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1.1 ROUNDTABLE DEBATE

Which investments can insurers look towards when diversifying out of investment grade?

Moderator

David Grana, Head of North American Media, Clear Path Analysis

Panelists

Elizabeth Jourdan, Deputy Chief Investment Officer, Mercy

Rip Reeves, Chief Investment Officer, AEGIS Insurance Services

Mark Silverstein, Chief Investment Officer, Endurance

POINTS OF DISCUSSION

- *Insurers are finding BBB/B- rated fixed income attractive*
- *Less liquid investments are gaining momentum*
- *The CMBS market appears less crowded than other high yielding markets*
- *10% seems to be the sweet spot for non-investment grade investments amongst insurers*

David Grana: How far down the credit rating scale do you need to go – or will you go – for decent yield?

Mark Silverstein: We haven't structurally shifted our portfolio to be necessarily lower in quality. Our focus is managing the portfolio at the desired risk level. We do have BBBs. And outside of high grade fixed income, we have allocated to High-Yield (HY), Bank Loans (HYBLs) and emerging market debt.

Rip Reeves: Similarly, we haven't re-positioned our portfolio down in credit quality for yield pick-up and potential return. Having said that, we have gradually increased our allocations to lower credit quality issues over the past few years. Within our below investment grade mandates, we have a BBB/B- minimum credit quality, with opportunistic use of credits rated CCC (10% maximum).

We also have a short duration target on our below investment grade mandates, and we utilize a flexible multi-strategy approach in the sector. We allow our managers to invest across the capital structure, to include traditional HY bonds, HYBLs, Collateralized Loan Obligations (CLOs), convertible bonds and other structured products.

Elizabeth Jourdan: A lot of our fixed income asset managers have been really pushing the relative value of BBBs. Historically, they have tended to do so anyway, but particularly over the past 9 months. We've kept the portfolio fairly up-in-quality to maintain liquidity – we'd rather take risk in other asset classes.

David: Are you looking at asset classes that you would invest in outside of bonds to attain some of the yield that you wouldn't be able to get in the fixed income space?

Elizabeth: We have increased our allocation to private investments and have a dedicated allocation to private credit. Earlier in the year, we invested in CLOs, European non-performing loans and high-yield dislocation funds. I have also been hearing from many insurance peers of their interest in direct lending and commercial real estate debt for yield, although that hasn't been a place we've allocated.

Rip: Over the past few years, we have done the "liquidity trade". We used some of our excess liquidity and gone into direct lending, real estate equity and utilized the Held-to-Maturity accounting classification. Investment allocations into less liquid alternatives have been gaining momentum in the insurance sector, and we have been investing in these areas for the past five years. Investments into liquidity constrained mandates necessitates a rigorous monitoring process on our excess liquidity levels to ensure proper cash for the enterprise.

Mark: We haven't taken the middle market direct lending route. Our non-investment grade credit exposure is primarily HY, HYBLs and credit hedge funds. We have considered giving up liquidity to participate in private placements for investment grade credits and commericial real estate mortgages to enhance return and further diversify. But we haven't taken any action to date, as we determine where we are most comfortable in giving up that liquidity. The unusual thing about an insurance company is that we have plenty of liquidity, but are reluctant to give it up through certain kinds of investments. We have to make sure that we are getting a good bang for our buck, because with illiquid strategies, we aren't going to be able to change our mind for a long time.

David: So mezzanine credit would not be on your radar?

Mark: No, for the most part, we have used our illiquid bucket for hedge funds - in the distressed area and structured products. We have done a few things on the liquid side in an effort to add more diversity to our credit exposure in areas where we see value. We are invested in emerging market debt, and we have also done some investing in the junior CLO traunches, which we compare to HY or HYBLs, depending on the credit quality. We also have AAA-rated CLO traunches in the high grade portfolio, which are pretty cheap relative to other investment grade credits. They have performed fairly well because there haven't been defaults of any sort to date. Granted, you do get periods of poor liquidity, which costs you in total return performance at times. But over the long run, we have done fairly well with that approach.

David: Do you see non-investment grade yields starting to become less attractive, as investors allocate more capital to this asset class?

Rip: The yield trade down in credit quality is a trade many insurance companies have been implementing since the 2008 Financial Crisis. Therefore, many of us have pushed that trade as much as we feel is suitable. I wouldn't say below investment grade sectors are unattractive, but they're never as attractive as we'd like them to be when funding! In an investment environment, where asset classes are not statiscally cheap, we generally reduce other forms of risk embedded in the credit quality decision. For example, we reduced the duration of our below investment grade portfolio by half - to 2 years. Another example the diversification of a larger number of active positions in the mandate, giving a more fully valued asset class.

Elizabeth: For below investment grade corporate credit, it's not really unattractive, but rather just fair value. One place that hasn't felt crowded is parts of the legacy CMBS market, which hasn't participated in the high-yield rally we've seen so far this year. There is also a life and health insurance company here in St. Louis which, in looking for yield, started originating commercial mortgage loans directly. It's developed into a pretty large program.

Mark: There is a lot of pressure on people who are looking for yield, especially with rates so low all around the world. While some areas are crowded, I am not as concerned about whether a crowd is driving up prices as much as making sure that we are getting a fair spread for the risks that we are taking. If that crowd causes prices to be unfair, we are less interested. The areas that seem to check the right boxes for most investors tend to be priced too high. For other items that don't check the right boxes, there tends to be better value. CLOs tend to trade at favorable prices because too many people put them in the box of being too complicated. They have periods of illiquidity and aren't likely to be a crowded area. Whereas, at times, BBB credits could become a crowded area because they are investment grade and will fit into many investors' guidelines.

Given the level of rates, there is less risk of demand vaporizing. The market can have air pockets for a week or month, where things can look scary. But fundamentally, there is good demand out there for yield. While we value income, we are much more total return oriented. Having a fair amount of our return generated through income is beneficial because it is consistent. But we won't do something because it has income in it. That is just one of the trade-offs to consider in an investment decision.

David: The National Association of Insurance Commissioners (NAIC) is now examining the capital charges based on investment risk. How does this and scrutiny from ratings agencies affect your allocation to non-investment grade investments?

Mark: The rating agencies tend to have capital charges bifurcated. For investment grade credits, the risk charges are generally low, but for HY, they are quite high, so it does have some impact. Fortunately, we are in a position where we have plenty of capital to cover those capital charges. To date, our allocations have been driven by our view on economic risk and expected return, while being aware of the capital charges. But the charges aren't constraining factors in our decisions.

Rip: In our asset allocation process, expected total return, income and risk budgeting for the enterprise are paramount. The rating agency consideration is absolutely part of our asset allocation process. However, it generally is not a primary driver. We have not found rating agency issues prohibitive to date. We approach our rating agency

> INVESTMENTS INTO LIQUIDITY CONSTRAINED MANDATES NECESSITATES A RIGOROUS MONITORING PROCESS ON OUR EXCESS LIQUIDITY LEVELS TO ENSURE PROPER CASH FOR THE ENTERPRISE

relationship with complete transparency regarding our asset allocation analysis and the risks we are potentially taking with new mandates.

Elizabeth: The recent flight out of hedge funds by insurance companies, such as with Metlife and AIG, has been interesting. Of course, they weren't hitting their return hurdles, but then on top of that, getting hit with higher capital charges. So in allocating to risk assets, it's a factor for many US insurers that need to make sure they are hitting the return hurdles to justify the capital charge.

David: Is 5-10% of the portfolio allocated in non-IG a fair number in your estimation?

Elizabeth: That is a fair number. The insurance company I worked for previously has had an allocation between 20-30% in alternative assets in the past (including non-investment grade fixed-income), but this is a max, from what I have seen.

Rip: We are slightly above 10%, but our below investment grade mandate is not just traditional HY bonds. Embedded in our HY mandate are several sectors where many P&C insurers invest in a "silo" approach. We have a multi-strategy approach to the below investment grade space to include HY, HYBLs, CLOs, convertible bonds and other structured product. Additionally, we have a 2-year target duration and a BBB/B- minimum credit quality.

Mark: Our HY orientated investments total around 13% of the portfolio, but it is allocated to a variety of sub-sectors. Our allocation includes generic HY and HYBLs, but we also have credit distressed hedge funds, emerging market debt and distressed real estate private equity. We count the latter as HY, because they are working out distressed debt through re-structurings. In summary, while credit has a meaningful allocation, it isn't just HY, which is why we call it HY orientated investments.

David: Thank you all for sharing your views on this topic.

1.2 INTERVIEW

What are some of the opportunities from market dislocation and how can insurers be nimble enough to capture them?

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewee

Todd Hedtke,
Chief Investment Officer, Allianz Life

SUMMARY

- *All asset classes seem expensive at the moment*
- *Private equity is presenting interesting opportunities*
- *Commercial real estate in some areas may be in a bubble*
- *Insurers have the ability to adjust their product offering to protect themselves from low rates*

David Grana: Are we seeing market dislocation? If so what are some of the areas where we are seeing that dislocation?

Todd Hedtke: Everything is a little bit expensive and it is a more difficult time for insurance investors. Insurance investors are patient, so when we do see some dislocations and areas widen out, it can actually be a positive for us. Right now, we went through a stretch at the end of the summer where volatility was at such low levels that there weren't so many opportunities. Although, we are longer term and like to make bigger moves day-to-day, there might be an opportunity in Treasuries or something similar. But in general, we haven't seen all that many great opportunities. In fact, more to the contrary. I do have to buy credit, since it is our business model, but there are days when it does seem a little too tight.

David: Are you seeing any opportunities in this market?

Todd: Clearly the world of private debt, infrastructure, etc. are still good investments for us as insurers. They provide nice diversification, customization of maturities, duration, as well as a little bit more control. Since we are a larger player, we can handle the complexity and can sell the liquidity. There are some good aspects in this area, but it isn't a secret. We are all pretty much in the same boat. The other interesting area is private equity. You see a lot of money going into private equity because it is an interesting space. If you do have good abilities and relationships in this asset class, there are some good opportunities. But you must be careful, because in that same breath, there are also landmines in that space.

David: Are you seeing the area of private equity debt being one that insurers are looking at?

Todd: Definitely, although we are looking in these spaces fairly selectively. It is an area that is of interest, but there is always a little bit of caution. When so much money is going in the same direction, there are only so many good deals.

David: What are some of the landmines that we should look out for?

Todd: It is about finding the right people to work with and doing the right amount of due diligence. What scares me are firms who, because of an equity raise, have had to go out and invest that money in a certain amount of time. This is invariably going to happen in some cases. And it will have an impact on prices. Quite frankly, it will lead to some losses.

David: Where do you see crowded trades and mis-pricing?

Todd: I would say commercial real estate is the main area. With residential real estate, we don't do anything too exotic. These are location and pricing specific. There is a lot of money going into these asset classes, which is somewhat thematic. In some property markets, I would say that pricing can be pretty challenging and unrealistic.

David: When you are going into the real estate investments, is this going to be via a real estate vehicle like a private equity type of vehicle or is it going to mostly be on the debt side?

Todd: In North America, because our capital regime is with Risk-Based Capital (RBC), we are focused more on debt. However, for Allianz worldwide, we do look at the equity side of investments – direct equity. We do these investments in the U.S. Of course, we do have global locations, but because other balance sheets are under Solvency II and other regulatory regimes, the cost of financing is different. My personal focus is on the debt side, whether it be through direct debt or the securitized market.

David: What are your main concerns around real estate investments?

Todd: There are a couple of factors at play. There has also been a lot of capital, not just from insurance companies but also sovereign wealth funds, etc. That capital has been chasing assets in some markets and that scares me. They'll pay a price that, in some cases, is impossible to rationalize.

David: Is the economy going to be bumping along the bottom for a while, with low rates and low growth expected. And what does this do to insurers and their investments?

Todd: At Allianz Life, we are selling a financial product. And when you look at the products we are selling, the easy thought is to ask whether the business is under stress or not. My view isn't as dark as that of many in the market, mainly because I see it as being all relative. We are selling a financial product. And, yes, a flat yield curve and low rates do hurt us. But in general, we are selling a financial product that has to compete against other financial products. All those expected returns are lower, so the entire bar is lower. We should all expect less growth and less income from savings products. But again, it is all relative. And these are needed products.

David: With things changing so rapidly in the market, do insurers take on a tactical approach to move their capital around? Are you having to be more nimble then perhaps you were in the past?

Todd: We have been somewhat tactical, but it is not out of necessity. On average, we are sticking to our knitting and not trying to reach for yield, because that is a very dangerous game which usually ends badly. It is very easy to want to reach for yield when returns are so much lower then you are used to. But that is where I ground myself in the fact that it is still a relative game. Yes, it is a lower relative game, but we shouldn't be chasing yield or doing bad deals. And we don't need to justify the business model.

David: In your desire to be more nimble, what are some of the elements investors can be doing in order to better react to the markets from a resource perspective?

Todd: In terms of how we can get faster, it is really about technology. I am not sure it is pertinent to my role just as an investor, but more to my broader business role. It seems as though I am having the same discussion, whether I am wearing my insurance executive hat or my investor hat. The questions around how we take out unnecessary process and improve our technology are the questions we try and tackle. And certainly, information is at the ready these days.

> "WE SHOULD ALL EXPECT LESS GROWTH AND LESS INCOME FROM SAVINGS PRODUCTS"

David: Do you have any final thoughts on this subject?

Todd: The opportunities these days are more limited and maybe we will see more volatility here in the next couple of months with the election. The Fed could also set off a wave of volatility. Private assets done in the right way and with a level head offer nice opportunities - from both a diversification and asset-liability management (ALM) standpoint. And from a control standpoint, we have more control over the actual paper when we are doing private debt. These are still decent assets, but you do have to proceed with caution. And, again, I don't feel that we are at the stage where we have to chase yield.

David: Thank you for sharing your thoughts on this topic.

1.3 INTERVIEW

Is sacrificing illiquidity to capture growth in this low-rate environment a wise decision?

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewee

John Gauthier,
Chief Investment Officer, Allied World Assurance Company Holdings, AG

SUMMARY

- *With low rates, it makes more sense to allocate capital to the underwriting side of the business*
- *The mid-market lending market is ripe with opportunity*
- *It is important to be nimble and react to market movements*
- *There is minimal pressure from credit rating agencies to change asset allocation*

David Grana: What has this low-rate environment done to the way insurers think about the way they allocate their capital?

John Gauthier: For property & casualty companies, all else being equal, given the low return environment on the asset side, you would be more likely to allocate the capital to the underwriting side of the balance sheet and take less of your capital allocation on the investment side. Obviously, the underwriting side is not free of challenges. It is not as if we can just turn off the investment risk and put all of that capital into the underwriting markets easily. We are tilting this way, but can't turn on a dime and put all of that capital onto that side of the ledger.

Within the investment portfolio, we are taking capital down across parts of the balance sheet that are more capital intensive and where we think we are getting paid the least. We are trying to optimize the yield and total returns within those asset classes that attract higher capital charges. We are taking less duration risk and less equity risk in our portfolio, and we are allocating that risk where we think we are getting paid the most. This is happening in the illiquidity space. We feel that we aren't too deep into the credit cycle and the disintermediation of the banks into the capital markets is an opportunity for capital providers. The combination of being able to put money into leveraged credit structures that have longer lock-up periods, but which can also provide some very attractive returns, is one we are taking advantage of.

David: What are some of the illiquid asset classes that you are pursuing at the moment?

John: It is a combination of leveraged corporate credit and securitized credit. On the corporate side, we are doing more mid-market loans through an affiliate of ours. We are doing direct lending to companies who used to be able to borrow from their regional banks, which, due to regulatory changes, no longer have the same lending appetite. We are filling voids in that channel of lending. On the securitized side, banks have become less of a provider of collateralized loan obligation (CLO) capital. With our partners, we are becoming an equity owner in some CLO structures.

Potential limitations on our ability to make these types of investments come in different areas. One is the regulatory limitations. We are regulated by a variety of jurisdictions and are group supervised by Bermuda. We don't have a large allocation to these types of asset classes.

Another potential issue is the rating agency capital charges that they put on these types of asset classes. We are pretty well capitalized, so within those capital models, it is not necessarily a binding constraint for us right now. The real short term limitations are really self-imposed. This is a combination of understanding the capital position and liquidity requirements that we have. The amount of illiquid assets is part and parcel of the enterprise risk management process that we run. We understand, in a meaningful tail event, how much illiquid assets we can own so that we stay within that band. The return opportunity, along with the comfort level of senior management, the board and shareholders are also factored within that self-imposed limitation.

David: Do you see any pressure from the credit rating agencies?

John: We don't. But perhaps if we had a much larger allocation, it would be something that the rating agencies would consider. At these levels, given the takedown of equity risk and the modest increase in illiquid credit risk, we see minimal concern from the rating agencies at this point in time.

David: What percentage of the portfolio is being allocated to this type of credit?

John: As of June 30th, we had about 8% of the portfolio in these types of structures or credit. This includes private debt, which are moderately syndicated deals of a couple hundred million. It also includes broadly syndicated bank loans, where those are really financing leveraged buy outs. And those deals are usually in the high hundreds of millions or multiple billions. They tend to be, or at least are supposed to be, more liquid. Through Crescent Captial, we also participate in the direct lending space, where it could be one of just a couple of lenders to a company. These loans are often very illiquid.

David: What is the range of credit quality? How far down do you go on the scale of credit quality?

John: Most of these are between BB and B. There are some interesting opportunities where we have small allocations to the CCC area, but these are much more episodic. Roughly 8% of our June 30, 2016 portfolio was in the below investment grade bucket.

David: Right now we are starting to see some weaker numbers in the economy, as well as the changing of the guard in presidential leadership. Are these assets sensitive to these factors?

John: Yes, these assets have exposure to economic growth and are sensitive to these factors. We will have to be nimble in moving around the problem assets. More broadly, credit and equity markets, in general, are going to have that risk. We are getting paid a fair amount of return and spread in these illiquid credit markets for the risk that we are taking, relative to the equity markets. The benefit within the credit space is that, because of the rates these companies are paying, even though they are a very attractive spread to Treasuries, the interest coverage levels on most of the borrowers across our portfolio are pretty robust. From a credit metrics standpoint, it is going to take a fair amount of pain at the top line to translate into meaningful risk of downgrade or even potentially default at the bottom line. We do have a pretty robust credit profile across the portfolio spectrum, and this should help us. If rates do rise, we would anticipate seeing negative repercussions in the core portfolio, but these will be less susceptible. A lot of these structures are floating rate, so we would anticipate seeing increased returns for a lot of these structures to compensate for the incremental risk.

David: You have to then be nimble to get out of these?

John: You do. It is tough to be nimble when you have illiquid assets, but the reality of today's market place now is that things that you think are liquid are only liquid on a really good day. One of our affiliates manages a portfolio of broadly syndicated bank loans and private debt for us. By definition, they are very similar credit quality, but the differential between those two sectors of the leveraged credit market is that. Broadly syndicated means you are supposed to be able to have a lot of buyers and sellers and brokers, thus making two-way markets. Within private debt markets, you expect to have three or four buyers buying a deal because there are smaller deals, so you don't have the expectation for liquidity. It turns out that when markets are in a risk-off environment and volatility spikes, there is no liquidity anywhere.

Broadly syndicated loans yield around 5%, and earlier this year, yields in the private debt market were between 7%-7.5% for bonds that we expected to be illiquid. By owning broadly syndicated loans, we were giving up 2%-2.5% for similar credit quality, for the expectation of liquidity. We determined that if both markets were equally illiquid, we might as well allocate more to private debt, subject to our own internal limits, so that we can at least get that incremental yield. You can be nimble in spaces that you feel are going to provide liquidity. But you need to be honest with yourself, which means understanding the true lack of liquidity across marketplaces, especially when you are in periods of heightened volatility. You have to size it right, so that is why even though we are pretty bullish in this sector, it is still less than a 10% allocation.

David: If interest rates were to start rising again would this still be an attractive sector or would you go back to your old techniques of capturing returns?

John: A bit of both. The private credit markets have also been an attractive sector, because you get incremental return for the illiquidity, even if it is higher levels of absolute yields. Parts of the market have also benefitted from the increased regulatory scrutiny on the bank channels, which has created dislocations in the formerly traditional bank market. There has to be capital to replace the bank balance sheet that supported that market. This has evolved over the past couple of years. This is attractive, because there are no banking markets to replace that capital. In effect, the insurance or pension company balance sheets can create reasonably attractive yields from the dislocation of the bank market in general.

We would be kidding ourselves if we thought we would be getting back to a 5% 10-year Treasury anytime soon. However, if rates do rise, on the margin, you would be adding interest rate risk (duration) to the portfolio and decreasing credit and illiquidity risk. But you wouldn't be going from 8%-10% down to 0%. This is especially true because of the floating aspect of a lot of these underlying structures. In other words, as the Fed is tightening, you are getting incremental return from them. We expect this to be an attractive asset class for the foreseeable future.

David: Thank you for sharing your thoughts on this subject.

1.4 INTERVIEW

What type of credit securities have insurers been migrating towards outside of investment grade?

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewee

Eric Kirsch,
Chief Investment Officer, Aflac

SUMMARY

- *Insurers are looking for new investments with characteristics distinct from high yield*
- *Middle market loans give the insurer a lot more power than publicly traded fixed income*
- *Non-investment grade is an inevitable part of an insurer's portfolio*
- *If rates stay at current lows, insurers will need to reconsider their product offering*

David Grana: With interest rates at historic lows and yields being squeezed, what non-investment grade securities are insurers investing their money in?

Eric Kirsch: Based on our own work and discussions with peers in the industry, there are a number of opportunities in the non-investment grade space, as well as investment grade. In the non-investment grade sector, we are seeing a lot of attention in the private lending space. This includes bank loans, middle market loans, as well as loans in the real estate sector. These are typically BB and B rated. In the real estate space, these loans may include commercial mortgage loans and transitional real estate. It's also worth mentioning that within some of the real estate sectors, you can find value in investment grade assets as well. Finally, within the investment grade space, there is a fair amount of attention to infrastructure assets. The traditional high yield sector is drawing some attention, but insurance companies have had allocations to this asset class historically and are searching for new investments that have other characteristics to ensure diversification.

With the first few asset classes I mentioned, that's where there's more focus and attention. And there are a couple of reasons for this. The macro reason in this private lending space is interesting. While it has been around for quite a while, banks were the traditional sources of capital to the lenders. With the advent of Dodd-Frank, banks are far less active and the lenders are searching for new pools of capital. And this has drawn them to the insurance industry, where there is not only a potential large capital base, but also synergies, as insurance companies are traditionally comfortable with credit risk. While insurance companies invested in the space to some degree, in the era of low interest rates, it's fair to say this is getting a lot of attention.

David: Is there a minimum hold period for liquidity to be available on some of these securities?

Eric: In the middle market loan space, you are actually making a loan to some company in the U.S., typically a middle-market company that generates $20-$30 million of profit per year. Some may be larger, and some even smaller, but in general they are good fundamental companies and business models. There are thousands of these types of companies across the U.S. and they need funding for their businesses. They come to the private market looking for 3-7 year loans, depending on their circumstances. And they're typically senior secured loans.

When you make them a loan, you are the loan holder on record and will be holding it until maturity. However, the benefits are that you get to negotiate strict and tailored covenants to the loan, providing superior credit protection. If you have a credit issue, most likely it will be because a covenant was breached, and you will have the opportunity to work with management to address that in the loan documents or business model. But you should be prepared to hold it until maturity, knowing that there are limitations on liquidity. So again, if something is going wrong at the company, you will be proactive. You have the ability to work with the company to improve the matter before it becomes a material issue and a threat to their ability to pay back the loan.

David: What's a ballpark estimate of how much of insurers' portfolios are allocated to these types of securities?

Eric: If you think of it as non-investment grade, it does have limitations, because you are paying higher risk charges for below investment grade. These asset classes typically have very attractive yields - LIBOR plus 400-500 basis points, BB, and a short, 3-10 year tenure. Many of them are floating rate in nature, so the coupons do reset based on LIBOR, though some are fixed rate. The downside is that you are paying a higher risk charge. But even on a risk-adjusted basis, it still makes sense to allocate to those assets versus investment grade. But because it is below investment grade, everyone will have their internal risk rules and diversification limits, so it'll make sense to have some limit on it. If you look at it as a percentage of your total balance sheet, for a life insurance company, they'll probably have between 5-8% exposure to below investment grade securities. That's a very reasonable limit.

David: We're seeing some economic hurdles in the U.S. and the global economy as a whole. Do you see these hurdles adversely affecting some of these holdings?

Eric: We certainly spend significant time analyzing macro-economic trends and integrate that thinking into our credit work. We look at how the economy is likely to perform over the next 3-5 years and how will that company perform in that economic cycle. Of course, we look over longer time periods as well. Some sectors, like automobiles, can be highly impacted by a downturn; if there is a recession, people buy fewer cars. On the other hand, there are certain industries that do well in a recession – such as discount retailers. This is all part of our credit work. We look at the loan market and which sectors we like today versus others we may be concerned about. You definitely want to do that macro work and factor it into the segments and industries of the loan market you want to overweight or underweight over time.

It helps you when you are underwriting and doing new loans today, but perhaps you made loans 3 years ago, when you believed the economic cycle was going to be positive for the next 7 years. It may not have worked out that way, so you are holding a loan in an industry that is suffering and the company you've lent to is feeling the impact. This is why in the private lending space you get to negotiate the covenants with the company. These are your protections. It is critical that you think that through the economic cycle changes and how that affects the company's profit margins, sales, and demand, to name a few factors. Again with a focus on less liquidity, ensuring strict loan covenants is critical to protecting you. This is very different than when you buy an investment grade bond from, say, AT&T. You have no control over AT&T's business, but on the other hand, with the AT&T bonds, we have a lot more liquidity options where we can sell the bonds. Granted, the price may be impacted.

David: What will it take to have non-investment grade credit allocations increase? Is this down to ratings agencies and the NAIC making changes in their own policies?

Eric: The 5-8% industry allocation reflects the risk charges that insurance companies use from the NAIC now. And even with some of the changes that they are talking about, I don't see this changing very much. It is very company-specific, and every insurance company has their own capital objectives. But when the new standards come out, for this part of the credit spectrum, I don't feel that there will be large differences, but there will be more tactical adjustments.

David: Do you feel that if we have prolonged low interest rates, the regulators will increase allowances for non-investment grade securities?

Eric: In my opinion, I don't think that the regulators will lower the risk charge for non-investment grade securities just because you don't have anywhere to invest due to the low rates. That could be perceived as them saying that firms should take more risk, especially credit risk. Prolonged low interest rates are a challenge, and it is going to take a holistic approach if they continue to stay this low. This means that, as an insurance company, at the top of the house, you are going to have to evaluate what products you offer to the market and if you can you still afford to offer them. If you know what you can get from investment yields in a prudent, risk adjusted manner, and the features you want to give to the policy holders, but the economics just don't make sense, then you need to adjust your product set to reflect this. You could adjust features in the product as well. With all the good work that insurance companies do with credit underwriting, risk management, etc., I think we would look at it from the top down. Take a close look at at the business model in a low rate environment and adjust accordingly.

David: Thank you for sharing your thoughts on this topic.

> “If you look at it as a percentage of your total balance sheet, for a life insurance company, they'll probably have between 5-8% exposure to below investment grade securities. That's a very reasonable limit.”

1.5 INTERVIEW

Broadening the scope of investment possibilities in a low-rate world

Interviewer

David Grana,
Head of North American Media,
Clear Path Analysis

Interviewee

Robert G. Absey,
Senior Managing Director, Insurance Business Development,
AB (Alliance Bernstein)

SUMMARY

- *Low rates and stricter oversight mean CIOs need to get creative with their allocation*
- *Emerging market investment grade and short-duration high-yield are viable options for insurers under current market conditions*
- *Bank disintermediation will continue to open the market for private credit investments*
- *Capital-ready insurers may consider equity strategies focusing on downside risk protection*

David Grana: How should insurance Chief Investment Officers (CIOs) be addressing the tougher investment landscape they face today?

Robert G. Absey: In this era of rock-bottom yields and stricter regulatory oversight, insurance CIOs realize that they need to think creatively about a wider range of investments than they have in the past to meet their long-term needs. For most, however, getting the return potential they need means moving out on the risk curve. The big question is, just how far off the beaten path can insurers go?

There are no easy answers. Insurance companies need their capital to stand the test of time— and with as little volatility as possible. How they "spend" their risk budget involves tricky trade-offs, depending on their business needs and their tolerance for realized losses— and potentially large unrealized losses— relative to their liability streams and excess capital. The recent market turbulence has left many riskier assets attractively valued, but it also underscores the risks involved in capturing these opportunities.

As they start investing in these nonconventional strategies, insurers must also secure the necessary expertise to evaluate how these asset classes behave under various market conditions and how they are likely to affect the specific regulatory, accounting and ongoing business challenges insurers face.

It's a complex balancing act. We've evaluated the spectrum of investment options. We see three paths insurers can take to improve their return profiles while staying within a capital-efficient framework: embracing the new "core" strategies in fixed income, tapping the illiquidity premium and, for those with adequate capital capacity, considering equity strategies that focus on downside equity risk protection.

David Grana: So, tell us more about each of those three paths. What new fixed-income strategies would you say are appropriate for insurance portfolios?

Robert: New fixed-income "core" strategies offer insurers attractive ways to add income and diversification. These include strategies that provide global bond exposure and those designed to capture the upside of the high-yield market with much less downside. As part of a holistic approach, these solutions can help improve the risk/return characteristics of an insurer's total portfolio.

We suggest two potential avenues that insurers can take – Emerging Market (EM) Investment Grade (IG) debt and short-duration high-yield debt.

Emerging markets play an important role in a diversified portfolio by providing investors access to many of the world's fastest-growing economies and companies. In a low-growth, low-yield world, the opportunity in EM debt is particularly appealing today. Compared to Developed Market (DM) securities with similar ratings and maturity— and, hence, similar capital charges—EM corporates provide an attractive spread pickup. And, in turn, a potentially higher return on capital than U.S. investment-grade credit. Spreads for EM BBB corporates, on average, are now 0.4% higher than those for U.S. BBB corporates.

Likewise, high-yield bonds provide investors with a consistent income stream that few other assets can match. However, though they tend to recover quickly, sizable corrections in this asset class are not unusual.

For insurers who want the income of high-yield bonds but not the volatility, we recommend a two-pronged strategy: shorten duration and focus on quality. We believe that a barbell approach that combines short duration high-yield bonds with some long-dated risk-free assets (government bonds) may be a particularly good fit for insurance companies. Like any other strategy, a short-duration one can lose money in down markets, but it generally loses much less than strategies with higher duration and additional risk. With this approach, insurers can potentially capture most of the income upside of the high-yield market but with a lot less of the downside risk. At the very least, it should enable them to stay the course and enjoy the income full-cycle income benefits of their high-yield investments .

David Grana: You also mentioned tapping the illiquidity premium. Explain the advantages for insurers in private credit investing.

Robert: We expect the bank-disintermediation trend to persist as alternative providers of capital move to fill the void left by banks retreating from certain lending activities.

As ready providers of liquidity with long investment horizons, insurers are well positioned to capture the above-average risk-adjusted returns available in illiquid assets, including directly originated private credit. We find the opportunities in three main segments of private-credit investing particularly interesting: direct middle-market corporate lending, direct US prime residential mortgage lending, and direct commercial real estate lending.

These areas share a number of characteristics that insurers should find particularly appealing. First, because private credit investments lack a deep secondary market, they offer investors a yield premium over comparable public credit investments. Moreover, middle-market loans and commercial real estate debt, because of their floating rates, provide a strong defense against rising rates. Though residential mortgages rates are fixed, they offer a yield premium to cushion the impact of a rate rise.

Private credit also provides capital efficiency across different jurisdictions. Under Solvency II, they allow for the matching adjustment, which may provide additional capital relief. Under risk-based capital (RBC), middle-market loans are rated by a national rating organization for efficient treatment. These investments also enjoy favorable accounting treatment because they are booked at cost rather than marked to market.

David Grana: You've also suggested that some insurers may want to rethink their equity allocations. Insurers typically steer clear of stocks, and new regulatory requirements haven't made that easier. What are your thoughts here?

Robert: We don't see insurers significantly increasing their equity allocations, given the much higher capital charges and the potential impact of equity volatility on their earnings and balance sheets. On the other hand, in the current low-yield environment, it's getting harder to outright ignore the higher return potential offered by equities. So, for those insurance companies re-evaluating their equity allocations, we believe that there are several insurance-appropriate equity strategies that may make sense—if assessed holistically from a risk/ return perspective.

Specifically, we think equity strategies that expressly focus on capital preservation and long-term outcomes are worth a look.

These solutions are governed by a simple math. By losing less when markets fall, less volatile stocks can recoup their losses faster when a stock recovery gathers momentum. Over time, this gentler pattern of returns can end up ahead of the market. Smoother-ride equity strategies can also help temper earnings and balance-sheet fluctuations.

We think an active approach is the way to go in this space. Building portfolios that can gain more in market upturns than they lose in downturns takes skill and the flexibility to pivot when opportunities arise (sometimes in unexpected places) or when the world throws curve balls. But to tip the scales to the upside, you must also stay alert to valuation.

A smoother ride that's easier on the nerves can help keep investors on course and ultimately improve the odds of meeting their long-term needs. But insurers must be willing to free themselves from the tyranny of benchmarks and adopt a new way of defining equity investment success that leans on absolute risk and return potential in the pursuit of long-term goals.

David: Thank you for sharing your thoughts on this topic.

SECTION 2

HOW TECHNOLOGY IS CHANGING THE SECTOR

2.1 WHITEPAPER

How technology is driving outsourcing expansion

2.1 WHITEPAPER

How technology is driving outsourcing expansion

Paul F. Fahey,
Practice Lead,
Insurance Solutions,
Northern Trust

SUMMARY

- *Outdated technology cannot meet the demands of today's insurers*
- *Insurers should look for systems with data portability*
- *Support for sophisticated asset classes is important to overcome accounting challenges*
- *Outsourcing is an important part of middle and back-office management for insurers*

The constraints insurance companies face from outdated technology are increasingly pronounced as demand grows for better, timelier data to satisfy the external needs of regulators and customers. Similarly, internal demands for data to support risk and governance continue to rise, placing further strain on an insurance company's aging systems.

As these challenges increase, insurers seek ways to meet them without making costly investments in systems infrastructure. Many have moved beyond the question of whether to outsource, recognizing that technological advancement and a maturing outsourcing industry have made it far easier and less expensive to outsource technology and operations solutions. They no longer need to support their business growth in-house with costly, non-revenue-generating operations. Instead, they can outsource these functions to experts who can manage them more efficiently and cost-effectively.

Having made the decision, what should an insurance company look for in an outsourced solution?

Data Portability and Flexibility

Growing complexity in global currency trading and regulatory requirements demands streamlined data that often reside on multiple systems and platforms. Look for a provider that currently offers an integrated solution for multiple data sources, producing a single book of record that can support investment, trading, performance and accounting decision making and reporting. Also important is the outsource provider's ability to produce custom templates and queries. The ability to manipulate and understand data is increasingly important to quickly create and modify reporting to fit specific needs. Having flexibility is essential as technology and needs evolve. For instance, can data analysis be performed on the go via a mobile tablet or smartphone? Does the outsource provider have a report writer with built-in features to manipulate the data to deliver both the required content and format? This should include data delivery integration between the outsourcer and an internal system. Finally, insurers should look for data portability. For example, can the firm run data through an ad-hoc report runner and export to a variety of different formats, including PDF, Excel, and CSV?

Support for Sophisticated Asset Classes

More sophisticated investment strategies generate greater accounting challenges. Insurance companies may determine they lack the in-house expertise or infrastructure to handle assets such as structured securities, complex fixed-income products, derivatives, bank loans and alternative investments. They may be unwilling to make the needed investment in technology and people to address these challenges. An external investment accounting provider can extend beyond an

> WHEN SEEKING OUTSOURCED SOLUTIONS, INSURERS SHOULD LOOK FOR A VENDOR THAT PROVIDES COMPREHENSIVE ACCOUNTING AND REPORTING CAPABILITIES THAT CAN EASILY BE IMPORTED WITH MINIMAL INTERVENTION

insurer's back office by delivering investment data and insights that enable better investment analysis and simplify data management.

To illustrate this point, recently, a large property and casualty insurer headquartered in the Midwest, with $15 billion in primarily in-house managed assets, decided to expand its allocation to bank debt and was hiring an external manager for the first time. The insurer's existing accounting platform struggled to comprehensively support bank loans, and the complexities of the asset class threatened to significantly strain in-house resources. With its component outsourcing solution, Northern Trust now supports investment and statutory accounting for the bank loan portfolio. Outsourced services include capture and validation of all bank debt activity, portfolio valuation, accounting and statutory reporting, and data feeds back to the client's systems for aggregated reporting. The insurance company avoided a major investment in systems and specialized talent necessary to effectively support the portfolio by outsourcing those activities to Northern Trust.

Capabilities for Financial and Regulatory Reporting

Some vendors fail to extend reporting that insurance companies need, such as footnote disclosures and other pertinent financial reporting. Investment accounting systems may not provide this data. As a result, companies may need to manually manipulate data from multiple providers; a costly and time-consuming task. When seeking outsourced solutions, insurers should look for a vendor that provides comprehensive accounting and reporting capabilities that can easily be imported with minimal intervention.

Outsourcing continues expanding into more back and middle-office functions of insurance companies, which for years have outsourced custody and over the last decade expanded insurance accounting outsourcing. With the maturity of outsourcing services comes the recognition that insurance companies have options. They no longer need to support their business growth in-house with costly, non-revenue-generating operations. Instead, they can outsource these functions to experts that can perform them more efficiently and cost-effectively. Most importantly, it allows the insurance company to focus on its core business and spend more time providing its customers with excellent service.


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SECTION 3

DIVERSIFYING INTO NEW ASSET CLASSES

3.1 ROUNDTABLE DEBATE

How are insurers integrating alternatives into their portfolios?

Moderator

David Grana,
Head of North American Media,
Clear Path Analysis

Panelists

Marc Tourville,
Managing Director,
Cardinal Investment Advisors

Paul F. Fahey,
Practice Lead,
Insurance Solutions,
Northern Trust

Chad Burhance,
Chief Executive Officer,
NewOak Capital

POINTS OF DISCUSSION

- *Alternative assets can have many definitions, depending on the insurer*
- *Insurers are increasing their exposure to a number of alternative assets*
- *Limitations on alternative asset allocation can be affected by state limits*
- *"Lower for longer" tends to be the consensus for economic growth among insurers*

David Grana: The term "alternative assets" is very broad and can apply to many different types of assets. How do you define "alternative assets" from the perspective of insurance investment portfolios?

Paul F. Fahey: It depends on the insurance company when referring to "alternative assets." We have seen that large insurance companies have increased their exposure to alternatives in recent years in search of yield. Their view on what constitutes an alternative includes commodities, mortality swaps and infrastructure investments. Some of the smaller insurance companies, who haven't had previous exposure to this space, would likely broaden the definition to include hedge funds, real estate and private equity.

Marc Tourville: The definition is ever-changing, so it does depend on the audience. Insurance companies have a number of stakeholders involved: whether it is their internal committee board governance structure, regulators or rating agencies. Each one of these can have a different view or perspective on what constitutes an alternative. If it is defined by liquidity, that would push private assets such as private equity, real estate and hedge funds into that definition. Most definitions would clearly include these as alternatives, but as you get closer on the spectrum to core bonds and public equity, the definition starts to become blurred. Defining whether high yield is an alternative might depend on whether you are talking to a Life or Property and Casualty (P&C) company. There could be an accounting perspective for the definition of alternatives, which might say that anything that doesn't go on Schedule D is an alternative. There could be a rating agency perspective as well. The definition has been changing. I imagine that many years ago, when a number of insurance companies managed their portfolio internally, alternatives were anything that they may not have managed internally. If they had investment grade bonds and domestic equities, I am sure that there were some insurance companies that considered publicly traded international equities as a form of alternative. It is tied to risk tolerance and is not necessarily driven by insurance company size. We know a number of small insurance companies who are comfortable with the markets and risks and have more alternative assets than some larger, more conservative companies.

Chad Burhance: As Paul noted, the persistent low rate environment has created new alternative investment strategies. It has also forced insurers to move into more traditional asset classes, such as commercial real estate, directly. In both cases, the purposes of these exposures are to generate yield that cannot be found elsewhere. At the same time, the traditional hedge fund model that was dominant with private equity in the alternative asset bucket, is slowly going away.

David: How important have alternative investments been for insurers since yields have been pushed so low?

Paul: As we look at the prospects and clients we are talking to, we are seeing increased exposure to alternative investments in varying shapes and forms. This is a clear indicator that they are important. As you press further into the conversation, you can see that this is being driven by the lower yield environment and the expectation that it will be around for a while. We have found that insurers are becoming more focused on creating more liquidity and are prepared to push out the curve. If you have multiple, underlying legal entities within an insurance company, the parent is looking at ways to pool its cash to make some of it go further out the curve without negatively impacting the overall liquidity of the underlying legal entities. We are seeing more of our clients go down the alternatives route. As they move into these new investment types, they may not have either expertise on the investment side or ability on the operations and technology side to support them and it is posing challenges. They are going to have to figure out a way to support it.

Marc: I agree. It all depends on the starting point for the insurance company and their current risk tolerance. Across all risk tolerances, there has been a shift to the next level. There are some insurance companies who have only expanded existing guidelines, implementations or maybe durations. You may change your equity implementation to be a dividend-focused implementation. You may expand your core bond guidelines to increase allocations to BBBs or added Collateralized Loan Obligations (CLOs) as a sector permissible within your guidelines. There are some insurance companies who are only expanding alternative implementations on their existing asset classes. But there are others who have already done that and feel comfortable adding a new asset class. And then there are some who have alternatives who may increase their allocations to the current alternatives or add another one. At all levels, we are getting the sense that people are pushing to a higher orbit depending on their starting point.

Chad: Alternative investments have been huge for insurers and are only going to become more important. They will play a big part in ways to fund the asset-liability gap. While there are various viewpoints about how long we will experience this rate environment, the general agreement is that this is the new normal for the next 5-7 years. As a result, funding long term liabilities is a real challenge with traditional investments, hence, the key focus on new alternatives.

> “AS THE ALLOCATIONS INCREASE, IT IS GOING TO POTENTIALLY ADD AN IMMEDIATE FOCUS FOR THE INSURERS TO INCREASE INVESTMENTS TO PROVIDE THE NECESSARY COMFORT TO THE REGUALTORS.”

David: What are the limits within the alternative space that insurers have based on regulations and ratings?

Marc: For our clients, who are predominately P&C and health insurers with state regulations, you've got issuer limits. Many states also have credit, investment vehicle and basket cause limitations. The biggest limitation we see is that anything that doesn't nicely fit into their categories of investments falls into a basket clause. The limitation by state is usually somewhere between 4-6%. The asset allocation work then becomes an optimization within that 4-6%. Within this, you can put investments such as private equity funds, hedge funds, co-mingled credit strategies and tactical allocation strategies, just to name a few. But your limitation on all of these is 5%. It becomes the task of optimizing your objective function, whether that is income, total return or some combination of both within that 5% basket clause limitation.

Paul: We talked about this internally, and certainly there is an insurer by insurer determination. It's not one-size-fits-all. Marc does raise an interesting point between the regulatory limits and the rating agencies. You would like for these two to be well aligned. But while a regulatory limit might be one thing, if a peer group is in another tiering, then the rating agencies tend to look at a comparison of where you are relative to your peers. That may dictate what they do from a ratings perspective. It may not be ideal. With multi-national insurance companies, we then have to factor in regulations such as Solvency II and European Market Infrastructure Regulation (EMIR).

Chad: I think they are both correct in that there are some clients who are restricted within certain regulations, but no two clients who are alike.

David: The National Association of Insurers (NAIC) is in process of proposing changes to the treatment of certain asset classes in their investment risk-based capital working group. Is there any indication as to how this will impact alternative assets?

Marc: From what I understand, a lot of their work is in trying to reconcile the differences between the life and P&C Risk-Based Capital (RBC) charges. They are trying to make sure that they are treating the underlying investment risks in a similar fashion. In terms of how it impacts alternatives directly, for years, the NAIC has said that if you have an investment on schedule BA, you need to make the case for why it shouldn't get a 20% capital charge. That includes explaining the underlying risks. They have always had that door open.

Paul: Where we are seeing more of their focus is looking at more granularity, particularly in the bond space. Today, they have 6 designations for their bonds. They are looking to have 14, or possibly 19 designations. I don't know where they will end up, but the goal is to distinguish between the higher investment grade corporate bonds and being more granular in the way that capital needs to be allocated. So really, more in the fixed income space.

Marc: Another element is that the rating agencies are a little further along than the NAIC. But for a while, both capital models were focused on what the investment vehicle was, not necessarily the underlying risk exposure or asset class. AM Best and the rating agencies are trying to look deeper into what the underlying exposures are in terms of liquidity, rate and market risk. They want to think about these and model them, regardless of whether it is in a mutual or co-mingled fund or a partnership. The NAIC is a little behind on this.

Chad: I see the requirement for transparency in new private/alternative credit instruments to be a great challenge for the insurers because of the technology demands. As the allocations increase, it is going to potentially add an immediate focus for the insurers to increase investments to provide the necessary comfort to the regulators.

Paul: That is one of the reasons why we are going to see this increased drive around transparency of underlying holdings. The hedge fund industry, in particular, has been challenging at times in the transparency department. As insurance companies move down this path, their size means they carry a bigger stick. That should help them apply a little more pressure, especially if they are getting pressure from both the regulators and the rating agencies for more transparency.

David: So no black box-type of investments?

Marc: Most of our clients tend to avoid investments or strategies where they can't understand what they are buying and how the strategies work. There are so many investment strategies and asset classes that have transparency and we don't see our clients willing to give a leap of faith for those that don't.

Paul: Their strategies and returns are directly linked to the liabilities they are trying to match. Not being able to understand what they are or there being any level of volatility and opaqueness is just not a fit for insurance companies. As they do become bigger investors in some of these strategies, again, they may be able to apply a little more pressure, so they may influence the level of transparency.

Chad: It's very difficult for a heavily regulated investor to not be able to demonstrate investment process and surveillance to manage the associated risk. Therefore, I believe the answer is no.

David: What are some of the inherent risks that investors face with a continuation of this low-rate environment, and what are some of the options that insurers have to manage those risks?

Paul: Our investment management arm has taken the view that it is a "lower for longer" environment. It was interesting to see three dissenting votes recently at the Federal Open Market Committee meeting. That gave some people hope for some movement in December. But that remains to be seen. Where we see some of the challenges is for some insurance companies, this is a new frontier. These challenges are matched by those on the investment accounting and operation side of the insurance house.

We see some system limitations from a pure operations and accounting perspective. These new securities have different cash flows, which may not have been accounted for when some of the technology and systems were built a number of years ago. Expanding into new orbits could pose a big challenge. The operations teams that support the investment teams may struggle to provide all of the transparency and reporting on the various securities. They may need to go to outside managers who can provide that level of exposure in those strategies. If they do outsource, is there a technology and operations outsourcing opportunity if the internal investment teams can't be supported by their internal groups?

Chad: The only risk investors can take to increase yield is to take on more credit risk. The proliferation of specialty/esoteric finance strategies is still relatively new. And it's certainly new for the scale. We are seeing money moving into various sectors, such as residential and commercial real estate, asset-based loans, middle market loans and direct consumer lending. Investors need to be careful that they understand the credit risk they are undertaking and have the requisite transparency to continue to measure and manage the risk.

Marc: The options insurers have to manage risks are similar to other institutional investors: making sure that they do their due diligence on the investments themselves, or the managers who are making those investments for them. What is unique for insurers versus other institutional portfolios is that insurers typically have a lot of cash flows, both in and out. To the extent that an insurer can manage their underwriting operations in a way that provides more positive cash flow, they are trying to increase yields by taking on more liquidity risk to some extent or another. Whether that means going longer in duration or into private asset classes, the implication here is that it buys time to ride out market volatility.

David: Thank you for sharing your thoughts on this subject.

3.2 INTERVIEW

How has private credit become the new darling of insurance asset management and how much further can it grow?

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewee

Nathaniel Molinari,
Senior Investment/ Treasury Analyst, AEGIS Insurance Services

SUMMARY

- *Trading liquidity for yield has made private credit very attractive*
- *Credit analysis is paramount for investing in this private credit*
- *Private credit is a buy and hold security*
- *There is a risk of oversaturation in the private credit market*

David Grana: For starters, which are the areas of private credit that insurers are leaning towards?

Nathaniel Molinari: Generally speaking, Property and Casualty (P&C) insurers continue to have excess liquidity and are constrained in their ability to find yield in the traditional corners of the market. In the public debt markets, investment opportunities are rather limited, unless the investor is willing to accept lower credit quality. The ability to trade liquidity for higher yields/potential return has made many private credit opportunities look more attractive in today's marketplace. One sub-sector that has received a significant amount of institutional interest is direct corporate lending, as these portfolios have become an attractive opportunity for insurers. Although the loans are typically smaller in dollar size, compared to public borrowers, they may be higher in credit quality metrics and they generally have floating rate coupons. The floating rate nature of the loans should benefit investors when interest rates rise, which we have expected for years now. Many managers focus on the top of the capital structure with senior secured loans to ensure capital preservation. The direct corporate lending sector may also include second lien and unitranche debt.

David Grana: What is the range of credit rating for these assets?

Nathaniel: Given these loans are not publicly traded, there is no corresponding credit rating. Private credit strategies may have variable risk characteristics, therefore, credit analysis remains paramount. Loan to value, leverage, seniority, covenants and collateral are all important factors investors and lenders alike need to keep in mind.

David Grana: How much of their portfolio are insurers typically investing in private credit?

Nathaniel: Allocations will naturally differ, given each insurer should weigh the needs of the enterprise when analyzing their appetite for liquidity-constrained investment opportunities. Another decision to consider when investing in private debt is where the insurer wants to assign the asset class within its portfolio – is it part of their alternatives bucket, below-investment grade or corporates? Where you assign private credit strategies can influence your weighting decision. Additionally, your level of "excess liquidity" is of primary importance regarding any type of liquidity-constrained investment.

David Grana: From a liquidity perspective, are the instruments easily traded, or is there a certain level of liquidity risk, relative to Treasuries and other traditional fixed income assets?

Nathaniel: Private credit is most closely related to the fixed income component of institutional investors' portfolios. However, the investment vehicles through which these loans are originated are inherently illiquid. The loans should be viewed as buy and hold, as they are not publicly traded. The illiquidity premium of the asset class is what provides additional spread relative to publicly traded credit. Although an investor is giving up temporary liquidity, they are typically at the top of the capital structure. Additional benefits include greater yield spread, higher potential return and lower levels of volatility and correlation to the public markets.

David Grana: What are some of the downside risks of private credit investments?

Nathaniel: Like other alternative investment options, such as real estate and private equity, illiquidity should be top of mind when weighing the risks. It should be a priority for investors to thoroughly understand and weigh the forecasted benefits of private credit versus the illiquid nature of the asset class. Typically, commingled funds will have a lock-up of five years, which includes an investment period, harvest and loan maturity. Manager selection is also key. Given investor interest, many new funds have been launched, and new managers have moved into the direct corporate lending and private credit space. Similar to the public markets, this trend has put pressure on spreads, as there is more capital chasing the same deals. Therefore, manager discipline in adherence to credit underwriting standards, and investment strategy is imperative in this market.

David Grana: If interest rates continue at current levels, is there a risk that private credit markets could become oversaturated with investors, thereby making spreads too tight for the credit risk?

Nathaniel: I believe we are already seeing this in some regard in 2016. However, I don't think the pendulum has swung so far that private credit has lost its attractiveness. There has been some spread compression, given private credit managers are seeing increased competition for loan origination. Since the 2008 financial crisis, traditional bank financing has decreased dramatically for many middle-market companies. Additionally, the increased regulatory environment has dampened the attractiveness of traditional bank financing for many companies. The void left by the banks' absence is being replaced by nonbank, private credit lenders. Private credit and direct corporate lending continue to receive institutional interest, as it provides attractive returns alongside reasonable/measurable risk parameters.

David: Thank you for sharing your thoughts on this topic.

"THE VOID LEFT BY THE BANKS' ABSENCE IS BEING REPLACED BY NONBANK, PRIVATE CREDIT LENDERS."

SECTION 4

HOW REGULATION AND CREDIT AGENCIES ARE IMPACTING ASSET ALLOCATION

4.1 INTERVIEW

The proposed changes and prospects for adoption of National Association of Insurance Commissioners (NAIC) 2017 investment risk-based capital changes

4.1 INTERVIEW

The proposed changes and prospects for adoption of National Association of Insurance Commissioners (NAIC) 2017 investment risk-based capital changes

Interviewer

David Grana,
Head of North American Media, Clear Path Analysis

Interviewee

Edward Toy,
Director, Capital Markets, National Association of Insurance Commissioners

SUMMARY

- *The NAIC's Investment Risk Based Working Group is currently focused on the treatment of bonds, and is discussing real estate investments*
- *Non-investment grade exposure has increased only modestly since 2013*
- *There has not been an industry-wide concern about low interest rates*
- *Changes to the treatment of bonds will take time before implementation*

David Grana: What are some of the more notable proposed changes from the Investment Risk-Based Capital Working Group (IRBCWG)?

Edward Toy: The Investment Risk-Based Working Group is charged with reviewing all of the Risk-Based Capital guidance for all of the investment schedules. Proposals for two schedules – for common stock and derivatives - were already sent to its parent committee, the Capital Adequacy Task Force. The current work is focused on the bond schedule, but the Working Group (WG) has also had discussions on a proposal for real estate investments. For the bond schedule, the recommendation from the American Academy of Actuaries is for a fairly substantial update of the current framework and factors, which date back to the early 1990's. Following on guidance from the WG and based on more current default and loss severity data, the Academy's recommendation is for an increase in granularity from the current six NAIC designations and adjustments. That would see many increases in factors for investment grade bonds. The additional granularity will do a better job of differentiating between risk profiles of portfolios, and therefore, reduce some of the arbitrage that exists with the current structure. The new factors will reflect more current market conditions.

David: Interest rates are obviously still the white elephant in the room. What has been the attitude towards lower grade bonds?

Edward: Insurance regulators continue to monitor investments in below investment grade bonds very closely. There are concerns about investors in general, including insurance companies, reaching for yield in what has been a low interest rate environment. On an industry wide basis, there has not been significant reason for concern. Industry exposure to below investment grade bonds decreased as a percent of overall invested assets through 2013. And it increased modestly in 2014 and 2015. It is still a well-managed overall exposure and is also heavily weighted to higher end of the spectrum (BB quality).

David: Is the consensus among the IRBCWG that rates will remain at these lows for the foreseeable future?

Edward: The IRBCWG does not express a view as far as the direction of interest rates. The work done by Academy of Actuaries does involve a significant amount of economic modelling (10,000 economic scenarios) over a ten-year time horizon.

David: The Ceres report earlier in the year pointed out some potentially risky investments by insurers in fossil fuels, to the tune of half a trillion dollars. Has this been a part of the discussions, and what have been some of the proposals?

Edward: The IRBCWG work thus far does not make distinctions based on industry or sector. The data used by the American Academy of Actuaries is based on rating agency default and loss severity statistics over a 20 year or more time horizon. The risks considered by Ceres would be included in that data. Separately, the NAIC has reviewed the exposure of the US insurance industry to energy related (oil & gas)

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companies. That was a more specific analysis than what Ceres did, and found total exposure of approximately $206 billion. A more detailed review also found that a substantial portion of that exposure was in investment grade companies and/or in shorter dated (10 years or less) paper. The $206 billion exposure as of year-end 2015 was a decrease from year-end 2014 ($226 billion).

David: Are there asset classes outside of bonds and equities where we are seeing proposed changes?

Edward: The IRBCWG has been considering a proposal on real estate. The NAIC adopted a new, more risk-focused approach, for mortgage loans in 2013. The IRBCWG has been charged with reviewing the results of the new approach with the possibility of refining it further.

David: What are some of the steps that the proposals need to go through before we see them adopted?

Edward: Any adoption by the IRBCWG needs to be coordinated with a number of other NAIC committees (the Valuation of Securities Task Force, the Statutory Accounting Principles Working Group, the Blanks Working Group, and the Risk-Based Capital working group for each of the major insurer types – Life, Property/Casualty and Health), and also must be adopted by IRBCWG's parent committee, the Capital Adequacy Task Force.

David: The end of 2017 is when we project seeing the changes adopted. Is there anything that could hold this up?

Edward: Work of this breadth and importance, with this much potential impact on insurance companies, must be thoroughly vetted in an open and transparent process. Coordination with other NAIC committees is also critical to be comfortable that the risk of unintended consequences is minimized. Changes to the regulatory framework do take time, but the end product is a more robust one.

David: Thank you for sharing your thoughts on this topic.

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