Insurance Asset Management

June 2018

SSLs
How insurers are using this niche asset class in their portfolios

Real Estate Debt
The attraction of real estate debt for insurers

Asian Credit
The benefits of investing in this asset class and how to implement it

BREXIT
How much of a threat does Brexit pose to the insurance industry?

M&A
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OUTSOURCING
Outsourcing trends in the UK/European insurance sphere

Editorial Comment

The ultimate aim is to provide an insightful resource to our readers, ensuring that we cover a broad range of subjects, relevant to all parts of the insurance asset management and investment industry

Welcome to the first print edition of *Insurance Asset Management*. Some may argue print is dead but not here at Perspective Towers!

Having launched the website in September 2016, with the aim of targeting global asset managers and chief investment officers in the global insurance space, engagement and readership has gone from strength to strength. On the back of this, we decided to launch this title, something I hope you will find as positive as the website and share my excitement at having an insurance print title which you can read from the comfort of your sofa or office desk.

Having covered pensions for six years on our sister titles *Pensions Age* and *European Pensions*, I find investment trends within the insurance space just as fascinating, as chief investment officers and asset managers continually look to outgun a low interest rate environment and reap the highest returns as possible.

Throughout this issue, we cover the issue of Solvency II and whether it is restricting insurance investment with excessive governance (p.23), the ongoing saga around Brexit and its impact on the UK and European insurance industry (p.28), and hear from our panel of experts on investing in the alternative credit space (p.36).

If that isn't enough to whet your appetite, the magazine also covers recent trends in the mergers and acquisitions space (p.32) and covers key investment areas such as senior secured loans (p.50) and real estate debt (p.53).

Further, we also interview a number of leading figures within the insurance arena, who have provided us with invaluable insight into the industry from an association point of view and from a CIO perspective.

The ultimate aim is to provide an insightful resource to our readers, ensuring that we cover a broad range of subjects, relevant to all parts of the insurance asset management and insurance investment industry.

Please feel free to contact me with your first impressions of the magazine and we are also open for suggestions on how to improve.

I hope you enjoy reading *Insurance Asset Management* and I look forward to continue working with you all over the coming year and beyond.

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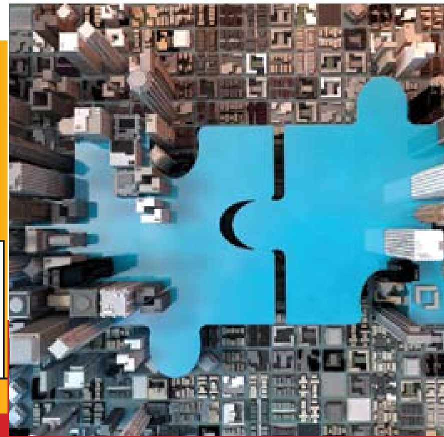

News focus

Risk exposure of insurance sector within EU 'stable'; low interest risks remain major issue

EIOPA chair says evolution of financial markets 'does not justify a change in the cost of capital'

Written by **Oliver Wade**

EIOPA has recently stated that the risk exposure of the insurance sector within the EU "remained stable" in its *Risk Dashboard* for the fourth quarter of 2017.

However, the authority has also stated that "despite positive macroeconomic developments, low interest rates are still a major source of risk for European insurers", although most indicators improved marginally compared to those shown for Q3.

There were also positive developments in forecasted real GDP growth and increased expected inflation closer towards the ECB target further contributed to a decrease in risk.

The report noted that credit and market risks continued at a "medium level", while spread further decreased and "concerns" about potential mispricing remained. Since the last assessment, spreads decreased among all bond segments, except for unsecured financial corporate bonds.

EIOPA reported that credit and market risks were stable at a medium level in Q4 2017, and most market indicators changed "only little" when compared to the previous risk assessment, bar investments in equity, where the volatility of prices increased. Due to this, valuations have decreased slightly.

Median profitability levels reflected those seen in Q4 2016 while solvency positions continued to be strong for both groups and individual companies, with ratio remaining "well above" 100% for most insurers.

Due to the unusually high number of catastrophe claims in the third quarter of 2017, insurance risks remained at a medium level.

The assessment revealed that market perceptions remained stable at a medium level since the last assessment. Positive developments related to the performance of insurers' stock prices relative to the overall market also contributed to a decrease in risk.

Despite the low interest rate environment however, "the evolution of financial markets does not justify a change in the cost of capital", EIOPA chairman Gabriel Bernardino has argued.

In the 2018 Review of the Solvency II Delegated Regulation speech, Bernardino said the decrease in interest rates has not led to a decrease in the cost of raising equity.

"Therefore, we are of the opinion that the cost-of-capital needs to be kept on the same level while the review of other aspects of the risk margin should be assessed in the upcoming overall review of the Solvency II regime scheduled for 2021."

During the speech, Bernardino also made reference to the interest rate risks, as the calculations previously carried out utilised data from 2008. Since then EIOPA has proposed that the directive implements "new calibrations" that take recent evidence, such as negative rates, into account as the current approach does not cater for them and, according to EIOPA, is not "effective" in the new world with low yield environments.

The purpose of the review was to "detect" areas of improvement and simplification, whilst also removing inconsistencies, being "guided" by evidence and facts, but Bernardino closed the speech stating "overall and leaving aside the advice on interest rate risk, EIOPA's proposals do not lead to significant changes in terms of capital requirements".

> The cost-of-capital needs to be kept on the same level while the review of other aspects of the risk margin should be assessed in the upcoming overall review of the Solvency II regime scheduled for 2021

Last month saw EIOPA publish its 2017 oversight activities report addressed to the European parliament.

Over the past year, EIOPA has conducted a number of activities that contributed to high-quality effective supervision, alongside overseeing a level playing field and appropriate application of supervisor provision within the EU.

During this time, EIOPA detected a "growing" number of issues related to cross-border business activities provided through 'freedom to provide services'. EIOPA has said that, in order to "enhance cooperation and communication" between supervisory authorities, it has rolled out cooperation platforms.

The so-called cooperation platforms will be "important' tools that facilitate stronger and timely cooperation between national supervisors in the assessment of the impact of cross-border activities and identification of preventative measures.

EIOPA reported that, at the end of 2017, nine cooperation platforms had been rolled out.

The firm has announced that, this year, in the field of oversight, EIOPA will "pay specific attention" to further implementation of prudential regulation, Solvency II and the conduct of business supervision.

News in brief

■ Aviva has announced that it will commence a share buy-back of its ordinary shares for up to a maximum aggregate consideration of £600m.

Aviva outlined in its 2017 results that it has "significant" excess capital and therefore committed to deploy £2bn of this in 2018. The deployment involves £900m of debt reduction, £500m for bolt-on acquisitions and the £600m ordinary share buy-back.

■ Pool Re has announced that it has appointed GC Securities as its insurance linked securities (ILS) adviser and placement agent, following a competitive RFP.

The newly announced partnership will enable Pool Re to further assess its options from the ILS market, including the types of structures available, the viability of a placement and the ILS market's appetite for terrorism risk.

■ Lloyd's of London (Lloyd's) chief financial officer (CFO) John Parry has decided to leave the organisation after being with the firm for 17 years. Parry joined Lloyd's in August 2001 and was appointed CFO in December 2014, being a member of both Lloyd's board and executive committee.

■ Achmea has reported earning €19.35bn from gross written premiums in its 2017 annual report, with health insurance contributing the biggest amount at €13.2bn. After health premiums, non-life insurance earned the second largest sum of €3.3bn, while pension and life and international insurance netted £1.6bn and £1.2bn respectively.

Paris calls for world's largest insurers to end support for coal industry

Unfriend Coal calls for insurers to be in the 'front line of the battle'

Written by **Oliver Wade**

The Paris city council is calling on the world's largest insurance companies to end support for the coal industry, reminding them of its impact on climate change and pollution that causes 23,000 premature deaths across Europe each year.

In 2015, the city chose to divest from fossil fuels and sectors contributing towards climate change, and it announced in February that it was considering the "feasibility" of suing fossil fuel companies for climate damages.

When asked whether we were really experiencing global warming, Paris mayor Anne Hidalgo said: "In the last 18 months Paris has lived through two major floods, one in June 2016 when the Seine rose more than six metres, and also four heat waves. So yes, we are really experiencing global warming."

Insurance CEOs will gather for the annual General Assembly of industry think tank the Geneva Association from 30 May to 2 June, where the world leaders signed the Paris agreement and committed to keep global warming "well below" 2 degrees Celsius. Climate change is also also affecting the frequency of natural catastrophes, which resulted in insurers experiencing record losses of $144bn and costing the world as a whole $330bn.

> Those who pay lip service to climate targets but continue to support coal are betraying their customers, their investors and the millions whose lives have already been devastated by global warming

Paris recently passed a motion directed at CEOs of the world's largest insurance and reinsurance companies, ahead of their annual meeting at the end of this month, which will increase the pressure on them to divest from coal and stop insuring coal projects.

Unfriend Coal campaigner Lucie Pinson stated: "Paris symbolises the world's commitment to prevent dangerous climate change and insurers should be in the front line of the battle. Those who pay lip service to climate targets but continue to support coal are betraying their customers, their investors and the millions whose lives have already been devastated by global warming. The city council is showing them what support for the Paris Agreement means."

The motion, tabled by five green councillors, noted that coal is the "most polluting" industry in the world and contributes to "accelerating climate change". Of the 23,000 deaths that Europe experiences as a result of the coal industry, the Polish coal sector is responsible for almost 6,000 of them.

"Major European insurance and reinsurance companies such as Allianz, SCOR and Generali massively support, insure and invest in the coal industry in Poland," the motion stated.

"The City of Paris invites the insurance and reinsurance companies, gathered in Paris for the meeting of the Geneva Association at the end of May, to commit to opposing air pollution and to withdraw their support from projects and companies in the coal sector, notably in the European Union and more particularly in Poland."

Furthermore, NGOs that are in support of the Unfriend Coal campaign published a briefing in February, revealing the European insurers investing in companies planning new mines and power plants and providing insurance to. The briefing revealed that insurers have signed at least 21 contracts underwriting existing operations and new developments since 2013 and invested more than €1.3bn in Polish coal companies.

"Insurance companies are uniquely placed to support the transition away from coal. By ceasing to underwrite and invest in coal projects, they can improve public health, increase life expectancy for thousands of people, and support international climate targets and the fight against dangerous global warming," Unfriend Coal concluded.

'Illiquid assets can be good, but bring a wider range of risks' - PRA

Insurers are seeking to support annuity books with with increasingly risky forms of investments

Written by **Oliver Wade**

Life insurance firms that are seeking higher returns from illiquid assets, such as equity release mortgages or student housing, have to properly understand the risks associated, the PRA warned.

Due to the low interest rates and declining yields, many insurers have sought to support their annuity books with increasingly risky forms of investments, according to PRA executive director of insurance supervision David Rule.

"Illiquid assets can be a good match for annuities. Diversification may lower overall portfolio risks. And long-term infrastructure investment has wider economic benefits.

"But these assets bring a wider range of risks than those familiar to bond investors. Insurers need to ensure they have the skills to understand and manage them," Rule said in a recent speech.

The PRA's estimates suggested that illiquid fixed income assets currently account for "more than" 25% of the assets backing annuities across UK insurers.

Rule further stated that insurers' business plans suggest this proportion might increase to around 40% by 2020, and that the "failure of Carillion left some insurers needing to replace a contractor on construction projects".

Woods also noted that "financing student accomodations exposes insurers to the risk of changing UK student numbers; and financing railway stock creates a risk at the point when a new train operator wins a franchise".

> These assets bring a wider range of risks than those familiar to bond investors. Insurers need to ensure they have the skills to understand and manage them

SLA progresses with Phoenix deal

Proposed transaction expected to complete in the third quarter of 2018

Written by **Adam Cadle**

Standard Life Aberdeen and Phoenix Group have provided an update regarding the proposed sale of Standard Life Aberdeen's UK and European insurance business, announcing that they are "actively progressing" with the separation and integration planning for the proposed transaction.

Standard Life Aberdeen has affirmed that the proposed transaction is expected to complete in the third quarter of 2018, while also reporting that it "continued to engage with its UK regulators" in relation to the future prudential supervision of the group.

Following completion of the transaction, Standard Life Aberdeen has also revealed that it is considering the potential for a "substantial" return of capital to shareholders.

It has been reported that Phoenix has made good progress with the financing for the proposed transaction and it had issued its inaugural Restricted Tier 1 bond in April while continuing to engage with regulators.

It is expected that the general meetings for each Standard Life Aberdeen and Phoenix shareholders to approve the transaction will be held consecutively.

'Life insurers' use of derivatives will continue to expand'- Fitch

Ratings agency sees growth of derivatives on balance sheets greatly exceeds asset growth

Written by **Adam Cadle**

European life insurers' use of derivatives will continue to expand to reduce exposure to market risks, Fitch Ratings has said.

In a report published last month, Fitch said the past decade has seen the growth of derivatives' positions on life insurers' balance sheets greatly exceed asset growth, implying more intensive use of derivatives.

"We expect that low interest rates and the significant share of products with options and guarantees within life insurers' books will continue to be a driver for the use of derivatives for asset-liability management (ALM) and investment portfolio management," it said.

Fitch also said that it expects the EU Solvency II regulatory regime will continue incentivising the use of derivatives. "Derivatives will likely get a further stimulus from the implementation of new fair value-based accounting standards. We expect insurers to use derivatives to mitigate solvency and reporting volatility magnified by the regulatory and accounting requirements.

"We view the use of derivatives for risk management as credit-positive, provided insurers have a robust governance framework in place that specifically address the risks of using derivatives, including but not limited to basis, counterparty, operational and model risk management."

> We view use of derivatives for risk management as credit-positive, provided insurers have a robust governance framework in place

Asset managers' fees bolstered

Strong financial markets, M&A and inflows increase total management fees for asset managers

Written by **Adam Cadle**

The combination of strong financial markets, industry consolidation and net fund inflows helped "bolster" total management fees for Europe's asset managers in the second half of 2017, according to a report published by Moody's Investors Service.

The report revealed that total management fees across the surveyed group increased by 12.7% during H2 of 2017, compared to the first half of the year. Without including merger and acquisition transactions, Moody's has estimated that overall fee revenue increased by 6%.

Commenting on the report's findings, Moody's senior analyst and vice president Marina Cremonese said: "About half of the increase in fees we recorded was due to the acquisition of asset managers previously outside of Moody's surveyed group, for example the Janus-Henderson merger and the acquisition of Pioneer by Amundi.

"However, the other half is down to market appreciation, higher performance fees, as well as positive net flows."

IFRS 17 will increase cost, complexity and transparency of insurance

97% of senior UK insurance professionals highlight these three factors as main ones to affect market on implementation

Written by **Oliver Wade**

The majority of senior UK insurance professionals (97%) expect the new International Financial Reporting Standard (IFRS 17) to increase the complexity and cost of operating in the industry when it's implemented, according to research from SAS.

However, despite this, 92% of insurers also believe that that new standard will "improve financial transparency" and 84% expect it to deliver additional benefits beyond compliance.

SAS has said that IFRS 17 will "fundamentally" change the face of accounting, with insurance companies having to report in greater depth on how insurance contracts affect their financial position. The new regulation will demand greater details in financial analysis and increased co-operation between actuarial and accounting departments.

The survey revealed that 61% of British insurers have already started making preparations for the introduction of IFRS 17, while 19% classed it as a "top strategic priority", despite it not coming into force until January 2021.

Although not all insurers have begun preparation for IFRS 17, 99% of them have stated that they are confident that they will have achieved compliance before the enforcement deadline. Of the insurers surveyed, 93% have said that IFRS 17 will completely change insurers' business models and 87% believe that the standard is crucial for the survival of the insurance industry or will, at least, increase its robustness against future stocks.

SAS head of risk business solutions for UK & Ireland Lee Thorpe said: "While the deadline may seem some time off, UK insurers must not wait excessively for a clearly defined interpretation of what IFRS 17 compliance means. Insurers should adopt an iterative approach to compliance."

While the deadline may seem some time off, UK insurers must not wait excessively for a clearly defined interpretation of what IFRS 17 compliance means

Lloyd's pushes underwriters to 'terminate' gun lobby ties

News comes after Chubb was recently fined $1.3m for involvement in NRA programme

Written by **Oliver Wade**

Lloyd's of London (Lloyd's) yesterday instructed its underwriters to terminate all insurance programmes that are affiliated with the National Rifle Association of America (NRA).

The firm said that it has given "careful consideration" as to whether syndicates at Lloyd's should continue to insure programmes "offered, marketed, endorsed or otherwise made available" through the NRA.

The news comes after insurer Chubb was recently fined $1.3m for its involvement in an NRA programme, after an investigation revealed that the NRA's 'Carry Guard' insurance programme had unlawfully provided liability insurance to gun owners.

Lloyd's has said that the move is now subject to an inquiry by the New York State Department of Financial Services (NYDFS).

PRA proposes amendments to SII internal model output reporting

Regulator's consultation paper relevant to all UK SII firms and the society of Lloyd's

Written by **Oliver Wade**

The PRA has proposed updates to the Supervisory Statement (SS) 12/15, 'Solvency II: regulatory reporting, internal model outputs', and SS26/15, 'Solvency II: ORSA and the ultimate time horizon – non-life firms' in its recent consultation paper.

The regulator has said that this consultation paper is relevant to all UK Solvency II firms and the society of Lloyd's in respect of each of their syndicates and in respect of outputs of the Lloyd's internal model.

The proposal includes amendments to the life, counterparty and non-life templates and the associated instructions (LOG files) in SS25/15 and SS26/15, with the changes set to take effect from 31 December 2018 for financial year-end 2018 reporting onwards.

The proposal comes as a result of the analysis of the year-end 2016 PRA internal model output request, feedback from individual firms and PRA's package of insurance reporting reforms.

In relation to the internal model outputs for life insurance firms, the PRA suggests that the regulator request the 'biting scenario' information in IM.01 for all risk variables, as it will provide insight into the interactions between calibrations of individual variables when determining the Solvency Capital Requirement (SCR). The PRA also would like the instructions for credit spread stresses to "clarify that it takes account" of the combined impact of spread widening, migrations and default, as this is an area in which the PRA has identified that life firms' interpretations of the instructions have "diverged".

The clarification should therefore increase the comparability of the life firms' stresses.

Furthermore, the regulator has proposed that the definition of best estimate for longevity risk be updated to include the impact of best estimate mortality improvement assumptions, to prevent insurers from interpreting the definition differently.

With regards to the internal model output for counterparties, the PRA has proposed to remove the request for counterparty risk information for non-life firms from IM.02 and retain it for life firms, because it does not consider that it is "proportionate" to require this information from non-life firms when considering their risk profiles against their reporting burden.

The regulatory authority additionally proposed changes to internal model outputs for non-life insurance firms, including removing the "skewness" for reserve risk, premium risk, catastrophe risk and market risk.

French life insurance market shows positive net inflows

Insurance companies collect €36.3bn of premiums compared to €34.1bn of premiums during the same period in 2017

Written by **Oliver Wade**

In France, net inflows for March 2018 were valued at €1.5bn among the French life insurance market, according to the French Insurance Federation (FFA).

From the beginning of 2018, insurance companies collected €36.3bn of premiums, compared to €34.1bn during the same period in 2017. Payments to unit-linked products also accounted for €10.8bn from the start of the year, the equivalent of 30% of premiums.

Over the same period insurance companies paid out benefits of €30.8bn.

Net inflows from the beginning of the year were €5.5bn, compared to £700m Q1 2017.

At the end of March 2018 in-force life insurance business, a combination of mathematical provisions and profit sharing provisions, stood at €1,681bn, representing a 2% growth year-on-year.

People on the move

ROB TOWNEND

Aviva UK GI managing director

Townend will report to Aviva UK Insurance CEO Andy Briggs and focus on driving continued excellence in general insurance, particularly in product design, pricing, claims and underwriting to provide customers with the insurance that best protects them, their families, their businesses and the things they value. He has worked for Aviva since 1996 and has held various senior sales, claims, operational and commercial roles.

ANNETTE SPENCER

IFoA director of public affairs and research

Spencer will report directly to the IFoA's chief executive Derek Cribb and brings experience gained from Zurich, RSA Insurance, the Universities Superannuation Scheme and the FCA. She was also director of communications at The Investment Association and is a fellow and chartered practitioner of the Chartered Institute of Public Relations (CIPR).

STEPHANE MICHEL

Hermes Investment Management senior portfolio manager

Reporting to Andrew Jackson, head of fixed income, Michel will be using his breadth of experience to assist in the build out of both the Asset Based Lending platform as well as the wider multi-asset credit (MAC) capabilities for Hermes. He will be responsible for identifying market opportunities, trends and strong risk-adjusted relative value across illiquid markets.

FLORIAN WIMBER

Insurance Ireland head of European affairs and international insurance

Wimber returns to Europe having spent 15 months advising the Ministry of Economy and Finance of the Kingdom of Cambodia on insurance and social protection policy. He began his career at the German Insurance Association, GDV, where he held various positions both in Brussels and Berlin including, most recently, as deputy head of the European Office.

CHARLES JEWKES

Aviva Investors head of global financial institutions

In this new role, Jewkes will lead Aviva Investors' third party strategic business development with global financial institutions outside the UK. He brings 12 years' experience of developing and managing asset management relationships with complex financial conglomerates in N.A, EMEA and Asia. He joins from Fulcrum Asset Management.

RICHARD HOAD

LV= director of new markets

Responsible for exploring new market areas and opportunities with the aim of generating long-term growth and creating value for members. He will also contribute to the evolution of the existing life and pensions business through developing new customer products and services. He has worked at LV= since 2011, and was previously group strategy and corporate development director.

Opinion

On Allianz investing €75m and $25m in African infrastructure projects

"We are delighted to put our infrastructure debt expertise to work to help facilitate Allianz's investment strategy in Africa. Over the last five years, our global infrastructure debt platform has invested over €10bn into infrastructure projects across the globe. As Africa unlocks its economic potential, the continent will become increasingly important for institutional investors."

Nadia Nikolova
AllianzGI director

On Athora Holding Ltd to acquire Generali Belgium S.A.

"Since our successful capital raise in April 2017, we have been rapidly expanding our presence in Europe. In addition to launching our business with the acquisitions of Delta Lloyd Lebensversicherung in 2015 and Aegon Ireland earlier this month, this transaction is another major step toward our goal of becoming the premier European insurance consolidator and life reinsurance partner. Belgium is a target market for Athora, where we plan to deploy substantial capital over the next few years, and Generali Belgium is a perfect fit for our strategy and growth plans in the country."

Michele Bareggi
Athora Group managing partner

On new FCA rules affecting fund managers

Gina Miller
Business owner

"It is shocking how long it has taken the FCA to achieve nothing more than restating the obvious. They have dealt with important but relatively minor negative industry malpractices, such as box profits, but not the substantive issue of misleading fees through the various distribution channels."

On Paris calling for world's largest insurers to end support for coal industry

Lucie Pinson
Unfriend Coal campaigner

"Paris symbolises the world's commitment to prevent dangerous climate change and insurers should be in the front line of the battle. Those who pay lip service to climate targets but continue to support coal are betraying their customers, their investors and the millions whose lives have already been devastated by global warming. The city council is showing them what support for the Paris Agreement means."

On long-term equity assets and infrastructure investment

Christian Thimann
High-Level Group on Sustainable Finance chair

"Capital flows need to be re-oriented so insurance companies can lead greater investment in long-term equity assets and infrastructure, but regulation must facilitate this. Asset managers are uniquely placed to help capital flow towards more sustainable investments. Embedding sustainability into stewardship codes and asset management agreements, requiring fund managers to disclose how they integrate environmental, social and governance factors into their strategies and how they vote on ESG issues, are all part of the measures that could be pursued."

Soapbox

The beauty of imperfection

Written by Adam Cadle

Having worked on our sister title *Pensions Age* for six years, the term 'Solvency II' was one all too familiar to me when I embarked on the journey of being *Insurance Asset Management* editor, a year and a half ago. Indeed the regulation was written for insurers in the first place, with the aim of acting as a comprehensive programme of regulatory requirements for insurers, covering authorisation, corporate governance, supervisory reporting, public disclosure and risk assessment and management, as well as solvency and reserving. Is it perfect? Far from it in my opinion but it does justify itself in some ways.

Ultimately it is attempting to ensure a more healthy playing field in the insurance space but I think people need to understand the model better when devising new proposals etc. On the investment side, there needs to be a greater degree of fluidity and let's be honest Solvency II proposals around infrastructure investing initially fell short. The EC had to publish new delegated regulation amending the Solvency II Delegated Acts, with the new regulation introducing significantly lower capital charges under the standard formula for qualifying infrastructure debt and equity investments to facilitate investment by insurers in European public infrastructure projects. In my opinion, the current system lacks transparency around the issue of asset class interaction and there seems to be too much a high degree of approximation around asset class which could ultimately lead to below par asset allocation decisions.

However as with anything, I am a firm believer that the imperfections can ultimately lead to a degree of perfection. People and regulatory bodies learn from mistakes to some extent and I do fully support some peoples' notion that Solvency II is a good thing as it has got us thinking a lot more about risk in the UK and European insurance environment. More and more insurance companies are now looking to diversify their portfolios to deal with economic volatility and areas like currency volatility.

I think Solvency II regulation is here to expand and two years on from implementation in the insurance environment, it certainly has done, but not always in the right way. In terms of the impact of Brexit on Solvency II regulation, I think there is a higher degree of fear within the industry perhaps than there should be. There cannot be a huge divergence in regulations conducted by the PRA as the UK already 'goldplates' insurance regulation as it is, and if this is done, then this will put the UK on a completely different insurance sphere which would affect potential business in the future. It will be more the EU continuing to evolve Solvency II which will result in the EU moving away from the UK and not the other way around.

> I am a firm believer that the imperfections can ultimately lead to a degree of perfection. The review at the end of this year will no doubt help guide us to reach a smoother insurance environment under SII

Whatever your opinions on the Solvency II regime are, I would say that surely most people would agree that there have indeed been imperfections along the way and it is how the industry goes about eradicating these and goes about making adequate adjustments to ensure a smooth regulatory regime. The EC, EIOPA, the PRA and the industry itself are all accountable here and must work together to make it a genuine success. The review at the end of this year will no doubt help guide us to reach a smoother insurance environment under Solvency II.

Painting the landscape

Oliver Wade talks to ABI director general Hugh Savill about the current major themes in the insurance industry

WRITTEN BY **OLIVER WADE**

Q Do you think that the current capital requirement is excessive under SII?

That is easy. Yes. The PRA jacked up capital levels in anticipation of Solvency II, and has left them there. The excessive levels of the risk margin stick out like a sore thumb, though to be fair the PRA has sworn to address this soon. However, the calibration of Solvency II is stuffed with less obvious but significant padded buffers – the overall assumption that insurers are traders of their assets, high capital requirements against equity investments, and over-cautious calculation of spreads. Not to mention the PRA's own secret quantitative indicators on credit risk and longevity risk.

However, I have to say that I don't know what the "right" level of capital is. Emboldened by the financial crisis, regulators have clearly pushed us way beyond the 1 in 200 confidence level enshrined in Solvency II. This makes it too easy for me to say that capital levels are too high, and entrenches a rather predictable debate between industry and regulators. We need to have the fundamental debate about the role of regulatory capital in insurance (as opposed to banking) that regulators ducked during the crisis because they were sure that the answer was higher.

Q Do you think that insurance companies have prepared sufficiently for Brexit?

No, but they have been more realistic in their approach to Brexit, and so have done better than most. Most insurers who wish to retain access to the EU markets are well advanced with their relocation plans. Many have made good progress with the Part VII transfers needed to keep in touch with customers once passporting goes. The ABI has had a fruitful exchange of letters with the FCA about customer communications for British policyholders whose contracts could change at Brexit. Agreement to a transitional period is important because it buys us all a little time to tie up loose ends. It is not an excuse for those toiling in the Brexit production lines to down tools – especially because the transitional is not yet sealed.

There are some issues where we need the authorities to step in because corporate preparations will not do the trick. One obvious example is the issue of contract continuity – contracts stranded by the loss of passporting, leaving the insurer unable to pay claims because it is no longer authorised to carry out insurance business in the country of the policyholder. We need EU authorities to reciprocate in kind to the pragmatic approach of the British authorities.

British authorities need to ensure that the UK remains after Brexit an attractive location for internationally mobile insurance business

Q What is your opinion on the long-term effects of Brexit on insurers?

There is everything to play for. Most commentaries assume that the Brexit effect will begin and end on the day of Brexit, when the sky will be black with planes carrying underwriters across the Channel. The reality is that this will be a process that unfolds over a long time. For years, groups will be taking strategic decisions about the allocation of capital between British and EU subsidiaries, particularly in the London Market. The British authorities therefore need to ensure that the UK remains after Brexit an attractive location for internationally mobile insurance business. The government has not so far given sufficient thought to this.

Q Do you think IFRS 17 will have a big impact on the insurance market? If so, why?

IFRS 17 will significantly change the basis on how insurers report their financial results from 2021.

It is complex, and will be costly and onerous to implement, as the industry's experience with Solvency II has shown. Surprisingly, given its decades of gestation, it has been subject only to limited operational testing, and its ability to support adequate communication with the market has not yet been evaluated fully. Work on this is now being carried out by UK and other European insurers, as part of the EU cost/benefit evaluation process which precedes IFRS adoption in Europe.

The EU evaluation process currently also includes looking at the potential economic effects of IFRS 17, on insurance products and on the insurance market, and includes the key test of whether insurers' cost of capital will change.

The financial reporting and economic effects will vary considerably by jurisdiction, depending on the extent and nature of the change compared with the current position. In the UK, with a strong history of current value financial reporting applied consistently by insurance product, the challenge for the benefits to outweigh the cost is particularly strong. On IFRS 17's publication, we said that the jury is out. That remains the case.

Q Going forward, what do you think the trend of mergers and acquisitions will be?

If I knew this, I would not be working for the ABI. This said, I would be surprised if the flow of M&A dried up any time soon.

As it stands, the Solvency II Directive does not correctly measure the risks related to long-term investments, including sustainable ones. Improvements to the Directive will only increase the percentage of ESG investments within insurers' investment portfolios

Q Are ESG investments beginning to account for a larger percentage of insurance companies' investment portfolios?

Over the last few years, ESG investments have accounted for a larger proportion of insurers' investment portfolios. ABI members are investing in socially responsible projects such as social housing, rail networks and renewables.

However, while insurers are keen to invest in socially responsible projects, there has been a limited increase in the pipeline of infrastructure projects. Supply historically low, and this contrasts with investors' higher appetite. There is a lack of diverse origination opportunities, and high fees on investment funds can create a barrier for smaller investors.

There are also regulatory barriers to ESG investments. As it stands, the Solvency II Directive does not correctly measure the risks related to long-term investments, including sustainable ones. Improvements to the Directive will only increase the percentage of ESG investments within insurers' investment portfolios.

Asian Credit

Adam Cadle talks to HSBC Global Asset Management global head of insurance segment Andries Hoekema and head of insurance business EMEA Deepak Seeburrun about investing in Asian credit for European insurers

WRITTEN BY **ADAM CADLE**

Q We want to talk about investing in Asian Credit for European insurers. There is a lot of talk about Asia's growth prospects and we will investigate whether and how it makes sense for European insurers to be exposed to this growth story. Can you tell us a bit more about the background to the Asian growth story?

DS: Asian countries have been showing some of the strongest economic growth in the world over the past years and consensus is that this high level of growth will continue for many years to come. A lot of it is driven by China and India, but there are many more countries in Asia with very good rates of growth. At the same time, we are seeing that many insurance investors are not really positioned to benefit from this growth.

Q Why do you think this is the case?

DS: I believe it is a combination of a few factors. Firstly, many insurance investors are very focused on fixed income and the use a limited set of benchmarks, such as the Barclays Global Aggregate for example. It is striking that Asia (ex Japan) represents over 35 per cent of global GDP but makes up only 3 per cent of the Global Aggregate index. And even in emerging markets benchmark indices such as the widely used CEMBI Broad Diversified we see that Asia is underrepresented: Asia makes up over 60 per cent of EM GDP but only 35 per cent of the index.

AH: There are some technical reasons for this difference, which have to do with how these benchmarks are constructed. For example, the Barclays Agg is a market cap weighted index, which means that countries and other issuers that issue more debt get a higher weight in the index. In addition, for some countries like China there have historically been issues around accessibility that have precluded significant inclusion of bonds from those countries in the benchmarks. The accessibility issues are getting smaller with developments such as Bond Connect that allow increased flows of bonds between mainland China and Hong Kong. Some index providers have also started to offer parallel indices that include onshore Chinese bonds alongside the main existing indices that do not.

The bonds traded on Bond Connect are RMB bonds, and we are today discussing Asian Credit in USD. Nevertheless, the development of these access links is an indication of the extent to which historically the various standard fixed income benchmarks have been disconnected from a large part of the global economy.

Q Apart from the underrepresentation and the exposure to high-growth economies, what other reasons are there for investors to look at Asian Credit?

DS: There are a number of reasons. Firstly, the credit quality of Asian countries is generally quite good, with many strong investment grade country ratings around the region. This compares favourably to the ratings of many other EM countries, and this is very important for insurers under Solvency II.

The credit quality of Asian countries is generally quite good, with many strong investment grade country ratings around the region. This compares favourable to the ratings of many other EM countries

Secondly, there is a large universe of Asian corporates that issue USD bonds that are freely available to global investors. The average rating of these bonds is BBB+, so similar to US and Euro credit. These Asian issuers offer a new source of diversification for bond investors. On top of this, they currently provide a yield pickup compared to Europe and US and they have a shorter duration.

TO WATCH THIS INTERVIEW IN FULL, please visit insuranceassetmanagement.net

Q Looking at European insurance investors specifically, why should they be looking at this asset class now?

AH: Asia USD Credit offers all the benefits that Deepak mentioned around diversification, yield pickup at a shorter duration than comparable US and European benchmarks, and exposure to fast-growing economies. For European insurers, the treatment under Solvency II is very important as well. Given that we are discussing USD Credit specifically, hedging back to base currency is relatively straightforward and the main drivers of SCR capital will be spread and duration. On a hedged basis, the SCR will be in the low teens. On top of that, the hedged expected returns as calculated by our multi-asset Strategy team for IG Asian Credit are in line with what they calculate for USD HY at the moment, and more than 1 per cent higher than the expected returns for EUR and GBP IG Credit.

Interestingly, it is currently also possible to lock in significantly higher effective yields by moving into Asian USD Credit and hedging to EUR or GBP. The exact pickup will depend on the terms of any mandate, but even in the shorter end of the curve it could be above 0.5 per cent and as much as 1 per cent.

So for insurance companies looking at improving expected returns, Asia USD Credit offers an opportunity to do this whilst adding diversification and shortening duration, which can also be attractive for insurance investors worried about rising rates.

In association with

HSBC Global Asset Management

Unshackling the chains

Solvency II has tied elements of the insurance sector to excessive governance and restrictively conservative investment strategies. Its upcoming reviews could provide some much needed freedom of movement

WRITTEN BY **MAREK HANDZEL, A FREELANCE JOURNALIST**

IT'S taken years to prepare for, cost billions to implement, and used up enough paper to cover the Amazon rainforest ten times over. So has Solvency II been a success?

"It's far too early to say," Aon head of delegated solutions for European insurers Gerard-Jan van Berckel says.

"To the degree that companies are better aware of the risks that they have, and better able to determine whether they are being compensated for those risks, then it has been beneficial. But the costs that companies have incurred to comply with the regulations has been significant, and whether the additional layers of reporting and complexity of risk analysis result in fewer defaults in the industry remains to be seen."

It may be premature to assess the EU directive's overall impact, but there have been some clear consequences for the insurance industry since it came into force at the start of 2016. One of these, says van Berckel, is the effect it has had on the investment capabilities of smaller players in the market. Insurers with fewer capital management resources have been stretched when it comes to reporting and risk analysis, putting them at a competitive disadvantage when it comes to allocating capital.

Insurance Europe head of prudential regulation and international affairs Cristina Mihai argues that Solvency II's treatment of risk measurement has also had a negative impact that resonates beyond the insurance sector.

"It treats insurers like short-term investors, such as traders, when they are in fact mainly long-term investors," she says. "As a result, Solvency II unnecessarily increases the cost of making long-term investments. This reduces insurers' ability to make such investments, which are crucial for providing good returns to policyholders, and which underpin economic growth and stability in Europe."

Although the regulatory regime has set high standards of solvency, risk management and reporting, improvements are needed in Mihai's view. Otherwise, insurers will pass on unnecessary costs to policyholders, and struggle to develop the best possible long-term products.

Mercifully, the two upcoming reviews of the directive that were scheduled into pipeline by the European Commission, provide a chance to resolve some of these issues. The first of these, due by the end of 2018, will focus on simplifications and fixing technical issues with capital calculations in the Level 2 delegated regulation. The second review, due by the end of 2020, will, it is hoped, address broader issues through the Level 1 legislation, including concerns that Solvency II places unnecessary constraints on long-term guarantees and investments.

Governance for the sake of governance

The burden of paperwork that has adversely affected mid and lower-sized insurers is something that Chartered Insurance Institute director of policy

Matthew Connell wishes to see tackled in the upcoming reviews.

As he explains, it was left to member states and companies to work out what Solvency II's thousand pages of legislation and guidance added up to for them individually, which led to a ramping up of red tape.

"It was a new piece of legislation and there was a tendency to be on the safe side and have more bureaucracy rather than less, because no one ever went to prison for introducing more bureaucracy," says Connell.

"That might not be a bad thing in something like the selection procedure for senior managers, but there are some areas where governance is being done for the sake of it being done."

To be fair to Solvency II's authors, the amount of bureaucracy imposed on insurers has come, to a certain extent, from local regulatory bodies. In the UK, the Bank of England's Prudential Regulation Authority (PRA), for example, has been very keen to err on the side of caution.

Association of British Insurers' (ABI) assistant director and head of prudential regulation Steven Findlay says that a number of aspects of the regime that the ABI wants to revisit do not necessarily pertain to the Commission's reviews, but rather the PRA's own implementation of Solvency II.

"There are a range of areas where we think they went further than necessary and certainly further than some of their peers on the continent went," he says. One of those was the PRA's insistence on not allowing insurers to design their volatility models dynamically until very recently.

"A big concern for us is this not delivering a level playing field across the whole EU," says Findlay.

The infrastructure question
Another positive outcome of the 2020 review could be to create room to encourage insurers to increase their allocations to infrastructure.

At present, as Findlay says, concerns about the matching adjustment remain in place for many. Its very strict criteria as to which assets can produce the necessary cash flows at the right times and in the right amounts leads insurers and reinsurers towards stable fixed income type investments such as government and corporate bonds.

"It is more challenging to get approval to invest in other types of assets such as infrastructure," he says. "And you often have to go through a convoluted process of securitisation where you're not actually changing any of the underlying economics of the asset but you're instead adding a lot

more complexity and operational risk to transform them into ones that are eligible for the matching adjustment."

"That could be improved at the EU level."

One way of doing this, suggests Franck Viort, head of non-bank financial institutions, EMEA, at Japanese bank MUFG, is to give managers and investment teams the flexibility to be able to make the right adjustments and make infrastructure work within the confines of the regime.

"We have the rules OK, but thankfully we also have risk managers who should be able to make decisions as they did before Solvency II," he says. "Regulation in selected areas that gives a bit more room for judgement is not necessarily a bad thing as you would hopefully have competent people making those judgements with the help of committees."

Expanding the universe of assets

As well as making it easier to support infrastructure projects, Viort says that the Commission must look at expanding the universe of assets that are eligible for matching adjustments.

This will improve the value of the assets as at present there is too much demand for a limited number of asset classes that drags down returns.

"Insurance companies are not always compensated for the risks they take," he argues. "So increasing the pool of assets can rebalance the spread and the yield to the underlying risk of the assets."

In van Berckel's eyes, a loosening of the rules should include securitised assets. He maintains that well structured securitised assets, with sound underlying collateral and cash flows are currently being unduly penalised.

"In particular, certain senior CLO structures and other asset backed securities have capital charges that are somewhat excessive," he says.

According to Mihai, part of the initial reluctance to provide a wider investment spectrum within Solvency II was down to how the regime was drawn up around theoretical risks based on market volatility, rather than investigating how to measure the real risks that insurance companies are exposed to.

"Capital requirements in Solvency II are measured on the assumption that insurers trade these assets and are exposed to the full market volatility," she says. "This assumption leads to very high and conservative capital requirements. In reality, when insurers buy, for example, long-term bonds with a long-term perspective, it's default risk that should be measured and not spread/market risk. Similarly, for equity, the current capital requirements assume insurers buy to trade, which is not always the case."

> There are some areas where governance is being done for the sake of it being done

Altering this measurement, and allowing for further equity investment, would be beneficial on two fronts, says Viort.

Firstly, equity still provides the highest return in the long-term and so should fit well with the business of insurance, whether it's listed or not. Secondly, rebalancing the European economy towards equity, even if it's private, it something that would be beneficial for its long-term health.

"We've seen the bond market grow like it's never done before, but if we go into a phase where rates are going up and monetary policy is altering then the idea that companies would shift their allocations towards equity can give them an upside and help manage the fixed income market. From a macro perspective, there's some logic there."

The question is, will the Commission follow the same line of reasoning?

CONTROLLING CAPITAL RISK UNDER SOLVENCY II

Solvency II forced European insurance firms to radically rethink the way they approach fixed income portfolio investments. The capital charge assigned to each bond is now a crucial part of every evaluation of risk versus return, making scanning the market for the best opportunities within strict maturity and rating limits even more important than before.

WRITTEN BY **TWENTYFOUR ASSET MANAGEMENT PARTNER AND PORTFOLIO MANAGER CHRIS BOWIE**

UNDER the terms of the "Solvency Capital Requirement" – effective from January 1, 2016 – holders of corporate bonds who also happen to be European insurers care a great deal about the maturities and the credit ratings of the bonds they own. There are of course other factors in the investment decision, but regulators' key focus here is volatility – the longer dated and lower rated a bond is, the higher its expected volatility, and thus the more capital an insurer should hold to protect against losses from the position.

Unfortunately, the capital cost of longer dated investment grade bonds, the staples of many pension and insurance funds, are now prohibitively expensive. And with a background of multi-year lows in long dated yields and inflation, we think it is time to pay attention to long dated exposure because the duration effect makes these risks loom large in capital terms.

Mexico 5.625% 2114 bonds have a 29.1% capital charge – fair enough you might think for 96-year risk. But British American Tobacco's 2.25% 2052s, Vodafone's 3% 2056s and Gatwick Airport's 2.625% 2046s – which are all rated BBB – all carry charges higher than that, at 31%, 30.5% and 29.2%, respectively. Even Wellcome Trust's 2.517% 2118, which are AAA rated, incurs a capital charge of over 20%. The list goes on. For every £100 invested, insurers need to provision an extra £20 or £30.

For high yield bonds, the base charges also become extremely punitive as maturities get longer, topping out at a base fee of 63.5%. So for every £100 invested in a long dated CCC bond, with a duration of over 25 years, an insurance company would have to set aside £63.50. Clearly this is uneconomical and is designed to be so.

By contrast, short dated investment grade and high yield bonds look relatively attractive. We know this because TwentyFour's proprietary Observatory system enables us to track the capital charge on any bond we care to look at. Developed in-house and specifically designed to seek out the best investment opportunities in fixed income, the system stores more than 26,000 bonds every day across global investment grade, sovereigns and high yield. With daily data going back to 2003, Observatory calculates the historic volatility of every bond and CDS instrument. The system shows us cost of capital on a line by line and sector by sector basis, flagging

opportunities to improve the capital efficiency of the portfolio.

We have two potential solutions for managing bond investments efficiently under Solvency II, both combining TwentyFour's unique Observatory system with the specialist fixed income knowledge of the firm's investment professionals.

The first is the Absolute Return Credit Fund, which has a highly efficient cost of capital that can be reported with full transparency on a daily basis if required. The current total capital charge of the fund is just 6.3% (as of May 4, 2018).

This capital efficiency is achieved with a primary objective of keeping annual volatility at less than 3%, and a return target of LIBOR plus 250bps as a secondary objective.

> TwentyFour's proprietary Observatory system enables us to track the capital charge on any bond we care to look at

The fund looks to eliminate unrewarded risks in order to lower volatility, keeping interest rate duration, credit duration and market beta low whilst embracing rewarded risks to generate returns. A minimum of two-thirds of the portfolio is invested in short dated investment grade bonds, a strategy which has proven itself through every market cycle, producing predictable, low volatility beta. The portfolio managers also asset allocate and identify the best risk-adjusted stocks to provide modest capital gains.

The second is a segregated mandate, creating a bespoke portfolio of stocks managed to target a specific or maximum total capital charge. This could be managed to agreed investment restrictions to give an insurance company some control over the shape of the portfolio, whilst tapping into TwentyFour's stock selection and asset allocation skills where appropriate.

The BREXIT countdown

A 21-month transition deal buys time, but much work remains to be done to ensure cross-border contracts for insurers are preserved. Graham Buck asks how much of a threat Brexit poses to the insurance industry and its potential effects on contract continuity

WRITTEN BY **GRAHAM BUCK, A FREELANCE JOURNALIST**

CHANCELLOR Philip Hammond professed himself to be "tiggerish" last month, as he attended the International Monetary Fund's spring meeting in Washington. The 21-month transition deal agreed in March between the UK and the European Union would, he said, avoid a potential "haemorrhaging of jobs" from the City to continental Europe post-Brexit. The resulting losses would be far more modest than the 75,000 financial services jobs and 340 billion income predicted in a report by consultancy Oliver Wyman.

"Do we expect the future financial services relationship will mean nothing changes?" asked the Chancellor. "No we don't. But we are confident that we will be able to negotiate an agreement that will allow sufficient access for the systematically important parts of the London financial services market to go on servicing European financial customers."

The more optimistic tone contracts with the early months of 2017, which saw insurers lining up to announce plans to transfer business and jobs from the capital to new offices in European locations, ranging from Dublin (Beazley)

and Madrid (Admiral) to Paris (Chubb) and Luxembourg (AIG, Hiscox).

More tellingly – as it was the source of the Solvency II regime that imposed heavy costs on the industry – Brussels was the choice of the venerable 330-year old market Lloyd's of London for its new European subsidiary. Lloyd's CEO, Inga Beale, says the transitional deal "will avoid a looming cliff edge for businesses at the end of March 2019" but is pushing ahead with the new company, which will start writing business for risks in all 27 EU and three European Economic Area (EEA) states from January 1 2019.

For the London-based International Underwriting Association, the confirmation of a transition period is a "welcome development" to ensure trading continuity until December 2020, says the IUA's director of communications, Scott Farley.

"Contract continuity is a key Brexit concern for insurers," says Farley. "To ensure that there is no danger of the London Insurance Market being unable to fulfil its existing commitments to EU clients, it must be agreed under the terms of the Withdrawal Agreement that any business contracts entered into pre-Brexit will remain valid. This will provide certainty to clients and businesses that contracts will continue to be serviced and that any claims will be honoured, whatever the outcome of the trade negotiations between the UK and EU.

"If no agreement is reached on this issue there may be profound implications for insurers and their EU clients. The process of insurance undertakings adjusting from one trading environment to the other will be hugely disruptive for EU consumers and businesses. It will be a lengthy and complicated process which will involve higher costs and create uncertainty as to the fulfilment of policies in the event of a claim."

Farley's welcome for the transition is further tempered by the observation that it will need to be accompanied by a reciprocal agreement on contract continuity. "Without this, firms based in the UK and the EU27 will continue to restructure and implement contingency plans to ensure that contracts signed prior to Britain leaving the EU will continue to be serviced and honoured post-Brexit," he says.

Ultimately, the draft transition agreement is time-limited. When it ends on 31 December 2020, issues around cross-border contracts could still arise and would need to be addressed by any agreement over the future relationship between the UK and EU.

A trio of challenges

News of moves to preserve cross-border contracts and the setting up of new subsidiaries in EU countries has centred largely on property/casualty (P&C) insurers, as a significant proportion of their current EU business is written in the UK and is consequently at risk from any change in passporting (i.e. the right of an EEA-registered firm to do business in any other EEA state without needing further authorisation in each country) or other rights.

Life insurers, by contrast, tend to have significant bases of operation in the countries where they write business, so there are fewer cross-border issues to deal with. However, this isn't to say that they are not also taking some action, MMC Mercer Investment principal – insurance group Andrew Epsom says. He cites as examples Aviva and Royal London, which are both converting their Irish branches into regulated subsidiaries, while Legal & General is transferring some of its investment management operations to Ireland.

Epsom sees Brexit as presenting three principal challenges for UK insurers including uncertainty around the future regulatory environment– i.e. how much of Solvency II will remain in force? The UK insurance industry largely expects the post-Brexit regulatory regime to look very similar to Solvency II (which is the standard to which most regulatory regimes globally are moving towards). However, there could be some changes in certain areas, including reporting requirements and more detailed aspects of the calculation of the capital that insurance companies need to hold. Secondly, the impact on investment markets of Brexit; in particular the investments insurers focus on and the interaction between these assets and their liabilities, and thirdly, the ability of UK insurers to continue to write business outside of the United Kingdom.

"Until the ongoing relationship between the UK and the EU is finalised, it's difficult for insurers to have full clarity on the work involved in preserving cross-border contracts – either insurance or investment ones – or even whether such preservation will be possible," says Epsom.

"However, insurers have been taking what actions they can to deal with the expected loss of future passporting rights, with many non-life insurers setting up new EU-based subsidiaries. Interestingly, there hasn't been a single focal point for these new bases."

Epsom believes that looking to non-EU member countries such as Norway and Switzerland can provide only limited insights for mitigating risks around areas such as cross-border contracts. Both countries are in the European Free Trade Area (EFTA), with Norway also a member of the European Economic Area (EEA, commonly referred to as the Single Market). Switzerland has a large number of bilateral agreements which, to all intents and purposes, broadly replicates the obligations – including freedom of movement – and benefits of the EEA.

However, the UK government has consistently ruled out membership of EFTA and the EEA, whilst the EU has squashed the option of a Switzerland-style approach.

The changed landscape

Since the June 2016 referendum the economic landscape has already changed, with a significant weakening of sterling, volatility in the UK equity market and a drop in UK government bond yields just after the Brexit result.

Epsom notes that while the majority of UK insurers undertook some form of scenario planning in advance of the vote, these market events still caused a significant weakening of Solvency balance sheets, particularly for those in the life sector.

"While sterling has partially recovered and gilt yields have risen, there is the potential for further ongoing volatility in insurers' balance sheets, particularly under some of the more adverse Brexit outcomes," he notes. "Insurers have, in general, been planning carefully around how best their financial exposures can be managed under different scenarios, but it is virtually impossible to hedge fully against this risk."

And despite the Chancellor's upbeat outlook, the risk that a 'hard Brexit' becomes reality cannot be ruled out. The Confederation of British Industry's (CBI's) recently-published Smooth Operations report – to which both the IUA and the Association of British Insurers (ABI) contributed – stressed that continued mutual recognition of UK and EU professional bodies, standards and professional qualifications "will be critical in enabling UK-qualified professionals to provide services to EU corporates across borders".

But is the EU in the mood to play ball? Chief Brexit negotiator, Michel Barnier, so far shows little appetite for concessions. Late last month he ruled out the possibility of any 'mutual recognition' deal – as proposed by the by the UK government, the CBI and various City groups – which would enable the UK to continue selling financial services into the EU's Single Market without following European regulations.

"The EU cannot accept mutual market access without the common safeguards that underpin it" stated Barnier, stressing that an equivalence system "will operate in a more effective manner if the UK decides not to diverge from our financial regulation".

Implementing ESG

WRITTEN BY **DWS HEAD OF ESG THEMATIC RESEARCH MICHAEL LEWIS**

DWS head of ESG thematic research Michael Lewis explores the investment solutions from a listed equity perspective around physical climate risk in insurers' investment portfolios, with the potential of these solutions spreading into other asset classes

THUS far, investors' approach to boosting climate resilience has typically involved measuring the carbon emissions of issuers in their investment portfolios. This carbon foot-printing exercise helps assess the transition risk, (i.e. the transition risk to a low carbon economy) to a portfolio as global efforts to limit temperature rise below two degrees Celsius gather momentum. Indeed, since the decline in global coal equity valuations from their 2011 highs, investors are acutely aware of abrupt changes in asset pricing and that this may become a more frequent occurrence in the event of tightening carbon regulations.

However, this foot-printing strategy fails to take into account the physical risks of climate change, such as sea level rise, droughts, flooding and cyclones and the effects these events have on companies' facilities, their operations and supply chains. Inevitably, different industries and sectors will experience different impacts. For example, extreme heat can hamper energy and industrial production, and lower productivity of employees across the economy. Meanwhile sea level rise could bring more flood damage and disruption to low-lying energy infrastructure and manufacturing, such as in the U.S. Gulf Coast or China's Pearl River Delta.

Even more worrying are the findings from a 2017 study[1] which stated that we probably only have a 5 per cent chance of limiting the rise in global temperatures to no more than two degrees Celsius by 2100. As a result, investors need to be cognizant of the ongoing risks that companies face around the world from the increasing frequency and intensity of extreme weather events not least since physical climate risks pose a far more immediate threat to investment portfolios than the transition to a low carbon economy.

Addressing this risk, however, is far from easy. To do so, investors first need to identify the physical locations of the companies they invest in, a task made tricky by the generally poor corporate disclosure around these topics. Investors then need to master the increasingly complex science around climate change to understand the vulnerability of corporate production and retail sites as well as their associated supply chains. And finally, investors would need to account for the nature of the business activity being carried out in these locations to gauge the sensitivity to specific climate hazards. For example, a water-intensive facility in a drought-prone region will be more vulnerable that a similar facility in the same region that does not rely as heavily on fresh water.

Data analytics from Four Twenty Seven, a California-based market-intelligence company that specialises in the economic risk of climate change maps the physical locations of corporate facilities around the world alongside climate models. Four Twenty Seven's scoring methodology identifies both the geographic exposure to climate hazards of individual companies, as well as the business sensitivity of facilities or companies to those hazards. This powerful data-set has identified over one million corporate sites and the risks to each site from heat stress, extreme rainfall, water stress and sea level rise.

While Asia is probably the most exposed region of the world, since five out of six people in the region live in areas vulnerable to extreme weather events, the past year has revealed how developed markets are equally susceptible. Recent data released by the National Oceanic and Atmospheric Administration reveal that there were 16 weather and climate-related natural disasters in the U.S. last year, with a cumulative loss of $306.2 billion. This marks a new all-time high, surpassing the previous peak of $214.8 billion hit in 2005 and largely

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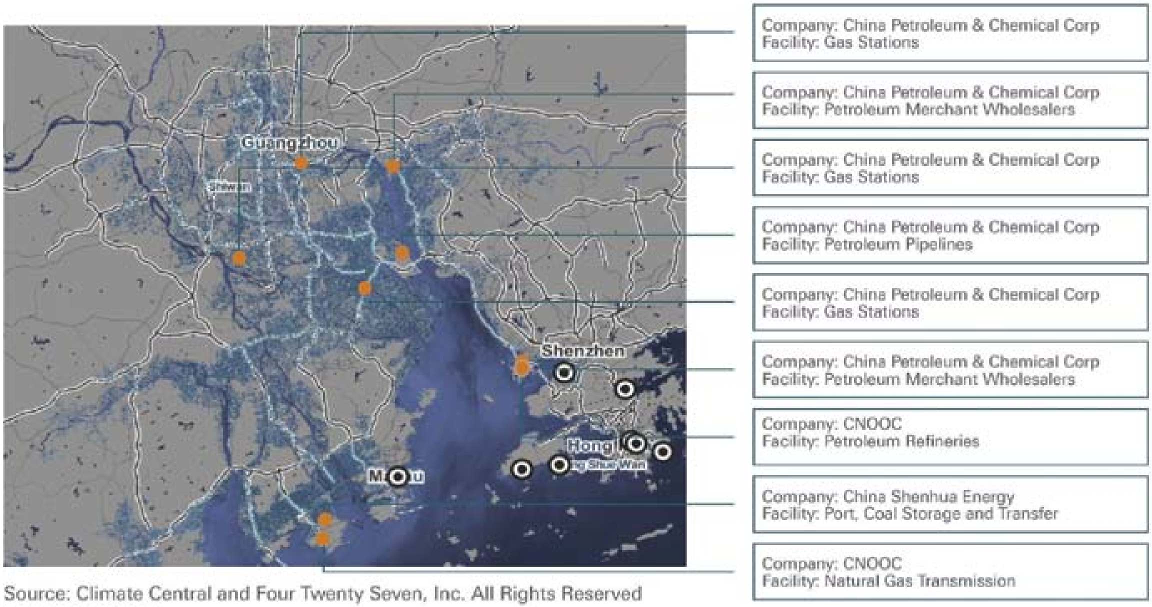


Source: Climate Central and Four Twenty Seven, Inc. All Rights Reserved (November 2017).

in response to the impacts of hurricane Dennis, Katrina, Rita and Wilma. This brings the number of weather and climate-related disasters since 1980 to 219 in the U.S., with cumulative losses in excess of $1.5 trillion and tropical cyclones alone representing 55% of the combined losses[2].

Of extreme concern in Asia is the region's vulnerability to flooding and sea level rise. For example, floods in Thailand in 2011 revealed the exposure many South Korean electronics' companies faced from their Thai supply chains. For future risks, China leads the world in terms of coastal risk with 145 million people and economic assets living on land ultimately threatened by rising seas as seen in (Figure 1). Not surprisingly, given the environmental impact of rapid industrialization in the country, but, also the likely liberalization of Chinese capital markets over the years ahead, the Chinese authorities are relentlessly focusing on measures to address the poor levels of air quality, contamination of surface groundwater and significant land degradation. Strong political will and incentives have therefore allowed China to maintain and extend its position as the world's largest renewable energy investor. In 2017, Chinese clean energy investment hit $132.6 billion, more than double the investment of the U.S. its nearest rival, and representing 40 per cent of global clean energy investment[3].

The major opportunities of this transformation are taking place across the clean energy sectors such as solar, wind, biofuels, compressed natural gas technologies, power storage and electric vehicles. In addition, efforts to improve energy efficiency and reduce energy and carbon intensity are delivering investment opportunities for the lighting, power distribution and building materials sector, as well as real estate assets. Meanwhile environmental resource management will affect the water, waste management, soil reclamation and clean agricultural sectors.

These investment opportunities are not just confined to parts of Asia. In the U.S., a significant transformation is also underway in the power generating sector and specifically in the distributed utility-scale solar and wind sectors. These investment opportunities are occurring at a time when an increasing number of global asset owners are establishing low carbon investment targets. This includes not just divesting out of certain fossil fuels holdings, but, also substantially increasing investments in clean technology, green infrastructure and green bonds. To that end, incorporating physical climate risk to build more climate-resilient portfolios can be the next frontier of the ESG investment landscape.

Reshaping the industry

David Adams looks at mergers and acquisitions in the UK/European insurance world, and why and how they are conducted

WRITTEN BY **DAVID ADAMS, A FREELANCE JOURNALIST**

Some insurers may give the impression of being huge, unchanging institutions, but this industry has always been characterised by mergers and acquisitions (M&A). In recent years this activity has slowed: there were insurance M&A deals worth $13.44 billion in Europe, the Middle East and Africa (of which Europe accounted for the lion's share) in 2017, compared to $14.26 billion in 2016, $16.5 billion in 2015 and £26.24 billion in 2014 (figures compiled by EY based on data from ThomsonONE.com and Mergermarket). Various reasons for this lull have been suggested: a recent report on the insurance sector by law firm DLA Piper cites the impact of political events such as the election of Donald Trump as US president and uncertainty in Europe related to Brexit.

Technology, regulation and Solvency II

But it will be interesting to see if this trend reverses in 2018, because multiple factors seem to be pushing more insurance companies to consider mergers or acquisitions. At a fundamental level, the 'transformation' of the insurance industry to which analysts often refer is driven in part by new technology and in part by the need for insurers to rationalise legacy liabilities and policy portfolios. These drivers are forcing insurers to alter business models, consider selling legacy elements no longer at the core of their business models. They may also be considering moving into other markets either through acquiring other companies or books of business, or by forming partnerships with other players, including non-insurers. One consequence of this is that the already blurred line between life/pensions activity and asset management is becoming even less distinct – as seen in the case of the merger between Standard Life and Aberdeen Asset Management.

DLA Piper's analysis suggests these trends will continue and accelerate, resulting in more "disposals, redistribution of assets and operations throughout Europe and an increase in activity in the run-off market". This will include UK companies seeking to extend European operations to hedge against the loss of passporting rights following Brexit.

M&A activity is also being driven by regulation, particularly Solvency II; and by other sub-sector or country-specific developments, such as the rapid expansion of, then consolidation within the UK pensions master trust market following the roll-out of auto-enrolment.

The net result of this is "a spate of mergers", as EY transaction advisory services insurance leader David Lambert puts it. Insurers are selling off portfolios of business "that are no longer not part of their future strategies, may be a drag on their capital, or may make it difficult for them to transform", he says. He believes the "transformation journey" for insurers will also have a significant impact on their asset management strategies.

Solvency II has also been an important influence on corporate strategy. "There were a lot of uncertainties around the solvency positions of many insurance companies when Solvency II was introduced," says Benjamin Serra, senior vice-president in the financial institutions group at Moody's. "Now, two years into this regime, insurance companies have more clarity around their capital position and some are more comfortable about redeploying excess capital. That may mean giving back some capital to shareholders, but for other companies it translates into researching which companies to buy."

A June 2017 survey of CFOs at European insurers predicted this trend, with over 40 per cent of respondents telling Moody's Investors Service they were actively seeking ways to deploy excess capital, up from just 10 per cent a year earlier.

Serra thinks Solvency II has also encouraged M&A because it has forced insurers to decide which risks they really wanted to keep. "Many have risks that they don't like, particularly on the life insurance side," he says. "They have stopped selling some of these products, but they still have a lot of legacy liabilities. We see a lot of insurance companies trying to sell some of their existing business. M&A is a way for companies to accelerate a change in their risk profile."

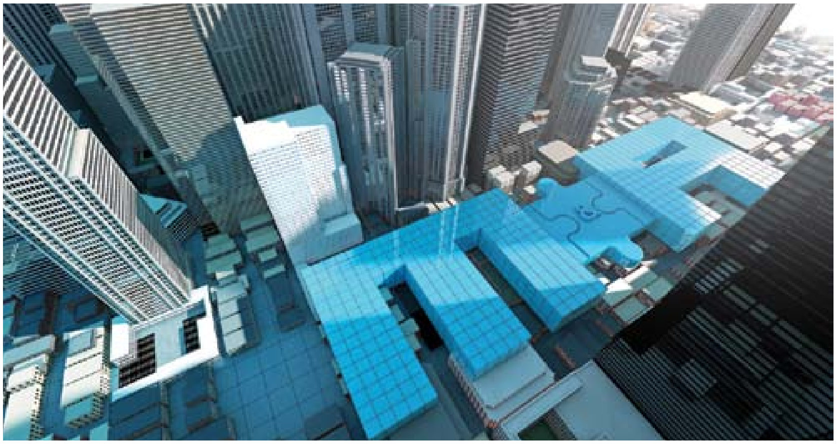
Deloitte partner and leader of the Deloitte Insurance M&A proposition Richard Baddon has been involved in most of the major life insurance M&A transactions seen in the UK during the past 25 years. He also believes Solvency II is a strong influence on strategy.

"Regulatory pressure is driving companies to want to dispose of non-core assets," he says. "Solvency II is being applied across Europe, although in some jurisdictions use of transitional measures and the approach taken by regulators means there isn't the same level of financial stress as seen in the UK. But all large insurance groups are going through the same thought processes, with non-core investments being split off."

"People are asking, 'what do we want to be: a large asset manager, an insurer or a composite business?'" Willis Towers Watson senior investment consultant Ash Belur states. "When they have made that decision they then need to decide how big they have to be if they are going to be relevant in that part of the market."

Consolidators, such as Phoenix Group and Reassure, are growing rapidly as they buy policies from insurers keen to offload them. At Phoenix, the acquisition of Standard Life Aberdeen's insurance business, subject to

> M&A is a way for companies to accelerate a change in their risk profile

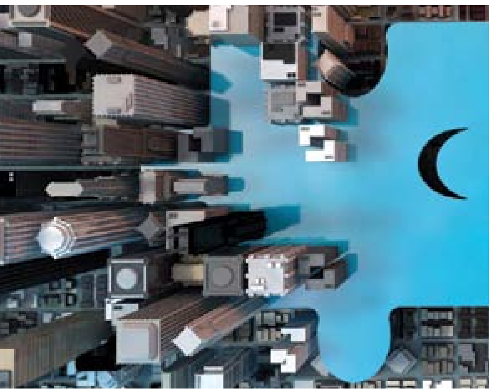


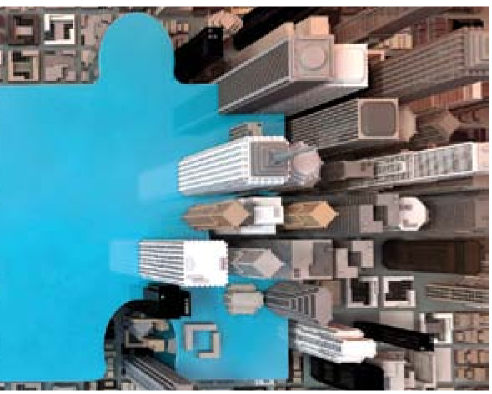
regulatory approval, will increase assets under its management from £74 billion to £240 billion, as customer numbers rise from 6 million to 10 million.

Investments

As consolidators acquire more assets their investment strategies will also become more complex. Phoenix Group head of the financial management Scott Robertson directs

> The owners of insurance assets will shift as large insurers look to future business models and offload legacy business; and that will mean more seperate investment strategies





strategic asset allocation for Phoenix's three life company subsidiaries and is responsible for direct sourcing of private debt to support those allocations. He stresses the need to look after the customers whose policies are now in Phoenix's care. This extends to taking a more active approach to managing investments than incumbent asset managers might have been accustomed to previously.

"If the asset manager has just been managing assets year by year there may not have been much interaction with [the insurer]," Robertson explains. "At Phoenix, the relationship between the asset manager and client is very hands-on in terms of developing and implementing strategies. Particularly with regards to investing in private debt, there is a lot of scrutiny over managers' sourcing and capability risk management processes.

"I want to see capability to do something different, to be at the forefront of investment practice. So for annuities you're not just buying corporate bonds and gilts. We like to work with asset managers that are proactive and offer new ideas."

Every insurer would claim to base strategies on the need to serve customers' best interests, but changes to investment strategies following M&A activity will have to be driven primarily by the bottom line and the need to manage liabilities effectively. This fundamental goal remains challenging in the current environment. Serra notes that while most insurance companies are increasing investment in high yield illiquid assets, some will struggle to find them. In the UK the Prudential Regulation Authority (PRA) has also warned that these types of illiquid assets present particular risks quite different to those associated with more conventional investment strategies.

In some cases, strategies and outcomes will be disrupted by regulator intervention or by commercial forces. In February 2018 Standard Life Aberdeen was rocked by the loss of a major (£110 billion) asset management mandate for Lloyds Bank and Scottish Widows. Reports then emerged that Lloyds Banking Group and Standard Life Aberdeen had previously tried and failed to negotiate a merger. It seems likely we will see other unexpected couplings between insurers and companies in other parts of the financial services sector during the next few years.

Alongside those broader changes underway in the industry, these M&A transactions are reshaping the insurance industry. The structures and strategies of companies and the nature of the asset management strategies they require will become more complex – and there is no end in sight to this phase of activity. "We're going to see the same trends in Europe as well as in the UK," says Lambert. "The owners of insurance assets will shift as large insurers look to future business models and offload legacy business; and that will mean more separate investment strategies." With growing competition from fintech-led players likely to create additional disruption to the sector, the future of insurance is looking more complicated than ever.

In association with

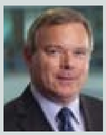
AXA Investment Managers

CHAIR

SHAZIA AZIM

Partner – Risk and Capital, Insurance, PwC

Shazia leads PwC's balance sheet optimisation proposition for financial services. She is a balance sheet optimisation expert who focuses upon capital and asset liability management across banks and insurance companies. Prior to PwC, Shazia spent 16 years in senior capital markets roles in investment banking and 10 years for Goldman Sachs.



CHRISTOPHER PRICE

Head of Insurance Solutions UK, AXA IM

Chris was appointed head of insurance solutions UK in June 2016. He is responsible for providing investment recommendations and developing customised solutions for UK insurance companies. Furthermore, Chris joined AXA IM from Deutsche Bank where he was director of insurance asset management and head of industry solutions in the UK.

ALEXANDRE MARTIN-MIN

Co-head of securitised & structured assets, AXA IM Structured Finance

Alexandre joined AXA IM in 2001 as head of the team in charge of investments in CLOs, ABS and regulatory capital transactions. In addition he has launched and managed numerous funds invested in CDO Equity and Debt, including the Saint Bernard Fund (US RMBS funds) and Opera (a CDO Equity closed-end fund).

PAUL AMER

Head of Investments, MS Amlin

Paul has eighteen years' experience within the asset management industry. He holds a degree in Economics and Statistics from Birmingham University and is a CFA Charterholder. Prior to joining MS Amlin, he served close to ten years as a senior investment manager at Insight Investment where he started managing traditional balanced funds.

ANTANAS CHRISTEV

Head of Investment, Direct Line Group

After graduating from the European Business School in London, Atanas worked as a bond analyst for ABN AMRO and later as a proprietary trader for S-E-Banken. Between 2000 and 2006 he ran Franklin Templeton's European High Yield Fund, before moving to the Kuwait Investment Office to co-manage their global corporate bond portfolios.

JAMES KENNEY

Former Chief Investment Officer, Novae

James was recently chief investment officer of Novae, a listed Lloyd's of London insurer, until its acquisition by AXIS Capital in late 2017. Prior to joining Novae, James was also deputy portfolio manager for Aviva Investor's fixed income hedge funds. Further, he is a qualified actuary who began his career at Mercer Investment Consulting.

Alternative credit in the non-life world

CHAIR: What are the key political and economic risks with your insurance funds that you manage and how do you deal with these risks?

PRICE: The interest rate cycle has changed direction in the UK and the US, and we are seeing central banks moving from providing liquidity to the market, to ending their QE programmes and potentially to unwinding their balance sheets. To get to where we are has taken 10 years, since the financial crisis, and I think that insurers see having higher interest rates highly desirable. The concern is how we get there however. A nice series of small steady steps would be ideal for insurers as obviously large interest rate spikes can be quite challenging from a balance sheet and capital point of view.

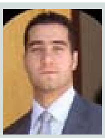
Global growth is looking quite positive and insurers are being much more global in their outlook in terms of where they invest. An insurer with sterling liabilities is happy to invest in eurozone assets, dollar assets or other currency assets, providing they can get the hedging in place at a fair cost. Insurers are sophisticated enough to capture the opportunities that appear more globally. From a UK point of view, inflation is probably higher than people would like it to be. When inflation started to re-emerge, I think the feeling was that most of that was coming from the devaluation of sterling. That is more than 12 months ago so that impact should have washed through, but the question is now why is it still high and where is it going next? Overall, diversification is probably the key to insurers getting more return while limiting additional risk.

SOFRONIOU: A key driver to understanding market moves is figuring out what economic environment you're in. As part of our regular market review process we look at how asset classes and the portfolio behave under different economic scenarios. This analysis drives our desire to hedge but also what hedging strategies to implement if we think a correction is on the way. What we found was short term corrections not driven by macro-economic fundamentals are not really worth hedging. For example if yields are rising slowly as a response to improving economic fundamentals that is good for the portfolio over a three to five year time horizon. If we get an event such as the 2008 global financial crisis where equity markets fall by 40% and credit spreads widen considerably that means the portfolio will suffer drawdowns that it won't be able to recover from. That is where we should be allocating our hedging programme. The key for me is the speed of the market's perception as to which economic scenario we are in. We have increased the probability that we see for "Normalisation" which we define as an environment of higher growth rates above and beyond potential therefore generating inflationary pressures and pushing both real and nominal rates higher. That is not necessarily a bad thing as long as it doesn't happen very quickly and we see the underlying picture remaining positive. The risk is that central banks remove accommodative policies too quickly pushing economies into recession.

CHAIR: One of the things that we have seen over the last 12 months is a spike in currency volatility and that has been a little more extreme than in previous years. Given that most of the insurance portfolios on the non-life side tend to be short-duration but with FX exposures, how do you think about your investments in different currencies and hedging around this?

CHRISTEV: We have recently put in a lot of work around our US dollar hedging strategy. We have US credit

ANKIT SHAH
Investment Manager, Antares Managing Agency
Ankit is responsible for structuring and implementing overall asset allocation of investment portfolios for Antares. In addition, Ankit has also worked with Qatar Insurance Company, Doha, Qatar (parent of Antares) as vice president – investments, overseeing the investment operations and strategic asset allocation across the QIC group.



ACHILLES SOFRONIOU
Senior Portfolio Strategist, Canopius Group
Achilles is responsible for monitoring economic and market developments and making both strategic and tactical asset allocation recommendations to the CIO and group investment committee. He also has primary responsibility for the development, maintenance and validation of the Economic Scenario Generator used in the internal model.




> We will see credit spreads widen because they have been squeezed by central bank activity. People will begin to get paid for taking credit risk again

portfolios where both interest rate and currency exposures are fully hedged. With the movement in the forward points, the currency hedging cost has increased quite dramatically, and a lot of people are wondering whether the right asset class remains attractive when compared, for example, to sterling credit. Our response has been to take a relatively small amount out of dollars into sterling credit as a tactical move. The bigger picture for us is that there are substantial benefits in investing in dollar credit in terms of diversification and access to a broad and liquid credit market. It would take a much bigger spread tightening in US credit (relative to sterling spreads) to force us into more radical moves. Over the long term hedged returns across the two markets tend to deviate by a limited amount, so I don't see us completely abandoning that market.

PRICE: On the credit spread side, I think there will be volatility but we will see credit spreads widen because they have been squeezed by central bank activity. People will begin to get paid for taking credit risk again, somewhere we haven't been for a while.

CHAIR: People have been calling the death of credit spreads for a while. We have been in a terrific bull market which has seen variation but these have been short term blips, but on the whole it has tightened and tightened and tightened and you are not actually getting paid for taking credit risk.

PRICE: But you haven't been getting properly paid for the risk you have been taking in other asset classes either? Arguably all assets have been over-priced. Currently the focus is on the relative value each asset class provides.

SHAH: I think that is what is driving the credit spread tightening. It is across equities as well. One of the concerns we see internally is where the US is actually in the growth cycle. Over the next 18 to 24 months we are likely to see a contraction in the US economy, maybe even a recession. Whether that will have an impact on other European economies or even EM economies remains to be seen.

AMER: It goes back to the old adage of 'if the US sneezes the rest of the world catches a cold'. At the moment I don't see why that would be any different. The US is much further along the cycle than the likes of Europe or the UK. With the fiscal stimulus boost that is going through they have managed to offset the probability of a for another 12 to 18 months. The question we have is where is the rest of the world at that time? Are we still going to see Europe at emergency levels, how many rate rises has the UK managed to get in by that point? If all of a sudden the US starts to roll, in an economic sense, you are looking at the UK and Europe with no room to move on the monetary side. So unless they restart QE which I imagine to be unpalatable, I fear economic pain has just been delayed. I don't see interest rates spikes occurring. Central Banks have learnt that slow and steady is the way forward and this has been evident from Federal Reserve rhetoric. We match our liabilities by currency but we manage it by duration. We currently have zero duration in Europe or the UK and we are significantly short in the US.

KENNEY: One fundamental change we made to the investment strategy framework at Novae was to move from an accounting basis to a more economic one, because fundamentally accounting principals don't always do a great job of capturing the real impact on your business of FX and interest rates movements. However, a problem with an economic basis is that it is not as easily defined as accounting principles. You have to make more assumptions or estimates, such as how sensitive your capital is to interest rates and FX. So it becomes far more subjective and complex. If you don't feel that you are measuring FX and currency sensitivities very well, then it is difficult to be confident of your true position in order to size your hedge. However, taking interest rates asan example of the benefits of an economic approach, our previous investment strategy was very short duration but some basic analysis showed that this had been costing us about £5m a year in negative carry. Given the investment portfolio p&l figures were only in the mid-teens (£m) that was quite a significant impact. Moving to a matched duration position on an economic basis, which was much longer than on an accounting basis, made us tens of millions of pounds over the next few years.

SOFRONIOU: We have a broad asset liability matching requirement at the aggregate level but we don't follow a LDI approach. The portfolio is managed in a "total return" way with the SAA set by the Boards following regular risk appetite reviews. While IG, HY & alternative credit will by definition score highly in any optimisation analysis due to the "low volatility" it is important to recognise that in this market environment positions that were once though to be liquid are no longer and so this has to recognised as a drawback for these asset classes. Also this low volatility is due to the fact that these instruments are not traded as they once were and have become buy and hold securities by necessity. The latest market flare-up has not really impacted the credit markets but it will be interesting to see how these assets will behave both in terms of price and correlation to equity markets.

MARTIN-MIN: If I compare with the global financial crisis, there is far less leverage in the banking systems. What we saw in 07/08 is unlikely to happen in the same way. We all think credit is very expensive and we try to find volatility ways to invest but we don't see on the other hand why margins should widen by a big margin. There is no default coming even in the US.

Alternative Credit

CHAIR: Looking at alternative credit, what is its popularity and what type of

> ❞ If you don't feel that you are measuring FX and currency sensitivities very well, then it is difficult to be confident of your true position in order to size your hedge

asset classes have you been investing in? What have you been finding interesting from a diversification perspective or from a risk/return perspective.

AMER: Our portfolios currently consist of equities, property, government bonds and the remainder in absolute return fixed income. We have a multi-asset, multi-manager approach and don't invest directly, using overlays to manage some of the equity risk. We have a number underlying absolute return fixed income managers and they all have varying targets and specialities. At the moment, in terms of the credit space, we have limited exposure. We have shied away from credit in the last three to four years as we don't feel as if we are getting paid for the risk being taken. With yields so low, you are having to push further and further into areas that would make you feel uncomfortable in normal situations just to try and achieve that return. From an asset allocation standpoint we prefer liquid areas such as equity which is easier to hedge with exchange traded derivatives but also then allocating it to specialist investors.

PRICE: There are some liquid alternative credit products out there and one of the interesting things for me is how regulation has distorted some of the opportunities for insurers. We have talked about CLOs to a lot of people this year. If you happen to be a standard model user, the capital you have to put up for CLOs is penal. However if you use the historical data on the CLOs you can actually see that internal models can quite easily justify a much lower capital requirement for them in terms of their historical performance. In fact, part of the problem with the calibration of the standard model is that CLOs were bracketed together with CDOs and other things. Some parts of that performed extremely badly during the financial crisis and some parts performed very well and although there was a lot of mark-to-market volatility for CLOs there was very little actual default. Looking at what is actually happening with insurers in the UK - when Solvency II first went live there was a relatively small number of large insurers that went down the internal model route. What we are seeing now is a trend for more and more insurers follow suit. This will open some additional opportunities, and potentially in the ABS space.

SHAH: Over two years ago we decided to go into the alternative credit space and we introduced securitised assets including some parts of leverage loans as well as CLOs. We are risk/return adequately adjusted on that basis. Last year we looked at the illiquid credit spectrum as well and we allocated two to two and a half per cent three percent into that space, but that we only see on the surplus assets which we are comfortable. We still feel as if you are being compensated adequately on the illiquidity premium.

CHRISTEV: We are using an internal capital model. With securitised credit we had a portfolio which included ABS, US student loans and CLOs. About

> Part of the problem with the calibration of the standard model is that CLOs were bracketed together with CDOs and other things

two years ago when the regulatory treatment of some of the assets changed, our initial response was to replace certain holdings with others with better treatment. In the end we decided that it was not worth the additional complexity. Recently we have been having discussions with managers about the changes that are expected to take place in the next couple of quarters and it looks like things will look up in 2019. We have about 10% exposure to UK property, both directly and through commercial real estate loans, as well as a portfolio primarily invested in UK social infrastructure. While we have no equity holdings we have made a small allocation to US short duration high yield bonds.

UK/EU Investment

CHAIR: If you look at the European non-life sector, it is considerably more advanced from an asset allocation perspective in terms of different asset classes. Sitting in the UK, for you is there a UK oriented issue that makes you feel more constrained or conservative in your investment outlook than some of the European insurers?

KENNEY: When considering alternative asset classes, size of portfolio was the main constraint. I would have gladly made a small allocation to a few different alternative asset classes but that was not practical given the relatively small size of the portfolio.

SOFRONIOU: Having an allocation to illiquid strategies makes sense especially if these strategies generate income early on. We created a few rules for illiquid investments driven by the Board. One of them was understanding what the underlying investments in the collateral pools are. The second one was a requirement for robust and independent pricing. The third one was that we couldn't hold the equity tranche within a securitised structure and be exposed to first loss. While these investments have performed well we are seeing a general relaxation of covenants in many deals as institutional allocations continue to flow into this asset class.

> If you look at the European non-life sector, it is considerably more advanced from an asset allocation perspective in terms of different asset classes

CHAIR: The modelling challenges involved in the construction of portfolios and the diversification and the standard formula versus the internal model approach, could I have a few comments on this. If I look at the life sector, that is an absolute constraint and there is no moving away from it. On the non-life sector it seems to be a little different because you do have a dichotomy between people with internal models and standard models.

PRICE: Some of the real assets such as infrastructure debt and real estate debt are relatively recently used asset classes and the challenge for these has been data. For an internal model the regulator requires you to support your application with considerable data and for some asset classes that is a challenge.

SHAH: I agree. Sometimes you may end up using a proxy index for this.

CHAIR: From my mind, I often find some of the Solvency II modelling arbitrary in the sense that if I feel from a risk/reward perspective I would say I am happy investing in student loans for now or equity release mortgages as an economic underlyer. What are the sorts of challenges that you get when you take some of you more interesting investments to your investment committee and you are faced with these capital actuaries?

PRICE: The single most important rule for any investor is to understand

what you are investing in. That makes complexity a key issue. In an ideal world most insurers would like to look at and assess every asset class out there but there is not infinite resource for this. Insurers prioritise those asset classes that they have the resource to review.

CHAIR: When you unpick these assets, it is non-trivial to think about the exact return I am getting paid and what are the cash flows. If we then move to diversification and the theory of economics and we say diversification ultimately pays you because it lowers the risk and therefore it means you would want to go to the committee with different asset classes and how do you pick which asset class to go for in the world of so many investments.

KENNEY: I always consider diversification as reducing your day to day risk, your volatility. I don't think of diversification as being anywhere near as beneficial when it comes to the tail risk. Yes there is also a keenness to reduce that reporting volatility and diversification is beneficial here but a good amount of this can be achieved through allocations to property and listed vehicles. Alternative credit has a very important role to play generally within the insurance landscape, and when we are talking about short tail non-life companies, that has got to be the area that has the biggest hurdles to clear and the biggest barriers to make its way into the portfolio.

SOFRONIOU: Being a P&C insurer with catastrophe risk being the main driver of capital, all the modelling we have undertaken suggests that increasing market risk has very little impact. We have looked at capital optimisation and focused on not only the 1 in 200 but all the distribution as increasing market risk has a bigger impact at different levels of the distribution the closer you get to the mean. Solvency II has more of an impact on the regulatory and reporting side of the business.

> Even if Solvency II is imperfect and a lot of it is, we think a lot more about the risks entailed on the investment side than we ever used to

CHAIR: What are the main challenges you come across from a Solvency II perspective?

CHRISTEV: It is about understanding the Solvency II model better. I do find it frustrating that for us on the investment side the model is to a certain degree a black box. There is little transparency on how asset classes interact with each other and one must use the output from various permutations to make inferences. Another issue is that a number of asset classes are represented with approximations which could lead to oversimplification and/or suboptimal asset allocation decisions.

PRICE: There is another side of the coin here and it is a lot more positive. Even if Solvency II is imperfect and a lot of it is we think a lot more about the risks entailed on the investment side than we ever used to and just the fact that it makes us think a lot more about it has to be a good thing. Brexit and impact on regulation is an interesting one. It seems highly unlikely that the PRA will do anything to rock the boat until well after any transition period has expired. The reality is that it may not be the PRA moving away from the remainder of the EU as the EU continuing to evolve Solvency II which won't automatically change UK regulations. In a sense it will be the EU moving away from us potentially.

AMER: There won't be a great divergence in regulations otherwise you start to put the UK on a different footing completely which affects potential business in the future.

ESG

CHAIR: Can we comment on ESG and responsible investing in the insurance space?

MARTIN-MIN: ESG and responsible investing in the insurance space is nothing new. Indeed we have been doing this in some form for more than 20 years. We have a lot of RI and ESG initiatives in the company - embedded across asset classes - and we are working heavily on plus 2 degree compliance. That's not just branding or advertising. ESG is at the heart of all of our investment processes including alternative credit. Even in the alternative credit space we try to avoid non-ESG compliant investments - for leveraged loans and all types of investments - and this will be a strong trend over the coming years. Beyond RI we also have a private equity impact investing team that seeks out innovative projects that balance the double objective of creating positive social impact and financial returns for our clients. They look to create this impact by addressing such needs as access to water, energy, financial services, healthcare and education - just to name a few.

PRICE: I think historically there has been the concern that to invest responsibly you have to give something up in terms of return. That is not really how we are looking at it when we integrate ESG into our investment processes and strategies. On the other side of the coin, you could actually be reducing risk. For example if you happen to be an equity or bond investor in a coal producer and the regulation in the country suddenly changes and carbon taxes increase sharply, the performance of that company and your investment may suffer. There is often an unrecognised tail risk in non-ESG products. Actually, therefore, you are potentially getting an improvement in your risk/return relationship by embedding ESG in your investment process.

AMER: I agree that from a portfolio construction perspective it is potentially a good thing, but equally it goes back to the liquidity question of some of these investments. This area is still very much in its infancy. It has to be attractive from a risk/return perspective before it gets included in a portfolio and I don't believe you can just conform to be socially acceptable - you have a duty of care around client assets, so if it is not in their best interests then it should not be included.

PRICE: We would agree. We want to invest responsibly but ideally with a benefit rather than a cost attached to doing that.

MARTIN-MIN: We have never traded in hedge funds that trade commodities as we see those things as negative. It is all about the social responsibility of us as institutional investors.

SHAH: I think a lot of time the shareholder expectation is around the return and deployment of capital and funds. This gets precedent to ESG criteria.

CHAIR: From an ESG investment standpoint, I think Europe is a lot more advanced than the US and it is really good to see AXA as one of the main trailblazers around this.

CHRISTEV: Maybe it has something to do with cultural differences. The relatively more 'dirigiste' continental European model of capitalism, compared to the laissez-faire Anglo-Saxon type, could be expected to nurture policies and approaches which are not exclusively focused on highest economic profit or returns. In any case, what has struck me over the last year having spoken to external managers, is the progress that has been made in quantifying and measuring ESG-oriented investing, and enabling the buy-side to consider seriously adopting one or another ESG-conscious approach to portfolio management.

PRICE: In the UK, the biggest take up from insurance investors to date is probably among mutual insurers because their policy holders and owners are aligned and also it sits well with the ethos of the sector. At the other end of the spectrum, you have insurers who have a high profile brand who want to say they are involved in ESG and investing responsibly. This feeds into their brand values. On the other hand we should consider what will happen to companies that get squeezed out of ESG indices but still produce something that is essential?

CHAIR: To me, I think the next 12 months will be very interesting from an investment perspective. Political risk is really high at the moment. Volatility for now is low but I do not expect it to remain low, I believe currency volatility spread will spike. Credit is something to watch out for over the next year as well. Around diversification, I do think it eventually pays, if only to mitigate the volatility you are running.

> ESG is at the heart of all of our investment processes including alternative credit. Even in the alternative credit space we try to avoid non-ESG compliant investments

Insurance Asset Management Club

The first Insurance Asset Management Club was held on 12 April in the heart of the London insurance district at The Lamb Tavern, Leadenhall Market.

A friendly gathering of insurance CIOs and asset managers gathered at the historic venue to discuss all things insurance over drinks and canapés.

Dating back to the 14th century, Leadenhall Market, originally a meat, poultry and game market, is now home to a number of boutique retailers, restaurants, cafes and wine bars.

Surviving changes in use, rebuilding, and even the Great Fire, the Market today acts as a thriving place for insurance networking and the Lamb Tavern is one of the main hotspots. Stretching out across three impressing floors on the cobbled streets of the Market, the tavern has been part of the tapestry of the city of London since 1780 and provided a perfect location for colleagues to discuss Brexit's impact on the insurance industry, capital modelling, internal/standard models and the life and non-life industries under strict Chatham House rules.

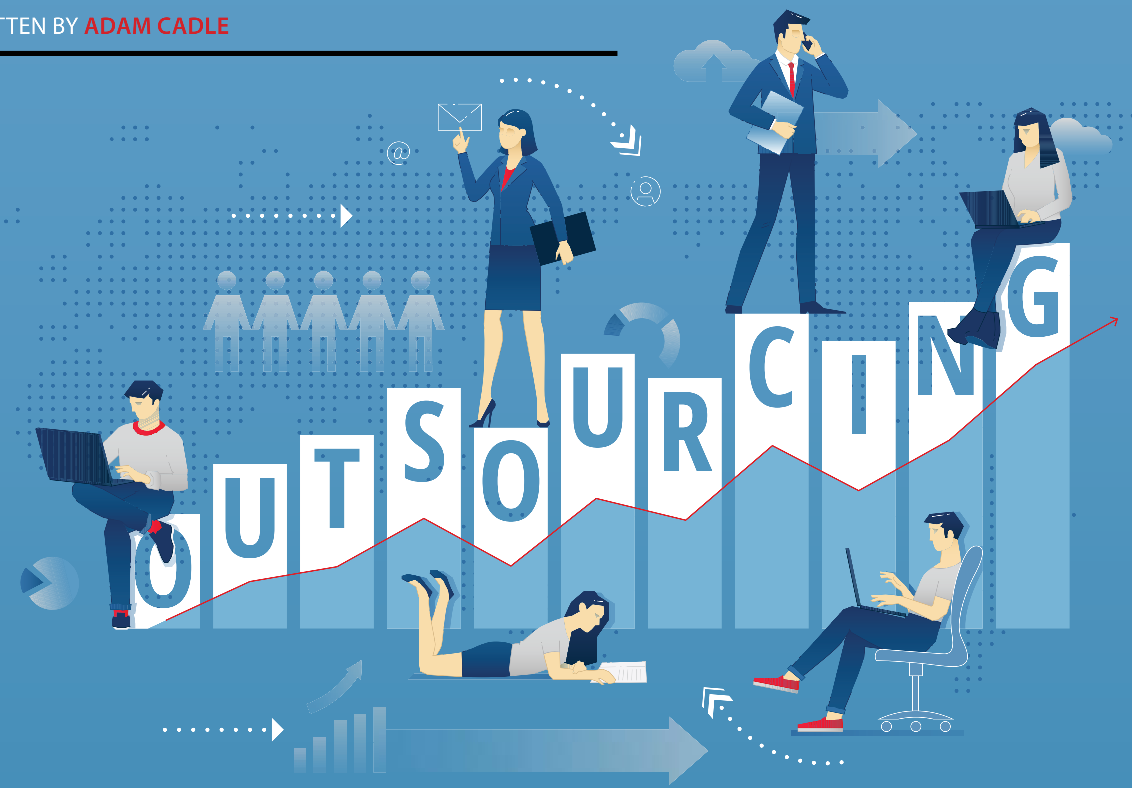
Regulation of the industry was also a hot topic on the tips of the experts' tongues, as well as the importance of the UK's 'goldplating' of the insurance market.

Insurance Asset Management is looking to hold a number of other Club events over the year to provide a unique setting for CIOs and asset managers to share views and thoughts.

Taking it outside

Adam Cadle examines outsourcing trends in the insurance space and the factors at play for moving from internalisation

WRITTEN BY ADAM CADLE



The continuing low yield environment and the capital efficiency of different asset classes have a knock-on effect on many aspects of the insurance industry, such as actual asset allocation choice and funding levels of insurance companies, but one thing that increasingly pops out at the top of the pile is the issue of outsourcing, and this investment method is likely to rise.

As Invesco head of UK insurance Ed Collinge notes "both of the above factors are encouraging insurers to diversify their portfolios globally (looking for a better risk adjusted return within an asset class) and to invest in new asset classes (looking for a more capital efficient return)".

"Both diversifying globally and investing in new asset classes often require external expertise which means outsourcing is likely to rise."

The figures speak for themselves. According to a report published in November 2015 by Standard Life Investments, 44% of insurers across Europe are now looking to outsource management of one or more asset classes, with an emphasis on specialist mandates, with management information and support around the regulatory treatment of assets being key considerations. Insurers are most likely outsourcing high yield-fixed income allocations, emerging market equities and multi-asset solutions where insurers identify that their internal asset management capabilities are weakest.

Aberdeen Standard Investments

> UK insurers are definitely further down the track and have already developed strategic relationships with asset managers who have genuine value-adding insurance asset management capabilities

investment director - global insurance solutions Bruce Porteous says "outsourcing is also increasingly being seen in the alternatives sphere mainly among real estate lending, infrastructure equity and debt, and quantitative investment strategies".

While outsourcing is a common driver, the nature of active outsourcing is changing faster than the quantum of outsourcing.

"Nearly all insurers explained that they were issuing more specialist mandates with increased emphasis on management information about assets and portfolio re-balancing, and support for regulatory treatment of specific assets. A total 41% of insurers now cite investment reporting as a key area for improvement. Over 30% of respondents were interested in insurance and regulatory expertise, and 27% cited liability management advice as key value-add services from asset managers.

Geographical differences

With outsourcing on the rise therefore, the question must be asked, is there a difference between geographies around outsourcing implementation? There is indeed now an increased demand for asset classes from a regional perspective, for example, increased outsourcing for equities is expected in Southern Europe while the UK demand focuses more on alternatives and high-yield fixed income.

Porteous states: "UK insurers are definitely further down the track and have already developed strategic relationships with asset managers who have genuine value-adding insurance asset management capabilities. This is reflective of the UK insurance industry being further ahead on updating their business models, so we expect the European industry to follow a similar course. Consolidation of outsourced asset managers is another UK trend we are seeing, and would again expect Europe to catch up soon."

When it comes to actual analysis and implementation of new asset classes, Collinge

notes that in Continental Europe senior secured loans are a part of many insurers portfolios, whereas in the UK we are only now seeing significant interest from insurers.

"Part of this relates to the focus of a particular market," he says.

"In Germany, where insurers have been looking to match their forward looking investment guarantees, many have already moved into senior secured loans, emerging market debt and USD credit. Whereas, UK life insurers have often been focused on matching adjustment and meeting longer dated liabilities. However, UK life insurers are now looking at their surplus asset portfolios as well which brings to the fore shorter duration asset classes such as senior secured loans."

Capacity

Whilst outsourcing may be on the rise, a question arises around whether there is a supply issue concerning the number of appropriate asset

> Areas where insurance expertise is most important are client advisory, strategy and analytics, portfolio management and data/reporting

managers, and a shortage of skills and operational capabilities among asset managers to deal with the specific insurance investment needs that insurance companies now have.

For Porteous, the answer is a firm "yes".

"Our European Insurance Survey identified this as an issue, increasingly, we see mandates being won on the basis of insurance thought leadership and operational capability differentiators, not just investment performance. Insurers are telling us that they prefer to deal with asset managers who have an insurance heritage, plenty of experience and with who, they can discuss and share ideas."

Operational worries surround asset managers, and asset data reporting requirements of Solvency II remain onerous.

"Companies have to look down deep into individual asset holdings and report on this very fast. If asset managers cannot meet these operational requirements, then you are effectively out of the game. Insurance companies cannot place business with these managers."

Collinge acknowledges that several asset managers have indeed strengthened their insurance capabilities to better meet insurers' specific needs.

"Areas where insurance expertise is most important are client advisory, strategy and analytics, portfolio management and data/reporting. Ultimately asset managers need to understand the regulatory and other unique constraints of insurers to better serve them. If, for example, a manager cannot provide an insurer's "look through" reporting needs then it is unlikely that insurers will continue to use that manager as the insurer will potentially need to hold additional capital to reflect the lack of data transparency."

Phoenix Group head of investment strategy Daniel Blamont believes there is no shortage of capable asset managers in the industry. However, "in some cases, mandates are very narrow and constrained to prevent the manager from inadvertently destroying balance sheet value from the insurer's perspective".

"This is what may drive insurers to internalise to avoid many investment opportunities being missed. We believe a collaborative approach is the most efficient to make best use of the insurer's and the manager's knowledge and skills."

Working in an environment with low yields and varying economic pressures therefore is generally causing a rise in insurance companies looking to outsource segments of their investment portfolios to seek higher returns, but obviously some issues remain around whether certain asset managers are able to meet a potentially niche and specific requirement issued by the insurer.

"It is at both extremes that we see the most value to outsourcing asset management," Blamont states.

"On one hand specialist strategies are more likely to be outsourced where insurers don't have capabilities. On the other hand, standard equity, gilt and corporate portfolios would be outsourced as large asset managers are likely to remain best placed to manage such assets."

The view from Ireland

Insurance Ireland CEO Kevin Thompson speaks to *Insurance Asset Management* about the state of the Irish insurance market

WRITTEN BY **ADAM CADLE**

Q Can you give an overview of the insurance sector in Ireland?

To give a sense of the industry in Ireland, half of the top 20 insurance companies globally have a presence in Ireland and half of the world's largest reinsurance companies include Dublin operations within their groups. Ireland has developed into one of the few truly international re/insurance centres. Insurance is a major industry that employs approximately 28,000 people and provides vital services for economic activity both in Ireland and internationally. Of these companies, approximately half are selling insurance internationally from Ireland. Gross premium income for Insurance Ireland's membership was €51 billion in 2015 with approximately €16 billion related to domestic business and €35 billion to international business. The Irish industry also holds €303 billion in assets under management.

Q How would you describe the state of the Irish general, life and reinsurance sectors compared to the rest of Europe?

Taken as a whole, Irish re/insurance market has a strong growth trajectory. Our members pay out annually more than €13 billion in claims and benefits to Irish customers with domestic life assurance pay-outs amounting to €9 billion; non-life pay-outs excluding health amount to €2.10 billion and health insurance pay-outs amount to €1.95 billion. There are policy priorities across the sector so for instance, on the life side there is a policy focus on a Universal Pension, which the industry supports, and on the non-life side the industry has been addressing the rising cost of claims. This resulted in the government publishing a Cost of Insurance Working Group report to review issues such as awards for the most common injuries, including whiplash where the average Irish award is €15,000 versus approximately €5,000 in the UK. These are important workstreams for the industry.

In addition, there are significant opportunities to build on the industry's diversity initiative, the Year of Inclusion, and our academic and industry collaborations in InsurTech which includes a Strategic Alliance Partnership with the Massachusetts Institute of Technology. Overall, the industry in Ireland is positioned for growth and

Overall, the industry in Ireland is positioned for growth and there is confidence in the industry's strengths

Our merger with DIMA has brought added scale and an opportunity to enhance our capabilities for our members

there is confidence in the industry's strengths and the opportunities that exist in relation to further investment and growth.

Q How has Insurance Ireland's merger with DIMA been progressing?

Our merger with DIMA has been a historic step for the sector as Insurance Ireland now has 130 members who cover all aspects of insurance both domestic and international across general, health and life across direct writers, reinsurance and captive management.

Looking more widely at our strategic positioning, our merger with DIMA has brought added scale and an opportunity to enhance our capabilities for our members. For instance, we have just opened a Brussels office and hired Florian Wimber as head of European affairs and International Insurance. Florian was formerly the deputy head of the German association's office in Brussels, so he has been able to hit the ground running for us.

Q How is Brexit affecting the Irish insurance and reinsurance market?

For us, Brexit is about getting clarity on the future trading arrangements and the future regulatory arrangements. Brexit brings many challenges but customer certainty is key. It is important that in a highly diverse industry, that there is not seen to be a 'one size fits all' approach to Brexit preparedness. Insurers are preparing for all eventualities, but their planning will reflect their risk assessments.

There are, however, issues outside the control of insurers that need to be resolved as quickly as possible, and they include theconfirmation of the transitional arrangement at the earliest possible stage. The transitional arrangement will have to be approved as part of the Withdrawal Agreement and this is an absolute priority.

Secondly, the issue of contract certainty. We have been advancing solutions at a European level on servicing contracts in the event of a hard Brexit and post a transition phase, and getting clarity on the future trading and regulatory arrangements is vital to this

Finally, data sharing post Brexit is also a key issue and early EU-UK agreement on the mechanism for this is a necessity.

A different **beast**

Oliver Wade analyses the senior secured loan market and examines how insurers are using this niche asset type in their investment portfolios following the implementation of the Solvency II Directive

WRITTEN BY **OLIVER WADE**

FOLLOWING the introduction of the Solvency II Directive at the beginning of 2016, and while interest rates remain at historically low levels, insurers are increasingly looking for alternative ways to deliver attractive returns, resulting in a growing interest in senior secured loans (SSLs) from insurers.

Columbia Threadneedle Investments head of insurance solutions Eugene Dimitriou says: "We see bank loans and senior secured loans extending across multiple areas of insurer balance sheets."

Dimitriou states that the "most obvious" place to find this type of asset is in annuity portfolios "where different forms of secured lending make up an increasing proportion of assets", with commercial real estate debt and infrastructure lending being prominent examples.

Dimitriou also says that "in general", there are fewer investment constraints with SSLs than in annuities, and that the asset type "to a certain degree" has a place within with-profits funds and similar savings products. "Typically with-profit pots have some scope for assets with lower levels of liquidity," he comments.

However, unlike Dimitriou, in a recent whitepaper published in conjunction with Hymans Robertson, Invesco says that SSLs are "unlikely to feature heavily" within annuity portfolios, due to them being "short-dated, floating rate and sub-investment grade" assets. Despite this, the white paper acknowledges that firms "may wish to consider" them for participating business, surplus capital and property and casualty portfolios.

Insurers have typically always allocated a portion of their fixed income portfolio to sub-investment grade and unrated securities, with Invesco fund manager Michael Craig saying that "the asset class (SSLs) in Europe has grown tremendously, with the asset class estimated at €160 billion at the end of 2016 and rising close to €230 billion at the end of March".

Craig further comments that this growth is a "genuine reflection" of how well the asset is currently performing.

"Last year there was around 100 billion transactions that came to the market, and around half of those were truly new deals, rather than reworking existing loans within the market. Supply has been tremendous from the back end of last year and into the first quarter of this year. Demand has

SSLs in Europe have grown tremendously, with the asset class estimated at 160 billion at the end of 2016 and rising close to 230 billion at the end of March

also grown on the insurance side as investors become more comfortable with Europe generally."

Benefits

Craig explains that there are many benefits to investing in SSLs, especially while interest rates are low. He further explains that as the loans are senior secured there is very low volatility, which provides investors with a consistent stream of income.

"Looking at the first three months this year, loans made around 90 basis points, whereas their close cousin, high yield bonds, lost around 80 basis points in Europe. The sharp ratios in loans are very high because of the low volatility, because they are floating rate, meaning that, unlike bonds when interest rates rise the price goes down, when interest rates rise every basis point of the Euribor is passed on to the investor."

Furthermore, SSLs have very little rate risk due to them paying floating rate coupons, whereas high yield bonds primarily pay fixed coupons, allowing insurers to swap overlays to manage interest rate mismatches between their assets and liabilities at a portfolio level.

Craig states that there are a "number of attributes which make it attractive and that are working well for it right now", as investors are seeking a steady income with low volatility that provides a "high sharp ratio". When this is coupled with a "good economic environment across Europe" it results in relatively low downside risk.

Craig says that even if there is a downturn, investors remain protected because the investment is senior secured, meaning that "you're the first to get your money back in a default scenario".

Invesco head of UK insurance Ed Collinge also comments on SSLs, stating that "insurance companies like them" due to their recovery rate of 80 per cent, in addition to their average life span of four years and floating rate. This "boils down" to them being favoured and popular, particularly among life insurers.

"The nature of non-life insurers' liabilities is relatively short-tail anyway. However, when we look at life insurers, we have seen an awful lot of interest in surplus asset portfolios recently, particularly in the UK, and they are relatively short duration in nature as well. So actually, something like bank loans, also short duration while providing a capital efficient return under Solvency II, fits quite neatly into that part of a life insurer's portfolio."

Variation

However, Collinge notes that the popularity of the asset varies across Europe. Within the UK, the SSL market remains relatively small at approximately $50 billion in comparison to the rest of Europe, which is worth over $200 billion. America has the largest SSL market, valued at $1 trillion.

Though the UK has a much smaller SSL market, Aberdeen Standard Investments global head of loans Paul

Mehta reveals that local market returns were higher than the returns seen across Europe with a growth of 1.92 per cent and 1.41 per cent respectively.

"Whilst there are certainly some differences between the composition of the two markets, the primary driver of the difference between the returns is connected to one of the basic features of the asset class – loans pay a margin (credit spread) over a specific reference rate, typically 3 month Libor or Euribor, to give a total return," says Mehta.

"In the US, 3 month Libor is higher and has been rising rapidly through 2018 as the market increasingly factors in rate hikes from the Federal Reserve. Whilst the prospect of rising rates is a negative for traditional fixed income, loan returns actually increase as this reference point resets at higher levels."

Mehta states that interest rates across Europe are gradually increasing, but from a negative base, with Euribor currently at -0.3 per cent. However, syndicated loans, such as SSLs, are usually issues with a feature labelled as a "libor floor". This floor is typically set at 0 per cent in Europe and offers protection to investors when Euribor declines into negative territory.

Despite the size of the market and the growth that it is experiencing, Collinge highlights that SSLs are a very difficult asset to invest in as the information is private, meaning that it is not possible to access the market as efficiently with a public credit team. However, for many insurers this proves to be beneficial as it provides them with a "premium uptick" as they are investing in "something that is much harder to research".

Invesco manages over $40 billion of SSLs, with over 20 European insurance companies invested in the asset via their platform. More commonly with continental insurers, SSLs sit within the surplus asset portfolio, "but a lot of them have written forward-looking investment guarantees".

Investec Asset Management credit strategy leader Jeff Boswell reports seeing a similar trend to Collinge and Craig, stating that he has "certainly seen insurers very willing to look at the loan space", as they are becoming more curious about the asset type, but acknowledges that "the more sophisticated insurers have been active in the space for a while".

Boswell further says that the asset type has gained popularity over the past few years, and credits this to "insurers looking for a means of getting relatively attractive yields, but in a risk controlled manner". The credit strategy leader also states that by utilising SSLs in their portfolios, insurers get a "little bit of a break" from the Solvency II Directive as the loans are unrated, resulting in a "yield pick-up" and "some sort of capital treatment break".

"This is a more defensive alternative, and I think that's the way a lot of insurers are coming at it, relative to high yield where you still undoubtedly have an element of rate risk as well as volatility, from a secondary price perspective, and that is where much of the appeal comes from," he explains.

Boswell describes loans as a "different beast" when it comes to investing, and mentions that the "bigger issue" for some insurers "depending on their sophistication and their liquidity requirements" is that they are harder to manage with regards to settlement. Echoing a similar point that Collinge made, Boswell states that accessing the market can prove to be more difficult, as insurers cannot do it directly and instead have to go via an asset manager who can carry the "burden".

It seems as though many investors advocate allocating a portion of their portfolio to sub-investment grade assets, such as SSLs, as their short-duration, low volatility and floating rates make them a flexible, sustainable and profitable asset class for insurance companies, particularly life insurers, especially in the current European economic climate.

As mentioned by Collinge, Mehta and Boswell, SSLs allow insurers to see attractive returns, but with a lower risk margin, while remaining protected by the "libor floor" and the restriction that prevents the information from being publically available.

Insurance companies like them due to their recovery rate of 80 per cent, in addition to their average life span of four years and floating rate

ACCESSING VALUE

Lynn Strongin Dodds explains the attraction of real estate debt for insurers

WRITTEN BY **LYNN STRONGIN DODDS, A FREELANCE JOURNALIST**

It is easy to understand why insurance companies are interested in commercial real estate debt. The asset class not only generates attractive risk adjusted returns but also offers capital protection and stable cashflows. However, these attributes are also drawing in other institutional investors which as seen in other popular asset classes can lead to overcrowding.

In fact, figures from Preqin show that despite a slowdown among traditional equity real estate funds, 2017 marked a record year for property debt funds with 47 vehicles raising an aggregate $28bn. Fast forward to this year and a report from Greenwich Associates shows that one-third of continental European insurance companies alone expect to increase investment portfolio allocations to property and infrastructure debt in the next three years.

Value and correlations

One of the main reasons is that value can still be derived especially when compared to other instruments. As Aviva Investors head of insurance investment strategy Ian Forrester notes, insurers are predominantly fixed income investors but they have come under pressure to explore other options as spreads have compressed across the credit spectrum. This has made it increasingly challenging for them to meet their targeted outcomes. Real estate debt, he says is not only more appealing than its equity counterpart but has the added benefits of favourable regulatory capital treatment, predictable returns as well as covenant protection for lenders.

JLL head of structured finance at EMEA Ben Roger-Smith adds: "There has been a tremendous shift into commercial real estate debt over the past two years but we are still bullish about the sector in general. For the insurance industry at the most basic level it offers a significant yield pick-up relative to other asset classes as well as the ability to match long dated liabilities. Also, the underlying assets that secure the loans often offer some inflation protection."

Insight Investment's head of insurance Heneg Parthenay echoes these sentiments. Commercial real estate debt "is a relative game," he adds. "Spreads are tighter than they were two to three years ago but you can still pick up extra yield due to the illiquidity premium over corporate bonds. Also, the real estate loans are a better credit risk than unsecured high yield and emerging market debt because investors will have access to the underlying properties if something goes wrong."

Low correlations are also a driver but Parthenay cautions that it can take longer for these benefits to materialise in illiquid markets. This is because there needs to be some transactions to occur to act as a benchmark and this may time. "Credit markets may all be heading in the same direction but not at the same pace," he adds. "For example, when the corporate bond spreads are widening, structured credit spreads sometimes lag behind."

Overall, performance depends on the types of structures, seniority and

If you are looking at mezzanine real estate debt which is farther down the capital structure, it can target a 7% to 8% return or higher if there is leverage

loan to value of the notes as well as the segment of the underlying real estate, according to JP Morgan Asset Management global head of insurance strategy and analytics Gareth Haslip. "If you look at high quality prime secured loans you can expect to see a spread of 100 to 150 basis points above A rated corporate bonds,'" he says. "However, if you are looking at mezzanine real estate debt which is farther down the capital structure, it can target a 7% to 8% return or higher if there is leverage."

Insurance companies typically prefer senior secured loans because of the capital charge reduction under Solvency II which sets capital reserve thresholds for insurance companies. This tranche is treated in line with investment-grade bonds, making it capital efficient. In addition, although this debt is often unrated, it has historically shown low default rates, due to factors such as asset-backed structures.

Another advantage is the capital preservation on offer especially in this late stage of the real estate cycle. "If there is a flood, investors have to consider where they would rather be sitting – the attic or ground floor," says M&G investor relations director in the real estate finance business Isabelle Brennan. "We would expect them to pick the attic; they are higher up in the capital structure, there is better security against the underlying assets and this position will offer the biggest cushion against losses in equity."

Horizons and strategies

While most insurers are keen to keep their heads above water, there are differences between countries in their investment horizons and strategies. This is mainly due to historical and cultural reasons regarding the structure of the insurance market. All agree that one of the biggest challenges of Solvency II is that the interpretations differ from jurisdiction to jurisdiction. Consultations and reviews are being held but regulators are at varying stages in their processes.

For example, last year the UK's Prudential Regulation Authority's (PRA) launched a consultation late last year on the Matching Adjustment (MA), which is designed to offer special regulatory treatment to long-term, illiquid assets such as property and infrastructure as long as insurers can provide certain cash flows and are matched to a portfolio of insurance obligations. Several industry participants and trade groups such as the Association of British Insurers have argued that the rules are too restrictive and offset many of the measure's expected benefits.

One concern in the current low interest rate environment is the difficulty in finding eligible assets that meet the stringent MA requirements. Although the PRA has said it would like to provide better clarity many in the industry believes that much more work needs to be done. As the Institute and Faculty of Actuaries (IFoA) said in its response to the PRA's consultation paper: "We do not believe that the new and additional guidance proposed… will be sufficient to allay the main challenges currently being faced by UK insurers running MA portfolios."

The IFoA suggested the ability to add new assets and liabilities to matching adjustment portfolios quickly, making changes to existing matching adjustment approvals, and the need to use artificial structures to include some assets in the portfolios.

While the MA is available to all, the main country who uses it is the UK and this is driven by the fact that it is has a large annuity market which previously operated under the Individual Capital Adequacy Standards (ICAS), says Haslip. "MA is similar to the ICAS liquidity premium which allowed insurers to discount their liabilities at the rate of return derived from their matching assets," he adds. "However, the MA is more complex under Solvency II and insurers have to satisfy much stricter criteria. For example, there can be no form of pre-payment or optionality without sufficient compensation through make whole clauses and there needs to be defined cashflows to meet their UK liabilities."

The other differentiator is that the application of MA eligibility is conducted under the internal model rather than standard model. This is why the model is more prevalent in the UK than the Continent, where they do not tend to benefit from MA eligibility, according to Brennan. However, she points out that the bar is higher.

"In general, larger insurers in the UK and Europe may have more resources to dedicate to running an internal model," she adds. "To qualify for MA eligibility, internal teams not only require greater detailed knowledge of the fixed income market and their specific investment metrics but also the real estate expertise to underwrite the assets and cashflows," she adds. "In addition, if they want to originate deals directly, they need a large, experienced team who can source deals, structure them appropriately and ultimately manage those investments."

> ” Another advantage is the capital preservation on offer especially in this late stage of the real estate cycle

Against this backdrop, the Europeans have been less constrained in their approach and have been able to adopt a wider view. However, this is changing as UK insurers are being forced to look beyond their own borders for higher returns. "The UK has been under more pressure to look outside the country for opportunities to better match their liabilities because the sterling market is much smaller and they need access to a broader and deeper pool," AXA Investment Managers head of insurance solutions Chris Price states. "In the past they did not want the complexity of hedging but two years or so ago, they started to look at the US and more recently the eurozone."

Track record and ambition

Adam Cadle chats to MS Amlin CIO Jayne Styles about the global (re)insurer, its investment profile and aims

WRITTEN BY **ADAM CADLE**

Q Can you provide an overview of MS Amlin please?

MS Amlin is a global (re)insurer with a 300-year track record and more than 2,400 people in 26 locations worldwide. We are part of the global top-10 insurance group MS&AD, whose support offers us a significant advantage in terms of the capital strength we can draw on, and the scale we can reach.

MS Amlin focuses on delivering continuity for businesses facing the most complex and demanding risks. Our role places us at the forefront of the Property & Casualty, Marine & Aviation and Reinsurance markets.

Q What is your overall investment portfolio structure and what are your main asset allocations in?

We are multi-asset, multi-manager investing globally in bonds, equities, cash, property and absolute return. One advantage of the multi-manager approach to investing is that it provides a wider range market and economic discussion than we would get if we only used sell-side or macro/market strategists input.

We have four main, clients, which are the (re)insurance legal entities and plc. Each of their investment processes is led by their risk appetites – we do not have return targets. Portfolio construction starts with the asset liability management of the policyholders' funds, which are only invested in highly liquid assets. Once the asset mix has been determined for the policyholders' funds we determine the appropriate mix for the capital funds, which can take more advantage of illiquidity premia. The aim is that, when the two 'pots' are combined, the overall entity's portfolio produces excellent risk adjusted returns.

Our core investment beliefs are that: strategic asset allocation adds most value; outstanding governance facilitates sophisticated investment strategies, which broaden our investment universe; we have a long-term time horizon but recognise that short-term market inefficiencies that can lead to return opportunities; diversification across asset classes/sub-advisors/counterparties/holdings; active management; best of breed fund managers can outperform in the medium/long-term; as wide an opportunity set as possible, such as global long/short strategies; and that costs matter.

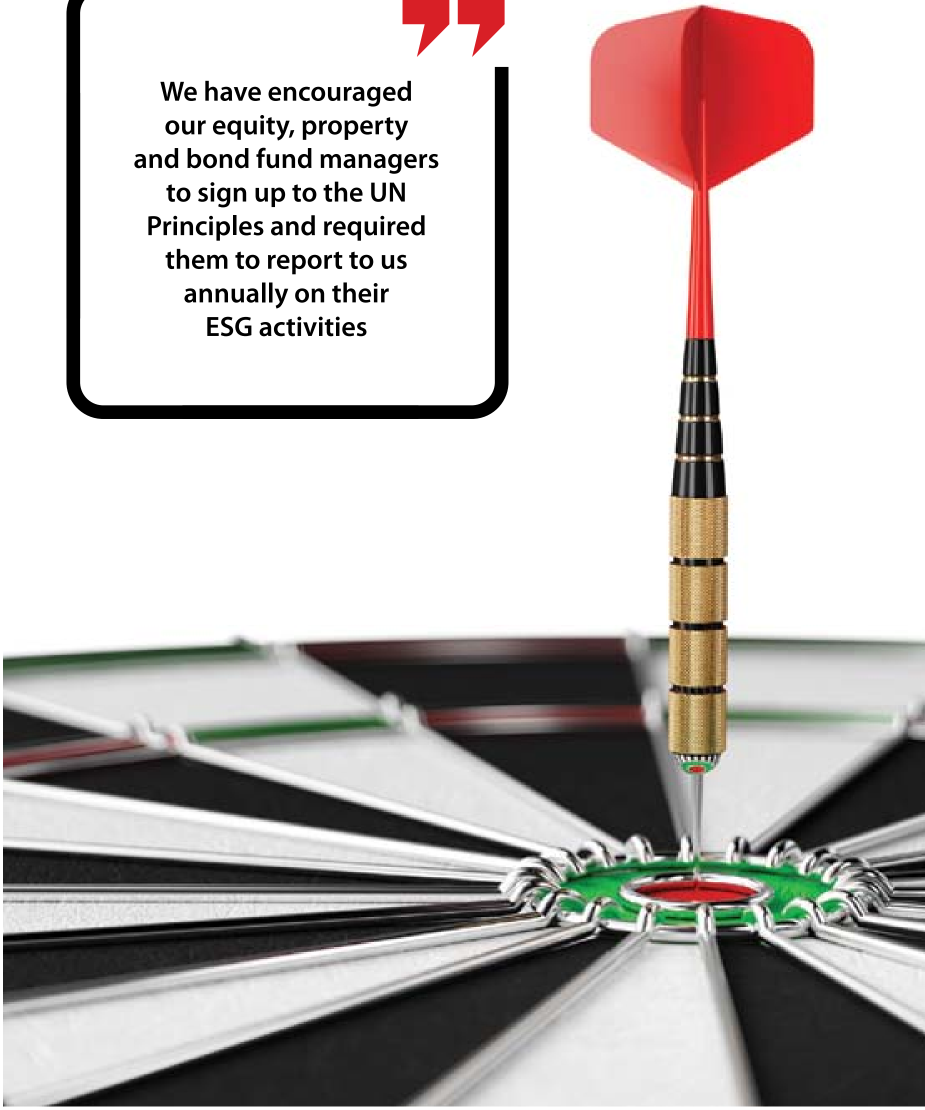
Q How is the firm adapting to Brexit, both in terms of geography and the investment portfolio?

We are in the process of re-domiciling our European insurance business to Brussels, Belgium in response to Brexit, however MS Amlin will retain its global headquarters in London.

This is a strategic move that ensures our European brokers and clients experience no disruption from the UK's exit from the EU, whilst continuing to enjoy the same high-quality service they have come to associate with MS Amlin.

As we have a global approach to investing, Brexit has no impact on the group. UK investment instruments and sterling continue to form part of our opportunity set.

> **We have encouraged our equity, property and bond fund managers to sign up to the UN Principles and required them to report to us annually on their ESG activities**



Q What have the effects of Solvency II been on your investment portfolio?

The impact has been limited as the rules align to our investment philosophy - our investment process has always been prudent and led by our risk appetites. We have sold a few structured products that did not meet the risk retention requirements, but that's about all.

Q Going forward, what do you think the trend of mergers and acquisitions will be?

If I knew this, I would not be working for the ABI. This said, I would be surprised if the flow of M&A dried up any time soon.

Q What is MS Amlin's Environmental Social and Governance thinking?

We don't have separate ESG strategies but we have long believed that companies who care about their long-term sustainability, their employees, society and the will tend to perform well.

For many years we have encouraged our equity, property and bond fund managers to sign up to the UN Principles and required them to report to us annually on their ESG activities.

Q What are your main aims over the coming years for MS Amlin and yourself as CIO?

As always, my main aim is to produce the best risk adjusted return I can.

Is the UK insurance industry over-regulated?

"There is no doubt that the UK insurance industry is heavily regulated, arguably the most regulated in the world. Generally speaking, the wider UK financial services landscape has seen its fair share of reguatory hurdles over recent years, and arguably with varying degrees of success. But one theme is prevalent: most, if not all regulatory initiatives have at their heart the prevention of consumer detriment. There are more regulations on the horizon, such as the Insurance Distribution Directive (IDD) which itself will place greater demands on insurers, reinsurers, financial advisers and other insurance distributors as requires non advised sales to ensure that the product addresses the client's need. Again, to prevent the consumer detriment. But there is more – as understanding the true requirements of regulatory change is only one aspect, but adapting often ageing IT systems to meet them is another aspect entirely. wwKey for companies is an early engagement with the regulator and collaborative working with clients. Using this approach will enable companies to establish a broadly 'shared view' on regulatory change, and a syndicated cost for delivering IT change – helping to manage the burden and cost of change more effectively."

IAN BETLEY
DST Systems head of FS sales EMEA and Asia

"The SM&CR represents a fundamental change for the insurance industry that will affect all firms in some way. Given the breadth and detail of the changes, brokers should start considering now what they need to do to comply with the legislation.

"However with brokers already facing a tide of regulation, including the introduction of the GDPR next month and the implementation of the Insurance Distribution Directive in October, it's perhaps no surprise that the majority haven't yet got to grips with what the regime means for them. Among those who are aware of the changes, the jury is out about how SM&CR will impact on their business."

ADRIAN SAUNDERS
Ecclesiastical commercial director

Technology is a powerful shaper of financial regulation, able to make compliance simpler and more efficient. Our TechSprints bring people from across the financial services world together to share their collective knowledge to solve common problems. We look forward to working with industry participants in the coming months to drive these ideas forward

CHRISTOPHER WOOLARD
FCA executive director of strategy and competition

"2018 is the year of reckoning for insurance. With growing demands from customers, the emergence of disruptive technologies and significant regulatory changes, like international financial reporting standards (IFRS) 17 and 9, it's little wonder CFOs of many insurance firms have been left reeling.

"However amongst the increased pain which regulation brings there is a silver lining for insurers, with one global insurer saying to me "If we don't take the chance to use IFRS 17 to fix our finance systems architecture now, when will we get another chance."

TOM CRAWFORD
Aptitude CEO

Given the nature of regulation of the insurance industry in the UK there is limited scope for companies established outside Europe to sell insurance to customers located in the EEA without being authorised (the exact requirements depend on the law in each member state). It is therefore unlikely that the widening of the scope of data protection law to cover companies outside the EEA will have a significant effect on the insurance industry outside the EEA

DAC Beachcroft

"The UK insurance industry has experienced a strong uptick in regulatory oversight in the last two decades. This has arisen from six main sources. First, the FSA's core agenda was the even application of strong consumer protection regulation across all sectors – an approach broadly continued under the FCA. Second, the global financial crisis produced a surge of regulation around governance and systemic risk, such as the Senior Managers regime, intended to improve bank performance but which has been imported wholesale into the insurance sector. Third, the re-creation of Bank of England oversight via the PRA after the crisis, produced a whole new regulator with its own prudential requirements. Fourth, EU regulation such as Solvency II and the Insurance Distribution Directive, arrived and had to be implemented. Fifth, specific to the important London insurance and reinsurance market. Lloyd's reconstructed itself as an additional layer of prudential oversight. And finally other regulators such as the ICO have arrived in force. One option would be to de-layer. This might, in part, happen as a result of Brexit, although it seems possible that the EU's price for market access may be regulatory equivalence to a degree that means UK regulators have to implement EU directives anyway. In addition, Lloyd's could decide that prudential oversight can usefully be left to the PRA."

PETER ALLEN
Moore Stephens partner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