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Loans – why now?

Although initially sluggish after the credit crisis, the loans market has grown in recent years. Paul Traynor, head of insurance services, EMEA at BNY Mellon, explains why investing in loans could offer high yield – and other numerous advantages – to insurers looking to diversify their portfolios

IT'S GREAT news for borrowers, but it's a dramatically different story for insurers. Record low interest rates on both sides of the Atlantic have provided a barren landscape for insurance companies in their search for yield. Global stock markets may have recovered some of their lustre of late, but the 10-year US Treasury yield is still under 2% and about half the rate it was five years ago. Value is hard to come by in the fixed-income market. This is why we're seeing more interest in floating-rate loans from insurance companies, which have traditionally been the domain of banks and mutual funds.

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An introduction to loans

The financial crisis and a deluge of new regulations have left a void in terms of bank lending, and this has created an opportunity for insurance companies. Banks still want to keep the borrower's business, but don't want to take on the risk of a big loan. So a bank will commonly act as an arranger for the loan and pass the risk on to a group or syndicate of lenders that want to generate a return. These syndicates include other banks, hedge funds and – increasingly – insurance companies. The advantage of a syndicate is that it helps spread the risk of exposure to the lenders, so no party is solely liable for the loan.

The loan is usually structured so the arranger, which is commonly a bank, will negotiate the broad terms of the loan between the borrower and the syndicate of lenders. One member of the syndicate will often act as the administrative agent, working as the record-keeper, the monitor and the paying agent. It is then that third-party administrators are appointed to service the loan portfolios, and are referred to as loan collateral administrators. This is where BNY Mellon fits in, and it's an area in which we have more than 20 years of experience as well as a significant market share. We act both as the administrative agent on the sell side and the loan collateral administrator on the buy side. Loans involve a lot of manual administration, and BNY Mellon has the infrastructure and global footprint to help insurers deal with the large network of parties in their portfolio of loans. We provide a full-service model that includes the settlement processes and tracking of loans, and carry out compliance tests to ensure all of the assets meet the investment criteria of the fund.

The benefits of investing in loans

Traditionally, insurance companies have been reluctant to invest in loans because they tend to be illiquid, harder to access – because they trade on an over-the-counter basis – and need specialist corporate credit skills. But, increasingly, insurance companies are seeing the advantages of investing in loans. There is generally a three- to five-year horizon on loans, which typically matches the liabilities of health and car insurers. Some loans, such as infrastructure loans, have a longer horizon of up to 30 years and provide a better fit for the liabilities of life products.

Alongside bonds and bilateral commercial bank loans, the floating-rate loan offers businesses another alternative to borrowing money and offers the lender numerous advantages. One major benefit is that loans are more senior in a company's capital structure than bonds because they are secured on the operating assets of the borrower. In the event of default, a company's assets are transferred to the holder of the loan before other equity or debt holders. In contrast, high-yield bonds are generally unsecured and issued at the level of the holding company.

Between 1987 and 2011, the average recovery rate – the amount recovered in the event of default – on floating-rate loans was 80%, according to Moody's. This was nearly three times the recovery rate on tradition subordinated debt, which recouped just 29% over the same period. When you consider that the yields on bonds and loans are trading at about the same level, some investors consider the risk/return ratio of loans is much better. That said, with a whole loan you are exposed to the very first dollar of loss – that may not be the case with a collateralised loan obligation (CLO), depending on the tranche one holds.

Another crucial advantage of loans over high-yield bonds is that they are issued with a floating rate and not a fixed-rate coupon. The loan coupon is tied to a variable rate index, which is often the Libor rate. The key to this is that the floating-rate coupon – which is generally reset every 30 to 90 days – acts as an insurance policy against rising interest rates. Historically, loans have outperformed bonds when interest rates have risen by 1% or more. When the US Federal Reserve cut interest rates to a record low in December 2008, few expected rates to remain at this level for more than four years. But economies are cyclical and interest rates will rise at some point. The floating coupon also acts as a buffer against inflation because rises in interest rates and inflation often go hand in hand. When an economy picks up, interest rates and inflation also tend to rise.

The final major advantage of loans is that new regulations are making them more attractive to insurers than investing in securitised debt. Under the Solvency II directive, insurers will have to set aside more capital to invest in what the European Union deems to be riskier assets such as securitised debt. This is the pooling of various types of debt such as corporate loans, residential and commercial mortgages and credit card debt. Post Solvency II, from a regulatory capital perspective, it will likely be more efficient to lend directly rather than via a CLO.

Loan options for insurers

The loans market has grown rapidly over the past 15 years. The total amount of floating-rate loans outstanding was $35 billion in 1997, which grew to $518 billion in 2011, according to Standard & Poor's (S&P). This growth was curtailed by the credit crisis, which led to a rise in defaults and this forced down returns and demand for loans. Although initially sluggish after the crisis, there has been a pick-up in loans over the last couple of years. The S&P/Loan Syndications and Trading Association US Leveraged Loan Index – which tracks the average bid price of the largest loans – reached its highest point in over five years at the end of March this year. Many new loan issues have been heavily oversubscribed recently, and the bid prices for loans in the secondary market are rising.

The range and depth of loans offer insurers an opportunity to diversify their portfolios. The recent acquisitions of both Virgin Media and Heinz were funded by billions of dollars in loans and we are also seeing borrowers across a diverse range of sectors, ranging from healthcare to hotels. For insurance companies entering the market, it is common to invest between $2 million and $3 million in each loan and, to build a diverse loan portfolio, you need to invest about $100 million.

The potential level of return on the loan depends on the credit quality of the borrower and average yields range from 4–20%. Many insurers, such as life insurers, which have longer liabilities, are looking for value and less volatility. They might opt for an unleveraged plain vanilla loan, which will offer a return of 4–7%. These loans offer a lower default risk, and are easier to enter and exit.

Insurers with a bigger appetite for risk can invest in subordinate debt or mezzanine loans, which offer a higher return of 10–12%. However, this market is less liquid, it's more difficult to exit and investors are further down this list of debt holders in the event of a company defaulting.

High yields are increasingly hard to come by in this low interest rate landscape, and loans offer insurers another opportunity to diversify their portfolios. In the current environment these opportunities are scarce.

The eurozone crisis has also offered plenty of opportunities for investors in distressed loans, which are even less liquid and even more volatile. These loans can offer returns of 15–20%, but are high risk. The borrower is often either in default or under bankruptcy protection, or at least heading that way.

In-house versus specialist loan managers

Insurers who are thinking about entering the loans market can chose to build up their expertise in-house or get advice from one of our specialist loan managers. These include Alcentra, which specialises in sub-investment-grade loans, and Insight Investment, a specialist fixed-income manager. There are advantages to going in-house; you have more control over your investment decisions and your monitoring costs are less. But many insurance companies will, especially in the initial stages of entering the loan market, opt for a third-party manager because they are more cost effective. Credit rating agencies, such as S&P, do provide ratings on loans, but you still need the specialist expertise and infrastructure to invest in this asset class properly. Third-party managers also have better access to the management team of the borrower and market opportunities. The loans market operates mostly as a private market, where you are invited to look at transactions. Unless you have a relationship with the banks and private equity firms, you'll struggle to get access to the market and see the best opportunities to invest.

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