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InsuranceTalks

How Do Insurance Companies Use Fixed Income ETFs?

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

Eric Pollackov is the Global Head of ETF Capital Markets for Invesco ETFs. In this role, Eric proactively develops relationships with sell-side trading desks, implements capital market strategies for Invesco's ETFs, and develops and measures the success of client interaction.

S&P DJI: Tell us a bit about your role at Invesco and how you serve insurers.

Eric: My role puts me at the center of the ETF ecosystem, where I interact daily with ETF trade desks, exchanges, portfolio managers, and various types of clients. Our team's goal is to provide the most seamless and efficient execution experience when using any of Invesco's 219 U.S.-listed ETFs.[1]

With insurers increasingly turning to ETFs, my team and I work in partnership with the institutional insurance group to assist clients in understanding the ins and outs of ETF structure, liquidity, and trading. Whether they are buying ETFs for the first time or adding onto established positions, we provide the information clients need to successfully implement their investment views via Invesco's vast array of ETF product offerings.

S&P DJI: In the past five years, we have seen ETF AUM in insurance general accounts double; as of year-end 2019, insurers held USD 31.2 billion in ETFs. What are some of the scenarios in which insurance companies may be utilizing ETFs, and why?

Eric: ETFs provide cost-efficient,[2] convenient, and nimble access to core and non-core asset classes, yielding a number of potential applications for an insurer's general account. One primary use case is for manager transitions. ETFs can help insurers maintain exposure to a given asset class or market, while the due diligence and implementation processes are completed on a separate account mandate. A second application is for tactical beta tilting. Tactical beta can take on many forms, but it is traditionally used to overweight or underweight

1 As of June 30, 2020.

2 Since ordinary brokerage commissions apply for each buy and sell transaction, frequent trading activity may increase the cost of ETFs.

specific risk factors, sectors, or asset classes to capture short-term investment opportunities. Also notable is the use of ETFs as a liquidity sleeve in the general account to complement individual securities or managers. Holding a small liquidity sleeve of ETFs may allow insurers to facilitate cash needs in a cost-efficient way by liquidating ETF shares to raise cash, rather than meddling with core positions in the portfolio.

S&P DJI: Fixed income ETFs, in particular, are one of the fastest-growing segments of the ETF market. How has insurance companies' adoption of fixed income ETFs compared to the growth of the market more broadly?

Eric: Over the past five years, the fixed income ETF market has expanded considerably, growing at an annualized rate of 23%. Throughout the first half of 2020, fixed income ETFs captured USD 92 billion, or 48%, of the ETF industry's USD 202 billion of net inflows, the largest half-year inflow ever for the category. At the end of June, fixed income ETFs accounted for 22% of the overall ETF market, nearly cracking USD 1 trillion in total assets.[3]

S&P DJI: While we've seen significant growth in ETF usage in the past five years, as of year-end 2019 ETF AUM in general accounts represents less than 0.5% of admitted assets. What are some of the pushbacks you've encountered in the adoption of ETFs in general accounts?

Eric: Despite the tremendous growth rate in recent years, we're still seeing hesitation and pushback throughout the industry to fully embrace ETFs. One of the major concerns by insurers includes wrapping a less liquid asset class, like high-yield or emerging market debt, in a liquid ETF wrapper that trades intra-day. The concern of what would happen to these products in a liquidity crisis or a "rush to the exits" type of event still weighs on many clients' minds. This, in our opinion, requires additional education around how the ETF structure performs in times of market stress, as seen during Q1 2020.

Additional hurdles to adoption include regulatory complexities related to capital, state codes, and concentration limits within insurance company investment portfolios. The statutory accounting and reporting procedures of an ETF held in the insurance portfolio have also been an obstacle to overcome. Fixed income ETFs are classified as equities by default and must be rated by the NAIC Securities Valuation Office to be classified as debt instruments. The SVO-Identified Bond ETF List of NAIC-rated ETFs has grown over time, gradually reducing this hurdle to adoption. Currently, there are over 150 fixed income ETFs with NAIC ratings, covering a range of asset classes, including treasuries, corporate bonds, and bank loans.[4] As these hurdles have come down, insurer ETF adoption has gradually accelerated, which we expect to continue in the coming years.

S&P DJI: How has insurance companies' increased adoption of ETFs affected the overall ETF industry?

Eric: One of the main benefits of insurance adoption of ETFs has been to further diversify the ETF investor base. Diversity of client type in an ETF is instrumental to the product's liquidity ecosystem. At a minimum, an ETF is only as liquid as its underlying holdings, and it takes a large and diverse group of investors trading the product to develop an additive layer of liquidity on exchange. If an ETF is held only by a group of like-minded investors with the same use case for the product, then market events may trigger these investors to buy and sell at the same time. As a result, there wouldn't be as much natural matching of buyers and sellers on exchange. If, however, there is a diverse client base of retail investors, financial advisors, pension funds, hedge funds, and insurance companies all with different use cases for the product, time horizons, trading strategies, and liquidity needs, then you get a healthy liquidity ecosystem that develops around the ETF.

[3] Source: Bloomberg LP as of June 30, 2020.

[4] Source: NAIC, *SVO-Identified Bond ETF List, ETFs Eligible to be Reported as Bonds*, June 9, 2020.

In March 2020, in the midst of stressed corporate credit conditions, USD 719 billion of fixed income ETF volume was matched off on exchange without causing a trade in the underlying bond market. Adoption of ETFs by insurance companies helps further this diversity and liquidity ecosystem.

S&P DJI: For the first time ever, the Federal Reserve is using fixed income ETFs as a monetary policy tool within the Secondary Market Corporate Credit Facility (SMCCF). Can you elaborate on why they would choose to purchase these vehicles? Is there a looming liquidity risk when the Fed will have to unwind their credit ETF purchases?

Eric: It was remarkable to witness the speed at which the Federal Reserve (Fed) was able to react to the coronavirus pandemic that hit the U.S. in Q1 2020. In 2008, the Fed cut interest rates seven times during that calendar year and used conventional monetary policy tools. This time around, on March 23, 2020, just two weeks in to the nationwide shutdown, the Federal Reserve created a plethora of new and innovative monetary policy tools to restore confidence and solvency in the corporate bond market. Particularly notable were the two corporate credit market facilities that helped to mitigate solvency risk and bolstered credit market liquidity. The Primary Market Corporate Credit Facility (PMCCF) helped ensure corporations had access to the new issue market to fund maturing liabilities and remain solvent through the shutdown. The SMCCF injected liquidity into the credit market, holding corporate borrowing costs in check as the Fed pledged USD 250 billion to buy corporate bonds in the secondary market.

Remarks from Fed Chair Jerome Powell indicate the primary intention of the SMCCF was to buy individual bonds; however, investment-grade and high-yield ETFs were also approved for purchase in the program. We believe the reason they turned to ETFs at the onset of the program was the speed at which they could inject liquidity into the corporate credit market versus buying individual bonds. A single ETF purchase could allow the Fed to provide liquidity to more than a thousand bonds in the underlying portfolio. It may have taken the Fed weeks to find and purchase a portfolio of that many individual bonds in the secondary market. We also believe ETFs helped de-politicize the corporate bond purchases, providing capital to a broad index of corporations rather than the Fed deciding which individual companies to allocate to. All in all, the ETF purchases have represented a small portion of the SMCCF program; however, these products were instrumental to the speed at which the program was implemented, restoring credit market confidence within a matter of weeks.

A criticism of the program is that although the individual bonds can mature and roll off the Fed balance sheet, the ETF purchases must eventually be sold. As of June 18, 2020, the Fed had bought USD 6.8 billion in fixed income ETFs, which compares to USD 9.8 trillion in corporate debt outstanding, so its ETF holdings represent a small fraction of the overall corporate debt market. A structural benefit of the ETF wrapper is the ability to convert ETF shares to the underlying holdings in an in-kind redemption. Thus, we cannot rule out the possibility that the Fed will work with ETF issuers and their Authorized Participants to convert their ETF holdings to individual bonds, ultimately to let those positions mature and roll off the balance sheet.

S&P DJI: Looking ahead, are there specific areas where ETFs may play a bigger role in insurance general accounts?

Eric: S&P DJI's research notes the projection based on historical trends for ETF holdings by insurance companies may double in the next five years. We echo this sentiment and see a few catalysts that may cause ETFs to play a larger role in insurance general accounts. First, we believe that the credit market stress in March 2020 has made the need for a liquidity sleeve evident in fixed income portfolios. In the first few weeks of March 2020, it is was quite difficult and expensive to raise cash from individual bonds across the spectrum of quality and duration. We discussed how ETFs can create an additive layer of liquidity over their underlying holdings, which is particularly beneficial in times of stress. We anticipate the use of ETFs as a liquidity sleeve in insurance general accounts to grow considerably as result.

Another area where we see a growth catalyst is with defined maturity ETFs. Previously a small segment of the ETF market, defined maturity ETFs now represent USD 20.3 billion of ETF assets.[3] Defined maturity corporate bond ETFs have reached scale and may now be useful tools to duration match liabilities or tweak portfolio duration while maintaining exposure to credit. S&P DJI notes that defined maturity ETFs have the highest usage of systematic valuation by insurance companies among all ETF categories as well, potentially due to the reduction in portfolio turnover that these products provide relative to traditional ETFs.

Finally, as alluded to before, we anticipate further growth of ETFs as strategic core allocations in general accounts as the actively managed ETF space develops. Passive ETFs may also play a larger role as core positions in place of SMAs as insurers become more familiar with the ETF market structure and overall cost benefits. Cost-conscious investors are beginning to look past the stated management fee to assess trade entry and exit impact, rebalancing costs, multiple layers of securities lending, and improved tracking error with scale to properly calculate total ownership cost among various investment wrappers.