

# PRIVATE CREDIT

---

## QUESTIONS AND ANSWERS

Why are life insurers **increasing the amount of private credit** held in portfolios?

- Private credit has long been a significant asset class for life insurers, **offering attractive returns and portfolio diversification while supporting long-term liabilities.** While some insurers have increased holdings of private credit over the last 20 years, the reality is that we have a long history of investing in private credit.
- The Federal Reserve estimates that life insurers' holdings of private placements grew from around 13% of bond portfolios in 2004 to around 20% in 2022. That growth occurred during a period of record-low-for-long interest rates.
- However, this growth has persisted even after interest rates rose – which points to different drivers behind the increase – including the need to diversify portfolios beyond public bonds, and critically, the need for insurers to offer attractive retirement products that address rising demographic demand for these products.

Are banks and insurers **exposed to the same risks** when holding private credit in portfolios?

- In this case, the risks associated with private credit, which by its nature is less liquid than public bonds, are very different for banks and insurers because they are using the assets to support **very different liabilities.**
- Banks are engaging in **“maturity transformation.”** That means they're using long-term, less liquid assets to back very liquid, short-term liabilities, such as on-demand deposits.
- That is a very different risk profile from life insurers – who are engaging in **“maturity matching.”** We are seeking out long-term assets with predictable cash flows to support long-term, relatively illiquid liabilities.
- The basic rule of thumb when evaluating assets or liquidity risk associated with any asset is that you must look at it holistically, which means evaluating the nature of the assets relative to the nature of the liabilities that the assets are supporting considering duration, liquidity and other characteristics.

- Investment-grade private credit tends to be long term and less liquid than a public security, but it can be an attractive investment when used to support long-term, relatively illiquid liabilities. Liquidity strain is more likely when a long-term, illiquid asset is paired with a short-term, highly liquid liability like bank deposits. Evaluating the liquidity risk without considering the liquidity of the associated liabilities can present a misleading picture in a world where a key risk mitigant for insurers is matching assets and liabilities through a **strong asset-liability management (ALM) program**.

Are insurers holding low-grade private credit investments?

- The majority of private credit investments held by insurers are **investment grade and often offer an illiquidity premium**, rewarding long-term investors, such as insurers, that can match stable, illiquid liabilities with similarly long-dated, higher-yielding assets.
- You sometimes see the term "junk bond" used interchangeably with private credit, which in the case of life insurers, is misleading. The vast majority of private credit held by life insurers is investment grade. A large majority of ABS and structured securities held by insurers are classified as high quality, with 97% rated NAIC 1 and NAIC 2.

## MYTHS AND FACTS

**Myth:** Private credit is a new form of investment for life insurers.

**Reality:**

- While it is true that the share of private assets is growing in our portfolios, life insurers have **decades of experience** investing in private credit through private placements, real estate and mortgage loans.

**Myth:** Private credit assets held by life insurers are speculative or risky.

**Reality:**

- The vast majority of private assets held by life insurers are **investment grade**.
- While many may think of private credit as being limited to small or mid-market firms, the reality is that investment-grade large companies are increasingly seeking to tap public and private markets to raise funds.
- In direct lending or circumstances when life insurers are involved in the origination, insurers take steps to **mitigate risk** in private credit by tailoring the deal structures and crafting covenants that enable close oversight of borrower performance and quick action if terms are at risk of being breached.

**Myth:** Private credit mostly involves direct loans to small or mid-size highly leveraged companies.

**Reality:**

- An increasing number of highly rated large companies, such as SAP, BMW and Mars, are **choosing to raise funds** in both public and private markets.
- More corporate borrowers are turning to non-bank lending channels because **bank lending has declined** since the Global Financial Crisis.
- There are more opportunities today for life insurers to invest in investment-grade private credit.

**Myth:** Insurers are holding non-investment-grade private credit assets. Private credit is always riskier than public debt.

**Reality:**

- The majority of private credit held by insurers is investment grade. A Federal Reserve paper on private placements showed **quality exceeded public bonds**. More investment-grade companies are choosing to raise money in both public and private markets.

**Myth:** Private credit is illiquid which means it is riskier.

**Reality:**

- Private credit can make investment portfolios more diversified, higher yielding and improve duration matches between assets and liabilities – which is key to insurance risk management.
- Private credit and alternative assets can **enhance market capacity and improve solvency** through robust ALM strategies when life insurers invest in long-term, less liquid assets that align with our stable, long-term liabilities. The nature of life insurers' long-term liabilities makes us well-placed to hold less liquid assets for extended periods and to capture the illiquidity premium.
- The ability to hold onto the assets often allows life insurers to absorb short-term volatility when markets tighten. This can **reduce systemic fragility** by dispersing credit exposure across non-bank balance sheets.

**Myth:** Private credit is complex and therefore riskier.

**Reality:**

- Complexity does not in and of itself make an asset riskier.
- Complex assets often **require specialized knowledge, expertise and governance** among life insurers and regulators. With those processes in place, complex assets can be part of a more diversified pool of appropriately managed assets.

**Myth:** Low interest rates are driving the increase in private credit in portfolios.

**Reality:**

- These assets have long been part of life insurers' portfolios.
- There are many drivers behind the increase. While low-interest rates played a role in encouraging some growth, the reality is that life insurers have **held private credit – in the form of private placements – for decades.** There has been incremental growth in life insurers' investments in private credit. Over the last 16 years, bond holdings went from 13% to 20%.
- The growth in private asset allocation has continued even after interest rates rose.
- Insurers are facing an unprecedented silver tsunami of retirements, **driving the demand for long-term products with guarantees.** Investment-grade private credit can help insurers offer more attractive benefits on long-term products.
- Investment portfolios like credit markets are dynamic. As the global credit market has evolved, portfolios are evolving as well. Life insurers' portfolios are diversifying to **reflect the current economy** – which is a mix of public and private.
- Insurers are generally not interested in taking on more credit risk. The increased yields that insurers are seeking from private credit comes from insurers' ability to capture illiquidity premiums – which rewards investors who are able to hold an investment until maturity.

**Myth:** Because it is not public, private credit has little oversight compared with bank-based lending or public securities.

**Reality:**

- Many private credit assets are exempt from the Securities Act of 1933. But life insurers – who comprise around 90% of the investors in U.S. private corporate bonds – are closely regulated where they are domiciled and in the states they are licensed to operate in.
- When you consider that the primary purchaser of private corporate debt in the U.S. is insurers, private investment-grade credit operates within a **robust regulatory framework** designed to maintain market integrity and protect investors.
- The NAIC oversees, regulates, and sets standards for the U.S. insurance industry.
- Standards include annual asset-adequacy testing. Companies must also disclose holdings on an asset-by-asset level, which provides significant transparency into insurers' portfolios, as well as discloses related party investments.
- The NAIC Securities Valuation Office is responsible for the day-to-day credit quality assessment of securities owned by state regulated insurance companies.
- Insurers are subject to disclosure requirements by credit rating agencies and undergo periodic stress and liquidity testing.

**Myth:** Life insurers' investments in private credit are a potential source of systemic risk.

**Reality:**

- A recent evaluation by the IAIS found that life insurers' increasing allocation to "alternative assets," including private credit, does not currently pose a threat to global financial stability.
- The diversification of lending sources, such as increased participation by life insurers, **mitigates systemic dependence** on traditional lenders like banks, thereby decreasing reliance on a single lending channel.
- The ability to hold onto the assets often allows life insurers to absorb short-term volatility when markets tighten. This can **reduce systemic fragility** by dispersing credit exposure across non-bank balance sheets.