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Widening the net

Why Asian insurers should be reviewing their emerging-market debt exposure

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Introduction

Offering comparatively attractive yields and diversification benefits, emerging-market debt (EMD) could have a bigger role to play in Asian insurers' fixed income portfolios as risk-based capital regimes continue to be rolled out across the continent.

As the global insurance market continues to grow, insurers are having to widen their investment universe as they search for assets capable of matching their liabilities while offering prospective risk-adjusted returns adjudged attractive.

Insurers have historically been natural investors in investment-grade corporate bonds given their ability to deliver reliable income streams and diversify sovereign bond exposures. However, while corporate bonds continue to play an important role in the asset allocation mix, firms are looking to expand their horizons. Over the past decade or so, European insurers have also been upping their exposure to EMD, albeit from an extremely low base, in the hunt for an additional yield kick and even greater diversification.

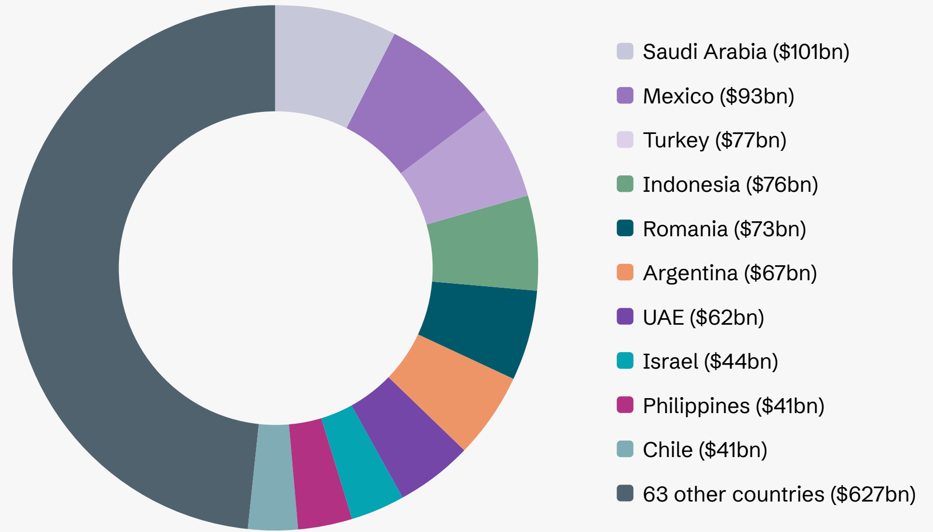
But their Asian counterparts have been reticent to follow suit. Despite rapid growth in the EMD universe, many appear to have been unwilling to look beyond their domestic or regional markets or the US. This is especially true of smaller firms.

Given the evolution of the asset class, hard-currency EMD should arguably be playing a bigger role in Asian insurers' fixed-income portfolios. After all, high-quality EMD can offer appreciably higher yields than other types of fixed-income assets they are likely to hold and sizeable diversification benefits too. The actions of European insurers following the implementation of Solvency II rules in 2016 suggests the ongoing rollout of risk-based capital regimes across Asia could be the trigger for businesses to up their allocations.

Aaron Grehan, head of capital opportunities group and co-head of emerging market debt at Aviva Investors, says European insurers' increased appetite for investing in EMD in recent years is partly explained by the introduction of Solvency II, a risk-based capital framework, in 2009. But at least as important has been the steady increase in the quality of the asset class and its ability to diversify a broader fixed-income portfolio.

For instance, the number of emerging market countries issuing external debt has grown significantly, from just four in 1991 to 74 (see Figure 1). This expansion has been advantageous for investors looking to diversify, as the increased number of issuers has lessened the dominance of the largest countries in major indices. The universe now contains a diverse range of assets from investment-grade to defaulted debt.

Figure 1. **EMD - an increasingly diverse universe**



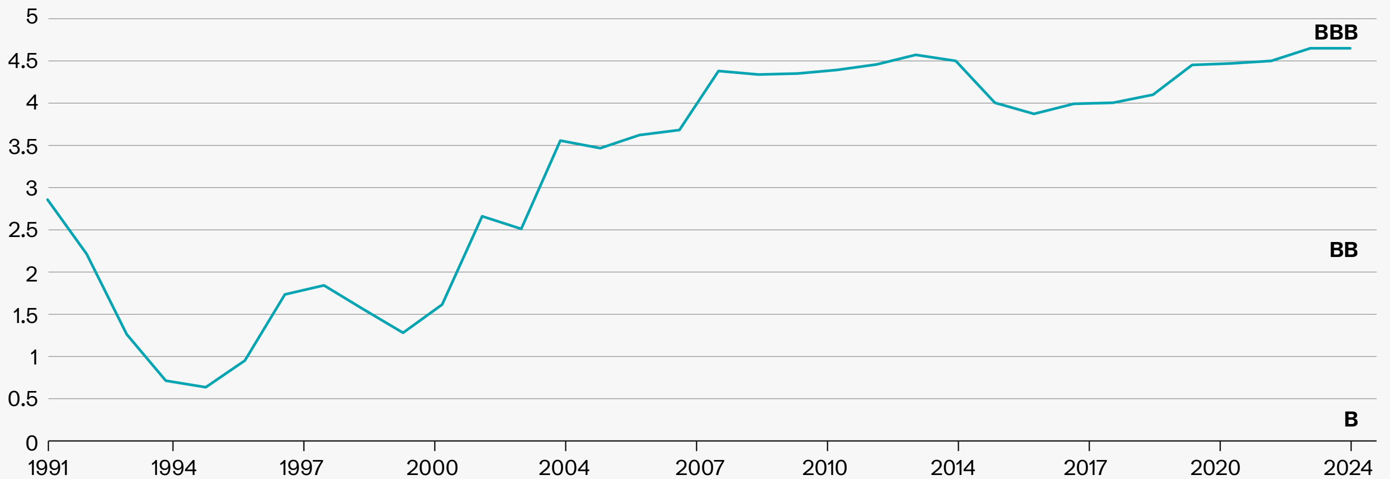
Source: BofA Global Research, Bloomberg, ICE Data indices, LLC. Data as of July 2024.

Currently, $2.7 trillion worth of emerging-market sovereign and corporate bonds are eligible for inclusion in these indices, meaning the market is around 30 per cent bigger than the global high-yield bond market.

Rising credit quality

At the same time, the credit quality within the asset class has been getting steadily better, helped by the fact many emerging-market nations have made a variety of structural improvements to the way their economies are run (see Figure 2).

Figure 2. **EMD credit quality is rising**



Source: BofA Global Research, Bloomberg, ICE Data indices, LLC (DGOV Index). Data as of July 2024.

These changes include improved fiscal discipline, the rolling out of new technology to bolster revenue-collection capabilities, and strengthened monetary-policy frameworks, with central banks shifting towards inflation-targeting regimes and greater exchange-rate flexibility.

It is worth noting that in 2022, emerging-market central banks were quicker to raise interest rates to try to quench inflation than their peers in advanced economies, which erroneously thought it would prove transitory. The result was increased EMD resilience.

It is not only the credit quality and diversity of the overall sovereign universe which has increased. The same goes for the investment-grade segment within it. Whereas in 2003 Mexico made up over 70 per cent of the investment-grade sub-component, with a BBB rating, and there were almost no issuers rated single A or better, today there are 42.

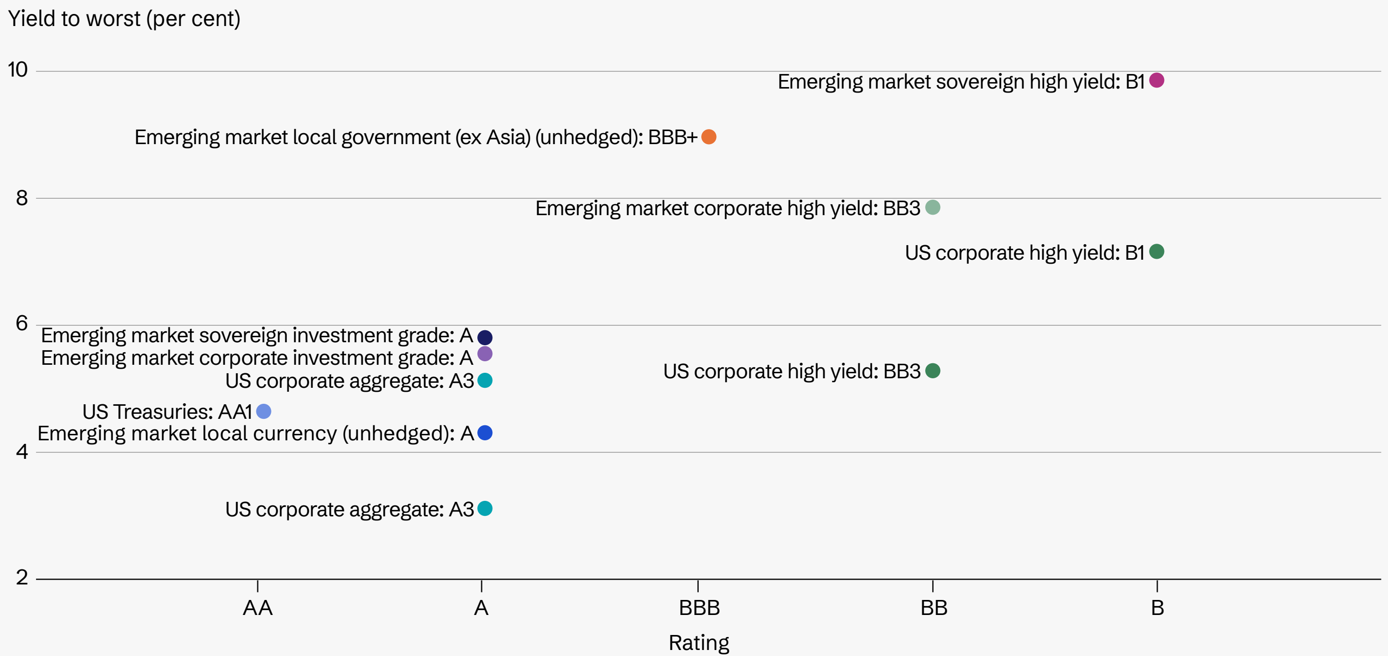
"EMD was once seen by insurers as a volatile and risky asset class. But in recent years that has started to change thanks to the increased quality of issuers. It's more and more relevant and usable for insurers' portfolios," Grehan says.

Yields remain attractive

He argues that EMD offers an attractive yield relative to other fixed-income asset classes, particularly when taking credit risk, or bond ratings, into account. Take sovereign bonds. EM debt offers a healthy pick-up in yields relative to comparable developed-market bonds. This is despite the fact emerging nations are expected to post considerably faster economic growth than developed ones over the medium term. That they are also generally in much healthier fiscal positions only adds to EMD's allure.

According to the International Monetary Fund, whereas government debt averages just below 72 per cent of GDP in EM countries, the corresponding figure for advanced economies is 111 per cent. And for the G7 nations it is 126.5 per cent.

Figure 3. **EMD offers attractive risk-adjusted yields**



Source: Aviva Investors, Bloomberg. Data as of February 25, 2025.

Grehan says developed market corporate debt also looks relatively unattractive with the yield pick-up so low from a historical perspective (see Figure 3). While even buy-and-maintain insurers need to be mindful of the dangers posed by a lack of liquidity, he sees a case for insurers to consider investing in emerging-market corporate debt.

"Until now, insurers never needed to look outside of developed markets. But with spreads as tight as they are globally, they're having to consider other opportunities. Whereas EMD previously had an image problem, things are changing quickly. The asset class has matured. With so much more investment-grade debt, it's increasingly suitable for insurers," he adds.

According to Iain Forrester, head of fixed income solutions at Aviva Investors, many Asian insurers will already allocate to Asian sovereign bonds and Asian investment grade credit. Their peers in the West may consider some of these assets within their EMD allocations.

When seeking to diversify their portfolios, Asian insurers have typically sought to incorporate US and European investment grade credit rather than adding allocations to EMD from other regions.

The case for diversifying away from Asia

Grehan says this is ironic since within the EMD universe, Asian debt is arguably the least underpriced segment with yields being suppressed by strong demand from domestic insurers and other types of institutional investors.

Furthermore, while all emerging economies are vulnerable to US President Donald Trump's threat to choke trade, Asian nations are among the most vulnerable. President Trump's overriding concern is to restrict US imports from China, a country on which the rest of Asia heavily depends.

Forrester believes the ongoing introduction of risk-based capital regulatory regimes across Asia presents an opportunity for the region's insurers to review and modify their allocations to EMD, especially in view of the favourable treatment given to more highly rated market segments in some jurisdictions.

"If you take Singapore as an example, there is no capital charge applied to sovereign debt rated single A or higher. Given the other attractions of the asset class, there is a strong case for insurers to be considering broadening out their EMD allocations to other regions," he says.

As for the regime in Hong Kong, there is no spread risk capital charge when investing in certain local currency sovereign debt, such as that of Thailand or Japan although investors would need to factor in the costs of currency hedging. Recognised emerging market 'green' bonds are also treated favourably, with the stress factor reduced by ten per cent compared with 'non-green' bonds.

"Given the other attractions of the asset class, there is a strong case for insurers to be considering EMD from other regions," Forrester says.

He and his team design and implement bespoke portfolios for insurance clients that attempt to deliver attractive risk-adjusted returns and consider the impact of capital charges. For example, his insurance clients could determine the amount of capital they are prepared to deploy and then design an EMD mandate that limits investment in bonds of certain ratings.

Case study

We have produced a model portfolio comprising sovereign, quasi-sovereign and corporate bonds denominated in US dollars. The portfolio has a duration of five-and-a-quarter years and produced a spread over US government bonds of 130 basis points as at the end of February. The key characteristics of the portfolio and illustrative capital charges in respect of spread risk capital are shown in Figure 4.

Figure 4a. **Asset allocation**

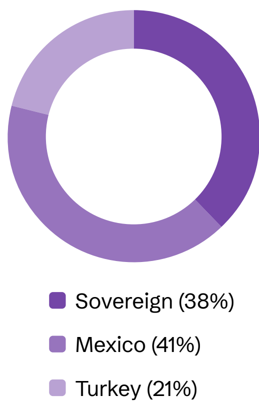


Figure 4b. **Country breakdown**

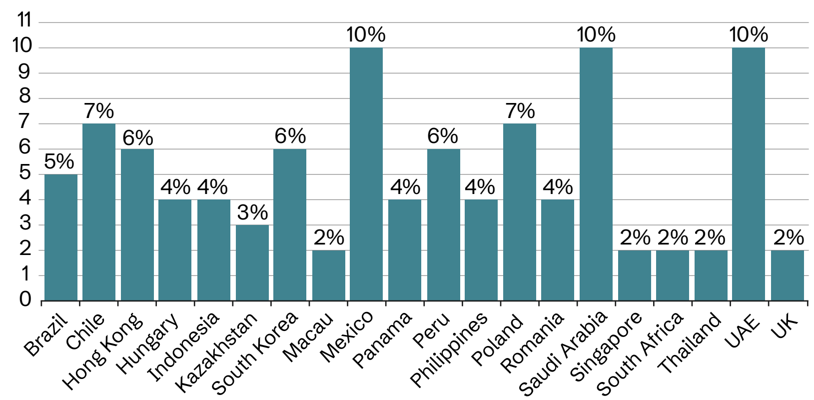


Figure 4c. **Ratings breakdown**

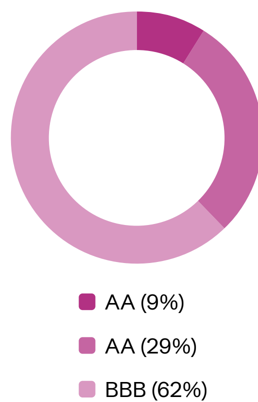
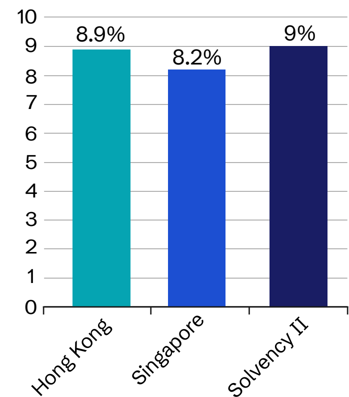


Figure 4d. **Capital charge**



Source: Aviva Investors. Data as of February 27, 2025.

"Our investment process is built on our fundamental credit views. Even if the outlook for emerging-market debt as a whole may look favourable, it is important to recognise that the asset class is far from homogeneous. Given the potential impact of downgrades, clients should avoid passive strategies," Forrester says.

He points to the fact that capital charges can jump significantly in both Singapore and Hong Kong when debt falls into high-yield territory.

Figures 5 and 6 show illustrative capital charges under Singapore and proposed HK regimes for investment in hard-currency emerging-market debt. We have shown this for bonds with different ratings and durations.

Figure 5. **4-year duration** (per cent)

Credit stress	Hong Kong		Singapore		Solvency II	
	Sovereign	Corporate	Sovereign	Corporate	Sovereign	Corporate
AA	0	4.4	0	4.8	4.4	4.4
A	7	7	0	6.6	5.6	5.6
BBB	11	11	9.8	9.8	10	10
BB	17	17	16.2	16.2	18	18

Source: Aviva Investors. Data as January 3, 2025.

Figure 6. **7-year duration** (per cent)

Credit stress	Hong Kong		Singapore		Solvency II	
	Sovereign	Corporate	Sovereign	Corporate	Sovereign	Corporate
AA	0	7	0	8.1	6.7	6.7
A	10.2	10.2	0	10.2	8.4	8.4
BBB	15.4	15.4	16.1	16.1	15.5	15.5
BB	27.3	27.3	25.6	25.6	27.5	27.5

Source: Aviva Investors. Data as January 3, 2025.

In our view, EMD offers an increasingly attractive option for insurers, given attractive spreads, its diversification benefits, and in some cases its favourable capital treatment. As the asset class continues to grow and mature, we believe EMD may soon be considered a core holding within fixed income portfolios, complementing more traditional DM holdings.

Key risks

Investment risk

The value of an investment and any income from it can go down as well as up. Investors may not get back the original amount invested.

Derivatives risk

Investments can be made in derivatives, which can be complex and highly volatile. Derivatives may not perform as expected, meaning significant losses may be incurred. Derivatives are instruments that can be complex and highly volatile, have some degree of unpredictability (especially in unusual market conditions), and can create losses significantly greater than the cost of the derivative itself.

Illiquid securities risk

Some investments could be hard to value or to sell at a desired time, or at a price considered to be fair (especially in large quantities), and as a result their prices can be volatile.

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