MONROE CAPITAL

Mutual Attraction: Making Sense of the Private Capital and Insurance Pairings

Insurers have the assets and alternative managers have the strategies to do more with that capital, which is reshaping the prevailing approach to investments across the broader insurance landscape.

Asset managers, historically, have been enamored with insurance companies. The steady migration of insurance balance sheet assets to higher yielding, less liquid strategies has brought to the forefront the rise of strategic alternative managers focused on the insurance sector. The recent seemingly feverish activity, however, represents something of an upward shift from past interest in the space. Alternative managers, in particular, are targeting insurance assets with more than just fund commitments, in some cases they are using their own balance sheet capital to merge with insurers to access permanent sources of capital.

In fact, in the decade following the GFC, AM Best calculated that PE-backed insurance assets have grown nearly tenfold, from $67.4 billion in 2011 to $604 billion in 2020, and today represents approximately 7.5% of the total admitted assets held across the broader life/annuity insurance industry.

Due to the persistent low-rate environment and the finite opportunities to deploy capital in higher yielding assets, there have been a substantial number of deals with managers that have specific private markets capabilities. These deals, to be sure, are creating a ripple effect across the broader insurance landscape. There is undoubtedly a greater focus to optimize the investment performance across the general and surplus portfolios to, both, meet future liability cash flows and also generate growth that either improves profitability or can be reinvested into the expansion of the enterprise.

The challenge, as most insurers well know, is that investment strategies are beholden to onerous constraints, regulatory, and otherwise. These hurdles require experience and expertise to navigate and manage mandates based on unique specifications. The Insurance CIOs and investment teams that manage general and surplus portfolios want managers that can work collaboratively, implement investment themes, and generate a compelling premium to public markets.

A MORE TAILORED APPROACH REQUIRED

If there's a distinguishing feature across most insurance investors it's that by and large their allocations to alternative products tend to be far more fixed-income oriented than most traditional asset owners. This is generally the case, at least, for assets that reside outside of their traditional employee pensions. Private credit, in particular, tends to have similar characteristics to traditional fixed income. The advantageous yield attributes and generally suitable risk characteristics are often an ideal fit for insurers to meet liability profiles. As a result, allocations to private debt have grown considerably over the past decade, from less than one percent 10 years ago to as much as 15% to 20% of an overall allocation today.

However, most insurers have unique requirements to satisfy their specific portfolio needs. And for fund managers who've been able to gain traction in the insurance segment, the common thread across their client relationships is the ability to satisfy the requisite customization needed to accommodate the investment criteria that can be quite disparate across insurer type and regulatory regime. Life insurance providers are writing policies that may extend out 30 to 40 years, and thus tend to necessitate investment guidelines with longer-duration benchmarks. Property/casualty insurers, on the other hand, tend to have shorter liabilities, which call for shorter- to intermediate-duration products.

No-to-mention that beyond just the very specific investment needs of each insurance entity, there is also no shortage of other, more administrative considerations that can present burdensome obstacles for fund managers new to the insurance space. These can range from nuanced reporting requirements, NAIC guidelines, state regulatory codes, tax guidance, capital constraints and rating agency considerations.

PRIVATE MARKETS – PLAYING THE SPREAD

Among insurance-focused asset managers, the draw of the insurance assets is the potential for a dynamic asset allocation and risk management implementation across large pools of capital. Given the appropriate opportunity, managers that can offer unique investment capabilities, that generate excess spreads, have become integral to the overall investment strategy. Insurers have become very comfortable with directly originated debt and other private market asset as a means to exceed cash flow demands and return expectations. The target result is to achieve better outcomes with lower volatility, while effectively managing risk exposures.

These opportunities, however, are generally confined to asset managers that have the expertise and acumen to consistently uncover idiosyncratic risk/return profiles that outperform across multiple market cycles. Insurers, for the most part, have a long-term time horizon that is generally conservative in nature. It has taken them several years to fully embrace these investment themes and thus manager selection and partnerships tend to be longer, more involved consultations. Therefore, the ability of a fund manager to solely generate yield is, often times, just the starting point, experience and awareness around each institution's nuanced needs is critical.

Given both the regulatory environment and emphasis around effective risk and capital management, plain vanilla fund structures rarely meet the particular needs of insurers. Asset managers, instead, must consider the regulatory regime, liability cash flows, yield expectations, duration, as well as the anticipated tax impacts before they even begin to discuss objectives around risk-adjusted returns.

Again, each insurance company may have very distinct needs. A property/casualty insurer is going to have a liability profile that's far different than the typical life insurer. This isn't news to anybody. But as a result, they may be seeking higher returns and shorter durations, but also require an SPV that provides the appropriate collateral – and credit rating – to check all of the required boxes before they can make a commitment. Having flexibility on structure, underlying exposure and vehicle domicile has become more critical to achieve the optimal solution, particularly, when it comes to private debt strategies. Providing an array of deployment options has become more important for alternative managers to satisfy insurance companies' investment constraints. The need for structured solutions has become more prevalent. They can sometimes provide the pathway to realize the most appropriate construct for an insurer. The ability to design a debt framework to achieve investment grade ratings alongside additional subordination is sometimes necessary to achieve the most efficient use of capital.

THE APPEAL OF THE LOWER MIDDLE MARKET

Insurers, especially today, have limited avenues to deploy large asset pools that satisfy their yield and risk-based capital objectives. This creates an added challenge when it comes to finding strategies and vehicles able to accommodate sizable commitments that also deliver duration flexibility, consistent yields, and adequate alpha to offset the lack of liquidity that may be associated with private debt. The lower middle market loan space stands out as a less-efficient, easy-to-digest alternative where premium yields are still available and will be for the foreseeable future.

The diversification attributes inherent to this segment of the market are considerable. Risk management through diversification is not only feasible at the asset class level as part of a larger private debt allocation, but also across borrower profiles (including sponsored- and non-sponsored credits); different types of debt facilities, from cash flow and ABL to opportunistic credits; and across industries with defensible market positions.

Not to be overlooked, the barriers to entry in the lower middle market tend to be higher than other segments across the lender landscape. Success in this segment requires a robust origination platform to source hundreds of deals each year, a deep underwriting skillset able to de-risk smaller assets, particularly for credits outside of the sponsor universe that offer very attractive yields, and deep structuring expertise, which is a prerequisite for insurance LPs.

Of course, this isn't necessarily news to CIOs well versed in private credit. In fact, Monroe has received interest from an insurer to be the cornerstone LP of a dedicated software and technology strategy to leverage its expertise in the technology space. This is further validation that prospective investors are not only keen to increase their exposures to the asset class but continue to seek out more influential roles within the funds they back.

Insurers didn't necessarily come to the realization overnight that their assets could generate better performance.
It reflects an accelerated maturation among asset managers to navigate the structural complexities that previously impeded the material integration of these types of investments. Asset managers have evolved and have shown the foresight to create and deliver customized strategies specifically tailored to the disparate requirements of the insurers they aim serve.

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