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Real asset debt: a substitute for bonds?

Collateralised assets benefit insurers under Solvency II

Nathalie Pistre, PhD
Deputy Head of Fixed Income
Head of the Quantitative Research and Analysis team

Natixis Asset Management

Key Takeaways:

- The limited availability and illiquidity of real asset debt create higher potential margins on the asset class compared to traditional bonds.
- The risks of real asset debt are reduced by high expected recovery rates thanks to the underlying collateral. The underlying assets include collateral across the real estate, infrastructure and aircraft segments, and other real assets.
- Collateralisation, or other reductions in SCR, can be obtained under the Solvency II Directive for insurers. This increases the returns for insurers relative to similar debt instruments that do not benefit from real asset SCR reduction.

Bonds have long been the staple of institutional investment portfolios, but they no longer perform their primary role – to deliver yields that match long-term liabilities, with relatively low risk. Yields on all bond types, from sovereign debt to high yield, have plummeted. At the same time, historically high bond prices mean many bonds offer the potential for greater downside than upside.

So investors are searching for replacements. One of these is debt backed by real assets which, in general, offers superior risk-adjusted returns relative to bonds with similar characteristics.

Relative returns from real asset debt are even more impressive when the Solvency Capital Requirement (SCR) under the Solvency II Directive is factored in, which makes debt backed by real assets particularly attractive to insurers.

The SCR of infrastructure debt, for instance, is considerably lower than for standard debt of the same maturity. Although liquidity and availability could limit the weight of infrastructure debt in the portfolio, it is a good diversifier as well as a yield-enhancer.

So let's take a closer look at real asset debt and consider how and why it can benefit the portfolios of longer-term investors and, particularly, insurance companies.

What is real asset debt?

Investors can potentially allocate to many types of real asset debt, but let's focus on three of the more mature and widely-used segments:

- Real estate debt
- Aircraft debt
- Infrastructure debt

These three segments share a number of common features which are attractive to investors.

First, they represent debt instruments which are issued to finance the acquisition, construction and operation of an asset. The management of the asset provides the income used to pay, in the first instance, debt holders and, only after that, equity holders. The assets are usually managed via a Special Purpose Vehicle (SPV), which ringfences the debt from other debt instruments and securitises the investments.

The first two segments (real estate and aircraft debt) are based on assets for which there is a secondary market, which creates liquidity for the assets and a robust pricing mechanism. Meanwhile, infrastructure debt can be used to finance a wide range of assets, such as power plants, railways, roads, schools and hospital, thereby offering investors large diversification benefits.

Generally, senior real asset debt benefits from high illiquidity premium vs liquid assets, and recovery rates supported by a strong collateralisation.

The SCR advantages

For an insurer, the return on any investment should take into account the SCR. This dimension is favourable to real assets debt.

In terms of the Risk Adjusted Return On Capital (RAROC), real asset debt tends to outperform senior unsecured and subordinated debt. A variety of real-asset debt classes show larger RAROC than investment grade corporate bonds and sovereign bonds[1]. RAROC is the ratio of risk adjusted return to economic capital. The economic capital is the minimum capital required to ensure survival in a worst-case scenario. In this sense, it is a buffer against unexpected shocks in the value of an investment.

The RAROC of real asset debt compared with traditional BB and Tier 2 bonds is larger still[1]. This reflects the reduced underlying risk of real asset debt, both in terms of the default rate and of the recovery rate, because the debt is collateralized.

The main risks that can impact the SCR calculation for a debt instrument are:

- Interest rate risk
- Spread risk
- Market risk concentration
- Currency risk.

Of these, spread risk generally has the most significant impact on debt assets.

Spread risk is significantly reduced for infrastructure debt: the potential market shock to infrastructure debt is reduced by 30% compared to the shock for corporate rated notes and by more than 40% compared with non-rated securities.

In addition, the SCR charge for corporate debt with a AAA rating, for instance, is larger than infrastructure debt with a rating of A.

Because real estate debt is collateralized, it enjoys preferential treatment under Solvency II. The SCR charge for real estate debt can be reduced by as much as half if the value of the collateral is high compared with the value of the loan. The threshold over which the exposure is taken into account is considerably higher than for non-collateralized debts.

But, for the collateral mitigation mechanism to work, there are a number of conditions that must be met. First, if there is a credit event, the insurer must be able to liquidate or take possession of the collateral. The collateral also must have sufficient liquidity and minimum credit quality, and should be stable in terms of value. In addition, it should be guaranteed by a counterparty for which there is no concentration risk. Finally, there should be no material correlation between the credit quality of the collateral and the credit quality of the counterparty.

For aircraft secured debt, the risk mitigation mainly arises through the debt rating, which may be higher than the airline's corporate rating thanks to the recovery potentially provided by the value of the aircraft.

Although airlines are generally unrated or sub-investment grade companies, thanks to the mortgage over their mobile and fungible assets - the aircraft - and the good level of recovery granted by that security, aircraft-secured debt ratings can easily reach investment grade, and the RAROC of aircraft debt is also attractive.

In a nutshell: the case for real asset debt

The benefits to insurers of investing in real asset debt as an alternative or as a complement to traditional bonds, are compelling.

First, in terms of returns, the limited availability and illiquidity of real asset debt create higher potential margins on the asset class compared to traditional bonds.

Second, the risks are reduced by higher expected recovery rates thanks to the underlying collateral, and the associated securities and covenants. The underlying assets include a wide range of collateral across the real estate, infrastructure and aircraft segments, and other real assets. This creates diversification, reducing the impact of negative market events on the overall portfolio. Also, since real asset debt is generally issued through SPVs, there is no corporate credit default risk.

Third, collateralisation or other reductions in SCR can be obtained under the Solvency II Directive for insurers. This, effectively, increases the returns for insurers relative to similar debt instruments that do not benefit from real asset SCR reduction.

Written on 3 July 2017

[1]Source : Natixis Asset Management Fixed Income, Solvency II for Real Asset Debt dated 20/09/2016, p.14-15, data as of 09/09/2016.

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RCS Paris n°329 450 738
21 quai d'Austerlitz 75634 Paris Cedex 13
www.nam.natixis.com

Natixis Global Asset Management S.A.
RCS Paris 453 952 681
Share Capital €178 251 690
21 quai d'Austerlitz, 75013 Paris
www.ngam.natixis.com

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