Private Credit Investment for Insurers – unlocking the challenges

Iain Forrester, Chair
Gareth Mee, Deputy Chair

Agenda

- Introduction
- Regulatory Requirements
  - Consultation Paper 48/16
- Key Considerations for Private Credit Investment
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- Looking Ahead
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Introduction

Background to the Working Party

- The investment strategy of global insurance companies is evolving, driven by the low-yield environment and the increasing introduction of risk-based capital regimes.
- One such trend is the rotation of investments into private credit assets(*), particularly within the portfolios backing UK annuity business.
- Over the last year, the IFoA and PRA have held a series of roundtable meetings to discuss emerging best practice in insurance investment activity. At those meetings, it became clear that meeting the regulatory requirements arising from private credit investment was a key challenge for UK insurers.
- For reference, Appendix 1 shows the assets backing annuity and WP business for selected companies and shows a range of 5% - 60% of “other assets” backing annuities (**30%-40% for most**) and 5% - 30% for WP (**10% - 20% for most**)

The Working Party was then established to provide guidance on emerging best practice in Private Credit investment by insurers.

(*) For the purposes of the working party, “private credit assets” have been considered to be any assets which are of fixed income nature and do not have an active secondary market (including but not limited to ERM, infrastructure debt, CRE debt, ground rents and SME loans.)

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Working Party Members

The Working Party comprises individuals in the following roles:

- Insurance Investment - 1st Line
- Insurance Investment - 2nd Line
- Asset Management
- Insurance Investment Consultant

Working Party Members		
Mike Ashcroft	James Hayes	James Lumb
Daniel Blamont	Roman Hederer	Gareth Mee (Deputy Chair)
Iain Forrester (Chair)	Wojciech Herchel	Rui Wang
Paul Harbord	David Leach	

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Regulatory backdrop

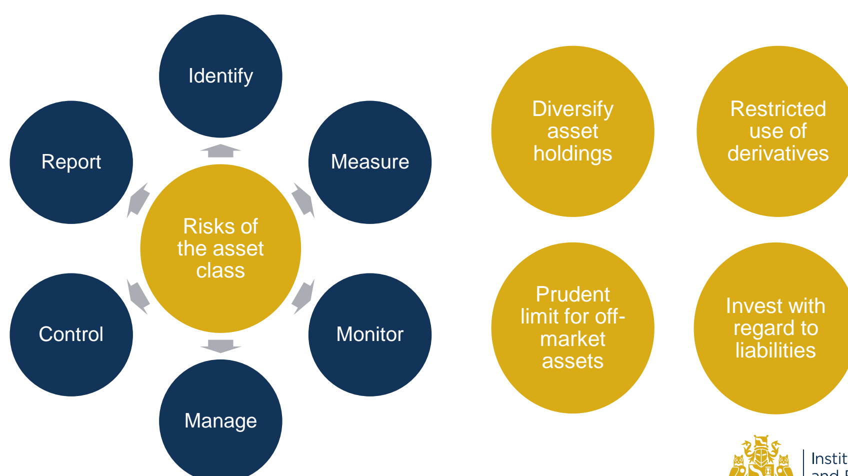
Regulatory Context

Sam Woods, Chief Executive Officer, Prudential Regulation Authority:

"… illiquid bespoke loans require very specific skills in terms of structuring, valuation and ongoing risk management. In particular, experience has taught us that the risk firms face from making such loans is related to how skilfully firms can manage any impairment process. These are not traditional areas of expertise for most UK insurers and, in my view, firms must clear a high bar in order to demonstrate that they have adequate systems and controls in place to manage these types of risks and exposures."

Source: Speech, London Business School, 20 March 2017

Prudent Person Principle



The PRA's Investments Framework

"The primary aim of [the investments] framework is to help supervisors better understand firms' investment strategies and systematically assess and evaluate the risks firms face from the investments.

The framework is structured into a four-level assessment approach that analyses:

- the rationale and the strategy of the investments;
- the processes, governance and controls around firms' investment decisions;
- the due diligence that firms carry out when choosing third party investment providers; and,
- the PRA internal evaluation and possible mitigating actions towards regulated firms over the general level of risk of assets.

Given the increasing importance of asset management activities in relation to insurance investments, the framework also helps the PRA to assess whether insurers have carried out a full due diligence analysis in choosing and monitoring external investment providers, as well as providing supervisors with support in assessing firms' compliance with the prudent person principle under Solvency II."

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Source: "The Prudential Regulation Authority's approach to insurance supervision", March 2016

CP48/16: Matching adjustment – illiquid unrated assets and equity release mortgage

The Working Party helped to draft the IFoA response to CP48/16, alongside members of the Working Parties covering the Matching Adjustment and Equity Release Mortgages.

"There are two overarching areas where additional clarity is needed from the PRA in order to ensure that the principles of the Supervisory Statement (SS) are implemented correctly:

a. *the scope of the SS should be clarified. At present, the draft refers variously to illiquid assets, restructured assets, and assets inside/outside of the MA portfolio, with some commentary being applicable widely and some not – yet the scope is limited […];*
b. *consistency should be maintained with the principles of proportionality and materiality under the SII regime. In certain areas, the expectations could reasonably be interpreted as going beyond proportionate oversight of material risks."*

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Source: IFoA response to Prudential Regulation Authority

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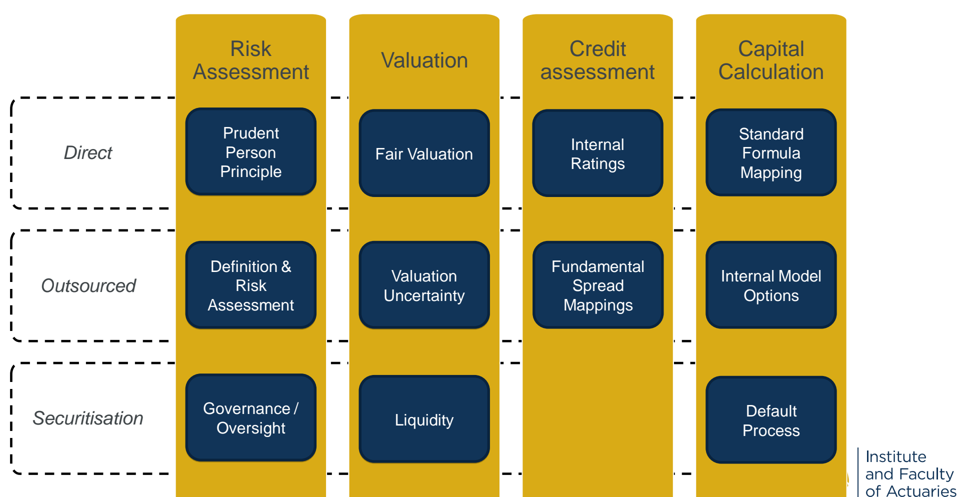
Working party analysis

Private Credit – Key Considerations



Risk Assessment

- Prudent Person Principle
  - Specialist expertise e.g. deal structuring, DD, security, workouts
  - Reliance on external managers and ability to challenge
  - Clear risk appetite
- Definition & Risk Assessment
  - Clear definition of private credit
  - Risks - legal, political, regulatory, operational, reputational, model, expense, valuation, …
  - Stress and scenario testing, breakeven analysis
- Governance / Oversight
  - Consider non-discretionary mandate to retain control & robust mandate waiver process
  - Regular oversight plus deep dives
  - Risk concentrations can be difficult to monitor e.g. energy price risk

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Valuation

- Fair Valuation
  - Alternative methods possible, but underlying principle that it must be suitably Market Consistent / Fair Valued, at inception and on an ongoing basis
  - Valuation uncertainty is likely to be particularly important for private credit
- Optionality
  - All optionality in the contractual cashflows should be valued appropriately
  - If optionality not material, monitoring processes should be put in place to ensure this remains so
- Restructured Assets
  - Equation of Value needs to be considered
  - Appropriate discount rate for junior/equity note

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Credit assessment

- PRA expects 4 areas to be covered (in MA application) wrt internal ratings
  a. rating methodology
  b. Calibration and back testing of ratings
  c. Governance around rating process
  d. Process for review of internally assigned ratings
- Rating *broadly consistent with rating produced by ECAI*… but which ECAI?
- Can an internal rating be truly internal?
  - governance of rating process requires expertise and independence
- A 2-stage process for Internal rating and fundamental spread assignment
  - isn't one process enough?

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Capital Calculation

- Capital calculations should be consistent with the fair valuation process in that scenario (including consistent rating model and optionality calculation).
  - A change in the fundamental spread in this scenario should also be calculated
- The same rating does not imply the same
  - Robustness of the rating (i.e. change under stress)
  - Default scenario (e.g. recovery rates)
- Paucity of data and sophistication of models define three methods:
  - A rating is a rating (i.e. corporate bonds and private credit are identical)
  - Private credit = f(public credit) i.e. public credit models are modified
  - Entirely bespoke calibration is used to define bottom up risk factors
- Private credit data is scarce. But public credit data is not infallible and any analysis should be proportionate to the risk.

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What's next?

Looking Ahead

- Economic climate means that investment in private assets required for investment return and liquidity purposes
- UK Regulatory Regime
  - Feedback from CP48/16 may influence valuations and appetite for investment
  - Further Internal model & Matching adjustment applications as well as "optimisation" means market practice will evolve
- EIOPA Review
  - Reducing reliance on external credit rating agencies may further incentivise private credit investment.
- Insurance Capital Standards (IAIS) & IFRS 17
  - The relative attractiveness of private credit will depend on emerging regulation in both of these areas, as well as UK's treatment of adoption of new standards

Conclusions

- It remains a challenge to invest in new asset classes as none of these areas are straightforward
- But it's an imperative that insurers explore opportunities in private credit given the current market and many are now becoming more mainstream
- More research and guidance is welcomed to help insurers reduce the time to invest and the ability to participate in new asset sales.
- Next Steps for the Working party
  – Guidance on Best Practice resulting in "Principles for investment" to be published in H2 2017.

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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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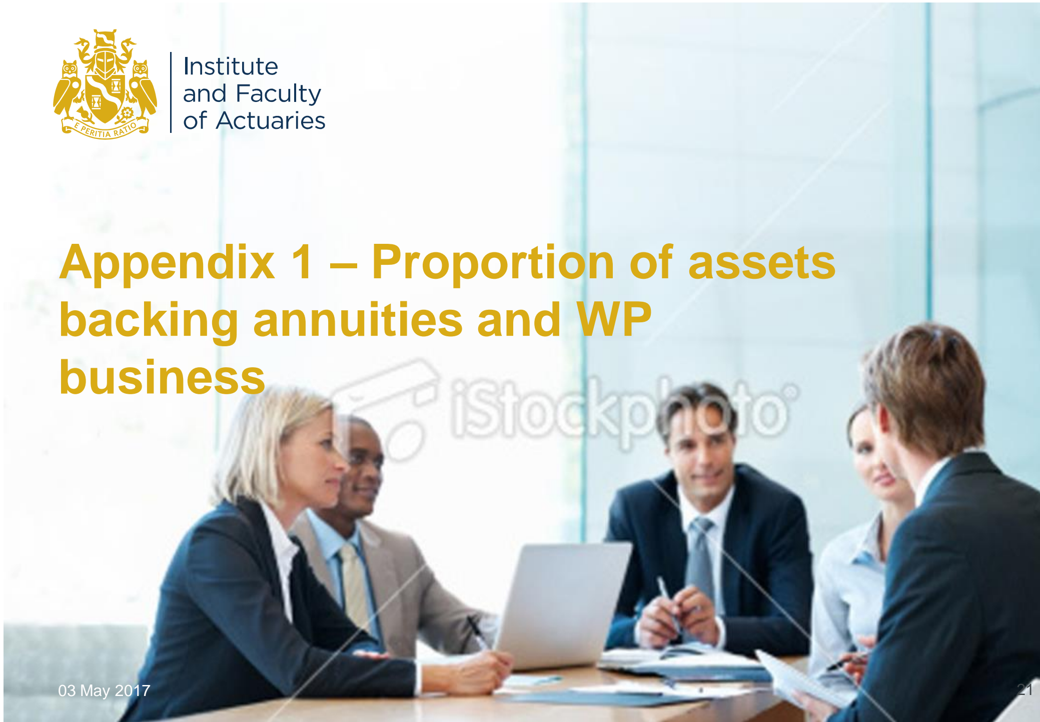
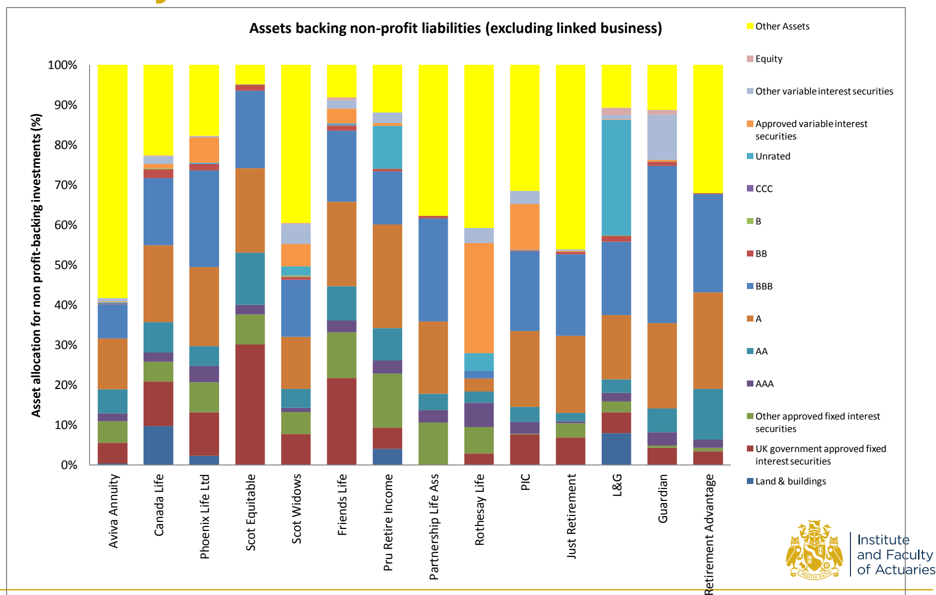


Annuity asset mix YE15



WP asset mix YE15