

# Insurance capital: Rich rewards for those that can step up.



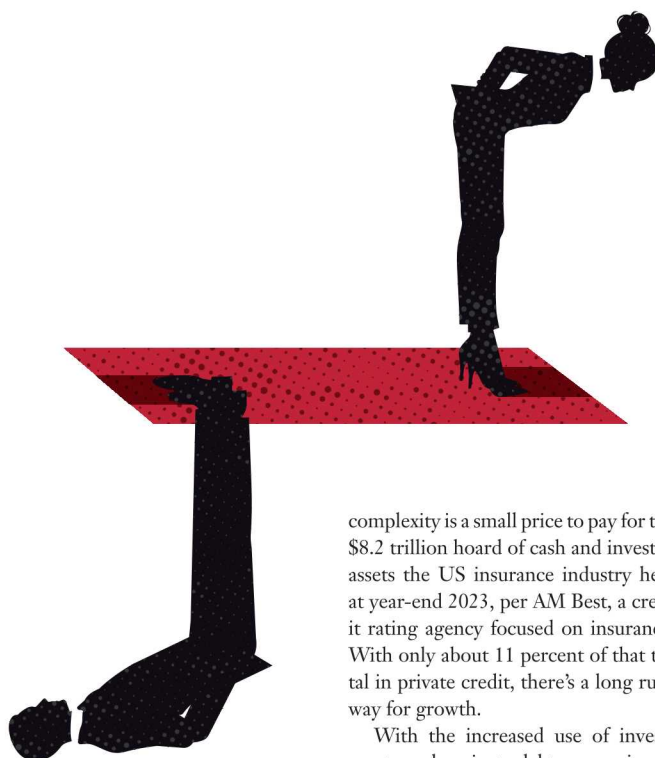
Cover story



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*A huge pool of insurance industry money could be headed for private debt but there are many levels of complexity for fund managers to navigate. Insurance and debt insiders talk to **Robin Blumenthal** about the potential benefits and challenges of partnering up*

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With regulatory regimes varying between countries – and in the US, between states – and insurers having different needs and restrictions, competing for prized “permanent capital” is no easy task.

“Insurers present a unique set of considerations; managing money for them does have layers of complexity that you don’t necessarily find with other institutional investors,” says Steve Peacher, executive chair of SLC Management, the institutional asset manager for Sun Life.

But for managers eager to increase their access to capital and management fees amid a somewhat tepid fundraising environment, dealing with

complexity is a small price to pay for the \$8.2 trillion hoard of cash and invested assets the US insurance industry held at year-end 2023, per AM Best, a credit rating agency focused on insurance. With only about 11 percent of that total in private credit, there’s a long runway for growth.

With the increased use of investment grade private debt among insurance companies, “the combination of the sheer size of the addressable market and how early it is in transition to private credit creates growth potential as big as anything we see within credit”, says Michael Zawadzki, global chief investment officer for Blackstone credit and insurance. He has predicted that the \$1.7 trillion private credit market could exceed \$25 trillion.

The orientation of insurance companies – particularly life insurers and annuity providers – towards long-dated liabilities, as well as their regulatory imperatives, would seem to align well with private credit’s longer duration and illiquid nature.

But the two businesses “are actually quite distinct in their dynamics”, given that insurance is a balance sheet business, says Himanshu Chaturvedi, partner at consultants Cambridge Associates. He notes that the talent pool, and generally, the time horizon, for the

two are very distinct, with life companies entering agreements for multiple decades. “That’s very different from the asset manager mindset, which is much shorter term,” he says.

“There may be an inherent risk for private credit firms that buy insurance companies as they must have the capability to maintain and drive growth in premiums,” says David Teh, who leads the alternative capital and private credit team at law firm Simpson Thacher.

**Liabilities also important**

“Understanding assets well is only part of the equation; you have to understand liabilities well so you can match and build the appropriate investments,” says Keshav Rajagopalan, managing director at PGIM Portfolio Advisory, the asset manager for insurance giant Prudential Financial.

“The regulatory implications of how an insurance company has to run its balance sheet affects portfolio construction and capital management.” Indeed, he notes, “asset managers have to be thinking about both the asset and liability side, as opposed to just the assets”.

Nevertheless, partnering with asset managers gives insurers potentially higher risk-adjusted yields for their fixed income allocations, greater total return and diversification that may not be available in public markets.

For insurers that lack highly developed in-house origination capabilities, “the assets generated by a private manager and the origination effort is something they can’t replicate on their own”, says Bill Sacher, partner and head of private credit at fund manager Adams Street Partners.

In addition to their long-duration liabilities that have to be matched, industry sources estimate about 70 percent of life insurance companies’ investment portfolios are invested in credit, about 95 percent of which is investment grade.

“It’s early days, but there’s more opportunity than there’s capital formation right now,” says Mark Jenkins, head of

global credit at Carlyle, which holds a stake of about 10 percent in reinsurer Fortitude Re. He says insurers can capture 150-200 basis points of spread investing in investment-grade private credit. “It’s the next great migration.”

**Hunt for yield**

The hunt for yield, characterised by the lengthy period of low interest rates, has increasingly pushed insurers into the arms of private credit managers and away from more traditional fixed income products. Indeed, private credit holdings accounted for more than 44 percent of bonds in 2023, climbing from just 27 percent in 2013, according to AM Best.

The National Association of Insurance Commissioners (NAIC) calculated that the US insurance industry’s exposure to bonds totalled nearly \$5.2 trillion at year-end 2023. ABS and other structured securities grew at a 10 percent clip last year, with total exposure of \$625 billion almost double that at year-end 2017.

A recent Moody’s survey found that insurers had the greatest appetite for ABF and private placements (see panel on p. 16), with 44 percent of respondents expecting to increase long-term allocations. Mid-market lending was at 39 percent, infrastructure lending on 33 percent and fund finance at 22 percent. Small wonder that the flurry of tie-ups between insurers and asset managers that began in earnest several years ago continues apace.

The deals vary, with insurers sometimes suitors (see Aflac’s \$100 million deal in May for a 40 percent stake in

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Simpson Thacher

Tree Line Capital Partners, Guardian Life in August increasing its minority stake in HPS Investment Partners, and Sun Life buying a majority of Crescent Capital Group in early 2021, with an option to buy the rest) – and managers sometimes taking the lead (Sixth Street leading a \$5.1 billion takeover of Enstar in July and Golub Capital in June paying \$200 million to be the largest minority equity holder in Nassau Financial).

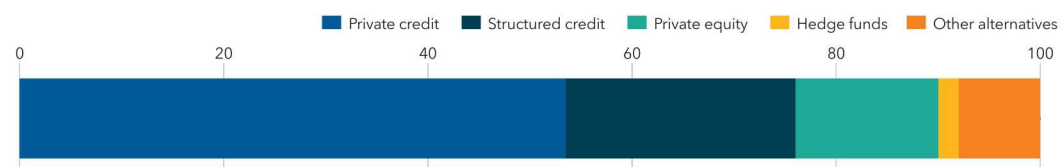
Some managers take a “balance sheet-heavy approach”, with KKR in January buying the 37 percent of Global Atlantic that it did not already own, after acquiring a majority of it in 2021 and serving as its asset manager. The manager funded the purchase 100 percent from its balance sheet, with the idea that “direct ownership is the best way to be aligned and to create value”, says Craig Lee, KKR’s head of insurance and strategic finance.

Others, like Blackstone, have pursued a more “balance sheet-light” approach, taking minority investments in insurers and earning management fees but avoiding insurance risks.

**Rated note workaround**

One big driver for insurers increasing their private credit holdings is the growth of structured debt in the form of collateralised loan obligations, and the development of rated-note feeder funds. These vehicles allow insurers to receive the same capital treatment as investments in bonds irrespective of the actual underlying assets held by the feeder fund, because under the current insurance risk-based capital framework,

Where are life and annuity insurers allocating new money in 2024? (%)



Source: AM Best

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### Is asset-backed insurance a match made in heaven?

**Some insurers are taking their foot off the gas on 'traditional' private debt, looking for something more esoteric. ABF will do, says Christopher Faille**

Kerry O'Brien, head of insurance portfolio management for North America at asset manager Insight Investment, has her eyes on the past seven years of the intertwining of insurance and debt managers. O'Brien points out that life insurers' net purchases of private placements nearly doubled in 2017, after nine years of rock-bottom interest rates. More recently, O'Brien adds, "some insurers are taking the foot off the gas on traditional private debt and moving into more esoteric ABS".

In June 2024, a KKR shareholder presentation showed in detail how marriage to Global Atlantic had helped scale operations. With respect to KKR's asset-based finance business, the scaling-up was dramatic. ABF represented AUM of approximately \$6 billion in the first quarter of 2020. AUM was *nine times* that – \$54 billion – by Q1 2024.

Why do insurers now have their foot on the ABF pedal? Part of the appeal is that it affords risk management, not through old-school diversification but by building resilience on an asset class by asset class basis. The head of BlackRock's financial institutions group for the Americas, Lyenda Delp,

spoke to this point two years ago. The world was then moving, she said, into a "new regime of heightened macro and market volatility", so insurers' risk managers have to re-evaluate the role that every asset class may play.

Asset-backed securities in general offer a parallel predictable stream of interest payments, analogous to bonds. Also, insurance companies (especially those that have partnered strategically with an asset manager) can get transparency. The insurers often want to assess the quality of the underlying assets before investing.

Most observers agree that the trend toward the partnering of insurance with ABF managers will not prove unique to the US. Manish Valecha, head of client solutions at Angel Oak Capital, says: "I think it is primed to go global. Its globalisation has begun, notably in the UK and in Japan."

Alex Schoenenberger, head of business development, US insurance, for Schroders, agrees. He says that in the UK the partnership trend is driven primarily by pension risk transfer growth. The pension risk transfer market in the UK saw a notable increase in volume last year, owing to the eagerness of pension schemes to partner with insurers.

One projection says annual PRT activity will settle at £50 billion (\$46 billion; €58 billion) to £60 billion, given a burst of activity in 2023 and more in the pipeline as of early 2024.

if the structured notes can be rated, they can be assigned a bond-like capital charge. Those can be as low as zero for Treasury bonds and less than 1 percent for top-rated non-governmental bonds.

The rated notes "are a workaround for insurers to invest indirectly in assets they otherwise might not be able to hold directly", such as consumer loans, says Eugene Benger, an insurance regulatory attorney at law firm Clifford Chance. The notes also enable insurers to hold as debt what are essentially equity investments that would have incurred a higher capital charge had the insurer held them directly. When such assets are securitised using a special purpose vehicle that issues rated notes, "insurers can get bond capital treatment for what might not be a bond risk," he adds, allowing rated notes to avoid the steep 30 percent capital charge that applies to all equities and the lowest rated (and unrated) notes.

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SLC Management



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This contrasts with the £31 billion annually in the five-year period ending in 2022.

Greg Leveto, portfolio manager and partner at Oak Hill Advisors, agrees with O'Brien on the special appeal of asset-based finance. He says: "The benefit to insurers is the opportunity to increase yields in unlevered terms and in a way that is efficient for regulatory and capital overlays, increasing ROEs. This allows insurers to offer more competitive products to their customers, notably annuities, with a higher yield."

Angel Oak's Valecha offers some macroeconomic context: the low-rate and low-yield environment following the pandemic pressured insurers and other institutions to look for alternatives to corporate credit. The insurance industry has a lot invested in corporate credit, but in recent years, insurers have had to move beyond that to optimise their portfolios.

Some observers note that there is also an accounting benefit: insurers want the ability to carry investments at cost, avoiding mark-to-market volatility.

The partnering of insurers with debt managers is a trend that will continue, Valecha said. Although it's no longer in the early innings, he believes it still has some room to run, especially where ABF is concerned. "In part, this is simply because the underlying assets or investments can be complex. If the investment team has a plan, they have to get clearance

from an accounting and legal perspective as well... there are surely some insurers who have not gotten through their deliberations yet, so there will be other combinations."

On the relationship between insurers and ABF, Schoenenberger says "risk-based capital requirements... play a significant role in this trend, with different regulatory regimes presenting unique challenges". Also, there has been an increased demand for "rated note/rated feeder solutions in private asset classes" (see main story).

Katie Cowan, head of insurance client solutions at First Eagle, which has about \$3 billion in insurance company assets across all strategies, observes that insurers can also participate in co-investments and purchasing CLO tranches, giving her confidence that this symbiotic relationship will deepen over the years to come.

Markets are anticipating a potential Fed rate cut sometime this year, Cowan says. This means that "asset allocation and diversification across the private credit landscape will be even more relevant to insurers".

Fed rate cuts make Treasury bonds less attractive, and given the weak US employment numbers issued in early August, markets expect a cut of at least 25 basis points in September. The volatility of many indices after markets had absorbed the employment numbers illustrates continued public market risks. That will likely keep the foot on the ABF pedal for some time yet.

**70%**

Percentage of life insurance portfolios invested in credit

**\$5.1bn**

Value of Sixth Street's July takeover of Enstar

**44%**

Insurers set to up long-term allocations to ABF and private placements

In addition, the rated-note feeder allows insurers to access a rated instrument without having to go through a registered fund, which is "limited in all kinds of ways, including leverage", says Michael Saarinen, a partner at law firm Lowenstein Sandler.

"Over time, managers have developed the ability to securitise below-investment grade assets into capital-efficient assets that an insurance company can more easily hold in a general account," says Adams Street's Sacher.

But there are potential issues with these structures, which have spurred

the growth of "privately rated" debt vehicles less transparent than their public counterparts. Indeed, the number of privately rated securities reported by US insurers rose 20 percent in 2023 – albeit from a small base – and is on pace to triple the 2019 count of 2,850 by the end of 2024, per the NAIC.

In a report this year, regulators expressed concerns about "private letter ratings", saying that an analysis found that their use "can result in lower risk-based capital charges and potentially lead to the undercapitalisation of insurance companies". Moreover, a majority of the industry's exposure, or

51 percent, is concentrated among 10 mostly large life insurance companies.

Perhaps that's one reason the NAIC now requires that insurers take a 45 percent capital charge for the equity tranches (also called "residual tranches") of all structured securities, according to Clifford Chance's Bengier. He says the body is pushing for look-through treatment of the underlying portfolio to determine the capital charge, rather than relying on the current form-over-substance approach.

Still, William Cox, global head of corporate, financial and government ratings at KBRA, notes that private

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letter ratings are “a tiny fraction” of a much broader category, the vast majority of which are corporate bonds that include private placements. Although feeder notes have grown significantly, they remain a very small category.

The debt/equity ratio of a rated note feeder is commonly around 85/10, although with a fund holding lower quality debt, in order for it to get a rating that will satisfy an insurance company may require increasing the equity portion to around 45 equity/55 debt, Saarinen says. In turn, those funds with bigger equity tranches carry a higher capital charge, which may be less appealing to an insurance investor. If structured properly, a rated note feeder should not adversely impact other fund investors, he says, noting, “investors in a rated note feeder are not at the top of the capital stack vis à vis other investors in the fund”, and “the expenses of the rated note feeder are typically borne solely by its investors, rather than the fund investors as a whole”.

In a commingled private credit fund rated feeder, an investor gets an equity interest that can be sold to third parties, says Adams Street’s Sacher.

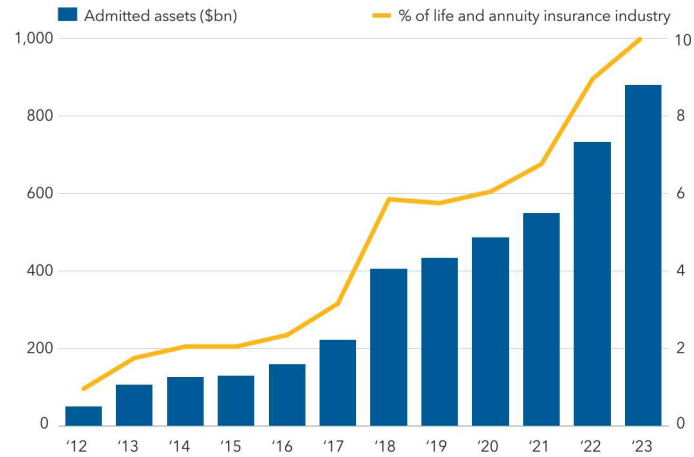
**Fair allocations**

One potential issue with managers buying insurers “is the risk you end up with so many different investors that there may not be enough dealflow to go all the way around,” Sacher says. “That raises the need for an investor to ensure that the manager’s allocation policy is fair.”

The model is a bit different when insurers buy asset managers. As for potential conflicts, PGIM Portfolio Advisory’s Rajagopalan says the asset management arm views itself as a fiduciary. “It doesn’t matter whether we’re a fiduciary to Prudential and its general account or to a third party – they’re both clients.”

He adds that PGIM discloses any potential conflicts. “When we’re originating private assets, there is a defined

US life and annuity private equity/asset manager-owned insurers



Source: AM Best

*“An investor or insurance company should ask: how did the manager do in the last recession?”*

**CHRISTOPHER WANG**  
Crescent Capital

we want Crescent to think of Sun Life as a client, just like it thinks of other clients.”

With the recent market volatility, there’s now a bigger premium on “choosing partners who are focused on downside protection, who have a track record and who have a plan for what to do when things go bad”, says Greg Halagan, Oaktree’s head of insurance solutions. Some caution that there’s a spectrum within structured credit, with some very strong, credible managers, and with some more aggressive than others or who may lack sophistication.

Already, higher rates have increased defaults, and “if the credit agreement has real covenants, borrowers will trip those as problems emerge,” says Jeannine Heal, head of insurance solutions, Americas, at Pinebridge Investments, whose deals typically have at least two financial covenants. If there are problems, “the important thing is covenants get us back to the table quickly”.

Christopher Wang, a managing director at Crescent Capital, expects defaults and restructurings to increase. “An investor or insurance company should ask the same question: how did the manager do in the last recession and the one before that?” ■

process that decides which clients those assets get allocated to, no matter who the client is – Prudential or anyone else”.

SLC’s Peacher says alignment with clients is key, and Sun Life’s ownership of Crescent Capital allows it to broaden its portfolio with below-investment grade strategies. Sun Life invests money from its own balance sheet next to Crescent, and often in the same funds as SLC’s insurance clients. “We’re eating the same cooking as our clients, and