Insurance Asset Management

Spring 2019

ILS
The trends within this investment field and the outlook ahead

Bank of England
The regulator provides its views on the UK insurance industry

Regulatory harmonisation
Is this a dream or can this be actually realised?

A race against time

Can insurers meet the demands behind IFRS 17?

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HEDGE FUNDS
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Editorial Comment

The question constantly emerges as to whether regulatory bodies could be simplified and harmonised, or whether there is further ground to be made up around transparency levels

The issue of IFRS 17 might not be one which you read about on a daily basis in the nationals, or indeed associate with the most pressing concerns within the insurance sector, but sure enough its impact may not go unnoticed.

Prior to Christmas, a group of 11 insurance companies from across the globe wrote a joint letter to the International Accounting Standards Board (IASB) chair Hans Hoogervorst, calling for a two-year delay to IFRS 17, citing insufficient time periods to implement the standard effectively. It's hoped that the standard will result in significant changes to the way financial information is presented, and its adoption will require significant planning. Furthermore, certain segments of the industry have argued that IFRS 17 presents opportunities to harness data more effectively. This edition's cover feature (p.22) looks at the current state of play surrounding this accounting standard, the complexities within it and whether insurers are generally prepared, or actually need this time or even more to prepare efficiently.

This issue also looks at authority harmonisation (p.26). Similar to the rest of the institutional investment space, the insurance industry has a number of authorities working within it, all with the ultimate aim of ensuring utmost fairness, smoothness and appropriate conduct in the insurance space. However, the question is constantly raised as to whether regulatory bodies could be simplified and harmonised, or whether there is further ground to be made up around transparency levels.

We also look at the role of the Chinese onshore RMB denominated bond market in the insurance market (p.62), something that has not been touched on before since the launch of the magazine. This asset class can deliver a wide range of benefits to insurers, particularly its elements of diversification and yield benefits. Rapid growth is expected in this market as foreign investors take advantage of the asset class's low volatility and low correlation to other asset classes. The potential for an appreciation in the RMB market is something definitely worth noting if looking to squeeze out that added return within an investment portfolio.

I hope you all enjoy this issue and gain some valuable information!

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News focus

Treasury Committee launches inquiry into future of UK's financial services post-Brexit

Brexit to have a 'significant and long-lasting impact' on the financial services sector

Written by **Adam Cadle**

The Treasury Committee has launched a new inquiry into the future of the UK's financial services, once it has departed from the European Union (EU).

In a statement, the Committee has said that it will examine what the government's financial services priorities should be while negotiating the UK's future trading relationship with the EU and third countries.

Furthermore, it will assess how the UK's financial services sector can "take advantage" of the UK's new trading environment with the rest of the world, and whether it should maintain or review the current regulatory barriers that apply to third countries.

Commenting on the launch of the inquiry, Treasury Committee chair Nicky Morgan said: "London is the world's premier financial centre, and many of us want to keep it that way." According to Morgan, Brexit will have a "significant and long-lasting impact" on the financial services sector, namely the insurance, retail banking and asset management sectors in the UK, the EU, and potentially the rest of the world.

"The UK may converge, seek equivalence, or diverge from the EU. As part of our new inquiry, the Treasury Committee will examine the risks and rewards of each of these choices," the Committee chair added.

Morgan emphasised that the Treasury also wants to explore opportunities "outside Brexit", such as FinTech, "on which we [the UK] should be capitalising".

Once the Committee has gathered evidence from the industry, regulators, ministers and officials, it will make a series of recommendations to the government and regulators in relation to what they should prioritise in negotiations with the EU and the rest of the world.

Finally, Morgan explained: "We'll also seek to conclude whether it would be in the long-term interests of the UK to align closely with EU financial rules, or to forgo financial services trade with the EU and pursue trade with other third countries." In response to the launch of the inquiry, UK Finance chief executive Stephen Jones said: "The UK's position as a world-leading financial centre post-Brexit is central to our economic and social prosperity. It is crucial that the government, Parliament, regulators and the industry all work closely together to preserve it.

"We must avoid fragmentation of global markets in which the UK is a leader, maintain strong and proportionate regulation whilst supporting innovation including in our critical FinTech sector. We also need to ensure the UK's tax policy is globally competitive."

Jones stressed that the UK "is and should always seek to be the safest and most transparent place" for financial service providers.

In preparation for a Brexit scenario, Luxembourg's regulators granted 80 new licences for banks, management companies, alternative asset managers, insurers and investment firms in 2018, demonstrating it is the 'go-to-hub' for financial institutions operating on a cross-border basis in the European market.

The number includes several financial institutions to have publicly announced their decision to relocate some activities because of Brexit.

To date, the Brexit relocation plans of 47 financial institutions involving Luxembourg have been made public. Half of these are asset managers and the other half are a mix of banks, insurers and payment service providers. Meanwhile, a number of firms have chosen to expand their existing Luxembourg operations without these plans having been made public.

An important factor in Luxembourg's ability to continue to attract new business is its long-term stability, underpinned by its consistent AAA credit rating.

Luxembourg for Finance CEO Nicolas Mackel said: "Luxembourg's proposition to the global financial sector is stronger than ever. We are known as a cross border focused centre and this status has only been underscored by Brexit. Our offer is also constantly evolving to meet the future needs of finance, which means continuing to curate a modern, ambitious and outward looking financial centre, that provides clear development plans and practical support."

London is the world's premier financial centre, and many of us want to keep it that way

News in brief

- Covéa has cancelled its earlier plan to acquire property and casualty reinsurer SCOR saying that "a transaction with SCOR is no longer part of its strategic options".

- Swedish insurer Folksam has invested in a Nordic-Baltic "blue" bond protecting water resources and a Swedish green bond for sustainable housing. The two bonds have been invested in to achieve a risk-adjusted return on sustainable projects.

- The Investment Association (IA) has announced the launch of the first industry-wide consultation on sustainability and responsible investment. The purpose of the consultation is to seek the views of asset managers on key aspects surrounding sustainability and responsible investment, with the intention of bringing greater clarity to help savers and investors navigate and grant better access to this "growing feature" of the investment management industry.

- India's insurance sector is set to mark strong growth due to the country's economy and evolving regulatory regime, Moody's Investors Service has said. Robust GDP expansion, coupled with current low insurance penetration, is expected to support double digit growth for the non-life sector over the next three to four years, it said.

- The French Insurance Federation (FFA) and the German Insurance Association (GDV) have expressed their support in the creation of the Franco-German economic area with common rules.

Market sentiment holding up among insurers

Business values fall, however, for banks and building societies

Written by **Adam Cadle**

Market sentiment is holding up among insurers in the UK amid general falling sentiment among the rest of the financial services industry, according to the latest *CBI/PwC Financial Services Survey*.

There was a continued expansion in their business values, however by contrast, values were flat or falling for banks, building societies and specialist lenders, while investment managers reported the steepest fall in activity since the financial crisis.

Financial services firms - particularly banks, building societies and general insurers - see macroeconomic uncertainty as the most important challenge over the year ahead, ahead of regulatory compliance and preparing for the impact of Brexit.

Profits in the financial services sector as a whole were remained flat for a third successive quarter, reflecting little change in business volumes and costs. Investment managers and general insurers reported declining profitability.

In the three months to March, overall profitability is expected to fall for the first time in over three years, as a result of a more widespread deterioration in expectations across the industry.

> It's clear the sector is grappling with a number of other challenges too, from using data to improve customer experiences, to new entrants to the sector. However, with new risks and demands come opportunities. Insurers in particular are pulling ahead

CBI chief economist Rain Newton Smith said: "A combination of macroeconomic and Brexit uncertainty, regulatory compliance and global market volatility are taking a toll on the UK's financial services sector. Financial services are a bellwether for the wider economy. The persistent weakness in optimism and the deterioration in expectations sound a warning for the outlook.

"It's clear the sector is grappling with a number of other challenges too, from using data to improve customer experiences, to new entrants to the sector. However, with new risks and demands come opportunities. Insurers in particular are pulling ahead, many of whom are moving into areas such as asset management outside of their traditional markets."

Following the publication of the results from the European Insurance and Occupational Pensions Authority's (EIOPA) 2018 Insurance Stress Test, Insurance Europe deputy director Olav Jones emphasised the "strength of Europe's insurance industry".

Jones brought attention to Europe's insurance industry baseline SCR coverage of over 200 per cent, along with an Assets over Liabilities (AoL) ratio of 109 per cent.

"The purpose of this test is to provide information on financial stability under adverse market developments. EIOPA chose in fact very extreme scenarios, for example the yield curve down scenario includes an interest rate which is equivalent to assuming zero European growth for the next 100 years," he said.

"The results confirm that, even under the very extreme scenarios applied, the industry would pose no concerns over their ability to pay claims, with the overall AoL ratio remaining above 106% for even the worst scenario."

Furthermore, Insurance Europe noted that it is important to recognise that the regulatory framework for the insurance sector, Solvency II, is already a comprehensive risk-based system which sets conservative capital requirements by covering all the risks that insurers are exposed to.

These capital requirements are based on stress scenarios applied to assets/liabilities and calibrated with extreme1-in-200 year type events and are publicly reported.

Insurance Europe welcomes new budget proposals for EIOPA

Suggestions include increased scrutiny from the European Parliament and the Council of the EU

Written by **Adam Cadle**

Proposals to link EIOPA's budget more closely to its actions, with increased scrutiny from the European Parliament and the Council of the EU, and to maintain a minimum of 35 per cent of EIOPA's funding from the European Commission have been welcomed by Insurance Europe.

Following the vote in the European Parliament's Economics and Finance Committee (ECON) on its report on the review of the European supervisory authorities (ESAs), Insurance Europe deputy director general Olav Jones said: "We welcome several of the proposals in the report, which could make EIOPA more accountable and give it a clearer mandate. The proposals also maintain the power of local supervisors to do their job, while enabling EIOPA to make better use of its existing powers."

> The proposals also maintain the power of local supervisors to do their job

Jones added that it is "also positive that national supervisors, rather than EIOPA, remain responsible for the oversight of internal models".

"The close links between an insurer's model and its risk profile mean that such oversight must remain with the lead supervisor. However, Insurance Europe recognises that EIOPA could, if requested by a supervisor, provide its advice and help resolve disagreements.

"The report's proposals on EIOPA's mandate are also welcome. Given that several of EIOPA's previous own initiatives have raised questions over its prioritisation of resources, it is important that EIOPA's work — including guidelines and recommendations — are strongly tied to its legislative mandate".

Bermuda-based (re) insurers continue to be tested

Heightened catastrophic losses and U.S tax reform hit industry

Written by **Adam Cadle**

Bermuda-based (re) insurers continue to be tested by challenging market conditions, including heightened catastrophic losses and diminishing competitive advantage resulting from U.S tax reform, according to Fitch Ratings.

However, the Bermuda market remains resilient given its strong global position, demonstrated underwriting expertise, robust and effective regulatory backdrop and Solvency II equivalence.

Mergers and acquisitions for Bermuda (re) insurers are expected to continue as larger and smaller players face the realities of economies of scale. Smaller, marginalised players have exited the market due to profit and growth challenges, while larger ones see increasing difficulties in attaining organic growth. Business combinations, while providing potential upside, are not without risk. Synergies are dependent upon the appropriate valuation of target companies, the level of integration risk and adequacy of reserves, among other considerations.

Internal models remain most accurate measure of insurers' risks - RAB

Also seen as the best driver of good risk management

Written by **Adam Cadle**

Internal models remain the most accurate measure of insurers' risks, the best driver of good risk management and the most appropriate basis for comparing risks between companies, according to a group of Europe's largest reinsurers.

The Insurance Europe Reinsurance Advisory Board (RAB) has published an overview of the benefits of insurers' use of internal models, entitled *Internal models: A reinsurance perspective*, stating that "while the resource demands of internal models are considerable, these costs are for many companies significantly outweighed by their substantial benefits in terms of companies' and supervisors' understanding of risks".

The report added: "The diversity of internal model approaches compared to a framework in which all reinsurers are obliged to use a standard model approach increases financial stability.

"Like all risk measures, models need to be adapted over time to reflect the emerging risk landscape. However, internal models are a much more flexible tool for this purpose than standard approaches, which frequently reflect market-wide political compromises and may therefore be more difficult to update."

The RAB said it encourages EIOPA and national supervisors to maintain a dialogue on national markets' experiences of internal model approval in order to document and encourage best practices.

> Models need to be adapted over time to reflect the emerging risk landscape

On the issue of risks, a report from De Nederlansche Bank (DNB) has revealed that the Dutch financial sector is exposed to environmental and social challenges, in addition to climate-related risks.

According to the study, pension funds, insurance companies and banks show interest in the sustainability sector but that they could take further action to integrate those ambitions into their operational management.

The DNB study has looked at the investment and loans portfolios of ten of the largest pension funds in the Netherlands, as well as ten banks and five insurers. It found that human rights controversies arise regularly around businesses in which the industry invests.

DNB said various guidelines have been drawn up over the past few years which aim to counter human rights malpractices which the pension, insurance and banking sectors have signed and agreed to.

"Media reports on human rights controversies can expose financial institutions to reputational risk. For these and other reasons, the study stresses the importance of these guidelines," DNB said in its statement.

The central bank found that water stress risks related to availability of fresh water around the world, could affect institutions, as the Dutch financial sector has invested at least €97bn in businesses operating in extremely water-scarce regions. The institutions have invested €56bn in businesses dependent on the most critical raw material which will be affected by consumption growth and the use of technology. DNB said scarcity or geopolitical factors could increase supply risks, which, in turn, could affect financial institutions.

Britain and Switzerland strike post-Brexit deal for insurers

Agreement will allow insurers to trade freely between the two countries

Written by **Adam Cadle**

Britain and Switzerland have struck a deal allowing insurers to trade freely between the two countries post-Brexit, Britain's finance ministry has said.

The agreement will replicate the effects of the EU's insurance agreement with Switzerland. British finance minister Philip Hammond, and Swiss Confederation president Ueli Maurer, signed the agreement at the World Economic Forum in Davos, Switzerland.

"Links to financial industries like the Swiss insurance market are important for global financial systems and it's vital that trade continues between our two countries so firms have the certainty they need to continue to do business and invest in the UK's bright future," Hammond said in a statement.

The agreement allows insurers to open branches in each other's jurisdictions. In January, MPs voted to eliminate the possibility of the UK leaving the EU without a deal.

It was Tory MP Caroline Spelman and Labour MP Jack Dromey that put forward the suggestion to attempt to prevent a no deal Brexit, and it gained support from MPs by eight votes

However, the vote is not only legally binding; it confirmed the view of the majority of MPs.

Prime Minister Theresa May has announced that she plans to re-open negotiations in Brussels with an "emphatic message" of what MPs need.

Commenting on the latest votes in Parliament, Association of British Insurers (ABI) director general Huw Evans said: "While further delay does nothing to relieve the uncertainty hanging over the country, it is at least encouraging to see Parliament saying it won't support a no-deal outcome.

Links to financial industries like the Swiss insurance market are important for global financial systems

FCA publishes new rules and guidance for fund managers

Aim is to improve the quality of the information available to consumers

Written by **Oliver Wade**

The Financial Conduct Authority (FCA) has published new rules and guidance to improve the quality of the information to consumers about the funds they invest in.

The regulator reported that its asset management market study revealed evidence of weak price competition in many areas of the asset management industry, resulting in lower returns for savers, pensioners and other investors.

Over £1trn is managed for individual investors, while £3trn is managed on behalf of UK pension funds and other institutional investors.

In April 2018, the introduced new rules to ensure fund managers act as agents of investors in their funds, with the latest rules and guidance designed to complement the work carried then by helping consumers gain a more comprehensive understanding on how their money is being managed, therefore allowing them to make better investment decisions.

Largest brokers refuse to rule out support for giant Adani coal mine

Decision comes despite growing opposition to the project among insurers and financial institutions

Written by **Adam Cadle**

The world's largest insurance brokers have refused to rule out support for the giant Carmichael coal mine in Australia, despite growing opposition to the project among insurers and financial institutions, according to Unfriend Coal.

A total of 73 organisations with a combined membership of more than 76 million wrote to Marsh, Aon, Willis Towers Watson, the JLT Group and Arthur J. Gallagher, who dominate the global brokerage market, calling on them to publicly rule out providing services to the mine.

Unfriend Coal said although the first four have all made climate pledges, none of them gave any commitment not to support Carmichael.

Unfriend Coal campaign coordinator Peter Bosshard, said: "Brokers' climate pledges are worthless if they continue to undermine global climate targets by supporting coal expansion. All actors playing a critical role in the global economy have a responsibility to bring their businesses in line with the Paris Agreement. The Unfriend Coal campaign will pay closer attention to the role of brokers in 2019."

Ten of the world's foremost insurers have either ruled out insuring the mine or pledged not to cover new coal projects. More than 37 other global financial institutions have publicly rejected any involvement in the mine.

Willis Towers Watson was the only broker to respond to the NGO letter. It stated it does not comment on specific projects as a matter of principle and refused to rule out support.

On the other side of the coin, a number of the industry's insurers have teamed up with the UN and the WWF to create a pioneering insurance industry guide to protect the planet's most special places.

The main aim is to provide practical guidance to insurers on how to prevent or reduce the risk of insuring and investing in companies or projects whose activities could damage World Heritage Sites.

This follows the 2018 launch of the world's first insurance industry statement of commitment to protect World Heritage Sites developed by UN Environment's Principles for Sustainable Insurance Initiative (PSI), WWF and the UN Educational, Scientific and Cultural Organisation (UNESCO) World Heritage Centre.

UN Environment PSI lead Butch Bacani said: "By working together with UN Environment, WWF and UNESCO to develop the first insurance industry guide to protect World Heritage Sites, insurers from around the world are demonstrating unparalleled leadership and raising their sustainability ambition as risk managers, insurers and investors.

"This is a clear signal from the insurance industry that protecting the priceless and irreplaceable assets that make up our world heritage goes hand in hand with insurable, investable and sustainable business."

To develop the insurance industry guide, the PSI and WWF will be collaborating with the UNESCO World Heritage Centre; ECOFACT, a sustainability service provider; and the founding signatories to the statement of commitment, which include leading insurers—representing about $170bn in gross premiums written and $2.7trn in assets under management—as well as insurance associations and key stakeholders.

> Sustainability risks should be considered in relation to the undertaking's risk profile

'SII already supports the integration of material sustainability risks', body argues

Insurance Europe says SII provides requirements on governance

Written by **Adam Cadle**

Solvency II does not represent an obstacle to the integration of sustainability risks, according to Insurance Europe's response to a consultation on EIOPA's draft technical advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and the Insurance Distribution Directive (IDD).

Insurance Europe said Solvency II already provides requirements on governance, risk management and investment decisions and those requirements apply to all material risks, including sustainability.

Regarding EIOPA's proposals to amend specific elements of Solvency II, Insurance Europe called for consideration of proportionality in the proposed requirements. It added that the environmental, social and governance (ESG) preferences of policyholders should be taken into account under the IDD instead of Solvency II.

Concerning the whole set of proposed changes, Insurance Europe said it would like to raise the following points. Sustainability risks should refer to financially material risks that might affect the risk profile of the undertaking, it said.

"Given the lack of a commonly accepted definition of sustainability risks and the fact that the legislation on sustainable finance is under development (eg sustainability taxonomy and disclosures), the definition of sustainability risks should be flexible and should provide insurers with sufficient methodological freedom to deal with these risks, in line with their risk appetite.

"Sustainability risks should be considered in relation to the undertaking's risk profile. As Solvency II has been designed as a risk-based framework with the objective of protecting policyholders, any proposal to change the framework should ensure that it remains risk-based. The inclusion of sustainability risks, where relevant, should be integrated in the already existing Solvency II requirements and not exceed them. Indeed, Solvency II already provides requirements on governance, risk management and investment decisions and those requirements apply to all risks. In addition, sufficient flexibility is key to allow insurers to integrate sustainability risks in their business model in a feasible manner. Proportionality in the Solvency II framework is key. When including sustainability risks in the Delegated Regulation, explicit references with regard to proportionality considerations should be reflected in EIOPA's proposals. EIOPA should recognise the current sparseness of data which represents an obstacle to monitor sustainability exposures. Information and related data would need to be available and transparent across the whole financial sector and various markets players."

> The IASB has tried to avoid an overly prescriptive approach, referring in its proposals to the exercise of judgement and 'a systematic and rational' basis

IASB proposes key amendments to IFRS 17 Insurance Contracts

Changes look to ensure reinsurance remains attractive as a risk mitigation

Written by **Adam Cadle**

The International Accounting Standards Board (IASB) met on 23 January and proposed amending key aspects of IFRS 17 Insurance Contracts.

In late 2018, the IASB agreed to reopen certain aspects of IFRS 17 Insurance Contracts as one of its highest priority activities, following concerns raised by the insurance industry and other key stakeholders. As a result, the IASB agreed to propose a one-year delay to the effective date of IFRS 17 to 1 January 2022.

Further to this, at a recent meeting and while reflecting on insurance industry feedback, the IASB agreed by a significant majority to propose four key IFRS 17 amendments.

These included changing the accounting of proportionate reinsurance held in respect of onerous insurance contracts; where reinsurance is held, to remove the accounting mismatch found in the original IFRS 17 standard in relation to the impact of financial movements over time; enable deferral of some insurance acquisition cash flows for newly issued contracts; and recognise both the insurance and investment components in setting the profit recognition patterns to help avoid distortions, for those insurance contracts containing both an insurance and investment component.

Commenting on the proposed amendments, Willis Towers Watson senior director Kamran Foroughi: "We welcome the IASB's pragmatism. The reinsurance decisions will help ensure reinsurance remains attractive as a risk mitigation / funding activity and avoid unintended consequences such as raising barriers for new entrants.

"In supporting these changes, the IASB has tried to avoid an overly prescriptive approach, referring in its proposals to the exercise of judgement and 'a systematic and rational' basis," added Foroughi. "The Board acknowledged that in making these changes there may be a resulting increase in complexity, albeit outweighed by the benefits arising from reflecting the economic substance. As a result, preparers will need to consider carefully how to interpret the standard. In some cases, this may require significant additional analysis to be performed.

"It is clear from the latest IASB meeting that insurers should keep going with projects ensuring they are on track for a 2022 implementation, with the direction from the IASB becoming much clearer and only a small number of topics outstanding.

"Although these proposed changes largely stem from industry feedback, the effort required to understand and assess their impact should not be underestimated."

Institutional investors to 'considerably expand' cryptocurrencies

'Bearish sentiment' of last quarter in 2018 now 'behind us', deVere Group says

Written by **Adam Cadle**

Throughout 2019, institutional investors, excited by the prospect of greater regulatory clarity, are going to drive "considerable expansion" of the cryptocurrency market in 2019, according to deVere Group founder and chief executive Nigel Green.

Recently, the three largest digital currencies, Bitcoin, Ethereum and XRP have climbed 4 per cent, 12 per cent and 3 per cent, respectively.

Green noted that he believed the "bearish sentiment" of the last quarter in 2018 is now "behind us" and he expects the current upswing to continue. Though, he acknowledged that there is sure to be "peaks and troughs as in any financial market".

"In 2019, the cryptocurrency market is set to radically evolve. We can expect considerable expansion of the sector largely due to inflows of institutional investors," the deVere founder added.

Green has predicted that major corporations, financial institutions, governments and their agencies, prestigious universities and household name investment firms are going to bring their institutional capital and expertise to the crypto market.

According to Green, the "acceleration of institutional investment" is likely to be driven by greater regulatory clarity.

"More and more global jurisdictions can be expected to join the likes of Malta, Hong Kong, Japan and Switzerland in becoming crypto-friendly from a regulatory and pro-business viewpoint."

> In 2019, the cryptocurrency market is set to radically evolve

Whilst Bitcoin, the world's largest cryptocurrency by market capitalisation, will remain dominant this year, Ethereum and XRP, due to their unique characteristics and problem-solving traits, can be expected to significantly fuel the 2019 upswing, the deVere CEO affirmed.

Green highlighted: "The smart contract abilities of Ethereum are already unrivalled. More and more institutional investors will be making use of these capabilities this year. Also, once Ethereum can accept outside data in its smart contract protocols, its price will rocket further.

"When it comes to XRP, hundreds of financial institutions across the world are already working with it and this is a trend that is set to continue and grow in 2019."

Just last year, the Prudential Regulation Authority (PRA) wrote to chief executives of insurance firms, banks and investment firms warning them to tread carefully when investing in cryptocurrency assets, such as Bitcoin, amid fears that it could leave them exposed to money laundering terrorist financing.

The head of the PRA Sam Woods wrote to the chief executives "to remind them" of PRA rules and expectations regarding their firm's "exposure to crypto-assets".

However, Woods stated that he was aware that some companies have already taken staked in crypto-assets, and are interested in the technology that underpins cryptocurrencies such as Bitcoin, commonly referred to as the blockchain or distributed ledger technology.

People on the move

NICHOLAS GARTSIDE

Munich Re, CIO

The Supervisory Board of Munich Re has appointed Nicholas Gartside as member of the Board of Management. As CIO, he will be responsible for the whole asset management of Munich Re (Group) starting on 18 March 2019. Gartside is currently managing director at J.P. Morgan Asset Management in London, where he is international chief investment officer of the global fixed income, currency and commodities group.

COLIN FORREST

Willis Towers Watson, Regional Leader, EMEA

Colin Forrest will take on the role of regional leader for Europe, Middle East and Africa (EMEA) in Willis Towers Watson's insurance consulting and technology business. Forrest takes over from Frank Schepers who, following a successful tenure leading and transforming the EMEA business over the past few years, has chosen to step into a new role managing large client engagements.

OLIVIA WATSON

Columbia Threadneedle senior analyst

Columbia Threadneedle Investments has appointed Olivia Watson as senior analyst and Jess Williams as portfolio analyst in the responsible investment team, based in London. Watson joins from the Principles for Responsible Investment. Williams was previously at S&P Global Ratings. A total of 12 investment professionals now make up the responsible investment team within the firm.

HAMID ASSEFFAR

ETF business development team, Invesco

Invesco has strengthened its London-based ETF business development team with the appointment of Hamid Asseffar. Asseffar will focus on growing Invesco's ETF business with UK asset managers and family offices. He joins Invesco from Amundi where he was a sales and marketing associate within the ETF, indexing and smart beta team.

CLIVE BOLTON

LV= managing director for life and pensions

LV= has recently appointed former Aviva retirement specialist Clive Bolton as managing director for life and pensions, subject to regulatory approval. He is currently a consultant with the International Longevity Centre, while also acting as a non-executive member of the civil service pension scheme advisory board. Bolton is replacing John Perks, who is joining Police Mutual Group.

COLIN DUTKIEWICZ

Aon global head of life, resinsurance solutions business

Aon has appointed Colin Dutkiewicz as global head of life for Aon's reinsurance solutions business. Based in London, he will draw upon his extensive market experience to bring together Aon's regional resources to maximise the power of its global life capability and grow revenues. In addition, he will develop and manage the firm's long term vision to increase cooperation across regions.

Opinion

On Luxembourg's offering to the global financial sector

Luxembourg's proposition to the global financial sector is stronger than ever. We are known as a cross border focused centre and this status has only been underscored by Brexit. Our offer is also constantly evolving to meet the future needs of finance, which means continuing to curate a modern, ambitious and outward looking financial centre, that provides clear development plans and practical support. The progress we have made over the last year in sustainable finance, digitalisation, and in deepening relationships with global brands and major economies like China is testament to that approach

Nicolas Mackel
Luxembourg for Finance CEO

On responsible investing

"There is a growing consensus among financial regulators, asset managers and end investors to invest responsibly. Excluding companies with any involvement in the production of controversial weapons is a key part of that. Such weapons – which include cluster munitions, anti personnel mines, as well as chemical biological and nuclear weapons – may cause indiscriminate or disproportionate harm."

Letter sent to global index providers from over 140 asset- and wealth management firms

On brokers supporting coal expansion

Peter Bosshard
Unfriend Coal campaign coordinator

"Brokers' climate pledges are worthless if they continue to undermine global climate targets by supporting coal expansion. All actors playing a critical role in the global economy have a responsibility to bring their businesses in line with the Paris Agreement. The Unfriend Coal campaign will pay closer attention to the role of brokers in 2019."

On the benefits of investing in Ethereum

Nigel Green
deVere Group founder and chief executive

"The smart contract abilities of Ethereum are already unrivalled. More and more institutional investors will be making use of these capabilities this year. Also, once Ethereum can accept outside data in its smart contract protocols, its price will rocket further. When it comes to XRP, hundreds of financial institutions across the world are already working with it and this is a trend that is set to continue and grow in 2019."

On climate change

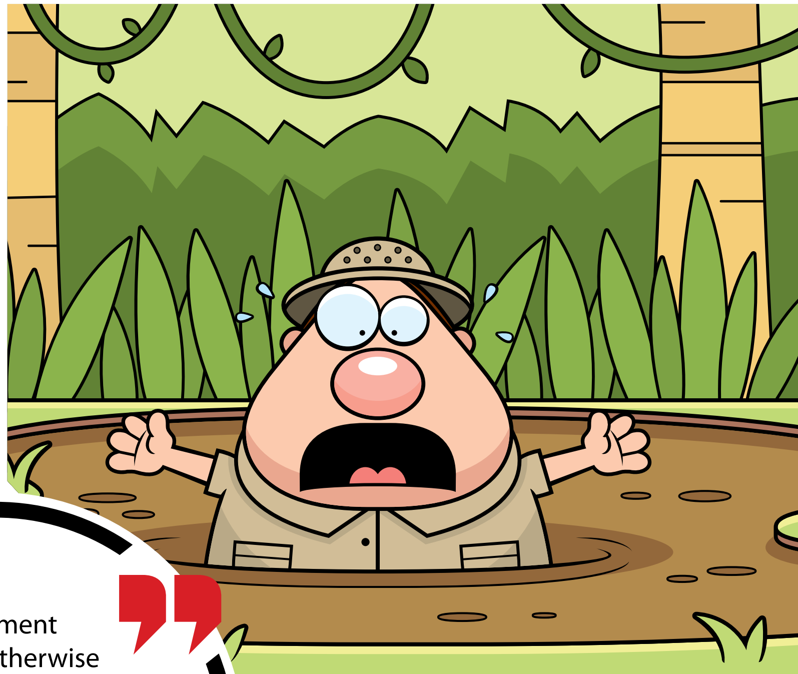
Robert Blood
SIGWATCH founder and managing

"It is unsurprising that consumer-facing companies are responsive to activists' concerns, as we know they feel their customers care about such issues and they want to protect their brands. However, it is new to see financial institutions joining them. Undoubtedly this is because they are facing up to the reality of climate change and believe they cannot avoid their responsibility to use their market power to make a difference."

Soapbox

Treading quicksand?

Written by **Adam Cadle**



A large percentage of the ideas and thoughts I have on the global insurance space arises from industry networking. Lunches, dinners, seminars and presentations provide me with the necessary material to keep the website and magazine updated with timely and thought provoking news and features that have the ultimate aim of informing our readership.

Having spoken to a number of heads of insurance over the past couple of months, one particular area has stuck out like a sore thumb - engagement.

Now, in an environment where the insurance industry has to deal with a number of challenges and hurdles - IFRS 17, Solvency II requirements and Brexit, to name but a few, the term ‘engagement’ appears to be rather a simplistic notion. It’s not. The heads of insurance and a variety of asset managers all accentuated the point that there is simply not enough engagement between regulatory bodies, insurers and indeed their clients. They were of the opinion that even when a regulatory spokesperson is encouraged to divulge information about projects, thoughts around industry improvements etc, they are bound by strict policy that allows them to do quite the opposite and hardly portray any message at all.

At a time when an increasing amount of regulation continues to swamp the market, some of which is arguably not necessary at all, there needs to be clear and transparent explanations between governing bodies and regulators about what exactly a new piece of legislation means for a particular firm such as an insurer. Engagement is crucial. Otherwise you end up having a sea of firms left behind, treading quicksand, struggling to make sense of large wads of paperwork.

Engagement is crucial. Otherwise you end up having a sea of firms left behind, treading quicksand, struggling to make sense of large wads of paperwork

Where engagement does work particularly well in the industry is around the issue of sustainable investing. It wasn’t too long ago that sustainable investing was not even within the thoughts of insurers and asset managers when constructing investment portfolios, but now like most of the institutional investment space, the matter is very much at the forefront of thinking. This is not just down to luck or coincidence. This is a case of the industry engaging well. Associations are very keen on spreading the message of sustainable investing to their members, and when the insurer or asset manager realises that they can reap the same returns investing sustainably as opposed to maybe a ‘sin stock’ investment, the bond is truly cemented. Although maybe not quite as advanced in the ESG space as pensions, the insurance industry is disclosing evidence of investing in this area and uses a wide range of screening processes on an increasingly regular basis. This can only be beneficial. I would argue that insurance companies aren’t treading quicksand so much in the sustainability field however. Why can’t this be the case therefore around specific regulatory policies?

Maybe we need a whole load more Sir David Attenboroughs’ in the industry to get levels of engagement at an absolute peak for other industries to take note of.

Climate change crossroads

How insurers can help lead the way with smarter investments

AXA IM GLOBAL HEAD OF RESPONSIBLE INVESTMENT, MATT CHRISTENSEN

THE escalating threat of climate change means business leaders and policy makers rapidly need to take collective action.

The contribution that corporations, and indeed the world at large, need to make to mitigate climate risk was brought sharply into focus recently.

At last December's United Nation's COP 24 Climate Conference in Poland, delegates were warned that the planet has reached a tipping point, as greenhouse gas emissions were once again on the rise, for the first time in four years.

The UN's 2018 Emissions Gap Report revealed that global CO2 emissions from industry and energy production went up by 1.2% in 2017, largely because of economic growth. But equally it seems that national efforts to cut carbon emissions have stalled.

The Intergovernmental Panel on Climate Change (IPCC) report highlighted that to avoid irreversible and catastrophic damage to the planet, global temperatures must not go up by more than 1.5°C. And according to the UN, to keep the world below that threshold, global greenhouse gas emissions must be 55% lower than they are today, by 2030.

But while COP 24, delivered some results, there was also disappointment. While delegates did sign an historic agreement on the Paris Climate Agreement rulebook, the event was marred by a lack of a political declaration on the urgent need to scale up countries' emission reduction commitments.

Large emitting countries such as the US, Saudi Arabia and Russia rejected calls from the majority to welcome the findings of the IPCC's report.

Tackling the threat

AXA IM Global Head of Responsible Investment, Matt Christensen, believes that the international business community and especially the insurance industry, can take a leading role in encouraging moves towards a more sustainable global economy.

He explains: "The insurance industry is uniquely well placed to influence and give momentum to sustainability efforts. And that applies to participants across all lines of business.

"It should include all key functions in an insurance company, from risk management and underwriting, through sales and marketing – and especially investing."

Christensen, who directs the development of AXA IM's responsible and impact investment programme, is also tasked with integrating Environmental, Social and Governance (ESG) criteria across the firm's €740bn of assets under management[1].

His role includes developing innovative solutions that help AXA IM's insurance clients invest sustainably while meeting their financial, accounting and regulatory needs.

Christensen says: "Of course insurers have a vested interest in future proofing their business models against catastrophic climate change, but they can drive positive changes for society in other ways too, via accountability and transparency, for example."

Leading the way

Christensen believes that together insurers and investment managers can make a big difference to climate risk, pointing to guidance put in place by the UN, as a starting point.

The cornerstone framework for the insurance sector consists of the UN Environment's Finance Initiative Principles for Sustainable Insurance (the PSI Initiative). Its aim is to prevent and reduce ESG risks, and better manage opportunities, to provide quality and reliable risk protection.

Co-founded by 27 organisations in 2012, it now has around 100 members worldwide, including insurers, representing around 20% of global premium volume, and US$14 trillion in assets under management.

Members, like AXA, of the PSI's new Climate Ambition Coalition, which starts this year, have further committed to taking action on decarbonisation and climate resilience in their insurance and investment activities.

Christensen believes there's plenty of scope for insurers of all sizes to start making a bigger difference through smarter investment decisions, with help from their investment advisers and partners.

From ESG to Impact

AXA IM is a leader in the ethical and sustainable investment domain, launching a fund in France in 1998, which integrated specific screening criteria.

"Today, ESG criteria are progressively being integrated into our investments irrespective of the asset class - across equities, bonds, high-yield, property, alternatives and so on," Christensen says. "As a responsible investment leader and as an investment manager with insurance heritage we're uniquely positioned to advise clients."

"Being an early starter in sustainable insurance investing, we have developed the resources to help clients drive change through their investments. Not only that, we're firm believers that ESG analysis can offer improved risk-adjusted investment returns, that are greater over the long term."

Christensen, who is in dialogue with AXA IM clients around the world, finds the pace at which responsible investing is developing varies across the global insurance markets.

He notes that while some insurers are just starting out, others are beginning to align their investments with core values and business lines, for example in divesting fossil fuels. A number of insurers are going further still, moving beyond ESG risk management onto impact investing opportunities.

Christensen says: "Impact investing solutions focus on financing innovative businesses and projects that are designed to have intentional, positive, measurable and sustainable impacts on society and the environment, while simultaneously delivering financial market returns.

"As an active practitioner in impact investing since 2013, we have seen substantial market growth over the past five years - in both public and private markets - creating a deeper and broader opportunity set."

"The environmental and societal challenges the world faces today are of a scale that requires ambitious collective action and we believe this rapid expansion and development is set to continue and indeed accelerate in 2019 and beyond."

Bonds go green

Green bonds are just one such growth area aiming to tackle climate risks.

Established in 2007, green bonds were developed to raise finance for climate change solutions. Over the past few years, rising awareness of climate change and the need to transition to a low-carbon economy has driven both bond issuers and investors alike towards the asset class.

The overall investment universe now stands at some US$235bn[2], having grown from a relatively small US$36bn in 2015. As the overall market has expanded, so too has the diversity of issuers, regions and sectors available to investors. Many sovereign issuers have emerged over the past year, with France and Poland opening the way in 2017, and subsequently Belgium and Indonesia in 2018.

Green bond issuers are expected to clearly identify the projects that they will finance upfront and provide reports that monitor each projects' environmental benefit. This transparency of proceeds is a key feature of green bonds as it enables investors to assess the positive impact of their investment and to measure their performance beyond just financial returns.

Harnessing technology

Investing directly in technological solutions to climate change, such as renewable energy projects, energy efficiency and storage, as well as the wider infrastructure and services that support them, is another route being explored by some insurers.

A new urgency

Christensen's conversations with insurance carriers worldwide have started to take on a new urgency, in response to the human and economic toll of recent natural catastrophes - like the historic wildfires in California.

"Taking a lead role in mitigating climate change is no longer a 'feel good' issue for insurers - it's a social issue and it's a business issue," Christensen stresses. "The insurance industry has the resources and expertise to make a real difference and I'm proud to be a part of it at such a time as this."

In association with

AXA Investment Managers

[1] *As at 30 September 2018* [2] *Merrill Lynch Green Bonds Index as at 30 November 2018*

A race against time

David Adams analyses whether insurers are prepared for IFRS 17, the sticking points that might prevent some from being so and what still needs to be ironed out

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

It's possible that nobody will ever be heard to say: "If only I was as dynamic as an insurer or an accountant."

Yet professionals working in these industries know that despite their shared reputation for caution, both accountancy and insurance companies can be dynamic, when plotting commercial or investment strategies in challenging market conditions, for example – and when a requirement for dynamism is thrust upon them.

This is what happened in May 2017, when the International Accounting Standards Board (IASB) issued the text of IFRS 17, the new financial reporting standard for insurance contracts that will replace IFRS 4 in most countries. Implementation of the standard represents a significant change in the way different types of insurance contracts are treated in accounting, with premium values no longer considered to be top line investment components and a separation in presentation of underwriting from presentation of finance results.

Preparing for implementation is forcing many insurers to carry out a major overhaul of processes and systems; and industry bodies and experts have expressed reservations about some elements of the standard. Some possible amendments have been suggested by EFRAG (the European Financial Reporting Advisory Group) following its testing of the standard.

The likely need for amendments has inspired some dynamism within the IASB too: in November 2018 it announced a delay to the implementation deadline, pushing the effective date back 12 months to 1 January 2022. It also announced that insurers qualifying for deferral of IFRS 9 (accounting for financial instruments), could extend deferral for a further 12 months, so insurers will apply both standards in 2022.

Insurers and professional service firms welcome the delay. A spokesperson for Aviva says the issues identified in field testing, "provided factual evidence demonstrating that the standard must not be endorsed as is and needs to be reopened to enable the issues to be fixed".

"By taking more time we have the opportunity to improve the standard and resolve operational complexity to reduce costs of implementation."

"It was the right thing to do," EY partner and global insurance IFRS lead Kevin Griffith states. "The clients I work with had timetables which got them to the 2021 implementation date, but there was no slack in those timetables. They would get over the line, but perhaps their controls might not have been as robust as they would have wanted."

> We have the opportunity to improve the standard and resolve operational complexity to reduce the costs of implementation

Ageing technology

Boston Consulting Group (BCG) partner and managing director Ofir Eyal believes some insurance companies are being hindered in their preparations for implementing the new standard by the limitations of ageing technology.

"That meant they were building something of limited effectiveness in terms of giving them the transparency they need; and limited efficiency in terms of what has to be done to get the [accounting] information out when required," he says.

There were some calls for implementation to be postponed for a further 12 months. In December 2018, a group of 11 international insurance associations, including Insurance Europe, sent a joint letter to IASB chair Hans Hoogervorst, calling for a delay of two years. They said this was needed to "give insurers enough time to have a successful global implementation … [which will be] critical to deliver the quality, decision-useful information that investors, analysts and other users are expecting".

Willis Towers Watson director, risk consulting, Roger Gascoigne welcomes the delay but thinks one extra year will be enough.

"It gives preparers more time to get to grips with some of the changes, which are quite complex, in accounts preparing and modelling," he says. "Most investors consider [IFRS 17] to be adding transparency and consistency, so don't want to delay it more than is strictly necessary. I think one year was a reasonable extension. Clearly, having taken so long to develop a standard that is intended to be applied globally, we want to make sure it's right and applied consistently."

At the time of writing, IASB was part of the way through a series of monthly meetings during which it will consider more than 20 possible amendments. Deloitte partner and global insurance IFRS leader Francesco Nagari points out that the IASB must act in accordance with established procedures: considering potential problems, voting on amendments, then reissuing an amended standard for further consultation. The delay, he stresses, "was not because they wanted to please the industry, it was because they decided there were some valid concerns around a narrow group of issues".

At its January 2019 meeting, the IASB voted in favour of four key technical amendments. The first would change the accounting of proportionate reinsurance held in respect of onerous insurance contracts.

The second addresses an accounting mismatch applying to instances where reinsurance is held to mitigate financial risk in contracts measured using the general measurement model.

The third would enable deferral of some insurance acquisition cash flows for newly issued contracts where there are related expected contract renewals. The fourth applies to insurance contracts that contain both an insurance and an investment component, measured using the general measurement model. It would recognise both components in setting profit recognition patterns.

The IASB said it would discuss further topics at its meetings in February and March, including one particularly controversial element, determination of the level of aggregation. It will also review the overall scope of the standard. Its stated aim is to issue an Exposure Draft on proposed amendments to the standard by the summer of 2019. This means the final draft of the amended standard may be available by the end of 2019 or in early 2020.

"Realistically it's unlikely that the things they change will result in significant adverse implementation impacts," says Griffith. "When the IASB has been going through these changes, one of its main principles is that anything it does decide to change must not cause significant disruption to anyone whose preparations are well underway.

> Those that are behind now have time to get moving, to make sure they will be compliant in time

"The companies that have less to do might not be quite so happy: they might say all this does is make us spend more money for an extra year. But the others will welcome this delay: the changes that are being made are largely ones they've asked for."

Confidence?

Research conducted by the Economist Intelligence Unit on behalf of Deloitte in March 2018 suggested that at that stage many executives working for insurers in Europe, North America and Asia were confident about meeting the original deadline. Nagari is certain this confidence is not shared by all insurers, but believes it does reflect the substantial amount of work insurers have put into implementation projects since 2017.

"From what we can see around the world, no insurance company is pulling their foot up from the pedal," he says. "They are focusing on the quality of the work they are doing, so they can capture the full benefits of doing this. Those that are behind now have time to get moving, to make sure they will be compliant in time."

Eyal believes some insurers will now put more work into revitalising IT infrastructures.

"Now we've got a little bit more breathing space, insurers should be asking: 'is this an opportunity to fix some of the financial systems we have, to make them flexible enough to accommodate changes to the regulation; and to make sure the systems can give us the reporting and the transparency we need to make decisions?'" he says.

"We are seeing clients who are saying 'I can use IFRS 17 as an opportunity'." The Deloitte research showed that 87 per cent of insurers believed their systems would require upgrades in order to capture the data and perform the calculations needed to achieve compliance.

Gascoigne doubts there will be any further extensions to the deadline. "This has been 20 years under development and probably on all sides now there's a desire to get it implemented," he says. "Probably we will now see discussions move away from technical, compliance issues to thinking about what this means for other stakeholders, including investors.

"I suppose there could be a financial crisis, which would get in the way – but I think even in that case, the IASB would say it's precisely because of this that we do need a better way of accounting." Indeed, as any of the wisest people working in insurance or accounting will tell you, dynamism is all well and good, but getting things right is what really counts.

With one voice?

The UK is a perfect example of how the dream of regulatory harmonisation may never be truly realised

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

In the 2017 — and most recent — version of the CSFI and PwC Insurance Banana Skins report, regulation did not appear as the number one concern for insurers for the first time since 2009. Instead, the issue dropped to sixth in the paper's list of risks, usurped by other worries such as change management and interest rates.

Although the report's headline views are based on a survey that aggregates views from every part of the globe, Europe's insurers were also happy to downgrade regulation's importance. The study puts this down to the attempted harmonisation of Europe's supervisory authorities through Solvency II. "While mastering regulation is still a tough challenge, there's a growing recognition that it's now only table stakes — the price of entry to the game," it said.

ABI head of prudential regulation in the UK Steven Findlay believes that insurance companies are now comfortable operating under the regime. "It was a significant step forward for harmonisation across the EU," he says. "Solvency I's previous basket of rules dated back to the 1970s and resulted in a real patchwork of rules and range of prudential regimes across the Single Market. We are now a lot more harmonised than we were at the start of 2016."

This accord is well illustrated within a UK context, where Solvency II has been rolled out with few glitches from a macro perspective. Its implementation has also come at a time when the country's two insurance supervisory bodies, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), seem to be writing the blueprint of how to operate a successful twin peaks regulatory system.

This collaboration was on show in October last year, when the two regulators simultaneously published papers in relation to financial risks and climate change. At the same time, they confirmed that they were planning to establish a climate change financial risk forum to advance insurance companies' approaches to managing the financial risks from climate change, suggesting that their Memorandum of Understanding is in fine working order.

> Efforts to harmonise the EU's regulatory landscape have left the UK, in particular, with new barriers to negotiate

"Despite a clear divide between the PRA and FCA, the organisations seem to work very well in tandem, with very little commentary around pitfalls," Pegasystems European insurance director Tony Tarquini states.

"Compared to the rest of the world, the UK is extremely well regulated and often viewed internationally as best in class."

Disharmony

Beneath the calm veneer however, disgruntled voices can still be heard.

Efforts to harmonise the EU's regulatory landscape have left the UK, in particular, with new barriers to negotiate. This is partly due to the UK's heavy reliance on investments that combine the holy grail of decent returns, low risk and liquidity. Although these are most in demand by life insurers due to their large annuity books, they are also sought after by general insurance divisions who have to honour periodic liability policy payments, for example. And as Dr Matthew Connell, director of policy and public affairs at the Chartered Insurance Institute (CII), explains, securing approval for innovative assets to back up such payment streams has proved taxing.

"Those type of low-risk high-liquidity promises tend to be backed up by government debt, but in some areas insurance companies are using fund managers to use more innovative strategies, such as consumer loans for car loans," he says. "That's an asset that if managed properly, can often produce a fairly predictable stream of income with a higher return, as it has slightly higher risk than government debt.

"Firms have been able to do that under Solvency II, but that kind of innovation takes up a lot of time and effort to justify what's been done to supervisors."

Meanwhile, Europe's overall efforts

at harmonisation have also not always followed the official PR campaign line either.

AMICE, for one, remains unhappy with the uneven adoption of Solvency II across the continent and the resulting possible effect on its mutual and cooperative members.

"Across Europe, there are some differences in regulatory regimes due to various factors such as national discretions and interpretation," AMICE's secretary general Sarah Goddard comments.

"AMICE has been focusing on the application of proportionality for the European insurance market for many years, and although this is highlighted as an importance aspect of Solvency II, its implementation at national level has been inconsistent. We would like to see best practice in proportionality to be shared among the European regulatory and supervisory community."

In an extensive report on the European mutual and cooperative market published last summer, the association lamented this piecemeal approach and blamed it for creating an unbalanced regulatory environment that leads to a "potentially unfair impact on policyholders in different member states, and has an additional consequence of creating barriers to entry for cross-border activities".

The passage of time however, offers cause for optimism. Connell argues that allowing regulation the room to bed itself down is sometimes the most important factor in determining its long-term success.

As he points out, when new regimes are in the early stages of implementation, those responsible for regulator liaison tend to tread very carefully. This sees insurers delivering meticulous explanations of their decisions, such as when they seek approval for new investment approaches. However, when these interactions become more routine under Solvency II, regulators will develop a sound knowledge of the judgements that have been made in the past, allowing them to streamline decisions.

"You get a dialogue going where both sides get to a common agreement about which key areas need justification and you can use convention from previous decisions," Connell says. "Then there's more of an instinctive feel for where the barriers are."

Regulatory imbalance

Nevertheless, the risks posed by regulation are still very real. While one regulator may eventually step away from forensic examination of certain asset allocation strategies, another may up its efforts in other areas, creating a possible imbalance.

In the UK, again, there is certainly a danger of this happening, according to Mark

Turner, managing director of the compliance & regulatory consulting practice at advisory firm Duff & Phelps. Following the 2007-2008 crisis, the focus of government, financial regulators and the public was heavily weighted to the banking sector,

which consequently experienced a period of intense regulation, covering both areas of prudential and conduct. Although it has had to deal with Solvency II, the same focus has not been applied to insurers. This could now change.

"The FCA may consider that some practices need to change — as they have done in the banking sector," Turner says. "This could be a painful process for the industry, and it is likely there will be tension at times."

The safest way to prepare for this possible extra scrutiny, Turner argues, is to embrace it. "It is important that the industry takes the opportunity to engage with the FCA in a constructive manner, and helps the FCA achieve its objectives in a way that supports an effective insurance sector, which is ultimately in the interests of the consumer, the industry and the regulators."

Post-Brexit

Several post-Brexit scenarios could also lead to further imbalance for the UK. The most likely, at present, is that the UK commits itself to a framework that is closely aligned to Solvency II. Under such a situation, Findlay pinpoints the European Commission's 2020 Solvency II review as a crucial juncture.

"That will be the first time that the long-term guarantees package will be back up for review," he says. "That's when you'll see concepts such as the matching adjustment and volatility adjustment back on the table.

"Seeing as the matching adjustment provides a significant benefit to the UK insurance industry on aggregate, ensuring that is preserved will be an important focus of the UK market for the 2020 review."

Any failure to maintain the matching adjustment could lead to further damage to the goal of harmonisation, particularly if the UK finds itself still adhering to the Commission's decisions as it negotiates the finer details of its withdrawal from the EU.

Similarly, if the UK opts to plot a different regulatory route post-Brexit by setting up an equivalence regime that mirrors that of the US or Swiss models, then it could find itself in a pitched battle with the European Commission.

"There's an argument that the UK can diverge a little from the EU and still be closer to the EU than the US is," Connell says. "However, there's the political dimension to consider. And once equivalence becomes politicised around the UK's future relationship with the EU, then the Commission may be more tolerant towards equivalent regimes that are converging, rather than going in the other direction and diverging, as the UK's may be."

In such an event, 2019's version of the Insurance Banana Skins survey could see regulation shooting up the rankings once more. In the UK, at least.

"There's an argument that the UK can diverge a little from the EU and still be closer to the EU than the US is

Thoughts from the regulator

Adam Cadle speaks to Bank of England executive director, insurance supervision, David Rule about the UK insurance market

WRITTEN BY **ADAM CADLE**

Q Can you explain your background and how you reached the position you are in today?

I joined the Bank of England from university in 1990. Since then I have supervised banks, taken time out to get an economics degree, helped manage the gilts market, overseen payments and settlement systems, analysed financial markets, reformed the sterling money markets, supervised banks again and developed banking and insurance regulations. I also had a period outside the Bank of England running a small trade association and then working at the Financial Services Authority. In 2016, I took on my current role leading prudential supervision of UK insurance companies.

Q Can you explain your thoughts on regulation within the insurance industry? Are we at a good level?

Solvency II is the framework for UK insurance regulation. Government has made laws so that this framework will continue essentially unchanged after the United Kingdom leaves the European Union. Solvency II was introduced at the start of 2016. Broadly speaking, it is working well. Some of the most important parts of Solvency II were drawn from the predecessor UK regime that was born out of UK experience, including the near collapse of Equitable Life in the early 2000s. Both regimes require firms to value assets at market prices; both require valuation of liabilities on a 'realistic' basis; both include the possibility for firms to determine capital requirements using their own group-wide stochastic modelling and scenario testing; and both set the same '1 in 200 years' target calibration for the level of capital an insurer should hold. A further key element of UK regulation is the Senior Managers Regime, which was extended to insurers on 10 December 2018. Insurers must allocate across their most senior executives and non-executives prescribed responsibilities, for which they are individually accountable.

Q What needs to be changed/ improved?

The Bank of England has said previously that the Solvency II risk margin is too sensitive to the level of long-term interest rates. This is particularly true for long-term insurance liabilities, such as annuities. At current levels of interest rates, the risk margin is too high. As a result, UK insurers have used reinsurance to transfer much of the longevity risk on new annuity business since the introduction of Solvency II.

Q Is there any major warnings you would issue to insurers across the UK in terms of investing in certain asset classes for example illiquid assets?

I don't have any warnings about particular asset classes. In general, insurers are required to manage assets in line with the Solvency II Prudent Person Principle. This includes that: "Assets shall be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole."

A notable market development over the past few years has been the shift in the composition of assets that life insurers hold to back annuities towards direct investments, or what are sometimes called 'illiquid assets'. These include commercial real estate loans, infrastructure financing and particularly equity release mortgages. Insurers typically hold these assets within portfolios meeting the requirements of the Solvency II Matching Adjustment, including that the assets and liability cashflows match and the assets have fixed cashflows. The Matching Adjustment is a significant regulatory benefit, allowing insurers to both hold lower reserves and have a lower capital requirement on the basis that the assets are held to maturity and therefore the insurer is not exposed to fluctuations in market prices. It is crucial, however, that insurers do not include within the Matching Adjustment the part of the yield on an asset that compensates them for risks to which they are exposed. Typically this retained risk is proxied using the rating of the asset. Traded assets are often rated by external rating agencies. Direct investments are normally rated internally by the insurer. A supervisory priority for the PRA is to ensure that these internal rating processes are robust and deliver ratings comparable to those of an external rating agency. That does not mean that every asset must have the same rating. But we do not expect to see an overall downward bias across internal ratings.

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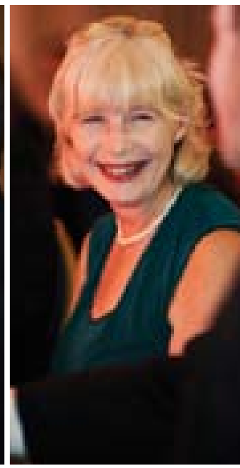

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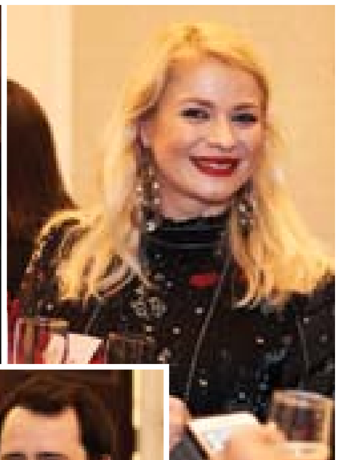

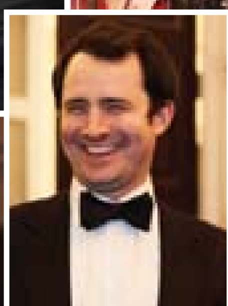

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OVERVIEW

The Insurance Asset Management 2018 Awards held at the De Vere Grand Connaught Rooms, London, rewarded all those who have excelled in the insurance industry and who have displayed exemplary levels of innovation in this space. Comedian Kerry Godliman conducted the evening, presenting trophies to all the winners. Congratulations to all the prize winners and a very well done to all those shortlisted firms.

Thanks must go to the Gold Sponsor of the awards Aon and the supporter, the Chartered Insurance Institute. The judges also played a huge part in helping to determine the winners.

We look forward to welcoming you all with open arms again in 2019 and rewarding all those that continue to excel in the insurance asset management and investment space.

Visit www.insuranceassetmanagement.net for more details and to read all the latest news and commentary.

JUDGES

Adam Cadle
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Insurance Asset Management

Bruce Porteous
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Standard Life Investments

Matthew Connell
Director of Policy and Public Relations
Chartered Insurance Institute

Hugh Savill
Director of Regulation
Association of British Insurers

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INSURANCE ADVISORY FIRM OF THE YEAR
EY

INNOVATION PROVIDER OF THE YEAR
Morgan Stanley Investment Management

CHIEF INVESTMENT OFFICER OF THE YEAR - sponsored by Aon
Guillermo Donadini, AIG

ACTIVE MANAGER OF THE YEAR

Morgan Stanley Investment Management

Morgan Stanley

INVESTMENT MANAGEMENT

The Active Manager of the Year Award recognises the manager that has demonstrated consistent outperformance and an innovative approach to its investment strategy.

With its strong proven performance in active funds, demonstrating consistent value add, according to the judges, the clear winner is Morgan Stanley Investment Management (MSIM). Its overall efforts in active management, the breadth of its actively managed strategies in conjunction with efforts to integrate insurers' objectives and Solvency II requirements, and its number one ranking in AUM for non-affiliated insurance actively managed equity mandates[1], makes MSIM an exemplary firm.

MSIM has a range of active fundamental equity investment teams who manage several strategies. All teams are dedicated to their own unique research approaches and core investment principals.

For the purpose of representing equity capabilities in this award category, MSIM has presented the Global Opportunity equity fund which, in the 12 month period ending 30 June 2018, produced outstanding performance.

As of 30 June 2018, the team managed £16.4bn in assets under management of which £850m is managed on behalf of global insurance clients.

The fund seeks to hold 30 to 45 positions with its top 10 holdings generally accounting for 50% of portfolios. The result is an active portfolio that looks very different from the benchmark, with active share generally 90% or higher, and tracking error ranging from 5% to 10%.

The Global Opportunity fund is managed by Kristian Heugh within the Counterpoint Global platform. The team has a strong culture, with guiding principles and core values. The investors are organised to encourage creative and collaborative decision-making and MSIM believes this contributes to their low turnover.

The team's culture, perspective and insight have produced superior results for clients over time. Indeed, the Global Opportunity strategy as represented by the MS INVF Global Opportunity Fund Class Z has achieved attractive absolute and relative net returns for all rolling 3-year periods since its inception on 30 November 2010 through to 31 March 2018. Congratulations.

[1] *Survey published by Insurance Asset Outsourcing Exchange: "Insurance Investment Outsourcing Report", 2017 edition. Figures provided as at date of award submission*

INNOVATION PROVIDER OF THE YEAR AWARD

Morgan Stanley Investment Management

Morgan Stanley

INVESTMENT MANAGEMENT

The Innovation Provider of the Year Award aims to reward those insurance providers/asset managers excelling in the area of investment, product design, technology or any other area and have met the needs of their clients.

Excelling in this field is Morgan Stanley Investment Management (MSIM) for its new protected equity fund designed by an interdisciplinary team of investment, insurance and structuring specialists to enable European insurance companies to access equity exposure in a Solvency II capital-efficient manner.

Generating attractive risk-adjusted returns in an environment characterised by low yields and high volatility is a challenge for all investors. Insurers have the added complication of managing capital requirements under Solvency II.

MSIM has designed the innovative Equity Risk Managed (ERM) fund that can provide significant economic and regulatory capital benefits to insurers. The structure combines efficient factor-based investing that has demonstrated substantial alpha potential, a risk-control mechanism reducing economic volatility, hard downside protection via a put strategy which reduces the SCR, and may also take advantage of call option premiums. These combined elements aim to improve the risk and capital efficiency of investing in equity for insurance companies. Since inception in April 2017, the fund has delivered robust relative performance while reducing volatility and the SCR (typically 13% but as low as 5%), is c. three times lower than the standard 39% charge.

The Equity Risk Managed (ERM) Fund can provide significant economic and regulatory capital benefits to insurers

The low volatility environment in 2017 supported the fund's +9.3% return to year end. The one-year return to April 2018 was +6.7% . The short-lived bout of volatility experienced in Q1 2018 demonstrated the responsiveness of the strategy to these changes – the strategy risk control was activated with a reduced equity weight and the put option was increased.

While performance was very similar to that of the MSCI World, the volatility reduction was notable. Since then the volatility environment has eased and the ERM fund beta to equity has increased.

The judges were very impressed with the performance of the fund and the structure within it to combat market volatility. Well done to all involved.

Figures provided as at date of award submission

GLOBAL BRANDS:

An investment solution for insurers in an uncertain world

WILLIAM LOCK
Portfolio Manager, Head of International Equity Team

BRUNO PAULSON
Portfolio Manager

Losing money is worse than missing the chance to make it – a belief long held by the International Equity Team, and one shared by many of the insurance companies that choose to invest with us. We understand that our clients' financial obligations are real, and that the risk of not meeting those obligations given loss of capital, takes precedence over the opportunity to earn excess relative returns.

The Morgan Stanley Investment Funds (MS INVF) Global Brands fund has almost two decades' track record of compounding. Our investment process has been tested in both up and down markets, and the resilient nature of the strategy has supported our clients in uncertain markets.

We focus on high quality companies with strong intangible assets, notably brands or networks, pricing power and strong management, which should deliver high and sustainable returns on operating capital employed, high gross margins and strong free cash flow generation.

These companies are fairly rare so, when we buy them, our conviction is reflected in meaningful position sizes, and an active share of greater than 90%. The fund has provided long-term capital appreciation with lower long-term volatility than that of broad benchmarks. This investment result resonates with clients seeking resilient long-term investment solutions.

ENGAGING WITH SUSTAINABLE COMPOUNDERS

As active investors, we are ever vigilant to the changing consumer and competitor landscape and mindful of potential risks to the sustainability of long-term returns on capital. This includes material ESG risks and opportunities. Our portfolio managers analyse material ESG factors themselves as part of their bottom-up fundamental research. We believe that incorporating ESG is essential to long-term compounding, helpful in identifying sustainable compounders and picking the winners from the losers.

AN ACTIVE PORTFOLIO TO PROTECT AGAINST TODAY'S UNCERTAIN MARKETS

High quality is by its nature less exposed to potential adverse events, as demonstrated by the Fund's history of relative out-performance in down markets. We believe the Fund can benefit investors who are looking for companies that are robust, and for portfolio managers that own stocks for the long term rather than just rent them.

Calendar Year Returns (%)	2018	2017	2016	2015	2014	2013	2012
Class I Shares	-2.04	26.00	5.11	5.72	5.39	20.08	14.05
MSCI World Net Index	-8.71	22.40	7.51	-0.87	4.94	26.68	15.83

Performance shown net of fees and in USD. Past performance is not a reliable indicator of future results. Returns may increase or decrease as a result of currency fluctuations. All performance data is calculated NAV to NAV, net of fees, and does not take account of commissions and costs incurred on the issue and redemption of units. The sources for all performance and Index data is Morgan Stanley Investment Management.

Morgan Stanley

INVESTMENT MANAGEMENT

Morgan Stanley

INVESTMENT MANAGEMENT

Global Perspective and Expertise in Insurance Investment Management

Morgan Stanley strives to provide outstanding long-term investment performance, service, and a comprehensive suite of suitable investment management solutions for insurance clients, including private credit and equity, real estate, infrastructure and traditional assets. Our dedicated insurance team are committed to understanding the objectives of each of our insurance clients, and striking the right balance in return, risks, and regulation.

Please contact us for further information:
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INVESTMENT STRATEGY OF THE YEAR

Wesleyan

WESLEYAN
we are all about you

Following on from its win as Active Manager of the Year at the Insurance Asset Management Awards 2017, Wesleyan scooped the Investment Strategy of the Year Award for 2018.

Getting the investment strategy right is one of the biggest challenges an insurance company has to overcome, particularly given the current economic environment. This award recognises the insurance company that has implemented an investment strategy that sets the standards for the industry to follow. Wesleyan excelled in these fields.

Wesleyan's Investments department is a well-established fund management team consisting of fund managers supported by investment analysts who cover specific market sectors. The firm's core 'buy and hold' strategy aligns with this objective and runs concurrently with a contra-cyclical approach, identifying out-of-favour stocks with long-term potential.

On days when markets are down, the firm is likely to be buyers of equities rather than sellers. If a company issues a profit warning, the share price may overreact, so Wesleyan assesses the reasons behind the fall, and if its team believes that long-term fundamentals are still supportive and the shares show value, it looks to buy. This leads it to become a liquidity provider typically allowing it to acquire shares without having to worry about market impact.

Having a long-term strategic view means that the firm's funds are well-positioned for potential market volatility such as political instability in the UK, particularly important given ongoing Brexit negotiations, and overseas. This means that Wesleyan can overcome many of the challenges faced by those who aim to achieve quick returns.

It is also a key element of Wesleyan's strategy that it maintains low portfolio turnover by industry standards. When combined with low market impact, it is able to keep direct and indirect trading transaction costs low for customers, with direct equity funds experiencing beneficial slippage. To further reduce the volatility of returns for customers, risk is managed through diversification both across and within asset classes.

The strategy works. Over the past 10 years, circa 80 per cent of the investment funds it manages have been in the top

quartile. The firm's Investments department manages a range of funds that have a collective current value of more than £7bn. Furthermore, according to the last published whole-of-market report, produced by an independent third party, Wesleyan's With Profits Fund was ranked as the top performer over the last decade. The judges were particularly impressed with the firm's clear approach and the people values within the company. Congratulations on an outstanding win for a firm which is a market leader.

PASSIVE MANAGER OF THE YEAR

SPDR ETFs

STATE STREET GLOBAL ADVISORS SPDR

The Passive Manager of the Year award celebrates the manager that offers investors cost effective market access and shows a true understanding of the needs of their clients. This year the award went to SPDR ETFs.

Standing out at the top of the pile, SPDR ETFs is a global industry leader and is well positioned to partner with insurance companies to help them understand how they can use ETFs to address various challenges. SPDR is backed by the strength and access of State Street Global Advisors, the third-largest asset manager in the world with $2.73trn in AUM and in 1993, created the first US exchange-traded fund, SPY, which tracks the S&P 500 and is the largest ETF in the world.

The firm has more than 35 years of indexing experience and over the decades, SPDR has demonstrated stability, reliability and a track record of innovation. As industry pioneers, SPDR has maintained thought leadership in the ETF space and introduced innovations including a full range of sector-focused ETFs and its convertible bond ETF.

SPDR's ETFs can be used to quickly provide diversified exposure that can shift the duration, credit quality or yield in a portfolio. SPDR has a range of Fixed Income ETF exposures that cover a diverse range of credit exposures and maturity segments.

In addition ETFs can be used during portfolio restructures to manage the associate portfolio risks such as interest rate and credit risk. The ability to mitigate market risk is a key consideration and ETFs can be used to gain specific market exposure on an interim or longer term basis. An increasing number of institutional investors are now using ETFs as a liquidity sleeve for portfolio management flexibility.

SPDR's size and position as one of the leading index portfolio managers allows it to effectively trade in both the primary and secondary markets which in turn optimizes benchmark tracking. They also allow cash allocation to be kept to a minimum which reduces cash drag. The judges were particularly impressed with the firm's performance over the year – finishing 2018 as the number 2 in gathering assets within fixed income ETF assets in Europe - in what is an extremely competitive market.

SPDR ETFs has proved time and time again throughout the year that it is a market leader in all that it has done and has repeatedly shown how important ETFs are within an insurance investment portfolio for balancing risk and obtaining returns.

Congratulations to all at the company for making SPDR ETFs such an influence within the insurance market.

FIXED INCOME MANAGER OF THE YEAR (up to €100bn AUM)

TwentyFour Asset Management

TwentyFour Asset Management now has £14bn of assets under management, including over £320m for insurance clients.

Described by the judges as displaying good performance, a fresh approach, strong endorsements and an effective service proposition, TwentyFour Asset Management also runs the highly exemplary Absolute Return Credit Fund with an efficient cost of capital that can be reported with full transparency on a daily basis if required.

The firm can also run segregated mandates with a bespoke portfolio of stocks targeting a specific or maximum total capital charge.

These funds can be managed to agreed investment restrictions to give an insurance company control over the shape of the portfolio, while tapping into TwentyFour's stock selection and asset allocation skills where appropriate. This is achieved with the help of TwentyFour's proprietary Observatory system, which enables its investment team to track the capital charge of any bond in the market.

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 and shows TwentyFour cost of capital on a line by line and sector by sector basis, flagging opportunities to improve the capital efficiency of the portfolio.

Across the firm, TwentyFour's process is high conviction, with funds tending to hold a relatively small number of stocks, allowing the managers to be nimble and respond quickly to changing risks. The business houses some of fixed income's best portfolio management talent, individuals who have been recognised with awards for their performance and excellence in growing the business from a standing start in 2008.

TwentyFour is now a truly global fixed income boutique, with a list of institutional and wholesale clients across North America, South America, Europe and Asia. It launched its first US mutual fund in April 2017. In the last 12 months, TwentyFour has broadened its client base significantly, adding a number of institutional clients, and the portfolio managers are making an ever increasing number of trips to Asia to respond to growing interest from the region.

It is all too clear why TwentyFour is such a special firm and currently stands out as the beacon among the crowd.

FIXED INCOME MANAGER OF THE YEAR (over €100bn AUM)

J.P. Morgan Asset Management

Fixed income has evolved from a safe sleepy asset class into a dynamic and diverse option for insurance firms today. The Fixed Income Manager of the Year (over €100bn AUM) Award recognises those providers with over €100bn AUM in the institutional investment space that have not only displayed innovation in this area to take advantage of the opportunities out there, but also have the performance numbers to prove their expertise.

Described by the judges as being a strong firm with solid supporting case studies, J.P. Morgan Asset Management (JPMAM) is the market leader. In 2017, JPMAM's insurance general account assets under management (AUM) grew by $17.6bn, or 20.6%. That growth was primarily attributed to new customised fixed income mandates. The firm's fixed income platform currently manages $66.6bn for insurers globally and $17.3bn for insurers in EMEA.

JPMAM's fixed income portfolios are managed by 21 dedicated fixed income insurance professionals globally, five of which are based in EMEA. They leverage the research and expertise from the sector specialists and work closely with their in-house global insurance strategy and analytics team.

The JPM insurance fixed income team has a background in portfolio management, derivatives marketing, accounting and insurance capital markets. This experience helps the firm to have a deeper understanding of the unique investment objectives and constraints of insurance companies and has helped to deliver customised fixed income solutions to clients with objectives such as buy and maintain, liability matching, investment income/book yield management, total return or SCR capital-adjusted returns.

JPMAM has consistently helped to solve client complex investment challenges through incorporating Solvency capital ratio requirements, quantitative research and book yield attribution. The firm recommends a balanced scorecard approach to defining and measuring performance, given the multiple stakeholders, investment objectives and constraints in an insurance company. A key component of this approach is providing accurate attribution of changes in book yield to trades actively implemented versus trades resulting from cash flows, coupons and maturities. The book yield of purchases is compared to the book yield of the weighted average benchmark yield on the date cash is available to invest; the book yield leaving the portfolio because of sales; and the book yield leaving the portfolio because of coupon, maturities and pay downs. Clients are delivered a detailed book yield attribution as part of a balanced scorecard.

Congratulations to a stand-out firm for an excellent year.

ALTERNATIVES MANAGER OF THE YEAR

Aviva Investors

Alternatives have become an essential part of UK/European and global insurance firms' portfolios. The Alternatives Manager of the Year Award recognises those firms that have shown a true flair for extracting value from the alternatives space to the benefit of their insurance clients.

Leading the pack is Aviva Investors. The firm's track record in alternative income assets dates back to 1984 when it started to provide commercial real estate finance. Since then, its private markets capabilities have grown, and as at 30 June 2018, it managed £20bn across infrastructure debt and equity, private corporate debt and structured finance (including senior debt on collateralised loan obligations, export credit agency loans and collateral swaps).

Origination of alternative income assets amounted to £3.9bn in 2017, with £2.4bn assets for the Aviva UK annuity portfolio across a range of asset classes, terms and investment grades. Aviva Investors has a broad platform for monitoring the illiquidity premia available across private assets for investors seeking multi-asset mandates delivering relative value.

As well as the firm's strong research and origination capabilities, Aviva Investors has a rigorous approach to monitoring environmental, social and governance (ESG) criteria. It aims to ensure that ESG considerations are wholly integrated into day-to-day decision making, to help improve investment outcomes for clients and society, through reducing environmental, regulatory and obsolescence risk. To do this, dedicated governance and responsible investment specialists work collaboratively with responsible investment officer, fund managers and analysts.

The firm's track record in alternative income assets dates back to 1984 when it started to provide commercial real estate finance

A dedicated credit team works alongside analysts and investment specialists, with the tools and skills to rate non-standard issues. All prospective investment decisions are assessed by this independent credit function – essential under the current regulatory regime.

Aviva Investors is at the forefront of innovation in alternatives, extracting value for insurance clients. It has the combination of skills and scale to take on a wide variety of complex transactions, drawing on a deep network of contacts. Its expertise in risk, credit analysis and data analytics is critical, allowing the firm to assess, rate and structure a variety of transactions across real estate, infrastructure and private corporate debt.

EMERGING MARKETS MANAGER OF THE YEAR

HSBC Global Asset Management

Emerging markets lie at the heart of HSBC Global Asset Management's business and strategy. The business has over $113.7bn in emerging market assets worldwide, managed by over 200 dedicated professionals in 10 emerging market locations[1].

In order to provide relevant emerging markets access to insurance clients HSBC Global Asset Management constantly reflects market developments by enhancing and evolving its capabilities while expanding the range of instruments in which we invest.

The firm's array of products and solutions includes a comprehensive range of EM debt and equity strategies. The global EM debt offering includes hard and local currency strategies (and blends of the two), investment-grade, corporate, inflation-linked and total return strategies.

On the EM equity side, HSBC Global Asset Management offers one of the longest running and most differentiated frontier markets equity offerings in the industry, with a dedicated team of investment professionals devoted to this resource intensive asset class.

The inclusion of mainland Chinese securities into some of the world's most widely tracked indices is a game-changer. HSBC has the widest and deepest presence in China among all foreign financial institutions, and is the leading foreign bank in China, having been actively participating in free trade zone developments. As these markets develop, they generate short-term inefficiencies which the firm's dedicated investment teams exploit to deliver superior risk-adjusted returns for clients.

On top of this, HSBC Global Asset Management applies three steps to make an EMD total return strategy more efficient in terms of the SCR market. It applies a re-weighting algorithm to increase the expected return on SCR Spread by 15% to 25%; hedges USD positions only, to EUR and leaving non-USD positions unhedged and only use CDS to buy protection and not to sell protection. This strategy gives an SCR Market of around 15% to 18% depending on positioning EM currency return potential is still available.

The judges were quick to applaud this leading proposition and it must be noted that this is a second successive win for HSBC Global Asset Management in this category.

The firm stands head and shoulders above the rest and looks set to continue its high generation of returns along with an exciting and positive continuing presence in the Chinese markets, all with the ultimate goal of boosting insurer's portfolios.

A huge congratulations to all at the firm on winning a prestigious award.

[1] *as at 30 September 2018*

BEST SOLVENCY II TECH SOLUTION OF THE YEAR

Moody's Analytics

Moody's Analytics

Moody's Analytics, a leader in Enterprise Risk Management (ERM), has won this award for the second consecutive year. Its RiskIntegrity™ Suite and Scenario Generation solutions are designed to address insurance companies' risk and solvency needs, including both regulatory and internal management requirements.

The RiskIntegrity Suite, an end-to-end regulatory risk and solvency solution, delivers out-of-the-box standard formula and internal model capabilities (covering SCR and MCR calculations) and regulatory reporting QRT capabilities. It has comprehensive risk module coverage for standard formula and offers complete flexibility for Monte Carlo aggregation to support internal model calculations. These features are combined with robust data management capabilities and integrated regulatory reporting. Additionally, Moody's Analytics offers RiskIntegrity™ Insight, a new strategic tool that allows insurers to project financial and risk metrics under alternative forward-looking economic and insurance scenarios.

Among the many insurers that take advantage of Moody's Analytics offerings, one leading insurer selected a number of Moody's Analytics solutions for the valuation components of their internal model, strategic asset allocation, and portfolio optimisation. Another chose the Moody's Analytics Economic Scenario Generator (ESG) for market risk calculation as part of their Solvency II internal model, and will also benefit from the flexibility of the ESG for investment modelling and stress and scenario testing.

The RiskIntegrity Suite, an end-to-end regulatory risk and solvency solution, delivers out-of-the-box standard formula and internal model capabilities

Moody's Analytics also assisted a firm which required a solution to model capital requirements in preparation for an internal model approval application to the UK PRA. Moody's Analytics software allowed the insurer to take ownership from an early stage in the project by being able to leverage the easy-to-use solution. The solution had to be flexible to meet the firm's business and methodology requirements, enable fast and effective transfer of ownership, provide appropriate governance and control, support a range of what-if analysis, and integrate with their existing IT infrastructure. The firm was able to configure their specific capital modelling requirements covering risk factor modelling, liability proxy modelling, and solvency metrics. Based on its range of technical offerings, the judges recognised Moody's Analytics for helping a number of insurers to achieve their goals.

Insurance Asset
Management Awards 2018
Winner
Best Solvency II Tech Solution

Insurance Asset Management Awards 2018

Back to the future

A more volatile geopolitical environment means that investment strategies and asset allocation are facing the possibility of a turbulent decade ahead, Graham Buck reports

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

The Seventies still exerts a fascination, particularly for those born since that decade. While the music and fashion appeal, it was a volatile period of inflation and 'stagflation', soaring oil prices and a disgraced US president. The Eighties brought more positive developments such as the dismantling of the Berlin Wall, but also further turmoil including 'Black Monday'.

Editorial credit: / Shutterstock.com

The decade since the global financial crisis has brought its own upsets, but as Colin Harte, portfolio manager and strategist within the multi-asset solutions team at BNP Paribas Asset Management notes: "Over the past 20 years, the world's central banks have all targeted a reduction in inflation, while governments have aimed to reduce deficits. Overall, the level of consensus has been extraordinary.

"Policies across both the developed markets and emerging markets have been broadly in line, but we can now expect a variety of different responses from individual countries. This offers potential for greater investment returns, but also makes buy-and-hold strategies more difficult with the greater likelihood of whipsaws.

"People will have to become accustomed to prolonged periods of increased volatility – possibly even another decade of uncertainty such as the Seventies," Harte warns.

The International Monetary Fund (IMF) has downgraded growth forecasts for 2019 and 2020, while many commentators have cut the odds on a global recession as early as next year – possibly accompanied by a further major credit crunch.

Assumptions made by chief investment officers and finance directors about this year's business climate are already being revised; for example, expectations that the Federal Reserve would maintain its policy of small but regular US rate hikes and selling off bonds acquired during the period of quantitative easing (QE). The Fed's chairman, Jerome Powell now declares he is "listening sensitively" to the message sent by the markets, which ended 2018 in sharp retreat.

"Last year was difficult for asset managers and 2019 promises to be equally challenging due to a paradigm shift," agrees Harte's colleague Guillermo Felices, head of research and strategy in BNP Paribas AM's multi-asset team. "Central banks are removing the stimulus provided in the wake of the 2008 crisis and ending QE, having supported the markets with high levels of liquidity.

"In a period of increased volatility, risk and the adjusted returns will be more challenging. Since the crisis, asset managers have relied heavily on government bonds – 2018 was the first year that saw negative returns both for bonds and equities."

Harte notes that the forecast by US political scientist Francis Fukuyama of 'the end of history' as the Berlin Wall fell,

with liberal democracy triumphant and the arrival of a post-ideological world, now looks premature. The shift has major implications for all asset classes.

"Insurers will have no choice but to live with and become accustomed to a greater degree of risk," he suggests. "There will be a greater focus on ensuring their underwriting operations are profitable. Companies can no longer assume that losses can be made good by healthy investment returns."

Asset diversification is likely to continue. "We've already seen a transition over the last decade, to diversify from public equity as the only risk source into several asset classes as credits, real estate and private equity and debt, as a response to the high volatility and low interest rate environment," says Erik Kleväng Callert, group chief investment officer for Nordea Life & Pensions.

Greg Fedorenko, SVP for manager research at Redington adds: "There's continued heavy interest in capturing illiquidity premia via investing in alternative credit, where investors hope to achieve better downside protection via the ability to negotiate bespoke, tighter covenants with borrowers than currently exist in the broadly syndicated market, as well as a pickup in yields.

"So the investment thesis is a mixture of improved defensive characteristics and the potential for higher returns."

Redington also reports keen interest in corporate direct lending strategies both within the investment grade and sub-IG segments of the credit market.

"The challenge for investors is finding a strategy offering favourable returns adjusted for capital requirements, which is simultaneously operating in a market niche that allows a skilled manager to build a proprietary 'moat' around future loan origination," adds Fedorenko.

Diminished expectations

Schroders' latest institutional investor study for the insurance sector, released in November, found that 40 per cent of investors polled anticipate average annual returns of below 5 per cent over the next five years, against 22% in 2017.

Insurers expect geopolitical events, higher interest rates and the likelihood of a global economic slowdown to dent future performance and most of those surveyed predicted a rise in equity market volatility, interest rate risk and credit defaults.

"It's certainly looking as though it will be a challenge to eke out decent investment returns this year without incurring greater risk," agrees Dr Bruce Porteous, investment director – global insurance solutions at Aberdeen Standard Investments. "That means there's an appetite for innovation."

The group's responses include the recently-launched private markets fund financing initiative in which Aberdeen Standard partnered with insurer Phoenix Group. Funded with £500 million of capital transferred from liquidity funds and short duration funds, the strategy seeks to generate increased returns from illiquidity premia while minimising credit risk, and offers investment grade, short duration loans to private markets funds in their early stages.

"It provides a short-term investment opportunity to package a fund used for assisting private equity managers through the initial J-curve," adds Porteous. "It's packaged in such a way as to be insurance company-friendly via a credit score, and also something that regulators are comfortable with."

Sustainability is growing in prominence among insurance investors. "Sustainable and ethical investing has

> It will be a challenge to eke out decent investment returns this year without incurring greater risk

steadily gained in popularity; albeit having started from a fairly low base," Porteous confirms. "It's driven to some extent by pressure from insurers' customers, who are keen to see more ethical behaviour introduced."

Mehdi Guissi, co-head of solutions strategy, solutions group at Legal & General Investment Management adds: "An increasing number of insurers are proactively integrating environmental, social and governance (ESG) themes into their investment strategy through three means: exclusion, integration and impact, driven by regulation as well as their belief that ESG investing fosters better investment decisions, performance and risk management."

Brexit strategies

Inevitably, investment strategy for the months ahead includes steering a path through the quagmire of Brexit. Guissi notes that UK insurers have employed a range of hedging strategies to combat unfavourable Brexit outcomes, amid a rise in general market volatility and as the economic cycle matures.

Hedges have included options on FX (such as a put or collar on GBP/USD) and equity (including a put or collar on the FTSE 100.

"Many UK insurers back part of their liabilities with UK Credit and this could clearly be impacted under negative scenarios, such as hard Brexit," adds Guissi. "It should be remembered though that about 70 per cent of the revenue of non-financial issuers in the sterling investment grade universe comes from overseas – so these revenues would rise, not fall, if sterling depreciates under a no-deal scenario, which would increase creditworthiness all else being equal."

Also on the horizon for insurers is the migration from IAS 39 to IFRS 9 on the accounting standards of financial instruments, which is expected to result in higher volatility of net income.

"For example, if they want to account for their fixed income instruments under fair value through other comprehensive income (OCI), they may need to think about how to change guidelines in their investment mandates – such as turnover limit – to make sure that fixed income instruments in their portfolios are solely payment of principle and interest (SPPI)-eligible," notes Guissi.

"Given that a forward-looking principle is applied to the modelling of impairment under IFRS 9, insurers are more incentivised to closely manage their credit risk in order to reduce profit and loss (P&L) volatility."

He sees the new rules also incentivising insurers with equity exposure to seek risk-hedging solutions through derivatives (such as systematic equity option strategies) to control P&L volatility. These hedges could be structured accordingly to achieve regulatory capital efficiency (for example higher cost of capital adjusted returns) at the same time.

"Despite a year's delay to 2022, implementation of IFRS 17 will inevitably cause variability in the degree of mismatches between assets and liabilities," Guissi explains. "Given that IFRS 17 will allow an election for the effect of changes in discount rate to be recognised through either P&L or OCI, insurers must be cognisant of their balance sheet management strategies and the accounting treatment of assets under IFRS 9 in order to reduce the volatility of net income and net asset positions."

Reaping rewards

Editor Adam Cadle talks to BNP Paribas Asset Management's Head of Emerging Markets Debt Bryan Carter about the asset class and the opportunities in this space

WRITTEN BY **ADAM CADLE**

Q EMD is not without risk at the moment. What is your overall view of the market environment?
Emerging markets certainly hit the headlines in 2018, in particular countries such as Turkey, Argentina, Brazil. I would summarise by saying we have a duality now in emerging markets. There are countries that have had poor governance, that have had irresponsible debt policies and poor fiscal policies over the past few years and it is not a surprise to see the chickens come home to roost so to speak in those markets. But what investors shouldn't lose sight of is that we have a whole cohort of higher quality emerging markets that are really improving the standards of living for the people in those countries that are really growing quickly and they are in the process of converging to or graduating to developed market status, so these are the most interesting countries in the world to invest in in our view right now. So separating the wheat from the chaff, the good from the bad within emerging markets is the way to think about investing going forward.

Q What makes it an attractive asset class within insurance portfolios?
Well first of all the yield. To buy a relatively low duration set of high quality emerging market dollar bonds at the moment would give you over 5% which is pretty good for low risk if we think about the credit quality of that basket. Secondly diversification is an attraction. We find that very few insurers have significantly diversified into emerging markets so it gives them a new way of expressing credit views and picking up carry in the more risk seeking component of their portfolio. A third reason, at BNP Paribas Asset Management we have developed a prudent way to approach investing in emerging market bonds specific to insurers. So the prudence is also a rationale because we believe have developed something innovative on behalf of insurers.

Q What is the SCR for EMD and how is it favourable for insurers?
In general SCR is not a favourable screen for emerging market bonds when it comes to insurers for three reasons. First of all the spread that comes with emerging market bonds, in general, the lower credit rating incurs a credit charge. Secondly, the duration. Emerging market bonds, and especially the sovereign issuers, tend to issue long duration instruments and so the duration is also a negative for insurers because it is magnified by the spread in the credit charge process. Thirdly, the bulk of the emerging market universe is denominated in local currencies and in dollars, and so the foreign currencies also incur a capital charge when insurers put this in their portfolios and then do their solvency analysis. But the other part of investing for insurers is the expected return. And in the asset only view as long as there is a compelling reason to look at return and yield, certain asset classes will still make sense especially relative to the risk. We find that emerging market bonds have relatively high expected return and high yield relative to the risk. So it is still interesting despite the fact that the SCR is not so favourable in general. That brings us back to our innovative solution. At BNP Paribas Asset Management we have attempted to make emerging market debt more attractive to insurers by doing

three things. First of all, hedging the currencies. In our insurance portfolio, our Flexi Emerging Market Debt Fund which invests in emerging market bonds on behalf of insurers, we have completely hedged all of our bonds back to European currencies. We are hedging not only the dollar bonds but anything in local currency and so that euro hedge should completely offset the capital charge from the FX perspective.

We also have a strict definition of investment grade. We only buy bonds with investment grade ratings and it must have three investment grade ratings in order to be eligible for our insurance portfolio. Therefore the ratings improvement vis-a-vis the broader asset class makes this much more favourable from the solvency perspective. Lastly, we maintain a low duration in our portfolio. It is not a short duration portfolio because we want to be able to access some of the interesting bonds in the three to five year segment but we are remaining below five years with the bulk of our investments. The shorter duration again will decrease the capital charge.

For more complex larger insurers they will want to consider their liabilities and their entire liability structure and wecan also help with tailored solutions if that is what an insurer is looking for.

Q Is there anything to avoid within EMD?

What we are focused on as an asset management team is the distress risk, the default risk. Any countries or issuers that have any risk of default on our horizon, any non-trivial risk of default, we completely exclude. Part of that is the insistence on investment grade in our insurance portfolios. That's the best protection – sticking with strong ratings.

Q The issue of ESG is growing all the time throughout the industry. How are you incorporating that within your EMD thinking?

We include a country level screen on all of our investments because we find the most predictive long term sustainability lens is by looking at the sovereign sustainability metrics. There we include E, S and G factors. On E we are looking at the country's commitment to climate change policies and to maintaining a sustainable living environment for people in the country. On the S category, we are looking at gender parity, access to human capital, internet, and technology. All of these are good proxies for long term investment for people within the country and a dedication to improve living standards. Most importantly when it comes to G, we define this as institutional sustainability. There, we want to not only see freedom of press, markers of democracy, but really long term fiscal sustainability and debt sustainability. We think that the main reason to invest with an ESG lens is to prevent investing in countries which have any blow up risk, any unsustainability risk over the long term, because going forward asset managers can generate outperformance, not only by owning the countries that will grow and perform the best, but also by avoiding the countries that are in this bad equilibrium.

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

We specifically separate our alpha generation from our ESG process. We are very good at finding securities that will outperform, we have a strong alpha generation process and we have talented senior portfolio managers with a history of picking good bonds. We overlay the ESG screen separate to that and the reason for this separation is that we believe the future won't look like the past. In the past we believed that all countries were getting better and that investors could naively and blindly invest in emerging markets and have good results at the end of that. Going forward we do see this duality complex. Some countries have had backsliding in terms of governance and we want to avoid those in our portfolios going forward.

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BNP PARIBAS ASSET MANAGEMENT

Hedging your bets

Hedge funds continue to play an important part in insurers' investment portfolios. Michelle Stevens explores current trends in the market and what the outlook might be for 2019

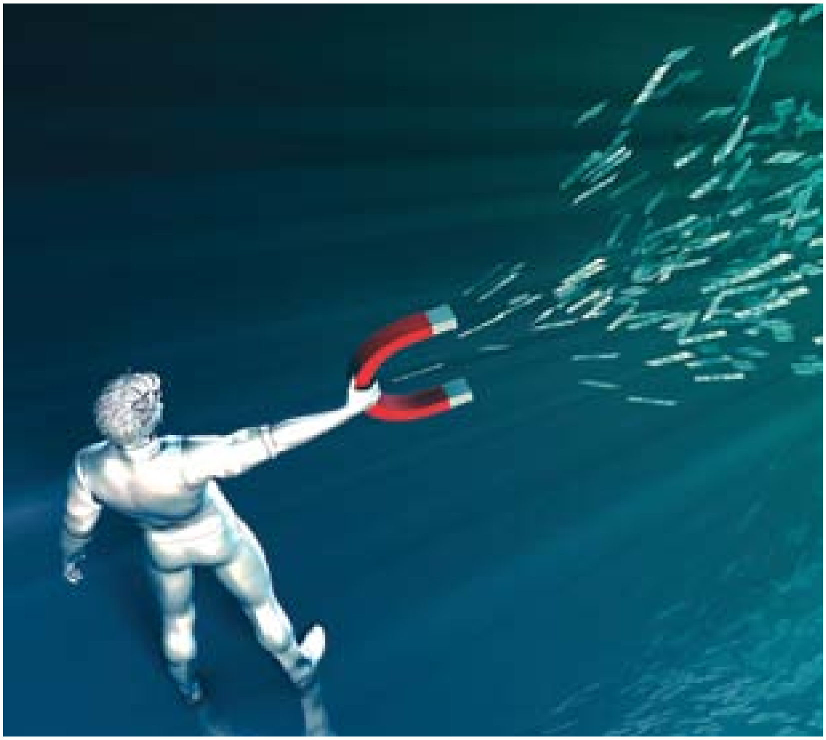
WRITTEN BY **MICHELLE STEVENS, A FREELANCE JOURNALIST**

Hedge funds have long been a mainstay for insurance companies investing their assets, offering the opportunity to invest in a variety of asset classes while guarding against losses by diversifying risk.

But in a landscape of ever-changing markets, evolving regulation and an uncertain political and economic outlook in some quarters, how is this form of alternative investment seen as part of the ongoing strategy for these institutional investors?

There are approximately 15,000 hedge funds worldwide, and while the amount invested in them has grown over the last two decades, this could now have hit peak levels, argues Donald Steinbrugge, the founder and CEO of Agecroft Partners, a global hedge fund consulting firm.

"Since 2000, the global hedge fund marketplace has grown from $600 million to over $3 trillion," he notes. "But the industry's allocation to hedge funds has reached a saturation point where I don't expect hedge fund investors to increase their current average allocation much more. However, I also think the market is stable and don't see a lot of investors that want to reduce their allocation to hedge funds."



Steinbrugge also suggests that UK investors' use of hedge funds is "very similar" to US investors, which in turn is "significantly greater than investors throughout Europe" – something that could be attributable to the varying rules that exist in different jurisdictions.

"The US and UK legislation tends to be very favourable towards hedge funds, which is no surprise given that the vast majority of hedge funds are located in the US and UK," he continues. "There are other countries throughout Europe that have very restrictive legislation relative to hedge funds. The number of hedge funds located in those countries and the amount of capital invested in hedge funds by investors in those countries is a small fraction of what you would see in the US and UK."

Continuing investment

As a sector, insurance companies in general continue to invest in hedge funds. According to the Alternative Investment Management Association (AIMA) – which cites the *2017 Preqin Global Hedge Fund Report* – insurance companies account for 4 per cent of institutions that actively invest in hedge funds.

Jonathan Warren, a consultant at Altus Consulting, also believes that while hedge funds still represent a "minor percentage" of an insurer's overall portfolio, they have become a key component.

"Traditionally, insurance companies have invested in fixed income assets such as bonds to provide cash flow and stability, and these assets remain the major percentage of an insurance company's asset allocation," he explains. "However, post the financial crisis, insurers have had to confront declining yields due to the low-interest rate environment. That has seen insurance companies look to allocate a small percentage to alternative asset classes, such as hedge funds, in pursuit of superior returns to increase profits, or to enable them to lower premiums in a competitive marketplace.

"But it's not the sole driver," Warren adds. "Exposure to hedge funds enables insurance companies to better manage risk through diversifying their portfolio with asset classes with low correlation - assets that react differently to one another when placed under the same economic conditions, for example, hedge funds normally thrive when the stock market falls. Therefore, a well-diversified portfolio should yield steady returns or help protect against large-scale losses."

The suggestion that hedge funds are being increasingly utilised because of their risk management benefits is also borne out by the *Schroders Institutional Investor Study 2018*, which includes a survey of 157 insurance investors, with a total of $10 trillion in assets.

The research states that the "differing burdens felt by insurers are leading to an increase in the importance of risk budgeting", with 79 per cent of respondents reporting that they are diversifying across asset classes and geographies, and 54 per cent indicating that they are increasing their use of alternative investments. The study finds that overall portfolio turnover is also rising, with insurers selling on average 19 per cent of their portfolios in 2018, up from 13 per cent in 2017.

Evolving nature of fees

One of the most perennial and pertinent topics around hedge funds is fees, which are charged by hedge fund management firms to those whose investments they oversee. Traditionally, these costs include a fixed fee to manage the fund, as well as a performance fee if returns exceed a pre-set target.

Management fees at present typically range from 1 per cent to 2 per cent of the value of the investment made, according to AIMA. But according to Steinbrugge, whereas a decade ago this fixed fee was more likely to be at the upper end of this level, between 1.5 per cent and 2 per cent, fees of 1 per cent to 1.5 per cent are now more common. This downward pressure can also be seen in the context of performance fees, he adds, with rates of 10 per cent to 15 per cent now evident, down from the 20 per cent more likely to be seen 10 years ago.

"It is now very common for hedge funds to discount their fees for large institutional investors," says Steinbrugge. "In addition to that, there is growing use of performance hurdles before the hedge fund participates in sharing the performance of the account. This can be achieved by making the hedge funds reach their high-water mark before they participate in profit sharing, meaning the investor has not lost any money."

> Exposure to hedge funds enables insurance companies to better manage risk

The more liquid nature of hedge funds, and the fact they are not as heavily regulated as other investment vehicles, has helped this form of alternative investment cement its place in many institutional investors' portfolios.

But the hedge fund industry does still fall under the scope of many financial regulatory frameworks around the world, including the EU's Alternative Investment Fund Managers Directive (AIFMD), Markets in Financial Instruments Directive (MiFID) and General Data Protection Regulation (GDPR).

Taken together with continuing technological advances – and threats – hedge funds should be mindful of the cyber and non-compliance risks they face in the current regulatory climate, says Steve Ellis, partner, financial institutions, at JLT Specialty.

"Hedge funds tend to operate with

minimal client information, transferring their data and research functions to third-party administrators. Although this reduces their level of cyber risk, it doesn't absolve them from liability in the event of a data breach," he explains.

"Last year's new regulations, GDPR and MiFID, applied a magnifying glass to the handling of data and made breaches markedly more expensive. MiFID II also extended hedge fund liability to third-party breaches, making outsourcing more of a minefield. The severe consequences of these regulations mean that hedge funds must take a more proactive approach to protecting themselves with effective preventative measures and specific cyber coverage."

The road ahead

Evolving technology is not the only change on the horizon – 2019 is no ordinary year, with the uncertainty of Brexit looming large on the wider political and economic landscape. This could, however, provide a slight boon for hedge funds, Steinbrugge predicts.

> It is now very common for hedge funds to discount their fees for large institutional investors

"Brexit might be a slight positive for the hedge fund industry relative to UK investors, because it could negatively impact the UK stock and bond markets," he reasons. "It could also be positive for hedge fund performance relative to long-only managers that invest in stocks and bonds, as Brexit could be negative for both of those markets and hedge funds should be better equipped to protect investors' capital."

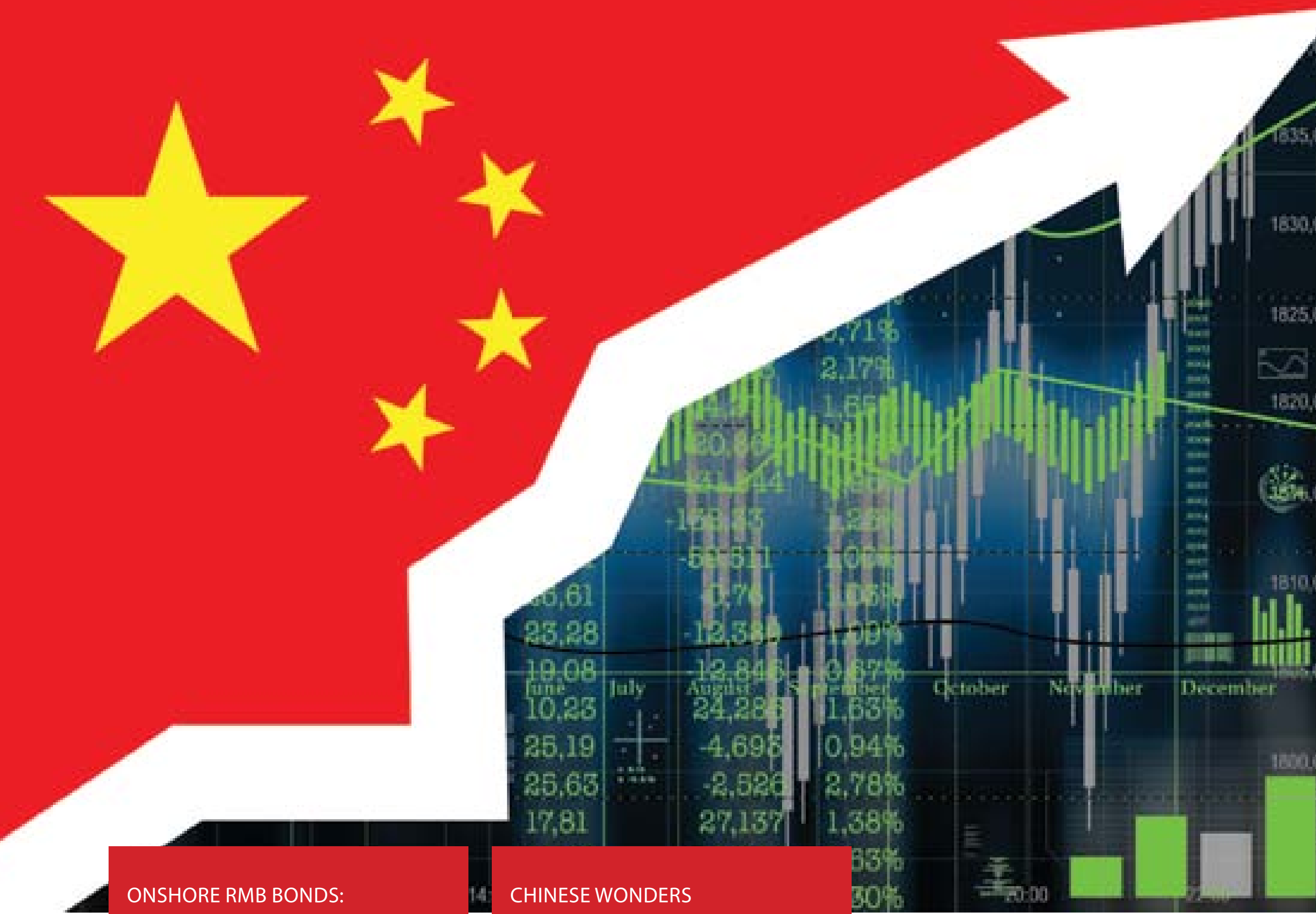
And of course, the ultimate arbiter of any investment type's popularity is performance. Overall, hedge funds have seen mixed fortunes since the 2008 financial crisis, with returns often trailing the stock market and some major funds closing entirely.

The industry has struck more positive notes of late, however, with "strong" hedge fund returns of 11.4 per cent recorded in 2017, according to Preqin's report for that year. But figures more recently released by Hedge Fund Research found there was a full-year capital outflow of $34 billion in 2018, lowering total hedge fund capital to $3.11 trillion.

Given the current changeable global backdrop, how hedge fund performance for 2019 pans out remains to be seen. But institutional investors such as insurers, who continue to allocate significant assets to these investment vehicles, are sure to be watching closely.

Chinese onshore RMB bonds

A SOURCE OF RETURN



ONSHORE RMB BONDS: PROMISING GROWTH, UNTAPPED POTENTIAL

Pictet Asset Management head of Greater China debt Cary Yeung explains the benefits of investing in China's onshore RMB-denominated bond market

CHINESE WONDERS

Adam Cadle talks to Pictet's Asset Management's head of Greater China Debt Cary Yeung about China's onshore RMB-denominated bond market

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Onshore RMB bonds:

promising growth, untapped potential

Pictet Asset Management head of Greater China debt Cary Yeung explains the benefits of investing in China's onshore RMB-denominated bond market

WRITTEN BY **CARY YEUNG**

The journey of a thousand miles has already begun. China's onshore bond market denominated in renminbi (RMB) has grown to around RMB70 trillion ($11 trillion), more than 10 times bigger than it was in 2002.[1] This odyssey will not end here.

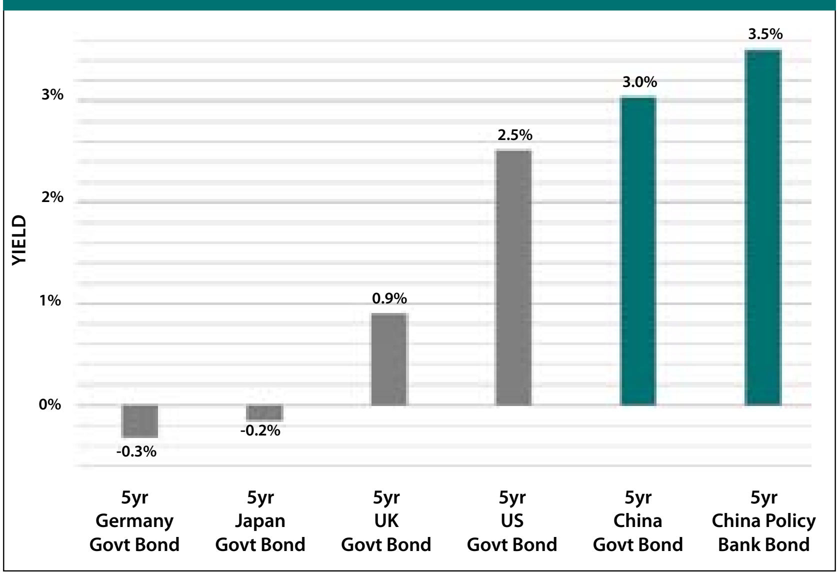
Over the next decade, this market is likely to expand even more rapidly to satisfy the financing needs of the world's second largest economy, which is both urbanising at an unprecedented speed and gradually opening up its capital markets. China's economy is on track to surpass that of the euro zone sometime this year and match the US in the next few decades; its bond market is likely to follow a similar path.

Trading dominated by interbank, domestic players

Today, interest rate-related instruments – as opposed to credit products – make up more than half of the bonds traded in the onshore market. These include:

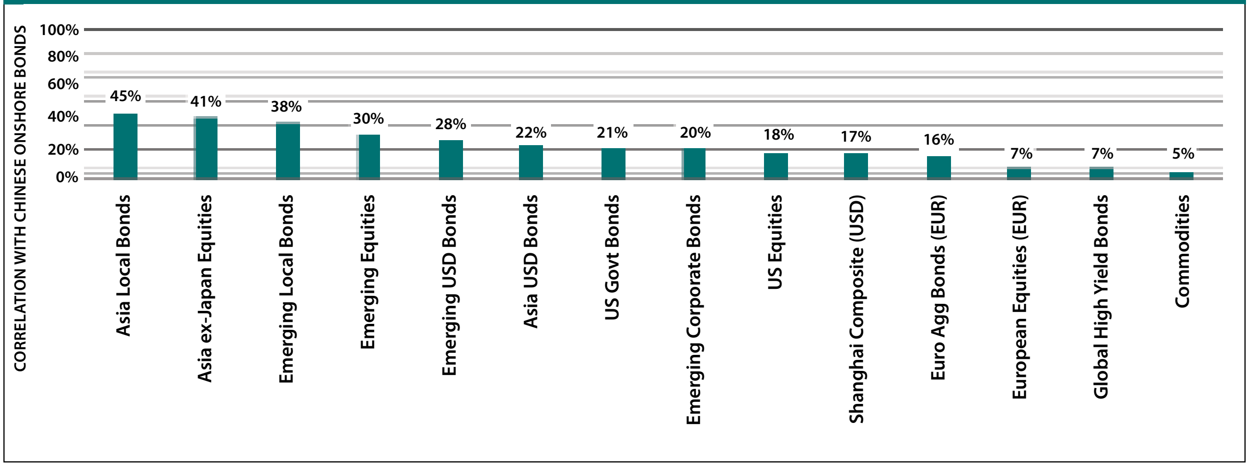
- Central government bonds: issued by the Ministry of Finance to fund government spending.
- Policy Bank/Financial bonds: issued by state-owned banks such as China Development Bank, which carry out policy roles.
- Local government bonds: issued by provincial governments.
- Corporate bonds: issued by Chinese companies, these make up a third of total bonds traded, yet most of the issuers are state-owned enterprises - only a small number of corporate bonds are issued by private companies.

CHINESE ONSHORE BONDS YIELD DOUBLE VS DEVELOPED GOVT BONDS



Source: Bloomberg as at 31 December 2018.

CORRELATION WITH CHINESE ONSHORE BONDS



Source: ChinaBond, JP Morgan, HSBC, Bloomberg.
All indices are total return and in USD unless otherwise stated. Based on monthly data from 31.10.2008 - 31.12.2018

Bonds are traded mainly by domestic investors. Commercial banks dominate, accounting for more than half of trading volume. This is mainly because the primary investment channel for Chinese savers is bank deposits, and cash-rich banks need to reinvest these funds. Foreign institutions currently make up 2 per cent of the market, but their share is growing.[2]

> In the current low-return environment, onshore RMB bonds offer attractive yields, diversification, and exposure to a currency with potential for appeciation

Why invest in onshore RMB bonds?

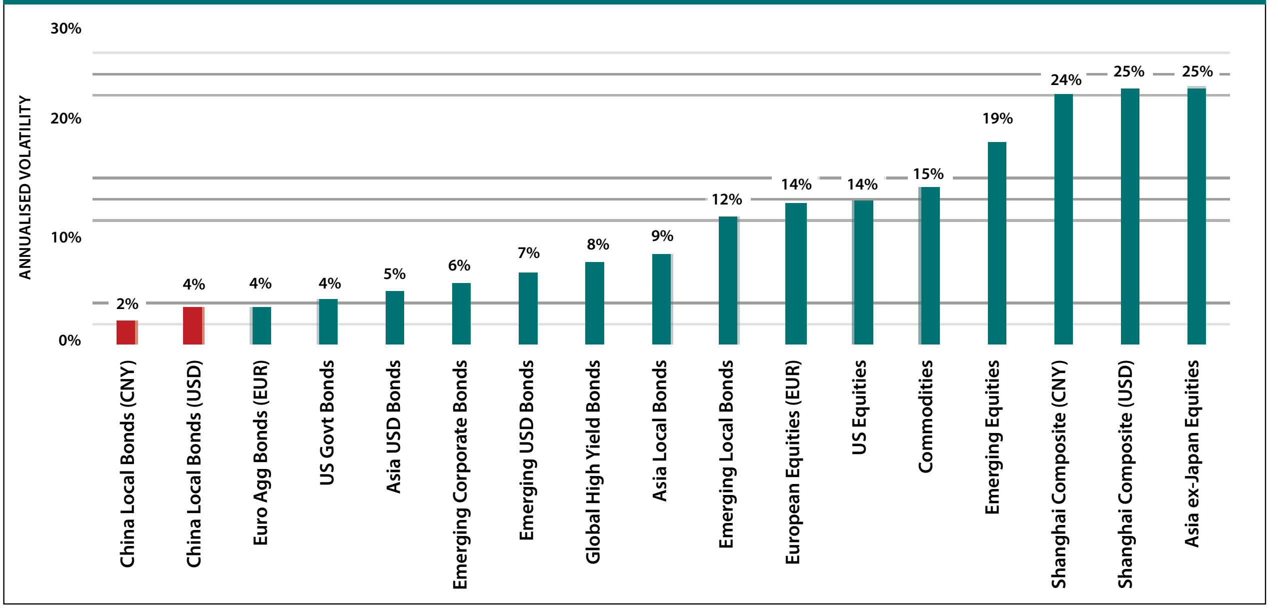
1) Attractive yields & potential returns
In the current low-return environment, onshore RMB bonds offer attractive yields, diversification and exposure to a currency with potential for appreciation. Yields on Chinese government bonds are higher than those of equivalent US paper, as well as debt issued by countries with similar credit ratings. According to our long-term fair value model, we expect that the RMB could strengthen from the USD in the next five years. In this case, currency appreciation is likely to contribute strongly to the return on the bond portfolios.

2) Diversification benefits
Chinese bonds have a low correlation with other asset classes.

3) Relatively low volatility
The relatively low volatility compared with other asset classes is another benefit. Significantly, Beijing's measures to open up the onshore bond market could help China's case for inclusion in the major globalbond indices – an important step in the market's evolution into a strategic asset class. Bloomberg has announced that it will start adding onshore RMB bonds to its benchmark Global Aggregate Index from April 2019. If the rest of major benchmark providers – JP Morgan and Citigroup – followed suit, it could generate as much as USD286 billion of fresh inflows.

A maturing economy
Investment in RMB onshore debt also allows investors to benefit from long-term structural changes within China's economy. Beijing is steering the economy away from an export-oriented model to one driven by consumer demand at home. As a result, headline economic growth is likely to slow to a more sustainable 5.5 per cent a year, from an average of around 10 per cent seen in the past decade. Inflation is likely to remain contained, providing a favourable environment for fixed income investors – our economics team expects it to stay below the central bank's target of 3 per cent over the next five years.

ANNUALISED VOLATILITY



Source: ChinaBond, JP Morgan, HSBC, Bloomberg.
All indices are total return and in USD unless otherwise stated. Based on monthly data from 31.10.2008 - 31.12.2018

Government support
The government is supportive of developing the bond market for a number of reasons. For one, it wants to open up a new source of financing for local companies which have become over-reliant on bank loans. Authorities are thus promoting better disclosure and transparency from issuers, which is beneficial for investors in the long term. The authorities are also keen to tap the bond market to finance urban infrastructure and construction projects to drive the next wave of growth as more workers migrate to cities. World Bank expects China need to invest USD 1.9 trillion in infrastructure by 2040 to keep pace with economic and demographic change.

RMB internationalisation
As the economy matures, the authorities are committed to gradually opening the financial market further, liberalising its capital account and promoting the greater use of the Chinese currency abroad. Chinese companies are increasingly settling their goods and services and foreign direct investments in the RMB. Transactions settled in the RMB have been grown at an annual rate of about 40 per cent since January 2012.[3] The IMF's landmark decision to include the RMB in its benchmark basket of currencies (known as Special Drawing Rights), effective October 2016, marked an important milestone in the currency's internationalisation. The move recognised Beijing's economic reform and raised the RMB's profile as an international reserve currency. As Beijing continues to loosen restrictions placed on the flow of capital across its borders investment flows in China is likely to grow further, leading to a gradual appreciation of the RMB.

> The IMF's landmark decision to include the RMB in its benchmark basket of currencies (known as Special Drawing Rights), effective October 2016, marked an important milestone in the currency's internationalisation

Debt levels are manageable
China public debt levels remain low, at around 46 per cent of GDP. However, the country's private debt (held by non-financial corporates and household) stands at 200 per cent of GDP, the highest in the emerging world.

> We believe Beijing's initiatives to cut private-sector debt and reduce financial sector risks should help improve China's economic fundamentals

Notwithstanding the headline figures, in our view, concerns over China's debt position appear exaggerated for many reasons.

First, most private debt is held by state-owned or quasi state-owned companies. Second, debt is mostly held at home, with external debt to GDP ratio standing at just 13 per cent.[4] Third, the market is also cushioned by ample domestic savings – China's savings ratio is the highest in the world at almost 50 per cent of GDP – and therefore is less exposed to foreign investment flows. Fourth, according to our proprietary debt gauges, which measures countries' credit standing via metrics such as property prices and savings rates, China's private debt fundamentals are in good shape. Indeed, China is better placed than EM peers such as Brazil and Turkey and is nowhere near the kind of debt bubbles that felled Japan in the late 1980s and plagued the euro zone and the US in the late 2000s. Fifth, we think the People's Bank of China has demonstrated its willingness to support growth and ensure liquidity, with multiple policy instruments such as reserve requirement ratio for banks, targeted easing measures including SLF (Standing Lending Facility), MLF (Medium-term Lending Facility) and repo rates. These are aimed at providing ample liquidity to the system and underpinning economic growth, which we believe will lead to a favourable climate for RMB onshore bond investors.

Finally, we believe Beijing's initiatives to cut private-sector debt and reduce financial sector risks should help improve China's economic fundamentals.

Risks surrounding RMB bonds

Ratings discrepancies

There is a huge discrepancy in the ratings of Chinese bonds between domestic and international agencies. Domestic agencies give AA ratings and above to about 97 per cent of locally issued bonds and BBB and below to less than 1 per cent.[5]
On the other hand, a substantial proportion of Chinese bonds are unrated by more widely accepted international agencies (S&P, Moody's and Fitch), whose criteria and methodology may differ from those used by local counterparts. Given these discrepancies, it is especially important for investors to conduct thorough credit analysis on each individual bond.

Transparency issues

As China's bond market is still in development, investor relation teams are not widely developed, while almost all the financial filings are in Chinese. The penetration of sell-side research is relatively low. This puts a high premium on local knowledge, which may be difficult for overseas investors to obtain.

Default concerns

Investor concerns about the debt levels of Chinese corporates and risks to the bond market have been growing, after private-owned Chaori Solar became the first issuer to default on a RMB bond in March 2014, followed by state-owned Baoding Tianwei in 2015. Defaults and credit events are unlikely to disappear in the next few years as Beijing cuts overcapacity in non-strategic and unproductive sectors as part of its deleveraging campaign. This underscores the importance of using independent credit analysis, rather than local ratings, to properly price debt risks.

Conclusion

As one of the world's biggest bond markets with a largely untapped potential, we believe onshore RMB-denominated bonds have a promising future. With improved access, foreign investors are increasingly able to tap into its attractive valuations, relatively limited volatility and low correlation to other asset classes and diversify their fixed income holdings. Moreover, the potential for the RMB appreciation paints a favourable investment climate.

[1] *ChinaBond, JP Morgan as of 31.12.2018*
[2] *Standard Chartered for China, Haver Analytics, IMF, Asian Development Bank, Reserve Bank of India, Goldman Sachs Global Investment Research; as at May 2018.*
[3] *Pictet Asset Management, CEIC, Thomson Reuters Datastream*
[4] *Pictet Asset Management, BIS, CEIC, Thomson Reuters Datastream*
[5] *Wind, BNP Paribas*

Chinese wonders

Adam Cadle talks to Pictet Asset Management's head of Greater China Debt Cary Yeung about China's onshore RMB-denominated bond market

WRITTEN BY **ADAM CADLE**

Q How large is China's onshore RMB-denominated bond market, and what kind of instruments are traded in the onshore market?

The onshore RMB-denominated bond market currently has a market capitalisation of around $12 trillion. It is the world's third largest bond market. In terms of exposure there are different instruments available - government bonds, quasi-sovereign bonds, local government bonds, corporate credits, which include state-owned enterprises and pure private-owned enterprises.

Q Why do you believe the asset class is attractive for institutional investors, particularly insurers?

There are several reasons for it. Chinese government bonds are rated as A1 by Moody's and A+ by S&P. Yields on Chinese government bonds are higher than those of many developed market bonds. As at the end of December 2018, five-year Chinese onshore government provided a yield of around 3 per cent. This compares very favourably with developed market government bonds, for example five-year UK government bonds provided a yield of 0.9 per cent and five-year Japanese government bonds -0.2 per cent (at the end of 2018), so we do think that valuation is one attraction.

The other is the low correlation with other major asset classes therefore being an asset class that offers true diversification benefits to insurance companies. For example, last year when US treasury yields rose significantly, Chinese government bond yields dropped and gave investors capital gain.

China is running a very independent and different economic cycle compared to the rest of the world. The behaviour of Chinese government bonds is often very different from the behaviour of major asset classes in other markets. Volatility of Chinese government bonds is low compared to other emerging market asset classes. The reason being is that the market is very much dominated by institutional investors, including banks, insurance companies and asset managers.

Finally, the market is growing and is becoming more recognised by the global communities. For example, Chinese onshore bonds will soon be added to major bond indices. In April this year, Bloomberg will start adding China sovereign and quasi-sovereign bonds to its Global Aggregate Bond index.

Q Foreign participation in Chinese onshore bond markets is still very low. How much of China's trillion in outstanding bonds is owned by foreigners and how do you expect this to change over the next few years?

We have around $12 trillion of market cap in the Chinese onshore bond market and right now there is only two per cent of foreign ownership. We expect it to rise, but it will not rise in a very aggressive manner. We expect it to gradually rise to around 5 per cent in the next few years because of the opening up of the market.

Q The Hong Kong Stock Exchange launched Bond Connect in 2017, how has this helped to open up the Chinese onshore bond market to overseas investors?

There were several schemes previously allowing foreign investors to access the onshore Chinese bond market. It started with schemes called QFII and RQFII which were subject to a very onerous approval process. But this improved with the introduction of another scheme called CIBM Direct scheme. You only need to file for an application and it may only take 20 days to get an approval, so that was a big progress. In 2017 Bond Connect was introduced representing a milestone in the liberalisation of Chinese capital markets. The benefit of this scheme is that you can buy bonds without quotas via an account set up in Hong Kong, without the need to appoint an onshore custodian.

Q Chinese onshore bonds are waiting to be included in major global bond indices. What will be the impact on the Chinese onshore bond market?

There would be around $100 billion of passive flow into the Chinese onshore bonds market because of the inclusion by Bloomberg Barclays Global Aggregate Index alone.
We believe there are two significant meanings to the Chinese bond market. One is the index providers spend years to conduct due diligence. If they agree to include Chinese bonds into the index, this means a lot to global investors because they know that the indices have already conducted the due diligence process. Secondly, the initial market consensus is estimating that if three global bond indexes are going to include Chinese onshore bonds, there will be around a $280 billion of inflows.

Q The trade war between China and the US has impacted on China's stock market and currency. What's the impact been from this on the Chinese onshore bond market?

Chinese Bond yields dropped due to the moderation of growth in China; Authorities have conducted accommodative monetary policies which resulted in the down shift of the yield curve. That actually benefitted the bond market. In fact in year 2018 our strategy returned 2.7 per cent, in US dollar terms, one of the few asset classes with a positive return in 2018.

Q Solvency II regulations have led to higher capital requirements for insurance companies. How does investing in Chinese onshore bonds compare with other bond investments, particularly around capital requirements?

Chinese onshore bonds require relatively favourable capital charges under Solvency II Rules. But we recognise insurance companies have different challenges and we can be very flexible with regards to in which part of the bond market they like to invest to optimise the SCR score.

Q Could you talk a bit about what Pictet are doing in the Chinese onshore RMB-denominated bond market?

I joined Pictet in year 2014 and in 2015 we launched the Pictet-Chinese Local Currency Debt fund to access the onshore Chinese bond market. We have a team of three people managing this strategy in Hong Kong, supported by global resources at Pictet including in London, Geneva and Singapore. In the team we have a senior credit analyst and also a dedicated trader. We are fluent in English and Chinese, which is crucial as trading and communication

> **The onshore RMB-denominated bond market currently has a market capitalisation of around $12 trillion. It is the world's third largest bond market**

with brokers are conducted in Chinese. Research materials, newspapers and financial information are also in Chinese. We also have three credit analysts in Singapore supporting the credit analysis part of the strategy. The fund itself is very much focused on high investment grade credits, sovereign bonds, quasi-sovereign bonds and local government bonds. The ratings of the strategy on average is single A rating with a short duration. The yield of the portfolio at the end of 2018 was around 4.2 per cent with a duration of 3.9 years. This goes back to the attractions of our strategy being the attractive yield with short duration and high quality credits.

Q Last year most stock markets had a negative return, what happened with the Chinese bond market?

We had around 20 per cent of negative return for China equity markets in year 2018. That's in CNY terms. But in the bond market there was a positive return of around 8 per cent, so you can see how different the performance of the two asset classes is. The equity market is historical much more of a retail market and therefore subject to big swings driven by consumer/investor confidence. But investors in the bond market in China are institutional investors with a long term focus, hence providing a more stable environment for investors.

Thoughts and insights

Aviva Investors head of insurance investment strategy Iain Forrester gives his opinion on investing and regulation

WRITTEN BY **ADAM CADLE**

Q How has the changing macro -economic conditions and political tensions changed investment strategies?

Our aim is to deliver bespoke outcome-orientated solutions to insurers, providing capital-efficient returns that take into account the constraints and objectives of each client. These solutions utilise the investment capabilities across our business, reflecting the different target returns and liability cashflow profiles over different insurers.

However, insurers' strategic asset allocations are also affected by shorter-term considerations. Macroeconomic developments, the end of the credit cycle and geopolitical tensions are having an impact on the tactical asset allocation of insurance companies. We can support our insurance clients through scenario analysis, understanding how their balance sheets might change in certain investment outlooks, and how hedging strategies could improve that position.

We are seeing insurers continuing to extend their investment into a broader range of diversified asset classes and geographies. Core fixed income allocations remain the dominant investment but we are seeing interest in private credit, with insurers considering multi-asset credit mandates relative to single-strategy credit. This gives managers the ability to move between assets according to where the best opportunities are, whether in public markets such as emerging market debt or private markets such as real estate and infrastructure debt.

Q How has the introduction of Solvency II changed the industry and the way insurers invest? Pension funds also seem to be following suit – what are the drivers behind this?

At the highest level, Solvency II has introduced more standardisation and comparability across the European insurance industry as well as establishing capital requirements that support policyholder protection. Although the UK industry has been used to operating under a risk-based capital regime, this has been a new requirement across Europe.

There is now greater attention on the market risks of insurers, driven both by the capital requirements and the second pillar of Solvency II. This sets out a risk and governance framework as well as a stronger oversight structure. The regulation also introduced the Prudent Person Principle which governs how insures invest. This means investing in assets they understand with risks that they can properly identify, measure, monitor, manage, control and report.

From an investment view, if you take a step back, the insurance industry has always been outlook-oriented – insurers need to deliver customer pay-outs for annuities or with profit products or to meet life insurance claims as they fall due. While this is still key, there is increased focus today on matching assets and liabilities, taking into account the interest rate sensitivity and liquidity of those liabilities. We are also seeing this trend taking place in pension funds, where cashflow driven investment is becoming increasingly more prevalent.

Q What type of investment strategies are being adopted. Is there more allocation to infrastructure and real estate as you mentioned earlier?

Although Solvency II and the way insurers view their balance sheets has had an impact, the low-yield environment in Europe and the UK as well as the growing importance of ESG factors has also changed the depth and breadth of the investment strategies and solutions. In general, there is more emphasis on diversification across a broader range of asset classes.

More specifically, the Solvency II capital charges have led to changes in insurers' asset allocations. We have seen a reduction of equities holdings, or the introduction of equity hedging strategies that provide downside protection, reducing the capital charge while still providing some upside participation.

We've also seen increased allocation to private credit, including infrastructure debt and real estate finance, reflecting the attractive capital treatment they receive under Solvency II.

Q What about private credit which has been popular across the investment world?

I believe the trend of increased insurance invest in private credit will continue. These assets provide illiquidity premia, diversification benefits, and downside protection. And the capital charges are not prohibitive. Some firms have looked at opportunities further down the credit spectrums – including lending to small to medium-sized enterprises and mezzanine debt - although there is reducing demand given where we are in the credit cycle.

We are also seeing more interest in structured finance, including deals backed by export credit agencies and swap repackage transactions. These opportunities are now available to long term institutions who can replace the reducing financing provided by banks. These markets are much more complex, and the risks are more granular, so they require extensive due diligence from specialist teams.

Overall, the industry has become much more sophisticated in the way they invest and manage their exposures in private credit, resulting in better investment outcomes.

Q You have talked about the importance of ESG and how it is being integrated into the insurance industry? What are some of the drivers behind this?

Sustainable investment is an increasing area of focus for insurers. For some insurers, it's an integral part of their investment decision making process and business model. More broadly across the industry, we see insurers looking at the risks that ESG factors can pose to their portfolio. Insurers' approach to ESG can also reflect the preferences of their policyholders, particularly in with profits and unit linked portfolios.

However, changes are also being driven by new regulations and directives. For example, European Insurance and Occupational Pensions Authority's (EIOPA) recent consultation is analysing how sustainability risks affect (re)insurers' investments, with a particular focus on climate change. It looks at potential changes to the Prudent Person principle which would require insurers to look specifically at sustainability risks. The Prudential Regulatory Authority also launched a consultation last year that focused on the financial risks of climate change.

Q How is ESG being incorporated into portfolios?

From an investment perspective, ESG is integrated into our investment analysis and decision- making process across the business. We look at things such as carbon emissions as well as corporate culture and good governance and have developed an ESG scorecard in order to benchmark companies against it. The scorecard sits alongside traditional financial metrics but we also take into account metrics that clients are specifically interested in.

For example, we can tailor and tilt the portfolio to reflect the client's particular view on how they want to invest sustainably, and how to balance this against their other key metrics. This could be, for example, to have a strategy aligned with the UN Sustainability Goals.

Q How have you responded to the regulation in terms of providing greater transparency and a better customer experience?

We are making effective use of technology in order to improve our understanding and engagement with the customer and their experience. For example, we have built a portal for our insurer clients that allows them to look at their investment portfolios in much greater detail. We're rolling this out to clients at moment. This reflects a fundamental change in the way investors can interact with their asset managers. Insurers want a deeper understanding of how their portfolios are performing, based on the metrics that matter the most to them. For example, our clients can log onto the portal and see the Solvency II standard capital charges arising from their portfolio.

Q Looking ahead, what other challenges and opportunities do you foresee?

In terms of investment opportunities, we believe there is still value in private credit particularly where insurers can take a multi-credit approach to investment. We also see opportunities for insurers to improve returns on their liquid assets, where we can deliver enhanced returns over money market funds with low capital charges. The challenges this year will be generated by the external economic environment and the risk of increased volatility – we expect insurers will be closely monitoring their risk exposure and risk appetite throughout the year.

In association with

WELLS FARGO Asset Management

CHAIR

ROSS PAMPHILON

Chief Investment Officer and Senior Portfolio Manager, Head of Credit Europe, WFAM Global Fixed Income

Ross is the chief investment officer and senior portfolio manager for the Wells Fargo Asset Management (WFAM) Credit Europe team. Ross was a founding member of the investment team and the architect of the firm's investment process, with over 20 years of experience in trading and portfolio management.

MARTIJN DE VREE

Senior Solutions Manager, Multi-Asset Solutions, WFAM

Martijn is a senior solutions manager for the Wells Fargo Asset Management (WFAM) Multi-Asset Solutions team in London. In this capacity, he designs and implements outcome-oriented investment portfolios. Prior to joining Wells Fargo in 2017, he served as a Senior Solutions Specialist at Insight Investment where he designed and delivered bespoke LDI pension solutions.

JENS VANBRABANT

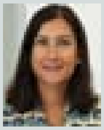
Senior Portfolio Manager, Head of High Yield - Europe, WFAM Global Fixed Income

Jens is a senior portfolio manager and head of High Yield for the Wells Fargo Asset Management (WFAM) Credit Europe team. He has served as a portfolio manager responsible for team's corporate investment grade and high yield credit risk before becoming a lead portfolio manager of WFAM Credit Europe's Multi-Asset Credit portfolios.

PRASUN MATHUR

Head of Shareholder Investments, UK & Ireland, Aviva

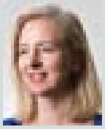
Prasun joined Aviva in October 2016 where is responsible for leading on the development and execution og investment strategy for the UK life shareholder business - this includes the £57 billion (and growing) annuity bank. Prior to joining Aviva, he headed up ALM strategy for Phoenix and has also worked for HSBC.



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.



LUCINDA DOWNING

Senior Research Analyst, Aon Hewitt, Retirement & Investment (R&I)

Lucinda develops asset class views within Aon's Global Asset Allocation Team for investment advisory and delegated consulting clients. She was previously Director of Balanced Funds at Russell Investments where she structured and managed multi-asset, multi-manager funds. She has also been a Portfolio Manager at State Street Global Advisors.

INVESTING IN THE EUROPEAN LOANS SPACE

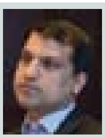
CHAIR: Where do we see the risks and the opportunities in the credit markets? Credit spreads generally widened last year in pretty much every sector. Valuations are now starting to look more attractive and offer a better cushion for default risk. Nevertheless, we are seeing increased risk dispersion and volatility, which can present opportunities but also certain risks.

At Wells Fargo Asset Management, we're expecting global growth to slow moderately as a result and we're seeing more risks to the downside, whether it's China, the impact of the US government shutdown or else political risk in Europe. With the ECB ceasing asset purchases, and looking to raise rates at some point later in 2019/2020, clearly we're in a different environment for risk assets. As a result we prefer to position more defensively, recognising that we are late cycle. So we're focusing on those credits and those companies that have strong access to capital, be it from their banks or a proven track record in the capital markets. We focus on those organisations that have strong balance sheets and stable cash flow generation.

DOWNING: As an asset allocator, we're also turning defensive, but at the asset class level, and clearly there are certain asset classes that perform better in this type of environment. I think a key question that everyone is asking is, when is the next recession? But we actually think that is the wrong question, because it's very difficult to tell, and a lot of the indicators, certainly on the credit sector side, can be coincidental, rather than forward-looking. The way we look at the market environment is that we think we're at the end of the up cycle, but not quite necessarily at the stage where we're going to see a big downturn. We call it a transition environment. You don't always have up cycles and down cycles. There is often a period where markets are just very choppy and broadly sideways, and we think we're in that type of environment, where volatility has picked up. That would mean generally taking opportunities to de-risk and move away from equities. Equities have been outperforming but we're moving towards a stage when bonds are going to outperform. Having some duration in your portfolio isn't necessarily looking such a bad thing over the next year or two.

CHANDRA: I think you're right to focus on the more secure parts of the capital structure at this stage in the cycle. But of course, many managers are looking in the same space, and yields are often not attractive in an absolute sense. It's important to look beyond the general matrix of asset class vs yield and seek out particular pockets of value. For example, within real estate finance, core properties outside Germany might provide a spread of 100 bps. But if you are willing to take a measured, calculated risk on asset quality – i.e. a fantastically located property that's been recently vacated, you can get a yield of, say, 200 basis points, as long as you have done the work to be confident that the property will be re-let. Finding those pockets of value is the key to generating attractive returns without chasing yield.

AZIM: From an advisory side, we sit across a variety of asset classes.



NIKHIL CHANDRA
Investment Strategist, Alternative Income Solutions, Aviva Investors
Nikhil is responsible for designing and delivering investment strategies to meet investors' specific objectives. In particular, he focuses on alternative income solutions. He works closely with colleagues across a wide range of functions including business development and client service, portfolio management, operations and legal.

We largely focus on risk and capital impacts. We do not advise on portfolio shifts per se. We are currently observing two main trends. One is definitely defensiveness - whether it's a late cycle, whether it's transition, it is not quite what you would call a robust and an up cycle. We are generally seeing clients shorten duration. It is tough to call the rate cycle, and it is very difficult to see what is going to happen with the continued, or discontinued unwinding of QE, so from our perspective, duration is definitely something we are asking our clients to look at. The second is to cherry-pick low volatility asset classes. Diversification is important, both at an overall allocation and individual asset perspective. If you take private credit, for instance, covenant-lite - this is not the time to be invested in this. So our views are coming from a holistic perspective.

MATHUR: We are long-term investors, so we invest for the cycle. We would carry on investing in every asset class. I think relative value becomes essential to the thinking here, when it comes to where you want to deploy your next fund of capital. That's where we spend a lot more time, because we expect that our asset managers will be assessing on an active basis, the through cycle risk of the individual credit, and as a consequence, some sectors will automatically be screened out and some sectors wouldn't.

CHAIR: Martijn, what about you, from your solutions perspective, how do you see the relative value across the asset classes?

DE VREE: We invest for the long term on behalf of our investors and position portfolios tactically to take into account current market conditions. Looking at the current environment, in the late stage expansion of the economy, we are carefully balancing global recessionary risks, on the back of slowing global growth, with increasing dynamism of the Fed with respect to their interest rate policy in the nearer term. There is a lot of focus on US policy and we also take a more global picture into account, for example Europe is in quite a different stage of the cycle and the yield curve is very different - portfolio positioning reflects that.

> In Europe we favour European loans compared to high yield. Across markets we like high quality securitised fixed income assets

More specifically in our multi-asset portfolios we favour high yield over loans in the US markets, with a particular focus on shorter dated high yield. We are generally short on duration in the US. In Europe we favour European loans compared to high yield. Across markets we like high quality securitised fixed income assets, as long as securities are selected by a skilful team.

US loan market

CHAIR: There's been a lot of press around the fact that the leveraged loan market in the US has grown significantly, over the last six years or so, to $1.2 trillion, and the CLO market accounts for about 50% of the investor base, so $600 billion. It's tempting to draw analogies to the CDO market and the subprime loan market, which grew to a similar size by 2007. How do we feel about the US loan market? Do we really see it as being a source of potential financial Armageddon? Or do we think that's going to play out differently? How is that going to impact global demand for credit risk?

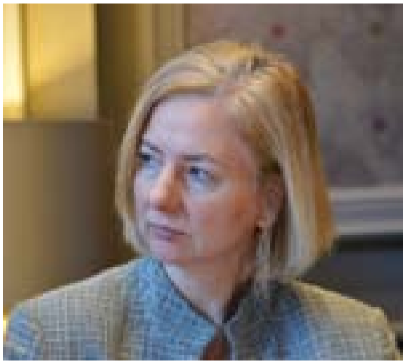
VANBRABANT: There have indeed been a lot of warnings about the state of the US loan market from central banks and news agencies, in particular with respect to its increasing leverage and its weaker documentation. We also know that when the US sneezes, Europe typically catches a cold so we are monitoring developments on the other side of the pond closely.

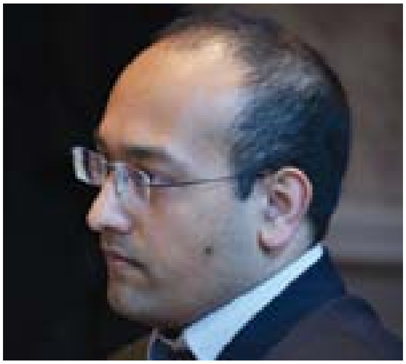
But it is also worth pointing out that some major differences exist between the US and European syndicated loan markets. Importantly, Europe is at an earlier stage of its economic cycle than the US with the first rate hike currently only priced in by markets for the end of 2019 versus the US which has already seen 9 hikes. Loans are assets that perform well during the latter stages of a cycle as they benefit from rising rates. Also, European loans on average offer stronger credit quality than US loans as they benefit from lower leverage, higher cash coverage and larger equity commitments from financial sponsors.

Regarding the CLO market, it is important to distinguish its performance from that of its cousin, the CDO. S&P did a study of CLO performance during the Great Financial Crisis. By 2008, S&P had rated over 4,300 CLO tranches. Of all those tranches, less than 1% defaulted in 2008 – 2009. CLO's are essentially quite robust structures. Since then, CLO structures have actually become even more robust because S&P has tightened its rating methodology: they've reduced the recovery rate assumptions for loans and increased the amount of losses a structure would have to suffer before AAA tranches would lose. So I don't think that the CLO market will be that source of volatility or systemic risk that maybe the CDO market was 10 years ago.

If we look at the 2018 returns on CLO equity tranches in the US, it was -11%, which is painful but not so bad as to cause holders to be forced to sell, particularly as these tranches are typically held by strong hands capable of dealing with a modicum of volatility. AAA tranches on the other hand, which represent two-thirds of a typical CLO cap structure, were up 2.5%. Not bad, when the overall US loans market was down -2.5% in 2018.

What will happen in the CLO market





this year? Well, the default rate in the US is expected to remain low 3.5% from a realised 2.8% in 2018, so with that level of defaults and with the threat of higher US interest rates off the table, I don't think that the US loan market will necessarily sell off as much particularly because right now spreads are higher than they were at the start of last year. So the US CLO market will generate positive returns in my view in 2019.

European loans

CHAIR: Do people think there are any reasons that Europe might be different, with respect to lending standards in the liquid loan market?

VANBRABANT: Specifically from a regulatory point of view, there have been two developments in the US that did not occur in Europe. One was the removal of the leveraged lending guidelines by the Trump administration. Trump sent out a clear message that those guidelines would not be

The CLO market will be that source of volatility or systemic risk that maybe the CDO market was 10 years ago

enforced, and those guidelines were essentially aimed at making sure that banks did not put too much debts on the balance sheet of borrowers. So with that cap removed in US, of course there's going to naturally be an incentive for borrowers to take on more leverage, for the private equity owners to put more leverage on their businesses. Inherently that makes investing in US loans slightly riskier.

Secondly, if you look at the CLO market the 5% risk retention requirement has been removed in the US. What that means in practice is that there is more freedom for CLO

managers to maybe put some riskier assets into their structures.

In Europe unlike in the US, we still have those two pieces of legislation in place, so the market is structurally more regulated and therefore safer here than stateside.

MATHUR: Do you see the interpretation of leverage loan lending guidelines in Europe as being different, depending on whether it's German loans, Italian loans, or Spanish loans?

VANBRABANT: I haven't seen differences. I mean I think the way the legislation works is that there is an onus on the banks to report to their regulator, when they are putting a certain amount of leverage - in practice six times - on a company. They have to report that, and they have to also indicate to the regulator how they think the company will be able to deliver to half the original levels of leverage within a 3 year time period.

CHAIR: How does your market, which is more liquid in the spectrum compete with the private credit markets, with respect to overlap, lending to larger SMEs? Do you see a similar lack of discipline, with respect to direct lending, regarding leverage levels and covenants?

VANBRABANT: Traditionally the cut-off between the private debt markets and the syndicated loan markets, the publicly-traded loan markets was EUR 50 million EBITDA. If your business generates EUR50 million EBITDA, you can take on 5 times leverage and issue a €250 million deal to the loan market. At that level, it's big enough for a number of banks to offer liquidity in it in the secondary markets.

One consequence of the leverage lending guidelines that I referred to earlier, has been that banks and financial sponsors looking for ways around this restriction have turned to the private debt market, where that requirement does not exist. So the European private debt market's growth can at least partially be explained by the leveraged lending guidelines. Direct lending funds have been more willing to offer these higher levels of leverage, often using unitranche deals, as they have been competing desperately for lending opportunities given the strong inflows into their asset class and the resulting need to get invested.

CHAIR: Does the private debt market sufficiently compensate you for illiquidity?

CHANDRA: I think it's important to look at this on a pan asset class basis. The key is relative value—different asset classes exhibit different illiquidity premia at different times. They don't all move in tandem. Hence a multi-asset approach to private credit allows an investor to take advantage of the best relative value opportunities. Historically

> In Europe unlike in the US, we still have those two pieces of legislation in place, so the market is structurally more regulated and therefore safer here than stateside.

we've seen illiquidity premiums go between 50 bps to 100 bps. The other point to be aware of is that not all managers define the illiquidity premium in the same manner.

MATHUR: I think we're not sure what illiquidity premium is right now. I think it has very different interpretations. That view keeps on evolving as the market changes.

AZIM: First, if you look at Solvency II, one of the things that it has done is it's crystallised the way of thinking about illiquidity premium. It is not about illiquidity, it is actually about thinking through the cycle, through the curve, about essentially what I would call credit fundamentals analysis. Clearly, if it's not publicly traded or publicly rated, at the end of the day it is still a credit, so how do you understand the major risk drivers, and then how do you price? How do you put a basis point price on those risk drivers and then understand their relative impact on spread. An interesting example on illiquidity premium is the private placement market. Pure credit analysis based on balance sheet fundamentals and business metrics can sometimes price private placements through traditional rated corporate credit.

CHAIR: How do insurers approach illiquid assets from a skill set perspective? Is it a case of building up internal teams with relevant expertise, or is it more a case of relying upon external consultants, advisers and asset managers?

AZIM: I don't see very many insurers relying completely internally on this. Due to its novelty, it is receiving increased public scrutiny, from regulators, internal first –second and third- line, analysts etc. This entails a focus on obtaining the right expertise and input. Whether that means having light internal teams, which are fully focused from a number of different aspects - i.e. manager selection, due diligence for different types of assets, strategic asset allocation, to different types of assets and then also understanding the quantitative illiquidity premium of those type of assets and relative value of those assets. Then thinking about how to rate these assets, how to monitor these assets.

It is quite a complex chain and I think that there are insurers who do it all internally, but there are a lot of other insurers who seek specific help.

DOWNING: At Aon, we have a big manager research team. We have a team that focuses on private credit, and obviously, we rely on manager insights as well. At this particular time in the cycle, we are stressing to our clients that you have to pick a good manager to get your good returns.

CHAIR: What do you look for in a good manager?

DOWNING: I think there's a few things that you can look at - strong deal-sourcing expertise and experience of past cycles and distressed credits.

MATHUR: The credit rating process is quite a big differentiator between different asset managers, and not every credit rating process stands up to scrutiny. That's especially true for private assets. So we definitely put a lot of focus on the ability of the investor to assess that.

AZIM: I think if it's private assets, the complexity of the investment and capital decision making process would make me question if insurers have the entirety of the skills needed to get all of that right. With private assets, credit and ratings is only one thing. A lot of these assets are structured or collateralised, hence a need to understand the cash flows, tax implications of putting one structure versus another structure. To do all of that internally needs a lot of different skills. I think that you'd be smart in making sure that you're reaching out to your advisers – asset managers or consultants.

DE VREE: Insurance companies make their own cost-benefit analysis in our experience, based on ability to attract talent, size of allocation and complexity. Private credit is one of those type of assets that more generally ends up being oursourced.

VANBRABANT: It depends on the insurer as well, because so many insurers are at different stages with respect to their expertise in terms of investing in credit markets to start with. I would say generally, insurers are comfortable doing investment grade in-house but when it gets to high yields, loans and private debt, they will typically use external managers.

Solvency II

CHAIR: What are the challenges insurers face when looking to incorporate credit into their portfolios, from a Solvency II perspective?

CHANDRA: Pre-Solvency II, an insurer would focus on asset selection and management and it tried to make that match with its liabilities. With the advent of Solvency II insurers focus much more on the liabilities side in terms of risk and duration. In the UK insurers are constrained by matching-adjustment eligibility criteria: prepayment protection, fixed vs. floating, investment grade, etc. In the Eurozone, it's much more driven by their underlying business model. Some insurers have shorter-dated liabilities, so they can't do longer-tenor deals. Most will have fixed liabilities, so will pursue fixed rate deals, unless they tactically prefer floating. It's also driven by whether they use an internal model, when they'll seek attractive assets on a capital basis as defined by them, or standard formula, in which case unrated investment grade loans become quite attractive.

MATHUR: The PRA is certainly pushing most of the insurers down the internal model route, rather than the standard formula route. This means that insurers can actually understand the risk, and this is very encouraging. Second, it means that different insurers, depending on their ability to understand that risk, will have different uptakes for them, from a capital perspective.

DE VREE: Insurance companies usually appreciate working with asset managers that have people with sufficient actuarial and Solvency II knowledge to speak the same language. Interestingly, we see different insurance companies in quite different situations, with those insurance companies that are better capitalised having the luxury of focusing more on investment efficiency and being less strictly influenced by Solvency II. We work with insurance companies subject to Solvency II both in the UK and also across Europe and customisation of the solution is key to cater for varying needs across these markets.

> Insurers are comfortable doing investment grade in-house but when it gets to high yields, loans and private debt, they will typically use external managers

DOWNING: However, Solvency II does restrict which asset classes are attractive to insurance firms. This can be seen by comparison with the investments we are recommending on the pension side. We're advising pension schemes to gain access to certain asset-backed securities and more absolute return products, whether it's alternative risk premia or hedge fund type structures. The eligibility and capital requirements make some of these types of assets less appealing to insurance companies.

CHAIR: The US credit markets have always been much larger than European credit markets, particularly in sub investment grade. Do you expect that gap, over time, to narrow?

VANBRABANT: I'm sure it will. Right now sub-investment grade markets in Europe are about 20% the size of the US. Our markets will never be as big as in the US because Europe is a patchwork of different countries and legal regimes but they will grow versus the US as European banks continue their battle to become more capital efficient.

One very effective way of becoming more capital efficient is for banks to become originators as opposed to lenders. So whereas in the past they would lend directly, they now prefer to underwrite deals and immediately recycle them to the public HY bond or syndicated loan market, pocketing an underwriting an origination fee and relying on institutional investors to carry that risk until maturity. That means banks' balance sheets become smaller and their return on assets and return on equity increases. European banks have an example in mind as they embark on this journey: their US counterparts, who have already succeeded in making this from lender to originator, which is exactly why the US HY bond and loan markets are so much larger than in Europe despite similarly sized levels of GDP being generated in the US and in Europe. The other benefit of having banks with smaller balance sheets and more capital is that it becomes much easier also for European governments and regulators to support their banks in case of difficulty.

ESG

CHAIR: Moving on to ESG, when I talk to the team internally, we refer to the three E's: exclusion, evaluation and engagement.

How do people feel about ESG? Firstly within private debt, the incorporation of ESG is more challenging, because you can't necessarily rely upon, for example, indices which can cover typically the more broad liquid credit markets. Do you see ESG as being necessary? One hundred per cent necessary? Relevant? Or a nice to have? With respect to the private credit markets?

CHANDRA: I think it's absolutely fundamental to what Aviva Investors does. On the one hand, it is imperative for us to be good corporate citizens. And on the other hand, this is increasingly important to clients. To your point about private credit, well thought out exclusion and engagement policies are absolutely feasible even in an illiquid context, and represents a good starting point for any asset manager in the space.

MATHUR: It's not an optional anymore. We've never considered it optional, but it's embedded in our investment beliefs. The regulator in the UK has put out a consultation paper on it - on how we expect to plan for it and demonstrate that we are thinking about it. We do look at ESG for every private or public credit that we do, whether it's investors or others.

We are much more familiar with the investors methodology than others.

The last I checked, it was the G that offered the maximum return on investment, but it's ever-evolving, that research, and I don't know what the latest is on it, but it does suggest a direction and an area of focus that maybe you can just be screening out the E and the S, but putting a lot more focus on the G.

> Integrating ESG will do no harm to performance, and therefore there's every reason why investors should look at it

DOWNING: I think the E and the S will come into their own in the longer-term. Our line is that, at the very least, integrating ESG will do no harm to performance, and therefore there's every reason why investors should look at it. We rely on managers to incorporate ESG into their processes and we rate them on how well they do integrate it.

For ourselves, we also give guidance to our clients. For example, we can run climate change scenarios on portfolios to demonstrate risks to long-term investment returns. This type of analysis is useful for our clients as it helps pin down potential outcomes.

CHAIR: How do you distil and separate out the good managers who take ESG seriously and adopt it as a philosophy, in their investment decision making, versus those that perhaps jump on the bandwagon to help them not being screened out? From an asset manager perspective, how do you perhaps balance those tough decisions between whether to invest and incorporate if you see a good opportunity to make a dollar, versus to not invest, based upon the ESG criteria?

DOWNING: I think you can tell if a manager is just writing an RFP as an ESG tick-box exercise. It's not that difficult to weed out those managers by asking for actual examples of how ESG concerns have affected past investment decisions. You really do need the thought process to be integrated into the whole investment process. Certainly we are seeing a lot of managers saying the right thing around ESG.

A life without limits?

Oliver Wade delves into the depths of insurance-linked securities and explains what the asset class has to offer

WRITTEN BY OLIVER WADE

The level of interest in insurance-linked securities (ILS) has grown significantly among insurers and other institutional investors in recent years, with the market increasing to a record size of $93 billion at the end of 2018, up from just $18 billion in 2009. The popularity growth of this asset type, though, should not come as a surprise, as the nature of ILS allows investors to diversify their portfolio and allows them to generate sufficient returns in a low-interest rate environment.

Incorporating ILS into a fund also prevents investors from being exposed to traditional risks found amongst broader financial markets, as the returns are dependent on natural risks rather than fluctuations in the stock market.

Taking it back to basics, TigerRisk Capital Markets and Advisory chairman Michael Wade describes ILS as: "At its simplest, Insurance Linked Securities provide a method of investing in insurance or reinsurance risks more directly than by purchasing shares in insurers or reinsurers. They tend to be catastrophe (CAT) risks for windstorms, earthquakes, floods, etc and not individual risks or policies."

Likely investors of ILS

Wade continues, adding that the more "obvious" investors of ILS would be pension or hedge funds, rather than forming part of an investment portfolio for an organisation that is "already exposed to such risks", such as insurers.

"For a pension or hedge fund, they will already be allocating a proportion of their investments into 'insurance' and which will include reinsurance. ILS are instruments that enable investors to gain a more direct exposure to the asset class where 'CAT' risk is a part of their interest."

Despite this, Wade underlines that ILS would more than likely only form a "modest proportion" of an overall investment portfolio, estimating that it would account for just 5 per cent of it.

However, Schroders head of ILS Daniel Inechein argues that ILS is appropriate and attractive for all types of investors and "should have room in any institutional portfolio", with the most appealing feature of the asset class being its ability to diversify a portfolio, while also providing "attractive returns". Despite this, he agrees that pension funds are very "prone, natural investors" to this particular asset.

He continues: "We see family offices also very interested in ILS.

"On the other hand, we also have investors across the board interested. Institutional investors, including insurance companies, are particularly interested in this asset class because they already understand the risk and how the asset works regulatory wise."

Inechein states: "When one of your main asset classes in a multi-asset portfolio, being it stocks, being it hedge funds, being it bonds, even commodities, when one of these referenced asset classes experiences negative months, on average, nine times out of ten, ILS actually provides a positive contribution. That's exactly what you [investors] look for, regardless of whether you are a player in the industry or not.

"You want an asset that is independent and provides positive return contributions, if your main assets are down."

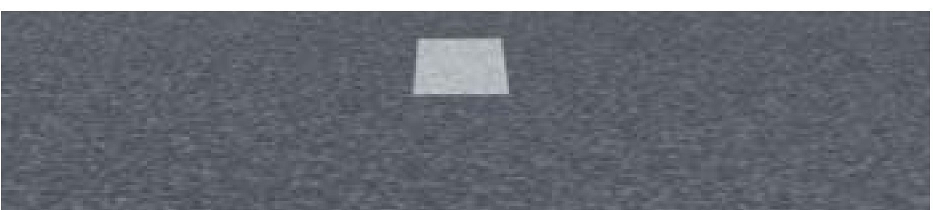
Benefits of ILS

As previously mentioned, there are many benefits of including ILS in an investment portfolio, namely its ability to diversify a fund while managing to offer positive returns.

According to Inechein, Schroders has identified three key benefits of this asset class; an asset type that provides "really interesting" risk-adjusted returns; provides strong diversification and independence from the primary asset classes; and it is an asset that possesses a floating rate "in nature", meaning that the interest rate risk is limited.

"In a bond book, usually if you want to increase your spread levels, you have to increase your duration. Whereas ILS is an asset class that allows you to buy additional spread while lowering your duration," Inechein explains.

> ILS is an asset class that allows you to buy additional spread while lowering your duration



Commenting on the asset type from a more interest-focused perspective, the Schroders head of ILS highlights that "more and more" consultants are including ILS in their strategic asset allocation, which is therefore impacting the way in which the market is being penetrated.

Wade highlights that the short duration of ILS, in many cases, can be advantageous to investors, stating: "An ILS contract is where an insurer or reinsurer transfers risks to a 'cell' and where the counter-party investor commits assets to cover the liability; once the liability has expired the cell is wound up, and the assets and profits are distributed back to the investor, unless, of course, there is impairment."

The TigerRisk chairman notes that many institutional investors, such as pension and hedge funds, will already be allocating a proportion of their investments into ILS, which will include both insurance and reinsurance. ILS are instruments that "enable investors to gain a more direct exposure" to the asset class where catastrophe risk is in their interest.

Furthermore, Insight Investment head of insurance Heneg Parthenay reiterates that ILS offers investors a great deal of diversification, highlighting it as the primary benefit of this asset type, while also protecting them against "classic" market risks.

"Even when a catastrophic event occurs, it does not last too long. When looking back at some of the most catastrophic events in the world, the impact on financial markets was very short-lived. This means that the lack of correlation between the types of risk can be back-tested to a certain extent."

Limitations of ILS

When questioned on the limitations of ILS, Inechein's immediate response was "that's a good question". Though this

> It will continue to grow in terms of market share, along with the volume of purchased reinsurance, so we are very positive for the growth prospects of ILS

asset type offers many benefits, it is not without its faults.

Inechein draws attention to one particular limitation of ILS: "The most obvious limitation of ILS is it's size.

"From a size perspective, currently, the market is estimated to be between $100 billion and $120 billion, so it is a relatively small market, and it only accounts for approximately 20 per cent of the entire catastrophe risk market. This, therefore, indicates that market size is a limiting factor because it is a smaller, niche market.

Parthenay emphasises this point, noting that it is difficult to predict the future returns an investor would gain from ILS. In order to forecast what kind of returns an investor might expect, they would need to analyse previous models. However, as the ILS market is still quite small, with it only beginning to see significant growth in recent years, the data cannot be too indicative.

"On top of that, we certainly do not have the amount of liquidity that you would typically experience in either the stock market or on a corporate bond market segment. So, it is likely less liquid, but we also have segments where we can actually manage its type of liquidity in product."

Furthermore, Inechein accentuates a further limitation of this asset type, noting that the choice of exposure available is "heavily dominated" by American risks, citing the examples of the Californian wildfires and the hurricanes in Florida which provided "peak exposure". However, he notes that the choice of exposure is becoming more diverse, with the risk of European windstorms, along with Japanese earthquakes and typhoons.

Expanding on this point, Wade emphasises that ILS has been impacted by the tremendous catastrophe losses experienced in both 2018 and 2018. This has, therefore, resulted in investors being "cautious" for the 2019 renewals, as well as expecting greater rate rises compared to what had been offered previously.

Future of ILS

Commenting on how the ILS market may evolve in the coming years, Inechein reaffirms his belief that the asset will remain "in a certain niche", but he is sure that the understanding of the asset class has increased, particularly over the last year.

"It will continue to grow in terms of market share, along with the volume of purchased reinsurance, so we are very positive for the growth prospects of ILS."

Whereas Wade insinuates that investors are being more cautious when it comes to ILS due to the high level of natural disasters in recent years, the Schroders head of ILS suggests that the rise in catastrophes is good for the market, with a growing focus on transferring risks.

"This is good for our asset class because it usually results in high yields and higher compensation for insuring the risk," Inechein explains.

It seems as though interest in the ILS market will continue to see significant growth over the coming years, with its ability to diversify a portfolio proving to be a key attraction for many investors. Arguably, the largest limitation of ILS is its size. However, as the market continues to expand at a rapid rate, this is sure to become less significant over time.

Current ponderings on industry themes

"Beazley saw strong growth in 2018 with gross premiums written rising 12%. Our US business has been growing extremely well and we underwrote more than a billion dollars of premium locally for the first time in the US last year.

"Although market conditions were challenging, depressing our earnings, we entered 2019 with positive premium rate momentum and higher interest rates that should deliver stronger returns going forward."

ANDREW HORTON
Beazley CEO

BERNARD SPITZ
President of the French Insurance Federation

With 54 million policies and 38 million beneficiaries, life insurance continues to be the favourite investment for the French.

"Faced with the uncertainties of the future, this product protects savings by offering the best long-term guarantees, and fulfils its role in terms of financing the economy."

Beazley saw strong growth in 2018 with gross premiums written rising 12%. Our US business has been growing extremely well and we underwrote more than a billion dollars of premium locally for the first time in the US last year.

"Although market conditions were challenging, depressing our earnings, we entered 2019 with positive premium rate momentum and higher interest rates that should deliver stronger returns going forward."

During the Brexit negotiations, our priority has been to ensure that we are positioned to continue meeting the needs of our policyholders who have assets and business across Europe.

"The authorisation of our subsidiary means it will be business as usual for our customers and brokers, and we will continue to deliver the expertise they have come to expect from Travelers."

MATTHEW WILSON
Travelers Europe CEO

ANDREW HOLDERNESS
Clyde & Co's Corporate Insurance Group global head

Transaction activity worldwide was buoyant in 2018. Against a backdrop of stiff competition on pricing, stock market volatility and persistently low interest rates, a merger or acquisition remains a key strategy to reach new customers and markets, and to drive down costs by delivering synergies.

However, factors including Brexit, trade wars and protectionism are generating uncertainty, the enemy of deal-making. The slowdown in the Americas in the second half of last year is indicative of heightened investor caution and we predict 2019 will be a year of two halves – a slowdown in M&A in some markets in the first six months, while the second half should see a return to form."