CADWALADER

Q & A With Howden

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Fund finance is evolving from a bank-dominated sector to a broader credit ecosystem. *Fund Finance Friday* readers are likely already aware of insurance capital emerging as a transformative force, bringing long-duration capital, credit risk tolerance, and balance sheet strength to the fund finance space. However, what is lesser known is that the other side of insurance business, the liability side, is also playing a significant role in strengthening and boosting existing lender's' fire power into an ever-expanding market.

Cadwalader's **Carla Pilcher** and **Emina Hodzic** sat down with **Punit Mistry, CFA, FRM**, **Jamie Stephenson** and **Steve McCafferty** from Howden CAP, a specialist arm of Howden Insurance Brokers, ("Howden"), to talk about how credit risk insurance is being used in the Fund Finance space by banks and non-bank financial institutions ("NBFIs") alike.

CWT: Most of our readers will no doubt recognize the Howden name, even if it's only from sports jerseys, but for the purposes of this discussion let's start with setting out who you are and what it is that Howden does?

Howden: Howden is the largest independent insurance broking group, headquartered outside of North America. Our division, Howden CAP, specialises in helping our banking, asset management and corporate clients to grow, optimise capital and achieve strategic objectives through the use of insurance and surety backed solutions.

Within Howden, our Credit Risk Solutions team acts as an outsourced credit insurance syndication desk to help clients access and navigate the credit risk insurance market, creating an operationally efficient tool for distribution for our clients. The way in which Howden sets itself apart is by bringing together expertise from both the insurance and banking sectors. For example, between ourselves Punit brings 10+ years from the banking sector including in Fund Finance, Jamie over 12+ years in the insurance market, and Steve with around 20 years within both banking and insurance. Across our team we have arranged the insurance for over 150 various fund finance facilities.

CWT: Tell us more about how long you have been involved in the fund finance space more specifically and what types of fund finance products have you been involved with?

Howden: We have been supporting the Fund Finance market including Banks, NBFIs and private capital funds since 2017. We placed the first comprehensive non-payment insurance policy in 2017 for a subscription line facility and the first NAV facility in 2019. Our comprehensive non-payment insurance policy is a form of Credit Risk Insurance ("CRI") that indemnifies a lender for any loss that occurs on a loan resulting from a non-payment of principal or interest by the counterparty. Cover can be arranged on any credit exposures our clients may have; to date we have arranged a total of $6bn of insurance across subscription lines, NAV financings and GP solutions.

Using the bank side experience we have in the team; we have been actively building more and more insurance capacity for all types of fund finance applications over the last 7 years by helping to guide insurers through the nuances with respect to structuring and limited partnership dynamics. We are now able to provide policies of up to $1bn on subscription line facilities and up to $300m on certain NAV transactions.

More recently we have also been pioneering more innovative solutions to help attract other sources of capital to the sector through insured structures, adding yet more diversity to the lender pool. This has proved especially useful for our non-bank clients who are always looking for alternative avenues for fund raising.

CWT: Getting into the details and practical applications, why do financial institutions use credit risk insurance ("CRI")?

Howden: CRI has been in its current form has been around for around more that two decades evolving out of the political risk and trade credit insurance markets. However, the product really came to prominence in the banking market due to the tightening of regulations after the 2008 financial crisis and the capital retention requirements that were put on banks. The market grew due to banks' motivation to optimise their balance sheet.

CRI is recognised by regulators as a valid credit risk mitigation tool and can be used to significantly reduce this capital requirements burden. As such, the product started life as a defensive tool for the middle/back office where subscription facilities attracted a high capital charge relative to their actual credit quality. This was especially relevant for subscription line facilities at banks that were calculating their capital retention based on the standardised model where subscription line facilities were given a risk weight of 100%. By purchasing a CRI policy from a AA rated insurer, this risk weight can be reduced 20% reducing the capital burden for the bank by up to 80%.

Increasingly however, particularly in this fast-evolving fund finance space, we are seeing CRI being used as an offensive tool allowing lenders to be more competitive and lend larger amounts to their clients.

As readers will be aware, GPs and their funds have been growing at an incredible rate over the last two decades and as a result so have their financing needs. Banks often struggle to expand their lending capacity fast enough to keep up and therefore have using CRI policies to respond quickly to these needs. Additionally, using CRI avoids introducing the competitive pressures that come from syndicating loans to other lenders. For our clients, insurance as a non-competitive, unfunded and silent distribution method has proved a real gamechanger.

CWT: To many of our readers, this may just sound like another form of syndication. Why is this any different (or even better) than the various other risk syndication tools out there?

Howden: You are right, this is another form syndication or risk transfer. However, the key benefit of CRI is that our insurers are silent partners, non-competitive and invisible to the borrower, meaning that lenders are able to protect their client relationships and borrowers aren't inconvenienced by the process. It is also a very quick execution process compared to other syndication methods.

The product also gets compared to alternatives like credit default swaps ("**CDSs**"). Unlike CDSs, CRIs can be tailored and customised to the risk being monitored and provide the buyer with a perfect rather than approximate hedge. NPI is also not accounted for on a mark-to-market basis like CDSs (avoiding P&L volatility) and are typically priced lower due to the way in which insurer balance sheets are structured.

Insurers, rather than being bound by the Basel regulations for banks operate, from balance sheets governed by the Solvency II regulations. As a result, they are often able to price risk more attractively than a bank can. Because they are providing an unfunded risk transfer, they do not have factor in the cost of funding into their return calculation and are able to underwrite risk at a fraction of the funded cost. For example, on a typical subline an insurer may charge a premium of 50% or less of the margin earned by the bank allowing the buyer of the policy to capture a larger share of the arrangements fees and other ancillary income, skim the upside and enhance their returns.

CWT: So other than capital relief and increasing lending capacity are there any other applications that our readers might find interesting?

Our insurance policies are regularly used by banks to manage concentration and aggregation limits on single name Borrowers, Fund GPs, Countries and Industry Sectors. It also helps some with their top exposure reporting as they are able to report their "net exposure" against various names and limits and therefore insurance has been a great tool for them to manage this.

Our policies are also used as a solution for situations where obtaining an external rating cannot help. CRI can be used to wrap a portfolio of exposures which would be rated as sub-IG with a policy provided by an insurer. The credit insurance providers that we work with are currently rated either A or AA, buyers benefit by inheriting the insurer's rating.

There are quite a few new innovations that we have pioneered in the fund finance space recently. For example, we have managed to help lenders in both the bank and private capital space attract new forms of funded capital through insurance backed structures and used insurance wrappers to transform a previously unattractive risk profile and/or structure into something that can be financed more cost effectively. At Howden we have an already established repack platform to offer a flexible compartment structure to facilitate financing and insurance transactions for our clients.

We also see some of our clients looking for solutions for geographical, sovereign or risk aggregation issues caused by certain LPs. Fortunately, the insurance market is often more comfortable with facing exposures to certain judications where banks and other financial institutions are not. Therefore, our solutions can be tailored to address these specific risks and provide them at the most efficient price possible.

We've also developed some solutions for GPs to be able to manage their cash flow with respect to their GP commitments. We'd be happy to expand into any of these in a follow up chat.

CWT: We think that would be a great idea, a lot of these applications are interesting especially in the context of current affairs. In the meantime, how can our readers get in touch with you?

Please get in touch with **Punit Mistry, CFA, FRM, Jamie Stephenson** and **Steve McCafferty**.

We are also sponsoring the 9th Annual European Fund Finance Symposium in London, where Jamie Stephenson will be speaking on the Risk Management in Fund Finance panel. We look forward to catching up with some of you there.