GCM GROSVENOR

Incorporating Alternatives into Insurance Portfolios through Structured Solutions

September 2022

***Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its given objectives or avoid losses. Unless apparent from context, all statements herein represent GCM Grosvenor's opinion. Select risks include**: market risks, credit risks, macroeconomic risks, liquidity risks, manager risks, counterparty risks, interest rate risks, and operational risks.*

Insurers are increasingly investing assets in alternatives to generate returns that complement their broader portfolios. However, there are many considerations, such as capital requirements and state regulations, that if not properly addressed, may constrain or cause challenges in implementing a successful alternative investment strategy. There are also a range of investment structures and approaches for insurers to consider when integrating alternative investments to optimize the success of their overall portfolio.

In the following, we look at the evolving alternatives industry as it relates to US insurers, discuss considerations insurers must keep in mind when making investment decisions, and explore several structured solutions that can help bridge the attractive nature of alternative investments with the unique challenges faced by insurance companies. Potential benefits of such tailored and customized structured solutions can include capital efficiencies, operational efficiencies, rating efficiencies, and more. Finally, we discuss the recent regulatory changes and their potential impact on structured solutions to investing in alternatives.

THE GROWTH OF ALTERNATIVES IN INSURANCE PORTFOLIOS

Over the last 15 years, alternative investments have become an increasingly important part of a diversified insurance portfolio as a way to enhance long-term total returns. As illustrated below, the amount of Schedule BA alternatives on US insurers' balance sheets more than tripled, from $63 billion to $217 billion, between 2006 and 2021[1]. As a percentage of total invested assets, Schedule BA alternatives allocations doubled from 1.6% to 3.1% during the same time period. The amount of dry powder* has also continued to grow steadily over the past 10 years, increasing from $28 billion in 2011 to $85 billion in 2021. While investments on Schedule BA are primarily in alternative funds, the insurance industry holds an additional $63 billion in private credit[†] on Schedule D, $619 billion in common stocks[‡], and $42 billion in directly held real estate on Schedule A.

*Defined as "commitment for additional investment" on Schedule BA.

[†]Defined as unaffiliated below investment grade private investments, excluding RMBS, CMBS, and loan-backed and other asset-backed securities.

[‡]Schedule D unaffiliated common stock.

We expect insurers' focus on deploying capital in the alternatives space to continue to grow over time. According to several industry surveys, insurers continue to favor alternative investments and expressed willingness to increase allocations to asset classes such as private equity, real estate equity, private credit, and infrastructure.

Insurers' Investments in Schedule BA Alternatives Continue to Grow

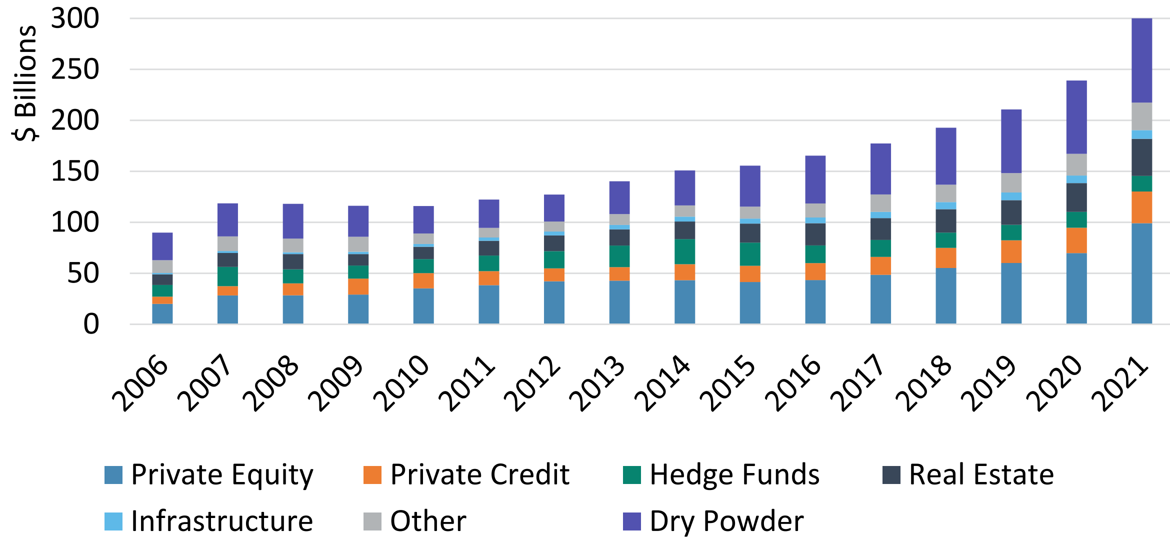

Figure 1
Source: Capital IQ Pro, Statutory carrying values[1].

Within Schedule BA, private equity allocations have grown most materially, increasing from 35.9% to 45.6% of all Schedule BA alternatives since 2015. In addition, we observe growth in private equity co-investments, private credit direct lending, and infrastructure investments which, for example, increased from 2.0% in 2006 to 3.9% of Schedule BA alternative investments in 2021[1].

As seen below, across US insurers both the total allocation to alternatives and the allocation's breakdown to specific asset classes tend to be largely dependent on the size of the insurance company. Insurers with a total portfolio of $5-10 billion have, on average, higher allocations to alternatives compared to their peers, likely due to their higher risk tolerance and need to grow their balance sheet. A similar pattern can be observed for both Life and P&C Insurers.

Schedule BA Alternatives Allocation by Company Size

% of Total Invested Assets

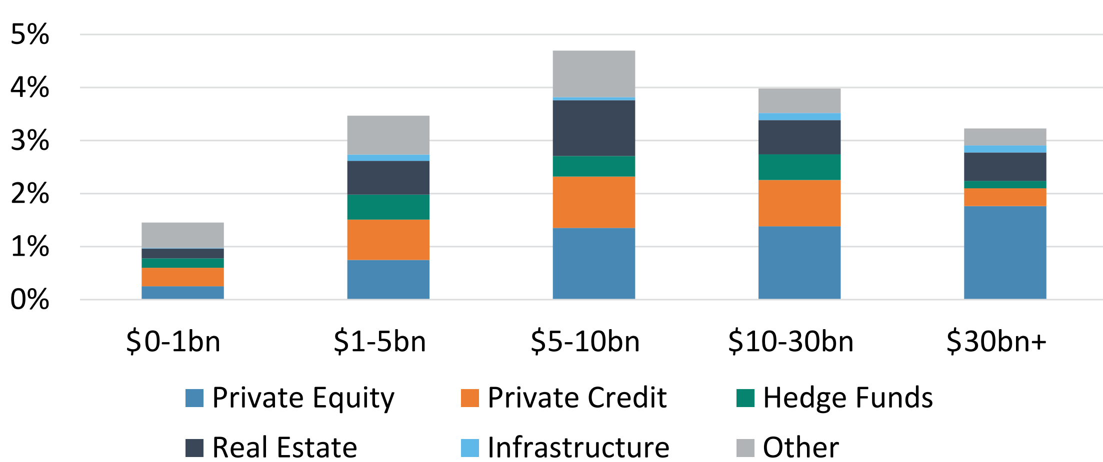

Figure 2
Source: Capital IQ Pro, Statutory carrying values[1], excluding P&C entities of Berkshire and State Farm as outliers.

As a percentage of total Schedule BA alternatives, larger companies tend to invest more in private equity, whereas smaller companies invest more in private credit. Private credit is a natural complement and extension of insurers' core fixed income portfolios, where they can enhance returns, often with reduced volatility compared to the public market. Private credit may also offer more favorable covenants and other flexibilities that the public market does not offer. It is also worth noting that larger insurers may have various ways to invest in private credit that are more capital efficient (often times on Schedule D, instead of Schedule BA), which can include structured solutions.

CONSIDERATIONS FOR A SUCCESSFUL ALTERNATIVE INVESTMENT STRATEGY

There are several areas for insurers to consider that can inform their strategy and impact their success when investing in alternatives:

Capital Frameworks (regulatory, rating agency, and internal)

One of the most important considerations for insurers when it comes to investing in alternatives is capital frameworks. In the US, the relevant regulatory capital framework is Risk Based Capital (RBC), in which alternative investments usually incur the highest required capital charges. For example, for life insurance companies, a BBB-rated corporate bond has an RBC (pre-tax) charge of 1.52%, while an LP stake in a fund investment has a before-tax charge of 30%[2]. Rating agencies may have their own versions of capital models (e.g., S&P Capital, AM Best's BCAR) that feed into ratings outcomes, which in turn, will impact an insurer's product sales, reinsurance transactions, and so on. Higher required capital means the insurer would either need to raise more capital to maintain a target RBC ratio or face a lower capital adequacy ratio.

State Regulations

Insurers are regulated at the state level. Each state has insurance laws dictating what assets insurers can invest in and how much they can invest in those assets. It is quite common for state regulations to have a "leeway" or "basket" clause that allows a certain amount (e.g., 10%) of total admitted assets to be invested in asset classes not explicitly disallowed in the regulations. This clause usually applies to alternative investments, especially in the form of LP interests.

Risk Tolerance

Insurers should consider how alternative investments fit into their existing risk and investment policies. Such policies may include limits on the amount of illiquid assets, risk budget, tail risk constraints, capital constraints, income volatility, and accounting measures, all of which are sensitive to the amount and type of alternative investments that insurers can pursue. Sometimes, to pursue an alternative investment strategy, insurers may need to change or update their existing policies.

Liquidity and Asset-Liability Management

Alternative investments are typically illiquid in nature, requiring capital to be locked up for a period of time. Therefore, insurers should consider alternatives in the context of their overall portfolio liquidity and asset-liability management to ensure there is enough liquidity to pay off their claims and expenses. They must also carefully manage cash flows to ensure capital calls are met. Insurers need to determine the source of funds, whether they are from new premiums, interest/return of capital generated from other parts of the portfolio, or through liquidating assets.

Manager Selection

Manager selection is an extremely important component of investing in alternatives regardless of investor type. A significant performance gap exists between first and fourth quartile private equity managers, suggesting there is much to be gained from working with high-quality managers[3]. In addition to performance, managers' ability to provide flexible, customized services also plays an important role in meeting the needs of insurers.

Implementation Methods

Insurers can invest in alternatives in various ways. Two of the most popular structures are separately managed accounts (SMAs), which allow for customization, or a commingled vehicle which can offer a turnkey solution. There is also a combined approach in which certain types of investments are more efficiently implemented through a fund vehicle, while other investments are managed through SMAs. Choosing the appropriate implementation method is an important decision for insurers as it can have an impact on capital, operational efficiency, accounting, and may cause tax implications.

In recent years, a variety of innovative structures have been introduced to the market as a way to solve the various and evolving needs of insurers, especially the need for capital efficiency. In the following section, we will explore the different types of capital efficient structures and highlight some of their potential benefits.

STRUCTURED SOLUTIONS FOR ALTERNATIVE INVESTMENTS

Over the past decade, various structures have been designed to help insurers access alternative investments more efficiently than they can by investing directly into such strategies.

Currently, the most prevalent structures rely on securitization, which gathers cash flows from the collateral pool and then redistributes the proceeds in the form of interest, principal, and dividend payments to note and equity holders. This process creates differentiated risk and return profiles among different note and equity holders. It usually consists of a combination of rated notes and an unrated subordinated note (also referred to as equity piece, residual interest, etc. apart from the legal differences). This structure can be particularly beneficial to insurers because it can provide cash flow priorities and credit enhancements for senior note investors, while providing efficient funding and leverage for equity holders.

The concept of securitization is not new — it has been used over the years for various collateral types, including RMBS, CMBS, CLOs, etc. Recently, more structures have been created using private credit and private equity funds as collateral.

Rated Notes with Credit Collateral

In separately managed accounts, individual credit investments would sit on an insurers' balance sheet and receive capital charges depending on their credit rating. Typically, private credit investments are either not investment grade or not rated by rating agencies, which causes them to incur higher capital charges compared to investment grade corporate bonds, for example. For unrated investments, to get a more precise credit assessment, insurers could have each individual investment rated, either by a rating agency or NAIC's Securities Valuation Office (SVO), which would likely reduce capital charges but at a higher operational and financial cost.

Additionally, managing a portfolio of tens or hundreds of individual investments can be an operational burden for insurers, which is why many instead lean towards investing in a private credit fund to reduce the lift for their team. However, private credit fund investments typically have higher capital charges that are similar to private equity and could be subject to state regulatory limits.

One alternative to investing in private credit funds is a rated note structure. In this structure, a Special Purpose Vehicle (SPV) would invest in private credit (either directly or through a feeder fund) and issue rated notes and an unrated subordinated note.

Benefits of rated note structures include:

Capital Efficiency: If an insurer chooses to own both the rated and unrated tranches, they will have a lower overall capital charge compared to owning the unrated collateral, which could be a better reflection of the collateral credit quality.

As illustrated in Figure 3, a hypothetical Life Insurer would have a 27.0% pre-tax RBC charge (after considering the diversification benefit) if investing in collaterals directly, compared to a 6.36% charge if owning both rated and unrated tranches, which is similar to a "B+-rated" corporate bond (B+ RBC charge is 7.39% pre-tax; with the same 90% diversification, the effective charge would be 7.39% x 90% = 6.65%).

Operational Efficiency: Insurers only hold line items for rated and subordinated notes, reducing the complexity compared to investing directly in numerous underlying investments.

Rating Efficiency: Ratings are issued on the few rated notes, instead of the 10-100+ underlying investments.

Lower Account Volatility: The rated notes, if rated investment grade, are carried at amortized cost for Life Insurers and P&C Insurers. Private credit funds or unrated collaterals would be sensitive to changes in fair value.

Limited Schedule BA Assets: Compared to a private credit fund, where the entire investment would be reported on Schedule BA, only the subordinated note is reported on Schedule BA through a rated note structure. This can potentially reduce the pressure from regulatory limits on Schedule BA assets.

	Weights	Rating	C-1o Charge (pre-tax)	C-1cs Charge (pre-tax)	RBC Charge
Diversification Effect			**90%**	**60%**	
Investment in Underlying Collateral					
Underlying Collateral	100%	Unrated	30%		
Total			27.0%		**27.0%**
Through Rated Notes					
A Note	70%	BBB	1.52%		
Subordinated Note	30%	Unrated		30%	
Total			0.96%	5.40%	**6.36%**

Figure 3
Illustrative example for life Insurers. Assuming underlying collaterals are unrated. Assuming diversification effect of 90% for C-1o and 60% for C-1cs, which means, for example, a $100 increase in C-1o will increase the required CAL RBC by $100 x 90% = $90. Assuming a rated note structure of 70% A note (rated BBB), and 30% subordinated note.

Collateralized Fund Obligations (CFOs)

Another structured security that can provide an efficient solution to insurers is a CFO. In this structure, collateral can consist of a range of fund investments. Typically, the structure would look something like the below, where a CFO issuer would own assets either directly or through a feeder fund (CFO Asset Co). The CFO issuer would issue rated notes and subordinated notes to investors in return for proceeds. The proceeds would then be invested in various alternative assets. The CFO issuer may also use liquidity and subscription facilities to efficiently manage cash flows and other short-term fundings.

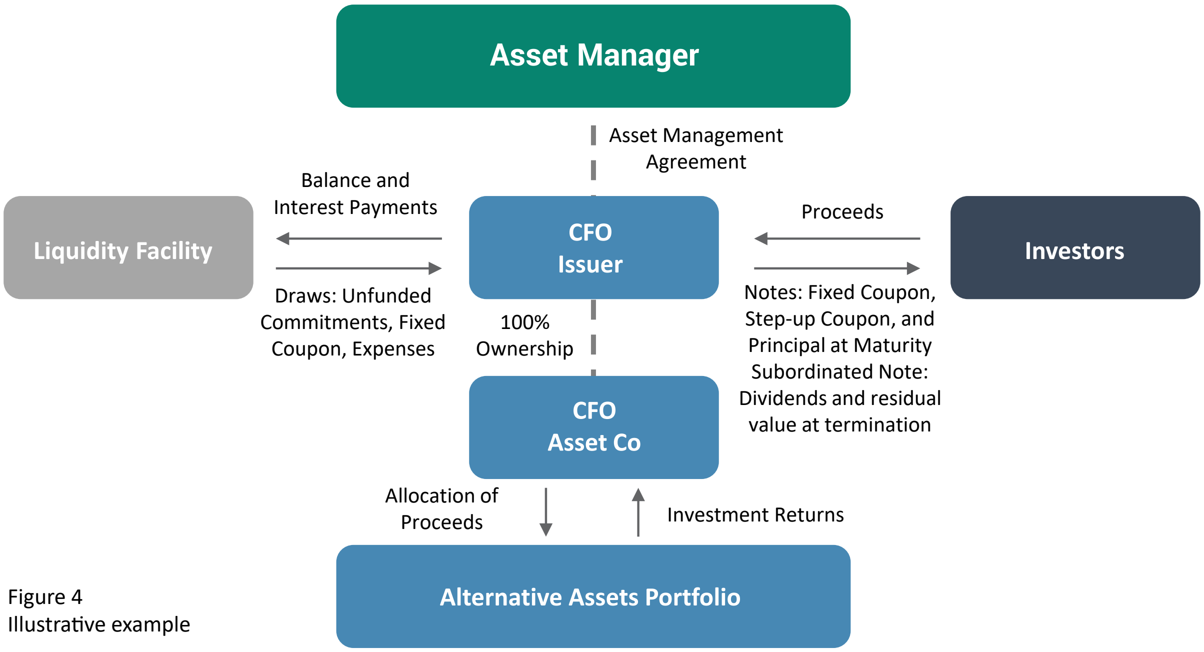

Figure 4
Illustrative example

Attractive Yields for Debt Investors

For debt investors, the senior notes are typically rated investment-grade, and can provide higher yields than comparable public corporate bonds with the same rating. Senior notes, through the Filing Exempt (FE) process, receive the same capital charges as a corporate bond with the same rating. See the below structure (GCM Grosvenor Diversified Alternatives Issuer LLC) as an example:

	Expected Amount ($mm)	% of Structure	Preliminary KBRA Rating	Expected Coupon	Comparable Corporates Yield	Difference
Class A Notes	250	50%	A-	4.25%	1.94%	2.31%
Class B Notes	75	15%	BBB-	6.00%	2.40%	3.60%
Class C Notes	50	10%	BB	7.00%	3.24%	3.76%
Subordinated Notes	125	25%	NR	NR		

Figure 5
Source: Kroll rating report, ICE data indices from FRED (Federal Reserve Bank of St. Louis), as of November 8th, 2021. The above structure closed on November 8th, 2021. The coupon rates reflect then market conditions. New structures will have notes paying coupons in line with current market conditions and interest rate levels. Expected coupons are coupons paid before anticipated amortization date, coupons will step-up after if there are remaining note balances. Corporate indices used are BAMLC0A3CAEY, BAMLC0A4CBBBEY, and BAMLH0A1HYBBEY.

Attractive Risk Return Opportunity for Equity Investors

For equity investors, the benefits of a CFO can come from a few different areas:

Turnkey Solution to Diversified Alternative Assets: CFO structures give equity investors access to institutional-quality alternative assets. Such assets can offer a diversified investment program across asset classes, strategies, vintages, industry exposures and risk return profiles. CFOs can provide investors with a turnkey solution to broad exposures to alternatives, through flagship funds offered by an asset manager.

Enhanced Returns: As seen in the illustrative example below, with leverage, CFO structures can allow for more capital efficient private equity investing and return enhancement opportunities. Historically, a diversified pool of institutional quality alternatives assets has typically exceeded the cost of capital seen in such vehicles, not only in good times but also across market cycles – making this opportunity attractive to both rated noteholders and equity investors alike. Based on Burgiss data as of June 30, 2021, North American private equity (buyout) median IRRs from 2002-2017 averaged 15.7%, while the median IRR from the worst vintage during such period was 8.1%, showing both attractive mid-cycle returns and resilient downside mitigation.

Illustrative Underlying Asset Return Profile					
IRR	2.5%	7.5%	12.5%	15.0%	17.5%
MOIC	1.2x	1.6x	2.1x	2.4x	2.7x

Illustrative Resulting Returns to Equity (75% LTV)					
IRR	(11.5%)	10.0%	24.0%	30.0%	36.0%
MOIC	0.3x	2.0x	4.0x	5.1x	6.3x

Figure 6
Illustrative example; underlying collateral performance and corresponding returns to CFO equity.

Utilizing the leverage uniquely available in these structures, investors can maintain aggregate private equity dollar profit goals with a lower amount of total capital invested. The following illustrative example compares a direct investment of $100 into private equity funds, targeting gains/distributions of $210.90. Through a CFO structure, an equity investor would invest $52.40 to generate the same gains, with a reduced capital investment of $47.60.

	Direct Investment	Structured Solution
Capital Invested	100.0	52.4
Illustrative Portfolio Returns	12.5%	12.5%
Equity Holders' MOIC	2.1x	4.0x
Targeted Gains	**210.9**	**210.9**
Excess Capital Retained		**47.6**

Figure 7
Illustrative example

Lower Statutory Carrying Value: CFO equity investors can have lower carrying values on their balance sheet, hence reducing regulatory and rating agency required capital as compared to investing in underlying funds directly. Carrying values can potentially be further reduced through additional features such as delayed draw mechanisms, further increasing the capital efficiency of such solutions and the return profile. Note that capital charges for a CFO equity are the same as capital charges for all fund investments in the collateral under the current RBC framework.

From a state regulatory perspective, reduced alternative investments on the balance sheet also means less consumption of the leeway bucket. The reduced commitments can be redeployed into other areas of the portfolio for strategy repositioning opportunities.

Attractive Financing Terms: The financing terms for a CFO structure can be more attractive compared to other financing options. For example, CFOs can offer investors a 60%-75% LTV (that is, 25% - 40% subordinated note), compared to a 30% LTV for traditional bilateral private equity financing. CFOs can also provide more flexibility in terms of interest deferability, maturity flexibility, and forced leveraging.

Flexible Structure and Innovative Use: CFO structures can also be created on a customized basis. Customized structures can be tailored to each individual insurer's needs and goals, and focus on key factors such as the look through-investment portfolio and key structure terms, duration, liability structure, etc.

For example, a bespoke CFO structure can be tailored for an insurer to create new dry powder. The dry power created can be used to fund existing and planned commitments, which can reduce funding pressure that would otherwise come from elsewhere. Additional dry powder can also be used for new investments, to achieve asset allocation pivot, to take advantage of new market opportunities, or to create diversification among strategies and managers, etc.

Additional Benefits: CFO investors can also enjoy operational efficiency in that they are only dealing with a few line items (only one for CFO equity) instead of multiple underlying funds when it comes to reporting and accounting. From an accounting perspective, the CFO equity tranche may be marked-to-model and can have lower volatility compared to public investments. Capital calls are also managed through the structure by the CFO manager. With a delayed draw structure and a subscription line, the CFO manager can make contributions to all underlying funds, and in turn call capital from investors on a consolidated and less frequent basis.

How Recent NAIC Developments Could Impact Structured Solutions

Given the complexity and rapidly evolving nature of capital efficient structures, the NAIC has been focused on reviewing their existing regulatory frameworks, industry practices, and new production developments to prevent any abuse and inappropriate application of frameworks from both an accounting and capital perspective.

In the table on the next page, we summarize the latest NAIC regulatory developments and discuss our view on their impact on structured solutions.

NAIC Group	Regulatory Effort	Explanation	Current Status (Aug 2022)	Impact for Rated Notes	Impact for Subordinated Notes
Statutory Accounting Working Group (SAPWG)	Bond Definition	• Defines what investments qualify as Schedule D bonds • Investments not qualified would likely end up on Schedule BA with higher capital charges • For ABS (including CFO rated tranches) to be considered bond, "substantive credit enhancement," with "pre-determined principal and interest payments"	• Definition and issue paper under revision based on insurers' feedback • Likely adoption in 2024 or later	• Current proposal provides a clear pathway for CFO rated notes to be considered bonds • Rated notes with credit collateral most likely continued to be considered bonds • "Stapling" of tranches does not change bond qualification	As before, not considered bonds, reported on Schedule BA
RBC Investment Risk and Evaluation Working Group (RBC IRE WG)	Structured Products RBC Charges	• To propose interim RBC charges for structured products to properly account for risks • More holistic RBC methodologies for CLO and other structured products to follow	• Early stage in discussion • No proposal yet	Too early to say	Too early to say
Valuation of Securities Task Force (VOSTF)	Concerns about Credit Rating Providers	VOSTF noting inconsistent rating outcomes from different credit rating providers; proposing a few possible solutions, including requiring at least two ratings, excluding the use of rating from certain rating agencies.	On hold, huge industry push-back; not likely to go forward in the current form	If adopted, rated notes may require more than one rating, or ratings from only certain providers	Not relevant
VOSTF	Private Letter Rating	NAIC requires investments with private letter rating to file rating rationale report	Adopted	• No change for publicly-rated notes • Report needs to be filed if private • Though no change for capital / accounting treatments	Not relevant

Figure 8
Source: NAIC, as of August 2022.

As illustrated in the above table, the regulatory environment is dynamic. The key to a successful structured solution is understanding the current regulatory environment as well as staying aware of and planning for potential future changes. Using that background knowledge, structures can then be set up to adhere to the spirit of regulatory goals in order to improve the chances that they will remain resilient to both current regulatory evolution, and potential future regulatory changes. It is vital for insurers to work with a trustworthy and knowledgeable partner in achieving this objective. GCM Grosvenor continues to actively monitor the regulatory environment and be thoughtful around structuring such solutions to meet insurers' needs while also being mindful of regulatory implications.

CONCLUSION

Insurers' allocations to alternative investments have continued to grow steadily over the last 15 years and show no signs of slowing down. However, along with the increase in allocations comes heightened scrutiny from state regulators, complex capital requirements, and many other considerations for insurers to navigate as they plan and execute their alternatives strategy.

Further, given the complex nature of the insurance industry and the heavy regulatory scrutiny insurers face, efficient structuring for alternative investments can play a critical role in success.

With considerable dry powder available for alternatives, insurers have an opportunity to integrate alternatives in a way that best fits their unique portfolio needs. Given this, insurers need a partner who can craft a customized approach to alternative investing that utilizes the full breadth of alternatives strategies. By selecting an experienced partner and working collaboratively together, insurers have an opportunity to use alternatives to pursue strong, risk adjusted returns in an efficient format.

Learn about GCM Grosvenor's structured and customized asset management solutions for the insurance industry **here**.

Data Sources
All data and discussion assume US insurance companies

Certain information, including benchmarks, is obtained from The Burgiss Group ("Burgiss"), an independent subscription-based data provider, which calculates and publishes quarterly performance information from cash flows and valuations collected from of a sample of private equity firms worldwide. When applicable, the performance of GCM Grosvenor's private equity, real estate, and infrastructure underlying investments are compared to that of its peers by asset type, geography and vintage year as of the applicable valuation date. GCM Grosvenor's Asset Class and Geography definitions may differ from those used by Burgiss. GCM Grosvenor has used its best efforts to match its Asset Class, Geography, and strategy definitions with the appropriate Burgiss data but material differences may exist. Benchmarks for certain investment types may not be available. GCM Grosvenor uploads data into its system one-time each quarter; however, the data service may continue to update its information thereafter. Therefore, information in GCM Grosvenor's system may not always agree with the most current information available from the data service. Additional information is available upon request.

[1] Source: SNL, Statutory carrying values, excluding affiliated investments. Schedule BA alternative investments exclude surplus debentures, low-income housing tax credit, mineral rights, oil and gas production, capital notes, transportation equipment, and working capital finance investments. "Other" includes hybrid investments, natural resources, other private funds, investments that cannot be identified, etc.

[2] Source: NAIC

[3] Source: Burgiss. Data as of March 31, 2022; downloaded August 3, 2022. US MMBO: Funds less than $3 billion; US Large BO: Funds over $3 billion. Consists of 2000-2013 vintage funds.

ABOUT GCM GROSVENOR

GCM Grosvenor (Nasdaq: GCMG) is a global alternative asset management solutions provider with approximately $71 billion in assets under management across private equity, infrastructure, real estate, credit, and absolute return investment strategies. The firm has specialized in alternatives for more than 50 years and is dedicated to delivering value for clients by leveraging its cross-asset class and flexible investment platform. GCM Grosvenor's experienced team of over 510 professionals serves a global client base of institutional and high net worth investors.

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