Goldman Sachs Exchanges

Global insurers turn to private credit — and AI

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Allison Nathan: As one of the largest investors in the world, insurers can have an outsized impact on markets and investment flows. So what's on the mind of this influential investor base?

Matt Armas: You have investors excited about the returns you get from the yields themselves, so just owning the asset. And then the potential appreciation you get as yields fall and bond prices rise. So I think there's real interest and excitement about fixed income returns for the first time in a long time.

Allison Nathan: I'm Allison Nathan, and this is Goldman Sachs Exchanges.

After taking a more cautious approach to their investments last year, insurance companies appear to be more willing to take on risk in their portfolios. Today, I'm sitting down with Goldman Sachs's Mike Siegel, global head of the insurance asset management and liquidity solutions businesses, and Matt Armas, global head of insurance asset management, to discuss how insurers are approaching the global macroeconomic environment as well as key findings from their 13th annual insurance survey. Mike, Matt, welcome back to the program.

Mike Siegel: Thank you.

Matt Armas: Glad to be here.

Allison Nathan: So when we sat down a year ago, we were facing a more worrying economic environment. Inflation and recession fears were top of mind. But today, the macro backdrop seems more constructive, so how are insurers thinking about the investment landscape today? Mike, maybe you can start?

Mike Siegel: So Allison, you're absolutely right.

When we spoke last year, if you remember, inflation was rising, interest rates were rising, and there was great concern that we were going to be heading into a recession. All of those concerns have moderated quite a bit. There is concern about an economic slowdown. There's concern about market volatility. There's concern about geopolitics in many different fronts. But generally, the attitude is much better, and we're seeing that in all of the reads that we get about risk taking.

Allison Nathan: And so what do you see as the biggest risks this year for the insurance industry?

Mike Siegel: By far, it's the performance of the global economy. Concerns about an economic slowdown, potentially leading to recession. That could have an impact on both equity valuations but also fixed income. Fixed income is the single-most important asset class that the insurers hold. And if we head into a weakening economy, a recession, that credit could deteriorate.

Allison Nathan: And so your survey also found that, for the first time in four years, the prospect of declining interest rates is a new cause for concern. Now, many investors seem to welcome lower rates, so that feels kind of counter-intuitive. Explain why falling rates is a risk for insurers.

Mike Siegel: Sure. 98% of the respondents think that short-term rates have peaked. 83% think that long-term rates have peaked. And you're right, most investors think that's a good thing, to have rates declining, the value of stocks and bonds go up.

On the other hand, if you think about the insurance industry, they're savers. They write policies. They take in premium. They have to invest the premium. And it's the return on those investments that they use to make claims payments. So as they're taking all of that cash in and they're investing at lower and lower rates, they have less income in order to support their claims payments. So that's why, in general, higher rates are better for the industry than lower rates.

Allison Nathan: So I want to dive into how insurers are managing that risk of lower rates, but before I do maybe we should just get a starting point in terms of the portfolios that the insurance industry is really sitting on today. What do insurers' portfolios look like today? And what tend to be the investment goals of these portfolios?

Mike Siegel: So the portfolios tend to be very conservative. They tend to be very well diversified across asset classes and, within the asset classes, across individual assets. They tend to be very heavily fixed income oriented, predictable cash flows. Along with the fixed income, there'll be some equity, private equity, real estate. But the majority of the holdings are going to be fixed income holdings.

Allison Nathan: Matt, let me bring you into the conversation. We've seen this rising concern about interest rates declining. How are insurers adjusting their portfolios today?

Matt Armas: Sure. And what we're seeing in response to yields peaking is investors focused on adding that yield into the portfolio. So adding yield in when yield is high and using that yield to support returns for things like the savings products or for protection products where they use yield to help offset the cost of providing the policy and to support claims payments. So we're seeing insurers very focused on adding yield.

We're also seeing insurers, because of elevated concerns of slowdown or recession or credit quality deterioration, focus on asset classes and asset types that improve the resiliency of the portfolio. Things like private credit, investment-grade private debt where they can get closer to the borrower so that, if the borrower has a problem, if inflation is higher than we think it is, or if the economy is worse than we think it will be, they have the ability to work with borrowers in order to reduce the risk of a potential default or to help them restructure the borrowings themselves. So focused on adding yield to deal with potential lower rates and adding yield now as well as adding resiliency into the portfolio in case it's worse than we think it will be by things like private credit.

Allison Nathan: And are there areas where they're actually paring back?

Matt Armas: Yes, we see them pare back in real estate, and concerns around real estate remain high. Insurers report that the largest asset classes that they're reducing are real estate equity and commercial mortgagebacked securities. I think that's consistent with just the general market concerns around real estate valuations as well as the availability of credit for refinancing as certain office properties in particular face releasing concerns and the return-to-office concerns. So we definitely see elevated concern around real estate, and we see continued interest in things like corporate credit.

Allison Nathan: How hard is it for insurers to pare back on areas like real estate? What does that look like?

Matt Armas: Well, it doesn't happen quickly. I think that's the first thing I would say. Investors and insurance investors in particular take a very long-term view when they do these allocations. And these allocations can exist for 10, 12, 14 years in portfolios. So it winds up being a very long-term change in those allocations.

But I will say, when we look at the data, you can go as far back as 10 years ago and see that insurance companies were already reducing exposure to office in particular. They had reduced exposure to real estate. So those reductions had started, not forecasting what happened with COVID, but just seeing general trends and valuation concerns in that period of very low interest rates. So it takes a very long time to turn the ship, but the insurance industry had already started that turn well ahead of this most recent event.

Allison Nathan: Interesting. And Mike, when insurers begin to turn the ship, as Matt this mentioned, it can have a big impact on asset markets because these are, after all, very large holders of assets. What are the implications for markets of some of the shifts we've been talking about?

Mike Siegel: Sure, Allison. So we estimate the global industry to manage approximately $26 trillion of assets. The insurers and the pension plans are the two largest institutional holders of assets. So you're absolutely right. When they start to make a shift into a certain asset class or out of another asset class, it has significant implications for the asset class and for other investors that are in the class or want to get in or out of the class.

Allison Nathan: And Matt, you've already mentioned the increased focus on private credit. It was striking to me that, for the first time in the survey's history I think, returns expectations for private credit actually exceed those for private equity. Talk to us a little bit about the implications of that.

Matt Armas: Sure. And I think the observation is absolutely correct, which is this is the first time we've seen fixed income asset classes -- private credit, investment-grade private debt, and developed market investment-grade debt -- at the top of the return expectations charts. Normally, they're much lower. Certainly over the last 10 years they've been substantially lower. But I think that reflects a couple of things.

One, the returns for -- and we'll use private credit as an example -- this year can be 8, 9, 10% depending on the type. And that is on par with where we would expect public equity returns to be. So I think that's why you see public equities and private credit in that very high return category. And that's largely because floating rate or short-term interest rates remain high, and private credit offers a very attractive credit spread.

In the other fixed income asset classes, we have high yields today. We have yields we haven't seen since before the Great Financial Crisis. So with those yields and those yields potentially falling, you have investors excited about the returns you get from the yields themselves, so just owning the asset, and then the potential appreciation you get as yields fall and bond prices rise. So I think there's real interest and excitement about fixed income returns for the first time in a long time.

Allison Nathan: Interesting. And we've already talked about real estate as an area that there's more concern about. Are there other areas where returns expectations are lower than they've been in the past?

Matt Armas: Sure. And you see a little lower returns in private equity. And I think one of the questions for private equity is, as the equity market went through a bit of a correction in 2022 and 2023, private equity exits were lower than what they had been recently. And as a result, there was some concern going through that period that private equity distributions or returns back to individual LPs would be slower than what has historically been experienced. So I think private equity came down the rankings a little bit but is still high. And you certainly see lower returns in things like cash and cash-equivalent securities, which you would expect, because that's just a base rate type of change.

So I think you see very good return expectations for public equities. I think you see lower return expectations for very low-risk assets. And you see continued concern around things like real estate.

Allison Nathan: One of the other areas of the survey that you had some findings on was artificial intelligence. Let me first ask had you asked about artificial intelligence before the survey this year? Had it been in the survey last year or in prior years?

Mike Siegel: No, this was the first time we asked about it.

Allison Nathan: Interesting. And so what did the survey show in terms of how the industry, which is an industry that has been identified as one that could see some big changes from AI, how is it adopting AI?

Matt Armas: So it's adopted it both much quicker and much larger than we had initially expected. So we asked the question as a starting point to begin working it into the survey, and the responses were quite strong. So you're seeing quite a take up in AI, and you're seeing AI focused on those areas where you would really expect it, right? Focused on cost savings and productivity as the largest area where people are focused on implementing AI. A little bit further out in the future will be things like investment decision making. And one of the things that, Mike, we've been talking about is that insurance is a great industry for AI given the amount of data that our clients take in.

Mike Siegel: You're absolutely right, Matt. If you think about it, these companies have a tremendous amount of claims information. They have a tremendous amount of transactions going through. They've got cash flow premium coming in. They've got claims payments making going out. They've got investments that are maturing. So there's a lot of data, a lot of activity, and it lends itself perfectly to AI. And indeed, as Matt said, the use, bringing efficiency to operations, using it in underwriting decisions, "Should I issue the policy and at what price?" and ultimately making investment decisions, "What securities should I be buying or selling?"

Allison Nathan: And so if you think about all the efficiencies that can be gained through the use of AI in the industry, is it possible that we see a wave of consolidation in the insurance industry?

Mike Siegel: We've seen the trend towards consolidation in the industry taking place for the last 25 years. And this is just one more area where size begins to matter. And you're right, the larger companies are going to be able to afford the investment in AI. It's going to continue to bring efficiencies to the operations of these insurers, which is going to continue the process that we've already been seeing of industry consolidation.

Matt Armas: But I think where it's going to have its most impact is on efficiency. So the ability to price appropriately the risks that individuals are taking so that the individual pays the right price for the right risk. And I think what that's going to do is lead to just a more efficient and faster market as things change, whether it's claims payments for auto accidents or inflation in the cost of rebuilding homes. The industry is going to be able to respond much quicker and much more efficiently than it has before.

Allison Nathan: How do you think that's going to trickle down to the actual owner of these insurance policies? Is that going to potentially reduce their costs because the efficiencies are allowing these insurance companies to just be more accurate in their pricing? What do you think the implications might be?

Matt Armas: So I think the industry getting more efficient is better for both the industry equity owners and the industry consumers as well. At the end of the day, this is a very competitive market. These are big brands that are largely national brands and names you know, and the ability to switch from insurance company to insurance company, particularly for things that protect us, things like auto policies or homeownership policies, your ability to switch is very high. And I think it only gets easier to switch. So I do think a more efficient, more competitive market benefits all participants, particularly consumers.

Allison Nathan: And everyone's very focused on AI, but ESG is still important in the insurer space. Matt, how are insurers approaching ESG and impact investing in their portfolios right now? And does that vary across regions?

What are you seeing off the back of the recent survey?

Matt Armas: We're seeing continued strong interest in ESG and impact investments, particularly in our European and Asian respondents. When you look at the data, something like 94% of Europeans and around 92% of Asian respondents are still very focused on environmental impact investments in particular. And both of those markets have over 95% of respondents say they use ESG criteria in their investment decision making, so it's still a very important, very impactful, and increasingly focused on the environment and climate.

Allison Nathan: And that goes well beyond their investment portfolios, right? Because if you think about insurers, they are a group that is quite exposed to the environmental impacts of climate change. So what are we seeing in terms of how insurers are continuing to adapt to a world that we experience global warming in?

Mike Siegel: So Allison, you're very right about that, that it affects all the insurers; one, on their investment portfolios, what's their exposure to earthquake, windstorms, fire, utilities that are located in those kinds of regions? So one, there's an investment aspect. But then of course there's a business aspect. How are they affected when they write policies and experience these natural events -- again, hurricanes, windstorms, earthquakes?

So they've really got to take into consideration all of these factors and project forward based on what they've been seeing taking place so far. And some of it becomes an underwriting decision. Should I continue to write these policies? Should I continue to write as many of these policies? It also becomes a pricing decision. What should I be charging for the risk that the insurer is taking on? So all of these are very important issues, which by the way does tie back a little bit to AI, which helps analyze all of this climate data, all of the housing data, all the location data, and can be used in terms of making these decisions, in terms of underwriting and pricing.

Matt Armas: But looking at the investment side of the portfolios, what you see are clients already well adapted incorporating ESG in decision making around investments in their portfolio. And what's changing now, what's happening now is ESG -- and let's think of things like climate transition or focus on certain social aspects like access to certain parts of the economy -- are providing great investment opportunities for insurance companies. When you think of the United States looking to roll out energy transition, the amount of investment required and how that gets financed is going to provide insurance investors a substantial return opportunity to provide the financing and earn strong equity returns. When you look at things like providing access to parts of the economy where maybe access was more limited -- say, education, financial services -- providing that access inside of an impact-oriented strategy is going to provide strong returns. So I do think ESG is moving a little bit away from focus on portfolio exclusions when you think of the investments and now really orienting towards: How am I driving returns?

Allison Nathan: So maybe just to wrap up, you've been doing this survey for 13 years. Do insurers actually do what they say they're going to do in the surveys?

Matt Armas: Well, actually, yes. We've been doing this for a while now, and every year there's a few surprises. But what I think is true is that the activity that we see generally conforms to how the insurers answer the questions, particularly on asset allocation. And when you look at where insurers are focused, where the industry is focused, where the products and services are being developed, it typically is pretty consistent with how they respond.

Certainly this year, a lot of activity in private credit, a lot of activity in investment-grade private assets. So I would say, yes, it's pretty consistent.

Allison Nathan: Mike, Matt, thanks again for joining us.

Mike Siegel: Thank you, Allison.

Matt Armas: Thank you for having us.

Allison Nathan: Thanks for joining us for another episode of Goldman Sachs Exchanges, recorded on Thursday, April 4th, 2024. To learn more about the 2024 Insurance Survey: Risk and Resilience, you can find a link to it in the show notes of this episode.

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