

Investing for Yield: Lessons from the Insurance Sector



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The rapid growth in private credit markets, now estimated to represent \$2.5 trillion in assets under management, has presented significant opportunities and challenges for institutional investors and allocators over the past decade. This growth has encouraged innovation by asset managers and investors in the search for differentiated product offerings and portfolios. In this article, we examine trends in the rated note feeder (RNF) market and explore its close cousin, the collateralized fund obligation (CFO). We also consider specific opportunities and potential use cases for this evolving technology to benefit institutional real estate investors and fund sponsors alike.



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Fund Financing

Fund finance has evolved enormously since the early 2010s, when insurance companies, faced with the repercussions of the global financial crisis, created ring-fenced portfolios of private fund commitments to manage their funding obligations and optimize liquidity. The

proliferation of financing options for private funds has resulted in near-ubiquity of subscription credit lines and net asset value-based loans. Alternative lenders have expanded massively during this period, providing additional depth and sophistication to the broader market and freeing up balance sheets of traditional financial institutions. Real estate funds in particular have benefited from an eager audience of lenders, offering tangible assets and (generally) predictable cash flows as collateral in a market increasingly defined by volatility and uncertainty. Real estate credit strategies have experienced outside growth during this period, as traditional commercial mortgage-backed securities

issuance diminished following the COVID-19 pandemic (from \$100 billion in 2019 to \$40 billion in 2023, per S&P Global), and refinancing demand remains robust across the industry.

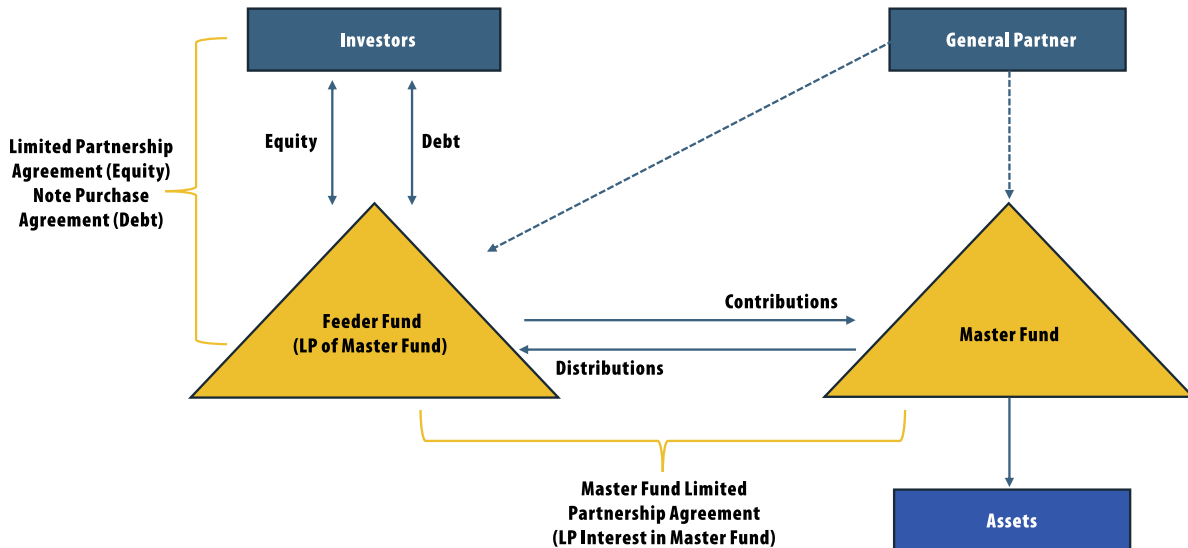
Despite their different regulatory regimes, pension funds and insurance companies share many similarities in their investment objectives. Both serve as providers of patient capital with longer time horizons, and a more conservative appetite for truly risk-adjusted returns. At the same time, competitive pressures and a historically long period of low inflation have encouraged creativity in portfolio allocation and investment strategies in the pursuit of sustainable financial performance. Traditional asset-backed real estate lending, like many sectors, has incrementally adopted more innovative financing strategies with flexible capital structures in pursuit of these goals.

Insurance companies, governed by strict prudential regulation, have historically played an important role as capital providers in the investment-grade corporate debt market. The emergence of private equity-owned insurance companies has driven an increase in financial structuring and innovation, from which pension funds and other institutional allocators now stand to benefit.

Rated Note Feeders

RNF structures emerged in part as a solution to perceived inconsistencies in how private funds were viewed by insurance regulators, including the National Association of Insurance Commissioners (NAIC). Private credit funds holding a basket of investment-grade debt instruments were often unable to achieve look-through treatment, despite the benefits of professional management and access to a diversified portfolio of suitable investments.

Early iterations of RNF structures offered insurance companies the ability to split a private credit fund commitment into debt and equity tranches. Backed by the underlying assets of the private fund and supported by the built-in “equity cushion,” RNFs issue debt instruments in

Exhibit 1: Feeder Fund Rated Notes Transaction Structure

Source: Fund Finance Association

multiple tranches. The most senior tranches can attract an investment-grade credit rating from a nationally recognized statistical rating organization, such as KBRA, Morningstar DBRS, or others. The beneficial risk-based capital treatment of these debt instruments makes them highly attractive to insurance companies. As a result, insurance companies could obtain comparable economic exposure to the underlying private fund with favorable (blended) risk-based capital across the debt and equity tranches, resulting in a lower overall cost of capital to the investor.

Perhaps unsurprisingly given their broader appeal to a sophisticated investor base, RNF structures adapted over time to offer more flexibility. Attracted in part by the embedded leverage, some well-capitalized asset managers now fund the equity tranche from internal capital, and a broader range of investors targets specific exposures at different levels of seniority and rating to accommodate their own investment parameters. The NAIC has also enhanced its scrutiny of structured asset-backed securities funded by equity, particularly in situations in which insurance companies have invested proportionately in debt and equity tranches of RNFs.

Rating agencies have developed their own investment fund rating methodologies to evaluate debt instruments issued by RNFs, which are discussed in further detail below.

Collateralized Fund Obligations

CFO structures resemble traditional securitization vehicles, with the distinction that the basket of assets held by the securitization vehicle comprises limited partner interests in underlying private funds rather than loans or real estate.

This provides CFO investors with access to a customized portfolio of underlying investment funds and strategies. As a result, these vehicles can be codesigned by an investor working closely with a fund sponsor as part of a separately managed account strategy.

Longer-dated CFO structures can include investment funds of different vintages, including otherwise closed and to-be-launched funds, providing diversification across vintages. This adds a degree of inherent uncertainty for the rating agencies engaged to assess a CFO structure but can be managed by varying the size of the “equity cushion” and other junior tranches of the CFO’s capital stack.

Importantly for real estate investors, the diversification across fund strategies is where CFOs and RNFs have gradually shifted away from their origin as feeder vehicles for credit strategies. This presents a particularly efficient opportunity for institutional investors, who can make a single fixed-income investment with exposure to a bespoke pool of cross-collateralized investment funds and vintages.

Because of the basket requirements applied by rating agencies, CFOs are more frequently established by large asset managers with a broader product offering. RNFs, in contrast, are accessible to mid-market and emerging managers who have determined that they have sufficient interest from fixed-income investors to justify the effort for a specific fundraise.

Pricing and Rating Agency Treatment

Rating agencies play a critical role in the structuring and issuance of RNFs and CFOs. Credit quality for RNFs and CFOs is typically confirmed by a private rating letter issued by a nationally recognized statistical rating organization, and several rating agencies have developed specialized teams and a broader market reputation for issuances in this area. Several agencies have also issued public ratings for RNFs that invest in business development companies, which are already subject to a greater degree of transparency and disclosure.

For issuers of RNFs and CFOs, establishing the applicability of the correct rating methodology is key. Rating methodologies for investment fund debt obligations incorporate a broad range of factors, including a sponsor's track record, organizational stability, and investment pipeline. Similar to other securitization vehicles with the ability to acquire additional assets, even a forward-looking investment strategy can be underwritten with the support of strict investment guidelines, debt covenants, and validation of historical investment performance.

The feasibility of an RNF or a CFO structure is driven by the anticipated pricing of the investment-grade debt obligations. Private markets, including real estate, have historically captured a return premium compared to public markets. That premium can be shared with RNF or CFO investors in the form of higher yield on debt instruments with an equivalent rating, making them an attractive proposition for pension funds and other fixed income investors.

Implications for Real Estate Investors

The shift away from early “credit-to-credit” look-through structures has created numerous opportunities for fund sponsors and institutional investors in other market segments. Core and core-plus real estate products in particular share

many characteristics of private credit funds and business development companies—stable returns, regular cash flows, and inflation hedging, with the added benefit of tangible underlying assets. Rating agencies' methodologies continue to evolve, and agencies have evidenced willingness to consider a broader range of asset classes when evaluating these structures. As a result, we expect to see a meaningful expansion of RNF and CFO structures available to real estate funds and institutional investors over the next few years.

Although most RNFs and CFOs have focused on investment in closed-end funds to date, creative structuring also allows for fixed-term investment into open-end funds. This can provide benefits for both investors and fund sponsors, who can adopt a “set-and-forget” platform strategy that includes greater certainty and visibility into long-dated redemptions, access to a broader investor base, and the ability to offer series of vintages for continuous fundraising and consistent deployment.

Conclusion

RNFs and CFOs serve a valuable and growing role as a hybrid investment vehicle, operating in the space between investment fund equity and debt exposure. Pension funds' strong appetite for investment-grade fixed income can unlock an additional source of capital for alternative asset allocations, which are typically constrained by liquidity and broader allocation policy considerations.

The potential for higher yield at equivalent ratings, combined with the flexibility of customized product portfolios, presents numerous opportunities for pension fund investors. Challenges also exist for investment teams, which need to collaborate on underwriting and diligence across the investment-grade credit and alternatives sectors. These challenges can be addressed more easily for RNF and CFO products issued by sponsors with whom institutional investors have existing relationships or with guidance from experienced advisors. A decade of valuable innovation and lessons learned from insurance companies now stands ready to benefit a broader class of institutional investors with similar investment goals. ■

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