For Investment Professionals only

Changing demand dynamics: Opportunities for European insurers

M&G Investments

September 2022 caused a fundamental shift in the UK defined benefit (DB) pension market, as well as the demand dynamics for certain asset classes. European insurers are one of the few large institutional asset owners who are able to take advantage of these changes with opportunities presenting themselves across the balance sheet.

The unprecedented levels of volatility in gilt markets during September 2022 has brought a fundamental shift in the UK defined benefit (DB) pension scheme market. The spike in gilt yields following the UK government's 'mini-budget' created significant operational challenges for many pension schemes, especially those that used 'liability-driven investment' (LDI) strategies and faced significant daily margin calls. Despite this, the overall funding position for DB schemes is now at a stronger level than before the crisis, with the rise in gilts yields generally leading to a decrease in the present value of their liabilities as a consequence of the higher discount rate.

As DB schemes approach the end game and continue to rebalance their portfolios, we think insurance companies have an opportunity to capture value opportunities across a range of asset classes

Given their stronger funding situation, a large number of DB pension schemes are now in a position to arrange a buyout, whereby their liabilities are transferred to an insurance company.

As schemes prepare their portfolios for a buyout, they will typically look to reduce their exposure to illiquid assets and to lock-in their current funding position by switching to lower-risk, more liquid instruments.

Autumn 2022 – unprecedented volatility in gilt markets

23 September
UK "mini -budget" confirms additional gilt issuance to fund energy price relief and tax cuts. UK gilt yields continue to spike.

26-28 September
Significant daily rise in yields exceeds typical levels of collateral headroom. Some DB schemes unable to post collateral, causing hedges to be closed out and the forced selling of gilts.

28 September
To restore financial stability the Bank of England announces a resumption of gilt purchases targeting long nominal gilts.

16 November
Jeremy Hunt, as Chancellor, unveils his Autumn Statement with £55bn of fiscal consolidation.

Source: WTW, 16 November 2022.

As DB schemes approach the end game and continue to rebalance their portfolios, we think insurance companies have an opportunity to capture value opportunities across a range of asset classes. In this paper we focus on the opportunities we see in three key areas:

- Asset backed securities (ABS)
- Senior real estate debt
- Multi-asset credit (MAC)

Background

Over the past decade DB pension schemes have been increasingly 'bar-belling' their investment strategies. Highly leveraged LDI positions, to hedge interest rate and inflation exposures, have been combined with growth allocations in order to meet their recovery plans and long-term funding targets.

However, the volatility in gilts yields since September 2022 has resulted in a fundamental change in the investment strategy and thinking of trustee sponsors. Most schemes tend to have a gilts-based valuation so the spike in yields has ultimately benefited the funding level of DB schemes and brought forward their journey plans.

It should be noted that not all DB schemes will be in a position to arrange a buyout imminently. This could be due to one of the following reasons:

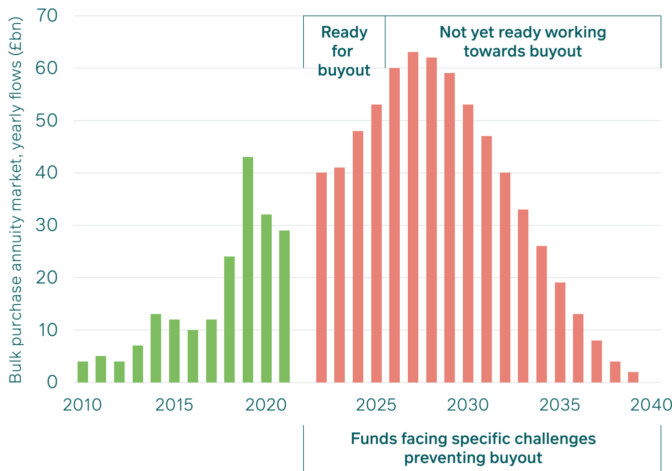
- Exposure to Illiquid and private assets may make it more difficult to approach insurers for favourable premiums.
- Some DB schemes may be just short of the required funding level and sponsors may be unwilling to provide additional funding in the current market environment.
- Insufficient capacity in the buyout market to be able to immediately absorb all the current demand.
- Some schemes may simply not want to seek a buyout due to the paternalistic nature of the trustee/sponsor, strong sponsor covenants and/or a desire to continue to provide discretionary benefits considering the current inflationary environment.

At the very least, when the dust settles DB schemes will be looking, and are already looking, to deleverage their LDI allocations and to reduce their illiquid holdings. Schemes may want to lock-in to their current positions and continue to limit dependence on the sponsor covenant (for those schemes with weaker covenants) by investing in lower risk portfolios.

In short, this means that pension scheme asset allocations have, and will continue to change as they approach the end game. Demand for asset classes that have previously had DB schemes as a large natural buyer will start to retract. We believe insurers are well-placed to benefit from these changing demand patterns.

Demand for risk transfer expected to exceed £40bn pa for next 10 years

Different funds, different pension solutions



Source: Hymans Robertson.

Ready for buyout
Almost £200bn looking for a buyout over the next four years

Not yet ready working towards buyout
Endgame planning, balancing funding, interest rate and liquidity risk

Funds facing specific challenges preventing buyout
Special situations funds overly exposed to illiquid assets, or reticent to enter BPA market

Where are the opportunities for insurance companies?

The table below depicts some of the areas where insurance balance sheet investing tends to be focused, and the asset classes we see as most suitable for those themes.

If we compare this with the assets that are being sold by many UK DB schemes as they prepare for a buyout, we can see how this might fit in the context of an insurance company balance sheet. In short, we think there are opportunities across the entire balance sheet.

Strategies currently of most interest to insurance companies

Out of cash		Diversifying core fixed income portfolios		Expanding non core holdings			
				Liquid		Illiquid	
Senior ABS	Active short dated government bonds	Senior ABS	Actively Managed IG Corporate Bonds	Multi-Asset Credit	High Yield Bonds	European Loans	Private Placements
Active short dated corporate bonds	Short dated Multi-asset credit	Opportunistic Buy and Maintain	Residential Mortgages	Emerging Market Debt	Consumer Loans	Direct Lending	Distressed Debt and Restructuring
		Senior Real Estate Debt	Infrastructure Debt	Long Income Property	Yield-focused Property	Infrastructure Equity	Mezzanine Real Estate Debt

Below we discuss three examples of asset classes that have been affected, either in the short-term, or in the longer-term as a result of likely changes in demand from pension schemes following the fallout from September 2022. We then consider how insurers could benefit in the context of their balance sheet investments.

1. High grade ABS: Optimising liquidity

We believe ABS can be an attractive asset class for insurers looking to redeploy cash in order to improve portfolio yield, while still offering good liquidity and defensive qualities.

The fallout from the UK government's mini-budget dominated European ABS markets throughout September and October 2022. The period saw an unprecedented volume of trading and forced selling out of ABS funds, which are typically used as a collateral allocation for large DB pension schemes. This led to a significant dislocation in the ABS market which active investors, such as M&G, were well placed to take advantage of.

Investors like M&G can benefit from this situation as they have the flexibility to invest across different asset classes within the ABS market (eg RMBS, CMBS, CLOs, etc) and are thus able to pivot their portfolios towards the most compelling opportunities. Having the ability to be flexible and to buy from forced sellers has meant that our monthly dealing portfolios were able to buy assets that were trading significantly below par.

Previously, there have been concerns about how liquid the ABS market really is. We believe the events that occurred in September and October 2022 demonstrated that the ABS market is sufficiently liquid to withstand a significant episode of market turbulence.

For portfolios that are designed to beat cash, while seeking to remain very liquid and defensive, we believe it is desirable to focus on the AAA-rated ABS, since lower rated instruments can add a lot of volatility during turbulent periods such as the LDI crisis.

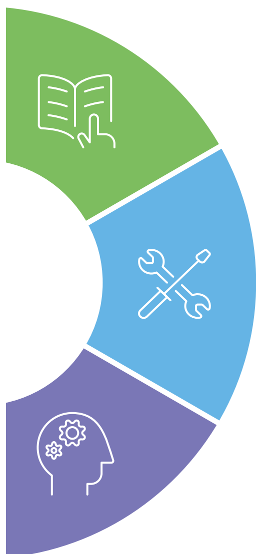
Why ABS could be good for insurers

We believe ABS offer a number of qualities which could be of interest to insurers looking to deploy high levels of cash in order to improve portfolio yield.

- Floating rate nature means that ABS have limited exposure to interest rate risk, and are therefore less sensitive to movements in short-term interest rates.
- The yield on ABS is typically as high, if not higher, than traditional corporate bonds of a given rating. This is due to the additional complexity that is involved with analysing these instruments. However, for those with the credit expertise, ABS could provide an attractive pick-up in yield versus corporate bonds, alongside lower levels of interest rate risk.
- Diversification benefits and credit resilience, with a different risk profile to traditional corporate bonds.
- We currently see more scope for ABS upgrades rather than downgrades. ABS credit metrics tend to improve over time as people pay down their mortgages and LTVs decrease. This may appeal to insurers who will typically want to minimise credit risk.

Allocating out of liquidity holdings with the aim to improve portfolio yield

Potential higher yielding and diversifying alternatives to liquidity provisions for an insurer



Challenge: Client 'optimising liquidity' Portfolio

- Client typically held a significant cash allocation
- Rising inflation environment meant it needed to reduce its cost of holding cash
- Exploring alternatives to cash to increase yield potential and maintain liquidity

Solution: High-Grade ABS as a suitable cash alternative

- Segregated client account investing in Asset Backed Securities (ABS) with a target return of 3m Floating Rate + 100-150bps
- Portfolio diversification from opportunities in Residential Mortgages, Auto Loans, Commercial Mortgages and Consumer Lending
- Over 90% of client's ABS assets rated AAA & AA and no assets rated BBB or lower

Benefits: Improved yield and protection from rising rates

- Higher yield potential and diversification within liquidity portfolio
- Strong liquidity maintained
- Protection from rising rates due to floating rate nature
- Maintained or potentially improved credit quality

Source: M&G Investments, for illustrative purposes only.

2. Senior real estate debt: Diversifying core fixed income holdings

Senior real estate debt offers a number of characteristics that may appeal to insurance companies looking to diversify their core fixed income exposure. We believe the asset class can offer the potential for attractive risk-adjusted returns with the benefit of hard asset security and structural protections, minimising the impact of a potential fall in real estate values. As a result, real estate debt can provide both downside protection and attractive return potential in a range of economic environments.

Senior real estate lending offers investors access to the least risky part of the capital structure. Loans are made at conservative loan to value (LTV) levels, having stabilised at between 50% and 60% following a substantial drop post-Global Financial Crisis.

Conservative LTV levels mean that significant falls in the value of underlying real estate assets can be withstood before principal is exposed, supporting capital and return potential. Senior lenders also benefit from first ranking security over the underlying real estate and priority access to cashflow from the property.

The significant pull back of traditional banking capital post-Global Financial Crisis has also resulted in an increase in achievable returns. Consequently, senior real estate debt secured against typical income producing assets could offer investors a spread premium relative to similarly rated corporate bonds.

For treatment under Solvency II, we tend to focus on the spread charge as interest and currency charges are consolidated by the insurer based on their specific liability profile. Real estate debt is a private asset class and in the majority of cases does not carry a nominated ECAI approved credit rating. As such, for insurers operating under the standard formula real estate debt is treated as unrated meaning that on the face of it, the spread solvency capital requirement (SCR) calculation may not differ according to the seniority of the debt.

However, senior real estate debt can attract a more favourable treatment under the Solvency II standard formula. The senior secured nature of the asset class means the ‘collateralisation benefit’ is potentially available, which can reduce capital charges by 50% and provide very compelling Return on Capital metrics in our view.

M&G structures senior real estate debt to achieve an investment grade internal rating, so for insurance companies using an internal model this rating can be used for capital charge purposes.

3. **Multi-asset credit (MAC): Expanding non-core holdings**

For UK insurers looking to diversify their sources of credit risk and to drive additional yield, we believe a multi-asset credit (MAC) approach offers a number of attractive features as part of the balance sheet that isn't designed to match against liabilities.

MAC strategies have traditionally been popular with the pension market and less so with insurers. However, we think MAC is also a good fit for insurers' surplus portfolio given the typical yield and Return on Capital (RoC) metrics. Whilst allocating to MAC funds as part of their core portfolio would be difficult from a duration and cashflow matching perspective, long-only MAC strategies could drive yield in insurers' surplus portfolios whilst avoiding unpredictable risks (eg interest rates or currency) or leveraged positions.

M&G's MAC strategies take a long-only approach that is focused on fundamental, bottom-up analysis making it well-suited in our opinion to insurers looking to diversify their fixed income allocation. Our managers are fully-focused on capturing the credit risk premium and the interest rate and currency risks are hedged away – this leads to lower volatility whilst still holding the potential to deliver high-yield like returns. A MAC approach also provides a high level of underlying diversification – typically over 500 holdings – along with the flexibility to invest across a wide range of fixed income assets, including investment grade, high yield, private debt and ABS.

As highlighted above, the third quarter of 2022 was characterised by significant volatility, and substantial asset price falls across both government and credit markets. Although this period of instability was concerning for many institutional investors across the market, a dynamic multi-asset credit approach allows long term investors to take advantage of market pricing dislocations by identifying value and investing in a nimble and agile manner. High performing multi-asset credit funds have historically generated a RoC of 25%-35% for insurers which significantly outperforms the single digit RoCs often seen on corporate bonds.

Increasing diversification and yield potential in a non-core portfolio

European insurer aiming to access the credit risk and illiquidity premium to boost yield

Challenge: Insurer's 'Non-Core' Portfolio

- Client looking for higher yield without additional risk approvals for new asset classes
- Diversification important to protect from downside risks
- Keen to deploy capital in a timely manner

Potential Solution: Access credit risk & illiquidity premium

- Fund investing in senior secured European leveraged loans & notes targeting EURIBOR + 4%
- Less liquid than comparable corporate bonds meaning potential for additional premium in yields
- No requirement for additional regulatory hurdles before investment
- Floating rate loans meaning no increased exposure to interest rate risk

Benefits: Higher Yield & Diversification

- Potential for higher yielding assets than equivalently rated corporate bonds
- Ability to access the illiquidity premium yet monthly fund dealing for investor withdrawals
- Diversified range of underlying loans – all senior secured loans & notes offering higher recovery rates than standard corporates

Source: M&G Investments, for illustrative purposes only.

In summary

September 2022 caused a fundamental shift in the UK DB pensions market and crucially demand dynamics for certain asset classes both in the short and long term. European insurers are one of the few large institutional asset owners who are able to take advantage of these shifting demand dynamics with opportunities presenting themselves across the balance sheet. The ability to take a long term investment view means that with the right internal frameworks, insurers can position themselves for long term, compelling and continued investment opportunities.

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