BARINGS

INSURANCE SOLUTIONS

Rise of the Residential Whole Loan

INSIGHTS

Given the potential for yield and capital efficiency, residential whole loan mortgages have been the fastest growing asset class in life insurers' investment allocations in recent years. Partnering with a manager that has the experience and resources to navigate this dynamic market is key.

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Regulatory Realignment

In the world of insurance regulation, change has historically been slow, maybe even glacial. Recently, however, regulatory anxiety has heightened, caused by rapid changes in insurers' investment allocations and led by new, non-traditional entrants into the insurance space. Financial innovation in certain structured securities has also contributed to concerns.

As a result, the National Association of Insurance Commissioners (NAIC), the main U.S. insurance regulatory body, has moved more rapidly than historic norms on a number of themes. The NAIC is now seeking to:

1. Redefine the classification of assets to better categorize their risk characteristics;
2. Re-evaluate the ratings of certain assets to consider default and investment return risk;
3. Revisit the capital charge factors used in setting capital standards for certain asset classes such as collateralized loan obligations (CLOs) and residual tranches.

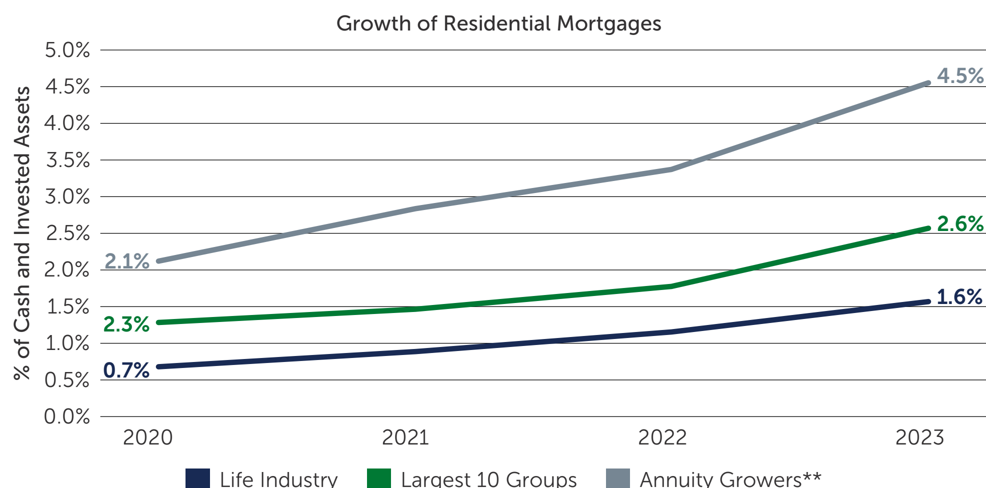
In the NAIC's 2023 report titled "Framework for Regulation of Insurer Investments—A Holistic Review", it laid out the blueprint to revamp their entire regulatory framework. The NAIC recognizes the industry has accelerated certain financial innovation, such as rated notes, to address inconsistent capital/risk-based capital treatment of funds—which typically receive a high equity charge regardless of the underlying investments. Funds with underlying investments such as private credit should ideally receive capital treatment commensurate with their fixed income risks. Rated notes help to improve this capital charge, but they involve added complexity that would be unnecessary if the NAIC were to allow proper look-through treatment. Currently, Statutory Accounting Principles allow capital look-through treatment for a limited set of asset types—including **residential whole loan** (RWL) mortgages.

Rise of the RWL Mortgage

RWL mortgages, or non-qualified (non-QM) mortgages, that do not conform to government sponsored enterprise (GSE) guidelines, have been the fastest growing asset class in life insurers' investment allocations over the past three years **(Figure 1)**. In particular, not only has the overall RWL allocation for the industry increased, but the growth is even more pronounced for the largest insurers—and even more so for the fastest growing annuity writers, where crediting rates are extremely competitive.

The search for achievable investment yield is paramount to growth in the annuity business, and RWL mortgages provide the potential for attractive option-adjusted spreads—particularly as banks have stepped back from originations given changes in their capital regimes. Capital efficiency is also a key feature as historically low defaults justify a low capital charge factor of 0.68%, analogous with corporate bonds rated A+.

Figure 1: RWLs are the Fastest Growing Asset Class for Life Insurers



Source: S&P Global. As of December 31, 2023.
*Defined as the top 10 life insurance groups by growth in individual annuities, among those who held significant reserves for individual annuities (at least $500 M) in 2019.
**The Largest 10 Groups composite and Annuity Growers composite have four common insurance groups: MassMutual, Athene, Global Atlantic and Pacific Life.

Requisite Resources as a Potential Roadblock

Though attractive as an asset class, investing in RWLs presents a number of logistical challenges, particularly for those insurers—both small and large—that lack the experience or dedicated investment resources in this space. For one, loan balances can average lower than $500,000, well below the average for commercial mortgages of closer to $10 million, leading to a cumbersome volume of loans which must be aggregated, accounted, and maintained. In addition, performance management and reporting issues must be addressed at a loan level, which can absorb resources and introduce additional challenges. Understandably, only 17% of life insurance entities have direct residential mortgage loans held on Schedule B of the Statutory Statements.[1] Larger insurers with scale hold the majority, with 90% of residential mortgages owned by the top 5% of entities by assets.

1. Source: S&P Global. As of December 31, 2023.

Where Should RWLs Reside?

In our view, an investment fund is an optimal vehicle for delivering RWLs to small- and medium-sized insurance investors. Even though Schedule B Mortgages are still expected to be more efficient for holding RWLs at scale for larger insurers, added accounting and reporting requirements make a compelling case for investment funds, which have much less operational complexity.

The NAIC recently added a new line item to the Life Risk-Based Capital Blanks template for Schedule BA Affiliated Mortgages—Residential—All Other, clarifying the capital charge at 0.68%, which is the same as the underlying residential mortgages. This change, effective at the end of this year, is to correct a form oversight from a decade ago but does draw attention to the favorable capital charge for affiliate mortgage funds. To qualify as an affiliated fund, the investor must own at least 10% of the fund, implying some measure of control for accounting purposes.

Schedule BA also allows for insured or guaranteed residential mortgages, which have an even lower capital charge at 0.14%, comparable to AAA-rated corporates. Mortgages eligible for this category are Government National Mortgage Association (GNMA) early buyout (EBO) loans, which are used to rehabilitate qualifying delinquent mortgages and are insured by the Federal Housing Administration and the U.S. Department of Veterans Affairs—and therefore draw the low capital charge.

Barings' Insurance Solutions: A Recipe for Relief

The Barings Global Insurance Solutions team can help insurance investors navigate the challenges to investing in this space. The Team has the ability to facilitate the Schedule BA Affiliated Mortgages classification to qualify for the favorable capital treatment, by limiting the number of investors in the residential mortgage fund. Barings also has a long history of originating residential mortgage loans for insurance investors.

Through investing in the Barings' originated RWL strategies, insurance investors can gain access to a number of potential benefits including:

1. Depth and breadth of investment experience in this asset class
2. Favorable capital charges
3. Potential for attractive option-adjusted spreads of 150–175 basis points above A+ rated corporates, which draw a similar capital charge[2]
4. More immediate exposure to a diversified portfolio of residential mortgages
5. Simplified accounting treatment in a fund format
6. Eligible collateral for member insurers of Federal Home Loan Banks borrowing programs.

2. Source: Barings. As of November 6, 2024.

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