actiam
PERSPECTIVE

The low yield environment of the last couple of years has led to a search for yield which started in public markets but has extended to private markets as well. Many institutional investors have made allocations to a range of alternative fixed income strategies including popular asset categories such as direct lending to middle market corporates, leveraged loans (also known as "bank loans"), infrastructure debt, commercial real estate debt and residential mortgages. In addition to these categories a range of other alternative fixed income categories can be identified such as trade finance, ECA and multilateral guaranteed debt, fund finance, SME lending and other debt outside the public capital markets typically provided by banks.

Interesting observations can be made when looking at alternative fixed income strategies from the perspective of insurance companies. More specifically, various insurance companies' key objectives proof to match quite well with a number of alternative fixed income strategies. However, some less obvious matches can be observed as well.

In general, three main objectives for investing in alternative fixed income can be distinguished:

1. Generate additional return by capturing a "liquidity" premium
2. Optimize return on regulatory capital
3. Diversification

In the rest of this article each of these objectives will be explored while adding practical examples of alternative fixed income investments.

1. GENERATE ADDITIONAL RETURN BY CAPTURING A LIQUIDITY PREMIUM

One of the key reasons for insurance investors to invest in alternative fixed income is to generate additional - risk adjusted – returns compared to fixed income investments in public markets. This is based on the premise that there should be a "liquidity premium" for alternative fixed income assets compared to public fixed income investments. In order to assess alternative fixed income investment opportunities it is import to quantify this premium (if any). In addition, the premium for alternative fixed income versus traditional fixed income can often be explained by factors broader than illiquidity only. It is key to understand the value drivers behind this premium.

Three categories of value drivers which explain the premium versus traditional investments can be distinguished:

- Illiquidity
- Complexity
- Market segmentation

Firstly, illiquid assets should have a premium over comparable liquid assets to compensate investors for taking illiquidity risk. Investors like insurance companies need to balance their need for liquidity with the opportunity to enhance their investment returns through less liquid investments. This balance will depend on risk and return preferences of the investor. Typically, insurance companies balance sheets are generally illiquid due to the nature of their long dated liabilities due to policy holders and P&L and Fiscal constraints. This allows for at least a certain degree of illiquidity on the asset side of the balance sheet.

This is a publication of ACTIAM's Fixed Income & Multi Asset team, consisting of 19 professionals with an average of 17 years in the industry. The team is responsible for the management of our (responsible) fixed income products, with a total AUM of over €40 billion (June 2018).

ACTIAM manages assets of over €56 billion, making us one of the ten largest Dutch asset management companies. Our solid strategies and sound performance track record will help you to achieve your goals. We offer sustainable solutions to insurance companies, pension funds, banks and distribution partners, as well as to private investors.

This is achieved through actively and passively managed investment funds, via impact investing, mandates and ESG advice (Environmental, Social & Governance).

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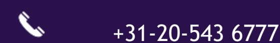


Sales Belgium, France, Luxemburg

Figure 1: Balancing the need for liquidity with the desire to generate additional returns

Secondly, certain asset categories have inherent complexities. These can be structuring complexity (e.g. securitization), operational complexity or complex underlying assets. Investors generally require a premium to invest in complex assets to compensate them for the degree of complexity. Complexity is often perceived as a bad thing which should be avoided (at any cost!). However, while unrewarded risks should be avoided, institutional investors are well positioned to assess complex investment opportunities and extract a premium by putting to work their expertise and long term horizon. Avoiding complexity at all cost means the investor needs to take other (undiversifiable) risks in order to generate the same return, e.g. take more credit risk.

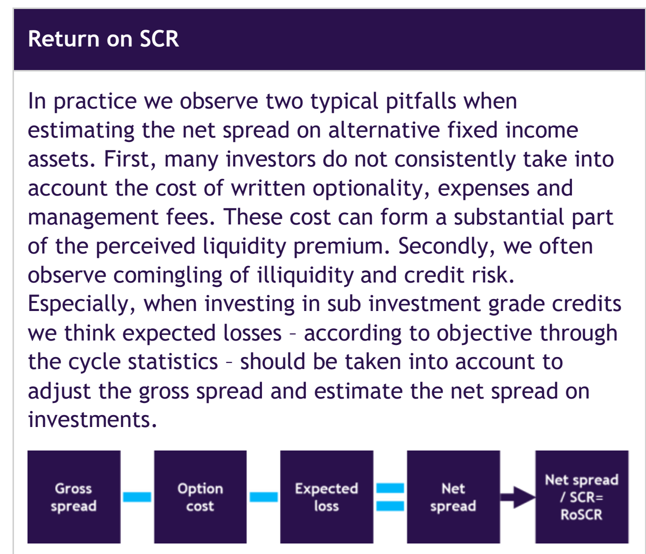
Thirdly, certain asset classes are dominated by bank lenders and are difficult to access for non-bank lenders. Market segmentation has usually grown historically, but is often based on some or multiple forms of complexity which act as a barrier to entry for institutional investors to enter the asset class. Examples of asset classes where clear barriers exist are trade finance and investment fund finance or capital call facilities which have high barriers to entry due to operational complexity. Often, attractive spreads can be observed in these asset classes which also tend to be floored due to Basel capital requirements for banks.

In order to be able to take well considered investment decisions and choose from the premia on offer, it is important to understand and quantify the premium for alternative fixed income assets. The three value drivers presented often exist together and they may be hard to separate and quantify in isolation. This probably explains why they are in practice often referred to as one category of “illiquidity premia”. Secondly, the so called liquidity premium fluctuates over time and especially through the cycle. In the current market environment some illiquid assets can be identified that have an actual liquidity premium close to zero when adjusting for all costs and expenses. This emphasizes the importance of understanding and quantifying the premium compared to traditional liquid fixed income investments.

2. OPTIMIZE RETURN ON REGULATORY CAPITAL

An important objective for insurance companies is to generate attractive returns on capital for their shareholders. In order to achieve this the investments will need to be optimized such that the return per unit of required capital (SCR) is optimal. This optimization will have to be conducted within many constraints including accounting and tax considerations.

Figure 2: Adjusting the gross spread on alternative fixed income assets to calculate a net spread and based on that a net return on Solvency capital


Return on SCR

In practice we observe two typical pitfalls when estimating the net spread on alternative fixed income assets. First, many investors do not consistently take into account the cost of written optionality, expenses and management fees. These cost can form a substantial part of the perceived liquidity premium. Secondly, we often observe comingling of illiquidity and credit risk. Especially, when investing in sub investment grade credits we think expected losses – according to objective through the cycle statistics – should be taken into account to adjust the gross spread and estimate the net spread on investments.

From this perspective, Alternative fixed income can be an attractive asset class since the additional yield earned through the liquidity premium generally does not require additional capital. There are no explicit capital charges for illiquidity in most regulatory frameworks for institutional investors including Solvency 2 (standard model). As eluded to earlier, the willingness and ability to take illiquidity risk will be determined by the insurance company based on its balance sheet management objectives and investment beliefs. As alternative fixed income can offer attractive opportunities for insurance companies who have a clear goal to optimize return on Solvency 2 capital. A premium return can be monetized without additional capital charges which allows for higher return on required capital (SCR) than traditional fixed income assets.

3. DIVERSIFICATION

Alternative fixed income can offer some form of diversification versus traditional fixed income assets. The diversification value depends on the relevant sub asset class and how this correlates with the rest of the insurance companies balance sheet. In general the diversification should not be overestimated since the vast majority of the investments for insurance companies are fixed income investments with correlated credit cycle features. The Solvency 2 diversification benefit will then be fairly limited too given that the most important capital charge for alternative fixed income is spread risk SCR. This is typically already the largest capital requirement for insurance companies investments and adding to this category generally does not give diversification benefits.

However, in some cases, alternative fixed income actually delivers exposure to new credit risk factors such as on offer through investments in whole loan residential mortgages, investment fund finance or trade finance. Secondly, it may actually be useful to diversify existing corporate credit exposure away from large cap publicly traded bond exposure to middle market corporates or even SMEs.

The potential area for diversification under Solvency 2 are specific sub asset classes in alternative fixed income which allow to use the counterparty risk module as opposed to the spread risk charge. A prime example are residential mortgages but also certain secured or guaranteed transactions can be accounted for in the counterparty risk module.

PRACTICAL EXAMPLES: HOW TO SOURCE "LIQUIDITY PREMIA" THROUGH ALTERNATIVE FIXED INCOME ASSETS

Government (credit) exposure can be bought in liquid public bond format, but also in less liquid tradeable or non-tradeable loan format or occasionally even receivable format. Obvious examples are Dutch WSW guaranteed loans and export credit agency debt. These investments generally attract 0% Solvency Capital (SCR) similar to the public bonds. As an alternative to monetize liquidity, government bonds can be used in repo or securities lending markets on an open or term basis. As such, various degrees of liquidity can be foregone for additional return with limited counterparty credit risk.

An extension of the more standardized term repos and securities lending transactions are collateral switch transactions or bilateral funding transactions. Typically in these trades, liquidity is exchanged for both additional credit enhancement due to the secured nature as well as additional return compared to senior unsecured bonds. Often, the reduction in credit risk can lead to reduced SCR charges. As such, more attractive return on SCR can be achieved.

Another source of liquidity premia can be found in residential mortgages where pension funds and insurance companies have invested heavily in recent years. Residential mortgages offer both an attractive risk return profile as well as attractive SCR treatment. Insurance companies as well as pension funds have become crucial funding parties next to traditional banks for up to 1/3rd of the Dutch residential mortgage market, especially concentrated in the longer fixed rate periods. This part of the market is expensive for banks and does match the long term liabilities from typical Insurance Companies well.

Alternative Fixed Income markets also include popular asset classes such as direct lending, leveraged loans and infrastructure debt. These three asset classes generally are loans to sub investment grade corporates with substantial credit risk often for longer durations. In these cases it can be hard to distinguish the actual credit risk from the liquidity premium. Secondly the sub investment grade nature and/or the longer duration of these asset classes could require substantial Solvency 2 capital resulting in low to modest return on capital.

Last but not least, substantial liquidity premia can be found in Alternative Fixed Income opportunities offered by borrower or loan specific circumstances, often driven by (regulatory) capital requirements and balance sheet management considerations from both Investor as well as Borrower. These transactions can offer attractive returns with premia of up to 200 basis points for comparable liquid credit risk but require extensive due diligence and structuring. As such the premia do not only reflect liquidity, but also an element of complexity premia. The return benefits can be substantial but an investor should weigh carefully the added complexity versus the additional return.

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