

Sub-investment grade private debt investment opportunities for life insurers under Solvency UK reform

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Executive Summary

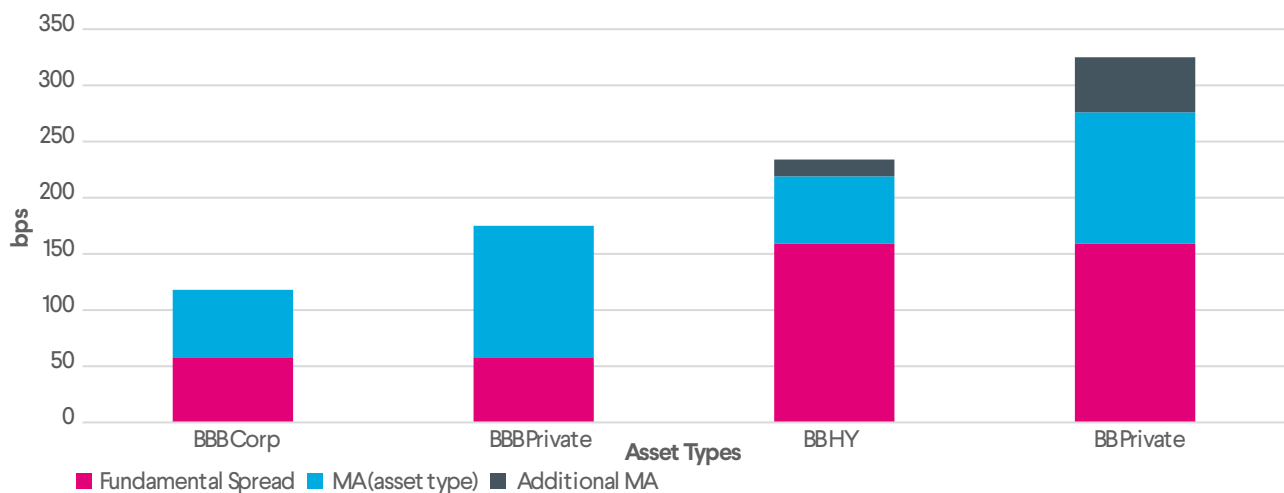
The recent Solvency UK reforms have removed barriers on the ability of UK life insurers to benefit from investing in sub-investment grade (SIG) assets. In particular, the Prudential Regulation Authority (PRA) policy statement PS10/24, published on 6 June 2024, sets out changes to the Matching Adjustment (MA) framework. This included the removal of the cap on the MA that may be claimed from individual SIG assets, allowing firms to benefit from any additional risk-adjusted spread available on SIG assets.

This whitepaper is primarily focussed on private debt with a credit rating of BB, i.e., those at the highest credit-quality end of SIG (BB, B, CCC etc.) assets. These opportunities are already utilised by those insurers who do not have to be concerned with the UK’s MA regulations, albeit they also face many of the other challenges covered in this whitepaper. Until now, MA insurers’ holdings of BB-rated private debt tend to be “fallen angels” - investments bought as investment grade that subsequently downgrade to sub-investment grade.

The so-called ‘BBB cliff-edge’ was a feature of the MA framework that disincentivised investment by annuity providers in SIG assets. The cliff-edge ensured that the MA benefit from SIG assets didn’t exceed the MA benefit that would arise on a BBB-rated asset with the same characteristics. This, and the fact that SIG assets will incur a higher capital charge than investment-grade (IG) equivalents, has contributed to MA firms largely avoiding SIG assets since the introduction of Solvency II in 2016.

With the removal of the cap, MA firms should now be considering the opportunities that this brings. In particular, how an allocation to lower rated assets can be complementary to their wider asset strategy, subject to compliance with the Prudent Person Principle and regulatory guidance¹. This could include both SIG assets and increasing allocations to BBB/BBB- assets where the impact (related to the cliff-edge effect) of a future downgrade may have previously made investment unattractive.

Chart 1: MA and Fundamental Spread for BBB and BB rated assets with 10-year maturity



Note: The data used in this chart is illustrative and based on estimated spreads. These estimates are for informational purposes only and are subject to change. They should not be relied upon as precise values or predictions.

¹Paragraph 7.13A of SS7/18 sets out PRA expectations for firms investing in SIG assets

As shown in Chart 1, we used GBP non-financial BBB corporate bonds, BBB private assets, BB high-yield index (i.e. BB public corporates), and BB private assets to illustrate the impact of the MA cap removal. The potential additional MA benefit (dark grey) resulting from the removal of the BBB cap becomes noticeable at the BB high-yield index level and is even more pronounced for BB private assets.

The UK Government sees the removal of this feature as one of the keys to encouraging investment in new and innovative asset classes close to and below the boundary between IG and SIG assets. The purpose of this whitepaper is to explore the opportunities available to UK insurers wishing to invest in such assets in their MA portfolios, along with a selection of additional considerations that such investments might require.

The changes to the MA framework also removed the existing requirement for MA assets to have fixed cashflows, meaning insurers will be allowed to hold assets which have highly predictable cashflows (HP assets). Such assets must have contractual bounds on both the cashflow timing and amount while meeting all other existing MA eligibility requirements. There is a limit on the total proportion of MA benefit that can be attributed to them, which effectively limits the total proportion of HP assets in the MA portfolio. The further investment flexibility offered by allowing investment into HP assets may also help in accessing SIG assets, including assets further down the credit rating curve such as B-rated assets.

Including an allocation to BB rated private debt within an MA portfolio can offer higher yields, which has the potential to be more than sufficient to compensate for the higher risk associated with the investments. Other benefits may include:

- Offering greater asset diversification
- Enhancing the ability to influence a financing structure (including legal protections and potentially security for instance the nature of covenants)
- Access to a wider range of ESG focused assets

However, in order to invest in SIG assets UK insurers will need to ensure they are able to meet additional requirements, in particular considering the Prudent Person Principle, additional risk management, higher expected defaults, stakeholder management, derivation of MA benefit, investment strategy, capital requirements, and legal and contractual matters. Underpinning these requirements are limitations in data availability, a lack of specialist SIG asset expertise, non-traditional risk profiles, and the potential volatility of asset value and credit rating.

These requirements can be addressed through:

- Leveraging and developing existing skillsets, available data and external resources and funds to bridge skills, knowledge and data gaps
- Performing stress and scenario testing
- Implementing robust risk management frameworks around SIG assets
- Engaging with stakeholders to explain updated strategy, performance metrics and risk management



Investing in SIG (BB) private debt

BB Investment

Given the importance that has traditionally been placed on an IG rating, insurers are naturally more nervous of the risk associated with venturing into BB-rated debt.

However, BB-rated credit does not always mean low or poor investment quality. It can be (and for some investors already is) a key part of investment strategies focussed on balancing risk and reward, particularly in portfolios that seek to enhance yield while managing capital preservation for long-term liabilities.

Diversifying with BB investment can help insurers to:

- Increase portfolio diversification, which might strengthen economic resilience, by using all of the core asset class components that constitute 'Private Credit' (corporates, infrastructure, real estate and alternatives – **and, to note, we define Private Credit as including IG and BB credit categories, which is different to some market parlance that classifies it as B (or below) focused.**
- Invest more selectively by accessing a broader landscape of opportunity, which provides for a better understanding of relative issuer strength
- Access opportunities which should benefit from long term structural trends
- Build long-term relationships with issuers

A key reason for looking at BB-rated private credit issuers is to identify those that have strong financial profiles but might be considered SIG largely because of other specific reasons. There is often a trade-off between financial risk and business risk. If a company's business risk is comparable to that of IG assets—meaning it operates in a stable industry with strong reliable earnings—investors might be willing to accept additional financial risk, such as structural sub-ordination or lower debt service ratio. This approach allows investors to invest in companies with solid business fundamentals while potentially achieving higher returns due to the higher financial risk.

Diversification Benefit

BB-rated private credit can be highly complementary to IG investments - from asset class, sector and issuer perspectives.

- **Asset class** – provides access to credit assets not available in public bond markets, including corporate, real estate, infrastructure and alternative investments.
- **Sector** – a wider array of sector investment potential than public bonds, including the above-mentioned asset classes, and can include less mature but valuable sectors such as healthcare, clean energy, and digital infrastructure.
- **Issuer** – public debt markets are typically dominated by large, well-established companies, whereas BB private credit issuers include the complete size range, from the largest international businesses through small-to-mid-size companies.

Funding

BB-rated borrowers have historically relied on banks for their funding, with selective institutional capital support (often from local lending institutions). However, there is significant demand for greater institutional investment to diversify capital/liquidity sources, particularly for larger scale and longer-term funding that will complement bank financing. Due to borrower size, issuing public bonds might not be a practical option.

The Asset Management division of L&G provides the following high-level estimate of the UK and European SIG market (outstanding size), indicating that the BB private credit market is sizable:

- **Infrastructure** – We estimate that the UK and European BB market is approximately £35-45bn in size, comprising areas that can have a real environmental impact, such as renewables, heating, battery storage and carbon capture. From a social perspective, there are growing areas such as last-mile networks², data centres and related storage.
- **Alternative** – The ‘Alternatives’ asset class incorporates many sub-sectors, including (among others) securitised assets, speciality and trade finance, and we believe totals approximately c£1.2tn (largely USD issuance followed by EUR, then GBP).
- **Corporate** – In the vanilla (non-structured) Corporate space, we estimate the UK and European BB institutional market to be approximately £15-20bn equivalent, with EUR issuance driving this figure. This includes financings undertaken in private placements (PPs) form, and financings that might include both institutions and banks. As one moves down the credit spectrum to single B and lower-rated credits (so called ‘direct lending’), floating-rate financing becomes more prevalent.
- **Real Estate** – The UK sub-investment grade lending market is approximately £50-60bn in size, covering a range of sectors from living (residential, BTR, PRS) to industrials, logistics, offices, retail, hotels, leisure, healthcare and alternative sectors. Sub-investment grade loans typically cover income-producing loans relating to good-secondary grade properties, ground up development financings and heavy refurbishment strategies; all akin to core-plus and value add real estate strategies.

One of the areas where the BB space may be particularly attractive for UK insurers, is assets that have a stronger Environmental, Social and Governance (ESG) profile. Insurers are integrating ESG considerations into their private credit allocation by targeting investments that deliver environmental and social benefits, including those that support the net-zero transition, sustainable real estate and social infrastructure, amongst others. Impact investing, particularly in emerging markets, is essential for closing the SDG financing gap and overcoming structural barriers. Despite challenges with data transparency, insurers are increasingly aligning their portfolios with both financial returns and long-term sustainability goals.

Structural features

Private credit assets typically come with additional protections, as compared to public bonds. This comes in the form of structural protections, such as financial and non-financial covenants, and/or security. Structural protections are an important tool for managing downside risk, providing investors with controls to manage asset credit quality by ensuring they do not significantly veer from pre-agreed parameters – for example, in relation to debt leverage or debt service cover. Protections can result in greater early-stage influence and control, which may force pre-emptive borrower steps to de-risk the situation and increase recovery rates in the event of default. The ability to negotiate bespoke structures for each transaction is an important feature of private markets, which become increasingly valuable the further down the ratings spectrum you go. BB financings typically range from 3 to 10 years in maturity, demonstrating potential suitability for medium to long-term investors.

²Last-mile networks are the physical part of a broadband network that serves as the final leg connecting the provider’s network to a home or building

Performance

It is worth noting that credit risk is dependent not only on the strength of the borrower or underlying asset, but also on the loan structure and expected recovery. Historic public data suggests that BB-rated debt has experienced low absolute levels of default (1.0% weighted average vs. 0.2% in BBB³) and loss (0.6% average vs. 0.1% in BBB) over the last 40 years. The same data is not available for private debt; however, the experience of the Asset Management division of L&G suggests only incremental differences in probability of default between BBB- and BB-rated assets. Despite this, there's a significant difference between investor appetite for BBB vs BB-rated assets.

Returns⁴

As stated, demand from investors reduces near the IG/SIG threshold due to mandate restrictions and capital constraints. BB financings can generate higher risk-adjusted returns above IG but do not typically generate the double-digit returns that lower rated sub-IG direct lending can generate. These investments typically price with a premium above public fixed income. As at the date of publication, an investment into European private market BB's is likely to generate returns of 300-350bps above risk-free rates, albeit the range we see in the markets is significantly wider. This equates to approximately 50-150bps above public BB spreads, providing compensation for the relative illiquidity of private structures. For 10-year BB debt, we might expect matching adjustments of 166bps compared to 117bps for a BBB equivalent as per Chart 1.

The BB private credit opportunity

There is a supply/demand imbalance in the institutional debt markets. The IG universe is very much sought after by pension schemes and insurers, who desire the long-term liability cashflows and credit quality. The B category (and below) universe is typically sought after by direct lenders, who are seeking greater return and willing to assume more risk. And then there's the space in between – the BB-rated category – which appears under-appreciated but with some attractive facets for lenders. This includes having some IG credit characteristics (metrics, underlying cashflow profiles) but which, potentially due to the size of the borrower or slightly higher leverage (for example), do not attain an IG rating. These are investments that can provide additional return relative to BBB opportunities, without taking significant incremental risk. As such we believe, there is an interesting opportunity for UK institutions.

BB private credit represents a unique and interesting opportunity for insurers without IG rating constraints or high return requirements. It can provide an attractive level of investment return to compensate insurers for the increased credit risk, provided this additional risk is well understood, managed effectively, and aligned with the firm's risk appetite. The relatively low competition in the BB space compared to IG or direct lending should help keep pricing from being squeezed down.

³Moody's Annual Default Study, 2023. Based on issuer-weighted average default rates and issuer-weighted senior unsecured bond recovery rates, from 1983-2023.

⁴Source: L&G, Bloomberg. Public market data is based on the option-adjusted spread of the ICE BofA Global Corporate Index as at November 2024. Private credit data is based on deal pipeline we are currently observing. Actual pricing varies by deal.

Current ESG focus

Insurers and other institutional clients have increasingly incorporated ESG considerations into their private investment strategies. There are two key aspects these investors consider from an ESG perspective: mitigating risk and making an impact. There are various types of green and social loans. One which allows the investor to take a more proactive approach to making an impact is ESG-Linked Loans, which tie financial terms of the loans to the borrower's achievement of pre-agreed sustainability targets such as reducing emissions, increasing renewable energy usage, or improving water efficiency.

To date, insurers have focused their private credit capital allocation towards the following sectors:

- **Clean Energy Infrastructure** such as wind, solar, and hydroelectric power are some of the most mature forms of investing which targets positive ESG outcomes within private markets. However, the growing demand for these assets has led to competitive pricing, making them less attractive from an investor's perspective.

The need for clean electrification is global though, and compelling investment opportunities still abound in Emerging Markets (EM) where the level of installed renewable capacity remains comparatively modest. Many investors find it more challenging to invest in these projects, due to the EM exposure, meaning there is a big opportunity for those that can.

- **Social infrastructure** (e.g., affordable housing, schools, hospitals, and social services facilities). These investments align with social goals by supporting underserved communities.
- **Sustainable Real Estate Financing** targeting buildings that adhere to green building standards, such as LEED or BREEAM certifications. These loans support projects that prioritise sustainability in their design, construction, and operations, ensuring long-term environmental benefits and energy efficiency.

ESG opportunities in BB-rated credits

As the Solvency UK reform gets rolled out insurers can benefit from the broadening of their investment universe to include BB rated securities, whilst opening new ESG opportunities. Moving from IG to SIG is not without its challenges, for example, smaller borrowers may be less willing or able to disclose data and have less focus on net zero pathways. That said, there are two areas in particular that can be considered positively; impact investing and supporting the energy transition.

Impact investing

Impact investing in its broadest definition from the Global Impact Investing Network (GIIN) is "investments made with the intention to generate positive, measurable social and/or environmental impact alongside a financial return". There is also increasing scrutiny from pension funds that are looking to select bulk annuity providers which align with their climate and socially sustainable objectives.

The primary challenge in *categorising* impact investments within private debt is the inconsistent definitions of impact among managers and the difficulty in reliably quantifying tangible outcomes. Enhanced reporting requirements can be problematic for private credit transactions, as private/smaller companies often lack the transparency and resources for ESG disclosures that larger public companies possess. Nonetheless, through engagement with borrowers and the standardisation of frameworks, opportunities are increasing, particularly within EM.

Financing a just transition

The transition to net zero has largely been driven by investments in renewable energy. Wind and solar energy are the most mature sectors, attracting a significant portion of debt financing over the past two decades due to technological advancements and revenue *stabilisation* mechanisms like subsidies and Power Purchase Agreements (PPAs). Most of these opportunities have been in the investment grade part of the market, but SIG debt opens up a broader set of infrastructure projects, aligned with the energy transition.

Current opportunities

Looking at the BB private debt universe that incorporates ESG factors, there is ample opportunity with borrowers that are supporting the energy transition. In Europe, the Asset Management division of L&G assesses these opportunities via two pillars: decarbonisation solutions, such as low carbon energy generation, electrification of public transport, heating networks, and key foundational infrastructure, or 'network resilience', such as smart meters, transmission, battery storage. These assets typically use proven technology, with credit risk dictated by size, maturity, cashflow stability, and financing structure of the underlying assets. By broadening our horizons beyond investment grade, we can invest in sectors that have traditionally been less supported by institutional capital, such as electrification of transport, which has established and proven technology, but needs funding to scale. As markets mature, we expect to include emerging sectors, currently reliant on private equity and venture capital, as their risk profiles become suitable for institutional capital. In the medium term, based on opportunities and market trends, there are potential SIG opportunities across:

- Renewables in Southern Europe
- Industrial decarbonisation in Northern Europe
- Electrification of passenger or freight transport
- District heating in the Nordics and Germany

In Emerging Markets there are similar SIG opportunities in the electrification of transport and build-out of renewable generation capacity, particularly in countries where there is still a material reliance on fossil fuel consumption for electricity generation or transportation purposes. ImpactA Global, a specialist Emerging Market impact manager part-owned by L&G believes the definition of a just transition is all-encompassing. They look to include other infrastructure strategies such as investing in the build-out of social infrastructure (e.g., hospitals or water access) in less-affluent jurisdictions (e.g., Latin America and Africa), where the scarcity of long-term capital can be a real bottleneck. These opportunities have not typically been supported by insurers in the past, but institutional capital can have a role to play in unlocking the foundational change needed for the transition.

CASE STUDY: Example 1

Providing financing to a diverse utilities business that owns infrastructure assets and provides related services, including metering.

Sector	Utility and related services
Deal Size	~ £100m
Income stream	Fixed
Tenure	7 years
Expected credit rating	BB
Margin	350bps

Investment rationale

Lending to a UK business which owns infrastructure assets (including utility networks and meters), provides data services, and has a construction offering for its own asset base and other infrastructure owners in the UK.

The business mix means it benefits from downside protection from the highly cash generative, IG-quality, infrastructure assets that it owns, while being exposed to infrastructure-related services. The latter has more cash-flow volatility and generates a materially higher return than the infrastructure assets.

We would expect such a transaction to be rated BB and priced at a margin of approximately 350bps (reflecting a premium to public comparators).

Sustainability

Metering is essential from a sustainability perspective, supporting conscious and increasingly 'smart' consumption thanks to better availability of data.

CASE STUDY: Example 2

Providing financing to a portfolio of operational, ground-mounted solar PV assets in the UK, which benefit from long-term Power Purchase Agreements (PPAs).

Sector	Renewable energy – Solar PV
Deal Size	~ £25m
Income stream	Fixed
Tenure	7-10 years
Expected credit rating	BB/BB-
Margin	400bps

Investment rationale

Investing in a portfolio of operational solar PV assets in the UK. The assets have a low operational complexity and a well understood generation capability. Energy price risk is substantially mitigated by long-term PPAs with credit-worthy counterparties.

From a financing perspective, the debt structure is secured and highly covenanted. Significant debt repayment is achieved through scheduled amortisation during the life of the debt instrument. Due to these features, we would expect the transaction to be rated BB/BB- and priced at a margin of approximately 400bps (reflecting a premium to public comparators).

Sustainability

Low-carbon generation is at the centre of the energy transition, with further investment being critical in renewable generation.

CASE STUDY: Example 3

Private healthcare operator - financing of a hospital PPP (Public Private Partnership) to build and operate non-medical services of a hospital in South America.

Sector	Healthcare
Deal Size	\$60m
Income stream	Floating
Maturity	2034
Credit rating	BB-/B+
Geography	South America

Investment rationale

Loan to finance the equity injection of a private healthcare operator in a rural municipality to build and operate the non-medical services of a hospital in South America. Two of the key risks, being construction and performance, are mitigated through a comprehensive security package including over two successful operating hospital PPPs (Public-Private Partnerships).

Sustainability

Social value through building the infrastructure required for the provision of free healthcare services by the local government in a low-income and historically underserved rural area. The project minimises downside environmental and social risks through construction of the hospital under the IFC Performance Standards with an experienced contractor.

Case studies shown for illustrative purposes only. The above information does not constitute a recommendation to buy or sell any security.

Addressing the SIG challenges for UK life insurers

Historically, UK life insurers have focused on IG assets for several key reasons, including the lower risk of default and capital inefficiencies under the Solvency II MA regime. According to Hymans Robertson's 2024 MA survey, at 31 December 2023 less than 1% of the assets in UK MA portfolios, where all Bulk Purchase Annuity (BPA) business is held, were invested in SIG assets. Of this small allocation, it is likely that this mainly reflects holdings of 'fallen angels' from IG rather than targeted SIG investment. Here we address the challenges UK insurers may face in increasing that investment.

Matching Adjustment (MA) and Fundamental Spread (FS)

With the removal of the BBB cliff-edge, insurers are now able to recognise MA on SIG assets in excess of that on similar IG assets. However, there are additional requirements before firms can access this MA, including those due to data limitations and MA Attestation⁵ requirements.

UK insurers under the MA regime have focussed their asset strategies to date on IG assets. As a result, there is less in-house knowledge or data for SIG assets. The Fundamental Spread (FS) table provided in monthly Bank of England Technical Information is based on public corporate and government bonds data.

The PRA expects firms to carefully consider whether the published FS allowance is sufficient for sub-investment grade exposures and this will be captured in the MA Attestation. The Attestation is a new requirement as part of Solvency UK reform, requiring UK MA firms to provide an annual attestation that the FS reflects all retained risks, and that the MA can be earned with a high degree of confidence. This may be particularly important for SIG assets as they will likely provide higher MA benefits and hence require additional scrutiny.

To calculate the MA benefit on SIG private assets, an insurer will likely use the basic FS (published by the BoE, based on global public asset data) and make adjustments, based on its own view of the risks. Considerations may include default rates, loss given defaults and credit-rating transition matrices. However this is no different, conceptually, for what should be done for any other private market investment.

The MA Investment Accelerator, a type of sandbox that is being considered by the PRA, could help insurers speed up the investment timescales for SIG asset classes with new features under the SUK regulation. At the time of publication few details are available, but we understand the Investment Accelerator is intended to help insurers invest a small proportion of the MA portfolio in assets that meet MA eligibility rules, without having to obtain full approval first. A more ambitious sandbox idea being discussed could allow insurers to explore future eligibility for assets that are currently ineligible for the MA but which the firm nevertheless considers suitable to back annuity liabilities, but this appears to be further from any potential implementation.

⁵Senior managers (E.g. CFO) are required to attest that as at the effective date of the firm's Solvency and Financial Condition Report (SFCR): the FS used by the firm in calculating the MA reflects compensation for all retained risks, and the MA can be earned with a high degree of confidence from the assets held in the relevant portfolio of assets (PRA Rulebook Matching Adjustment 9.1(1)(b))

Investment expertise

To invest in SIG assets, firms will need specific investment expertise in categories of asset class, sector, structure and issuer that could be less familiar. They will need to perform enhanced due diligence of potential investments including creditworthiness of issuers, understanding industry dynamics, and considering macroeconomic factors that may affect performance. Prior to investing in SIG assets, firms will need to augment processes for the end-to-end investment lifecycle such as governance, reporting and capital requirements.

However UK insurers have been successfully managing credit risk for decades, with many having built up large teams of in-house analysts and credit rating experts along with established robust risk management processes and systems. This expertise can be expanded to cover the additional requirements of SIG assets.

While they build up their in-house SIG asset expertise, insurers may be able to rely on external support such as from established asset managers for the desired investments.

Investment strategy

When considering investment strategy for investing in SIG assets, insurers may face challenges around asset allocation, MAP credit rating and Risk Management Framework.

Asset allocation

A balance is needed between:

- Investing enough of a portfolio in SIG assets to justify the outlay of investment expertise and enhanced procedures required
- Keeping holdings of SIG assets at a sufficiently prudent level to satisfy risk management and regulatory requirements
- Diversification by asset class and sector
- Origination capability and access routes for the various forms of SIG assets
- Higher volatility of probability of default (PD) and cost of downgrade (CoD) on smaller portfolios (and associated modelling contingencies needed to get comfortable in an MA portfolio)

When deliberating this, insurers will also need to consider the potential downgrade of IG assets under stressed conditions. In terms of allocation within the SIG portion of the portfolio, there is a wide range of SIG assets available for investment within the wider Income Asset Universe. Firms will need to decide which types of SIG assets suit their investment strategy and overall risk profile:

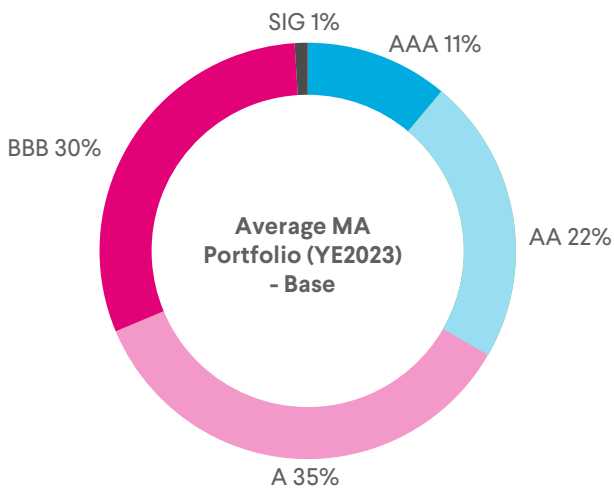
Starting with a small allocation of SIG assets and leveraging existing ESG expertise to invest in similar sectors will potentially allow insurers to build expertise, grow organically, closely monitor performance and adjust their strategies as necessary. For faster growth in the SIG space, insurers can use external expertise and diversify through joint ventures or investing in private debt funds that meet look-through regulatory requirements. Stress and scenario testing should be used across the portfolio to ensure potential allocations remain compliant with risk requirements, limits and investment mandates.

Overall portfolio credit rating

Inclusion of SIG assets can reduce an insurer's overall MAP credit rating. The level of impact will depend on an insurer's investment strategy. Insurers can adopt a range of approaches depending on their risk appetite and investment strategy:

- **Barbell approach:** Maintain an unchanged average credit rating by 'barbelling' the portfolio—holding a mix of higher- and lower-rated assets at the expense of mid-rated ones. This minimises the impact on the overall rating but can result in higher credit risk volatility and doesn't fully take advantage of the opportunity available.
- **Alternative approach:** Allow the average credit rating to decline slightly by integrating SIG assets strategically which can lead to better economics. The overall rating impact is mitigated given that the allocation to SIG assets will remain at prudent levels, although it requires stronger stakeholder management to address concerns about perceived risk increases.

Chart 2: Average MA portfolio allocation by rating



The average MA portfolio for BPA firms is illustrated here, based on Hymans Robertson's 2024 MA survey. It shows an average of A rating.



Risk management framework

SIG assets pose additional risks for an insurer compared to IG assets:

- **Liquidity risk:** SIG assets may have lower liquidity compared to IG assets due to factors such as lower market demand and depth, making it difficult for insurers to buy and sell positions without adversely affecting prices (especially in periods of market stress). Additionally, cashflow uncertainty of SIG assets may impact an insurer's liquidity.
- **Concentration risk:** The PRA expects firms to consider any potential concentrations in their SIG (or near SIG) exposures, when setting their investment strategy and limits.
- **Reinvestment risk:** SIG assets are more likely to downgrade or default, and particularly during stressed market conditions when it can be difficult to find like-for-like replacement assets, leading to higher reinvestment costs.
- **Credit risk:** The credit rating of SIG assets is generally more volatile than that for IG assets and the probability of default is higher which may lead to more workout scenarios.
- **Rebalancing constraints:** Like most private assets, these investments may take longer to rebalance in stressed conditions, which may lead to a lower overall MAP credit rating or require rebalancing of more liquid securities in their place.

When selecting which SIG assets to invest in, firms should, in our view:

- Perform a comprehensive risk identification process and map risks identified to the risks present in the underlying FS data to identify where expert judgement overlay may be required for MA Attestation purposes. Drivers of any additional return (i.e., MA benefit) should be well understood and articulated.
- Carefully analyse the cashflows they expect to receive from these assets and how the cashflows can be shown to be sufficiently relied upon for the purposes of cashflow matching, given their greater risk of default. Some SIG assets which do not have guaranteed fixed cashflows, such as those with prepayment risks and callable features, can still be included within the MA portfolio if they can be treated as HP assets, or potentially subject to the application of prudent assumptions in relation to prepayment outcomes.

Firms should update their relevant risk management framework (e.g., through the use of portfolio limits) to manage these extra risks. Use of stress and scenario testing will help insurers assess the risk of their SIG holdings. As part of their ongoing risk monitoring, firms should establish robust frameworks for surveillance of credit quality and market conditions and consider further metrics around SIG asset exposure e.g., total monetary value of MA benefit.

Risk management does not fully eliminate the risk of investment loss.

Wider PPP considerations

The Prudent Person Principle (PPP) regulation outlines the requirements of insurers' investment practices. The PRA expects firms to keep holdings of SIG assets to prudent levels and requires firms to consider the adequacy of their workout processes when determining the size of their SIG exposures.

To facilitate this, when investing in SIG assets, firms may want to consider scenarios and triggers for defaults, impact on valuation, rating, MA benefits (as described above), capital and reputation, as well as recovery strategies for individual assets.

Additionally, firms may want to enhance restructuring capabilities and familiarity with bankruptcy processes, or partner with an experienced asset manager, before investing in SIG assets.

Portfolio valuation

Challenges in valuing private SIG assets include:

- The sensitivity to expert judgements
- The credit ratings of SIG bonds are generally more likely to change than IG assets
- Issuers of SIG assets could have more complex financial structures and less stable revenue streams

Hence, SIG asset values may be more volatile than IG assets. Additionally, SIG assets could have lower liquidity compared to IG assets resulting in wider bid-ask spreads and more difficulty in estimating market values. The Matching Adjustment should cushion this volatility, albeit it is still a feature to be aware of.

Insurers should monitor SIG assets closely and have a robust valuation framework to mitigate these additional challenges around valuation.

Internal credit rating

Where SIG private assets have an out-of-date, or no credit rating from rating agencies at all, insurers will need to derive their own internal credit ratings. Regulation requires internal ratings to be in line with those from credit rating agencies, which creates a challenge for firms to demonstrate compliance.

If firms invest in asset classes and sectors similar to existing IG assets, there may be a limited number of new risks or features, so existing credit rating methodologies may be appropriate for use. Otherwise, new methodologies may be required. Firms should be able to leverage and develop their internal credit skillset, potentially with the support of external experts, to develop methodologies. Increased rating volatility will likely require increased monitoring for drivers of rating changes.

Capital requirements

In addition to considering the base balance sheet, insurers also need to consider the investment portfolio under stress and assess potential changes in capital requirements. For insurers with an internal model, internal model changes may be required to reflect increased holdings of SIG and their particular risk profile(s). Lack of data may present challenges, both with risk identification and assessment and establishing suitable probability distribution for recalibration. SIG assets may require different modelling approaches due to new asset classes or sectors.

We expect to see expert judgements, and stress and scenario testing to inform capital model updates. Where modelling capital for SIG assets is too complex or uncertain, firms may use approaches with additional prudence as often happens for other asset classes.

Legal and contractual

SIG assets can have a more diverse range of structures, security packages, covenants or amendments, waivers and consents than IG assets, representing the more complex nature of such assets. These should be carefully assessed as a part of the due diligence work and more consent solicitation will be required than for IG assets. Insurers should check their investment, risk and legal teams' capabilities of dealing with these.

Workout capabilities

Firms should establish clear workout policies and processes for decision-making and escalation within the organisation to ensure a swift and co-ordinated response to the increased expected workload for resolving distressed debt. Ideally firms should be able to demonstrate that they, or their asset management partner, already have in-house capabilities for engaging in proactive discussions with issuers to explore potential solutions and evidence of successful workouts in their portfolio – for example, in renegotiating the terms of debt/restructuring transactions. Insurers may also need expertise to pursue legal action to recover the owed amounts. They may require access to a wider range of external firms to support with workout capabilities (restructuring, workout negotiations and turnaround strategies) and associated legal work, and ensure that these firms will be available to support in stressed conditions.

Stakeholder management

While an increase in SIG allocation may not materially increase the total credit risk in an insurer's investment portfolio, it is likely to require enhancement to the risk management approach. Any change in strategy requires careful stakeholder engagement to manage expectations. External stakeholders' perception of the insurer will also be impacted by these outcomes and will need to be managed.

When pro-actively increasing the investment into SIG, it's crucial to engage effectively with all stakeholders, including the following key groups.

Board and investment committees

Initial approval from the Board and internal committees will require clear communication from outset on:

- The rationale behind investing in SIG, and new risk appetite
- The risk management strategy in place to mitigate potential downsides (e.g. limits, stress testing and scenario analysis)
- Projections of impacts on existing, and introduction to new performance metrics

Regular updates should be provided on the performance of SIG assets tracked against agreed metrics.

Shareholders

During investor presentations, it is common for BPA insurers to reference their historic low experience of defaults, or average credit ratings in portfolio. To build confidence among shareholders, firms should signal they are increasing allocations to SIG assets. They should explain why they are doing this and the expected benefits, alongside expectations for future defaults and average portfolio credit ratings, along with the risk management policies that will support this.

The PRA & credit rating agencies

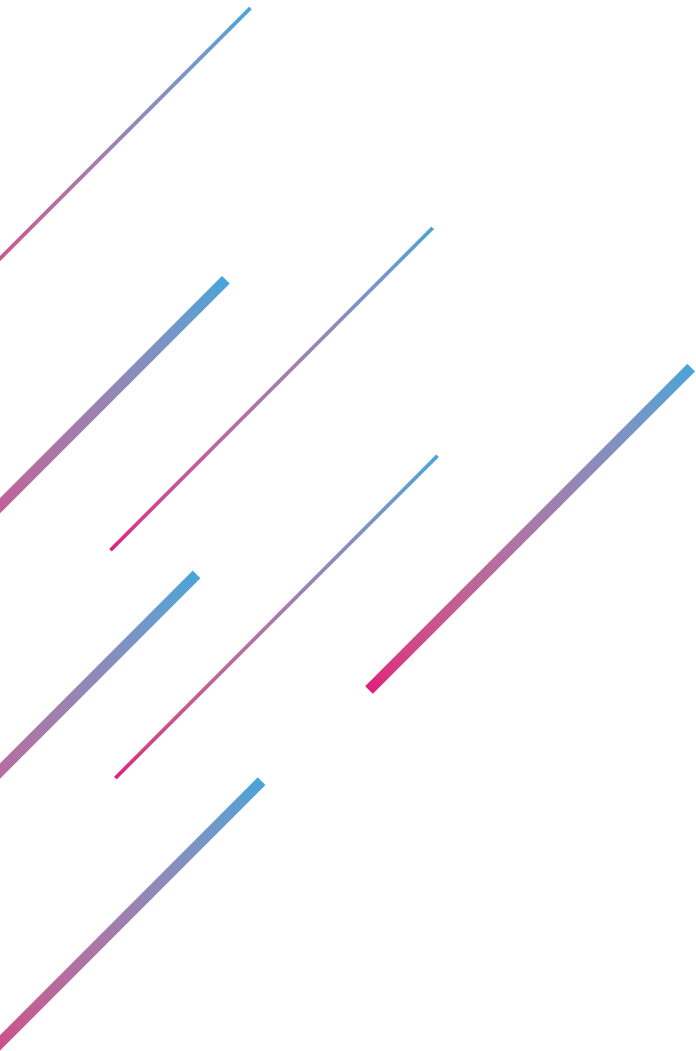
To ensure a positive reception from credit rating agencies and regulators, the insurer should demonstrate their robust risk management frameworks, including comprehensive credit risk assessments and liquidity management plans. There should be engagement with credit rating agencies to provide them with detailed analysis and to be responsive to their queries and concerns.



Conclusion

As the financial and regulatory landscape evolves and the demand for higher returns remains, there is a growing argument for insurance companies to consider SIG assets as part of a diversified portfolio. While the associated risks should not be overlooked, insurance companies may be able to not only enhance their yield potential but also strengthen their overall financial resilience. As the market continues to evolve, those that adapt and strategically incorporate SIG assets into their investment frameworks may be better positioned to meet their obligations to policyholders while pursuing growth in their investment portfolios.

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.



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