Kris Kraus

Episode 210: Asset-Based Lending for Insurers with PIMCO's Kris Kraus, Portfolio Manager & Co-Head of Specialty Finance

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. Welcome back, and thanks for joining us. To the home of the smartest investors on Earth, the insurance investment community. I'm very happy to be joined today by Kris Kraus, Portfolio Manager and Co-head of Specialty Finance at PIMCO.

And today we're going to be talking about asset-backed lending and specialty finance. Kris, thanks for taking the time. Thanks for being on. We can't wait. You're our third PIMCO guest, and we've learned a bunch from the first two, and looking forward to this one.

Kris: Stewart, it's a pleasure. Thank you.

Stewart: So first, I want to get started the way we always do, which is, what town did you grow up in, what was your first job, not the fancy one, although sometimes the first ones are fancy from our guests, but mine was not, and what makes insurance asset management so cool?

Kris: Oh, wow. All right. No, it sounds good. And thank you, again. Thanks, again, for the time. I grew up in Northern California, in the heart of Silicon Valley, San Jose. My parents had moved from Iowa when my father took a teaching job. And so, it was a great place to grow up, and I spent the first 18 years of my life there, and I still get back from time to time.

Stewart: That's super cool. Did you have an illustrious beginning of your career there in Iowa as well as I did in Missouri?

Kris: Well, my first job, and at this point we're in San Jose, I was 12 years old, but I looked much older than I actually was, and I was able to take up a job at a local public golf course parking golf carts at the end of the day when people had finished their rounds. And for a 12-year-old, this was a dream job.

Stewart: That is a dream job. That's just what I was thinking. That's what I thought too. You get to drive those golf carts around by yourself?

Kris: Yeah.

Stewart: That's awesome.

Kris: You drive them around, you pick up the flags at the end of the night, and all that stuff. And I'm years away still from getting my license, but I got to drive something, so that was pretty cool. And on my days off I got to play golf for free. So that was another perk, and that's been a lifelong game of fun for me as well.

Stewart: That's great. And what do you think makes insurance asset management so cool? You guys run a bunch of money for a bunch of insurance companies and, obviously, your parents as well. And so what do you think is... I've always said this is the smartest money on Earth. I think that is due to the externalities that these folks have to deal with in addition to trying to discover strong relative value in an always-challenging capital market.

Kris: Yeah, that's a good question. I think, for myself, and I probably speak for the wider team as we think about insurance asset management, our client base is rightfully known for its stability, but it doesn't mean that the practice of managing money for them and how they manage their risk doesn't continue to evolve.

And I think it has been, as we think about private credit, and we're going to talk more about this, I guess, today, but I got a real direct first taste years ago. I'd been at PIMCO for a little while and we started working for a client, really in what you'd call an M&A context, doing a whole bunch of asset analysis and trying to design portfolios for what that company could look like on a pro forma basis.

And it was through that we began to realize that repositioning assets that were then on the balance sheet that maybe weren't providing the necessary yield, uplift, or return for a unit of credit risk, that by optimizing that there was a lot that could be gained for that client.

And clearly, in the ensuing years, this moving into private credit has been an exciting part of the market for investment managers. And we've taken much more of, I think, a solutions-provider approach as well. And where we sit today, the spread pickup, the clients are able to realize for that unit of credit risk, I think, is quite meaningful. So, there's a lot to play for in the market today.

Stewart: That's cool. And most people, everybody who knows me knows I'm a fixed income geek, and I'm thrilled to be talking about this today. So, asset-backed lending, which is sometimes referred to as specialty finance. I love the names we give these things. Specialty finance is a market that has grown rapidly since the GFC. It would be really helpful for me to understand and our listeners to understand how PIMCO defines this asset class, and really, to get a sense for the scale of that market.

Kris: So, as we think about specialty finance we're thinking about the world of private lending that sits outside the corporate market. We've seen, for many years now, the development of the private corporate direct lending market. And as we think about specialty finance, there's this very, very large world that sits outside of that that we've been active in. The form that that risk has taken has changed. Some of the risks that we work on, underwriting and managing on behalf of clients may have been originally developed years ago in a securitization market, but now, in the private markets, we may have better access to information.

People are looking to use alternatives to securitization as they seek to diversify their funding models, and so that's brought significant amount of risk, as we think about opportunity sets, into these markets for us. So, think about the world of residential credits, the entire consumer complex, from unsecured consumer lending, student loans, auto finance, solar loans, residential solar loans, which are very popular obviously in the world that we're in today, home improvement loans, another area that's seen significant growth.

But then you also have this whole world of non-consumer-related activities, which includes aviation finance that's an enormous market as you think about the growth there globally. There's a lot going on, obviously, in the world of data infrastructure and chip finance. Everyone's reading about AI and the enormous amount of investment required there. There's a very large world of equipment finance too. So there are many of these parts of the market, which actually we touch in our day-to-day lives in an effort to demystify them.

And so, there's a lot to play for. These are, depending upon how you want to measure it, it could be $40-plus trillion as we think about target-addressable markets that we're able to invest in, and they're just continuing to grow. So, there is a significant scale.

Stewart: Yeah, it just seems like there's just a bunch of opportunity. Just to give you a data point, so we were surveying the people who have registered for our symposium in June, and the top two topics were private credit and structured finance, ABS, esoteric finance, specialty finance. And that's why the timing of this podcast is particularly good.

It seems to be the topic de jure for every global allocator. What I'd like to get your take on is, why specialty finance is particularly interesting right now, and I think you just touched on that a little bit. But do you see this more as an opportunistic play that will wane over time, or do you think this asset class has got the kind of runway that I think it does?

Kris: I think it's more in the latter camp, from our perspective. And there are reasons for that. I think that there's, an intersection of several market forces in play right now, which is going to support more of that secular time horizon versus something that's more cyclical and could potentially wane.

When you think about post-GFC, we all knew that the world was going to be different. We knew that how banks, which had been the primary source of risk for ourselves and others, that their business model was going to change. The amount of capital that would be required to support trading books as well as risks that you would hold elsewhere within the institution, that that was going to change.

And we've seen that evolution with Basel, and now in the United States, we're talking about the Basel III Endgame, which has a sort of apocalyptic name to it, but it's something that, depending upon where that ultimately lands, institutions are going to have to further grapple with that, and we're now in 2024.
I think what's been arguably equally as acute or if not even more impactful for institutions has been on the accounting side, the advent of CECL, which is Current Expected Credit Loss, which has led to a material change in how institutions provision for losses in certain parts of their business.

So, years ago, prior to its implementation, you would essentially realize those losses, provision for that as they were being realized in real-time, or as it was blindingly obvious that you were going to take a loss on something, you would need to provision for that.

And that, I think, looking back on GFC, you had substantial levels of correlation across asset classes, and you had banks that arguably were not as well capitalized as they should have been, and there were these big hits to the capital base for institutions.

What CECL will do, and this CECL's now fully live as of January 1st 2023, is essentially see you provision for those expected losses today. So, in a book of risks that you have on balance sheet, as we go through an ever-changing economic cycle, those provision numbers will change and that can introduce volatility in the income statement, and you have to think more carefully, or even more carefully, about how you manage capital.

It also is impactful as you think about growth in various lending businesses where it's just inherent that there will be some measure of loss that you need to think more carefully about that. And so, you're seeing that play through, and in some cases that's leading to bank retrenchment in these markets.

And we've been knocking on these doors for 10-plus years now. This isn't necessarily something that's happening today, it's been happening for some time. But also too, you're seeing partnerships develop with banks. No one, certainly not PIMCO's calling for the death knell of banking, definitely not. There's a lot of highly profitable banks that do really good work for shareholders and customers, but you're seeing this growing need to develop partnerships with institutions such as ourselves where we can be an offtake for that type of risk, which helps them mitigate some of that provisioning volatility, helps them mitigate some of the capital volatility. And I think that's something that's going to develop in an even more significant way as we go forward in the world that we're in today.

So that's, again, going back to this, is this a near-term event that could wane over time, I think you're just seeing some fundamental changes in how the economy operates, who are the providers of credit to those in demand of credit, and I don't think we're going to look back. And there's this room to grow. And as we think about specialty finance alongside direct lending, borrow whatever metaphor you want, direct lending, whether that's in the 6th innings, 7th innings, people can debate, I think for specialty finance and for asset-based lending more broadly, we're much more at the beginning of the game, and there's just, I think, a lot of tailwinds to support this development.

Stewart: I think there's a strong case to be made that the liability profile of the insurance companies is far better suited to do this kind of lending than the banks that have overnight deposits with the FDIC backing them up to prevent a run on the bank, but insurance companies are beautifully suited for this, it seems. And based on... it seems to be working pretty well.

How would you characterize insurers' activity in this asset class post-GFC? We've talked a little bit about the banks reducing their footprint and looking for capital partners. How do you think about the insurance industry? If I'm somebody who hasn't yet made my entrance into specialty finance, talk to me about the relative value today versus back in the day versus what you think it is going forward.

Kris: I fully agree with your comment about insurance companies in many parts of this market are a natural home as you think about their business models. As you think about the need for, perhaps, in many cases for longer duration, it's a really good match in a lot of places, and that's obviously something we spent a lot of time on in terms of, from a sourcing and structuring perspective.

If I look back since the GFC, in the immediate period, from the depths of it in 2008 to probably 2012, obviously a lot was getting done in the mortgage space at that point in time, and more broadly with structured products.

And I think folks made a significant amount of money during that period of time coming out of the bottom. Then you had this move post-that for probably 2013 to 2017-type time period into more of the semi-liquid types of solutions that clients were seeking.

And since, this is just before COVID, I guess, a lot more getting done in the private lending part of the market, you saw the beginning of the rated note vehicles as a structural form for insurance companies to participate.

Stewart: It's interesting, I don't know, this just occurred to me, but as you think about insurance companies in the different food groups, PNC Life, Health, and then all the specialty underneath there, they all have a liability profile. Are there particular lines of business that line up with particular areas of specialty finance and private credit? I guess what I'm wondering is if you could say, "Oh, there's liability buckets." I'm wondering if there's a way to match or if there's some commonality with the type of insurer versus the investor that you're actually seeing?

Kris: I think the longer duration risk, and this takes you into areas' infrastructure, a lot of what gets done in the renewable space fits well with more of a life-insurance-type balance sheet. We tend to be more in the shorter duration part of the market for the PNC part of the market.

I think our activity up until very recently was probably more on the Life side as we think about sourcing risk for clients or folks looking to solve for both parts of their business, but we've also seen more recently coming out of the Bermuda Reinsurance community, where you have maybe more of a PNC-type focus, a need to, or at least a willingness, desire to see what they're able to do within private credit. So, liquidity can be a little bit more of a focus there, or making certain that we're at a shorter end of the duration spectrum.

Stewart: Big shout out to the Bermuda Insurance community. I'm going to be seeing those folks next week, so looking forward. Always nice to get to Bermuda, for sure. To many of our listeners, well, and me included, I know PIMCO as a very well-known, dominant global fixed-income manager with something on the order of $1.9 trillion of AUM. How and when did PIMCO develop this platform and the capabilities to invest in specialty finance?

Kris: Was there a bright line? I'd say no. We've been doing this as just part of our core portfolio management for well past my time here, and I joined the firm in 2010. Our CIO, Dan Ivascyn joined in 1998, but I think it's important to remember, our roots and our DNA coming out of the insurance community at our inception back in 1971 with Pacific Life, and more recently being owned by Allianz, insurance has just been part of our DNA since day one and continues today.

Fortunate to, again, I have been here for 14 years now, and I might be the newbie compared to some of my colleagues, but I think there's just a natural rhythm to how we operate through different cycles. We've been through different rate cycles, we've been through the GFC, which no one's going to forget anytime soon, and more recently, a pandemic. And I think that the firm's approach to relative value, obviously, where it's important for our clients to focus on liquidity, less so maybe with some of what we're doing on the insurance side, but it's certainly, for other clients, been an area of focus. All of that's just part of the approach that we've taken, that's been time-tested.

I would say that as part of this evolution, we're always looking to invest in the business. It's been a strong area of growth for us. So, as I look at the resources today, focused on specialty finance, we're organized around areas of subject matter expertise. So, you'll have individuals where they'll focus specifically on European residential credit, for example, or they'll focus specifically on private label student lending or residential solar finance. So it's important for those subject matter experts to be on top of their markets from a sourcing perspective, and that's an aspect that continues to change and evolve, obviously the underwriting, which is critical to getting the investment decision right, and then heavily involved in the asset management of that as we go forward.

I think too, that, again, with the view of there's been just this continued evolution to the team, which was led out of our New York office. That part's been absolutely critical for us.

And also, it makes risk management just a lot more seamless as you think about consistency that you have across investments, whether it's any type of financing associated with it. So, we're fortunate. We've always taken a data approach to our markets. There's been significant investments in analytics for many years. We try to remove as much of the bias in the investment process as we can and let the data and the analytics do a lot of the leading.

Again, as we think about data infrastructure, we think about private label student lending, there's a lot that we're focused on. And we just did a quarterly review in terms of Q1 activities with our counterparties, and we're now working with over 60 different non-bank-originating partners, where that could be through forward-flow or some other type of offtake arrangement where we're able to use just our size and scale to source risk for clients.

Stewart: That actually takes me right into my next question because deal flow is often a point of differentiation. And so, I'm curious to know, how does PIMCO source deals? It sounds like you're looking to take the role that banks played in some of these asset-backed verticals, but deal flow is really an important part of the game here. How does that happen at PIMCO?

Kris: So, if we go back, and again, we have to go back to right after GFC, when we knew that the rules of the game had changed and how we'd source risk, needed to expand beyond maybe traditional channels, and some of this was born almost out of necessity. Your post-GFC, the non-QM market really hadn't got going yet. No one really was yet sure how mortgage credit was going to be underwritten and securitized and financed.

And we took, I think, a meaningful role in developing that market because frankly, we needed that market to get going again, could be an offtake for what ultimately ended up being billions and millions of dollars of risk. As the markets have evolved, we've continued to take an approach to wearing much more of a sourcing hat in what we do, identifying sourcing partners who oftentimes are in the non-bank space, who are looking for a stable balance sheet, and one that can operate at scale.

And that's something that I think, even in my prior life when I would be trading on the other side of PIMCO, PIMCO is a stable provider of liquidity to the market in times of stress. And I think that we saw this too with the regional bank collapse and stress this time of year last year. I think a lot of non-bank originators of risk that were relying on regional banks to fund their businesses quickly realized they needed to come up with alternatives. And that's been an area where we've been able to step in a meaningful way in a number of asset classes to be that offtake for risk.

And even though some of that pressure has come off, you still see CFOs, treasurers, CEOs, boards wanting to diversify their funding model, and that's proven to be a fertile sourcing channel for us. I think there's a lot of talk about origination platforms and how owning origination platforms can be beneficial. We don't necessarily disagree with that view because we ourselves have taken ownership stakes in platforms, but I think our approach has oftentimes been led with a view of, do we actually find value in what it is that that origination platform produces, and would we be a buyer of that risk because we think that that's an indicator for whether or not there's support for the enterprise value of that company itself?

And so, as I think about what we've done in the mortgage space, I think about what we've done in the aviation finance space, it's oftentimes been through that lens of, we are looking for a higher quality originator or we're looking for more offtake, and owning or developing that business can be one way to achieve that. So, we're certainly open to it, but I think we've been perhaps less reliant on that as being the primary sourcing engine compared to the arrangement that we've been able to strike up in a forward flow context.

And I would say you continue to see, and this sometimes goes back to my comment at the beginning in terms of capital pressure and banks looking to generate, let's call it a lot more capital velocity, they want to be more in the moving business as opposed to the storage business. And just given our size and scale and ability to move quickly, we're oftentimes the first phone call for an institution looking to do something that can be relatively material. And we always appreciate those calls of course, and can work quickly to try and get to a commercial understanding. And that continues to be an important sourcing channel for us as well.

Stewart: My friends, my CIO buddies, let me put on the CIO hat just occasionally, just to try it on. I don't get to really pull any triggers, but this stems from that. So, if I am a CIO of an insurance company and I'm interested in accessing specialty finance with you, what are my options as far as, I mean, as you know well, how the form in which these assets come matters because it can have a material impact on the capital charges and the way that the ratings are assessed and so forth. So what are my options as far as being able to access this asset class?

Kris: We fully agree with the structuring, the packaging, that sensitivity and adherence to the criteria that the insurance company needs to meet or satisfy is top of the list as we think about anything that we do. And those are active discussions. And as we go forward in the management of that, you're having regular pipeline calls with the client.

They appreciate the heads-up as to where you're seeing opportunities, what's going on in the market overall, how you're positioning risk. Oftentimes there can be sensitivities around fixed rate versus floating rate, and obviously you need to stay well within the lines associated with that, but we're providing color to the clients in that context.

Rated notes, as I mentioned before, have really become a popular form for insurance companies to invest . So, as we think about the specific finance market and strategies associated with that. And sometimes too, that can take you into rated notes. That continues to be a key area. We do continue to see that, and that's obviously been a long-standing forum for clients to utilize as a form of participation.

Stewart: And so, when I mentioned that the two top topics were private credit and structural ABS, insurance companies have expanded their allocations to both IG and non-IG private credit with rates at the highest level since 2007. What should the insurers be prioritizing when they're looking for a specialty finance partner?

Kris: I think it's important that you work with a partner who understands how insurance companies work. This may seem obvious, but if you as an investment manager have historically been focused on other types of clients, and you want to essentially helicopter into investing on behalf of insurance companies, it's a pretty steep learning curve. And we're fortunate, insurance has been part of PIMCO's DNA for over five decades and continues to be today under Allianz's ownership, with whom we work very, very closely. So, we appreciate that relationship, we appreciate the attention to details.

You think about reporting, the infrastructure that goes into reporting, the timeliness of that, clearly understanding clients' objectives, and that's why we've, for years, had dedicated resources across portfolio and client management. I think you have to take that approach. That's led to us now, I'm just checking the numbers, we're managing over $450 billion in global insurance assets today across a wide range of clients. But some of it, as I look in working with my colleagues on the team, communication's key. I think people really appreciate, what are you seeing in the market today, how is it changing? Sometimes you'll see these imbalances that exist between private markets and public markets. And we've seen public markets get off to a relatively fast start in the first quarter, and spreads have been pretty tight for similar levels of risk.

So I think having a partner who has a large footprint in both private markets and public markets, just thinking about relative value, is certainly important. And I think, as well, you want to try to avoid... we've taken a view of trying to avoid conflicts. And by that I mean sourcing risks that might come from some other part of PIMCO that you're then plugging into a portfolio. I think sometimes, and rightfully so, that can catch the attention of clients. And so, we're doing it in a way that isn't introducing conflicts, that touch some other part of PIMCO or some portfolio company that we hold. I think we try and do it on a clean, objective basis.

Stewart: I really appreciate that. I've gotten quite an education today on specialty finance, and I really appreciate it, Kris. And I know our audience does too. I've got a couple of fun ones for you out the door, if you'll engage me. And we always said, there's optionality. You can take either of these, or both. Most of our guests take both, no pressure.

First is, what's a good piece of advice that you've gotten along the way that you'd care to pass along to our listeners? And the second one is, if you could have lunch with anybody alive or dead, who would it be? It doesn't have to be just one person, but it could be-

Kris: These are good.

Stewart: Yeah.

Kris: I think I want to have lunch with-

Stewart: The people say, "I love your podcast." I don't think they care about the middle part. They just want to hear the beginning and the end.

Kris: Good advice, someone said this to me years ago, always try to hire people that are smarter than you.

Stewart: Yeah.

Kris: It gives your team, it gives your business more operational leverage. So definitely try to hire people that are smarter than you. And probably try to get out of the way a bit. That would be the career advice. Question on-

Stewart: I'll take it. That's good advice. I'll take that advice.

Kris: ... lunch topic. All right. As a lunch date, yeah, I've been enjoying this Walter Isaacson book marathon, and his books, I think, average, I don't know, 900 pages or something. And a lot of them focus on the inventors; Elon Musk most recently, Steve Jobs, Da Vinci, and others. I think Steve Jobs would be pretty cool.

When you think about people who have transformed how we as a society function, he's got to be at or near the top of the list. And I was watching, again, recently, his 2005 commencement speech at Stanford, which I definitely recommend people checking out, quick 15 minutes, three stories that he tells that can really serve as an inspiration for people. So, he'd probably be the lunch one.

Stewart: Wow, that's great. I really appreciate you being on. It's been a pleasure and a great education. We've been joined today by Kris Kraus, Portfolio Manager and Co-head of Specialty Finance at PIMCO. Kris, thanks so much for taking the time.

Kris: Appreciate it, sir. Thank you.

Stewart: Thanks for listening. If you have ideas for podcasts, please shoot me a note at Stewart@insuranceAUM.com. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.