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No Need to Stress About Less Distressed

Following the Global Financial Crisis (GFC) of 2008, the distressed credit landscape has been substantially reshaped by regulatory changes, shifts in economic cycles and the growing influence of alternative investment strategies. This article explains why the economic and market trends of the past 15 years mean outright distress has become rarer and asks, are there other areas of the credit markets where insurers can look for a similar return profile?

Traditionally conservative insurance companies began to allocate to distressed debt in search of higher yields in a low-interest-rate environment, encouraged by regulators urging diversification through investments with relatively efficient Solvency Capital Requirements (SCR). At the same time, the opportunity set grew, as reforms to banking regulation such as Basel III and the U.S. Dodd-Frank Act introduced stricter capital requirements and a decrease in their distressed asset holdings. That opportunity set was especially abundant in the immediate aftermath of the GFC, when the corporate default rate soared and financial institutions reeled from crisis-related losses.

However, default rates soon began to decline significantly. According to Moody’s, global speculative-grade default rates peaked at 13% in 2009, but decreased to approximately 2 – 3% by 2024. This came as a result of a number of structural trends:

A prolonged period of economic expansion and low interest rates allowed companies to refinance debt more easily, with even the shock from the COVID-19 pandemic proving short-lived in the new era of responsive fiscal and monetary policy.

A shift toward covenant-light loans, which have fewer financial maintenance requirements and other protections for lenders, has reduced early warning signals for potential distress. That has made it more challenging to identify and act on distressed opportunities before they escalate into defaults; and by the time a default does occur, assets have often already been stripped, lowering recovery values for lenders.

Liability Management Exercises (LMEs), such as debt exchanges and buybacks, have become more common tools with which companies manage their balance sheets in recent years. While reducing the availability of traditional distressed opportunities, LMEs have also opened new avenues for investors to engage in complex restructurings and debt-for-equity swaps.

Ownership of corporate loans has shifted away from banks and toward private credit funds, collateralised loan obligations (CLOs) and even private equity funds pursuing "loan-to-own" strategies. Banks, with their short-term capital focus, tended to quickly offload distressed assets to specialist investors, whereas these newer entrants bring locked-up capital and longer investment horizons to the market. That means their strategies are more likely to involve working through restructuring processes, potentially delaying or even preventing the realization of distressed opportunities that would previously have come to the wider market. This has led to a more complex and competitive environment for distressed credit specialists, who must navigate these new structures and relationships to identify and capitalise on potential opportunities.

The result of these trends is that, while smaller and more nimble distressed debt specialists have been able to identify and capitalize on stress in specific sectors, such as shopping malls or consumer cyclicals, the largest, multibillion-dollar managers have struggled to find sufficient opportunities.

This has been problematic for many insurance companies' credit portfolios. Despite higher capital charges for distressed debt compared with traditional credit—SCR can exceed 20% under the Standard Formula—as we noted above, these requirements low in relation to the double-digit returns associated with the asset class. Faced with such a dearth of opportunity, insurance investors are looking for other credit markets that can offer similar return-to-SCR payoffs.

The most common place to look is private credit direct lending. This is senior and secured and generally incurs a lower SCR but, even in a higher-rate environment, yields will tend to be lower than those in distressed debt. Moreover, many insurers are already fully allocated to this asset class.

We now see more attention being directed to asset classes that stretch across the debt-equity divide, such as mezzanine finance and the suite of strategies often referred to as "capital solutions."

Capital solutions involves providing bespoke, flexible growth capital to companies unable to raise more debt or requiring a more bespoke funding and unwilling to dilute existing shareholders. Its return profile is very similar to that of distressed debt. While these strategies generally have more predictable return profiles than more volatile distressed debt exposures, borrowers pay a premium for the bespoke nature of the financing and for the flexibility of the debt-equity hybridity: private preferred stock, often with payment-in-kind (PIK) optionality, is a common constituent of capital solutions strategies, for example.

That hybridity also means that the SCR of capital solutions can often be higher than that of distressed debt. Selecting investments that are eligible for Long Term Equity (LTEI) capital treatment can make all the difference, potentially delivering an estimated return-on-capital that is notably attractive. The diversification benefits provided by the spread risk factors of these strategies make them valuable components of insurance portfolios, in our view.

A turn in the economic cycle, perhaps triggered by the impact of higher rates, could see a substantial rise in default rates; however, we think it more likely that companies will continue to prioritise proactive balance sheet management, in partnership with alternative lenders, limiting the generation of new distressed debt opportunities. In our view, private credit, mezzanine and capital solutions strategies have emerged permanently as preferred avenues for both issuers and investors, reshaping the landscape of credit investing.

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