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# Insurers and Direct Lending: Diversification, Performance, and Attractive Regulatory Capital Cost

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Frantz is responsible for fundraising and investor relations. When joining Kartesia in 2016, Frantz had over 9 years of experience in private equity and 7 in audit and transaction services. Prior to joining Kartesia, Frantz set up and headed the equity co-investment activity of Crédit Agricole Private Equity, where he invested in buyout and growth capital transactions across Europe. Previously, Frantz worked in a family office specialized in the healthcare sector. He started his career as an auditor with PwC in London before joining their Transaction Services department in Paris, where he conducted due diligence assignments for corporations and private equity funds.

# Insurers and Direct Lending: Diversification, Performance, and Attractive Regulatory Capital Cost

## Executive Summary: Tailored to Fit

Investments in direct lending transactions can offer insurers relatively strong risk/return profiles at comparatively low regulatory capital costs.

The return premia and sources of risk of this asset class differ from those of many traditional, listed instruments. This makes direct lending a useful diversifier when included in a portfolio in which publicly-traded asset classes provide liquidity. As hold-to-maturity investments without a public market, direct lending transactions are not usually marked-to-market and are less volatile.

These attributes can make direct lending a good fit for insurers. To harvest their potential, insurers should have internal investment teams or external asset management partners with significant sourcing, due diligence and deal-monitoring capabilities. Such expertise can address the complex, heterogeneous and private nature of direct lending.

# Introduction: Insurers Investigate Alternatives in Uncertain and Low-Rate Environment

## In a Challenging Investment Environment...

The past decade has been ripe with challenges for European insurers and their investments. With low and even negative rates, generating returns on general account investments to meet liabilities and support business growth has been tough. Listed investment-grade instruments remain a significant share of core holdings, with government bonds accounting for around a third of these. Low rates not only depressed investment income, they also impacted balance sheets by increasing the calculated present value of liabilities.

Changing regulation and accounting standards further complicated the landscape. The integration of Solvency II requirements in asset management required significant resources, rendering certain performance-driving assets more costly in terms of regulatory capital.

- The investment paradigm for general account investments shifted to encompass both return/risk, and return/regulatory capital considerations.

- Listed insurers subject to IFRS 9, the new international accounting standard for financial instruments, are likely to experience stronger linkages between the short-term volatility of investments and the volatility of their income statements. , and are hence seeking low-volatility solutions. As a result, interest in low-volatility investments is increasing.

This challenge – to identify performance sources under regulatory requirements – was further toughened by geopolitical uncertainty and frequently volatile markets. For example, through most of 2018 it seemed as though Quantitative Easing policies might be winding down, yet conversely 2019 encountered new bond-buying programmes and additional rate cuts. Visibility was hindered, while returns on core fixed income holdings were impeded for insurers.

With such reversals and uncertainties plaguing the global economy and markets, investor sentiment swung between worst-case scenarios and more optimistic outlooks in mere days. Markets remained twitchy. Issues between the United States and China, Brexit, tensions with Iran, and social topics in several European countries meant that volatility spread across the riskier asset classes, with stronger and more rapidly-occurring gyrations.

These investment complexities increased the pressures on prices and margins for many segments of the insurance sector, leading to waves of consolidation.

Then came the unprecedented crisis of Covid-19, and its profound repercussions on the economy and financial markets. Global economic prospects may have improved over recent months, but the speed of recovery is likely to be quite uneven geographically and by sector, as well as highly dependent upon the public health policies and economic programmes of individual states. Uncertainty remains high, particularly with regards to the duration of accommodative monetary policies and interest rate levels.

## ...Insurers are Turning to New Sources of Return

In this decade of challenges, insurers are seeking new sources of return. Asset allocations continue to undergo significant adjustments, and portfolios are more diversified. Core holdings of listed fixed income instruments, meant to match liabilities and ensure sufficient liquidity, have increasingly included non-domestic and non-European bonds as well as cross-over and high-yield instruments.

The most noteworthy portfolio change has been in the performance-seeking bucket. Insurers have both diversified their listed equity exposures and *taken a keen interest in alternative assets,* especially non-listed investments. Private debt in particular has become an important diversifier and partial substitute for certain traditional listed assets. The increased demand has caused certain private debt sub-segments, such as syndicated and senior bank loans, to become crowded.

One sub-segment in particular still offers insurers attractive return potential, comparatively low regulatory capital costs, limited volatility, and diversification for their portfolios — ***direct lending.***

# The Role of Direct Lending in Private Debt and Fixed Income

## Emergence of Direct Lending

Direct lending emerged during the 2007-2009 financial crisis as an alternative to bank lending, further spurred by the regulatory tightening which followed. During the crisis, insurers and other institutional investors helped manage the shortage in bank lending by purchasing syndicated loans on the secondary markets or by acquiring loan portfolios directly from banks – at discounts. Afterwards, the tightening regulation further dampened bank lending. The Basel III bank capital accord forced banks to increase their focus on balance sheet strength and preservation. They imposed tougher capital requirements on lending, squeezing loan availability particularly for mid-market and lower-rated companies.

Institutional investors became more important providers of financing to the real economy. As traditional bank-arranged syndicated or senior loans became increasingly difficult to obtain, loans arranged by non-bank intermediaries, or even directly with the borrowers, became a much-needed alternative source of financing. At the same time, companies that had seen bank lending dry up were willing to pay higher interest rates for capital for buy-outs, acquisitions, growth, refinancings, recapitalizations or other purposes,

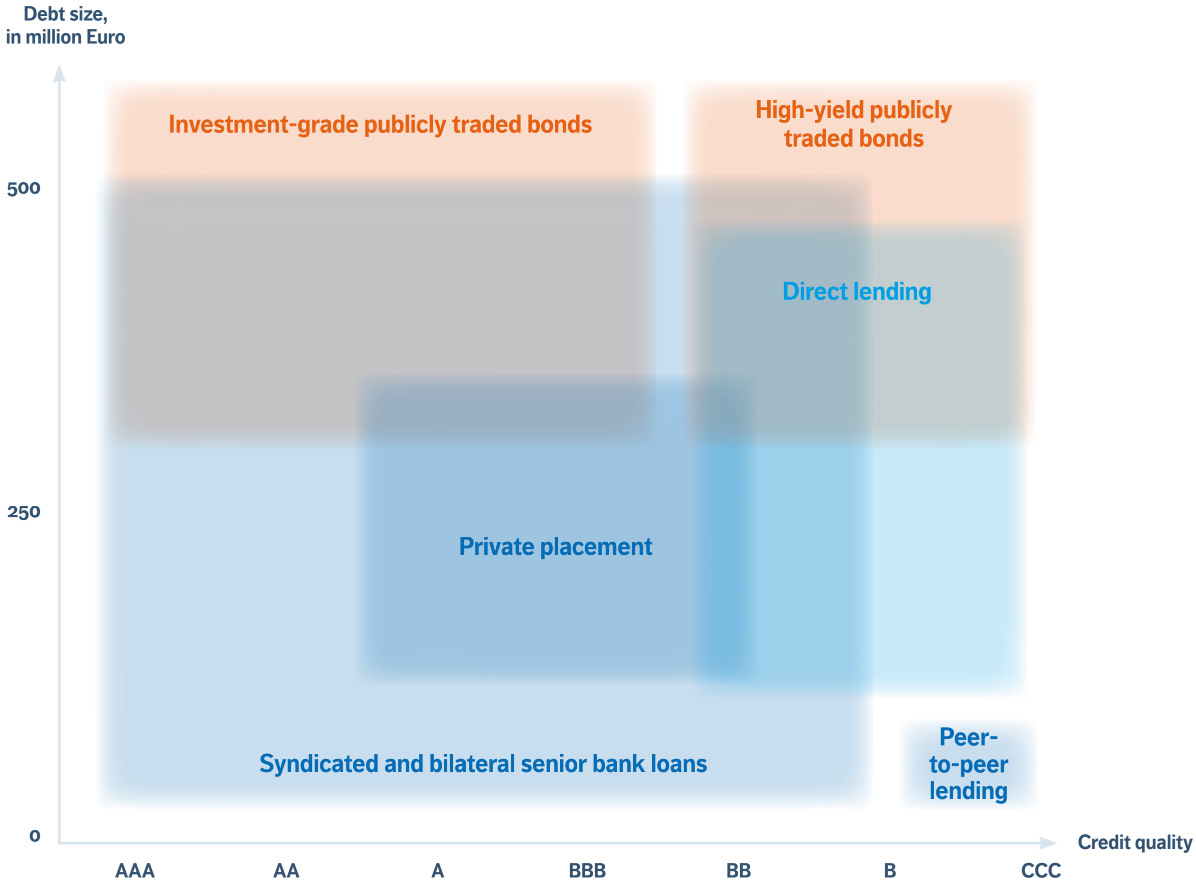
For insurers, Solvency II made investments in unrated debt instruments relatively more attractive from a capital cost perspective, when compared to listed and rated debt with similar or lower yield expectations.

## Direct Lending in the Private Debt and Fixed Income Universe

A look at the position of direct lending within the private debt and the wider fixed income asset class helps demonstrate the role which direct lending can play in an insurance portfolio.

'Private debt' encompasses a range of non-listed instruments, including syndicated and senior loans (often arranged by banks), private placements as well as direct lending – which is generally not bank-arranged. The chart below compares these private debt segments based on typical credit risk and debt size. It also shows the positioning of direct lending, vis-à-vis public fixed income instruments such as listed investment-grade and high-yield bonds. Direct lending covers primarily the sub-investment-grade space from BB to CCC-rated transactions, with deals typically ranging between approximately €50 and €500 million.

**Figure 1: Segments of the Private Debt Market**




*Source: Deloitte, industry sources, Candriam. March 2021. Simplified representation for illustrative purposes only.*

Direct lending has some overlap with senior bank loans, as shown in Figure 1. However, the senior or syndicated loans segment has become quite saturated. This segment has also seen a deterioration of covenant strength, with so-called 'covenant-light' transactions coming to the fore. For investors, this increases the relative attraction of direct lending opportunities.

In contrast to bank loans – and of course to investment-grade and high-yield bonds – there is no active market for direct lending, meaning it offers investors an illiquidity premium. And relative to high-yield bonds, unrated direct lending transactions often carry a lower regulatory capital charge.

## Other Distinguishing Features

Direct lending transactions are by nature flexible and customizable, with covenants and security negotiated on a deal-by-deal basis. To many of these often mid-sized borrowers, this customization is a key benefit.

Yet direct lending transactions share a number of key features. In most cases, interest is floating and tenor ranges between 5 and 7 years. Leverage is generally up to 6 times net debt/EBITDA and often repaid as a lump-sum 'bullet', with negotiable call protection.

A particularly interesting part of the direct lending space consists of 'sponsorless' transactions, i.e. transactions with companies that are not private-equity owned. In the broad debt market, sponsorless transactions represent a larger part of overall lending than sponsored transactions. This means that Insurers wishing to invest in a direct lending strategy can access a larger investment universe, offering greater selectivity, if they include sponsorless transactions. Another important feature is that sponsorless transactions are by nature 'less intermediated'. In many cases, this feature means stronger loan documentation as well as better financial conditions and higher target internal rates of return (IRR) for the investor. For instance, sponsorless transactions avoid the crowded auction processes in which multiple potential lenders compete by offering lower margins and more borrower-friendly terms.

Insurers investing in projects without a private-equity sponsor should partner with direct lending experts which are well-versed in identifying and managing these deals. Success in sponsorless direct lending requires local sourcing capabilities on the ground that are well-connected and have strong trusting relationships directly with the borrowing companies. In the absence of a private equity sponsor, the private debt manager must have the resources and skill for thorough due diligence and, during the life of the loan, the resources to support the borrower in acquisitions and other matters.

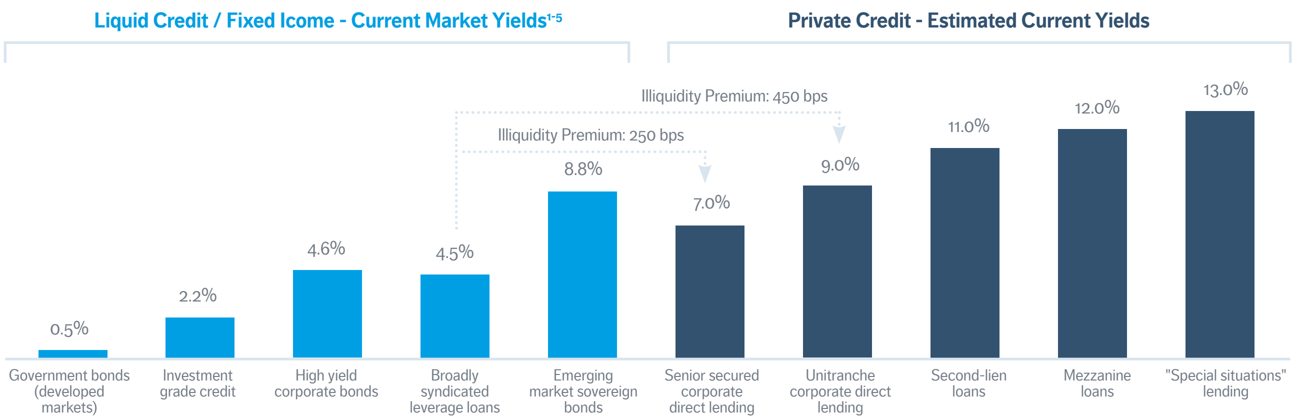
# Benefits for General Account Portfolios

Direct lending investments can offer a number of advantages in an insurance portfolio: Attractive returns with both relatively low regulatory capital costs and moderate risk; Low volatility; and Diversification. Many insurers find the illiquidity a more than acceptable trade-off for these advantages. A well-constructed asset allocation, backed by solid asset-liability management, generally allows insurers to carry an allocation of illiquid exposures within their performance-seeking portfolio. The core portfolio should provide sufficient liquidity to meet obligations.

## Performance Potential

With potential returns often at 6% or more depending on the credit profile of the issuer, leverage and other factors, direct lending offers higher yields than publicly-traded bonds with similar risk profiles. These returns compensate for the lack of liquidity – in the absence of a public market, insurers typically hold the instruments for longer. The illiquidity premium typically adds around 100 to 250 basis points over the returns of comparable syndicated loans. The manager skill premium can further add to returns, given the complexity of sourcing and structuring. Accordingly, direct lending can offer returns to insurers which are comparable to those of listed high yield bonds.

### Figure 2: Relative Expected Returns by Segment based on Market Prices

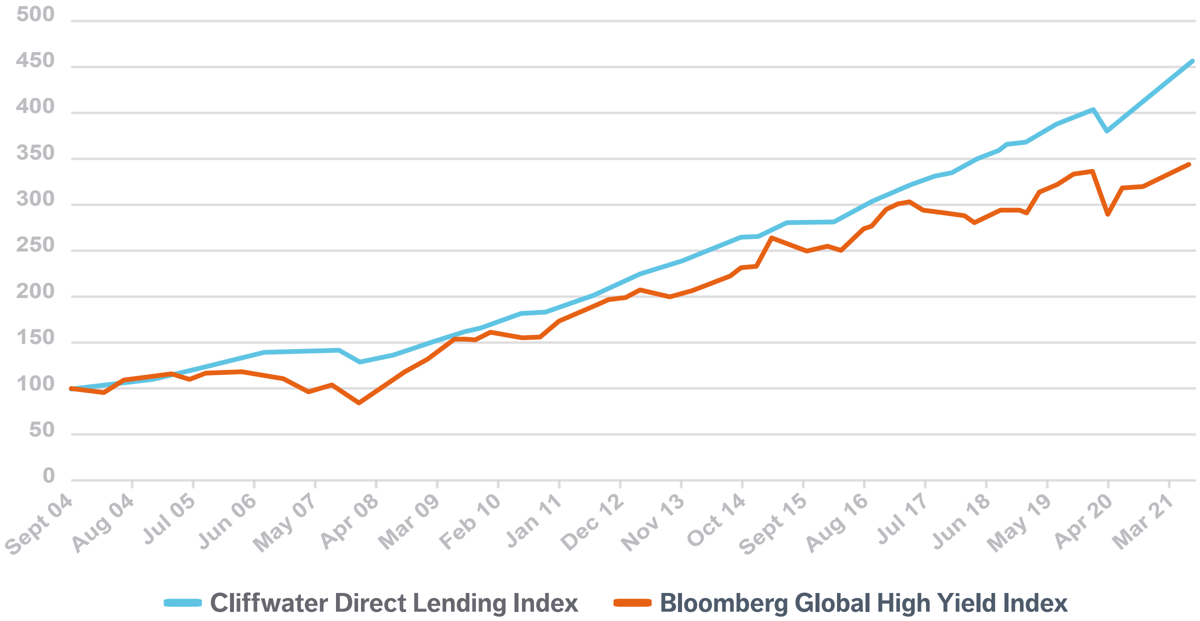



*Source: Campbell Luytens, 2021.*

*1. All returns are expressed gross of any hypothetical fund management and performance fees, are unlevered and assume no defaults/losses. Contains estimates that are not intended to predict returns in any way*
*2. 10-year government bonds reflect the yield to worst on the S&P Global Developed Sovereign Bond Index (USD) as of 12 May 2021.*
*3. Investment Grade Credit reflects the yield to worst of the S&P 500 Investment Grade Corporate Bond Index as of 12 May 2021.*
*4. Broadly Syndicated Leveraged Loans from the S&P LSTA U.S. Leveraged Loan 100 Index, yield to maturity as of 12 May 2021.*
*5. High Yield reflects the yield to worst on the S&P US High Yield Bond Index as of 12 May 2021. Emerging Market reflects the yield to maturity on the S&P Global Emerging Sovereign Inflation-Linked Bond Index (USD) as of 12 May 2021*
*6. All illiquid credit yields reflect Campbell Luyten's estimates based on private market observations.*

Figure 3 illustrates the quarterly returns of direct lending in comparison to high yield bonds since 2004.

**Figure 3: Comparison of Returns Over Time by Sector**




*Sources: Candriam, Cliffwater, Bloomberg*

*Cliffwater Direct Lending Index: Data downloaded from http://www.cliffwaterdirectlendingindex.com/ on 11 October 2021.*
*Bloomberg Global High Yield Index: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). BARCLAYS® is a trademark and service mark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Bloomberg and Bloomberg's licensors, including Barclays, own all property rights in the Bloomberg Barclays Indices. Neither Bloomberg nor Barclays approves or endorses this material, or guarantees the accuracy or completeness of any information herein, or makes any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.*

Of critical importance for insurers is that **direct lending offers this return potential at** generally **lower risk,** and **lower regulatory capital costs.**

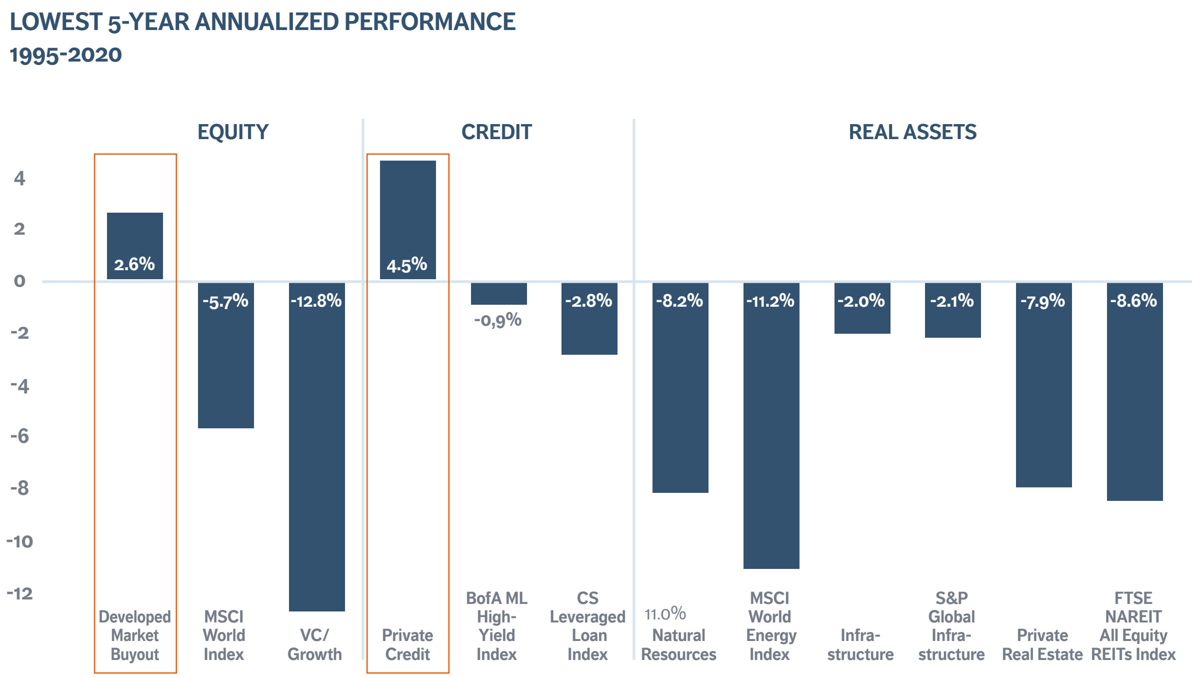
## A Different Type of Risk Profile

The risk profile of private debt differs from that of traditional public debt. The primary distinctive risk of private debt is liquidity risk. As direct lending is less sensitive to interest rates, it can be used to diversify the interest rate risk of listed debt in a portfolio.

Direct loans offer high transparency, with strong legal documentation and contractual protection. The heterogeneous and private nature of direct loans limits meaningful data on aggregate default rates. However, generally speaking, history shows that direct loans compare favorably in terms of default risk. For many investors, loss-after-default is an even more important metric than default rates. Such losses tend to be lower for direct lending space than for high yield bonds, due to the quality of direct lending covenants. In fact, arrangers of direct lending transactions, such as specialized managers, are known for thorough due diligence and tight covenants. This can enhance default protection and, notably, recovery levels. It is important that insurers pay careful attention to the skill sets and track records of managers.

Figure 4 provides a more general view of downside investment risk of private debt, represented here in the private credit and developed market buyout categories. It shows the **lowest** five-year annualized performance compared to other asset classes for the period from 1995 to 2020.

## Figure 4: Downside Performance Risk of Selected Asset Classes



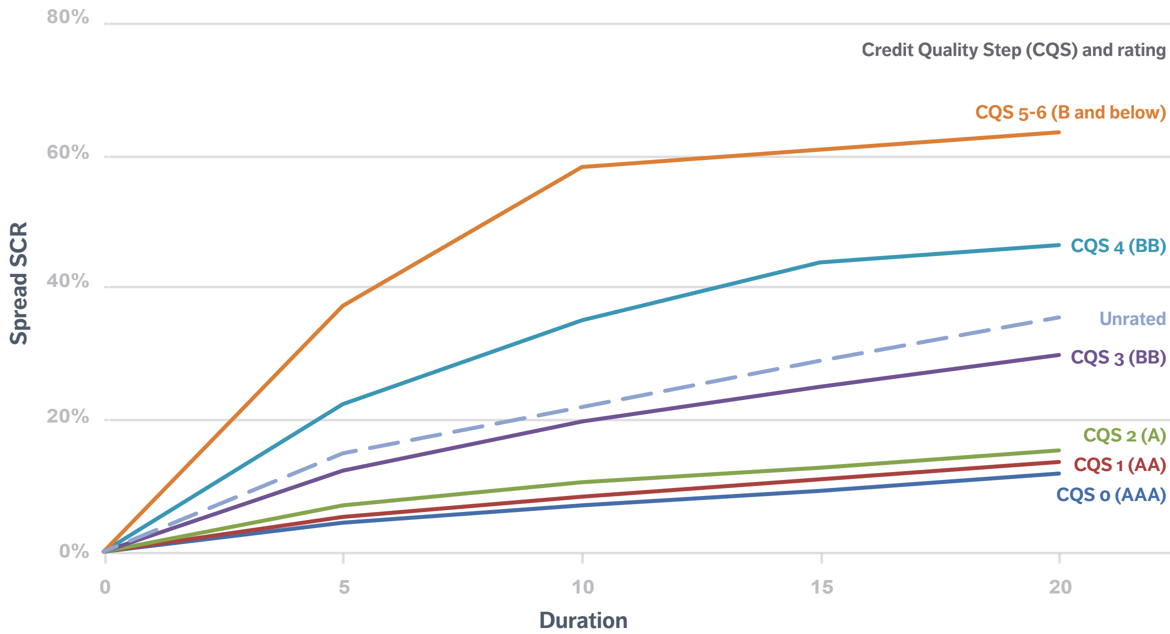

*Source: Hamilton Lane, Market Overview: The "Real" Risk, April 14, 2021. Chart downloaded from https://www.hamiltonlane.com/en-US/Insight/07e30ecb-24b8-47f5-8538-971bd50b7bef/Market-Overview-The-Real%E2%80%9D-Risk on 11 October 2021.*

## Regulatory Capital Costs

The risk/return potential for direct lending is even more attractive for insurers, as the investment carries a relatively low regulatory capital requirement. Under Solvency II, the overall capital charge of a debt instrument depends in large part on its spread SCR (Solvency Capital Requirement). Spread SCR in turn depends on the CQS (Credit Quality Step) of the instrument. In other words, the capital charge is a function of credit rating and duration. Direct lending is generally not rated. Under Solvency II, the "unrated" category incurs a spread SCR that is slightly higher than that of triple-B-rated bonds.

*That is, the regulatory capital requirement for direct loans is similar to investment-grade bonds, while the return expectations are comparable to or better than those of high-yield bonds.* Public high-yield bonds are rated and therefore incur significantly higher capital charges, as Figure 5 illustrates. As a significant portion of the syndicated loan universe is rated, direct loans also enjoy a capital benefit relative to syndicated loan investments.

**Figure 5: Regulatory Capital Requirements by Credit Quality**




*Sources: Candriam, EIOPA (European Insurance and Occupational Pensions Authority).*

## Low Volatility

With no quoted market prices in direct lending, it is inherently a low-volatility investment. The volatility of listed assets is affected by factors well beyond fundamentals, such as shifts in sentiment or contagion from market moves in unrelated assets. This can be especially noticeable in the short term. Direct lending investments are less affected by such movements and can to a certain extent be managed in a counter-cyclical or business cycle-agnostic fashion to support returns in both economic expansion and contraction.

Two additional elements of the low volatility of direct loans are their lower sensitivity to increases in interest rates, and that they are not usually subject to mark-to-market valuation.

This is of particular interest to insurers seeking to limit the reported volatility of their investments. European listed insurers subject to IFRS 9 reporting will have to measure an increasing number of investments at Fair Value Through Profit and Loss (FVTPL). In this methodology, fluctuations in the fair value of an investment affect the insurer's profit and loss during the entire time the asset is held, as gains and losses in value are recognized directly in the income statement, even if unrealized. For insurers concerned about this effect in their financial communications, the low-volatility nature of direct lending is attractive.

## Diversification, Diversification, Diversification

Incorporating direct lending into asset allocations can ***improve diversification*** of general account portfolios. Correlations among traditional asset classes have been increasing over the last decade, particularly during periods of market stress when decorrelation is most needed. Effective diversification has become increasingly important and increasingly difficult to achieve.

Direct lending has low correlation to most of the publicly traded assets that represent an important part of insurers' portfolios. A direct lending allocation also ***diversifies sources of return,*** by adding illiquidity and manager skill premia. This complements other sources of return of traditional asset classes such as credit quality, interest rates, inflation and equity performance. Most direct lending transactions are floating rate deals and can thus help offset the interest rate risk of listed corporate fixed-rate instruments.

Direct lending also offers ***issuer diversification,*** as the universe of companies borrowing via direct lending agreements includes many which are not accessible via listed fixed income or even syndicated loans, notably mid-sized companies. Borrowing directly is often a more attractive proposition to these companies, as it offers flexibility and speed of execution.

# Implementing a Direct Lending Investment

## The Liquidity Question

The benefits of direct lending investment come with a certain illiquidity. While liquidity is an important consideration for general account portfolios, traditional fixed income and other publicly traded assets remain the bulk of the investments, generally providing sufficient liquidity. (Except, perhaps, during a short-term market freeze at the peak of a financial crisis.)

Thus, less-liquid private lending instruments can fit very well into well-diversified strategic asset allocations for insurers, without compromising underlying asset-liability matching structures. Insurers with long-term liabilities, such as life insurers, are likely to find excellent alignment with the buy-and-hold nature of direct lending.

## Manager Selection

In contrast to most publicly-traded debt and to many syndicated loans, direct lending transactions are not rated. Insurers depend on their own analysis or on the analysis of the private debt managers with which they partner. The chosen managers should have experienced teams who are experts in credit risk, structural analysis, and legal assessment, as well as in the ongoing monitoring through maturity.

The ability of the asset manager to source the most attractive deals, ensure a substantial deal flow and deploy capital in a timely fashion while minimizing risks, is critical. This is due to the complexity, heterogeneity, and private nature of direct lending transactions.

The right partner is key. The choice of a partner should consider the manager's sourcing capabilities and expertise, track record, and on-the ground presence in relevant markets. These are the potential source of a manager skill premium.

## Market Segment

Upper mid-market? Mid-market? Lower mid-market?

Segment focus is another consideration. These segments present different risk profiles and have evolved differently. For example, the lower mid-market, the most illiquid segment, currently offers the least competition. Experienced managers in this segment can maximize deal flow and optimize deal selectivity.

The sponsored versus sponsorless choice also matters. Sponsorless transactions might require more experienced managers, but can offer particularly strong covenants and better pricing.

# Conclusion: Insurers and Partners

Direct lending investments are particularly well-suited to insurers.

Incorporating carefully-sourced and well-managed direct loans into general account portfolios can offer insurers superior return potential at relatively lower regulatory capital costs. Direct loan investments are relatively insulated from short-term market volatility, and less exposed to interest rate risk than traditional fixed income.

Direct lending introduces new categories of return premia and offers access to issuers that are not present in the listed fixed income markets, diversifying general account portfolios across multiple dimensions.

Direct lending investments are more heterogeneous than many asset classes. To fully harness their potential while controlling their risks, insurers require experienced and reliable partners when sourcing and managing investments. The private and illiquid nature of the transactions requires excellent industry relationships and sourcing capabilities, expert understanding of the specific risks and experienced teams to carry out in-depth due diligence and disciplined legal analysis.

Insurers will also want to consider the asset manager's ability to understand and manage the investments in an insurance asset management context.

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