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# The Case for Private Credit in Insurance Portfolios

## An ever-expanding menu of private credit strategies can offer insurers the potential for attractive risk-adjusted returns.

We believe private credit markets—now with nearly $1.8 trillion in assets under management across an array of subsectors[1]—have the potential to offer attractive structural advantages for many institutions, especially insurance companies. In this paper, we discuss the rise of private credit, the potential merits of this burgeoning asset class, and why we believe it should continue to play an important role in insurance portfolios. And for a closer look at various strategies across the private credit landscape, please see Private Credit: An All-Weather Asset Class.

[1] Source: Preqin, data through June 2022.

## The Rise of Private Credit

Starved for yield in the easy-money era following the 2008 Great Financial Crisis, many institutional investors looked to private credit markets for relief. Insurance companies were especially keen to take advantage of private credit's predictable cash flows, risk diversification and illiquidity premium relative to public markets; furthermore, under the Solvency 2 framework, which was established in 2011, private credit was considered a lower-volatility assets class, which eased insurers' capital requirements.

But when central banks tightened the monetary reins in 2022, embarking on the fastest interest-rate increase in a century, it seemed only a matter of time before considerable asset flows would come rushing out of private credit markets into public credit. Surprisingly, quite the opposite happened, and we believe that the expected gush turned into a trickle for three reasons:

- First, private credit had come to play a vital role within insurance portfolios, thanks to its lower observed volatility and favorable return-on-capital treatment under the Solvency 2 framework.
- Second, as interest rates increased, so did yields on most private credit assets, which tend to have floating rate structures; likewise, the illiquidity premium also increased, we observed, which made private credit often look relatively more attractive versus its public peers.
- Third, rising rates led to sharp declines in both public bond and equity markets, which meant that insurers with a duration gap between their long-term liabilities and short-term assets saw the present value of their liabilities fall meaningfully more than the value of their assets. This improved their overall solvency position while reducing the need for higher-growth, yet riskier assets (like equities) to meet long-dated liabilities—resulting in more demand for longer-dated private credit.

We believe private credit, now a nearly $1.8 trillion asset class, will continue to play an important role as other avenues of financing—including bank loans, broadly syndicated loans (BSLs), and high-yield bonds—remain stubbornly out of reach. Banks have been less inclined to lend into a downturn, and banking regulations require considerable capital charges for long-term loans. In the BSL market, some lenders are still working through perhaps $50 billion in various "hung deals" that could trigger substantial losses if the underperforming loans were sold. And the skittish high-yield bond market remains accessible mainly to ostensibly safer, large-cap borrowers.

The last 12 months have been a reminder that debt financing is about more than rates and terms—it's about availability. In our view, access to available funding will remain especially critical for private equity (PE) sponsors who rely on private debt to finance the lion's share of their transactions—and we believe it will remain an important source of funding even as capital markets gradually re-open.

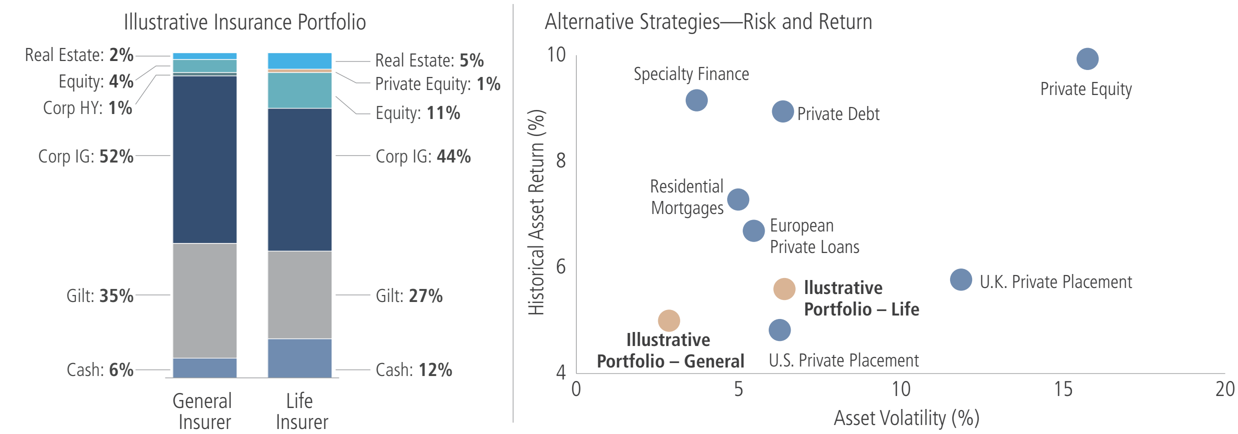
## The Value of Private Credit Strategies in Insurance Portfolios

While most insurance companies have a structural need for private credit, there are now myriad forms to choose from—including direct lending, mortgages, private placements, mezzanine debt, speciality finance (such as asset-backed lending) and distressed debt, all spanning a vast array of maturities and durations. (For a deeper discussion of some of these specific strategies, please see Private Credit: An All-Weather Asset Class.)

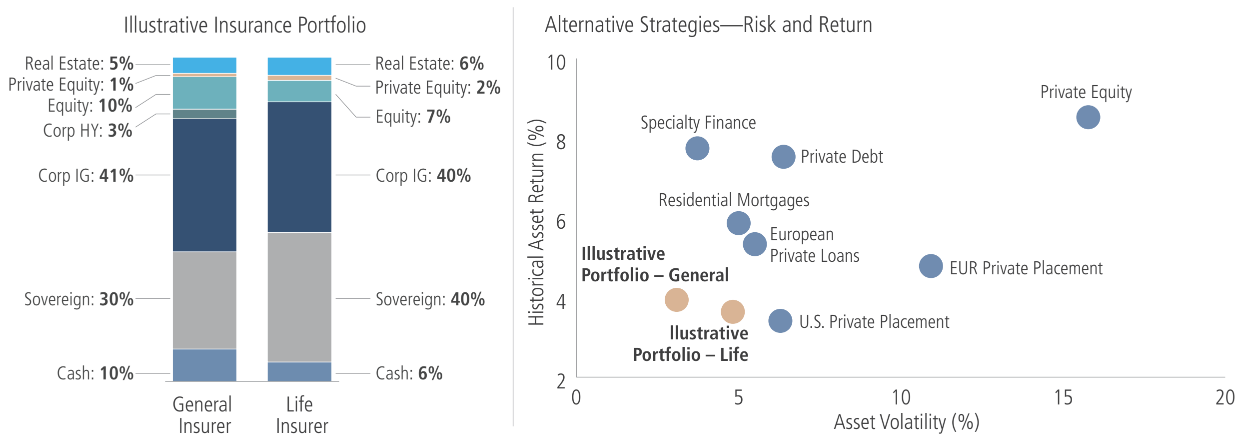
In our view, private credit's broad menu of strategies can potentially help insurers satisfy their specific risk-return requirements at a more granular level than public debt markets often can (see figure 1). Private-credit investors now can select sub-asset classes that match their required duration (specialty finance for shorter maturities), seniority (mezzanine debt for lower seniority), credit quality (distressed private credit for lower credit quality), or preferred collateral type (such as mortgages).

**FIGURE 1. POTENTIAL RISK/RETURN PROFILES FOR VARIOUS PRIVATE CREDIT STRATEGIES**

Incorporating Private Debt into an Insurance Portfolio (GBP)*




Incorporating Private Debt into an Insurance Portfolio (EUR)**




Source: Neuberger Berman, As of March 31, 2023. U.S. residential mortgages and Specialty Finance's gross return assumptions are based on the historical returns of NB strategies, while the rest are index based. Underlying Calculations and NB strategy assumptions are found in Endnotes. Mortgage loans of sufficient quality are only subject to counterparty credit risk under Solvency 2 – capital charge is then nil if LTV < 60%.

* Non-GBP assets are assumed to be fully hedged into GBP via rolling 3-month FX forwards / Expected return is defined as market yield to worst adjusted for expected default costs for fixed income assets and intermediate-term (5 – 7 year) expected returns for equity & alternative assets.

** Non-EUR assets are assumed to be fully hedged into EUR via rolling 3-month FX forwards (US private placement is hedged using 10-year cross currency swaps) / Expected return is defined as market yield to worst adjusted for expected default costs for fixed income assets and intermediate-term (5 – 7 year) expected returns for equity & alternative assets. Any comparisons herein of the investment performance of a referenced strategy to a benchmark or an index are qualified as follows: (i) the volatility of such benchmark or index may be materially different from that of the referenced strategy(s); (ii) such benchmark or index may employ different investment guidelines and criteria than the referenced strategy(s) and, therefore, the securities held by such strategy(s) may differ significantly from the securities that comprise such benchmark or index; and (iii) the performance of such benchmark or index may not necessarily have been selected to represent an appropriate benchmark or index to compare to the performance of the referenced fund(s) or strategy(s), but rather, is disclosed to allow for comparison of the referenced fund's or strategy's performance to that of a well-known benchmark or index.

Regardless of the underlying strategy, we believe insurers have the potential to earn higher returns with private credit than often possible with public debt. And while private credit's illiquidity premium varies over time, liquid-loan indices demonstrate that the premium has increased as rates have risen.

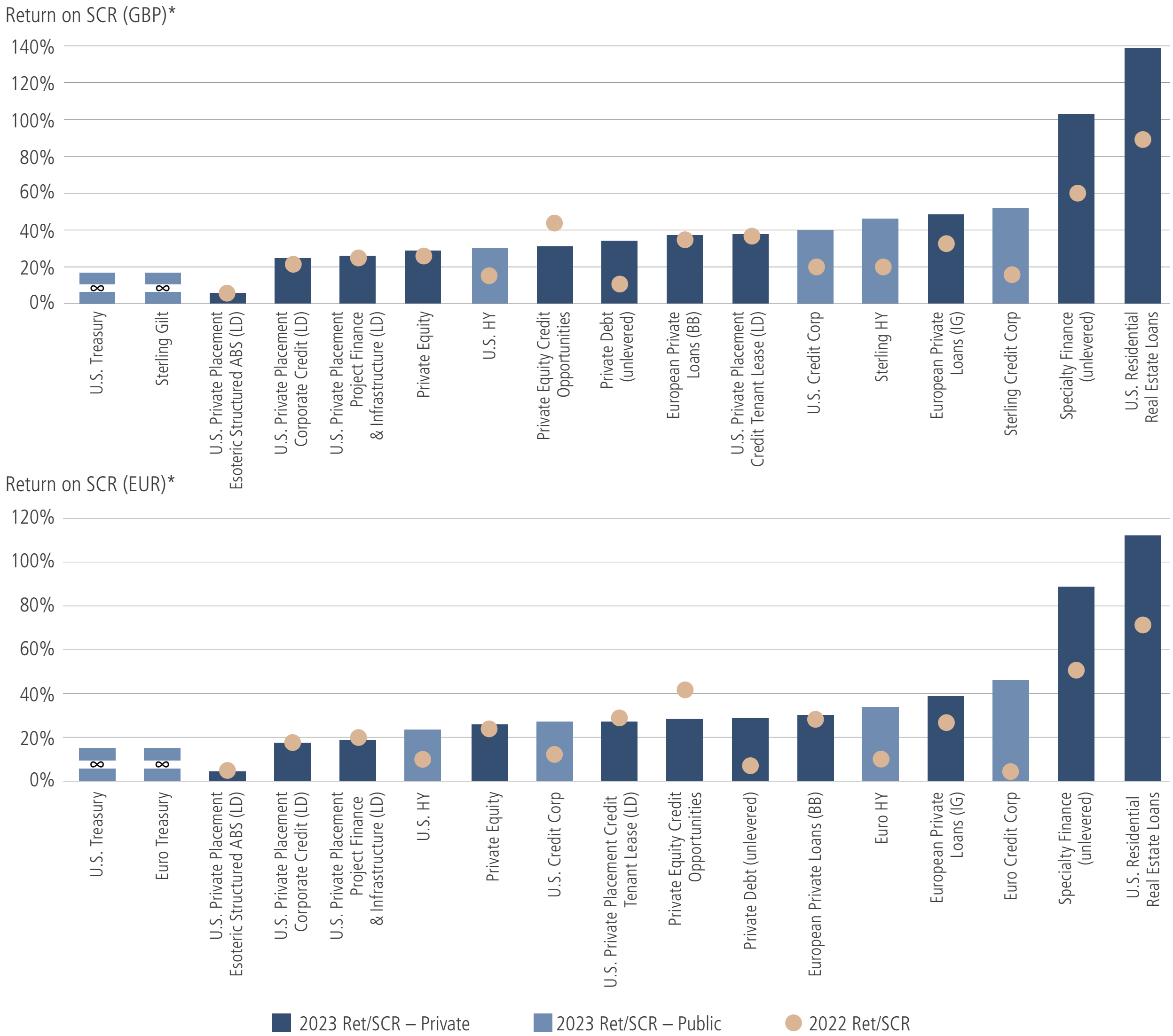
For example, in early January 2023, the YTM of the JP Morgan Liquid Loan Index[2] stood around 8.5%; by comparison, between September 2022 and January 2023, we observed that unlevered direct lending transactions were being underwritten at roughly 12.5%—a 400-bps pickup per annum. We also found that non-sponsor investment grade (BBB/A) borrowers in the European middle market were paying a consistent 200-bps premium over comparable public market rates.

[2] The J.P. Morgan Liquid Loan Index (LQLI) selects the 200 largest loans in the broader leveraged loan index, but is limited to only one loan per unique borrower. As such, the LQLI is intended to track the most liquid portion of the institutional loan market, thereby providing a theoretically more accurate proxy for real-time market performance.

Private credit's defensive qualities are another reason we believe this asset class can be an attractive addition to insurance portfolios. Between 2008 and 2022, maximum drawdown (defined as the decline from peak to trough) for unlevered direct-lenders has been -11.5%, versus -29.2% and -27.9%[3] for the liquid leveraged loan market and the U.S. High Yield market[4] (BB+ and below), respectively.

Finally, we believe private credit assets have the potential to deliver yields with relatively moderate capital charges. For insurers, that combination can translate into attractive returns on solvency capital requirements (SCR), as shown in figure 2.

**FIGURE 2: PRIVATE CREDIT CAN POTENTIALLY DELIVER ATTRACTIVE RETURNS ON CAPITAL FOR EUROPEAN INSURERS**




To note: Special Situations, Opportunistic Private Credit, Specialty Finance may incur a mixture of debt and equity investments (and sometimes securitized for Specialty Finance), which attract different levels of SCR. Numbers provided are a snapshot from a recent look through of the strategies and will vary depending on future underlying investments.

* Yield/ IRR/ target IRRs current as of March 31, 2023. All yield, return or IRR are hedged to GBP or EUR via 3-month forwards. U.S. Residential Real Estate Loans: Mortgage loans of sufficient quality are only subject to counterparty credit risk under Solvency 2 – capital charge is then nil if LTV < 60%. Underlying calculations can be found in Endnotes.

LD: Long dated. Net IRR is used for Private Equity Credit Opportunity, Special Situations, Private Debt and Specialty Finance, it can indicate a strategy where Yield does not constitute 100% of the returns. Net Target IRR used for Private Equity and Strategic Capital.

[3] Estimated from historical total return series of proxy indices. Source: Neuberger Berman, Bloomberg Barclays, HFRI, Credit Suisse, Citi, Citiwater, Cliffwater.

[4] The U.S. High Yield market includes USD bonds/loans from issuers/borrowers rated BB+ or below.

## Other Structural Benefits of Private Credit

In addition to higher yields and limited drawdown, we believe many private-credit assets have other positive attributes that can make them relatively attractive versus comparable public debt:

- **Seniority:** Direct lenders tend to sit high in the capital stack and are well guarded by covenants to help preserve capital.
- **Tighter documentation:** Private credit managers can often negotiate better terms relative to public offerings, most of which are covenant-light.
- **Fewer defaults:** Having open lines of communication with PE sponsors can help private credit providers act swiftly to stabilize portfolio companies and potentially dodge defaults. For example, at the peak of the Great Financial Crisis, in November 2009, the default rate of sponsor-backed loans hit 7.5% while non-sponsored leveraged loans surged to 16.2%.[5]
- **Constructive restructuring:** Unlike more broadly syndicated loans, private credit arrangements usually involve fewer players, which can help lenders form quick forums and make rapid course corrections with borrowers.
- **Diversification:** While most public debt is issued by large, listed companies, private credit providers can build diversified portfolios that complement their public debt holdings.

Risk, of course, remains. In the wake of rising rates, many life insurers suffered massive unrealized losses on their fixed-income portfolios (for more, see Bridging the Gap: Insurers and Fixed Income). Also, insurance policyholders who initiated coverage when interest rates were low may choose to surrender their policies in favor of potentially higher-yielding, more liquid products available in today's market.

As a result, and as with any illiquid asset class, we encourage insurers to continually assess their liquidity needs and calibrate their private credit portfolios accordingly.

## Conclusion

Even as yields on public debt have risen, we believe private credit markets continue to offer insurers an array of structural advantages—including a meaningful illiquidity premium, lower drawdowns, and favorable solvency capital requirements, among others. As private credit—in all its forms—continues to evolve, we believe this asset class will give insurers more tools by which to tailor their portfolios to meet their specific risk/return requirements.

[5] Source: S&P LCD. Includes default rates for leveraged loans for all companies in the S&P LCD Index.

## Appendix

### INCORPORATING PRIVATE DEBT INTO AN INSURANCE PORTFOLIO (GBP)

| Asset Class | Currency | Expected Return (%)[1] | Annual Vol (%) | OAS (bps) | Rating | Market SCR(%) |
|---|---|---|---|---|---|---|
| **Illustrative Portfolio – General** | **GBP** | **5.00** | **2.86** | **113** | **A1/A2** | **4.8** |
| **Illustrative Portfolio – Life** | **GBP** | **5.59** | **6.41** | **163** | **A2/A3** | **13.2** |
| European Private Loans | EUR | 6.69 | 5.47 | 250 | BAA3 | 14.9 |
| UK Private Placement | GBP | 5.77 | 11.86 | 213 | A3 | 11.3 |
| US Private Placement | USD | 4.82 | 6.27 | 183 | A3/BAA1 | 10.4 |
| Residential Mortgages | USD | 7.28 | 4.99 | 456 | | 5.3[2] |
| Private Debt | USD | 8.94 | 6.37 | 635 | B2 | 26.3 |
| Specialty Finance | USD | 9.15 | 3.71 | | | 15.7 |
| Private Equity | USD | 9.93 | 15.76 | | | 49.7 (22.0 if LTE[3]) |

### INCORPORATING PRIVATE DEBT INTO AN INSURANCE PORTFOLIO (EUR)

| Asset Class | Currency | Expected Return (%)[2] | Annual Vol (%) | OAS (bps) | Rating | Market SCR (%) |
|---|---|---|---|---|---|---|
| **Illustrative Portfolio – General** | **EUR** | **3.94** | **3.09** | **95** | **A1/A2** | **7.8** |
| **Illustrative Portfolio – Life** | **EUR** | **3.64** | **4.82** | **65** | **A1/A2** | **7.3** |
| European Private Loans | EUR | 5.34 | 5.50 | 250 | BAA3 | 14.9 |
| EUR Private Placement | EUR | 4.79 | 10.93 | 251 | A3 | 11.5 |
| US Private Placement | USD | 3.41 | 6.29 | 183 | A3/BAA1 | 10.4 |
| Residential Mortgages | USD | 5.87 | 5.00 | 456 | | 5.3[2] |
| Private Debt | USD | 7.53 | 6.39 | 635 | B2 | 26.3 |
| Specialty Finance | USD | 7.74 | 3.73 | | | 15.7 |
| Private Equity | USD | 8.52 | 15.78 | | | 49.7 (22.0 if LTE[3]) |

Source: Neuberger Berman, As of December 31, 2022.
U.S. residential mortgages and Specialty Finance's gross return assumptions are based on NB strategies, while the rest are index based. Underlying Calculations are found in Endnotes. Mortgage loans of sufficient quality are only subject to counterparty credit risk under Solvency 2 – capital charge is then nil if LTV < 60%. Any comparisons herein of the investment performance of a referenced strategy to a benchmark or an index are qualified as follows: (i) the volatility of such benchmark or index may be materially different from that of the referenced strategy(s); (ii) such benchmark or index may employ different investment guidelines and criteria than the referenced strategy(s) and, therefore, the securities held by such strategy(s) may differ significantly from the securities that comprise such benchmark or index; and (iii) the performance of such benchmark or index may not necessarily have been selected to represent an appropriate benchmark or index to compare to the performance of the referenced fund(s) or strategy(s), but rather, is disclosed to allow for comparison of the referenced fund's or strategy's performance to that of a well-known benchmark or index. This summary is for illustrative and discussion purposes only and does not constitute an offer or a solicitation with respect to the purchase or sale of any security. Note: Limitations of Expected or Target Returns: Returns data is for information purposes only. There is no guarantee that expected returns will be realized or achieved or that an investment strategy will be successful, and may be significantly different than that shown here. Prospective investors should keep in mind that the securities markets are volatile and unpredictable. There are no guarantees that the historical performance of an investment, portfolio, or asset class will have a direct correlation with its future performance. Net returns will also be significantly lower. Please see important disclosures regarding forward looking statements at the end of this document.

[1] Non-GBP assets are assumed to be fully hedged into GBP via rolling 3-month FX forwards / Expected return is defined as market yield to worst adjusted for expected default costs for fixed income assets and intermediate-term (5-7 year) expected returns for equity & alternative assets.

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[3] LTE: Long-Term Equity treatment with a 22% capital charge in listed and unlisted equities if specific regulatory requirements are met.

**RETURN ON SCR (GBP)**

As of March 31, 2023

| Index Name | Currency | YTW (LC) | YTW Hedged | SCR | BSCR | SST | 2022 Ret/SCR | 2023 Ret/SCR |
|---|---|---|---|---|---|---|---|---|
| U.S. Treasury | USD | 3.8 | 3.1 | 0.0 | 0.0 | 0.0 | ∞ | ∞ |
| Sterling Gilt | GBP | 3.6 | 3.6 | 0.0 | 0.0 | 0.0 | ∞ | ∞ |
| USPP Esoteric Structured ABS (LD) | USD | 6.6 | 5.9 | 100.0 | 1.5 | 100.0 | 5% | 6% |
| USPP Corporate Credit (LD) | USD | 5.6 | 4.9 | 20.0 | 3.0 | 22.9 | 22% | 25% |
| USPP Project Finance & Infrastructure (LD) | USD | 5.9 | 5.2 | 20.0 | 3.0 | 23.7 | 25% | 26% |
| PE Broad Index | USD | 15.0 | 14.3 | 49.7 | 45.0 | 48.0 | 26% | 29% |
| U.S. HY | USD | 7.2 | 6.5 | 21.5 | 13.0 | 22.1 | 15% | 30% |
| Private Equity Credit Opportunities | USD | 16.2 | 15.5 | 49.7 | 45.0 | 48.0 | 43% | 31% |
| Private Debt (unlevered) | USD | 9.6 | 8.9 | 26.3 | 15.0 | 23.3 | 10% | 34% |
| European Private Loans (Broad) | EUR | 5.7 | 7.1 | 19.1 | 4.5 | 23.6 | 34% | 37% |
| USPP Credit Tenant Lease (LD) | USD | 5.6 | 4.9 | 13.0 | 1.5 | 17.6 | 36% | 38% |
| U.S. Credit Corp | USD | 5.1 | 4.4 | 11.0 | 2.2 | 16.1 | 20% | 40% |
| Sterling HY | GBP | 8.7 | 8.7 | 19.0 | 11.8 | 18.7 | 20% | 46% |
| European Private Loans (IG) | EUR | 5.5 | 6.8 | 14.1 | 2.7 | 21.0 | 32% | 48% |
| Sterling Credit Corp | GBP | 5.5 | 5.5 | 10.6 | 2.2 | 14.9 | 16% | 52% |
| Specialty Finance (unlevered) | USD | 11.0 | 10.3 | 10.0 | 3.6 | 13.8 | 60% | 103% |
| U.S. Residential Real Estate Loans | USD | 8.0 | 7.3 | 5.3 | 1.5 | 6.0 | 89% | 139% |

To note: Neuberger Berman Special Situations, Opportunistic Private Credit, Specialty Finance may incur a mixture of debt and equity investments (and sometimes securitized for Specialty Finance), which attract different levels of SCR. Numbers provided are a snapshot from a recent look through of the strategies and will vary depending on future underlying investments.

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**RETURN ON SCR (EUR)**

As of March 31, 2023

| Index Name | Currency | YTW (LC) | YTW Hedged | SCR | BSCR | SST | 2022 Ret/SCR | 2023 Ret/SCR |
|---|---|---|---|---|---|---|---|---|
| U.S. Treasury | USD | 3.8 | 1.7 | 0.0 | 0.0 | 0.0 | ∞ | ∞ |
| Euro Treasury | EUR | 2.9 | 2.9 | 0.0 | 0.0 | 7.4 | ∞ | ∞ |
| NB USPP Esoteric Structured ABS (LD) | USD | 6.6 | 4.5 | 100.0 | 1.5 | 100.0 | 4% | 4% |
| NB USPP Corporate Credit (LD) | USD | 5.6 | 3.5 | 20.0 | 3.0 | 22.9 | 17% | 18% |
| NB USPP Project Finance & Infrastructure (LD) | USD | 5.9 | 3.8 | 20.0 | 3.0 | 23.7 | 20% | 19% |
| U.S. HY | USD | 7.2 | 5.1 | 21.5 | 13.0 | 22.1 | 10% | 24% |
| PE Broad Index | USD | 15.0 | 12.9 | 49.7 | 45.0 | 48.0 | 24% | 26% |
| U.S. Credit Corp | USD | 5.1 | 3.0 | 11.0 | 2.2 | 16.1 | 12% | 27% |
| NB USPP Credit Tenant Lease (LD) | USD | 5.6 | 3.5 | 13.0 | 1.5 | 17.6 | 29% | 27% |
| NB Private Equity Credit Opportunities | USD | 16.2 | 14.1 | 49.7 | 45.0 | 48.0 | 41% | 28% |
| NB Private Debt (unlevered) | USD | 9.6 | 7.5 | 26.3 | 15.0 | 23.3 | 7% | 29% |
| NB European Private Loans (Broad) | EUR | 5.7 | 5.7 | 19.1 | 4.5 | 23.6 | 28% | 30% |
| Euro HY | EUR | 6.6 | 6.6 | 19.6 | 11.3 | 20.4 | 10% | 34% |
| NB European Private Loans (IG) | EUR | 5.5 | 5.5 | 14.1 | 2.7 | 21.0 | 27% | 39% |
| Euro Credit Corp | EUR | 3.7 | 3.7 | 8.1 | 1.9 | 11.9 | 4% | 46% |
| NB Specialty Finance (unlevered) | USD | 11.0 | 8.9 | 10.0 | 3.6 | 13.8 | 50% | 89% |
| NB U.S. Residential Real Estate Loans | USD | 8.0 | 5.9 | 5.3 | 1.5 | 6.0 | 71% | 112% |

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