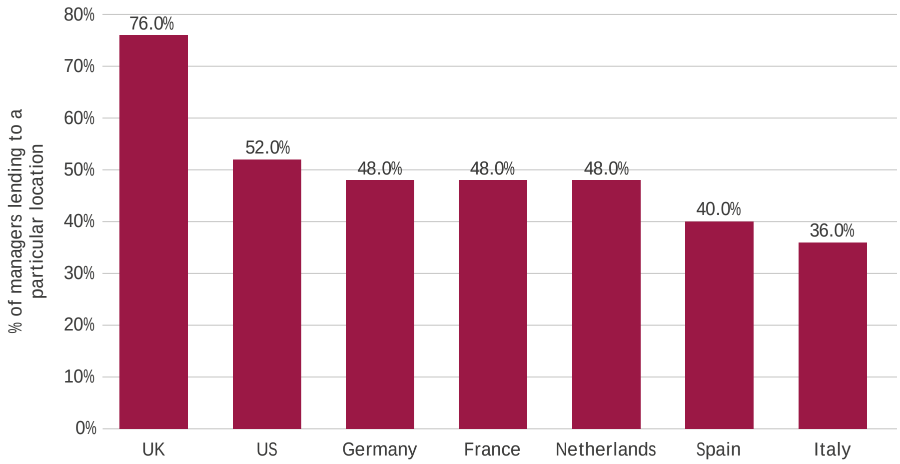
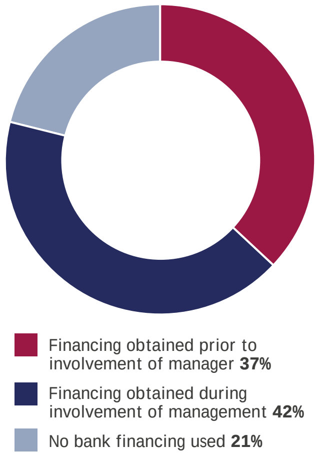


Figure 12: Borrower use of bank financing



Almost 80% of companies financed by asset managers have obtained bank financing either prior to the financing from the asset manager or during the involvement of the manager (figure 12). Further, companies are seeking to diversify their sources of funding and access the solutions (including the longer terms) that asset managers are able to provide. While this blend of financing is very much mainstream across the US, the gradual diversification of debt financing is positive for the European economy where bank lending comprises approximately 80% of all external long-term financing. The significance of having a diversified credit market beyond bank financing is that the overall risk in the system diminishes and exogenous bank-related shocks such as those that occurred in 2008 are better absorbed.

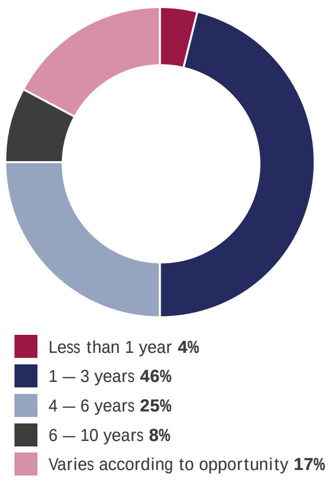
Of the remaining 20% of companies that have been unable or may not have attempted to secure bank finance, it is important to understand that this may not necessarily be due to them having poor credit, but more that the bank in its lending capacity only has so much risk-based capital available to underwrite or hold this type of risk. Loans that are not bank approved, per se, should not necessarily be deemed "loans of last resort."

An increasingly popular trend in recent years is banks and non-banks' lending alongside each other.[14] In most cases, commercial banks will retain the primary customer relationship and continue to provide less capital-intensive products and services.

Private banks and investment banks could therefore also use non-bank lending partners to meet their customers' credit needs without using up much needed capital. For banks, this effect would be to move their corporate lending function closer to a debt capital markets model.

Managers are generally not supplying short term capital (i.e. under 1 year), rather the financing loan term is typically 1–6 years in maturity, affording the investment companies stable funding in the mid-term (figure 13). Almost 35% of the managers surveyed provide financing terms of 4 years or more. This is in contrast to the banking model whose liability structure (deposits) is short term in nature and which as a result are naturally inclined to issue loans (a bank's assets) with smaller durations. Almost the entire sample of managers currently provide committed term loans to borrowers while half provide revolving term facilities (figure 14). Revolving credit facilities, (which permit a company to drawdown, repay, and re-draw loans

Figure 13: Managers' preferred investment maturity



advanced to it), the preferred loan type for banks, are more often than not shorter term in nature than a committed term loan.

Private debt funds are embracing their role as financiers of small businesses. More funds have launched in recent years in response to increased demands for funding. For those managers operating a dedicated private debt fund (an overwhelming majority of participants), 48% of those funds have launched within the past two years (figure 15).

Managers engaged in alternative credit typically operate dedicated funds of the same. 80% of managers operate one or more dedicated funds while 52% are operating two or more dedicated funds as their preferred method for investing in alternative credit strategies (figure 16). This implies that asset managers are adopting a focused approach to the alternative credit sector and building up expertise. This preference by managers to have their alternative credit investments operated out of a dedicated fund marks a clear change from previous years where such investments were part of a multi-strategy fund operated by the manager.

The majority of managers also operate managed accounts, which is reflective of the strong institutional investor presence allocating to alternative credit. Institutional investors prefer managed accounts as their preferred investment structure as they offer them better control, can facilitate bespoke fund liquidity conditions, as well as offer greater levels of transparency and customisation.

Of the managers surveyed, there are few “smaller” funds (funds below $250m in AUM) active in this strategy. It is likely that the esoteric nature of the strategy benefits larger funds that have built up the necessary operational capabilities and infrastructure to invest.

Many of these dedicated funds have only launched in recent years perhaps as a consequence of banks having decreased the size of their balance sheets and credit managers’ realisation that there is still plenty of capacity for investment left in this area. Investors also prefer to allocate to managers that have standalone funds dedicated to direct lending. The improving economic environment necessitates that more companies will need financing given the recovery or early expansion stage of the business cycle in most developed economies.

Figure 16: Investment vehicles utilised for alternative credit investment

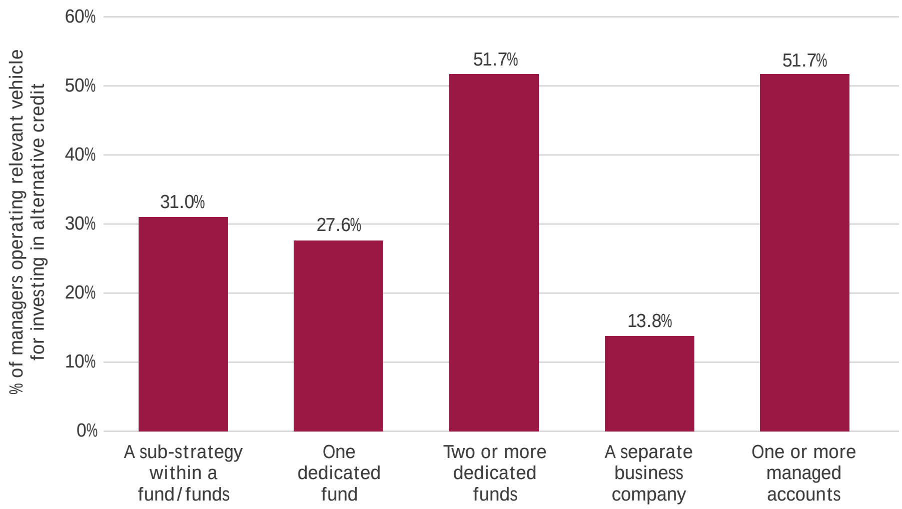


Figure 14: Structure of financing that managers provide

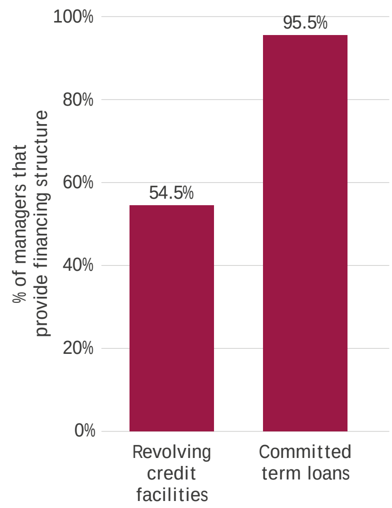
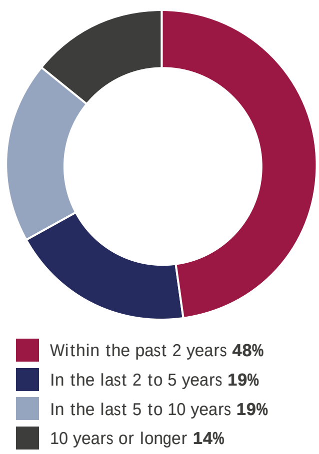


Figure 15: Launch date of dedicated alternative credit funds



2 Funds operated by private debt managers are structured to limit systemic risk

Regulatory concerns regarding asset management activity have centred on the issues of maturity and liquidity transformation.[15] Maturity transformation concerns usage of short-term capital to fund longer-term loans, while liquidity transformation focuses on using liquid allocations from investors to buy harder to sell assets such as loans. Evidence from our survey demonstrates that managers are structuring their funds more like private equity vehicles rather than a typical hedge fund, which greatly reduces maturity and liquidity transformation risks.

Among the variety of alternative credit funds in our survey, 63% of funds are closed-end while approximately 50% are closed-end with maturities in excess of 3 years (figure 17).[16] Investors are increasingly accepting initial long lock-up periods whereby the invested funds cannot be redeemed before the lock-up period expires.

Maturity transformation as defined in the context of a typical bank model involves taking a short term deposit and lending the money out over a longer term, as a consequence, banks tend to have much shorter liabilities and with the threat of a (deposit) withdrawal at any given time are therefore best suited to lend for only shorter periods of time. In contrast non-bank investors in the credit space, these being predominantly large pension plans, sovereign wealth funds and life insurers have the ability to match their liabilities in a more tailored and bespoke manner. Most of these investors have liabilities that stretch 20 plus years and can therefore guarantee lending for that term. Given their long dated liability profile, they are less vulnerable to the types of financial panic and runs on deposits witnessed by banks when the model comes under stress. Investors in credit investment funds, hedge funds and private equity funds provide stable, longer-term capital; and crucially these types of investors, unlike bank depositors cannot instantly withdraw their capital. Private debt funds do not borrow from central banks or possess guaranteed government deposits and therefore cannot and should not be expected to obtain government support in case their investments do not perform well.

Dependent on the fund offering and the type of instrument invested in, funds have a set of tools at their disposal to restrict or prohibit withdrawals under certain conditions. Hedge funds in particular are designed to ensure that investment strategies are capable of being carried out as intended. Further, certain restrictions are designed to avoid mismatches between liquidity offered to investors and that of the underlying assets in the fund. Among the measures available to help managers withstand periods of significant market stress are limits on investor redemptions through gates, the use of side pockets, the suspension of a fund's NAV or otherwise allowed by various fund offering documents.

For those funds that are open-ended, there is no specific tool universally used for managing liquidity mismatches (figure 18). The use of unencumbered cash is among the more popular measures (notice periods, gates and side pockets aside) employed by the funds in this survey.[17] A fund using its unencumbered cash (holding cash that is free of any encumbrances and can be re-directed to meet any unanticipated needs) provides it with the benefit of not having to terminate various fund positions in order to meet redemptions. Other tools used to prevent liquidity mismatches include a full or partial match of liquidity – that is to say a full or partial match of the risk exposures of the fund's liabilities.

Figure 17: Structure of funds that invest in private debt

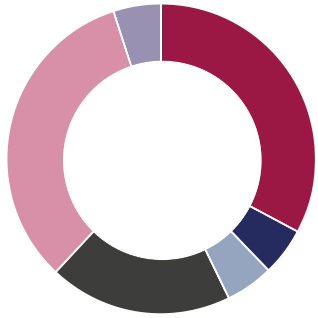
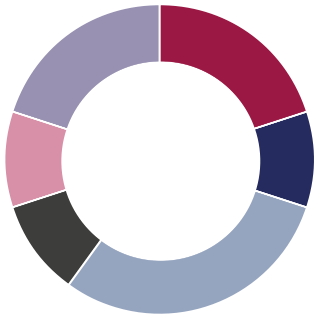


Figure 18: Principal tool used to manage liquidity mismatches for open-end private debt funds (aside from notice periods, gates and side pockets)



* Other includes holding liquid investments and having multiple investor types

15 FSB concerns around certain hedge funds being contributors to maturity transformation/liquidity transformation because of direct lending strategies or through the chain of credit intermediation in purchasing ABS.

16 A closed-end fund is a collective investment scheme whereby a fixed number of shares are issued (sold at one time) and the shares are not redeemable from the fund until maturity. The implication is that a fund can invest in more illiquid assets to match the longer duration of its liabilities.

17 An open-end fund is a collective investment scheme whereby shares can be issued or redeemed by the fund at any time. The implication is that the portfolio has to be sufficient liquid in order to meet redemption requests from investors.

Funds can control, manage and change their liquidity profiles ex-ante by aligning their redemption policies with the liquidity profiles of the funds and ex-post by potentially limiting or even suspending redemptions (and therefore lengthening their liability profile) depending on the market liquidity situation. The option to impose redemption gates is prevalent with over 70% of funds able to impose a gate at some level (figure 19).[18] Redemption gates essentially limit the amount of redemptions from a fund in a specific period or by a specific date, thus ensuring that a manager does not have to sell off large parts of the portfolio quickly in order to meet redemption requests. This offers an extra level of protection during times of market stress.

Among the managers that participated in the survey, the use of side-pockets is not very popular – only 35% of funds utilise them.[19] Among the fund structures that are open ended, all managers can utilise fund suspensions or redemption gates to some degree should they wish to. Further for these open-ended funds, notice periods are also very common with 87% of the funds in this survey able to utilise them, and almost two-thirds offering quarterly or longer notice periods (figure 20).

Most funds surveyed have a minimum investment/lock-up period. Around 50% of the respondent funds insist on a minimum investment period of three years, while just under a quarter of the funds have a minimum investment period in the range of 5 to 7 years (figure 21).

Figure 19: Possibility to utilise redemption gates among open-end private debt funds

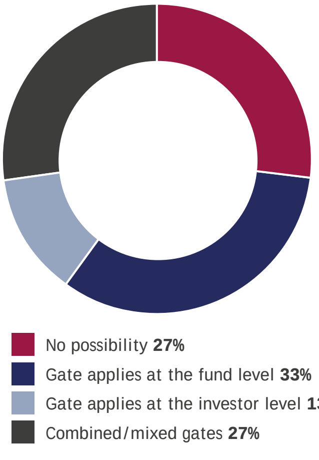
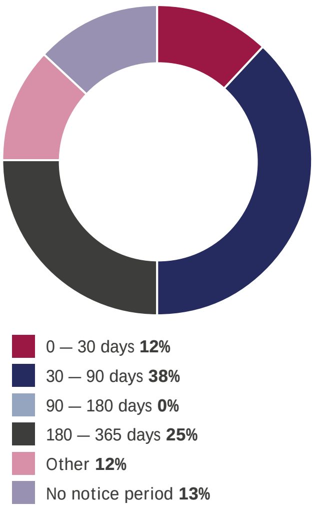
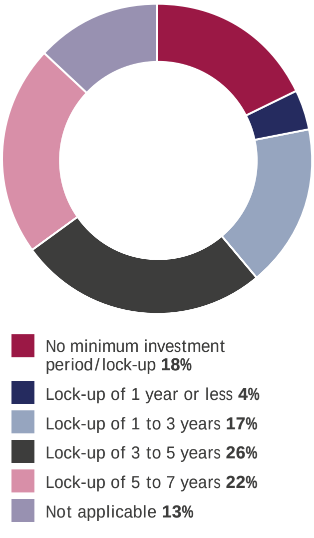


Figure 20: Length of notice period among open-end private debt funds



* Other includes holding liquid investments and having multiple investor types

Figure 21: Prevalence of minimum investment period/lock-ups among private debt funds

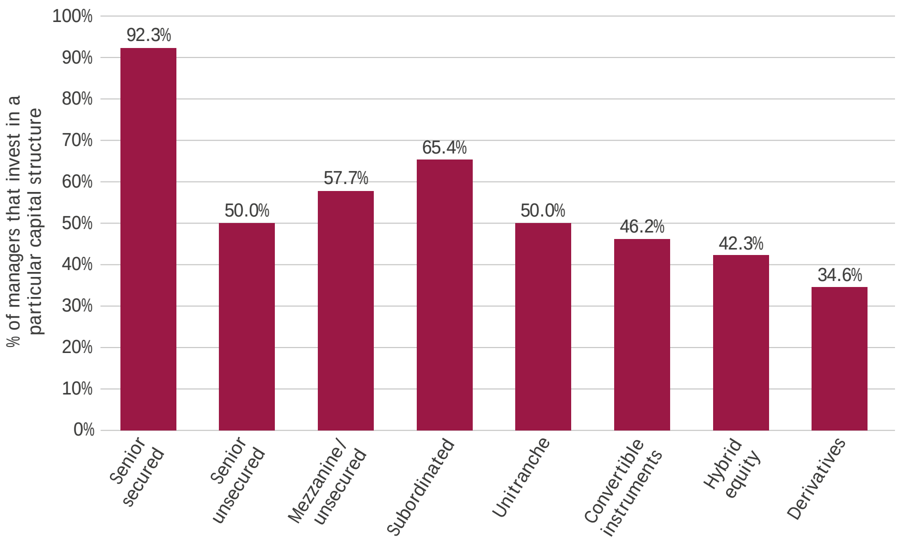


18 Redemption gates at the investor level independently limit redemptions for each of a fund's investors. If the redemption gate is at the fund level, then only a certain % of the fund's assets can be redeemed in a period. Redemption gates can also be mixed (on a number of levels).

19 Side pocket arrangements segregate illiquid or hard-to-value positions from the main pool of assets in a fund until such time as they are realised or are no longer difficult to price.

3 Managers are employing responsible risk management techniques

Figure 22: Capital structures that managers invest in

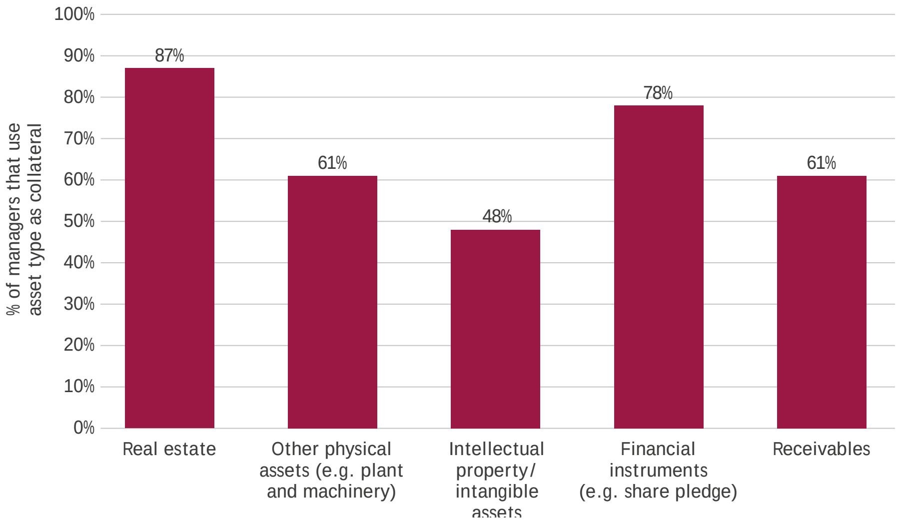


92%

of the managers surveyed invest in senior secured capital – a relatively low risk form of credit

Over 90% of the managers in the survey have a strong preference for their debt to be structured as senior secured capital (figure 22). By this nature, any investment in such a structure tends to be secured by collateral and is less risky than an unsecured investment. Half of the managers surveyed invest in a unitranche structure – a combination of senior and subordinated debt – which has become more popular since the financial crisis due to its comparative simplicity. Considered a lower-risk form of credit, it is now commonly used in mid-market leveraged buyouts and other acquisition-related financing across the US and Europe.

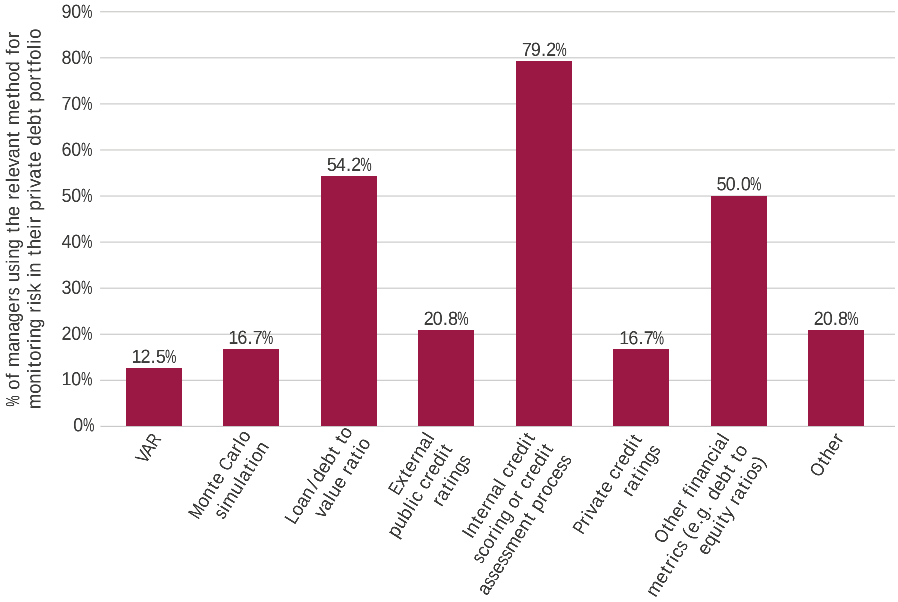
Figure 23: Collateral used in secured investments



20 The aim of the Liquidity Coverage Ratio (a key reform of the Basel Committee) is to ensure than banks have an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet their liquidity needs within 30 day

Among the preferred collateral used, managers are using a diverse range of assets to secure their investments and minimise on risk (figure 23). Real estate, the use of other physical assets such as plant and machinery and financial instruments such as pledging shares in the event of a credit event are the more common types of collateral used.

Figure 25: **Methods used by managers to monitor risk in their private debt portfolios**

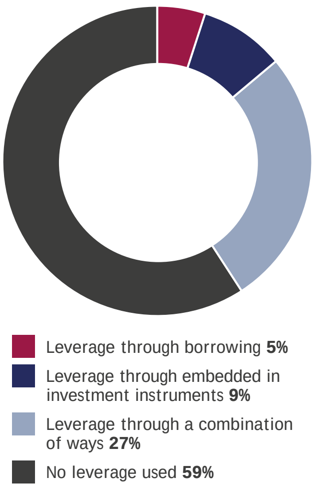


Bank reform including the tightening of banking restrictions have made it more expensive for banks to lend to middle market and SMEs. Further, additional rules as to how much capital banks must hold in reserve is likely to restrict bank lending to a limited percentage of their balance sheet and consequently higher leverage levels will be required.[20] In contrast, direct lenders tend to use all of their balance sheet, and consequently leverage levels are negligible.

Almost 60% of funds do not employ leverage (figure 24). Of those that do, 70% utilise leverage between 1x – 1.5x NAV. By comparison, an analysis of 20 leading banks yields an average balance sheet leverage of 16.4 times.[21]

Firms are using multiple methods for measuring and monitoring risk (figure 25). Internal credit scoring is the most commonly used method with 80% of managers using the method. Because the nature of the strategy requires detailed risk management techniques, it is reasonable that managers use in-house methods for monitoring risk in their private debt portfolios.

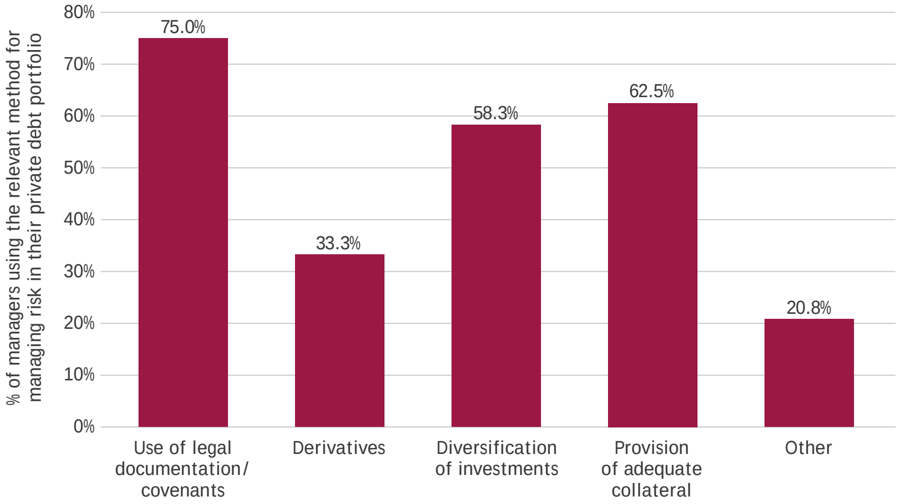
Figure 24: **Private debt funds' use of leverage**



21 Analysis by AIMA research, March 2015.

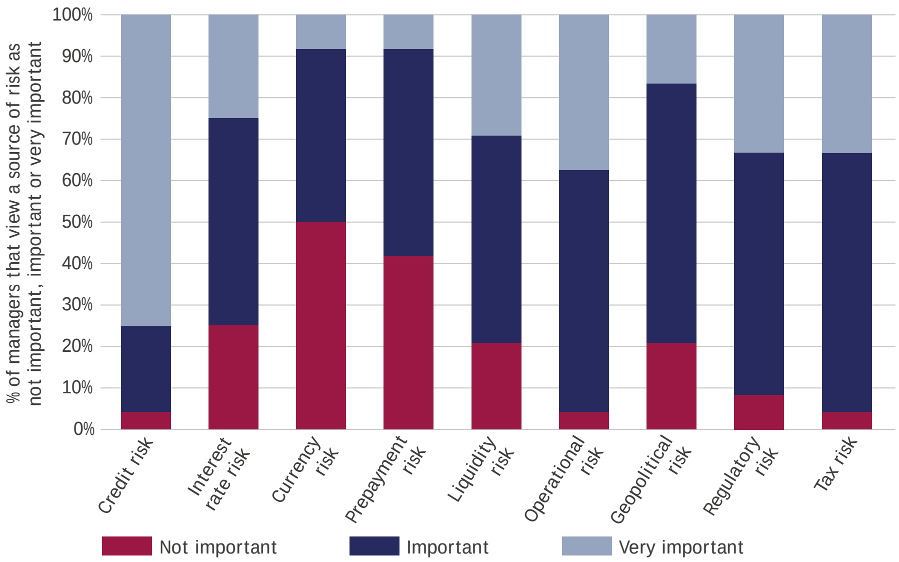
Covenants and collateral (in keeping with the strong preference for secured investment) are also very common for managing risk (figure 26). Derivatives are a less commonly used tool due to the difficulty in finding a good hedge for a non-traded security. Rather managers would have to create a cross hedge by taking a position in a different asset that they believe is highly correlated with their investment.

Figure 26: **Methods used by managers to manage risk in their private debt portfolios**



Managers view credit risk as their most important source of risk. Over 95% of managers view credit risk as being important or very important. Liquidity, operational, tax and regulatory risk are also important considerations (figure 27).

Figure 27: **Manager perceptions of risks in private debt**



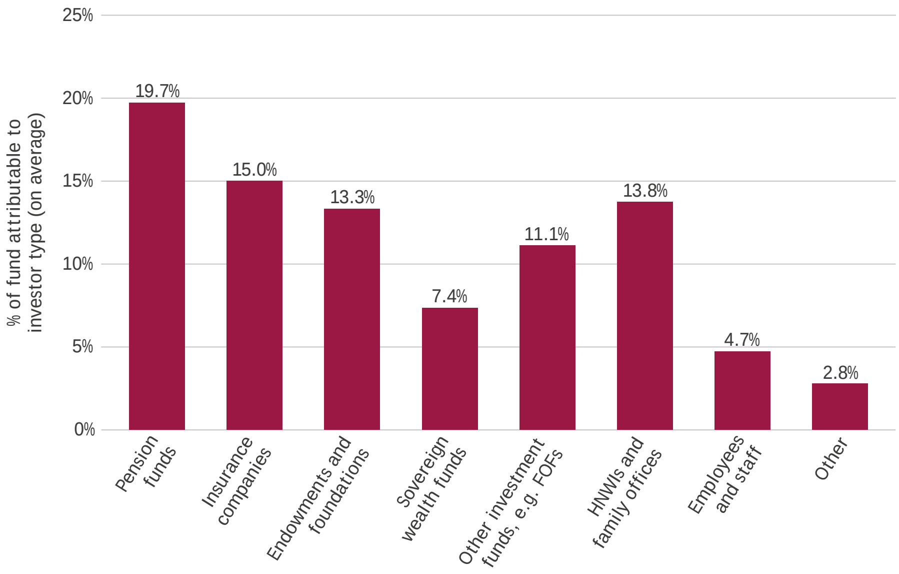
4 Institutional investors are helping to drive growth in the private debt market

A diverse array of investor types are investing in private debt funds, both institutional and otherwise. Looking across the investor base that allocates to the various private debt funds in this survey, pension funds and other institutional investors comprise the majority of all capital allocated to the sector (figure 28). In the US, large state pension plans and insurers in particular have been playing a key role in providing debt finance to all types of companies. Across Europe also, some of the continent's largest institutional investors are helping to bridge the financing gap for the SME sector and are increasingly moving into the middle market segment offering an alternative to traditional bank finance. Given the relatively illiquid nature of private debt investment, these institutions are likely allocating to the strategy within the surplus segments of their portfolios as a means of making capital gains. Other institutional investors such as endowments and foundations also allocate significant capital to private debt funds. Employees and staff of these private debt funds have smaller investment (around 5% on average of a fund's capital), which ensures an alignment of interest between the fund managers and the main institutional investors.

55%

of all capital allocated to private debt funds is provided by institutional investors such as pension funds, insurers and endowments

Figure 28: **Investors in private debt (average allocations)**



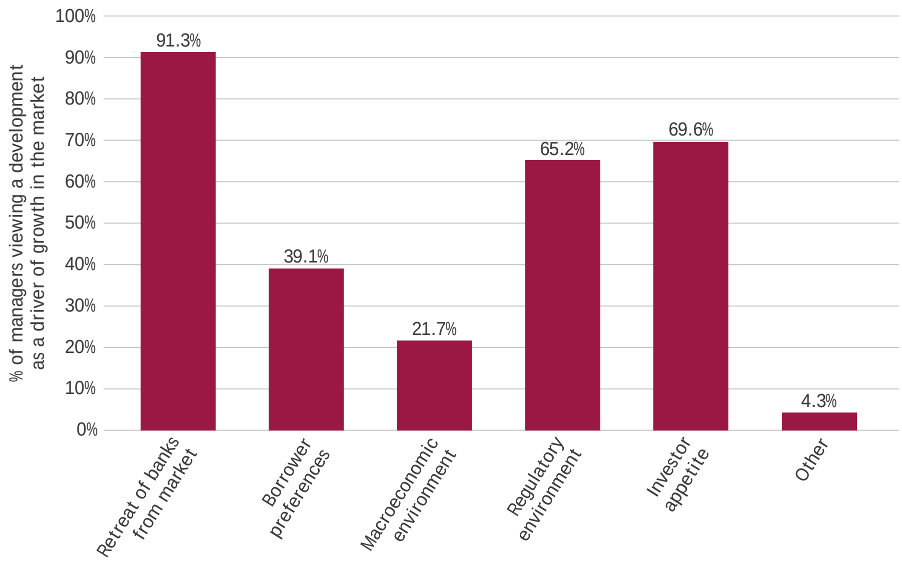
With the esoteric nature of some of the alternative strategies being invested in, typically allocators prefer to partner with hedge funds. Further, investors work with the relevant managers to road-test a particular idea, or to get a better understanding of a particular strategy before committing more significant capital or embracing the strategy fully.

Increasingly investors are also offering financial assistance to a broad variety of infrastructure projects. Pension funds and insurers are working side by side to put money into funds originated by banks which can take on structured debt, for example for financing aircraft or infrastructure projects – a practice already dubbed "syndicate to originate".

5 Manager perceptions of the private debt market

As mentioned in the first key finding, tighter banking restrictions (new capital and liquidity requirements) prompting a widespread retrenchment from the lending market has seen a significant increase in non-bank financing activities, including an increase in asset managers jumping in to fill the funding gap by launching direct lending funds.

Figure 29: Drivers of growth in private debt



Amidst historically low interest rate environments (in particular across US, Europe and Japan) and by extension the low yield on offer from traditional fixed income products, investors are having to look further out the investment spectrum in their hunt for greater yield opportunities. In recent years, an investment in private debt has proven to be very attractive to some investors who are looking at ways to drive additional yield from their fixed income portfolios. Senior debt backed by ample collateral could offer low but attractive yields, while unsecured, unitranche or leveraged loans could offer stronger yields to investors with a greater risk appetite. Among the private debt strategies, direct lending is becoming increasingly popular as it is one of the most straightforward private debt strategies for an investment committee to understand and analyse.

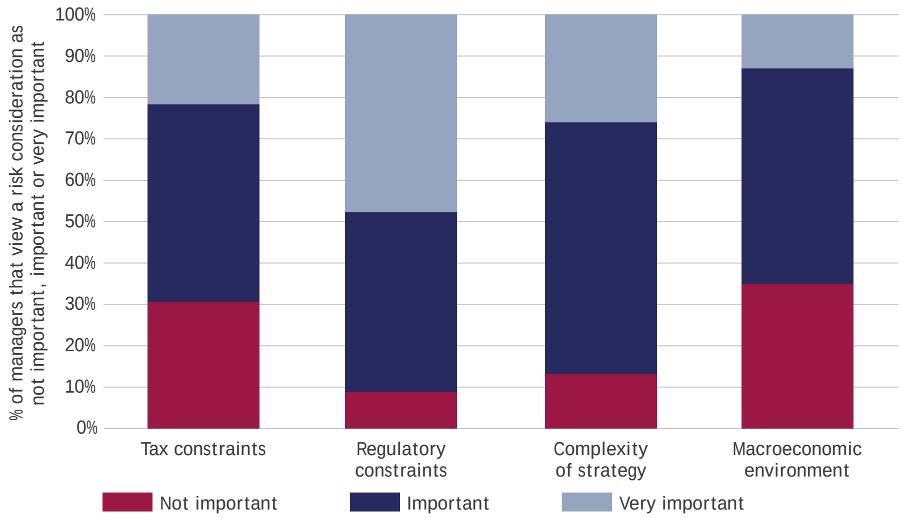
There has been an increasingly widespread acceptance of the role direct lenders have to play, particularly in stretching leverage to support deals that are not attractive to banks. The performance of the individual perception of each of these lenders is dependent on the size of their footprint, fund size, and chosen strategies, which will ultimately define the performance of each portfolio.

91%

of managers surveyed cited a decline in bank lending as a major driver of growth in the private debt market

Among the most important risk considerations associated with private debt involvement are constraints imposed on the sector by regulators (figure 30). Many jurisdictions restrict some or all activities associated with non-bank lending such as loan origination. The key challenge is to understand that asset managers are a useful complement to the banking sector. Today, hedge funds and private equity fund managers must be authorised and are the subject of strict regulation across all major financial jurisdictions and so certain concerns which may have been associated with their activity in the past should have been alleviated. Managers are now subject to strict operational standards and organisational requirements such as conflicts of interest and conduct rules, the protection of client assets as well as prudential regulations on liquidity and risk management. Furthermore, as already mentioned hedge funds are not large users of leverage (unlike banks) and can offer unique liquidity terms for its investors.[22]

Figure 30: Manager perceptions of risk considerations associated with private debt investment



22 AIMA's paper in 2012 "the role of hedge credit hedge funds in the financial system: asset managers not banks" explores this discussion further. www.aima.org

Key regulatory and tax changes needed to improve the environment for private debt investment

Alternative credit funds are increasingly taking on a greater role in the lending market and direct lending funds will establish themselves as a key part of this evolution. Indeed governments acknowledge the need to develop a more diversified lending market in Europe.[23] Unanimously manager respondents to our survey believe a key to unlocking funding constraints across Europe will be to boost its securitisation market. As highlighted throughout this report, as a consequence of bank retrenchment and macro-economic conditions, it is becoming increasingly challenging for SMEs and middle-market companies to secure the necessary appropriate financing. While direct lending is proving invaluable, it is critical for all borrowers and lenders concerned that they are given access to finance via a fully functioning and efficient securitisation market and other forms of bond issuance are made available to borrowers of all sizes. It is clear that there is very much a two-tier market in terms of government support for EU SME lending. While countries across western Europe typically support and endorse lending to SMEs through a variety of schemes, elsewhere within the EU, support is not as strong which begs the question as to whether the size of pan-European and national government support programmes is large enough to contend with the riskier end of SME lending. Additional improvements that could be made to bank-lending would be improved SME data availability (to facilitate a better credit rating awareness) as well as the potential consolidation of SME support schemes. On similar lines, loan origination is still very much restricted to the banking sector across the EU to the detriment of SMEs and other borrower types. Even where loan origination by non-banks is permissible, many of its participants argue that it does not fit with their business model due to the need for local origination capabilities. This is likely to restrict the financing of SME lending to banks rather than capital market participants, ironically at a time when banks' lending capacity is restricted.

Finally, it is vitally important that greater clarity is provided around EU member states bankruptcy laws and that member states strive for a harmonised corporate tax regime comparable to the US system. The lack of a standardised environment in regard to legal systems, loss default provisions and the bankruptcy process has ensured that private debt markets across the jurisdictions are at different stages of development creating confusion for all concerned.

23 Long Term Financing of the European Economy, EC, March 2013

Conclusion

The alternative asset management industry plays a vital role in the world's capital markets. Unlocking gains from market-based finance can produce significant benefits in terms of economic growth. Policymakers have an important role to play in this development as a number of restrictions hinder the activity of asset managers in the private debt space. However, it is crucial to understand that sometimes even well-intentioned regulatory intervention may lead to significant disruptions and hinder the activity it is meant to assist. The inability of the first wave of securitisation reforms to create a workable regulatory framework is perhaps the most visible example.

Asset managers are not banks and therefore need a different regulatory approach. Indeed, what most managers to the survey indicated is not a demand for a different approach to asset management regulation but a simple need to dismantle regulatory and tax barriers to direct lending by non-banks. Looking at intelligent, incremental changes such as permitting loan origination and associated services could go a long way in supporting economic growth. As our research shows, those jurisdictions which have provided for a greater diversity in the funding mix have been able to unlock significant sources of flexible capital, particularly for their SME sector.

Appendix: Case Studies

Asset Managers are providing finance to a number of private debt markets with the borrowers using this finance for a variety of purposes. Below are real world examples that detail asset managers providing finance to not only SMEs but also for various infrastructure projects and social housing initiatives.

Case 1: M&G Investments lends to a popular UK business

M&G Investments provided Caffè Nero with a £30m loan in early 2014. Caffè Nero had sought the funds as part of a refinancing package that would allow for greater flexibility and would provide diversification to its sources of financing. The loan will support Caffè Nero's growth objectives including expansion both internationally and within the UK.

The Financial Director of Caffè Nero said of the deal, "M&G joined later in the process and is the only non-bank participant in the senior debt club. The team was very quick in getting their heads around the business. The speed of the deal and responses were very impressive."

Case 2: York Capital supports Canadian infrastructure project

In December 2012, York Capital provided Cecon ASA, the Norwegian subsea installation contractor, with a $107.5m in financing by way of a multi-tranche senior secured bond issue for the purpose of purchasing the existing loan with the Export Development Bank of Canada, providing incremental working capital and also funding the completion of construction of Hull 717 at Chantier Davie Canada. York also made available additional construction financing of up to $175m for the completion of Hulls 718 and 719.

As part of the financing, York received detachable warrants representing a 15% pro-forma equity interest in Rever Offshore AS (Rever) – a 100% owned Cecon subsidiary with ownership of the three hulls and the construction contracts at Davie.

Case 3: Cheyne Capital provides a solution for an urgent transaction

Cheyne Capital (along with DRC Capital) provided a £170m loan in September 2013 to Queensgate Investment Fund to buy a serviced office provider with 28 properties across central London. Not long after the loan, Barclays took on £130m of senior debt from the two lenders secured against Queensgate Investments' Executive Office Group, leaving the original lenders each with £20m of junior debt from the portfolio.

A DRC Capital representative said that it was originally clear that the transaction was financeable in the senior market but not in the desired timeframe, hence it was necessary to underwrite it first and then syndicate it subsequently.

The end result was that Cheyne Capital were left with a mezzanine piece.

Case 4: Aviva Investors finances a new hospital in Scotland

Aviva investors co-lent £218m in senior debt alongside the European Investment Bank for the construction of a new 350-bed acute hospital in Dumfries and Galloway. The hospital will be completed in 2018 and will serve 150,000 people living in the south-west of Scotland.

Case 5: KKR invests in renewable energy project

As part of a £200m joint initiative with the UK Green Investment bank (managed by Temporis Capital), KKR provided an £8m loan to a wind farm in Scotland to finance the installation of three turbines. The initiative marks the first non-bank lending platform dedicated exclusively to the renewable energy sector.

The deal will assist in the UK's transition to a sustainable energy-based and greener economy. Further, the wind farm will be partly owned by the local community ensuring that the host community retains commercial benefits.

Case 6: Chenavari Investment Managers provides flexible funding to a UK-based SME

Chenavari Investment Managers provided Sceptre Leisure with a £20m of flexible funding comprising both senior debt and mezzanine finance to support the company through further growth. Sceptre Leisure specialises in the rental and operation of coin operated amusement equipment found in pubs and other businesses across the United Kingdom.

A partner at Grant Thornton who advised on the transaction, noted that a solution which did not involve the shareholders selling an equity stake in their business to outside investors was of great appeal.

Case 7: Pine River Capital provides acquisition finance for an aircraft parts dealer

Pine River Capital provided a $26m loan to an American aircraft parts dealer for purchasing a target company. The loan was backed by the assets of the target company with the borrower assuming the liabilities. These assets consisted of a pool of aircraft parts, which the borrower would earn a commission to sell over time.

The loan benefited the aircraft parts dealer and allowed it to expand globally and enter new markets. Further, the company became a prominent participant in the aircraft parts space and the transaction provided other opportunities for future growth.

Case 8: Cheyne Capital finances real estate initiative

In early 2014, Cheyne Capital provided an investment loan facility of £22.35m to the Fusion Group for the conversion of a 15-storey office building in Bristol known as Froomsgate House into student housing. The funds helped Fusion Group finance the acquisition (purchase of the entire issued share capital of the company holding the freehold title of the property) and will finance the planned development of the property into student accommodation with at least 438 beds.

The development will benefit the students of Bristol where the supply of housing has seemingly not kept up with applications to study at the university. The average monthly rent per bed in Bristol is one of the highest in the UK for students and it is estimated that over 40% of students live in private rentals with less than 30% living in university accommodation or private halls.[24]

Case 9: Avenue Capital provides acquisition finance to support growth in consumer loans

Avenue Capital acted as sole lender and agent in connection with the debt financing of the acquisition of Freedom Finance Nordic by H.I.G. Europe (H.I.G. Capital's European arm). Freedom Finance Nordic is the leading consumer loan broker in the Nordic region. Further aligning itself with the long-term interests of the borrower, Avenue Capital also invested in a minority equity stake in Freedom Finance alongside H.I.G. The debt facilities consisted of a unitranche acquisition facility and a revolving credit line.

Case 10: Proventus Capital Partners provides debt facility to Swiss company

Proventus Capital Partners, a Swedish investment company, provided a €23m junior debt facility to Bilcare Research AG ("BRAG"), who are a leading producer of packaging films. The facility will allow Bilcare Research to refinance existing debt and to also pursue its growth objectives. In addition, Proventus Capital Partners also invested in €65m senior facility arranged by Deutsche Bank. Proventus listed BRAG's strong market position in its industry and a diversified customer base as some of the motives for pursuing the transaction.

24 Savills Spotlight on UK Student Housing 2013

Case 11: Macquarie lends to Heathrow Airport

Macquarie, the asset management arm of the eponymous bank, provided £115m in inflation-linked financing to Britain's largest airport. The debt is unique in that aside from being inflation-linked, it has delayed settlement and is at the Class B level. Further, with a maturity of 2036 it is believed to be one of the longest Class B notes ever finalised.

The £115m forms part of a greater fund raising effort by Heathrow and will allow for continued investment in and development of the airport.

Case 12: Ardian provides acquisition finance for biotech expansion

Qualium Investissement, the private investment arm of French state-controlled Caisse des Dépôts, has received €92m from Ardian in unitranche financing to support the acquisition of IMV Technologies (a French biotechnology company). IMV Technologies is a pioneer in animal artificial insemination. Ardian had previously supplied the company with a mezzanine credit line and a subordinated debt facility.

Case 13: Muzinich & Co. provides bond financing for an Italian waste management company

Muzinich & Co., a global asset manager specialising in corporate credit provided €10m in bond financing for Eco Eridania SpA. Eco Eridania specialise in managing hazardous, medical and industrial waste. The financing which is in the form of a seven-year senior secured debt facility will support the company's organic and acquisition-based growth.

Case 14: Alcentra supports French prosthetics group

Alcentra invested in Menix, a holding company for healthcare firms manufacturing orthopaedic and dental implants in France. The funding which is in the form of a unitranche facility will support further expansion of Menix in the French and international prosthesis market.

Case 15: GSO Capital finances an independent oil and gas company

Blackstone's GSO Capital Partners provided $500m to fund the drilling operations for 5 years of Houston-based, LINN Energy. The financing covers the cost associated with new wells drilled in exchange for GSO holding an 85% working interest in the wells. The deal takes some pressure off LINN's balance sheet during a period of energy price lows and will allow the company to drill more wells without needing to raise further capital upfront.

Alternative Investment
Management Association

About AIMA

The Alternative Investment Management Association (AIMA) is the global hedge fund industry association, with over 1,500 corporate members (and over 8,000 individual contacts) in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members manage a combined $1.5 trillion in assets (as of March 2014). All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide. AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) -the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, www.aima.org.

About AIMA's Alternative Credit Council

The AIMA Alternative Credit Council – a group of senior representatives of alternative asset management firms – was established in late 2014 to provide general direction to AIMA's executive on developments and trends in the alternative credit market with a view to securing a sustainable future to this increasingly important sector. Its main activities comprise of thought leadership, research, education, high-level advocacy and policy guidance.

Special thanks also to Deloitte, and the UK Debt Advisory team (Alternative lender coverage) who provided their expertise on the paper.

Deloitte.

Deloitte has an unparalleled breadth and depth of services which make it a world force in its chosen areas of business - audit, tax, consulting and corporate finance. As a leading business advisory firm in the UK, we are renowned for our commitment to innovation, quality, client service excellence and for the calibre of our people.

We provide insightful and impartial advice to many of the UK's leading Financial Services firms. By harnessing talent and expertise across the firm, we deliver solutions to clients that inspire confidence in what we promise.

Alternative Investment
Management Association

AIMA
Alternative Investment
Management Association

www.aima.org