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Insurance Talks

Why Insurers Are Increasingly Considering Infrastructure Investments as Core

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Insurance Talks is an interview series where insurance industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Robert Amodeo is Head of Municipals at Western Asset Management Company, LLC and has more than 30 years of investment experience. Since 2005, Robert has been part of Western Asset's municipal bond investment team and is the sector head of that group.

S&P DJI: Tell us a bit about your role at Western Asset Management Company and how you serve the insurance space?

Robert: At Western Asset, I lead a team of investment professionals including portfolio managers, research analysts, and quantitative analysts with an average of 27 years of experience in the muni market. Our investment philosophy at the firm is centered around a long-term, fundamental value approach and this is woven into the portfolios we manage for insurance clients. Our firm manages over USD 85 billion of insurance company mandates for U.S. and international companies across business lines, including life, health, property/casualty, and reinsurance. Our muni portfolios reflect the unique objectives and constraints ranging from full discretion, total return focused clients to book yield focused clients that are constrained by capital, regulatory, and accounting considerations.

S&P DJI: Fixed income comprises a significant portion of insurers' portfolios. What trends have you seen in terms of asset allocation within this sector in recent years?

Robert: Two trends we have been seeing in munis is the search for yield and the growing allocation in taxable bonds. Book yields have declined since the global financial crisis and many of our clients partner with us to generate yield for their general account assets via yield curve management, sector allocation, and security selection. We look to add value to their portfolios by capitalizing on opportunities in undervalued securities, out of favor industries, trading inefficiencies, and rising stars.

Since December 2011, the aggregate market value and number of issues in the S&P Taxable Municipal Bond Index have grown 39% and 42%, respectively. A combination of factors including tax reform, relative value, and good capital treatment have also spurred interest from U.S. and international insurance companies in taxable munis.

S&P DJI: What specific characteristics of infrastructure have traditionally appealed to insurance investors?

Robert: Infrastructure may include many things depending on who you speak to, but it can generally be classified as three key areas: transportation, energy & utilities, and social infrastructure.

Exhibit 1: Infrastructure Sectors

Transportation	Energy & Utilities	Social Infrastructure
Toll roads	Electricity and renewables	Healthcare
Airports	Transmission (oil, gas, water)	Education
Ports	Distribution (oil, gas, water)	Economic development
Rail	Generation (contracted)	Defense facilities
Parking	Waste management	Correctional facilities
		Sports facilities
		Housing (multi-family, senior, student)

Source: Western Asset Analysis. Chart is provided for illustrative purposes.

Features of insurance investments:

- **Durable cash flows** – Established projects can provide stable and predictable cash flows due to the essential nature of the services provided
- **Inflation hedge** – Cash flows are usually inflation linked over the long term
- **Portfolio diversification** – Direct infrastructure investments tend to have low correlation to other financial assets held by insurers
- **Long duration for certain sectors** – The long service life of many infrastructure subsectors lends itself more to a long duration bond than many corporate notes held by insurance companies
- **Environmental, social, and governance (ESG) sensitive** – European insurers may be able to generate yield while meeting the environmental and social criteria of their ESG policies with investments in areas such as renewable energy, water & sewer, healthcare, etc.
- **Illiquidity premium** – Companies with long-dated liabilities are in a position to trade off some liquidity for higher spreads offered by infrastructure deals

S&P DJI: Are any of these features of infrastructure investments more relevant given today's market?

Robert: Absolutely. The search for yield represents a major challenge for insurance companies, and today we're experiencing a market that's offering low yield and an abundance of risk. According to CreditSights,[1] statutory book yield has declined for life insurance companies from 5.24% in 2010 to 4.57% in 2018, and property/casualty companies have experienced a similar decline, from 3.73% in 2010 to 3.35% in 2018. The shape of the yield curve has been a hurdle in recent years, especially for life insurers looking to match assets and liabilities.

At the same time, an estimated USD 57 trillion will be needed to finance infrastructure development globally through 2030. Historically, in the U.S. a large portion of infrastructure has been financed through the municipal bond market (according to the National League of Cities,[2] three-quarters of all U.S. investment in infrastructure is accomplished with tax-exempt bonds), but this is changing. Due to financial stress in municipalities, the market is gravitating away from conventional municipal bond financing toward public-private partnerships (PPPs), which opens the door for institutional investors such as insurance companies. PPP projects are most commonly employed in the construction of social projects, such as hospitals, schools, and courthouses. The model has also been extensively applied to civil projects, such as roads and bridges, as well as to other infrastructure elements.

As we touched on already, infrastructure is a broad category that includes a variety of products, and we are finding value across all phases of the infrastructure lifecycle—including the design, building, financing, operating, and maintenance phases.

The leading purpose of infrastructure investments, aside from all of the features we've already talked about, is to improve economic activity and increase productivity and—to a degree—improve social welfare, too. Insurance companies are active in all of those aspects.

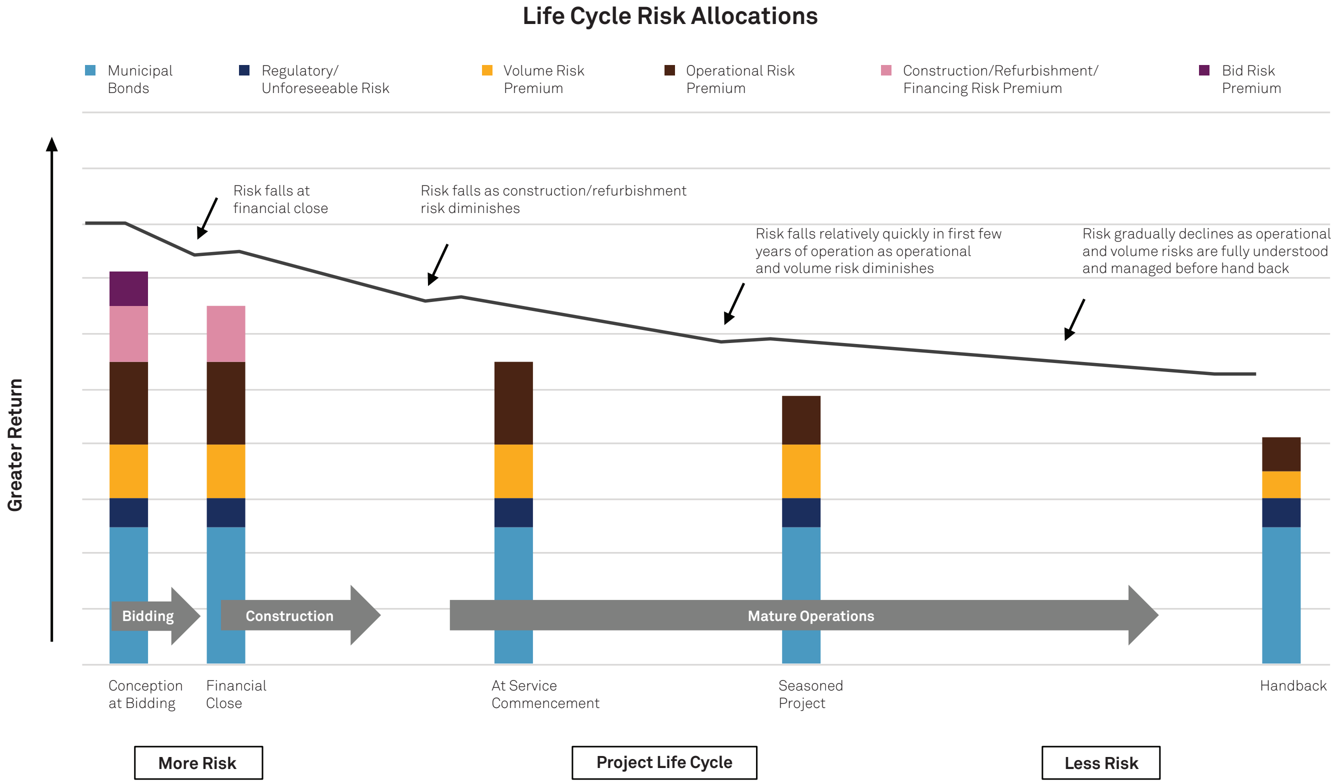
S&P DJI: With all of these attributes in mind, why do you think insurance investors should consider infrastructure as core?

Robert: Infrastructure makes sense for insurers—especially life insurers—due to the long duration of some sectors. In the U.S., the number of fixed income securities with a maturity past 30 years is limited, prompting many institutional investors with long time horizons to allocate elsewhere. The growth of some longer-dated insurance business lines, such as pension risk transfers, may prompt more companies to consider infrastructure investments.

Infrastructure is a natural extension of current investment processes as large U.S. insurers already allocate to revenue-backed municipal bonds, as well as maintain large private placement books. The risk of infrastructure projects decreases over the life cycle of the project, so insurers can be selective about where within the life of the project they want to participate.

[1] "Life Insurance: $4.1 Trillion Investment Portfolio," May 6, 2019, CreditSights.
[2] "Cities Tell President, 'Go Local' in FY2016 Budget Proposal," January 29, 2015, National League of Cities.

Exhibit 2: Risks of Infrastructure Projects Over a Life Cycle



Source: Western Asset. Chart is provided for illustrative purposes.

S&P DJI: Outside of the U.S., Solvency II has made infrastructure top-of-mind for insurers. Why is that?

Robert: In short, capital relief. To promote infrastructure investment while prudently calibrating risks to insurers, the Solvency II framework grants favorable capital treatment to investments that meet the infrastructure criteria set forth in the regulation. Specifically, the spread risk capital charge for a qualified infrastructure investment is approximately 25% to 30% lower than that of an otherwise comparable corporate bond.

S&P DJI: While the regulatory environment is different for U.S.-based insurers than for those in Europe, do you still see appetite or applicability in the U.S. for more tailored infrastructure solutions, like those that are being developed to address Solvency II?

Robert: Unlike the Solvency II capital framework, the U.S. NAIC risk-based capital framework does not provide capital relief to infrastructure investments solely for the purpose of promoting social policy goals. However, infrastructure investments may be highly attractive from a purely economic (expected return versus risk) perspective, and their attractive risk profiles may be reflected in low risk-based capital charges.