

Investment grade private assets in P&C insurance portfolios: leveraging excess liquidity to improve investment outcomes

The persistently low rate environment has challenged all insurers' ability to meet their return and income objectives while balancing the risk they take within their investment portfolios. This dynamic has resulted in a search for yield that has pushed insurers to add credit risk and allocate to higher-yielding asset classes beyond public fixed income. In fact, U.S. P&C insurers have nearly doubled their allocation to BBB rated public fixed income over the past decade (from 9% to 16%) and have continued to make allocations to higher-yielding assets in high yield bonds, public equities, and other alternative asset classes within their surplus portfolios.

While they can achieve enhanced returns, the addition of higher-yielding assets to insurance portfolios is constrained by a matrix of regulatory, capital, accounting and rating agency considerations. When compared to public fixed income, most of these asset classes are subject to higher risk-based capital and rating agency risk charges, as well as the volatility of fair value accounting.

Rather than simply continuing to add risk through surplus portfolio

allocations and dropping lower in credit quality, we believe many insurers can improve their overall investment outcomes and increase income by adding to private market investment grade strategies. Two of the options are investment grade private credit and commercial mortgage loans, both of which can be utilized in liability-backing and surplus portfolios.

By allocating to investment grade private market asset classes, insurance companies have the potential to enhance returns and income, while optimizing their asset allocation in a capital efficient way. One of the many benefits of moving to private market investment grade offerings is the ability to increase yield without significantly increasing credit risk but rather adding liquidity risk. We often see significant levels of excess liquidity when analyzing portfolios, which can be deployed by most companies to capture this additional yield while avoiding unnecessary credit risk.

In order to gain comfort adding illiquidity to the portfolio it is important to model downside risk to fully understanding the liquidity needs of the portfolio. We recommend

using an in-depth, enterprise based framework for evaluating this liquidity risk that stresses both the operational and investment sides of the business in tandem.

While insufficient liquidity is a major operational liability, excess liquidity is a missed opportunity. Based on our analysis, we believe that most insurers have excess liquidity and, subsequently, the capacity to re-deploy a portion of their public fixed income holdings into higher-yielding, less liquid investment grade asset classes like investment grade private credit and commercial mortgage loans.

Industry outlook

There are a few reasons we believe that insurers can take additional liquidity risk. First, the industry has increasingly become better capitalized with improving operating metrics and risk management practices. Life, Health and P&C insurers have all reduced balance sheet leverage while growing capital positions since 2000. With stronger balance sheets, insurers have room to examine asset allocation refinements.

Many P&C insurers have recognized their strong capital positions, including the ability to take liquidity risk, and have re-deployed assets into higher-yielding strategies (see Chart B). One asset class that hasn't been broadly adopted is investment grade private credit. As of year-end 2019, the P&C industry average allocation to investment grade private credit (excluding 144a securities) was just 1.4% of total assets. We believe there are significant income benefits left on the table by excluding the asset class given the investment yield for P&C companies invested in the asset class versus those who were not was nearly 60bps higher (3.79% vs. 3.23%).¹

Chart A: Insurance leverage ratios

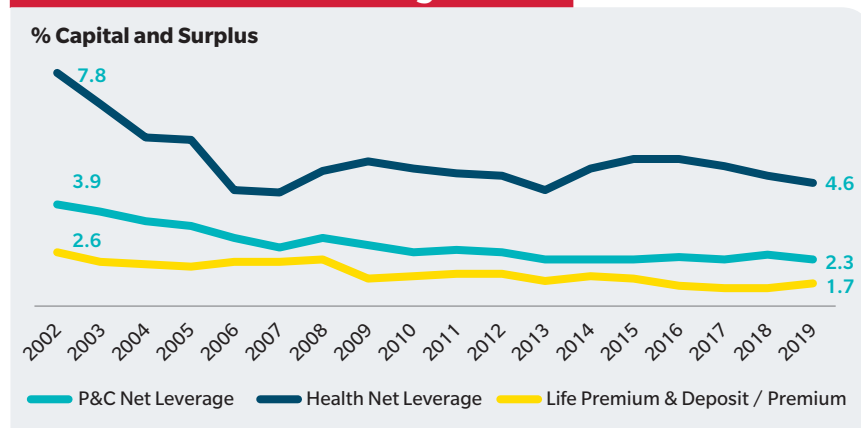
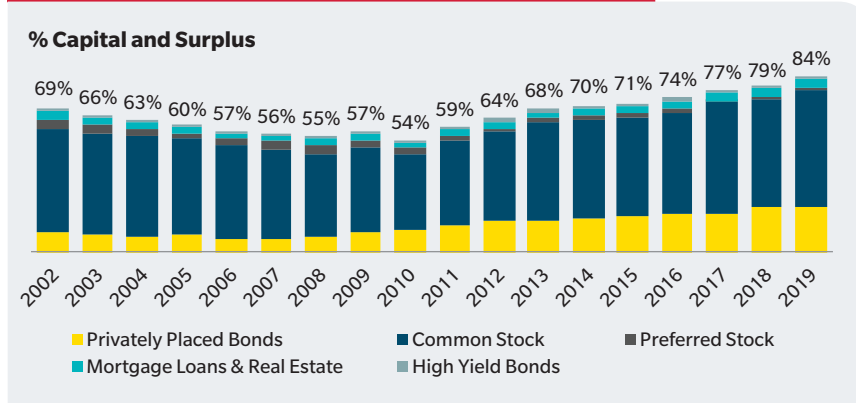


Chart B: P&C insurance risk asset ratios



Risk management framework – a case study

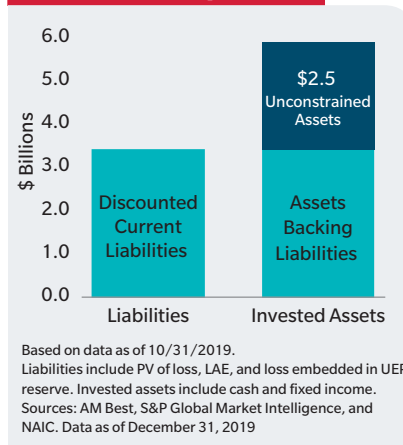
We believe that an in-depth understanding of liquidity needs serves as the foundation for optimizing *capital efficient* asset allocation. These decisions are unique to each company’s operating profile and we will demonstrate our framework using a case study. Company ABC is a ~\$6B P&C insurer which we believe is a good representation of the industry at large. In summary, our framework consists of the following steps:

- Step 1: Model the available capital** – identify the reserve (liability backing) and unconstrained (surplus) assets
- Step 2: Model liquidity needs** – stochastically forecast inflows and potential outflows to highlight stress points
- Step 3: Identify sources of liquidity** – analyze areas of available liquidity to meet potential shortfalls
- Step 4: Optimize capital efficient asset allocation** – use enterprise-based analysis to highlight portfolio constraints
- Step 5: Recommendations for asset allocation changes** – include impact on regulatory and solvency

Step 1: Modeling available capital

Our first step is a customized balance sheet analysis to identify assets required to support liability obligations (the reserve portfolio). In our example, Company ABC has \$3.4B of discounted liabilities, and therefore, \$2.5B of non-core assets available for optimization (the surplus portfolio). This is a meaningful percentage of overall assets and is a common characteristic with many P&C insurers. As the industry has

Chart C: Model of available capital



experienced a decline in balance sheet leverage, there has been a related growth in surplus portfolios. Surplus portfolios can be used to enhance portfolio returns while reserve portfolios should be constrained by duration, cash flow,

volatility and asset classes. Along with public fixed income, investment grade private credit and commercial mortgage loans are commonly used in both surplus and reserve portfolios to diversify credit risk and enhance returns.

Step 2: Modeling liquidity

Once we understand the size and nature of the reserve and surplus portfolios, stochastic cash flow modeling is used to forecast liquidity needs and highlight areas of operational stress, including reinsurance limits, CAT risk and premium collection rates. Based on the modeling outcomes in our case study, Company ABC can meet operational liquidity needs through current portfolio maturities and income.

The modeling reveals that Company ABC can meet operating cash requirements using a portion of the reserve portfolio. Specifically, the insurer is expecting a cash outflow of \$119M in 2020, and in a VaR 85, would anticipate an outflow of \$504M (85th percentile value at risk is defined as a worse case expected net cash outflow of \$504M in 85% of tested scenarios). Reserve portfolio maturities are projected to be \$626M.

Stress testing a range of scenarios can give insurers confidence to increase portfolio yield by reducing excess liquidity and allocating to higher-yielding assets beyond public fixed income.

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Chart D: Model of liquidity needs

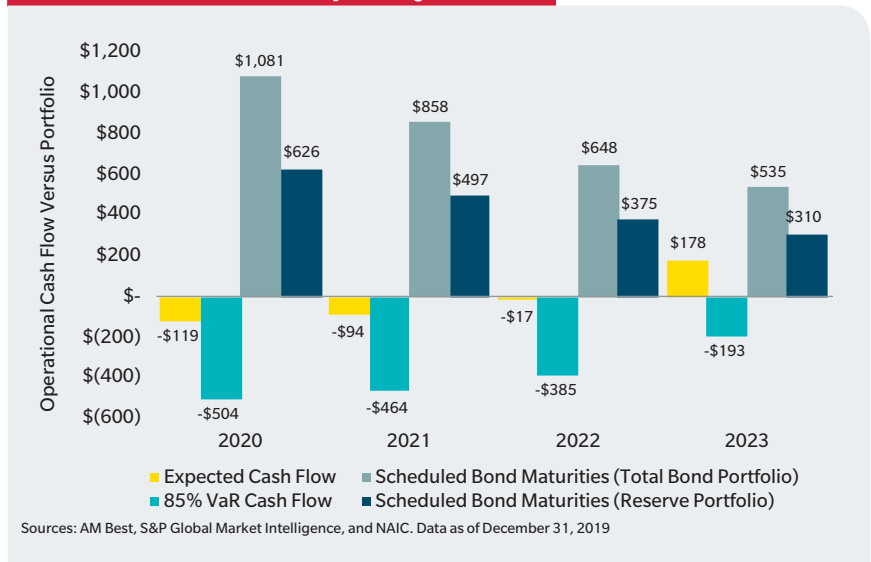
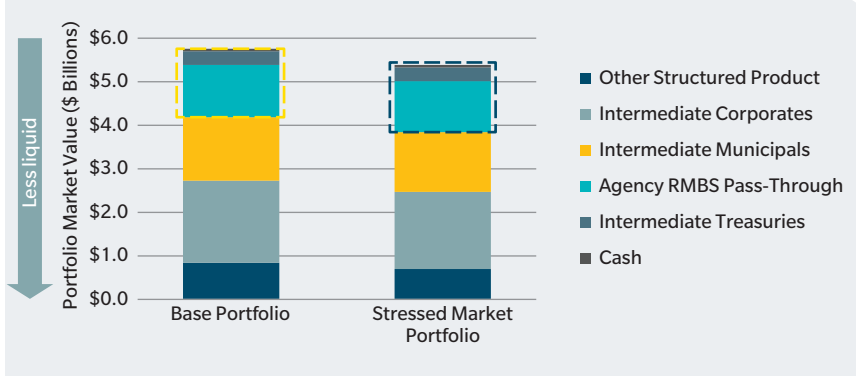


Chart E: Model of portfolio liquidity



Step 3: Identifying sources of liquidity

Depending on liquidity forecasts, insurers should examine all sources of liquidity to mitigate the risk of forced liquidations. Typical sources of liquidity include:

1. Premium collection and operational cash
2. Cash and cash equivalents
3. Line of credit / FHLB advance
4. Maturities, prepayments, coupon income
5. Forced liquidation of portfolio holdings

Cash, Treasuries and other government-backed debt are typically the only truly liquid assets during a market downturn. Therefore, we recommend that insurers’ stress test their holdings to understand their true

liquid holdings and anticipate potential impairments or losses. Company ABC has \$1.5B of government-backed securities and should anticipate a \$400M decrease in portfolio market value in a stress scenario.

Step 4: Capital aware portfolio allocation process

Once operational, investment and liquidity constraints and objectives have been determined, we begin to examine a range of relevant asset classes based on a matrix of factors, including those below. This assessment is directly related to our downside modeling in previous steps, which indicates the capacity for higher-yielding assets.

Asset class characteristics:

- Risk and return profile
- Risk-based capital charges

- Rating agency risk charges, limits and concerns
- Valuation for statutory reporting
- SAP Schedule
- Statutory limits

It is critical for insurers to evaluate asset class alternatives using factors beyond risk/return profile to avoid the risks and potentially deteriorating economics of sub-optimal asset allocations.

Step 5: Developing an asset allocation recommendation

By following our framework and partnering with Company ABC’s management team, we recommended that Company ABC:

- Maintain a significant allocation to public fixed income in order to meet required liquidity needs in a range of economic and operational scenarios
- Continue to fund projected cash outflows using only a portion of its reserve portfolio
- Leverage excess liquidity to increase exposure to higher yielding asset classes with close consideration to regulatory and rating agency limits to avoid deteriorating economics
- Add an allocation to investment grade private credit (from 0% to 6% of total assets) and commercial mortgage loans (from 0% to 7.6% of total assets). These shifts can provide additional spread premium and diversification to the portfolio.

Figure E: Recommended portfolio allocation changes

Asset Class	Current Portfolio	Peer Group Avg.	Constraint	Minimum	Maximum	Asset Class	Optimized Portfolio
Cash	4.00%	3.90%	Duration	3.5	5	Cash	2.60%
Taxable Bonds	59.70%	53.50%				Taxable Bonds	44.60%
Tax-Exempt Bonds	14.90%	19.20%	Risk assets (% of Surplus)	0.00%	45.00%	Tax-Exempt Bonds	12.50%
High Yield Bonds	0.00%	2.60%				High Yield Bonds	1.80%
CLOs	0.00%	1.20%	Liquid Assets (% of Assets)	10.00%	20.00%	CLOs	0.50%
Private Credit	2.50%	0.20%				Private Credit	6.60%
Commercial Mortgage Loans	0.00%	0.00%	BBB Restriction	0.00%	35.00%	Commercial Mortgage Loans	7.90%
Emerging Market Debt	0.00%	0.00%				Emerging Market Debt	0.40%
Preferred Stock	0.00%	1.20%	Avg Credit Quality	A+	AAA	Preferred Stock	0.50%
US Equity	17.30%	16.50%				US Equity	12.60%
International Equity	1.70%	2.00%				International Equity	2.40%
Core Real Estate Fund	0.00%	0.00%				Core Real Estate Fund	7.60%
Expected Return	3.77%	3.79%				Expected Return	4.20%
Expected Volatility	3.70%	3.86%				Expected Volatility	3.70%
Sharpe Ratio	0.68	0.66				Sharpe Ratio	0.80

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Conclusion

Insurers should optimize their capital efficient asset allocation by modeling downside risk to ensure they fully understand their liquidity needs. Many insurers have excess liquidity and a meaningful capacity to allocate to higher-yielding asset classes beyond

public fixed income – and unused liquidity presents a missed opportunity. Changes to asset allocation should carefully consider the matrix of regulatory, capital, accounting and rating agency implications. For most insurers, we see significant benefits to re-allocating a portion

of excess liquidity to investment grade private credit and commercial mortgage loans within reserve and/or surplus portfolios. Adding investment grade private credit has no regulatory, capital, accounting or credit risk implications, addresses certain risks (diversification, better recovery rates and senior debt to public bonds in default), enhances yield and expands the portfolio’s efficient frontier.

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Endnotes

1 S&P Market Intelligence as of 12/31/2019 and NAIC as of 12/31/2019

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The relative value over public benchmarks estimate is derived by comparing each loan’s spread at funding with a corresponding public corporate bond benchmark based on credit rating. Loans that are internally rated as “AA” are compared to the Bloomberg Barclays U.S. Corporate Aa Index, loans rated “A” are compared to the Bloomberg Barclays U.S. Corporate A Index, while loans rated “BBB” are compared to the Bloomberg Barclays U.S. Corporate Baa Index. For certain power and utility project loans, a best fit approach of a variety of Bloomberg Barclays’ indices was employed prior to September 30, 2016. After this date, these types of loans were compared to Bloomberg Barclays Utilities A Index and Bloomberg Barclays Utilities Baa Index, for “A” and “BBB” internally rated loans, respectively. Relative spread values obtained through the above methodologies were then aggregated and asset-weighted (by year) to obtain the overall spread value indicated in the piece.

Unless otherwise stated, all figures and estimates provided have been sourced internally and are as of March 31, 2020. Unless otherwise noted, all references to “\$” are in U.S. dollars.

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