Cameron Hume

Fixed Income Specialist

Responsive Credit Allocation

Insurance companies typically have a large allocation to corporate bonds ("credit") as the asset class offers a predictable set of cash flows for matching liabilities, and, often, an excess spread after adjusting for expected defaults and downgrades. Credit does however attract regulatory capital under the Solvency II regulations.

Allocation to credit should be responsive to market conditions – increasing when credit offers good value, reducing when spreads become very tight. However, the appropriate allocation to credit is a complex decision that has to balance risk against expected return and consider regulatory capital requirements.

We have developed guidelines to enable a Cameron Hume insurance client to navigate the trade-offs involved while still allowing for a credit allocation that is responsive to market conditions. We have chosen two measures that enable us to capture and reflect client views in an investment strategy:

A. a limit on the capital requirement arising from an allocation to credit; and

B. a minimum return on the capital allocation.

These measures allows us to help insurance clients to vary their allocation to credit in a way that reflects good value while still matching the client's liabilities.

Limit on Capital Requirement

The first component that we use to control credit allocation is to agree a maximum capital budget. The Solvency II credit charge[1] assigns an amount of capital to a corporate bond based on the rating and maturity of the bond. In our approach, the total Solvency II credit charge is limited to a maximum e.g. 10% of NAV, and we can decide how best to allocate this budget. For example, a securitisation that incurs a high charge may lose appeal by using up a large share of the capital allocation.

Minimum Return on Capital

The second component that we use to control credit allocation is a minimum target return on capital. We measure the return by impairing the bond for expected default and downgrades, with the excess return being the residual "risk/liquidity premium" the insurer expects to earn. A regularly updated set of impairments are provided as part of Solvency II along with a minimum floor. When spreads become excessively tight this residual risk premium can become negative.

For example, an insurer prepared to allocate 10% of its capital to credit might require a return on capital of at least 5%. We would use the limit on capital requirements to allocate to the most attractive bonds, but only if they meet the return requirements of the client.

The combination of a limit on capital allocation to credit and a minimum return on this capital provides a flexible way for an insurer to specify their credit objectives and hence provide guidelines for investment managers. The guidelines can be regularly reviewed and provides a level of control over the balance sheet for asset allocation purposes.

[1] A measure of market risk that captures a 1 in 200 year event

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Integration into the Investment Process

We have found that the return on capital measure is an easy and intuitive way for investment managers to think about a credit portfolio. By reporting the measure, it also encourages asset allocation discussions to consider the whole balance sheet and the expected return on the capital these decisions determine.

Figure 1 shows the credit holdings of a client portfolio. Bonds in green have a high return on capital while those in red score poorly. Ideally, we would own bonds in the top left quadrant of this chart, where the expected return is high and the capital requirements are low. We can see a number of bonds on the lower half of the chart in amber and red that provide a poor return relative to the amount of capital they require. Following an exercise to improve the return on capital, we were able to switch out of the lower scoring bonds, improving the return on capital for our client from 3.8% to 6.3% (the resulting portfolio show in figure 2).

High ESG rating → **Low ESG rating**

AAA AA A BBB BB B CCC NR

Figure 1: Return on capital before rebalancing

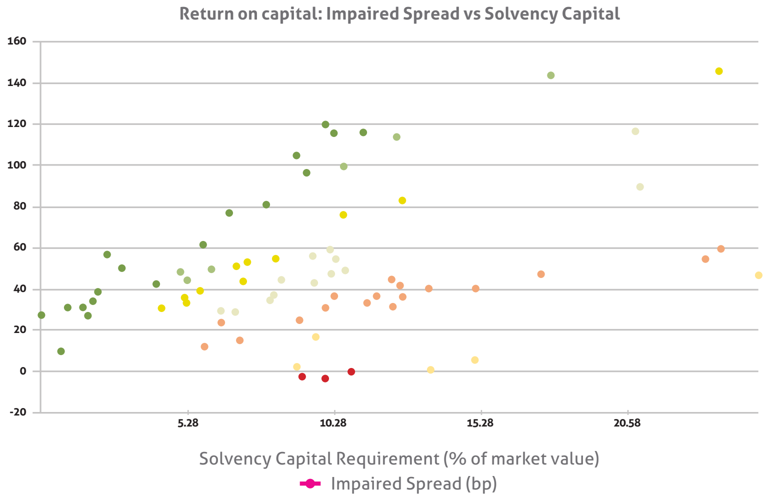
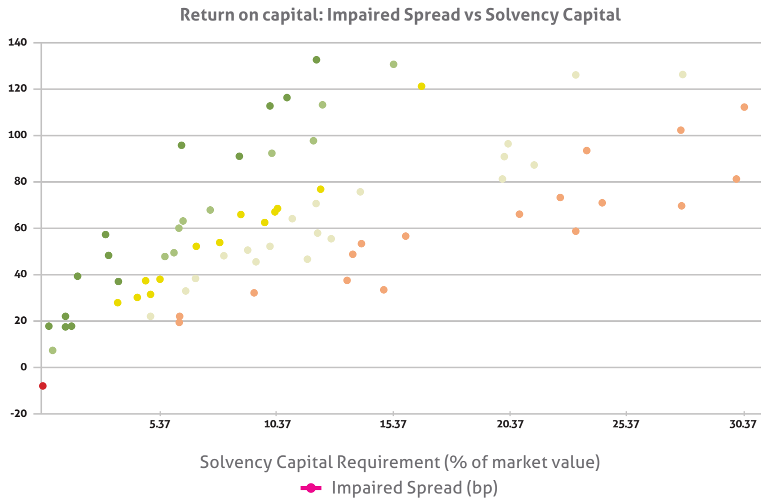


Figure 2: Return on capital after rebalancing



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