Quasi-government loans

An investment opportunity for European insurers
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The insurance market is under increasing pressure to find new and innovative solutions to help drive strong and sustainable returns.

In the current low-yield environment, insurers are seeking new types of investments that capitalize on the competitive advantages that they have over other investors in capital markets. One approach to increase returns is to sell high-quality liquid assets and invest in illiquid assets. In the past few years, this has led to an increasing interest in less liquid and alternative assets.

This paper briefly explores one of these illiquid asset types, quasi-government loans, an area that European insurers are finding increasingly attractive and are actively pursuing.

Quasi-government, in this context, refers to loans to institutions across the market that have some form of explicit or implicit government support. Among these nontraditional asset classes, insurers are investing in assets such as social housing loans, education loans (for both higher and further education), student accommodation loans and infrastructure loans.

The level and form of support (or mitigants to credit risk) provided by European governments varies greatly within each of these sectors and across different countries. Examples range from direct support, through explicit guarantees within lending arrangements, to indirect support such as establishing relief funds to be drawn upon under stress.

While these features can make widespread investment attractive, the long-term nature of these assets and the lack of an openly traded market reduces the range of market entrants, leaving insurers uniquely placed to access potentially increased risk-adjusted yields.

When deciding whether to invest, there are a number of key areas that insurers must consider. These include:

- Mitigating and calibrating models for different types of risk that these assets give rise to compared with more traditional investments
- Confirming appropriate treatment of the features of these assets under Solvency II to obtain the matching adjustment, where relevant
- Developing the level of in-house skill and the operational processes to manage a loan portfolio that will require significantly more ongoing management than a bond portfolio (e.g., dealing with borrower requests)

Investors should also be aware of additional key risks, such as the exposure to changes in government policy, that arise on these forms of asset.

Those that make the right investment in dealing with issues such as these will be best positioned to take advantage of this opportunity. These investment considerations are discussed in greater detail later in this paper.
The majority of European quasi-government loan issuances emerge as a result of financing needed to support social welfare and education systems. It is universally recognized that a healthy and educated population is integral to economic growth. This pushes the provision of high-quality systems to the forefront of the social agenda.

While a number of different regimes are employed across Europe to help support these systems, funding commonly consists of both public and private sector lending and issuances into capital markets. Barriers in sourcing public and capital market finance, such as scale and government policy, mean that private sector institutional lending will continue to play a key role.

Quasi-government loan types

Although provisions differ between states, there are some common examples across European markets, such as:

- **Social housing loans (SHLs):** These loans are issued by financial institutions to support the development and maintenance of affordable housing for those on low incomes. While the precise form of this part of the welfare system differs across Europe, these loans are generally issued to social housing organizations that borrow to build, renovate or maintain properties on behalf of tenants. The housing associations in the UK are an example of these social housing organizations.

- **Education loans:** These are loans issued to higher education and further education institutions that generate income primarily through tuition fees, income from research and wider operating activities. Relatively recent changes to tuition fee structures in the UK means universities receive significantly less direct support from the government, but for many universities, this has not led to reductions in overall income.

- **Student accommodation loans:** These loans are issued to the providers of student accommodation (e.g., Unite in the UK) that generate income through rents and require loan finance to either develop or maintain student dwellings. Growth in the university student population and providing accommodations to meet the needs of the modern student has attracted investors to this sector.
How insurers invest

A number of major insurers have actively entered the market in recent times, as shown in these examples:

- **Lloyds Banking Group Insurance** has invested in a range of illiquid assets, including both social housing and education loans.

- **M&G**, a UK fund manager and business unit of the Prudential Group, in 2015 lent £30m to a UK housing association to support the building of 400 homes. At the time of investment, this took M&G’s total investment in social housing to over £6bn.

- **Legal and General**, a UK life insurance company, agreed to a 40-year £25m debt facility with Adactus Housing. This followed its 25-year £40m debt facility with Thames Valley Housing Association in February 2014, as well as earlier investments.

Typically, we have observed that these activities and investments have been the result of:

- Portfolio acquisition, where existing loan books have been made available for purchase by other parties.

- Loan origination, either indirectly through provision of funds to investment managers or, where an adequate level of operational capability is in place within the insurer, direct origination. The latter, in particular, provides the potential to retain further value.
Why European insurers invest in these assets

Factors leading insurers to consider quasi-government loans as an option include:

| Supply and demand of banking finance | Penal regulatory treatment in the banking sector means that:  
|                                      | • When acquiring portfolios, differences in capital treatment between banks and insurers can make risk-adjusted returns look more attractive to the insurance sector.  
|                                      | • Since 2008, there has been a decline in the supply of bank funding, creating an opportunity that insurers can capitalize on. A study on commercial property lending by De Montfort¹ has shown that this trend has reversed slightly in the past year. |
| Matching annuity liabilities         | The long-term nature of these assets offers a cash flow stream that may be used to match illiquid long-term liabilities, such as annuities.  
|                                      | • When coupled with a hold-to-maturity strategy, these may allow the insurer to crystalize some of the additional illiquidity on their economic balance sheet.  
|                                      | • Under Solvency II, insurers will need to consider the challenges associated with matching adjustment approval when looking to crystalize some of this illiquidity (see page 10 for more detail). |
| Matching participating business      | These provide an attractive investment option for participating business, as the assets have the potential to carry relatively low credit risk while retaining a desirable yield over and above government issuances.  
|                                      | • This makes cash flow streams ideal to support the guarantees that arise when regular bonuses are distributed. |
| Increased shareholder returns        | Potentially attractive risk adjusted returns make these assets a viable investment for insurance companies’ free assets. |

Credit characteristics

The level of credit risk within quasi-government loans will partly depend on the level of support provided. As shown below, this varies by geography:

- In France, educational institutions raise funds via local authorities issuing loans on their behalf, making the local authority the direct counterparty.
- In the UK, this financing is directly raised by the educational institutions; thus, the government support is only implicit.

In addition to this support, these illiquid assets may be structured in a manner that reduces the likelihood of default or increases expected recoveries on default.

The following case study looks at some of the features of the UK social housing market, outlining why the credit risk characteristics may be attractive when compared with more traditional corporate lending or investments.

Case study – SHL market in the UK

In the UK, some social housing institutions pursued financing by issuing bonds into capital markets. Figure 1 shows the average Z-spread across over 20 social housing bonds available within the market against the Markit iBoxx corporate bond indices at A and AA credit ratings, all sourced from Reuters.

This indicates that the long-term yield for social housing assets is broadly comparable to the historic yields observed at both of these credit ratings. Loan assets would be expected to trade at a margin over and above these bonds to reflect their increased relative lack of marketability.

However, a number of features of the SHL market, and specifically the terms on which loans in this sector are written, potentially allow for differentiation in both the likelihood of or loss on default, when compared with wider corporate bond markets.

**Figure 1. Social housing spreads from 2010-15**

Total historic social housing yields

Source: Reuters, EY Social Housing Bonds Z-spread Index versus iBoxx corporate at A/AA rating
Mitigants to the likelihood of default:

- **Stable revenue streams:** The sector receives direct funding from the central government. Until recently in the UK, the sector also received indirect support from the central government through welfare benefit payments to housing associations.

- **Effective regulation:** The UK SHL market is heavily regulated and the regulator has considerable powers to affect the ongoing management of housing associations.

**Ujima Housing Association (UK 2007)**

An example of the power and effectiveness of regulatory intervention

Mismanagement of this housing association came to light in 2007, and the High Court was petitioned. Corrective supervisory action quickly resolved the situation, with the regulator mobilizing a 28-day moratorium on secured creditor action and working to protect the interests of all stakeholders.

This ultimately allowed time to transfer Ujima liabilities to the London and Quadrant Housing Trust in 2008, with no lender losses. While the action was reactive, this was a clear indication of the effectiveness of the regulator within the sector.

Mitigants to the size of losses made

- **Collateralized deals:** The market norm is for these loans to be heavily collateralized, with lenders potentially able to call upon property as collateral. There is no historic experience of this occurring. However, one would expect that in such a default event, upon failure of any forced takeover or workout solution, lenders would consider re-letting the property within the sector in the first instance and ultimately look to foreclose and privatize either via rental or sale. This presents political risk to investors that requires careful consideration.

- **Strong covenants:** The strength of covenants help trigger early warnings and allow the lender to step in promptly. For example, these covenants may specify minimum debt service coverage ratios over which borrowers must remain to avoid lenders stepping in.

- **Regulatory intervention:** The power of the regulator in default events allows it to both take control and seek resolution through routes such as mergers in a short space of time. To date, this has been effective in cases of distress in the UK market.
Insurers are required to hold regulatory capital against the risks within their investments. The introduction of Solvency II has increased the need to understand and model risks within their portfolio as part of calculating the Solvency Capital Requirement (SCR). The capital charge on an insurer’s assets is an addition made to a company’s liabilities to suitably accommodate for risks inherent in its investments (for example, currency and interest rate risk). Under the standard formula, the capital requirements for quasi-government loans are the same as for an equivalent-rated corporate bond.

A key consideration for insurance companies investing under Solvency II is the relative capital efficiency for different assets. As a result, the full benefit of investment in quasi-government loans should be assessed using a return-on-capital metric, as opposed to merely the available spread. In particular, return-on-capital appeals to insurers where quasi-government loans provide a higher (or equivalent) yield relative to equivalent corporate bonds (in terms of rating and duration), but carry a similar (or lower) capital charge.

**An internal model approach**

An internal model could be beneficial for insurers investing in quasi-government loans, potentially offering more efficient capital treatment than under the standard formula.

As noted in the previous section, data on the actual incidence of default events is in short supply. The lack of a liquid market for these investments means that there is generally limited data available to calibrate a spread risk stress and no clear mechanism for deconstructing the spread into components attributable to credit and liquidity. However, the credit characteristics of these assets have been measured within the banking sector for a significant period of time. The techniques employed in this sector can provide some insight into ways to surmount the difficulties associated with a lack of data.

We have constructed a model designed to overcome this issue. This provides further insight into the potential merits of an internal model approach over the standard formula. The steps of this model cover a range of quasi-government investments:

1. Identify indices that reflect the relative levels of credit and liquidity risk in the market to be used as a proxy for credit and liquidity spread movements in quasi-government investments. The concept is that the theoretical (non-observable) spread on these investments can be deconstructed into a linear combination of market credit and liquidity indices:

   \[ \text{Theoretical quasi-government investment spread} = \alpha \times \text{market credit index} + \beta \times \text{market liquidity index} \]

2. Estimate the through-the-cycle (TTC) credit and liquidity spreads for the quasi-government investment portfolio. These spreads can be derived using available data, coupled with techniques such as scenario, stress testing and low default portfolio (LDP) analyses. These TTC spreads are used to scale the market indices identified in step 1 to make them specific to the quasi-government investment in question.

3. Scale the specific indices derived in step 2 to reflect the credit quality and tenor of the actual quasi-government investments relative to the reference index.
4. Calibrate specific credit and liquidity spread shocks by making an appropriate transformation to the specific indices in step 3 prior to applying suitable distribution and methodology to derive the spread shocks. The choice of distribution and estimation methodology is as material as any other choice within the calibration process, and requires a proportionate level of validation.

5. Perform scenario testing to assess the suitability of the calibrated spread shocks and the implied level of required capital, particularly since the calibration is based on minimal data. This testing should also include assessing the derived calibrations against other benchmark assets, wherever possible.

Solvency II: benefits of the matching adjustment

With the introduction of Solvency II, many European insurers have reconsidered the extent to which their asset and liability portfolios match. For those applying (or applying for) the matching adjustment, this consideration is of particular importance. The matching adjustment allows insurers to benefit from holding assets to maturity by increasing the discount rate used in the calculation of the company’s Solvency II best estimate liabilities in a manner that reflects their asset holdings. This higher discount rate reduces the valuation of these liabilities, which can ultimately materially strengthen an insurer’s solvency position.

As quasi-government loans may provide additional return to compensate the investor for illiquidity risk relative to more traditional investments, quasi-government loan investments that qualify for the matching adjustment may be lucrative.

To apply the matching adjustment, insurers must satisfy strict requirements associated with their assets, as well as ongoing portfolio management and governance. As a consequence, there are limitations on which assets qualify for the matching adjustment.

To confirm that these assets qualify, insurers should systematically review the features of their portfolio and test them against the qualifying criteria. For example, where options exist, insurers must demonstrate that adequate compensation is provided when these are exercised to replace the lost future cash flows. There are a number of features within loan assets that may require further consideration, including:

- Borrower early repayment options
- Borrower interest rate and inflation selection options
- Performance-based clauses that may alter borrower payments over time

These need to be investigated systematically. Companies may wish to consider hedging or structuring options to help mitigate the risk of assets being considered ineligible for the matching adjustment.

Other risks and considerations for quasi-government loans

- The ability to exercise step-in-rights and act on security may be legally constrained in the case of syndicated loans. However, a more subtle issue is the reputational consideration in relation to calling the security (e.g., social housing). Insurers should consider these risks related to step-in-rights, especially political issues that may arise, as part of any investment plans.
- Skills and expertise are required to access the quasi-government loan market. This will include deal identification, credit analysis, legal due diligence, documentation and ongoing loan portfolio maintenance.
- Compared to bonds, loans require a high degree of ongoing management. This will involve monitoring an asset that does not have market quoted prices, ongoing credit assessments, dealing with borrower requests and exercising options.

While these issues add potential complexity, they are not insurmountable for potential investors with the right skills and knowledge. Those that build the right capability in these areas will be best positioned to take advantage of this opportunity.
Concluding remarks

In the current economic environment, with low interest rates and organic growth through new business sales increasingly difficult to sustain, companies are looking for new ways to boost risk-adjusted returns. Nontraditional insurance investment is becoming more commonplace and quasi-government loans are one of the asset classes where we see insurance companies investing.

Over the past few years, the natural investors in these assets have been insurers with annuity liabilities. However, the long-term nature of the assets, coupled with the potential for strong risk-adjusted returns, make them candidates for investment in pension and participating funds.

These attractive characteristics mean that we expect further investment growth in this asset class in the future.
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