Antares Capital

The Magnetic Power of Private Credit:

Attracting Insurance Investors with Stability and Returns

Private credit, here defined as corporate direct lending, is an asset class that we have seen grow rapidly in the last few years for many types of institutional investors. For insurance companies, in particular, the asset allocation decision makers for the general accounts had already increasingly turned their attention to alternatives in the prolonged low-yield environment prior to 2022. In the last two years with rapidly rising rates, private credit has emerged as an attractive asset class that fits well into the overall investment portfolio. In fact, multiple insurance investor surveys conducted in 2023 have mentioned private credit as one of the top asset classes that insurers are looking to grow[1]. Given life insurers' sensitivity to the asset risk component of risk-based capital, exposures to private credit are frequently structured in a capital efficient manner. Later in this piece, we discuss some of the common structures for insurance companies to access the private credit markets.

Why Private Credit for Insurers?

We will first take a deeper dive into some of the unique characteristics of private credit as an asset class that we think make it attractive for an insurance portfolio. Senior corporate direct lending, in particular, benefits from being high in the capital structure and typically strong covenants. We will also examine what we believe are the pros and cons of the various structures that an investor can use to access this asset class.

Characteristic	Description	Implications for Insurance Investors
Illiquidity Premium *Figure 1*	There exists an excess spread, referred to as "illiquidity premium," which is driven by the complexity involved in originating, underwriting and structuring private loans, as well as the non-traded nature of these loans. Such illiquidity premium can also persist over the syndicated loan market as well.	Higher spreads and yields allow for higher net investment incomes and more competitive product offerings (e.g., higher crediting rates on investment products such as fixed annuities). Life insurers with longer dated liabilities can afford such illiquidity on the asset side.
Loss Mitigation and higher capital structure *Figure 2*	Lenders have direct access to the company after the deal's inception and greater control over deal terms and structure, which can result in lower loss rates and higher recovery rates. Direct loans are collaterialized, senior in the capital structure and typically include strong covenants relative to liquid loans. Added protections come from the priority of repayments to lenders in a default scenario.	Lower expected default costs and fewer expected potential downgrades minimize risk for rating migrations (which can often lead to investment limit breaches from Investment Policy Statements or state regulators). More favorable results for internal or externally mandated stress tests.
Loan Valuations	Valuations methodologies focused on company credit fundamentals rather than shorter-term market volatility, smoothing the return profiles and lessening the market price volatility.	Less frequent and smoother price changes under both statutory and GAAP accounting.
Floating Rates	Loans have floating-rate coupons that increase in line with the underlying reference rate and conversely have contracted floors that offer protection as rates decline.	Suitable for property & casualty and health insurers that do not want to bear interest rate risk. It is also an effective inflation hedge as P&C and health insurers frequently have liabilities that are sensitive to inflation (e.g., workers compensation, personal lines in auto or home, etc). Another potential use of private credit for life insurers is for pure spread pickup from Federal Home Loan Bank borrowing.
Market Access and Diversification	Private credit can offer access to opportunities not available in public markets (e.g., direct lending) as well as asset-level diversification in market and borrower profiles.	Diversify against the rest of the portfolio which is primarily bonds issued by larger cap or public borrowers. As an example, the correlation between unlevered direct lending and US core bonds (which comprise a substantial part of the insurance portfolio) is 0.19.[2]
High Interest Income *Figure 3*	Direct lending offers high levels of coupon income.	Relatively high levels of interest cash flows from coupons to defease liability cash flows or fund operational needs.

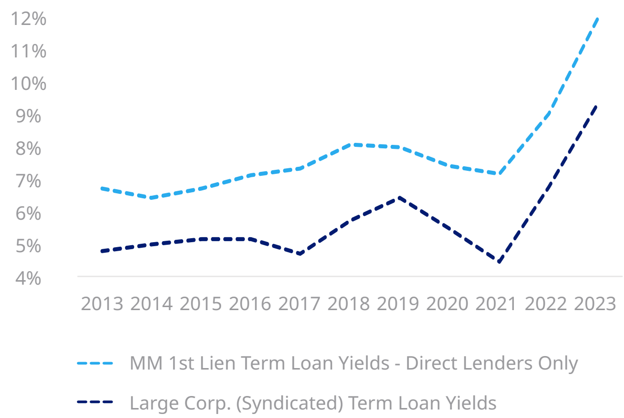
From an asset allocation perspective, an allocation to private credit can be framed in one of two ways:

- As part of the below investment-grade corporate bonds portfolio. Compared to high yield bonds, private credit (particularly senior direct loans) has lower average default loss due to strong covenants, less duration, and less liquidity. While syndicated loans, also known as leveraged loans, can benefit from many of the same structural protections as private credit, historical loss rates for the market have been higher.

- As part of the alternatives portfolio. Private credit is lower risk and return compared to private equity, with higher income, lower volatility, and better downside protection.

FIGURE 1

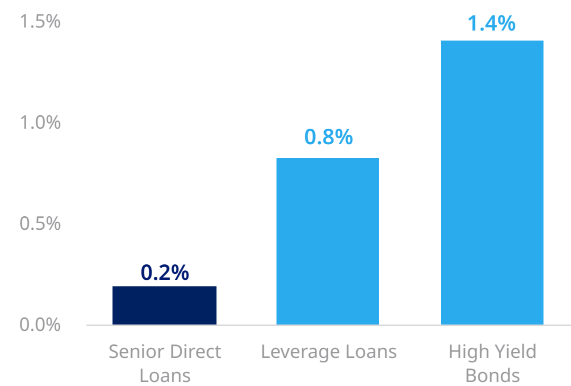
1st Lien Term Loan Yield Premium (3-Year)



Source: Refinitiv LPC data as of December 31, 2023

FIGURE 2

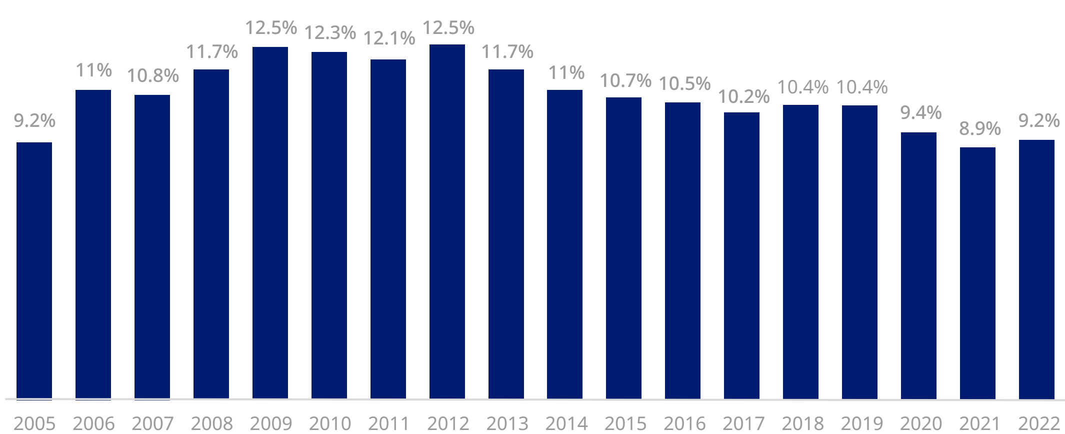
Average Annual Loss Rate (2011- 2022)



Source: Data from 2011 – 2022. Senior direct loans represented by Cliffwater LLC CDLI-S Unrealized Net Gains(Losses). Loss rates for leverage loans and high yield provided by Fitch.

FIGURE 3

Income Return of Cliffwater Direct Lending Index



Source: From Cliffwater 2023 Q3 Report on U.S. Direct Lending.

Note: Unless otherwise stated herein, the statements included in this whitepaper reflect Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially.

Historical Industry Trends

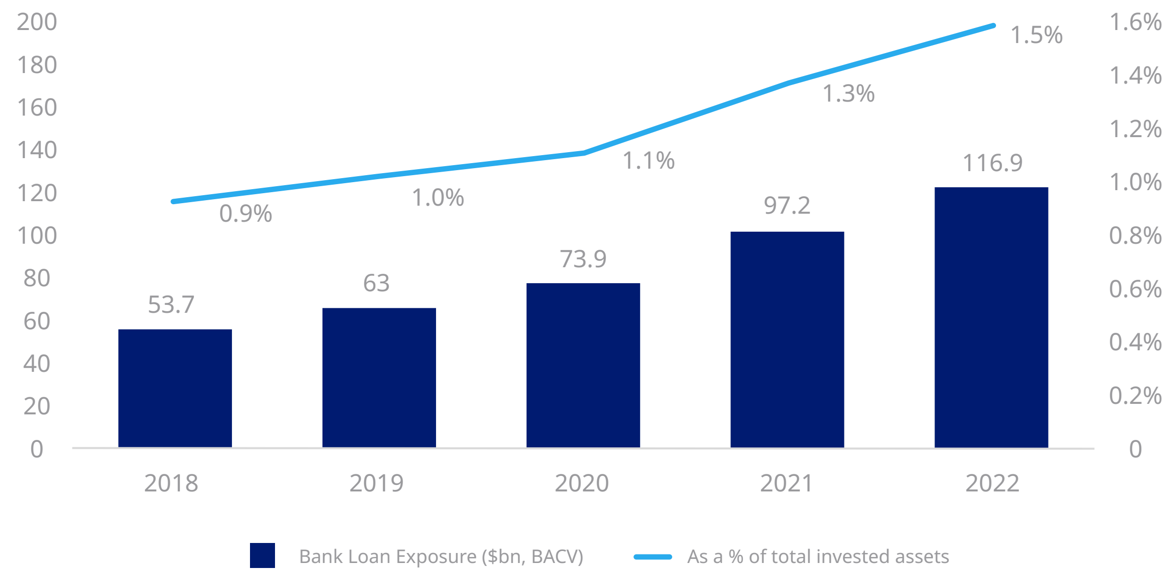
The allocation to private credit within insurance invested assets is difficult to track, but we can get a glimpse from the growth of two related asset classes: collateralized loan obligations (CLOs) and bank loans.

CLOs have collateral pools consisting of broadly syndicated loans (BSLs) or private credit loans. For US life insurers, CLO allocations have steadily increased from under 1% in 2013 to more than 3% as of 2022 year end[3]. Note that this would include both BSL CLOs and private credit CLOs.

Another indicator of increasing appetite for private credit is the growth of “bank loans”, which have been conveniently separated into its own category on Schedule D of the statutory statements since 2018. Note that “bank loans” are in quotes here because US insurers seem to be capturing both liquid credit and private credit loans in this category. Within the US insurance industry, bank loans increased by 32% from 2020 to 2021, and 21% from 2021 to 2022 (refer to Figure 4).[4]

FIGURE 4

US Insurers Bank Loans Exposure



Source: NAIC, S&P Capital, Antares Capital proprietary research

Structural Considerations

For an insurance investor, there are various ways to gain exposure to direct lending: such as through a separately managed account (SMA, or direct ownership of loans), comingled fund as an LP investor, CLO, or a Rated Note Feeder. There are structural, operational, accounting, regulatory capital and rating agency capital considerations to these choices:

Vehicle	Tradeoffs[5]	NAIC RBC Considerations	Est. RBC Charge (post-tax)	Other Considerations
Direct ownership of loans, such as in an SMA	• Higher degree customization as the asset manager can tailor the type of the loans to the investment mandate, allowing investor to have direct control • Can have higher administrative and operational burden as each loan is held directly on balance sheet • Distressed names would appear in watchlist and may result in rating migration and investment guideline breaches	• If the loans are unrated, they would incur the unrated C-1o bond charge • If the loans are rated through a private letter rating ("PLR"), then the C-1o charge corresponding to the eligible NRSRO rating will be incurred. However, there is regulatory uncertainty as to Securities Valuation Office's discretion over NRSRO ratings • Note that for liquid credit loans, the vast majority of them already have public ratings	• 7.9% C-1o if rated B- • 23.7% C-1o if unrated	Under S&P capital, in the latest proposal for revised criteria, unrated loans of Category 1 with US economic risk is treated as BB (rather than D, for example)
Commingled non-SEC registered funds	• Easier administration and operational burden as it appears as a single line item on balance sheet • Little to no degree of customization as all LP investors have the same exposures	• This would fall under Schedule BA which would lead to an unrated bond charge by default, unless the fund has obtained an SVO designation	• 23.7% C-1o	For an US insurer, this would appear on Schedule BA
CLOs	• Can purchase different tranches with various degrees of credit enhancement through subordination • Highly diversified exposure in the collateral pool • Operationally easier to hold tranches of instead of individual loans • Debt tranches may provide more liquidity than holding the loans • Structuring costs would be incurred, although likely lower than other forms of costs • Composition of the collateral pool is to the discretion of the CLO manager(s)	• CLOs have become modeled securities and there is an ongoing CLO project to revise its C-1o charges. Current project focuses on BSL CLOs, but PC CLOs are to follow • Residual tranche are likely to receive higher capital charges in 2024 • NAIC CLO project would result in new capital charges in 2025 and beyond	• Varies by tranches. If vertical slice: 3.3% C-1o, as of 2023* • Up to 4.7% in 2024* • TBD in 2025 and beyond	For US insurers, need to be cognizant of foreign issuer limits from state regulations as most CLOs are domiciled in the Cayman Islands or Jersey

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Vehicle	Tradeoffs[5]	NAIC RBC Considerations	Est. RBC Charge (post-tax)	Other Considerations
Rated note feeder funds	• Similar operational and administrative ease to CLOs • Only unrated tranche will consume Below-IG investment limit • Additional capital efficiency vs. other vehicles • Structuring costs would be incurred, although likely lower than other forms of costs	• Residual tranches are likely to receive higher capital charges in 2024 • Similar to private credit CLOs. NAIC CLO project will be broadened to ABS creating regulatory uncertainty	• 5.6% C-1o, as of 2023** • Up to 7.9% in 2024**	Conversion to IG tranches leads to an efficient way to reduce consumption of below-IG and Schedule BA investment limits

Estimated RBC charges do not take into account covariance benefits in the RBC formula, which would vary by company.

**Assuming 59% AAA, 12% AA, 7% A, 6% BBB-, 6% BB-, and 12% unrated tranche. 2024 capital charges are subject to change, and residual tranche capital charges may flow through C-1cs (which may further benefit from covariance effect).*

***Assuming 80% BBB and 20% unrated tranche. Residual tranche charges may flow through C-1cs.*

In recent years, the need for capital efficiency under the NAIC RBC framework has given rise to more structuring solutions such as rated note feeders (included in the table above) or collateralized fund obligations (CFOs), which provide many of the same economic benefits as CLOs. While they have garnered increased regulatory scrutiny from the NAIC, it appears that if the underlying collateral consists entirely of private credit loans, and that the cash flow profiles satisfy certain qualitative criteria, the rated tranches of such structure will likely qualify as bonds – ABS, and continue to be reported on Schedule D. There is a longer-term project of evaluating new C-1 charges for ABS, so it remains to be seen how the capital efficiency of such instruments will be affected.

Concluding Thoughts

In summary, Antares believes that private credit – especially senior secured direct lending, should be an integral part of many insurers' portfolios. Implementing its allocation would require thoughtfulness around investment vehicle, manager selection, and relevant capital and regulatory considerations.

For more information, please contact InsuranceSolutions@antares.com.

Sources:

1. Surveys include Goldman Sachs Asset Management Insurance Survey 2023, BlackRock 2023 Global Insurance Report, Mercer 2023 Global Insurers Investment Survey, Clearwater Analytics 2023 Insurance Investment Outsourcing Report, Milliman's 2023 Illiquid Asset Survey

2. From Exhibits 21.2 of Nesbitt's Private Debt: Yield, Safety, and the Emergence of Alternative Lending, 2nd Edition. This figure is derived from direct historical returns data for public asset classes and unsmoothed historical data for private asset classes.

3. C1 Work Group (C1WG) Presentation to the Risk-Based Capital Investment Risk and Evaluation Working Group (RBCIRE WG) on Collateralized Loan Obligations (CLOs)—Status Update, Dec 2022

4. NAIC Capital Markets Special Report: Another Year of Double-Digit Growth in U.S. Insurers' Bank Loan Exposure in 2022 https://content.naic.org/sites/default/files/capital-markets-special-reports-bankloans-ye2022.pdf

5. Potential tradeoffs for the various investment vehicles are included in the table, but are not limited to those listed

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