SLC Management

Reinvesting legacy book yield maturities in a low rate environment? Start with trading liquidity

The average Property and Casualty (P&C) insurer will see between 15-25% of their portfolio mature each year. With fixed income yields at all-time lows, the outlook for reinvesting these proceeds – while maintaining existing portfolio yields – can look grim. However, certain levers for increasing yield in a capital efficient manner have traditionally been underutilized. Below, we explore how Investment Grade Private Credit can help P&C insurers maintain income levels without taking on additional credit risk.

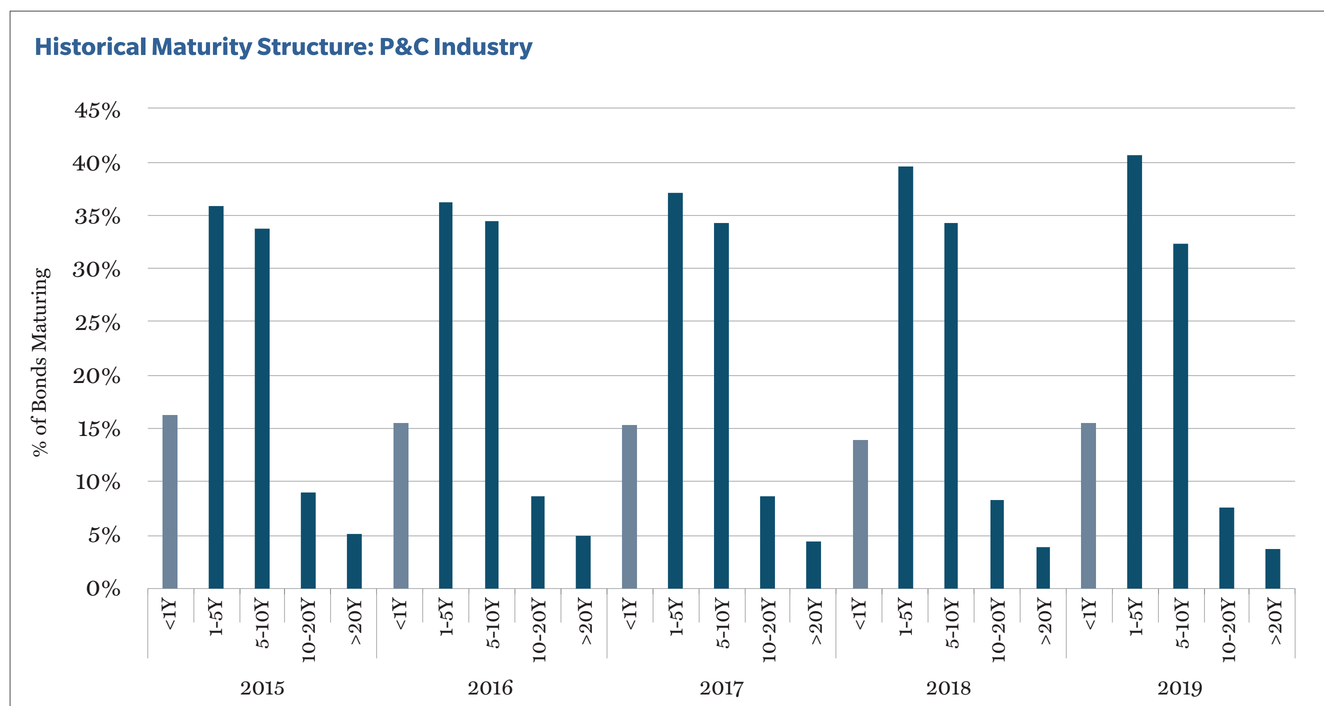
While current portfolio holdings have seen significant price appreciation from April market lows, insurers find themselves in a difficult position. For many P&C insurers, book yield has continued to erode. In 2021, P&C's forecasted maturing book yield is approximately 3.5%. With the Bloomberg/Barclay U.S. Aggregate yielding approximately 1.2%, insurers are desperately looking for new capital efficient investment strategies to help alleviate future income concerns. Against the backdrop of a "lower for longer" environment, the challenge of meeting investment objectives has continued to steepen as the Fed recently updated longer term inflation goals.

Insurers are constrained investors with fewer levers to pull to increase portfolio yield – Given the nature of their liabilities, insurers require a substantial allocation to fixed income, or defined maturity investments. In addition, the focus on regulatory or solvency modeling further restricts an insurer's ability to access certain asset classes. These constraints leave traditional P&C insurers with fewer alternatives to increase portfolio yield.

The typical levers available to insurers focus on:

1. **Duration:** extending fixed income exposure further along the yield curve
2. **Credit:** taking on additional credit risk in the form of lower rated securities
3. **Market or equity risk:** looking towards alternative asset classes to leverage balance sheet strength in the hopes of earning a risk premium
4. **Liquidity risk:** trading the ability to quickly sell a security for an increased yield or return profile

Duration Risk: Utilizing duration risk can be difficult for insurers who typically face the competing challenge of immunizing future cash flows by aligning with their liability



Source is S&P Global Intelligence as of 12/31/2019 and NAIC as of 12/31/2019.

duration – Even for companies with strong cash flow profiles that can handle an extension of duration, the flat yield curve provides limited upside to duration extension. The yield difference between the 2-year Treasury and the 10-year Treasury is approximately 100 basis points below its trailing 10-year average.

Credit Risk: Accessing credit risk to increase yield has been a favorite tool for insurers, but is proving tougher in the current environment – The migration to lower quality assets has been a staple of insurance portfolios since the 2008 Global Financial Crisis. As recently as Q1 of 2020, investors were able to take advantage as corporate spreads rapidly widened. However, these opportunities have since evaporated and corporate spreads are back within their trailing 5 and 10-year historical averages. Given increased volatility in the markets, the worry of headline risk and growing downgrade potential, many insurers have opted to stop increasing NAIC 2 or BBB-rated securities.

Market/Equity Risk: Trading out of core fixed income into alternative investments presents a new set of challenges – From a solvency perspective, capital requirements increase as assets are invested outside of investment grade bonds, limiting an insurers' ability to execute this tactical trade. From a more practical risk management perspective, alternatives present higher volatility profiles and under statutory accounting guidelines are valued at fair value. As many insurers are unfortunately now aware, significant market fluctuations – such as those experienced in Q1 2020 – can materially affect an insurer's surplus position.

Liquidity Risk: Insurers can capture significant yield through reinvestment into less-liquid assets – One investment lever the broader insurance industry has started to utilize more frequently is liquidity. Investment grade private credit can improve return and yield profiles, while oftentimes having no material impact to current risk based capital or solvency measures. In addition, an analysis of an insurer's liquidity profile will often reveal an excess capacity to carry less-liquid assets.

Comparing the fixed income levers in the current market:

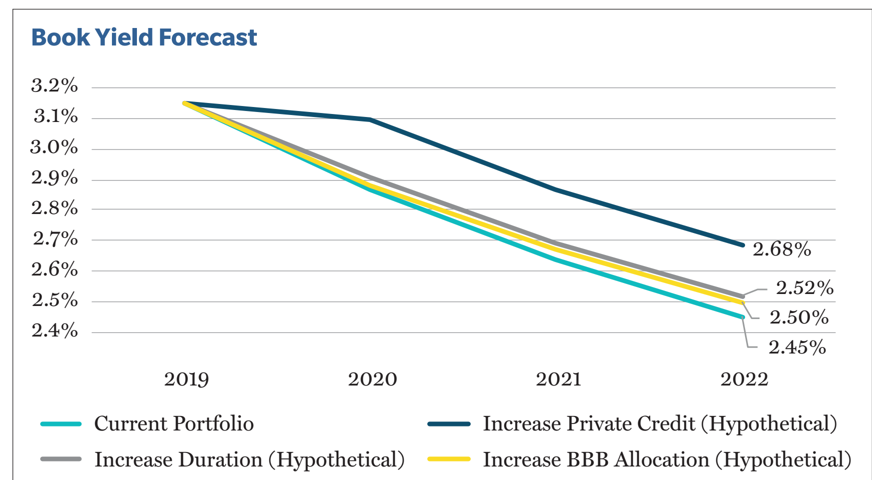
In order to demonstrate the impact of each approach in the current yield environment, we examine a case study on a traditional $1 billion P&C insurer in the U.S. For the purposes of our example we assume this entity is subject to traditional statutory filing requirements and solvency metrics. The base asset allocation follows the P&C industry averages as of 12/31/2019 and we have not adjusted equity or other risk asset allocations.

We consider and compare three unique scenarios:

1. Increase fixed income duration by 1 year
2. Increase BBB (NAIC 2) allocation by 20%
3. Increase investment grade private credit allocation by 10%

In line with current market conditions, we assume that all reinvestment occurs through maturities, as legacy book yields are currently significantly higher than current market opportunities. Due to the nature of current capital systems in the U.S., all strategies are invested via separately managed account or approved SVO-rated funds. These funds appear on Schedule D- Part 1, and maintain or slightly increase current capital positioning.

First, we examine a yield forecast over the next two years:



In our forecast period, private fixed income leads the strategies tested – Utilizing investment grade private credit increases yield by over 20 basis points, materially higher than the other scenarios tested. In terms of annualized income, given an original portfolio size of $1B, this translates to roughly $7 M in incremental income over the forecast period, approximately three times larger than the other scenarios.

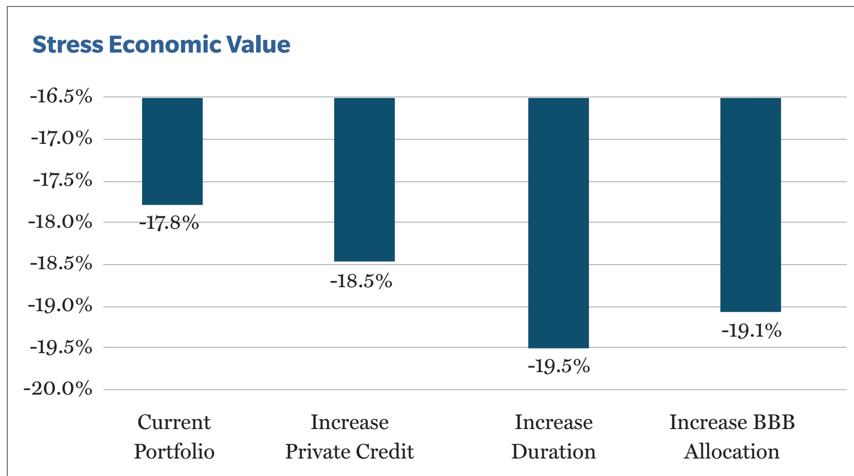
	Incremental Income (Total)	Annual Incremental Income
Current Portfolio	N/A	N/A
Increase Investment Grade Private Credit (Hypothetical)	$6.9M	$2.3M
Increase Duration (Hypothetical)	$1.8M	$0.6M
Increase BBB Allocation (Hypothetical)	$1.1M	$0.4M

For illustrative purposes only. Investing presents the potential for loss as well as profit. The value of investments and the income derived from investments will fluctuate and can go down as well as up. A loss of principal may occur. See important disclosures at the end of this article.

Yield and diversification benefits outweigh marginal increases in capital requirements – In terms of solvency, all three scenarios present largely similar outcomes, which is a marginal increase in required capital. Given the reallocation

strategy remains within the core fixed income bucket, there is no impact on required capital charges under risk based capital or AM Best BCAR. Investment grade private credit is typically treated like any other fixed rate corporate debt security from an accounting and capital perspective.

While all three scenarios increase potential market volatility, the increase is minimal – As with any investment, understanding economic downside is still important to assess balance sheet strength during periods of market volatility. To stress test the strategies, SLC Management employs the Federal Reserves “Comprehensive Capital Analysis Report” (CCAR) to understand the impact of a severely adverse market cycle on the portfolio. Stress testing of this nature should be employed alongside operational stress testing, to help understand total levels of risk before undergoing any asset allocation shifts.



Is now the time to optimize your capital efficient asset allocation and consider private credit?

While every insurer is unique, we believe that leveraging excess liquidity and allocating to investment grade private credit can help materially improve yield and return profiles. Examining strategies that can help offset declining book yields is not only of paramount concern to many of our clients, but a top priority of our investment teams. With little relief on the horizon, as monetary policy looks to remain accommodative, SLC Management encourages every insurer to ask themselves if their asset allocation is maximizing investment opportunities in these difficult times.

To learn more, please contact
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