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Credit risk: Let's get smarter

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Credit risk: Let's get smarter

- The request
 - “The event will involve interactive sessions and lively debate will be encouraged”
 - IFoA website on this conference
- The provocation
 - “a conference that thus far has had only a little more oomph than a convention of actuaries”
 - Robert Peston on the Labour Conference last week

Questions

Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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Agenda (1) :

- The credit landscape
 - Where we are
 - Where we are going

a review

a perspective



Agenda (2) :

- Practical considerations

- Implications of matching adjustment*
- Investing in overseas bonds
- Dynamic liability driven investment
- Alternative credit

some observations

some challenges and an idea

an idea

more challenges

Agenda (1) :

- The credit landscape

Where we are

a review

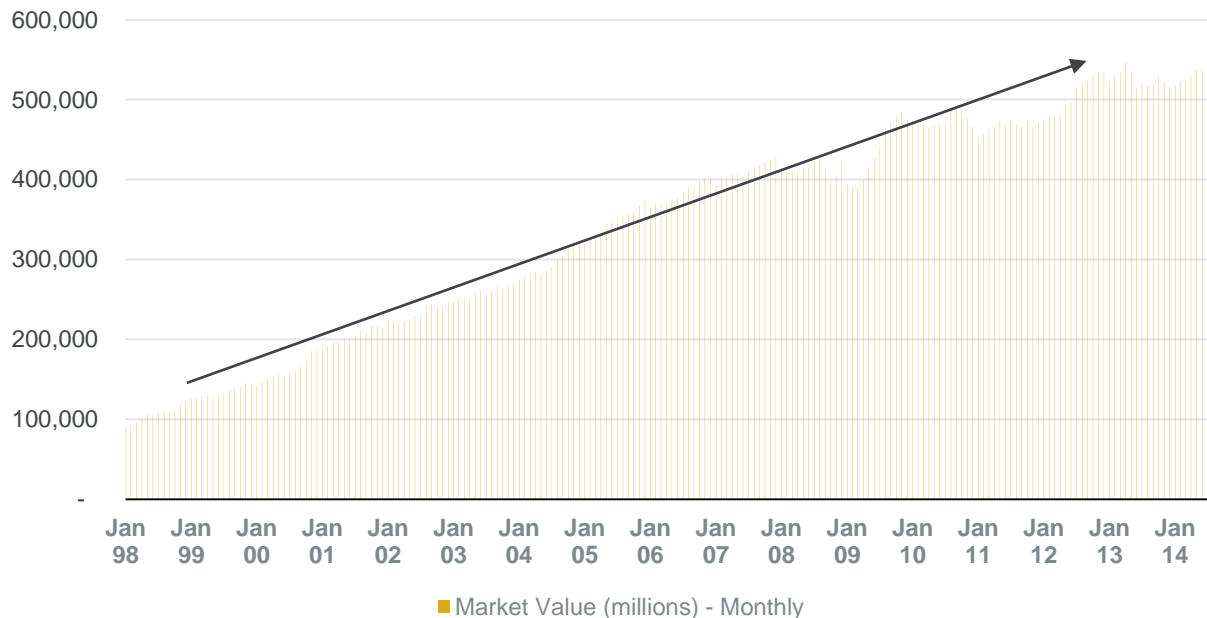
- Where we are going

a perspective



Changes in the market

Market value (sterling non-government millions) – monthly



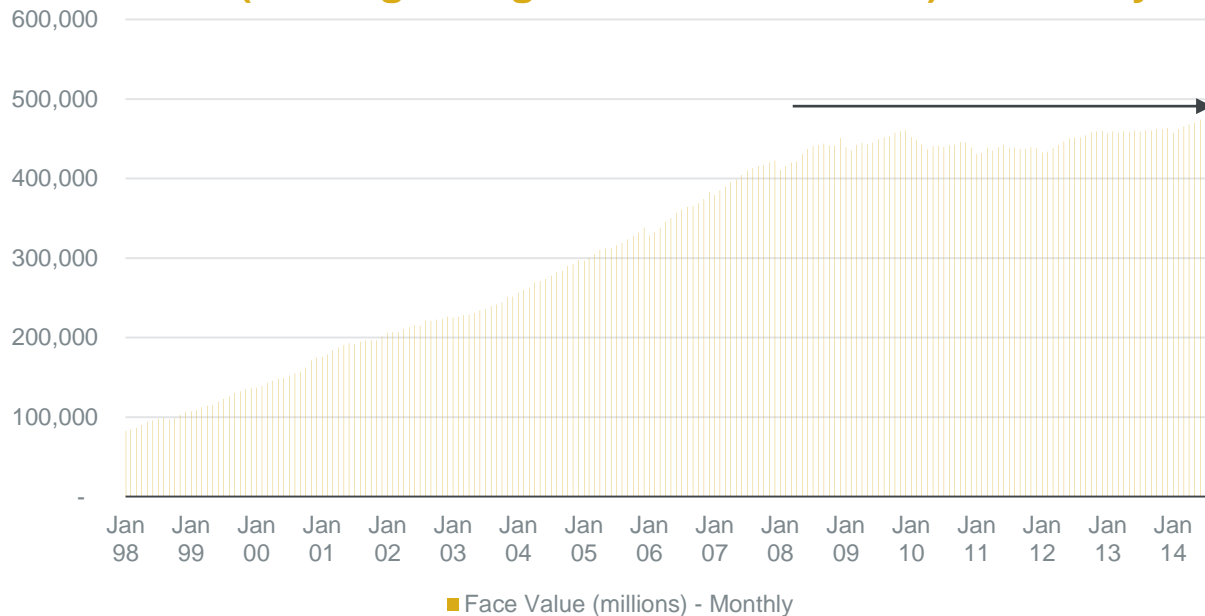
Source: iBoxx,



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Changes in the market

Face value (sterling non-government millions) – monthly



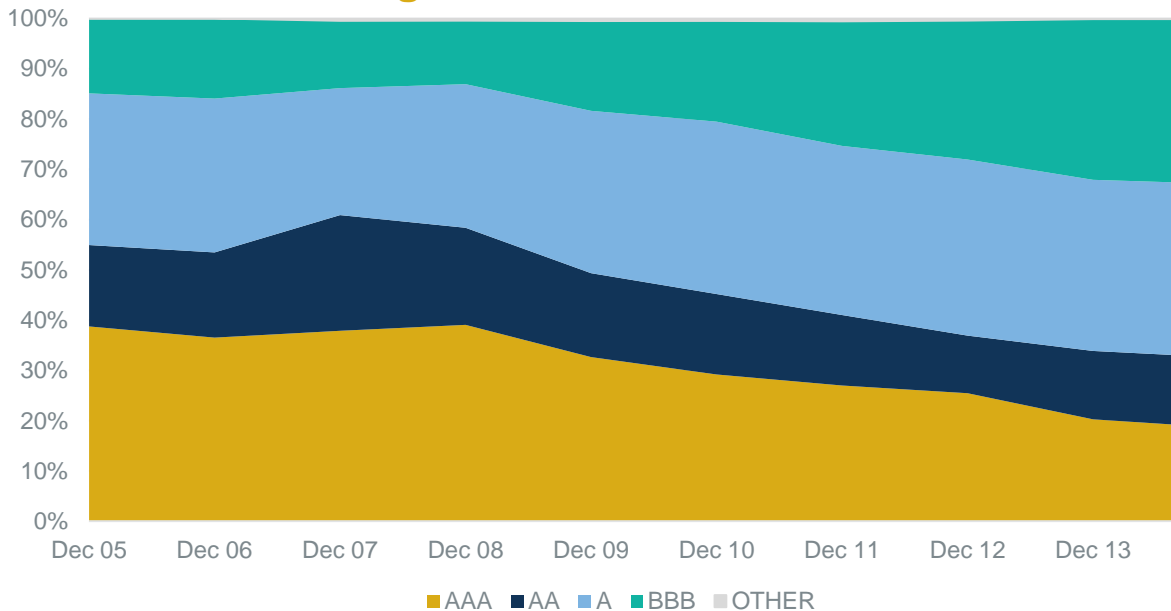
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Changes in the market

Breakdown of ratings



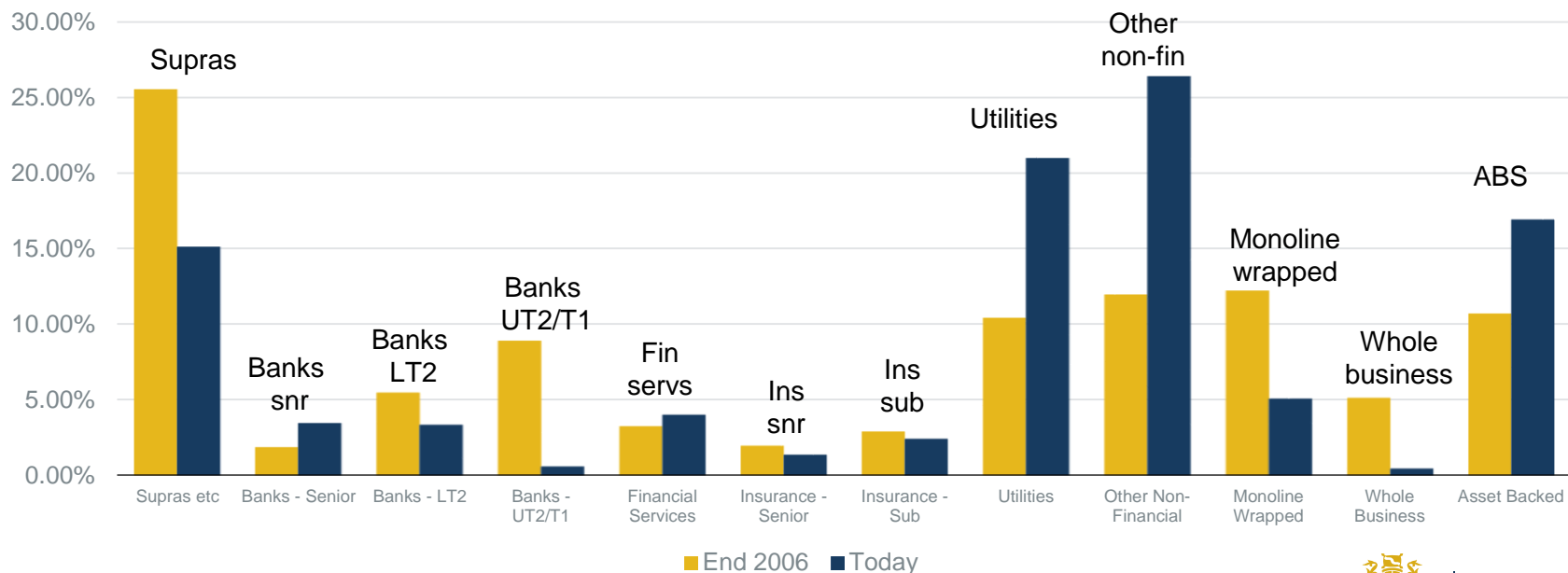
Source: iBoxx,



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Changes in the market

Breakdown of sectors - sterling non-government bond over 15 years



Source, F&C, BofA/Merrill Lynch

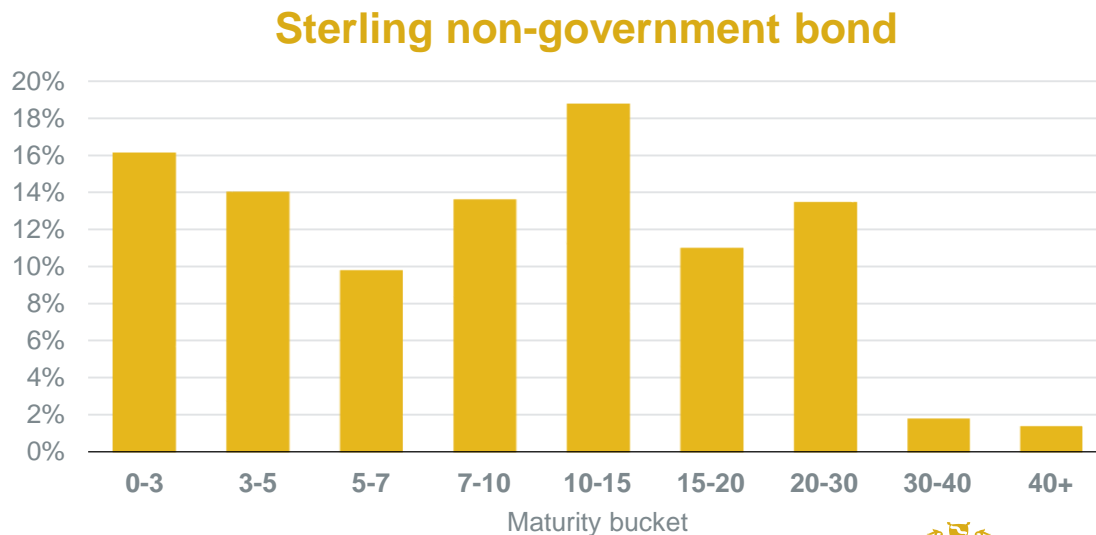


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Seeking return 1 – non-sterling

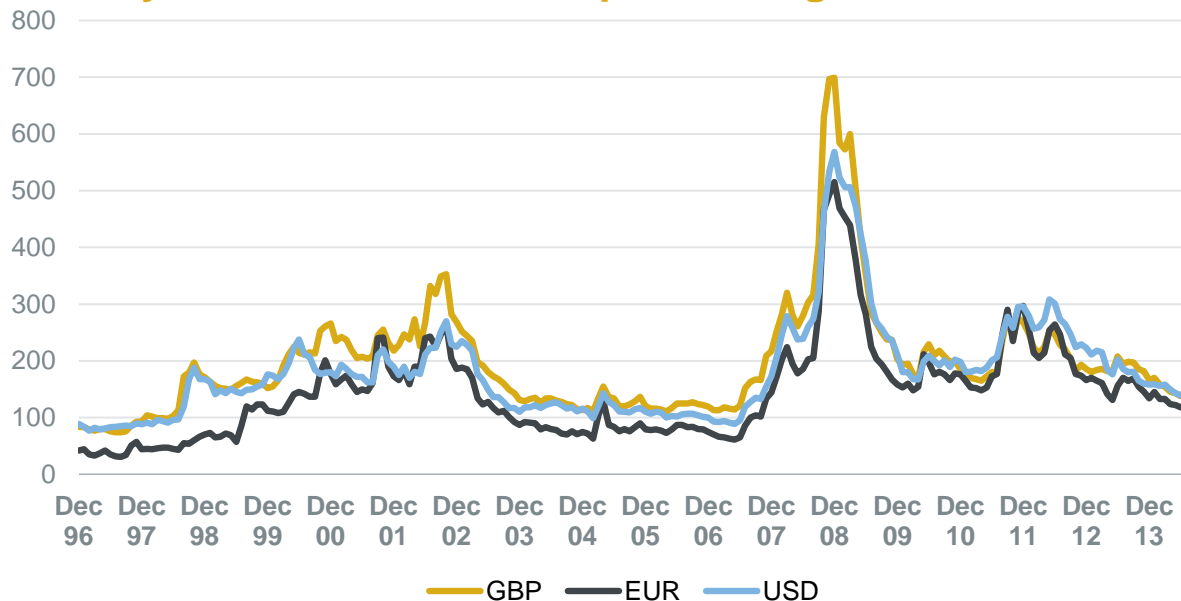
Why go overseas? Because you can't get it at home!

- ✗ Maturity
- ✗ Ratings
- ✓ Diversification
- ? Spread



Seeking return 1 – non-sterling

5 – 10 yr BBB non-financial spreads to government bonds



Source: BofA/Merrill Lynch



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Seeking return 2 – alternatives

Why go alternative? Because you can't get it mainstream!

- ✗ Maturity
- ✗ Ratings
- ✓ Diversification
- ? Spread



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Seeking return 2 – alternatives

Why would an issuer not go to the traditional bond market?

- Not big enough
 - Most new issues at least £100m
 - Needs to be £250m to enter the iBoxx index
- Not willing to get rated / market to a large audience
 - Costly in cash and time
- Flexibility
 - Non-standard terms such as a drawdown/pre-payment requirement
- Cheap enough without the hassle



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- The credit landscape

- Where we are

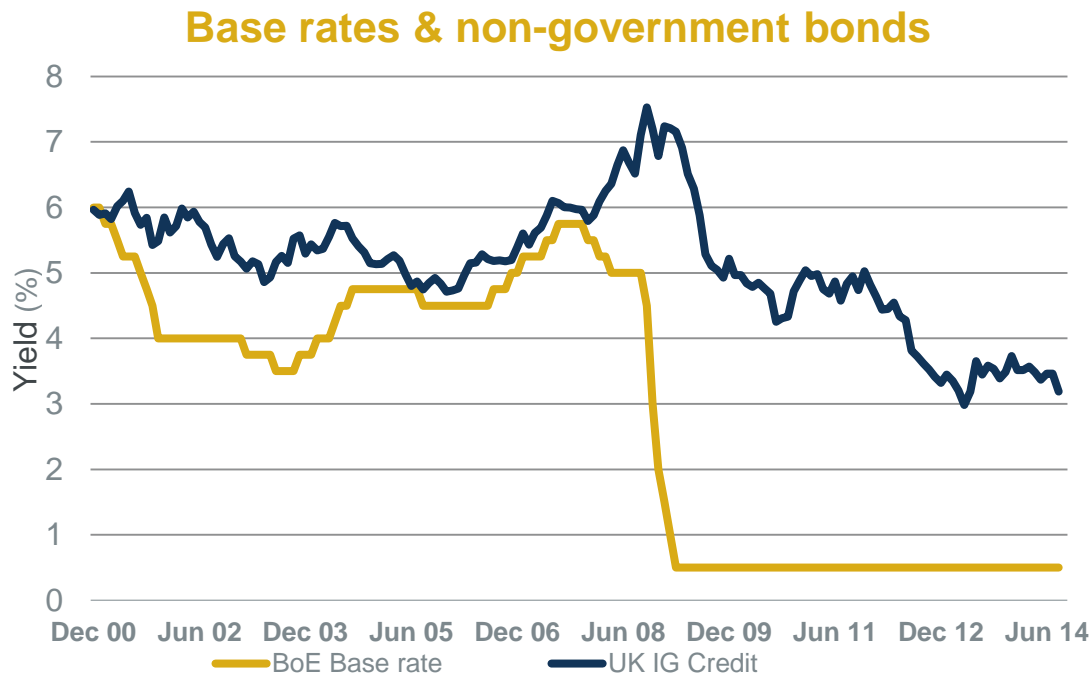
a review

Where we are going

a perspective



Low returns – here to stay?



- Credit has benefited as interest rates have stayed low

Low returns – here to stay?

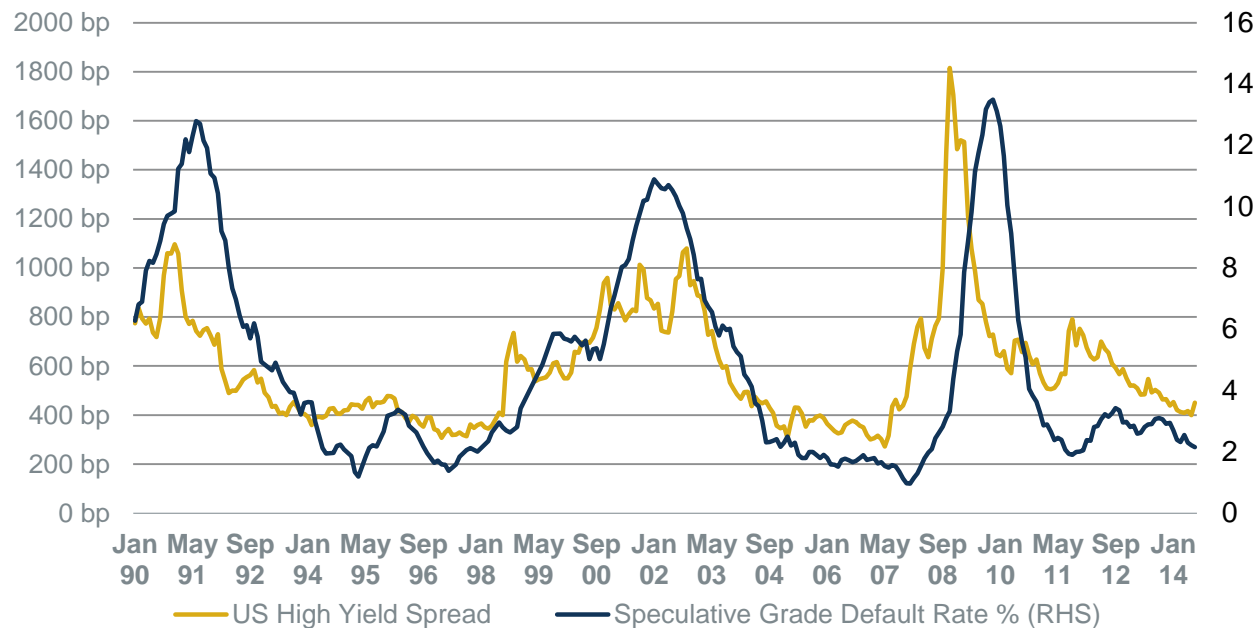
Fed balance sheet vs Dow



- Central Banks have not stopped intervening

Low returns – here to stay?

US high yield spreads vs defaults



- Spread movements primarily linked to credit risk but defaults stay low

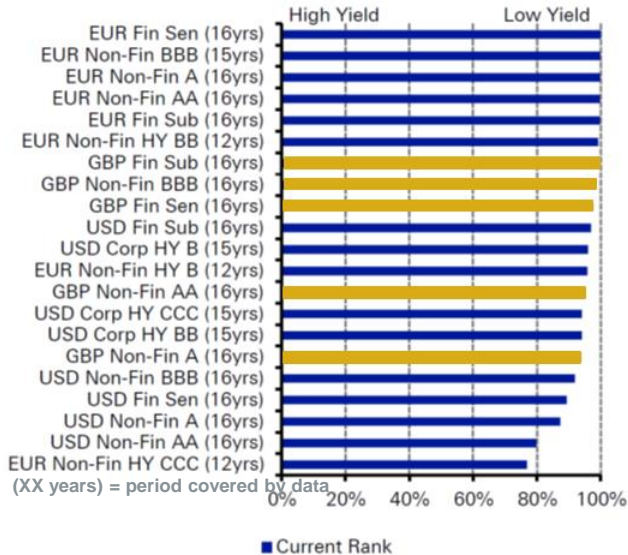
Source: Credit Suisse, Moody's, F&C Asset Management



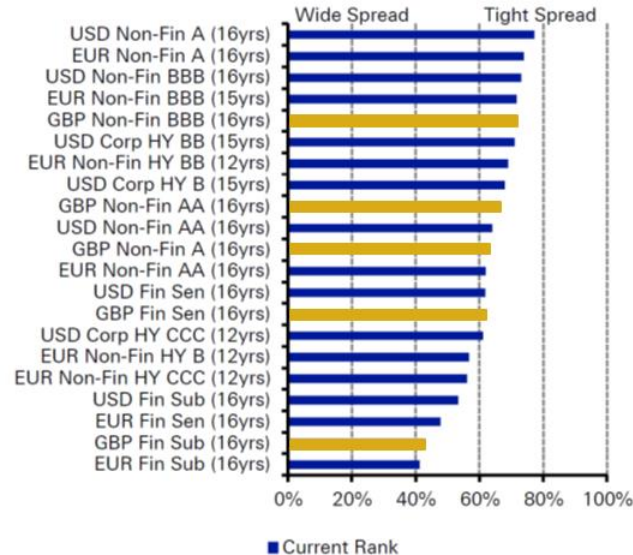
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Spreads relative to history

Yields



Spreads



- Spreads have been lower

Agenda (2) :

- Practical considerations

Implications of matching adjustment

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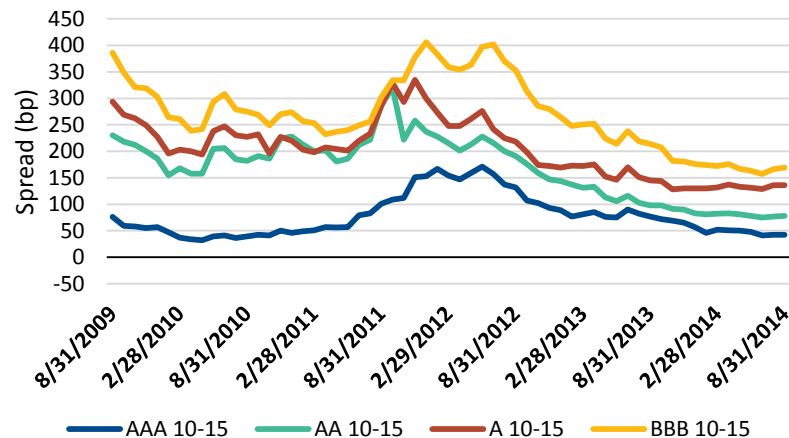
more challenges



Introduction

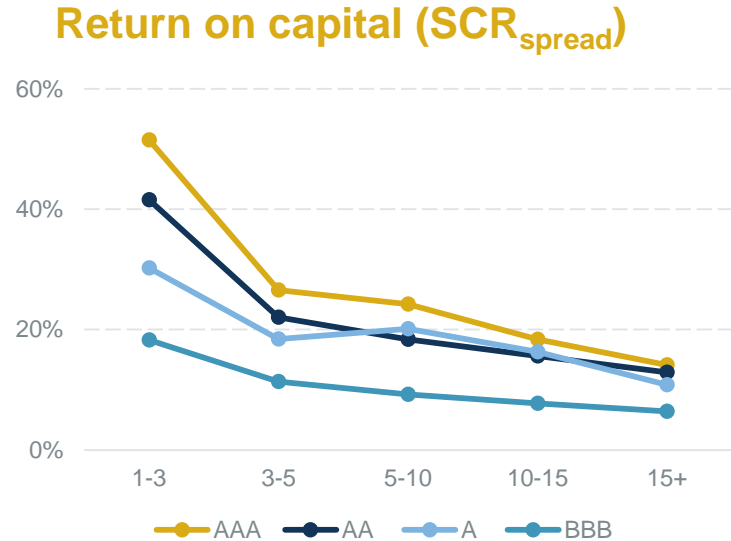
- Yields are low
 - Combination of rates and spreads
- Implications for life insurers
 - Annuities look unattractive
 - Meaningful guarantees expensive
- The search for “smart ideas”

Spreads 10-15 year tenors



Without matching adjustment

- Ability to manage credit and rate risk separately
- Capital requirements favour shorter dated credit risk
 - Are returns on capital attractive?
- Rates risk can be managed by swaps
 - Liquidity requirement has an opportunity cost



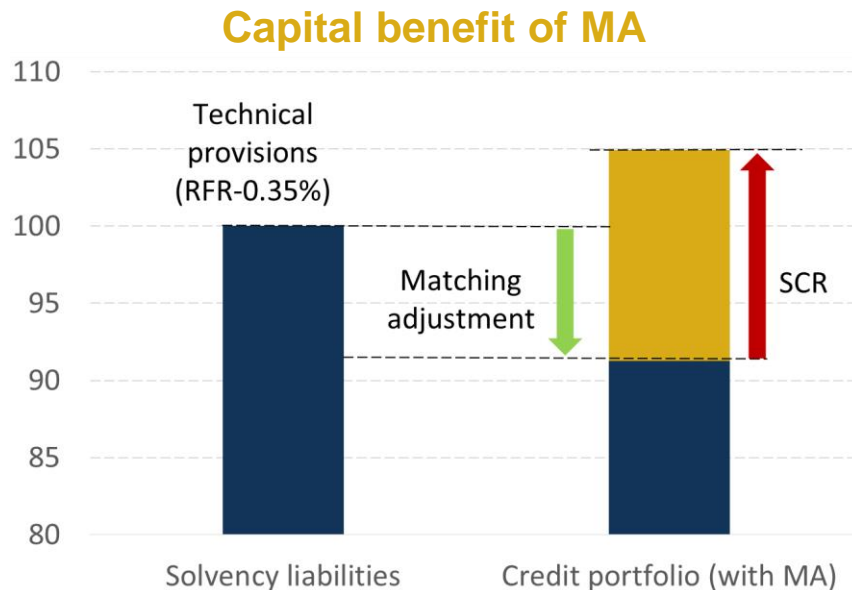
Managing rates risk with swaps (an aside)

- These will be centrally cleared for new trades in 2016
- Removes direct counterparty exposure BUT clearing broker can terminate your contract
 - This is a tail risk but tail events happen!
 - Termination would increase risk position
 - Find replacement broker
 - Find alternative means to manage rates exposure



With matching adjustment

- A valuable capital benefit subject to constraints
 - Cash flow matching + liquidity plan
 - Investment grade (IG) only
 - Fixed/indexed GBP cash flows
 - Something akin to a buy and maintain strategy
 - Pre-payment options require appropriate compensation



With matching adjustment

- Implications for asset management
 - Capital aware investment management agreements (IMAs)
 - Capital requirements
 - Set framework ✓
 - Nominate stocks ✗



With matching adjustment

- Optimal portfolio will change over time
 - As spreads change
- New premium income
 - Can allow rebalancing without selling
- No new premium income
 - What scope does MA give to buy/sell to re-optimize ?
 - Alternatively optimize on “more typical” credit spreads
- Regard to average credit quality as portfolio runs off
 - Consider impact of credit migration
 - Skew investment preference to higher quality, long-dated assets



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Investing in overseas bonds

some challenges and an idea

- Dynamic liability driven investment

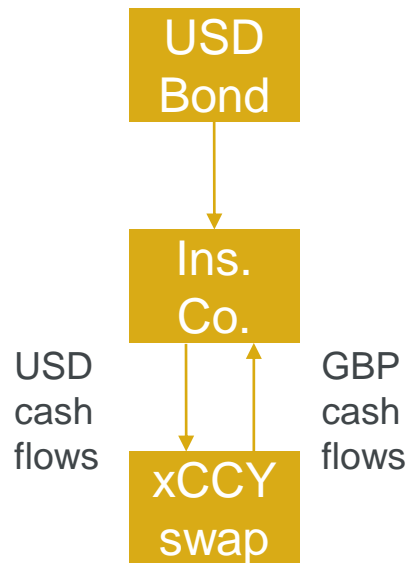
an idea

- Alternative credit

more challenges



Overseas bonds – hedging out currency risk



- ✓ Simple
- ✓ Meets MA requirements
- ✓ Easy to operationally manage
- ✓ Well suited to small portfolios

- ✗ Swap illiquid
- ✗ Costly to trade and exit
- ✗ Mark-to-market profit/loss on default
- ✗ Collateral requirement



Building your own cross currency swaps

■ The building blocks

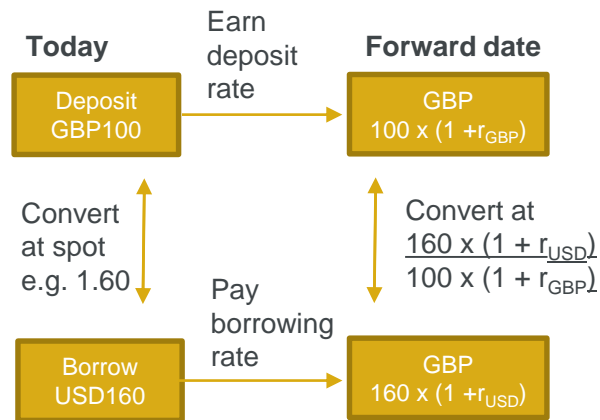
- USD fixed to floating
- FX Hedge
- GBP floating to fixed
- 3m/6m basis
- Funding costs
- Capital charges

✗ More complex to understand and operate

✓ More liquid instruments

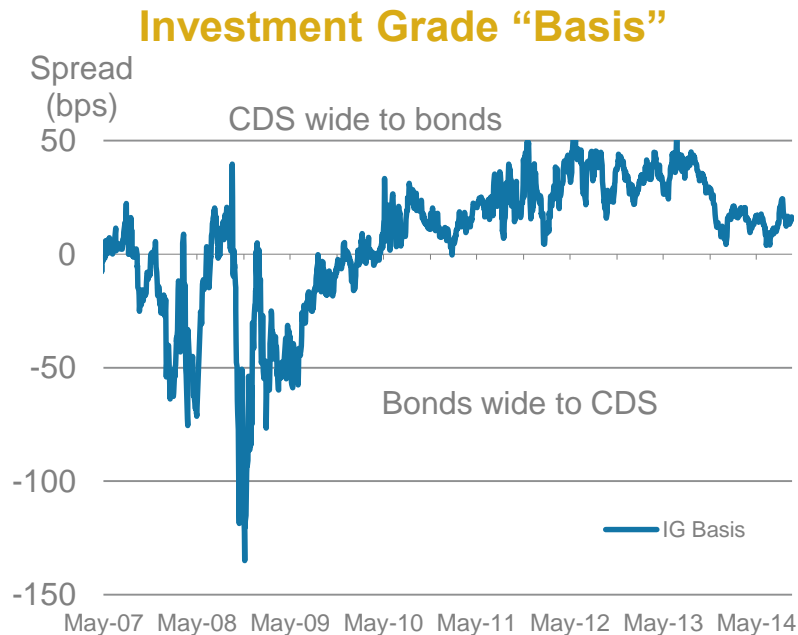
- Buy components from cheapest supplier
- Save on bank funding and capital charges

The theory of an FX hedge



Synthetic overseas bonds

- ✓ Buy gilts and take overseas credit risk through CDS
- ✓ Diversified exposure through an index
- ? CDS spreads different to Bond spreads
- ✗ CDS typically traded in EUR/USD
 - Currency risk limited to spread and losses on default
- ✓ iTraxx Main will be centrally cleared
 - Defaults to risk off position if CDS clearing broker terminates



Source : Morgan Stanley Research



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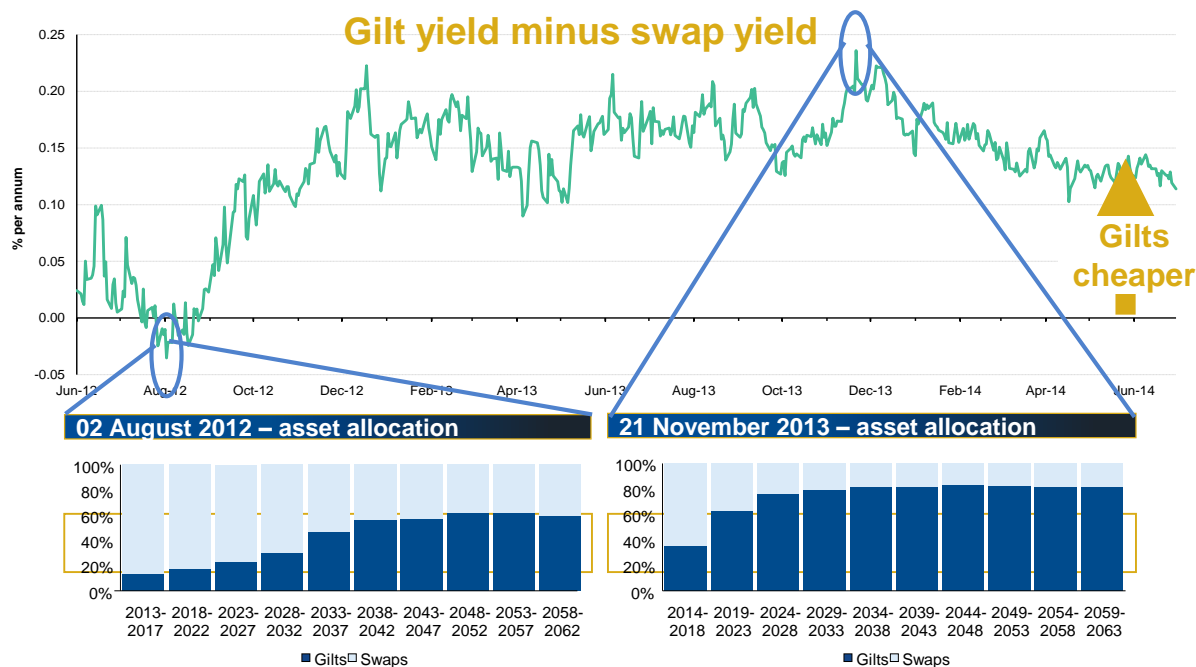
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Dynamic liability driven investment

Is there something to learn from the pensions industry?



Source: F&C Management Limited. Weighted average gilt less swap yield. Target allocation for Nominal Dynamic LDI fund.



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Dynamic liability driven investment

- What about eligibility under matching adjustment ?
 - Liability cash flows met if assets held to maturity
 - Liability cash flows still met by moving to a cheaper portfolio and releasing cash
 - Does this fit in with the spirit or letter of Article 77b of Omnibus II ?



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Alternative credit

- Maximising the illiquidity premium (and stepping into the shoes of banks)
 - Export credit agency loans
 - ✓ Implicit government guarantee
 - ✗ Usually not GBP (if GBP then not ECGD)
 - ✗ Pre-payment clauses
 - ✗ Trend towards bond format for some ECAs
 - Infrastructure
 - ✗ Bond markets work well for bond type risks
 - ? Returns and risks are in initial development phase
 - ✗ Lack of GBP supply



Alternative credit

- Maximising the illiquidity premium (and stepping into the shoes of banks)
 - Commercial real estate (CRE) lending
 - ✓ More akin to traditional credit risk with asset backing
 - ✗ Underwriting, structuring, management, rating skills required
 - ✗ Spens type clause needed for MA eligibility
 - SME lending
 - ✗ Typically lower credit quality than CRE
 - ✗ Underwriting, structuring, management, rating skills required
 - ✗ Spens type clause needed for MA eligibility



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