PGIM
MULTI-ASSET SOLUTIONS

NAVIGATING THE NEXUS PART II:

THE INTERSECTION OF INSURANCE AND ASSET MANAGEMENT

Private Credit is Defining the Intersection of Insurance and Asset Management

Insurers have always played a meaningful role in how private credit has evolved over at least the last 100 years. But their appetite for private credit has grown significantly and this is having a profound impact both on insurers and asset managers, drawing the two industries ever closer together.

One factor underpinning this trend is that private credit has expanded significantly to fill a gap left by banks retrenching over the last decade and a half.

Another is that, as private credit has grown, the line between it and public credit has increasingly blurred. Indeed, much of the growth in private credit has been direct lending to larger companies that have migrated from public markets.
Both factors mean that private credit is a much larger investment proposition for insurers than in the past.

But private credit has always been a natural fit for insurers, with long-term, relatively illiquid liabilities making for a much more natural match for the illiquid nature of private credit than banks with their less stable deposits.

The early pioneers of the insurance industry understood that investing policyholders' premiums ('deposits') in illiquid asset classes like private credit made sense because the promise of payment made to their policyholders are specific and a long way into the future.

Insurers earn a premium in return for illiquidity which helps them provide better pricing and ultimately be more competitive. Meanwhile, the range of long-term liabilities that insurers have provides the ideal source of funding for private credit, and their long-term nature mean insurers' investments in private credit tend to be stable. The suitability of insurance capital for private credit, and its 'stickiness', are key reasons why asset managers are drawn to insurers.

This simple, powerful alignment of interests is central to the relationship between insurers and private credit, and it is the primary reason why insurers and asset managers are being drawn to one another.

A more recent desire to generate higher returns and achieve greater capital efficiency has added to the magnetism between insurers and private credit. As private credit has grown and expanded, the marriage between the two has only become closer and the asset class is increasingly critical to the commercial success of both insurers and asset managers.

Tread Carefully

But marrying insurance capital and private credit is not straightforward. It is critical to understand the possible implications for liquidity management, pricing transparency and risk management, as well as the emerging opportunities.

The lynchpin of insurance investment strategies is asset-liability management (ALM) - the coordination between investing in appropriate assets based on the specific nature of the liabilities. Getting this right has to be the singular endeavor of both insurer and asset manager.

To be relevant, managers need to understand liabilities and have scale across the credit spectrum. Private assets including asset-based financing (ABF) and direct lending are typically shorter in duration and often floating, which means investing in them to access better yield should be complemented with allocations to more liquid and longer-duration assets, including interest rate derivatives to mitigate ALM risk. Moreover, robust credit monitoring capabilities help ensure early identification of potential issues, while building sector and geographic diversification into the portfolio mitigates concentration risk. Correlation analysis with existing portfolio exposures supports optimal construction as well.

Given the changes in strategic asset allocations among insurers and related shifts in market dynamics, regular liquidity stress testing and adequate liquidity buffers can help portfolios seek resilience under possible adverse scenarios that may develop. Moreover, detailed contingency funding can provide a framework for addressing potential market disruptions and mitigate the risk of being a forced seller in the secondary market at less favorable exit points.

Effective ALM should consider the cash-flow profile of the liabilities and seek to address liquidity, interest rate, and other risks through both portfolio construction and well-designed hedging strategies. For insurers with sufficient liquidity tolerance, private ABF may offer an additional yield source with spreads that could contribute to potential returns.

Asset managers equally need to excel at origination in order to provide the right opportunity set for insurers. Specifically, they need to originate a large volume of high-quality, diverse credits, while capturing healthy illiquidity premiums as a source of added value to support insurance product pricing. They also need to consistently source and manage these illiquid assets through credit cycles by repeatedly finding deals, underwriting them and managing them at the back end. Repetition is key.

The ability to operate at scale across both public and private credit is also critical. As the line between public and private blurs, companies are increasingly moving between both to meet their financing needs. Credit investors need to move with them and use their expertise in public credit to complement what they are able to achieve in private markets, or vice versa.

Not Just an Entrée, But the Whole Menu

For insurers (and other investors), private credit is too often thought of as an item on a menu, but the varied characteristics of the asset class make it more like an entire menu. There has been explosive growth in large-cap direct lending, for instance, but an investor who considers that their entire private credit allocation is missing the whole picture. There is extraordinary diversity and much more complexity than the one-liner of 'private credit', including significant, high-value opportunities in the middle market such as in infrastructure debt, direct lending, mezzanine, credit secondaries and investment grade debt as well as private asset-based financing, and private commercial mortgage loans.

Opportunity, Not Without Challenges

The current uncertainty in financial markets only serves to highlight why getting the marriage of insurance capital and private credit right is so important.

As they have for a century or more, insurers will prove to be a stable source of capital for private credit through this period because they do not have immediate liquidity needs that must be met from illiquid investments. But success will hinge on ironclad ALM, particularly if we are in the foothills of a credit cycle. Additionally, the asset managers who succeed will be those who are able to repeatedly find, underwrite and manage illiquid credit, and move deftly across public and private markets to meet companies where there financing needs are.

Finding Expertise in the Middle-Market

The $80 trillion global credit market is rapidly expanding in support of broader global economic growth, replacing financing that has historically been provided by commercial banks. The expansion of the asset class is happening across many industrial and consumer sectors of the economy but also into new segments and will continue to grow as the line between public and private credit blurs further.

Even with this private/public convergence, an important fundamental relationship remains between access, complexity and illiquidity relative to return. The importance of this relationship is particularly evident in the middle market, for example, which offers investors premium yields relative to larger market segments, portfolio diversification through access to unique issuers, and risk mitigation features from carefully structured covenants on the loans.

However, true middle-market expertise isn't easy to find; it requires long-standing relationships with businesses and an origination network deep enough to source credit assets across the globe consistently over time. By having a local presence and strong relationships with owners and management teams, managers can achieve attractive pricing and terms that work together to provide long-term value for investors.

In addition, given the illiquid nature of private credit, having the experience of working through challenging situations to maximize value is important. And while there are attractive economics to be earned in this market, a credit manager must be able to originate, underwrite, and then manage these loans through credit cycles to deliver for their investors.

The middle market presents significant opportunities, and asset managers with broad, established origination networks and significant experience underwriting and managing these illiquid assets may be better positioned to seek competitive returns and consistent deployment for investors over time.

The ABF Opportunity

Private asset-based finance (ABF) spans a wide range of sub sectors, including mortgage, consumer, commercial, and fund finance. Investors with a tolerance for less liquidity may seek additional yield and diversification through these investments, with underlying assets within varied sectors, generally up in quality, and potentially offering competitive risk-adjusted returns versus other comparable fixed income sectors.

Growth within the space has been driven by the secular retrenchment of banks, mainly as a result of increased regulatory capital pressures, along with the increased appetite of large asset managers, particularly those with expertise and scale within structured credit, and frequently, deep pockets of insurance capital.

Scale within the asset class is a barrier to entry as transactions are often large, structurally complex and resource intensive. Asset managers with capabilities across both public and private markets have a sourcing advantage as they can deliver more holistic financing solutions to end borrowers.

Structuring is often a necessary evil in many private ABF transactions. Through the structuring of these assets, ABF can become a bespoke option for insurers seeking a tailored credit strategy, while also delivering stronger covenants that create downside protection — particularly useful in an uncertain business and macro environment. As lending competition intensifies and spreads compress, investors may be able to identify appealing ABF investments by taking a bottom-up approach and leveraging big data in risk assessments.

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