

Investment Insights for Insurance Leaders

June 2025



Private assets, public impact: Optimising asset liability management (ALM) strategies in Asian insurance markets

Investors allocate to private markets in pursuit of yield enhancement and risk diversification, but for insurers there is an additional benefit to be gained from including private debt within liability matching investment portfolios: increased Tier 1 capital through higher discount rates.

Enhanced liability discount rates

Under a market-consistent valuation framework, liability cashflows are discounted using a risk-free interest rate (RFR) term structure, derived from government bonds or swap rates.

If the liabilities and their associated matching assets satisfy certain eligibility criteria, insurers can incorporate an element of the spread earned on these assets as an addition to the RFR. This serves to reduce technical provisions, leading to improved Tier 1 capital availability, all else being equal.

The eligibility criteria aim to promote ALM practices, largely limiting spread adjustments to those on portfolios that demonstrate cash flow stability and liability matching attributes.

While these concepts have been established under Solvency II for some time via the Matching Adjustment, similar approaches are being adopted in new and evolving risk-based capital (RBC) regimes in Asia.

- **In Hong Kong (RBC), Singapore (RBC 2) and Korea (K-ICS¹):** a Matching Adjustment is added to the RFR to reflect asset spreads corrected for risks of default and downgrades.
- **In Japan:** uplifts are permitted under the forthcoming Economic Solvency Ratio (ESR) framework. Liabilities are grouped according to their illiquidity characteristics, with a risk-corrected spread added depending on the group to which they have been assigned.
- **In Taiwan (TW-ICS):** requirements have yet to be finalised but are expected to be modelled on Insurance Capital Standards, which would allow for spread adjustments.
- **In China, Malaysia, Indonesia and Thailand:** portfolio-based adjustments do not apply.

Eligible private debt strategies

Asset eligibility criteria include requirements that their cashflows should be stable and predictable and closely align with those of the liabilities that they are assigned to match. For these reasons, we view infrastructure debt and real estate debt as particularly suitable for providing RFR uplifts².



Infrastructure debt

Infrastructure debt finances physical and digital assets including transportation (e.g. road and rail networks, airports, ports), utilities and power (including renewables and energy transition projects), social infrastructure (e.g. schools, hospitals), and digital infrastructure (e.g. data centres and telecommunications networks).

From an ALM perspective, infrastructure debt is well-suited to buy and hold strategies for medium-to long-dated liabilities. It features stable and predictable cashflows often backed by long-term contracts; tenors are typically 5-10 years but can extend beyond 30 years for investment grade assets. Prepayment risk is generally managed through make-whole clauses.

Due to their illiquidity, the instruments typically convey higher spreads than equivalently rated corporate debt, with investment grade spreads at 150-250 bps and below investment grade spreads at 350-600+ bps³.



Real estate debt

Here we refer to involves loans secured against commercial property. Attributes of this asset class include predictable long-term cashflows, and low correlation with corporate bond markets. Senior secured debt benefits from strong downside protection through collateral benefit of conservative loan-to-value ratios. Other risks such as prepayments can be managed through features to protect lenders including prepayment penalties and lockout periods.

Illiquidity typically enhances yields, which are higher than equivalent corporate bonds. Investment grade spreads are at 125-275 bps, and below investment grade spreads are at 275-600 bps³.

1. K-ICS = Korean Insurance Capital Standard, a new capital adequacy framework implemented in South Korea in 2023 to replace the previous RBC regime.

2. We note that although spread adjustments may be capped at those available on investment grade corporate bonds, the cashflow profile and diversification from traditional bond markets convey additional positive features for asset allocation.

3. Macquarie Asset Management estimates.



Secure income

This refers to loans backed by long-term, stable, income-generating residential and commercial and infrastructure adjacent property. Predictable cashflows are secured through lease agreements with strong tenant counterparts (corporate, regulated and implicit government backed), while additional security is often available through collateral arrangements.

Spreads in the region of 125-300 bps may be achieved³.

These assets are particularly suited to long-dated life and annuity liabilities, offering cashflows in the region of 10-50 year terms, and have recently gained traction with insurers in the UK and North America for matching annuity liabilities.



Direct lending

Direct Lending is typically unrated, pays a floating rate, and lacks prepayment protections, characteristics which preclude it from qualifying for matching adjustment assets.

That said, Senior Direct Lending in particular, can be attractive from a return vs. capital perspective when compared with corporate bonds with spreads typically in the region of 475-600 bps³.

Key considerations for CIOs & actuaries

Whilst we have focused on the impact of private debt on ALM strategies, we recognise there are several other impacts which need to be considered when making investment decisions:

- **Capital efficiency:** investors must balance capital requirements⁴ for spread risk with expected returns.
- **Risk appetite:** higher discount rates are associated with higher risk.
- **Currency hedging:** to liability currency for spread adjustment eligibility.

How we can help

Under today's evolving regulatory frameworks insurers face pressure to optimise their portfolio yields within asset and liability-based constraints. Private debt offers a compelling solution for enhancing returns, diversifying risk, and enhancement of ALM strategies through Infrastructure and Real Estate associated debt.

At Macquarie Asset Management, we are experts in sourcing and investing in private markets for our insurance clients. If you wish to discuss any of the issues raised or asset classes described in this newsletter, please reach out to your relationship manager or our team using the contact details below.

3. Macquarie Asset Management estimates.

4. Due to the strict asset-liability matching criteria for Matching Adjustment, interest rate risk will be minimised.

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Investment strategies that hold securities issued by companies principally engaged in the infrastructure industry have greater exposure to the potential adverse economic, regulatory, political, and other changes affecting such entities. Infrastructure companies are subject risks including increased costs associated with capital construction programs and environmental regulations, surplus capacity, increased competition, availability of fuel at reasonable prices, energy conservation policies, difficulty in raising capital, and increased susceptibility to terrorist acts or political actions.

Liquidity risk is the possibility that securities cannot be readily sold within seven days at approximately the price at which a fund has valued them.

Tier 1 capital refers to a financial institution's core capital, which includes shareholders' equity and retained earnings. It represents the most reliable and permanent source of funding for absorbing losses.

Risk-free interest rate (RFR) term structure refers to the relationship between the interest rates (or yields) of risk-free bonds (or other financial instruments) with different maturities. The proxy for risk-free instruments varies by jurisdiction but is usually taken to mean government bonds or swaps in deep, liquid and transparent markets (DLT).

Solvency II is a European Union directive establishing a harmonized, risk-based prudential framework for insurance and reinsurance companies within the EU. It sets capital requirements, governance standards, and reporting/disclosure obligations to ensure insurers can meet their obligations to policyholders and beneficiaries.

Matching Adjustment is an upward adjustment to the risk-free interest rate used to value insurance liabilities. It allows insurers to recognize the long-term, illiquid nature of certain assets and liabilities.

Risk-based capital (RBC) in insurance refers to the amount of capital an insurer needs to hold, based on its specific risk profile, to ensure it can preserve solvency, including under adverse (stressed) conditions. Capital is commonly assessed to cover underwriting risk, market (asset) risk, counterparty default risk and operational risk.

Insurance Capital Standard (ICS) is a global initiative aimed at creating a consistent measure of capital adequacy for internationally active insurance groups, dictating the minimum amount of risk-based capital an insurance company must hold.

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