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## Sourcing corporate bonds for your Matching Adjustment portfolio

Anil Shenoy  
Director of Institutional Business  
Henderson Global Investors

Allen Twynning  
Head of Debt Origination  
Pension Insurance Corporation

**Henderson**  
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### Matching Adjustment assets

- “...bonds and other assets with similar cash-flow characteristics, to cover the best estimate of the portfolio of insurance...obligations...”
- “The expected cash flows of the assigned portfolio of assets replicate each of the expected cash-flows of the portfolio of insurance or reinsurance obligations in the same currency and any mismatch does not give rise to risks which are material in relation to the risks inherent in the insurance business to which the matching adjustment is applied”
- “the cash-flows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties;”

Source: Solvency II Directive, Article 77b



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## Matching Adjustment assets

- **Buy and Hold (or Maintain)**
- **Cash-flows of assets and liabilities need to be matched**
  - Subject to tests
- **Bonds need to have:**
  - Clearly defined (fixed) cash flows
  - Limited optionality (sufficient compensation through Make-Whole clauses)
  - No deferability
- **Considerable ambiguity and interpretation but long dated Sterling corporate bonds are potentially ideal for MA portfolios**



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## The Long Dated UK Sterling Corporate Bond Market

Specifically look at:

- The opportunity set
- Liquidity
- Value

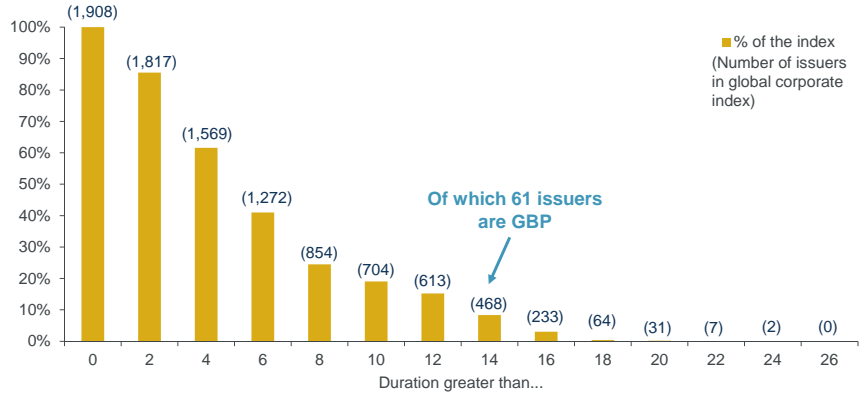


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## A relatively small opportunity set of suitable bonds



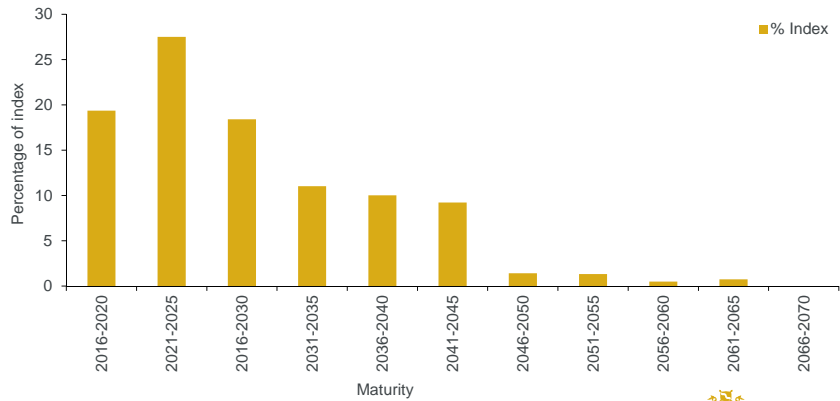
Source: Bank of America Merrill Lynch, as at 23 March 2016



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## A relatively small opportunity set of suitable bonds

Market value of sterling corporates issued by maturity



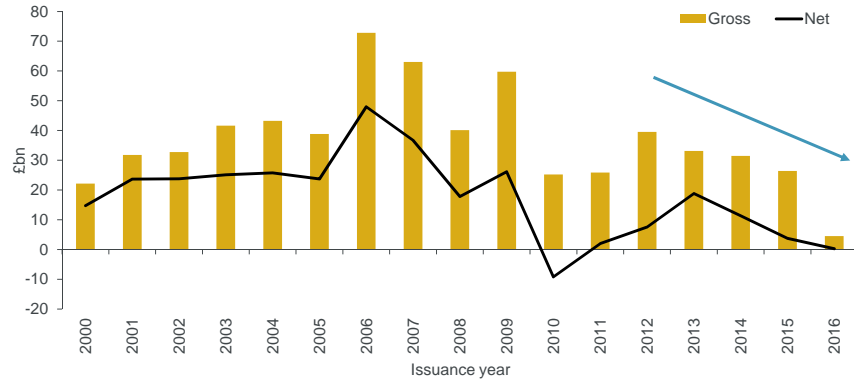
Source: Bloomberg, Bank of America Merrill Lynch, as at 20 April 2016



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## Compounded by a lack of new issuance

Total Sterling denominated investment grade issuance (£bn)



Source: JP Morgan, as at April 2016



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## Especially at the long end (+10 years)

Year of Issuance	Total issued £bn
2012	28.7
2013	23.1
2014	19.7
2015	10.4
2016	3.5



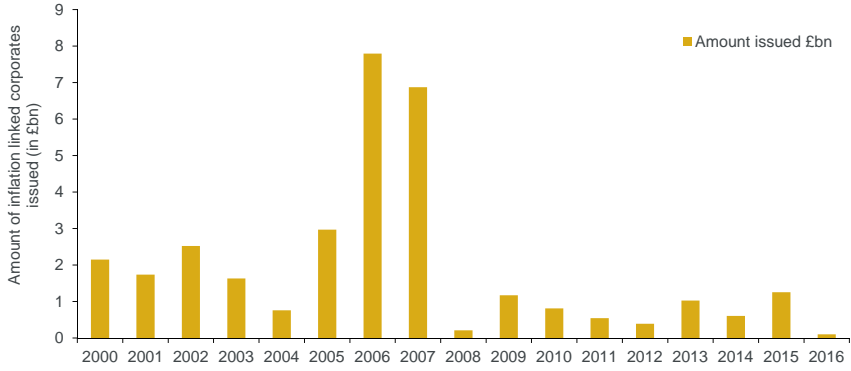
Source: JP Morgan, as at 20 April 2016



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## Compounded by a lack of new issuance

Issuance of inflation-linked corporates

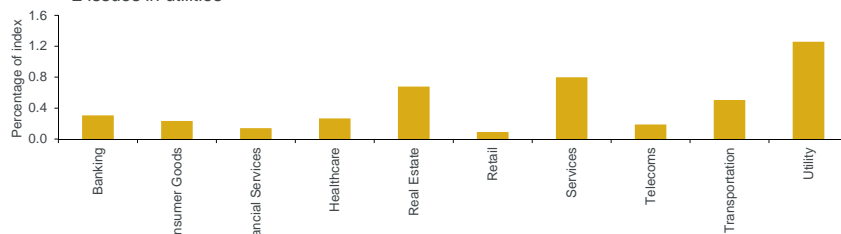


Source: Pension Insurance Corporation, as at April 2016



## High concentration by sector

- The index contains 726 issues
- 31 issues (4.5% of the index by market value) have a maturity date of 2045 and beyond
- High concentration by sector
  - 8 issues in real estate
  - 8 issues in services
  - 2 issues in utilities

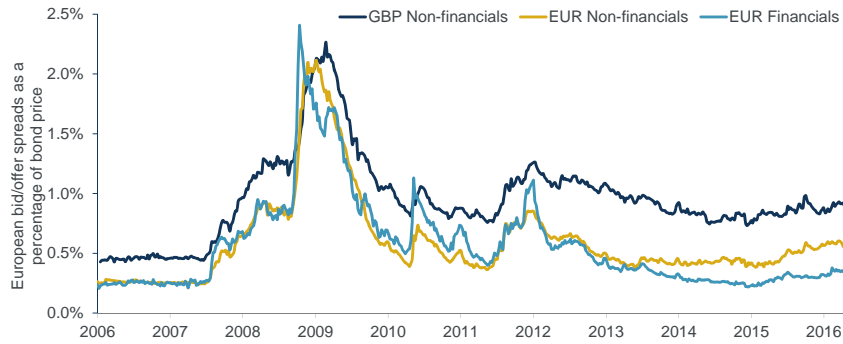


Source: Bank of America Merrill Lynch, as at 23 March 2016



## Sterling bond liquidity remains poor

European bid/offer spreads



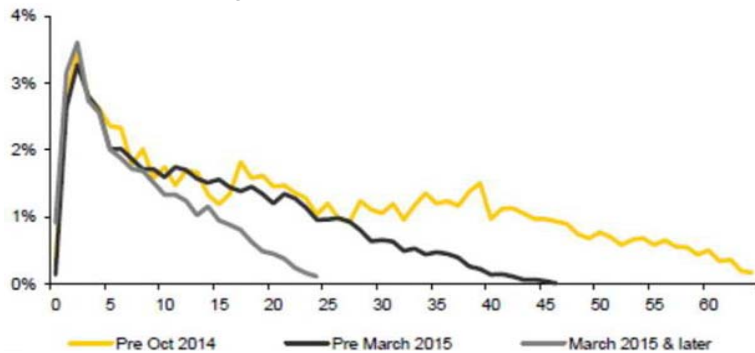
Source: Morgan Stanley, as at April 2016



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## Sterling bond liquidity remains poor

Average weekly turnover of newly issued corporate bonds 'n' weeks after issuance, in percentage of nominal



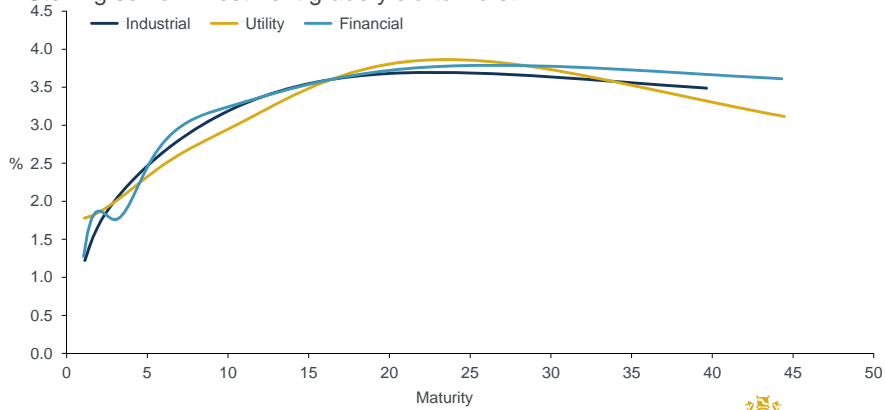
Source: Commerzbank, as at April 2016



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## Long end lacking incentive

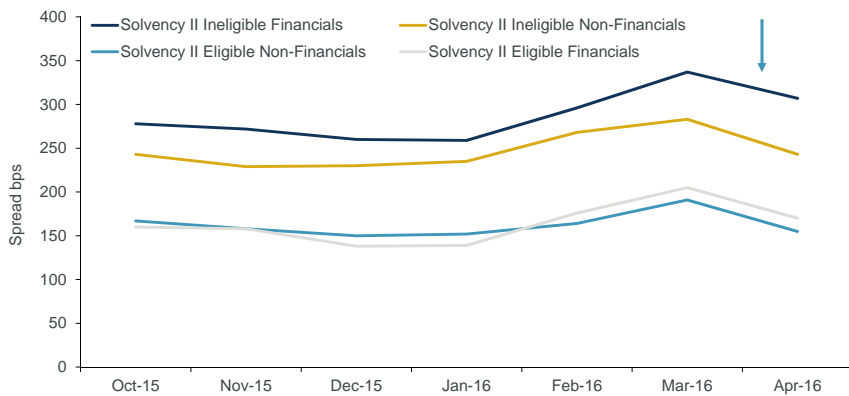
Sterling senior investment grade yield to worst



Source: Barclays, as at April 2016



## Matching Adjustment compliant bonds have been bid up



Source: Henderson Global Investors, Bank of America Merrill Lynch, as at April 2016



## Bank disintermediation

- Banks have pulled back from long-term lending and derivatives (10 year+)
- Deleveraging is the focus
- Independent bond arrangers have stepped in
- Some outliers continue to lend
- Institutional investors have responded
- Borrowers still need long-dated debt



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## Originating direct debt – a potential solution?

- Process overview
- A potential source of MA-Compliant bonds?
- Risks and expected returns
- Case Study – The Church Deal

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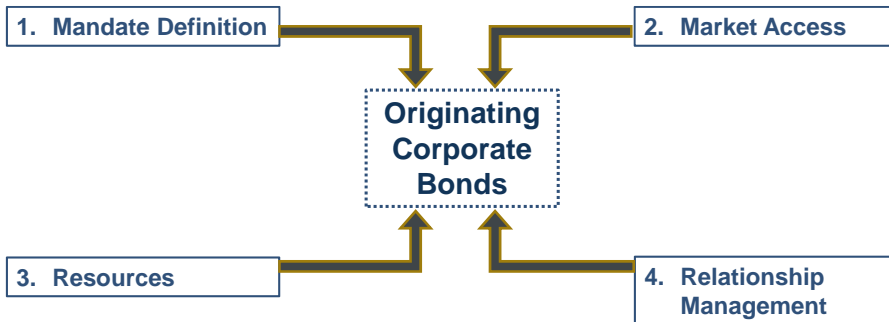


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## Process overview



## Process overview

### 1. Mandate definition

- Economic risk tolerance
- Risk-adjusted ticket size
- Focus on particular sectors?

### 2. Market Access

- Employ a dedicated sourcing manager
- External fund manager?

## Process overview

### 3. Resources

- Internal ratings methodology
- Bespoke valuation model
- In-house sector expertise
- Draw on internal legal, analytical, actuarial expertise

### 4. Relationship management

- Partnership approach required for long term relationship
- Regular meetings and information flows (turnover consents and waivers)
- Potential for repeat issues



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## A potential source of Matching Adjustment (MA) compliant bonds?

- **MA –compliance driven by insurance company internal models**
  - No 'standard' MA-compliant bond
  - Essentially down to call protection
- **Bond issuers need to offer flexible cash flow profiles and structural protections**
- **May be a challenge for some collateral/assets, e.g. mortgages**



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## Risks and issues

- **Initial analysis/due diligence**
  - May be the sole investor
  - Financial close is a long-term commitment
- **Resource intensive**
  - Deal may not ultimately materialise
  - Active maintenance required over transaction life
- **Competitive market**
  - Sometimes market can get 'hot' e.g. Social housing in 2013/14
  - Pressure to loosen credit criteria or to overpay



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## Risks and issues (continued)

- **Lack of liquidity**
  - Difficult to exit a position if the credit profile of the bond deteriorates
- **Credit default/losses**
  - Pension Insurance Corporation focuses on bonds secured on property, project finance or regulated assets
  - Security structure vital when lending for 25 years+



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## Expected returns

- Issue premium – typically between -25 to 25 bps
- Illiquidity premium – typically between 0 to 50 bps pa
- Opportunity to obtain inflation-linked cash flows

Source: Pension Insurance Corporation April 2016



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## Church case study



- **Senior secured debt**
  - The deal was to finance subsidised retirement housing for clergy
  - Owned/operated by the Church of England Pension Board
- **£70m initial investment with the potential to purchase another £30m**
- **Bespoke cash flows**
  - CPI-linked coupons
  - Issuer wanted long dated funding
  - Pension Insurance Corporation needed cash flows with a WAL of 30 years

Source: Pension Insurance Corporation



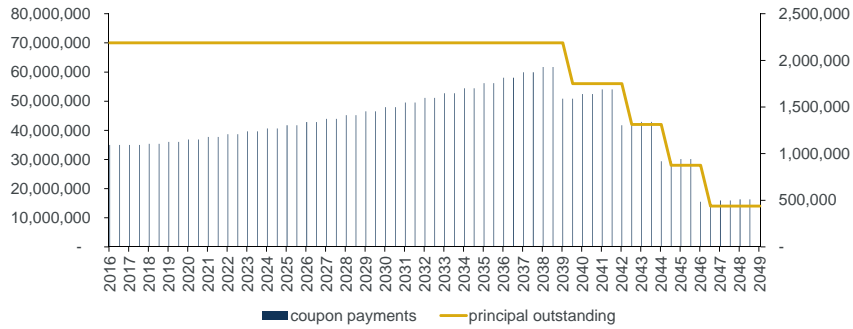
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## Church case study



£m Cash flow profile



- The spread pick-up versus comparable rated corporates was circa 25bps
- Deal amortises in key years where PIC has a specific need

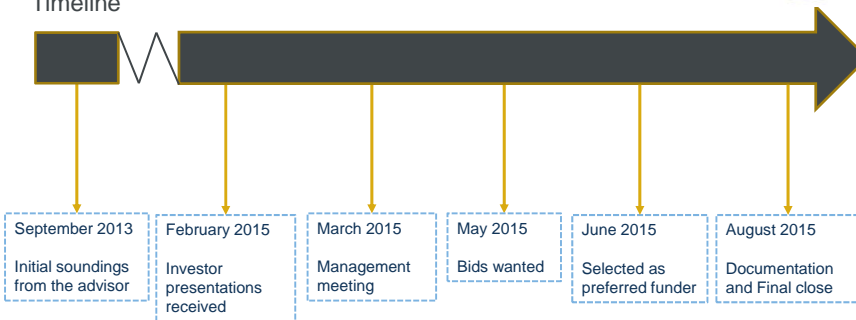
Source: Pension Insurance Corporation



## Church case study



Timeline



Source: Pension Insurance Corporation



## Conclusion

- Supply of GBP credit is **severely** constrained
- Creative approach is needed to **diversify sources of assets** with **appropriate cash flow characteristics**
- **Bilateral transactions** are a **potential solution**

### However

- This is **resource intensive** and **expensive**
- They are **buy and hold** assets
- **Scale is required** to be successful

