Fund financing

An opportunity for insurers

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In this article we provide a guide to fund financing, and explain why the strategy can be an attractive addition to an insurer's portfolio.

Executive summary

- Innovative investment strategy for insurers, targeting a global opportunity set of over $1 trillion[1]
- Developed in close collaboration with insurers seeking to extract greater yield from short-duration assets
- An opportunity to create customisable investment strategies across tenor, geography and currency profiles.

The case for insurers

The backdrop of low interest rates in Europe prior to 2023 prompted insurers, like many other investors, to turn to private credit in search of much-needed yield. Whilst the interest rate environment has since changed, another theme that's less headline grabbing remains: the high cash balances and money market fund investments that insurers have continued to maintain since the run-up to Solvency II. Quite rightly, insurers are asking themselves whether they really require access to such high levels of liquid funds on an overnight basis to finance claims and operational cashflows and are increasingly looking at alternative sources of short-dated exposure. We believe our innovative work in the area of fund financing is one potential solution, offering a diversifying source of short-dated, capital-efficient yield for insurers.

Fund financing: what is it?

Fund financing facilities are loans provided to private market funds including private equity, credit, infrastructure or real estate across various stages of their lifecycle. The market is often divided into two areas:

- LP backed or subscription line financing – backed by first recourse to undrawn LP commitments. These are typically by blue-chip clients, including insurers, pension schemes and sovereign wealth funds
- NAV backed – secured on a diverse portfolio of underlying assets and cashflows of private market funds typically at a later stage of their lifecycle.

Why is fund financing used?

There are a number of operational, as well as financial, reasons why these facilities may be beneficial to both investors and the manager/general partner of the fund. These include:

- providing managers with capital to finance investment activity within a few days, rather than drawing capital from investors, which requires a much longer drawdown notice period
- giving greater clarity of the timing of cash calls to help investors manage their own cashflows
- allowing cash calls to be consolidated or batched to delay drawing down on investors, bridging the finance of a portfolio company
- delaying drawdown from investors can enhance IRR-based returns.

What is the opportunity set?

The global annual demand for fund financing is over $1 trillion and we expect this to increase significantly in the coming years as private market fund sizes grow consistently larger.

Currently, the world's largest banks dominate this market but new banks are now entering at the syndication level due to the attractive returns available. Indeed, given the increasingly large size of the financing facilities, a lead bank typically syndicates the facility across a number of other banks, reducing its risk exposure. This is because banks will often have single credit limits, sector limits and counterparty risk to manage, and syndication can assist in dealing with these. However, given that other banks represent direct competitors, lead banks are increasingly looking for non-traditional lenders to participate in their lending programmes. In addition, several major US and European bank lenders have reduced lending capacity.

[1] Prequin, February 2025.

Bank lenders are focusing on key relationship clients, further increasing opportunities for non-bank lenders to grow market share.US regional bank failure has further restricted lending supply for fund finance and added to increased deal flow for non-bank lenders as GPs seek to reduce counterparty exposure on banks. This is where insurers can come in.

Why may fund financing be attractive for insurers?

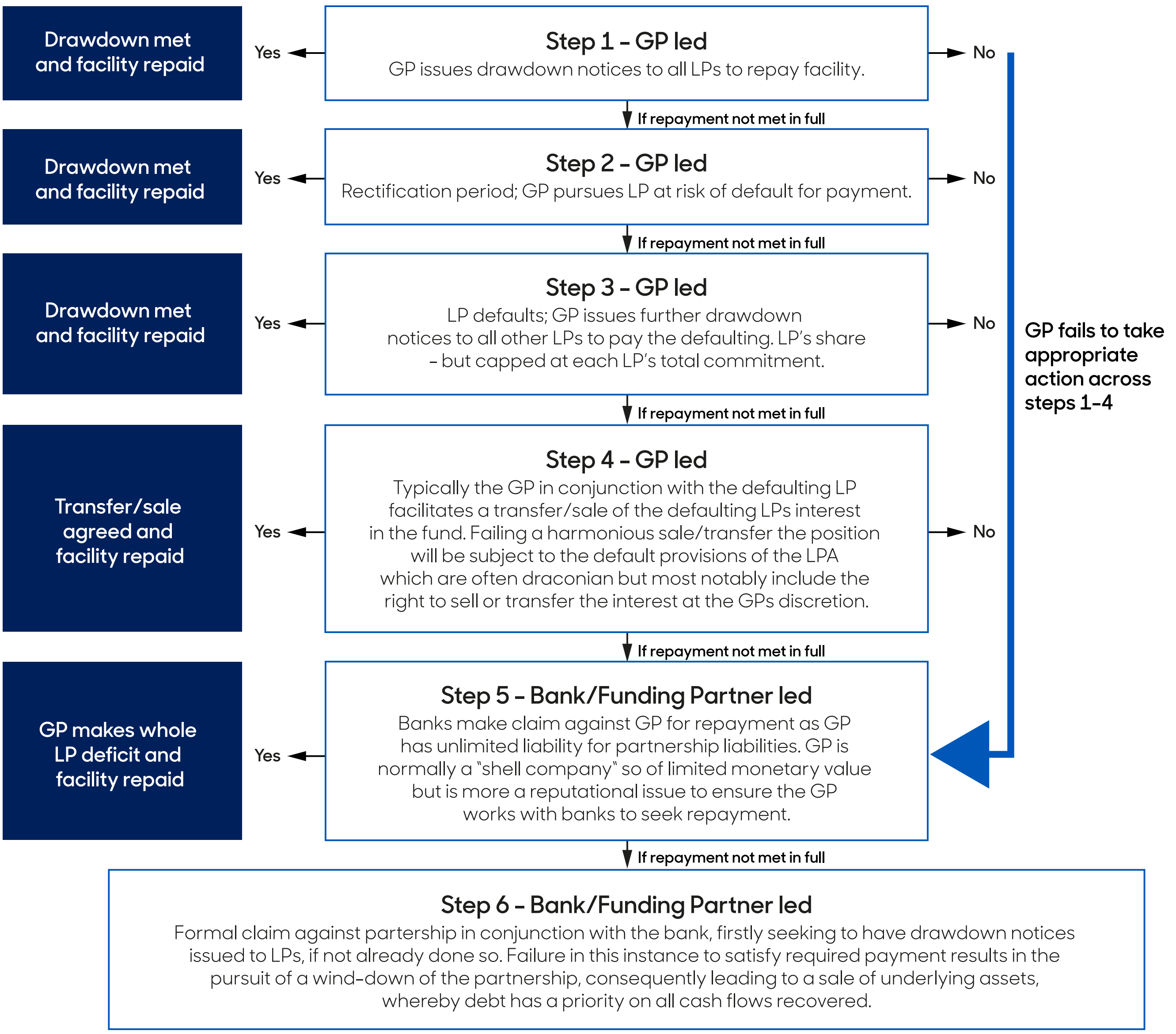
Fund financing can be well-suited to an insurer's financial (including capital efficient investment) objectives due to its characteristics, such as:

- attractive credit quality
- enhanced yield possibility
  a. LP backed 200-250 basis points over a reference rate
  b. NAV backed 350-500 basis points over a reference rate
- short duration, maturity between two and five years
- uncorrelated returns to public credit markets
- low volatility and credit risk
- strong structural protection. The chart below shows the various sources of recovery of payment for a LP backed fund financing facility.

Why is now the right time for insurers to enter this market?

The lending market has generally been the preserve of the banks. However, in recent years, stricter regulation has pushed banks to co-invest with private investors; but sourcing deals for private investors is a challenge. Private market fund managers will usually want to work with banks that can offer a range of banking services. This can be daunting for those not familiar with the legal documentation and the structure of funds.

Sources of recovery of payment for fund financing facilities



The complexities that are embedded within the banking and fund documentation can also be a hurdle for many. Being able to perform the required due diligence on the manager's track record and strategy will prove challenging and time consuming and then there is the ongoing cash management and monitoring of each loan.

Investment managers can provide an efficient way for insurers to participate in the fund financing market. For example, within our team at Aberdeen Investments, we have investment professionals that have worked in the fund market for over 20 years. Many have been both investors in, and providers of, these fund facilities while working for banks. As such, they understand and can fully articulate the risk of each opportunity, which provides a competitive advantage. We've also invested in over 500 private equity managers across 1000 funds globally,[2] giving us in-depth knowledge of each manager.

Determining capital treatment and credit ratings

Although classed as private loans, such holdings can represent a capital efficient investment under Solvency II. For example, for standard model insurers, the capital charge for LP fund financing can be estimated as the tenor of individual loans multiplied by a factor of 1.5%.[3] For those with an internal model, the treatment can be even more attractive.

Some of these loans are increasingly externally rated but are normally unrated. At Aberdeen Investments, we leverage our own internal private credit ratings process to help our insurance clients determine and affirm the appropriate credit assessment for unrated private credit.

Fund financing process

When it comes to choosing a fund financing investment manager, clients may want to consider those with broad capabilities including credit and liquidity management, currency hedging and of course, operational, legal and structuring expertise.

It also helps if your fund financing manager is already conducting ongoing in-depth due diligence of private equity vehicles, managers and their investors. Access to lending programs across all the dominant banks active in this market is also essential.

Investment managers with these contacts and skillsets can provide clients with different currency loans as well as a range of tenors and pricing options to support their specific requirements.

Clients can also benefit from the due diligence and cashflow management capabilities of asset managers' private equity teams. Asset managers with these capabilities can save clients time, allowing them to pursue other yield-enhancement opportunities.

The importance of insurance investing expertise

Fund financing can be a very attractive addition to an insurer's overall portfolio. In making such an addition, and in the context of Solvency II's 'Prudent Person Principle', it is important that an insurer has access to the right expertise and experience. Working with the right investment manager can provide this.

Investment managers can provide an efficient way for insurers to participate in the fund financing market.

[2] Source: Aberdeen 2024.

[3] Assumptions: (i) a tenor < 5yrs and (ii) the investment doesn't have a rating from a nominated ECAI but has collateral which is recognised under Solvency II such that we would expect beneficial capital treatment to apply.

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