NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Investing in Structured Securities Under Solvency UK: Attractive Opportunities for Lloyd's Syndicates

An easing of regulation surrounding structured securities is an opportunity for UK insurance entities to potentially enhance portfolio yield and increase diversification.

INTRODUCTION

On 1 November 2024, the UK implemented Securitisation Regulation 2024, which is reshaping how institutional investors – such as Lloyd's syndicates – assess the structured securities markets. This departure from the EU regulations has modernised the regulatory approach, which aligns better with practices in the US market, and streamlines compliance for UK-based institutional investors.

This publication discusses the investment opportunities for Lloyd's syndicates and other London Market entities.

REGULATORY CHANGES

The UK's new framework replaces the retained EU regulations with a **principles-based approach**. Key changes include:

- Removal of prescriptive reporting templates (which were incompatible with US and some global deals).
- **Flexible due diligence rules**, allowing investors to independently assess risk without rigid formats.
- The scope of "institutional investor" expanded to include Financial Conduct Authority (FCA) investment firms, broadening access.

For insurers, the most consequential areas relate to the risk retention and due diligence requirements.

RISK RETENTION

A “material net economic interest” in the securitisation of “not less than 5%” should be retained by the originator, sponsor, or original lender. This can be achieved through retaining 5% of the nominal value at each tranche / exposures level, including through retaining a certain level of “first loss” exposure.

A certain proportion of issuances now have risk retention language in the documentation that commits to complying with Solvency II / Solvency UK’s requirements.

DUE DILIGENCE REQUIREMENTS

The investor is required to have “a comprehensive and thorough understanding of the securitisation position and its underlying exposures” and have certain risk management policies and procedures in place.

An investor, such as a (re)insurance firm, can delegate the compliance with and surveillance of the due diligence requirements to an asset manager, with the asset manager being responsible for complying with them

WHY ARE STRUCTURED SECURITIES ATTRACTIVE TO LLOYD’S SYNDICATES?

Certain types of structured securities, as highlighted to the right, align well with the unique investment requirements of Lloyd’s syndicates. The broad spectrum of available securities allows syndicates to tailor credit quality, duration, and liquidity profiles to suit their liability matching and capital efficiency objectives.

What are Structured Securities?

The following types of securities (with AAA or AA credit rating) are generally considered suitable for UK entities.

ABS (Asset-Backed Securities)

These are debt securities backed by pools of consumer assets such as auto loans or credit card receivables. These securities are predominantly rated AAA and are short-term in duration.

CLO (Collateralized Loan Obligations)

These securities are backed by portfolios of leveraged loans to below-investment-grade companies. Issued in tranches of varying risk, return, and maturity profiles and typically paying interest at a floating rate.

Non-Agency RMBS (Residential Mortgage-Backed Securities)

These are securities backed by private residential mortgages which are not guaranteed by government sponsored enterprises (GSEs), such as Fannie Mae or Freddie Mac. Unlike agency MBS where GSEs guarantee the payment of principal and interest, non-agency RMBS investors receive additional compensation to bear the credit risk of the underlying residential mortgage loans. These securities are characterized by robust levels of credit support which are intended to withstand the level of credit stress suffered during the Global Financial Crisis.

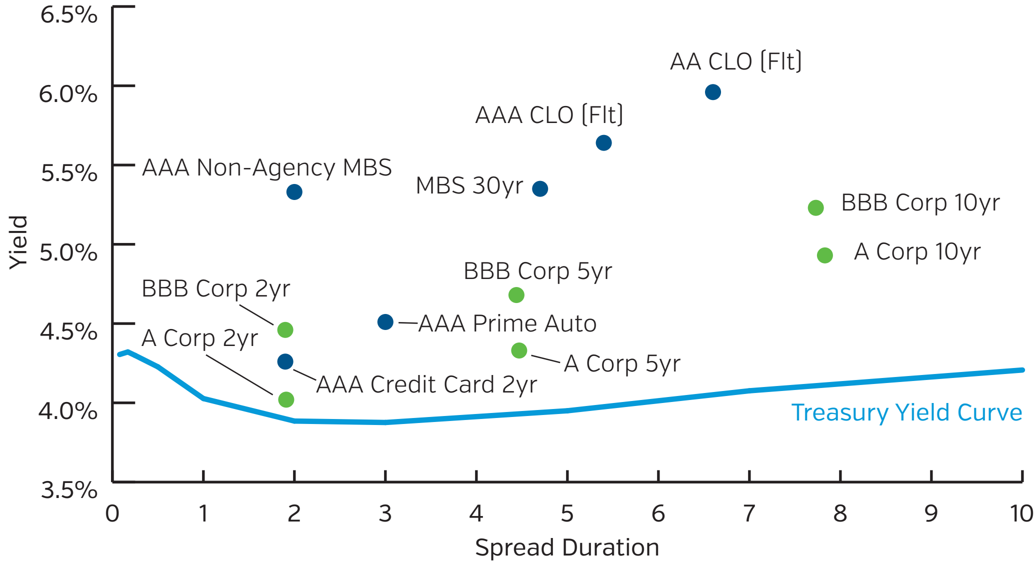
Agency Collateralized Mortgage Obligation (CMO)

Agency CMOs are backed by GSE-guaranteed mortgage pools that have been tranched into securities with varying maturity profiles (time tranched). Because of their high quality and short duration, these securities can be attractive alternatives for Lloyd’s portfolios. CMOs are offered with both fixed and floating rate coupons.

From a portfolio construction perspective, structured securities can bring the following benefits.

- **Higher risk-adjusted yield than corporate securities:** as shown in exhibits 1 and 2 below, these structured securities can provide higher spreads and yields than corporate bonds, while the historical credit loss experiences are significantly lower. Exhibit 1 compares the yields between selected structured securities and investment grade corporates. In addition to the potential yield pick-up opportunities, comparable structured securities also offer higher credit ratings – sometimes at a much shorter duration – both suiting the profile of a Lloyd's portfolio.
- **Diversification and risk protection:** Lloyd's portfolios tend to have a concentration in credit exposure to the corporate sector; introducing structured securities would help diversify the credit risk exposure. Structured securities also benefit from protections such as credit enhancement, subordination, over-collateralisation, and performance tests. By combining multiple protections, structured securities can maintain very low default loss rates in senior tranches – even if the underlying loan pool experiences significant stress.
- **Liquidity:** High-rated ABS and CLOs typically offer reasonable liquidity even in stressed markets.
- **Floating rate with CLOs and CMOs:** Floating rate securities pay interest tied to a benchmark (typically SOFR[1]) so coupon payments increase (decrease) when interest rate rise (fall). In addition, floating rate instruments provide a natural hedge to any duration and inflation exposure.

Exhibit 1. Comparative Yields for Structured vs. Corporates as of April 30 2025



Source: NEAM, Bloomberg

Exhibit 2. Historical Default Losses (Cumulative)

	Corp Senior			Structured Securities				
Average Life	AAA	AA	A	AAA ABS	AAA CLO	AA CLO	Non-Agency RMBS*	CMO*
4 to 5-Years	0.04%	0.14%	0.36%	0.10%	-	-	-	-
9 to 10-Years	0.18%	0.39%	1.01%	0.19%	-	-	-	-

**Post-Financial Crisis data is used due to the change in the issuance structures.*

Source: Moody's Default Study, NEAM

LLOYD'S SYNDICATES

When it comes to Lloyd's syndicates and investing for premium trust funds, the types of structured securities detailed above are permitted within both regulated (e.g. Credit for Reinsurance Trust Fund) and non-regulated (e.g. Lloyd's Dollar Trust Fund) portfolios.

Exhibit 3 shows the impact of adding structured securities to a representative Lloyd's portfolio demonstrating the yield pick-up of c. 30 bps while increasing the average portfolio credit quality by 1 notch from AA- to AA.*

Exhibit 3. Lloyd's Syndicate USD Portfolio – Case Study*

Sectors	Current Portfolio	Revised Portfolio (Adding Structured Securities)	Difference
Short-Term/Sovereign	35%	33%	-2%
Corporate/Taxable Muni	52%	36%	-16%
Agency MBS	13%	12%	-1%
ABS/CLO/RMBS	-	19%	19%
Average Credit Rating	AA-	AA	+ 1 notch
99.5% VaR	-6.5%	-6.8%	-0.3%
Duration	2.67	2.63	-0.04
Market Yield	4.43%	4.73%	0.3%

Source: NEAM; Figures are as of April 30, 2025 and are for illustrative purposes only

** NEAM applies constraints (i.e., sector limits) to the hypothetical Current Portfolio via its Portfolio Optimization tool to generate the hypothetical estimates of yield, duration and other portfolio metrics shown in the Revised Portfolio. The tools' objective is to maximize yield under these constraints using NEAM's reinvestment set of securities and their attributes as of 4/30/2025. The Revised Portfolio does not reflect actual trades or the effect of material economic and market factors. Actual results will vary from the information shown and include the potential for loss. Results may vary with each use of the tool and over time.*

FUNDS AT LLOYD'S (FAL)

Structured securities can also be used as part of a FAL investment portfolio, subject to meeting credit quality, duration, and liquidity requirements/preferences. Incorporating structured securities into FAL portfolios could enhance income while maintaining capital efficiency.

Per Lloyd's regulation,[2] up to 80% of the FAL portfolio can be invested in AAA/AA rated structured securities, before risk capital charges being potentially applicable to the capital provider.

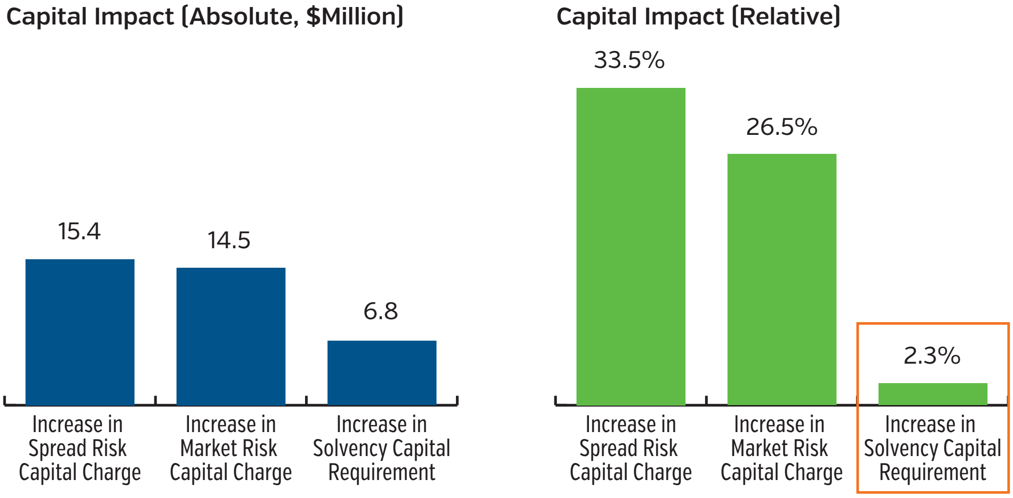
SOLVENCY UK CAPITAL TREATMENT

Solvency UK, like Solvency II, applies higher standard formula capital charges on structured securities than on corporate bonds. However, syndicates or entities using internal models can achieve lower capital requirements that better reflect the actual credit risk. Treatment may vary depending on the internal model's philosophy and structure, but the structured holdings above should attract a lower capital charge than A rated corporate bonds.

In our experience, a 5% to 10% allocation to high-rated structured securities typically has an insignificant impact on the Solvency Capital Requirement (SCR), after allowing for diversification effects.

Exhibit 4 assesses the level of impact on the SCR (under standard formula) of introducing a 5% allocation to AAA rated structured securities to a $1.0 billion investment portfolio of an insurer.

Exhibit 4. Illustrative Example



Source: NEAM

This analysis provides an example of possible capital consumption under Solvency II. NEAM has made reasonable assumptions on the investment portfolio and Solvency Capital Requirement structure, in order to demonstrate the impact of diversification when assessing capital consumption under Solvency II. NEAM expects individual insurance entities' actual results to deviate from the estimates provided. Analysis outcomes are explicitly not supposed to be used for evaluating or making investment decisions, conducting trade-off analyses, or be used for or in lieu of actual regulatory risk assessments or submissions. NEAM makes a reasonable attempt but cannot guarantee that the latest Solvency II methodology updates are always reflected in NEAM provided estimates. Results shown were achieved by the application of certain assumptions. NEAM does not make any representations or warranties as to the reasonableness and completeness of these assumptions or any outcomes. Changes to these assumptions may materially change results. Clients will likely experience actual results that differ from the estimates shown.

HOW TO MAKE IT HAPPEN?

Bringing it all together, what are the steps a Lloyd's / London Market entity should take to add structured securities to their portfolios? We propose a 4-step process:

1. Partner with an experienced asset manager in structured securities. The manager should also have solid knowledge on insurance regulation (including Solvency UK and Lloyd's regulations).

2. Conduct strategic asset allocation (SAA) – Ideally, the risk and return characteristics of structured securities are evaluated as part of an SAA exercise. This will help determine the levels of allocation to the different types of structured securities.

3. Obtain board / investment committee approval and formally delegate due diligence obligations to an asset manager. This process will also help ensure that the insurer complies with the Prudent Person Principle under Solvency UK.

4. Deploy the strategy with an asset manager. Where applicable, investment guidelines and benchmarks may need to be revised. The deployment period could vary depending on the mandate size and availability of qualifying investments.

KEY TAKEAWAYS

- UK's post-Brexit securitisation regulation allows flexibility and broader access to structured securities.
- Certain high-grade ABS, CLOs, Non-Agency RMBS and CMOs meet the risk retention requirements and provide potential yield enhancement with structural credit risk protections.
- Opportunities exist for Lloyd's syndicates to use structured securities to diversify risk, enhance yield, and manage duration.
- Robust due diligence, careful security selection and rigorous portfolio construction are essential to unlocking benefits, while insurers should also manage any capital implications.

ENDNOTES

[1] Secured Overnight Financing Rate (SOFR) is a measure of the cost of borrowing cash overnight collateralised by Treasury securities.

[2] See Lloyd's Market Bulletin Y5435 "Clarification of Membership & Underwriting Conditions and Requirements ('M&URs'): Investments"

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