Insurance Asset Management

Winter 2019

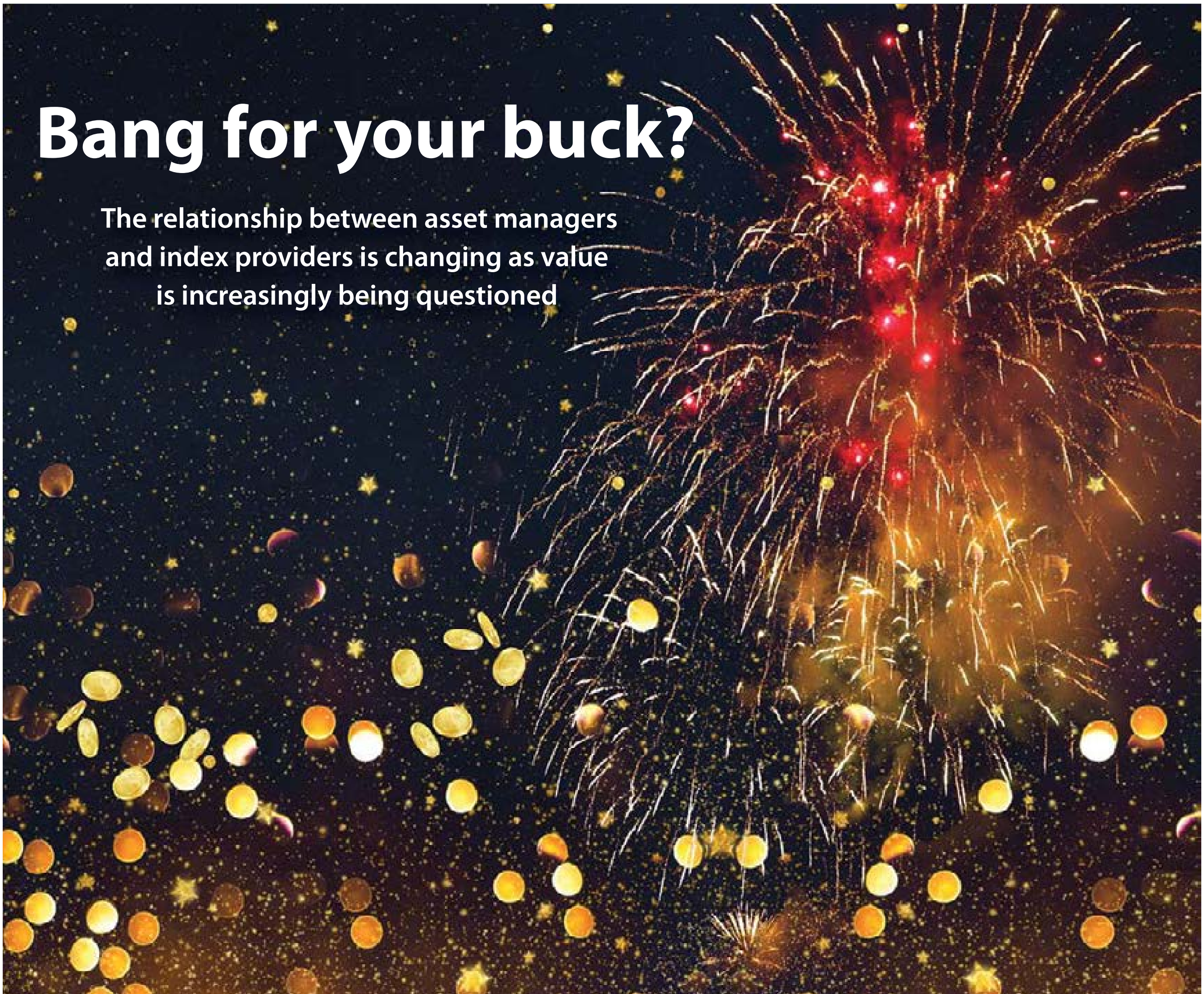
GDV
Update from the German Insurance Association

UNEP FI
The latest from the PSI's programme leader

Diversified Private Credit
The benefits of investing in this asset class for insurers

Bang for your buck?

The relationship between asset managers and index providers is changing as value is increasingly being questioned



CLIMATE CHANGE
How realistic are the latest climate-related financial disclosure requests?

SII 2020 REVIEW
The suspected impact the proposed reforms could have on the industry

GERMANY
Why are German insurers increasing their infrastructure allocations?

Editorial Comment

In order for any industry to work well, relationships and value for money are key. The insurance industry is no different. Just in the same way chief investment officers should have healthy relationships with asset managers and vice versa, particularly if the former have chosen to outsource the management of a particular asset class, a key partnership should also be cemented between asset managers and index providers.

Our cover feature (p.27) looks at the relationship between the two bodies. Can this be improved? Should index providers be adding value by creatively using their wealth of data, analytics and intellectual capacity?

Over the past few months, the issue of climate change has been rife. Extinction Rebellion protestors have again been making themselves and their messages known in London, as the government is being urged to look into this area further. Our feature on p.30 looks at whether the insurance industry needs to be doing more, particularly after Bank of England governor Mark Carney stated insurers must increase the quantity and quality of climate-related disclosures. "The demand for TCFD disclosure is now enormous," he said.

"Current supporters control balance sheets totalling $120trn and include the world's top banks, asset managers, pension funds, insurers, credit rating agencies, accounting firms and shareholder advisery services."

As is the norm with every issue, I like to focus on one or two particular asset classes, and how insurers are infiltrating each area for very specific reasons. This month we focus on infrastructure and the German market (p.42), as German insurers look to generate predictable and steady returns.

With a stronger focus on infrastructure, companies are trying to become more independent of the capital market and low interest rates. Infrastructure projects, with their long maturities, also fit well with the life insurance business model.

News also filtered in last month, that the European market on a wider scale has seen stability recently, with $10.3trn invested in bonds, company shares and other assets on behalf of millions of life and non-life insurance customers, making it the largest institutional investor in the EU. Stability is what we like to see and long may this continue.

> In order for any industry to work well, relationships and value for money are key. The insurance industry is no different

Editor
Adam Cadle

The team

Editor
Adam Cadle
+44 20 7562 2410
adam.cadle@insuranceassetmanagement.net

Reporter
Michael Griffiths
+44 20 7562 2427
michael.griffiths@perspectivepublishing.com

Commercial
John Woods
+44 20 7562 2421
john.woods@insuranceassetmanagement.net

Commercial
Camilla Capece
+44 20 7562 2438
camilla.capece@insuranceassetmanagement.net

Design & Production
Matleena Lilja
+44 20 7562 2403
matleena.lilja@insuranceassetmanagement.net

Accounts
Marilou Tait
+44 20 7562 2432
marilou.tait@insuranceassetmanagement.net

Circulation
Joel Whitefoot
+ 44 1635 588 861
joel.whitefoot@insuranceassetmanagement.net

insuranceassetmanagement.net
6th floor, 3 London Wall Buildings
London, EC2M 5PD
ISSN ISSN 2516-8096

Publisher Member




Winter 2019

FEATURES

INTERVIEWS


INTERNATIONAL MONETARY FUND

News focus

UK public calls for legal accountability for financial institutions investing in fossil fuels

ClientEarth's latest report said almost half would support rules requiring all companies on LSE to have Paris Agreement compliant business plans

Written by **Adam Cadle**

Three in five people believe that financial institutions and banks should no longer invest in fossil fuels (59%) and that they should be legally accountable if they choose to do so (60%), according to ClientEarth's *Climate Snapshot 2019*.

Almost half (47%) would support rules requiring all companies traded on the London Stock Exchange to have business plans that are compatible with the Paris Agreement or face delisting. Just 20% disagreed.

ClientEarth said the findings come as new research has revealed that the world's largest asset managers, BlackRock, Vanguard and State Street, are now the world's largest investors in fossil fuel companies with a combined shareholding worth $286.7bn.

ClientEarth finance lawyer Joanne Etherton said: "People are desperately worried about intensifying climate change and what they don't know is that their everyday financial products are in many cases heavily contributing to the issue. Too many banks, pension funds and insurers are propping up fossil fuel giants.

"The way the financial world responds to the climate crisis will be make or break for the health of our planet. People have clearly shown their appetite for action to tackle climate change and it's now over to financial institutions to respond, and align their business decisions with the Paris climate goals."

In the battle against climate change, Bank of England governor Mark Carney has argued insurers must increase the quantity and quality of climate-related disclosures; refine disclosure metrics to determine which ones are most decision-useful; spread knowledge on how to assess strategic resilience and consider how to disclose the extent to which portfolios are ready for the transition to net zero.

Speaking at the Task Force on Climate-related Financial Disclosures (TCFD) Summit 2019 in Tokyo, Carney said "the demand for TCFD disclosure is now enormous".

> Too many banks, pension funds and insurers are propping up fossil fuel giants

"Current supporters control balance sheets totalling $120trn and include the world's top banks, asset managers, pension funds, insurers, credit rating agencies, accounting firms and shareholder advisory services."

Carney said "the Bank of England is doing its part by assessing the strategic resilience of the world's leading financial centre".

"The Bank will be the first regulator to stress test its financial system against different climate pathways, including the catastrophic business as usual scenario and the ideal – but still challenging – transition to net zero by 2050 consistent with the UK's legislated objective."

According to AM Best, green and sustainability bond issuance by insurers may continue to grow, however.

AM Best associate director Michael Dunckley said: "Although insurers currently account for a very small proportion of the total issuance of the ESG bond market, given the strong reception these issues have had, other insurers around the globe may begin issuing more such bonds."

In its commentary, *Green and Sustainability Bond Issuance by Insurers May Continue to Grow*, AM Best also noted that national efforts to accelerate green initiatives could provide incentives for green bond issuers, gaining them access to a broader field of investors, which creates more competition at placement and could result in lower financing costs.

Senior finance analyst Jessica Botelho-Young added: "A further benefit of green bonds is the likelihood they will enhance a company's public image through its green credentials. Insurers that have issued green bonds to date have large retail operations and are keen to boost their brands' perception and goodwill."

News in brief

- MetLife has seen its net investment income rise by 3% to $4.6bn in the three months ended 30 September 2019 compared to a year earlier, driven by favourable changes in the estimated fair value of certain securities which do not qualify as corporate accounts under GAAP. Net derivative gains amounted to $1.3bn, or $991m after tax during the quarter.

- AXA has announced it has entered into an agreement with Crelan Bank to sell its Belgian banking operations, AXA Bank Belgium. Under the terms of the agreement, AXA will sell 100% of AXA Bank Belgium to Crelan for a total consideration of €620m.

- Beazley, the specialist insurer, is making a strategic investment in Hong Kong-based coverholder, Pegasus Underwriting Limited, which will see Beazley become a 30% shareholder in Pegasus. Beazley and Pegasus began working together in January earlier this year.

- AG2R La Mondiale, the multinational insurance firm, has obtained a historical interest rate of 4.375%, the lowest recorded rate to date on the issue by a European insurer on securities.

- Clearwater Analytics has announced the launch of a new platform connection in partnership with Goldman Sachs. The arrangement will link Clearwater with the Goldman Sachs Liquidity Solutions Portal, an online platform for trading, reporting and analytics for liquidity investments – for a single sign-on experience.

Insurance companies turning to customised passive mandates

ETFs not the sole focus now for investors

Written by **Michael Griffiths**

DWS Group has announced a new research paper on how insurance companies, in their search for value, are increasingly turning to customised passive mandates rather than just ETFs.

The asset manager suggested it is well documented that institutional investors, including insurance companies, are increasingly utilising ETFs to take certain investment exposures.

DWS has also said, however, that the rapid rise of another form of passive investing is lesser well known – customised passive mandates – which have also started to find their place in the general accounts of insurers.

The new paper notes that traditionally, insurers have been active investors – usually matching their liability streams with corresponding assets and playing around the margin with security selection – as well as asset allocation to attain additional investment income.

Besides their liability structure, DWS has suggested insurance companies must also consider regulatory and accounting constraints in their investment decisions, and in order to comply with these constraints, insurers should require a high degree of customisation in their investments – especially in the fixed-income space.

The DWS paper has revealed passive investment products – which are often only associated with one-size-fits-all ETFs, or index funds – may not be the first choice for insurance companies to make any strategic investment.

DWS said it believes that by neglecting the value that an additional form of passive investing can bring, the insurance industry could miss an opportunity in customised passive mandates – which can offer a broad range of different investment outcomes, while also considering individual investment constraints such as exclusion lists, or target durations.

The research paper outlines some of the considerations that have led these insurers to embrace passive mandate investing, and summarises the advantages that ETFs have for insurance investors.

Attention is also gathering pace in the real asset investment space. Fifty-one per cent of insurance executives expect their investments in real assets to increase over the next 12 months, according to Aviva Investors' 2020 Real Assets Survey.

> Institutional investors continue to look at private assets for diversification and potential illiquidity premium over public markets

"With uncertainty over global growth and the likelihood of interest rates remaining lower for longer, institutional investors continue to look at private assets for diversification and potential illiquidity premium over public markets," the firm stated.

Forty-four per cent of insurers said escalating trade wars were a concern to their real asset investments over the next 12 months, whilst the continued lack of clarity over the future relationship between the UK and the EU was also a concern.

On the issue of ESG, 40% of insurers consider a 'favourable ESG impact' of real assets to be integral. Insurers are also more likely than pension funds to consider the transparency of asset managers' ESG investment approach when looking at external investment providers. Investors also highlighted a preference for multiple strategies within real assets allocations. Over half of insurers increase investments in real estate finance (54%), infrastructure equity (52%) and structured finance (51%).

Argentina capital controls could create uncertainties for insurers

Growth prospects and business opportunities for domestic insurance companies may be hit

Written by **Michael Griffiths**

Capital controls imposed by Argentina's government to combat economic instability could limit the growth prospects and business opportunities for domestic insurance companies, according to a new AM Best commentary.

The new commentary, titled *Argentina Capital Controls: More Uncertainties for Insurers,* has also suggested the capital controls could undermine the efficiencies of the carriers' operations.

AM Best has noted that the new restrictions on foreign currency transactions to stop money from flowing out of the country is an attempt to stabilise reserves – which are being depleted as Argentina supports the peso.

For Argentina's insurance industry, however, the capital controls could lead to economic contraction, and the industry is already dealing with high inflation levels and foreign exchange rate volatility – both of which are impacting insurers' underwriting performance.

Capital controls could also increase management expenses, as well as lead to higher capital requirements and solvency ratios for numerous insurers. The commentary suggested that short-term public debt restructuring – that which results from the decision to deploy international reserves to contain peso volatility – is also posing an additional issue for the insurance industry.

> Capital controls could also increase management expenses, as well as lead to higher capital requirements and solvency ratios

Swedish insurance premium income increases by 50%

Non-life insurance premium income amounts to SEK 88bn

Written by **Adam Cadle**

Swedish non-life and life insurance premium income has increased by about 50% during the past ten years, according to a report published by Insurance Sweden.

For non-life insurance, premium income amounted to a total of more than SEK 88bn in 2018. For life insurance, premium income amounted to a total of almost SEK 295bn. The four non-life insurance companies with the highest premium incomes were Länsförsäkringar, Folksam, If Skadeförsäkring, and Trygg-Hansa. These companies together accounted for about 80% of the market in terms of premium income.

The four life insurance companies that received the most premiums were Alecta, Folksam, Skandia and SEB Pension. These companies accounted for almost 50% of the market in terms of paid-in premiums.

On average, in 2018 each individual in Sweden paid about SEK 7,000 in premiums for non-life policies and about SEK 29,000 in premiums for life insurance policies.

IMF urges ACPR to begin field testing on improved monitoring of liquidity risk

Focus also applies to additional reporting of liquidity risk

Written by **Adam Cadle**

The Autorité de contrôle prudentiel et de résolution (ACPR) has been encouraged to begin field testing on additional reporting and improved monitoring of liquidity risk for the French insurance market.

The IMF said ACPR should "begin field testing such requirements at the earliest opportunity on a voluntary basis".

A discussion paper was published by EIOPA in March 2019 indicating additional reporting on liquidity risk and improved monitoring of liquidity risk are under consideration at a European level for macroprudential purposes.

"While the EIOPA discussion paper stops short of recommending liquidity requirements of insurers, given the prevalence of bancassurance models France should consider the development of a liquidity requirement for financial conglomerates," the IMF stated.

The ACPR had its say on the Solvency II (SII) review last month stating that it should not lead, all other things being equal, to increased capital requirements on the European insurance sector", Banque de France governor and ACPR chairman Villeroy de Galhau has said.

In a speech delivered at the 11th International Insurance Conference in Paris recently, de Galhau called for the weight of the risk margin – which represents on average 30% of the capital requirements at European level – to be reduced.

The governor did however acknowledge that SII has indeed strengthened the European insurance market.

Furthermore, de Galhau stated the importance of not losing sight of the long-term perspective – outlining that low interest rates are not just about monetary policy, but primarily the result of long-term structural trends.

These include finding the balance between a high level of savings and lower investment – a change, de Galhau claimed, that is linked to an ageing population and a slowdown in productivity.

"Low interest rates are thus a reflection of the historically low level of what economists call the real natural interest rate, which has fallen by around 2% over the last 15 years, in both the euro zone and the United States.

"In addition, we have been experiencing economic cooling for several months, the causes of which are largely external to the euro zone. According to the IMF, the intensification

> France should consider the development of a liquidity requirement for financial conglomerates

of trade tensions would cut world GDP by up to 0.8% in 2020, mainly due to rising political uncertainty and the consequent decline in business confidence.

"Global growth in 2019 is at 3% – its lowest level since 2008/2009. Overall, the euro area (has been) hit hard, mainly because of the weight of Germany, whose growth would reach at best, 0.5% this year."

BaFin urges providers to 'protest' against ultra-low interest rates

ECB rates 'jeopardising business models'

Written by **Adam Cadle**

Germany's financial regulator has urged major asset owners to protest against the European Central Bank's (ECB) ultra-low interest rate policy.

Speaking at an event in Bonn, Germany, BaFin's executive director Frank Grund said: "It has reached a point where market participants should make it very clear how bad low interest rates are now jeopardising their business model and thus their contribution to funded pensions."

According to German newspaper *Handelsblatt*, Grund said he had previously told pension providers and insurers not to complain but to accept the situation. This has resulted in lower rates available to customers.

He said BaFin was closely monitoring 15 life insurers and 31 pension funds amid concerns that they might not be able to fulfil the promises made to customers on a 15-year time horizon.

"The situation of life insurers and pension funds in these years requires us to strengthen our control," said Grund.

He added that BaFin was "committed to the protection of the policyholders and beneficiaries".

The ECB's marginal lending facility for the eurozone has been below 1 per cent since 2013. It has been set at 0.25 per cent since March 2016.

Meanwhile, the bank's deposit facility interest rate was cut to zero in 2013 and has been in negative territory since June 2014. In September it was cut by 10 basis points to -0.5 per cent.

The low rates, coupled with falling bond yields, has put huge pressure on pension funds across Europe.

German pension funds and insurance companies have seen their solvency levels come under pressure in this environment.

(This was first reported on sister title *European Pensions*)

> The situation of life insurers and pension funds in these years requires us to strengthen our control

Insurance 'a safe refuge in an uncertain world' - BaFin

Regulators forcing industry to increase its level of resilience

Written by **Adam Cadle**

Insurance "is a safe refuge in an uncertain world", BaFin president Felix Hufeld has said.

Speaking on a panel at the French Insurance Federation's conference, Hufeld said "insurance as a safe refuge in an uncertain world means very simple things if you are an insurance company, it means keeping your promises".

"If you take risk which is the very business of insurance, you have to be capable to keep your promise and that brings us back to one of the oldest concepts of insurance, solvency. If we take on long term risk, we have to be in a position to keep long term promises. If it is short term, it is much easier to calculate. So how do we do that in a world where interest bearing returns are approaching zero or even returning negative? The simple answer is you have to re-allocate portfolios of investments to streams of revenues which are not interest-bearing, which of course increases risk."

Hufeld added that regulators are forcing the industry to increase its level of resilience.

"The good old basics of managing an insurance balance sheet is still as important as it was 10 years ago, or 50 years ago, or 150 years ago. If that has been screwed up, you can forget about everything else."

US life insurers would see 15% decline in RBC ratios under severe credit migration stress

RBC ratio of 447% would drop to 378%, according to Moody's Investors Service

Written by **Adam Cadle**

The US life insurance industry is well capitalised with a median RBC ratio of 447%, however, applying a rating migration stress lowers the median RBC ratio by 69 points (15% decline), to 378%, according to Moody's Investors Service.

Although insurance companies would still remain well capitalised relative to regulatory requirements, some companies' credit ratings would likely face downward pressure, it said.

"For most US life insurance companies, asset risk is a significant risk included in the calculation of the RBC ratio," Moody's vice president Manoj Jethani stated.

"A sharp downward turn in the credit cycle that leads to a large number of credit rating downgrades within insurers' bond portfolios, and a corresponding rise in defaults, would reduce life insurers' capital strength."

According to Moody's, rating migration for those insurers with high concentrations of securities rated at the lower end of A-rating and Baa-rating can cause increased regulatory capital requirements relative to insurers with less exposure, reducing RBC ratios and potentially limiting insurance companies' ability to take out excess capital as dividends to service holding company obligations.

US direct written premiums in 2018 rose by 40.7% from levels recorded in 2009, according to latest data published by the NAIC on P&C insurance companies.

Total direct written premium values increased to $677,382,129,000, and the US P&C industry surplus is $779bn, up from $556bn in 2009.

The combined ratio in 2018 of 99.3% indicates an industry-wide underwriting profit for the year.

Total European insurance direct gross written premiums amounted to €1,311bn in 2018, up 6.2% on 2017.

According to Insurance Europe's latest *Insurance Europe - Key facts* report, total premiums in 2018 were made up of €764bn of life premiums (+6.7%), €407bn of property and casualty (P&C) premiums (+5.7%) and €140bn of health premiums (+4.8%).

> For most US life insurance companies, asset risk is a significant risk included in the calculation of the RBC ratio

European life premiums make up 33% of 2018's global life premiums and European non-life premiums make up 29% of 2018's global non-life premiums.

In 2018, insurance penetration increased by 0.21 of a percentage point to 7.46% and ranged from 0.5% in Liechenstein to 14.3% in the UK.

An average of €2,170 per capita was spent on insurance in Europe in 2018, compared to €2,049 in 2017. Of the per capita spend in 2018, €1,264 was on life insurance, €673 on P&C and €232 on health.

European insurers paid out €1,069bn in claims and benefits to insureds in 2018, a 3.1% increase on 2017. Life insurers paid out €705bn — a 2.6% increase — in benefits to insureds, providing them with capital and/or annuities.

Investments in liquid alternative ETFs to double over next year

Currently, liquid alternatives represent about 4% of institutional assets

Written by **Michael Griffiths**

Institutional investments in liquid alternative ETFs will more than double in the next year, according to new research from Greenwich Associates.

Liquid alternatives are investment vehicles that deliver exposure to alternative asset classes with daily liquidity, and common examples include closed-end funds, mutual funds and ETFs.

Currently, liquid alternatives represent about 4% of institutional assets, with average allocations ranging from a high of 6% of total assets among public pension funds, to a low of 2% among corporate funds and OCIOs in the US.

These allocations represent $882bn in institutional assets currently invested in liquid alternatives, including $564bn from public funds.

Greenwich Associates managing director, Andrew McCollum, commented: "For more than 20 years, institutional investors have been adding alternative asset classes to their portfolios. More recently, institutions have been adopting ETFs as a versatile, jack-of-all-trades portfolio tool.

"The intersection of these trends could ultimately bring about a transformation of alternative investments in institutional portfolios."

Greenwich Associates suggested growing numbers of institutions are taking advantage of liquid alternative ETF's liquidity and relatively low costs, in tasks ranging from manager transitions and tactical portfolio adjustments, to taking on long-term investment exposures and replacing fund-of-fund investments.

> Allocations will rise steadily for the foreseeable future

Institutions using liquid alternative ETFs invest an average 3% of total assets to the funds – bringing the current institutional market for liquid alternative ETFs to $47bn.

Greenwich Associates suggested almost 20% of institutions not currently investing in liquid alternative ETFs have said they would consider using them in the year ahead, and projected that over the next 12 months, institutional investment in liquid alternative ETFs will climb to approximately $114bn – roughly 2.5 times the current allocations.

McCollum, also author of *Liquid Alternative ETFs: The Next Frontier in Institutional Investing*, added: "Given institutions' embrace of ETFs in other asset classes and their ample appetite for alternatives, it's possible – even likely – that large numbers of these investors will experiment with liquid alternative ETFs when given an opportunity, and that allocations and total investment will rise steadily for the foreseeable future."

Between April and June 2019, Greenwich Associates conducted in-depth telephone interviews with 107 senior fund professionals at large U.S. institutions.

Study participants included public funds, corporate funds, endowments and foundations, and family offices, as well as representatives from OCIOs and consultants.

> The highest ratios tend to be held by mutual groups which do not have to consider return on equity for shareholders

More than half of largest 30 European non-life insurers have solvency ratios above 200%

Just a handful of insurers have ratios below 120%

Written by **Adam Cadle**

More than half of the largest 30 European non-life insurers for 2018 and 2017 have solvency ratios above 200%, according to AM Best.

Its new report, *European Insurers: Concentration, Competition and Markets Remain Key*, stated only a handful have ratios below 120%.

"The highest ratios tend to be held by mutual groups which do not have to consider return on equity for shareholders, and by those underwriting reinsurance and large corporate risks, where strong solvency is a competitive advantage," AM Best senior director, analytics & head of operations - analytics Angela Yeo said.

Gross premiums written of the five largest insurers in this ranking have been largely stable at just under 50%.

"When we look at the largest 10, we note that the proportion of premiums accounted for by them is also unchanged at 70%," director, analytics, Mathilde Jakobsen underlined.

"Despite this concentration, most European insurance segments are experiencing a relatively strong level of competition. Furthermore, each market has its own idiosyncrasies, with product and distribution channel mix dictated by the history and culture of each particular country, with some of the groups underwriting the majority of their insurance portfolios in their country of domicile."

Last month, however, French life insurers' reported that SII ratios declined in the first nine months of 2019 because of falling interest rates, reflecting pressure on future profits if rates do not increase, Moody's Investors Service has said.

Some large French life insurers' SII ratios declined between 15 and 23 percentage points in the first six months of 2019. As interest rates have further fallen by more than 30 bps between the end of June and the end of September, insurers' solvency ratios are likely to be even lower at the end of the third quarter.

"Solvency ratios are sensitive to falling rates as French life insurers are highly exposed to savings policies with guaranteed rates of return, and because their liabilities tend to be longer-dated than their assets," Moody's senior vice president Benjamin Serra stated.

"Weaker solvency ratios mainly reflect pressure on future profits and increased vulnerability to a further decrease in rates, but the risk of accounting capital losses remains limited."

People on the move

KEVIN WHITE

DWS, global co-head of alternatives research & strategy

DWS Group has announced that Kevin White has been named global co-head of alternatives research & strategy, reporting to Pierre Cherki, head of alternatives and co-head of the investment Group. White, who is based in New York, has been with the firm since 2015, working closely with the alternatives team as head of Americas strategy, alternatives.

SIMON WALLACE

DWS, global co-head of alternatives research & strategy

Simon Wallace has been named global co-heads of alternatives research & strategy, reporting to Pierre Cherki, head of alternatives and co-head of the investment group. Based in London, Wallace joined the firm in 2011. He currently holds the role of head of research for Europe, alternatives. DWS Group (DWS) is one of the world's leading asset managers.

JON MANSLEY

LV= sales and marketing director

LV= GI has appointed Jon Mansley to the newly created role of sales and marketing director. He will take on his new role on with immediate effect, reporting to Heather Smith, managing director of the LV= GI direct business. As part of his new role, Mansley will be responsible for bringing together the marketing and distribution strategies and delivery models at the insurer.

KEVIN THOMPSON

RSA, CEO

Former Insurance Ireland CEO Kevin Thompson has been appointed CEO of RSA Ireland, after being approved by the regulator Central Bank of Ireland. Thompson will replace Ken Norgrove, who is moving to the role of CEO of Codan/Trygg-Hansa, RSA Group's Scandinavian business. In his prior role, Thompson spent seven years as CEO of Insurance Ireland, where he had overall responsibility for the organisation.

JULIAN ADAMS

ABI deputy chair

The ABI has appointed Julian Adams, director, public policy and regulation at M&G, holding company of the Prudential Assurance Company, as deputy chair. He will serve alongside chair Jon Dye until summer 2020 and has been an ABI board member since 2016. Prior to this he was executive director of insurance supervision at the Bank of England, a role he held from April 2013. He has also served a similar role at the FSA.

DANIEL BECKER

Hymans Robertson insurance investment lead, life & FS

Hymans Robertson has appointed Daniel Becker to the role of insurance investment lead within its life & financial services practice. In this role, Becker will lead the firm's development of targeted solutions for insurers and financial services providers to support their insurance investment and asset liability management (ALM) activities. He joins from KPMG.

EXCHANGE TRADED FUNDS:
Enhanced portfolio solutions for insurers


John Adu
Co-Head of ETF Distribution, International ETF Team


Edward Malcolm
Head of UK ETF Distribution


Charles Matterson
Head of UK Insurance Solutions

Exchange-traded funds (ETFs) provide low cost and easily tradeable investment solutions for insurers looking to manage portfolio cash flows and maintain liquidity. In addition, new active and strategic beta[1] ETF strategies are increasingly helping insurers to design and build full portfolio solutions that can maximise income within individual duration and solvency capital constraints.

Access the power of ETFs
Thanks to their liquid, transparent and low cost structure, ETFs provide attractive tools for insurers looking to efficiently manage their portfolios or implement tactical changes to long-term portfolio allocations.

One of the key features of ETFs is their obligation to provide full portfolio transparency, thereby allowing insurers on a daily basis to look through to underlying portfolio holdings for full reporting purposes and to make accurate Solvency II capital charge calculations. Active and Passive ETFs that physically own bonds (rather than those that use synthetic replication) allow for full transparency and look-through within the Solvency II regulatory regime.

The obligation for ETFs to provide portfolio transparency allows insurers to look through for full reporting purposes and to make accurate Solvency II capital charge calculations. Active and Passive ETFs that physically own bonds (rather than those that use synthetic replication) allow for full transparency and look-through within the Solvency II regulatory regime.

Another advantage of ETFs is the intra-day liquidity facility that they provide, which can help insurers manage cash flows (for example, claims) or achieve a "fair" price in challenging markets, without modifying long-term allocations. The ability to get up-todate pricing throughout the trading day also allows risk managers to monitor changes in a portfolio's market exposure in real time.

ETFs are increasingly looked upon as market access tools, irrespective of an active or passive investment engine. They offer investors an increased level of transparency and liquidity, in addition to low cost market exposure compared to conventional active mutual funds. Investors now have a broad range of active and passive strategies to choose from across different maturities—providing the ideal risk and return building blocks for insurance portfolios.

Helping insurance portfolios reach their full potential

Different types of insurers can use ETFs to achieve different portfolio solutions. For example, the low cost, liquid and transparent market exposure provided by ETFs can help insurers to manage portfolio transitions, allowing market exposure to be maintained while changing investment manager, making a significant change to asset allocation or even while waiting for an appropriate market entry point to deploy cash.

Similarly, ETFs are often used by insurers to make tactical asset allocation changes (within their fixed asset class bands) by dialling up or down market exposure in reaction to changes in macroeconomic sentiment or market opportunities—all at low cost and with full look-through for regulatory capital purposes.

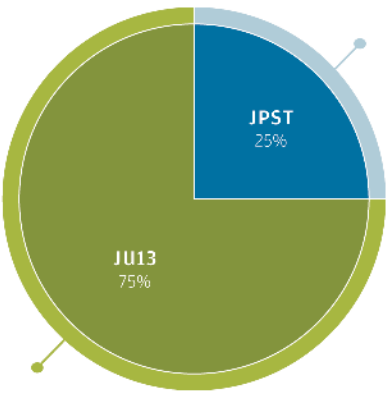
As well as being used for efficient portfolio management, some insurers are now beginning to use ETFs to design and build full, low cost portfolio solutions—blending active as well as passive strategies to meet long-term return targets or to match a particular portfolio duration to manage their individual liabilities, within a specified solvency capital ratio (SCR) range.

Building model ETF portfolios: An insurance case study

The ability of ETFs to provide full portfolio solutions can be particularly useful for smaller insurers, who tend to have high cash balances and who are

CASE STUDY: USING FIXED INCOME ETFS TO TARGET A 1.5 YEAR DURATION THROUGH CASH TIERING

MODEL STRATEGIC ASSET ALLOCATION



ULTRA-SHORT FIXED INCOME
JPM USD Ultra-Short Income UCITS ETF

US TREASURIES
JPM BetaBuilders US Treasury Bond 1-3 yr UCITS ETF

MODEL PORTFOLIO CHARACTERISTICS (USD):
Yield to worst (YTW) 1.90%
Total portfolio duration 1.59 years
Market SCR 2.64%
Blended Total Expense Ratio 12 bps

The model portfolio characteristics are simulated, which are subject to change without notice and are not reliable indicators of current and future results. As in any investment, there are risks to return and capital.

Source: J.P. Morgan Asset Management, extracted from PRISM, our proprietary portfolio management tool. The portfolio's yield-to-worst is the weighted average of each ETF's weighted average individual bond holding yields-to-worst as at 9th November 2019, in USD (unhedged). Both JU13 and JPST are two examples out of a number of sub-funds of JPMorgan ETFs (Ireland) ICAV.

not usually able to access dedicated segregated investment mandates.

Our simple case study shows how a blended portfolio of both passive and active ETFs can help insurers target a particular return and portfolio duration, within a given SCR budget. In the above case study we look at the example of a short duration property and casualty (P&C) insurance company that is looking to target a 1.5 year duration to match its liabilities, while also seeking to gain more yield than is typically available from money market funds.

The model portfolio consists of two fixed income ETFs (combining a benchmark-tracking ETF with an actively managed ETF), designed to help insurers make their cash balances work harder while managing risk. 75% of the portfolio is invested in the JPM BetaBuilders US Treasury Bond 1-3 yr UCITS ETF (JU13), which is a passively managed fund that provides access to short-dated US Treasury bonds by tracking the J.P. Morgan Government Bond Index United States 1-3 Year.

25% is invested in the JPM USD Ultra-Short Income UCITS ETF (JPST), an actively managed ultra-short duration fund that is designed to help investors seek an attractive yield compared to cash, while focusing on active credit risk management to target stable returns.

By investing in this blend of active and passive fixed income ETFs, the model portfolio provides an attractive low cost investment outcome compared to holding inefficient cash on 2019, a duration of only 1.59 years and a market SCR of 2.64%. All this is achieved with a blended total expense ratio of just 12 basis points (bps).

Target superior outcomes with ETFs

In summary ETFs offer a low cost, transparent and liquid structure. They are often used by insurers for efficient portfolio management, such as to manage portfolio transitions or to implement tactical asset allocation decisions.

However, insurers can also use ETFs to design and build stronger outcome-oriented portfolio solutions that can help them to reduce inefficient cash holdings and target attractive levels of income, while managing duration and SCRs within individual risk parameters.

For more information please contact us via email: jpmorgan.etf@jpmorgan.com

References:
[1] In the case that ETFs by JPMorgan track a strategic beta index, such indices will have been designed by or in collaboration with JPMorgan Asset Management

Soapbox

Ruling the roost?

Written by Adam Cadle

As we currently live in a world where we find ourselves discussing driverless cars, the potential for widespread drone deliveries and general automation, I put the question out there this month, as to whether technological innovation in the insurance industry will eventually drive out the 'manual' need for portfolio risk assessments, data analysis and stress testing?

The past few months have seen a wide range of technological innovations occurring in the sector, and this continues to gather pace. Clearwater Analytics announced the launch of a new platform connection in partnership with Goldman Sachs, which will see the former utilise the latter's online platform for trading, reporting and liquidity investments analytics. Investors who use both money market funds and separately managed accounts, or invest in direct securities, are currently required to access multiple systems to view their short-term investments, obtain information to help make informed investment decisions, or place trades.

With accounting standards, regulation and capital requirements coming at us all the time, the need for human skill AND technology has never been stronger

The new partnership will enable Clearwater and Goldman Sachs Liquidity Solutions Portal users to access their investments through connected platforms – which offer consolidated dashboards for all short-term investments. The platform will provide an optimally designed view across funds, direct securities, and separately managed accounts.

In addition, recently we have seen Moody's Corporation acquire RiskFirst, a leading FinTech company providing risk analytic solutions for the asset management and pension communities. Asset owners are able to use more sophisticated risk solutions as a result of RiskFirst, supported by advanced technology and analytics, to address growing financial management, funding and capital management challenges.

All of this, I wholeheartedly agree, is helping the industry to deploy more sufficient, in depth investment analysis, perhaps also at a more efficient pace as well, but does this have an adverse impact on the influence and power of the human being controlling risk analysis etc.

I remember writing about the same issue of automation and technological advancements on the pensions side of the institutional market particularly within administration.

Data cleansing is a big thing in the pensions industry and data records must be as up to date as possible. It takes a lot longer for an administrator to data cleanse than it does technology. The same thing can be argued on the insurance side of things, and I have heard many an argument that technology should rule the roost. However, I am a firm believer that chief risk officers, risk analysts, investment strategists, whoever it may be, can continue to live alongside increasing technological advancements. To ensure the safest routes possible, the two must act hand-in-hand, it should not be the latter driving out the former in my opinion. Every insurance company and asset manager would like speed and efficiency, there is no doubt about that, but what happens when discrepancies arise been the two's results? Both need one another to eradicate this and to ensure stability in an ever growing and complex sector.

With accounting standards, regulation and capital requirements coming at us all the time, the need for human skill AND technology has never been stronger.

How smarter ESG integration can preserve your free lunch

The first generation of ESG strategies excluded whole sectors from investors' portfolios. Such approaches are still widely used, but investors may be underestimating their impact on portfolio diversification

WRITTEN BY **LEGAL & GENERAL INVESTMENT MANAGEMENT HEAD OF INDEX EQUITY & SMART BETA DAVID BARRON AND INVESTMENT ANALYST JENNIFER SHERING**

Some investors value the peace of mind that comes from diversification, through owning different assets so that risks aren't overly concentrated.

Meanwhile, as many institutional investors are recognising a "climate emergency" and are under pressure to seek sustainable investment solutions, there is increasing demand for reflecting environmental, social, and governance (ESG) considerations in portfolios. But for some investors, excluding fossil fuels could mean excluding the entire energy sector.

In these terms, the objectives of diversification and of avoiding particular economic sectors because of ESG criteria appear contradictory.

We investigated this apparent conflict in order to quantify more accurately the relationship between negative screens and portfolio diversification in equities: put simply, are they friends or foes?

Sector inspector

We compared the correlation of each sector in the MSCI World index to that index to show the long-term diversification impact of each sector. Some sectors, such as consumer staples (including tobacco), healthcare and utilities, have consistently been diversifiers. However, correlations are dynamic, not static, and can switch unpredictably. Excluding sectors can deprive investors of diversifying assets unexpectedly, exposing them to greater risk.

Table 1: AVERAGE SECTOR OVERWEIGHTS IN MSCI WORLD EXCLUDING ENERGY INDEX (percentage points), 31.01.1995 to 28.06.2019

Materials	0.53
Industrials	0.96
Consumer Discretionary	1.03
Consumer Staples	0.81
Healthcare	0.94
Financials	1.84
Information Technology	1.07
Telecoms	0.43
Utilities	0.36

Source: LGIM, MSCI, Bloomberg

When sectors are omitted from a market-cap portfolio, how is their index weight redistributed among the other sectors? This could create unintended risks: a portfolio could end up with a higher beta than desired, or may not offer the required market performance.

When energy is excluded, the largest overweights have tended to be to consumer discretionary, financials and technology. The overall effect of rebalancing away from energy and into these three sectors is likely to result in above-average beta. Furthermore, these sector weights will vary over time.

We have focused on global developed market-cap exposure, with over 1,000 securities across more than 20 countries. For regional allocations, the impacts of reweighting can be even more pronounced: in UK equities, three energy stocks from just two issuers make up over 15% of the FTSE 100. Exclude these, and

the redistribution effect could create an overweight of almost four percentage points to financials.

> The objectives of diversification and of avoiding particular economic sectors because of ESG criteria appear contradictory

Matter of factor

We also looked at the factors (risk premia) that the energy sector has contributed over time.

The decline in the oil price from 2014 left the energy sector heavily overweight the value factor (although this has moderated). This led some to presume that negative screens systematically underweight value, but this is not the case. Recently, excluding energy has certainly left portfolios underweight value, but not so long ago, quality and momentum were major forces in the energy index.

Investors may recently have been willing to forgo value exposure because of underperformance, but would they have wanted to minimise quality and momentum factors in previous market conditions?

Portfolio permutations

In summary, traditional negative screens may be appropriate for investors who must avoid certain sectors. But others could preserve diversification without sacrificing their ESG criteria, by integrating those criteria into their investment process in more nuanced ways. The exploration of innovative and effective ways to incorporate ESG is the focus of our current "Friend or Foe" research.

At Legal & General Investment Management, we believe ESG scoring provides a framework for engaging the companies in which we invest, and also allows us to tilt portfolios to reflect ESG criteria while maintaining diversification.

An expert's outlook from Germany

Adam Cadle speaks to German Insurance Association (GDV) managing director and chief economist Klaus Wiener about the body and the German insurance market

WRITTEN BY **ADAM CADLE**

Q Can you explain your role at the German Insurance Association (GDV)?
I am member of the management board and responsible for the departments of economics, investments and law. GDV has 457 member companies. Based on premium income, our members account for 97 % of the German insurance market.

I joined GDV in late 2015, following 18 years in investments as chief economist and head of Tactical Asset Allocation at one of the largest European insurers. I had started my career in the banking sector.

The tasks of my current departments at the GDV range from legal, economic, and insurance market analysis to the provision of services to our member companies. We also represent the interests of the insurance industry vis-à-vis policymakers, supervisors and society, both at the national and European level.

Q In this role, what are your aims and ambitions for the year ahead?
The economic, social and market backdrop for the insurance industry is changing dramatically. In the GDV's work, we have two main aims: First, to help our member companies meet the challenges they face. Second, to contribute to the debate on future framework conditions. Let me give two examples.

We are witnessing an unprecedented yield environment, following the extreme monetary easing of the recent past. The strategy debate on the future course of monetary policy has intensified, and we try to provide some input. We firmly believe that unconventional measures should only be applied in times of crisis. Low inflation does not justify measures like negative rates or massive government bond buying programs, which have numerous risks and unwanted side effects. We are also against the idea of adopting a symmetric inflation target with price levels as the key monetary policy variable. This would only prolong an extreme yield environment. Instead, a more flexible inflation target with a price band could be adopted (e.g. 2 % +/- 1 PP).

Second, we believe that nothing will change the lives of people and the business models of companies more strongly over the next years than digitalization. Here, we analyse market developments for our members and engage in the ongoing dialogue on an appropriate regulatory framework, e.g. regarding the use of big data (BD) and artificial intelligence (AI).

Q Can you describe the current state of the German insurance market? What areas if any are a cause for concern?
As mentioned, the German insurance market is undergoing far reaching change. However, the development is evolutionary, not disruptive. For example, premium growth has been quite steady over the last years - and it is actually rising quite noticeably this year. Regarding the economic and political environment, however, there are certainly causes for concern. Geopolitical risks are at levels not seen since the fall of the iron curtain, and financial markets are quite volatile. What is special in Germany is the extent to which yields in bond markets have fallen. A couple of weeks ago, the yield on all maturities of German government bonds were in negative territory. Even the yield on the 30-year bond traded below zero, a situation never seen before in nominal terms. Apart from some smaller economies, this is not the case elsewhere.

Since guarantees have been the

centre piece of German life contracts for decades, the yield environment poses the biggest challenge at present. That said, companies have already reacted by adjusting their asset allocation in sensible ways without taking excessive risks. For instance, while we saw some rating drift in the IG space, exposure to high yield credit has not been raised, and the share on non-rated debt has even been reduced.

With yields likely to remain depressed for quite some time to come, companies have also reacted by adapting products to the new yield environment. Guarantees are still an important element in most life contracts sold but they are now more flexible than before. For instance, instead of annual interest rate guarantees there is a nominal capital guarantee at maturity or – in the case of pension products – a guaranteed life annuity. In this way, insurers can offer higher expected returns by being able to allocate a larger share of investments to higher yielding real assets.

Q From a strategic asset allocation angle, what changes has there been among German insurers, and where do you see this heading over the coming years?

There have been some changes in the asset allocation structure which are quite noticeable. For example, the share of investments in infrastructure has risen quite strongly in recent years. From an almost non-existent share of 0.1 % of all assets in 2012, it has risen to 2.4 % last year. This amounts to almost half the money allocated to equities. I expect this share to rise even more over the coming years, not least because alternative energy as an asset class is also getting more and more attention on the path to a more climate-friendly economy.

In fact, if the project pipeline were fuller, much more money from the insurance industry could be put to work here. The European Commission reckons that in order to meet the Paris agreement climate goals, roughly €180 bn to €290bn will be needed annually for the European Union alone. Given strained public finances in many regions, private capital will have to play a large role in financing a more sustainable infrastructure in Europe. We have long argued that public-private partnerships could be an excellent vehicle to mobilize the funds needed.

Q What are the main worries affecting the European insurance market currently?

Apart from the extreme low-yield environment and the numerous geopolitical risks we are faced with today we see a regulatory overload as the main challenge. Following 15 years of development, Solvency II was finally introduced in 2016 but a major review is now under way already. In view of some of the current discussions among regulators and supervisors it has to be feared that this review will lead to stiffer regulation in numerous ways, thereby increasing capital needs and raising compliance costs even further.

For example, EIOPA proposes enhancing Solvency II with new macroprudential tools and measures. We have long argued that Solvency II by being one of the best regulatory frameworks in the world does already provide a large degree of security at the micro level. We believe that this also translates into stability for the sector as a whole, in particular in light of the numerous macroprudential elements we already have, e.g. stress tests or risk dashboards. Yet, despite the fact that the insurance sector is far less systemically relevant than the banking sector quite a number of new measures could be implemented, ranging from additional capital buffers to new liquidity tools. The regulatory burden is also a worry when it comes to digitalization.

Q Turning to Solvency II, what is your opinion on how the Directive is faring so far? What do you think the main elements are that need to be changed in the 2020 Directive?

In our view, Solvency II has proven a highly effective supervisory regime. That said, for the 2020 Review of the Solvency II Directive we see several reforms which should ideally be implemented. For one, we would like to see a lower reporting burden for companies. As it stands, there is plenty of duplication and overlap in the reports companies have to provide. Likewise, the application of the principle of proportionality should be strengthened so that smaller companies and companies with less risky business models would suffer less from the costs the regulatory framework imposes on them.

In quantitative terms, we believe that the Solvency II framework should reflect more strongly the long-term nature of the insurance business. Solvency II has a tool to address this, the so-called volatility adjustment. As calibrated today, however it does not adequately reflect the illiquidity premium insurance companies are able to collect in financial markets.

And finally, it is important to refrain from some of the measures proposed. For example, a feature which should not he changed is the so-called last liquid point. As it stands, it is calibrated to be at year 20. To push it further out the yield curve would be in stark contrast to the real liquidity situation in bond markets which has deteriorated in longer maturities in recent years as a result of the large asset purchase programs conducted by central banks. So, if anything, the last liquid point should in view of current market conditions be brought forward.

The trouble with bonds

Why bond investors should consider making an allocation to absolute return fixed income strategies

WRITTEN BY **ANDRES SANCHEZ BALCAZAR, HEAD OF GLOBAL BONDS, PICTET ASSET MANAGEMENT**

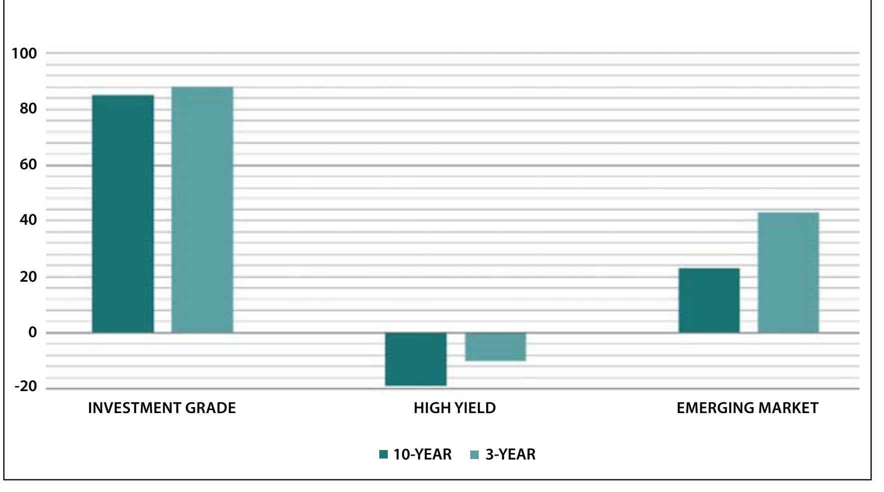
Bond investors could be forgiven for feeling a little disoriented. It turns out, for instance, that negatively-yielding bonds are no longer an absurdity. Thanks to sustained quantitative easing, the volume of fixed income securities trading at negative yields has never fallen below $6trn since 2016. (The figure recently leapt to as high as $17 trn).

Also consigned to history is the notion that government bond markets are oases of calm. On one eventful day in May 2018, the yield on Italy's two-year bond spiked by more than 150 basis points, the sharpest one day sell off in more than 25 years.

Bond investors face an additional complication. The definition of a diversified bond portfolio has also had to be torn up. That's because the various fixed income asset classes that make up the global bond market[1] have been tracking one another more closely in recent years. The correlation of the returns of US Treasuries, corporate debt and emerging market bonds have been higher in the past three years than in the past 10 (see chart).

Insurance companies can of course accept this new reality. They can simply resign themselves to owning a more volatile portfolio. But there is an alternative. And it comes in the form of an absolute return fixed income (ARFI) strategy.

MOVING IN LOCKSTEP: Correlation of returns vs US Treasuries: investment grade, high yield and emerging market US dollar bonds



Source: Bloomberg; data covering period 30.06.2009-31.07.2019 and taken from Bloomberg Barclays US Credit Index, the Bloomberg Barclays US High Yield Index and the Bloomberg Barclays US Dollar Aggregate Emerging Market Bond Index.

> The definition of a diversified bond portfolio has also had to be torn up

Untethered from bond benchmarks, and free to deploy risk management techniques, ARFI strategies are designed to deliver returns independent of the fixed income market.

Typically, ARFI funds target a specific level of return over a specific time-frame, expressed as a percentage point gain over a commercial lending rate or inflation. We believe delivering on this goal requires a multi-faceted approach to portfolio construction.

First, the investment universe needs to be broad. Investments should be chosen from the widest possible range of easily-tradeable bonds, currencies and derivatives. This makes it easier to construct a diversified portfolio composed of assets whose returns don't move in tandem. An additional benefit of having flexibility is being able to incorporate Solvency II considerations.

Second, more attention should be paid to the structural trends that influence bond returns than cyclical, and more volatile, factors such as economic growth and inflation. Although many bond investors spend a lot of time and effort attempting to forecast future economic conditions, such predictions are rarely accurate. An alternative strategy is to focus on the long-term structural changes in the economy and markets. We have built our portfolio around four long-term trends:

a. Lower rates for longer. Global economic growth and productivity has been lacklustre, and developed world governments face an uphill struggle to reduce public debt to levels that can support more fiscal spending. This means real interest rates are likely to remain at unusually low levels for some time.

b. Stuttering, protracted reform of the euro zone. The financial crisis has highlighted the need for far-reaching reform of the euro zone. Establishing a common banking union and a fiscal transfer mechanism under which the public debts of euro zone members are pooled and supported is essential.

Yet given the politically-charged environment in which decisions are taken, it will take time for the region to implement reforms. Europe's increasingly vocal populist movements are likely to further delay progress, as could the fallout from the UK's decision to leave the European Union. We believe this presents as many opportunities for investors as it does risks.

> Untethered from bond benchmarks, and free to deploy risk management techniques, ARFI strategies are designed to deliver returns independent of the fixed income market

c. A newly-assertive Japan. Thanks to the radical policies of Prime Minister Shinzo Abe and Bank of Japan governor Haruhiko Kuroda, Japan appears to be slowly moving away from the problems that have plagued it for the past two decade. There is a chance that weak growth, deflation, debt and ineffective government could be consigned to history.

d. An economic and financial transformation in China. China's sweeping reforms are yielding early dividends, as its economic focus switches from exports to domestic consumption. Capital market liberalisation and the expansion of the country's local bond market will transform global financial markets, with far-reaching consequences for countries in the developed and emerging world.

Third, every investment (risk-on) idea must have a corresponding hedge (risk-off) in place to ensure the most favourable trade-off between risk and prospective return. The changes in the economic and political landscape, and their effects on the fixed income market, make bond investing more risky. We have devised a process that seeks to contain such risks at every stage. On one level, this involves taking great care to avoid over-exposing a portfolio to any one investment theme, idea or source of return. On another, it means ensuring investment strategies are expressed in a way that offers the most efficient trade-off between risk and return.

More resilient fixed income portfolios

Bonds have historically provided Insurance Companies with steady capital returns and reliable streams of income. Yet the structural trends unfolding in the fixed income market have changed this dynamic. Not only are a large proportion of government and corporate bonds offering negative yields, but the fixed income asset classes that make up the market are more in sync with one another than they have been for decades.

Investors looking to build and maintain diversified portfolios should consequently modify their approach. By allocating some capital to strategies that aim to deliver attractive returns irrespective of market conditions, investors have the opportunity to build more resilient fixed income portfolios.

In association with

PICTET 1805 Asset Management

[1] *As defined by the range of Bloomberg Barclays global bond indices*

Bang for your buck?

Marek Handzel explores the relationship between index providers and asset managers, and whether better value can be obtained?

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

ARE index providers delivering value for money?

The question has vexed the investment world for years, having been brought to the fore by the rise of ETFs, which exposed gaps between asset manager cost expectation and index provider delivery that had previously been masked by a tolerance of high fees across the investment spectrum.

A recent study from Greenwich Associates has added further to the debate. After quizzing 86 executives at North America-based active asset managers, Greenwich found that asset managers believe they should be deriving more value from index providers' vast databases and analytic expertise. This desire for further value extraction has grown as the costs of index data have increased over the last two years. Investment houses also expressed an interest in partnering with index providers at a deeper level, beyond core benchmark creation.

At present, the value that the big brand index providers — the S&P Dow Jones, MSCI and FTSE Russell — offer more mainstream index tracker funds is clear, says Joseph Molloy, head of index and systematic equities, at HSBC Global Asset Management. They are simple to understand, backed by recognised brands, very transparent and of sufficiently low cost.

"However, this is where the real value stops, as the information provided tends to be very backward looking, static by nature and, depending on your subscription, can be less comprehensive when compared to what is on offer in the market by alternative methods and providers," he says.

As a consequence, there is an unwelcome cost associated with accessing further information on indices such as long index performance histories. "Therefore, the value that can be extracted tends to be costly and incremental by nature," continues Molloy. "The same data — and in some cases better data — can be sourced from other alternative providers at a lower cost [and] this same information can be used by asset managers and beneficial owners in the same integrated way within the investment process."

Timo Pfeiffer, chief markets officer at Solactive, the Frankfurt-based index provider, shares a similar story. "We get feedback [from managers] that says 'I pay a very high price but I don't usually get the quality or a lot of value or client service out of it'. So the issue is with value proposition in terms of price and a client focussed service."

Enhancing value

Following its study, Greenwich suggested a number of ways that index providers could enhance interaction with clients. One of those is helping to drive change. An obvious area where this could happen is in ESG screening.

"ESG is only going to become more important as an investing strategy, yet there remains a lack of clarity on how exactly to measure and benchmark a company's ESG factors," said Greenwich in its September report on the study.

In a broader context, managers believe that index providers could offer better tools and analytics to assist with the investment process, incorporate more industry feedback into the index construction process and more comprehensive customer support. The latter could include offering services beyond core benchmark businesses by tapping into their deep data wells, analytics and intellectual capacity.

> The value that can be extracted tends to be costly and incremental by nature

Greenwich points out in the study that a small number of asset managers already derive value from thought leadership, research, events, and marketing collaboration with index providers, and suggests that this figure should rise significantly.

It is certainly in the index providers' interest to pay heed to Greenwich's suggestions. As Molloy says, index providers are now operating in a world that is very mindful of costs.

This has resulted in new market entrants capturing increased market share, including asset managers developing in-house self-indexing teams and the emergence of smaller and more nimble index and data providers.

"There is less reliance on calculation of benchmarks by the big index providers as this is being captured by new competitors in this space at a lower cost," explains Molloy.

Improving the relationship

In their defence, index providers have been keen to underline how they continue to make improvements to their service offerings.

After revealing the results of its third annual global index survey in October — which found that the number of indexes globally has dropped from 3.73 million to 2.96 million in the space of a year — the Index Industry Association delivered a robust rebuttal to its critics.

Rick Redding, the CEO of the association, pointed to encouraging developments in fixed income and ESG benchmarking. "Index providers are continuing to expand their fixed income offerings to give investors more accurate benchmarks," he said at the time. "Moreover, the number and variety of ESG indexes indicate that investors are looking for benchmarks that conform to their investment objectives and beliefs."

FTSE Russell, which sponsored the Greenwich study, has said that it makes "stronger client relationships a key priority", stressing that it is investing in a range of value-enhancing products and services across its business.

In a blog post on the report's findings, it said: "As client requirements evolve in line with market developments, we will continue to listen to our clients and respond to their needs, providing them with new tools to grow their business and help them prepare for the future."

This is a message that has been consistent from the big index brands, especially within the ESG space, the fastest growing area of indexing.

In its most recent quarterly earnings report, MSCI highlighted its own ESG credentials, pointing out that it had recently purchased Zurich-based environmental fintech and data analytics firm, Carbon Delta. MSCI hopes that it can create extensive climate risk assessment and reporting solutions for global investors with its new acquisition that will comply with increasing mandatory climate risk disclosure requirements.

Disruptors

The relationship between index providers and the asset management industry is also changing as more investors demand bespoke and niche asset allocation plays.

"Investors are noticing that the 'one size fits all' proposition from the index providers that meets a vast amount of the global AUM today, doesn't meet all investor needs, as each investor has different requirements," explains Molloy.

"This is why the buy side has seen a growth in portfolio solutions versus the off-the-shelf benchmarks being offered by index providers."

"What we have observed recently is that beneficial owners are not initially going to the index providers for a benchmark, but approaching asset managers with an investment problem [and] expecting a solution crafted in the portfolio such as stock exclusions, ESG criteria, regulatory constraints and specific investment outcomes such as tracking error or outperformance objectives."

This has created an environment that is ripe for disruption. As Solactive's Pfeiffer, point out, "one of the drivers for our business is the flexibility in the custom-index business. Our US large cap index will be similar to the other large cap indices out there and for benchmarking purposes or ETF launches, it can be a "one-size-fits-many" approach that is standardised and will always be the case.

"But in institutional sectors in particular, there is a strong demand for customised indices with different rebalancing schedules and ESG criteria."

Disruptive index players such as Solactive can benefit from this trend as they rely on fintech to create speedier response times, efficiencies and flexibility.

This difference can be seen in index rebalancing in particular, says Pfeiffer as there is a price attached to rebalancing generated by the likes of hedge funds who jump in to take advantage of any changes with arbitrage.

"You can generate more money for the investor by being more efficient around the rebalancing of what should be at the end of the day a pretty straightforward, simple index," says Pfeiffer, "with the benefit ultimately ending up with investors".

This can translate into relatively large savings, given that the average charge on index-linked funds is three basis points. In contrast, Pfeiffer says that Solactive can provide standard market cap benchmark indices at a "very low 5 digit" flat fee annual cost.

Disruptors also have the potential to slow down the self-indexing trend, which has its own challenges, mainly in the form of regulation and the general cost of in-house benchmarking.

EU regulation demands that managers effectively acting as index providers can prove their independence and manage conflicts of interest within their own organisations. And some investment houses may not be able to sustain the expense of self-indexing in the long-term, as pressure on active management and passive fund fees remain on government and investor radars. In contrast, says Pfeiffer, holding and processing data and tracking corporate actions is already embedded into independent index providers' business models.

Thanks to disruption, the good news for managers looking to re-engage with index providers is that the old oligopoly may be on the way out. And better value may be on the way in.

There is a strong demand for customised indices with different rebalancing schedules and ESG criteria

Climate ready?

Following BoE governor Mark Carney's speech to the TCFD on climate-related financial disclosures, David Adams looks at how realistic the requests are of insurers and whether the industry has the ability to improve its standards?

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

Increasing disclosure

In October 2019, during a speech to the Task Force on Climate-related Financial Disclosures (TCFD) Summit in Tokyo, Bank of England governor Mark Carney said insurers must increase the quality and the quantity of the climate-related disclosures they make.

He said insurers should refine disclosure metrics to establish which are most useful in informing decisions; and should share knowledge of best practice around the assessment of strategic resilience. They should also consider how to disclose the extent to which their investment portfolios are prepared for the transition to a net zero carbon emissions world.

"Changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset," Carney told the audience. "To bring climate risks and resilience into the heart of financial decision-making, climate disclosure must become comprehensive, climate risk management must be transformed and investing for a two-degree world must go mainstream."

He also suggested that "the biggest challenge in climate risk management is in assessing the resilience of firms' strategies to transition risks". Some of the companies using the TCFD recommendations (including some insurers) are already using scenario analysis to assess the resilience of strategies. But Carney highlighted the uneven rate of progress and the need for more cooperation and information-sharing.

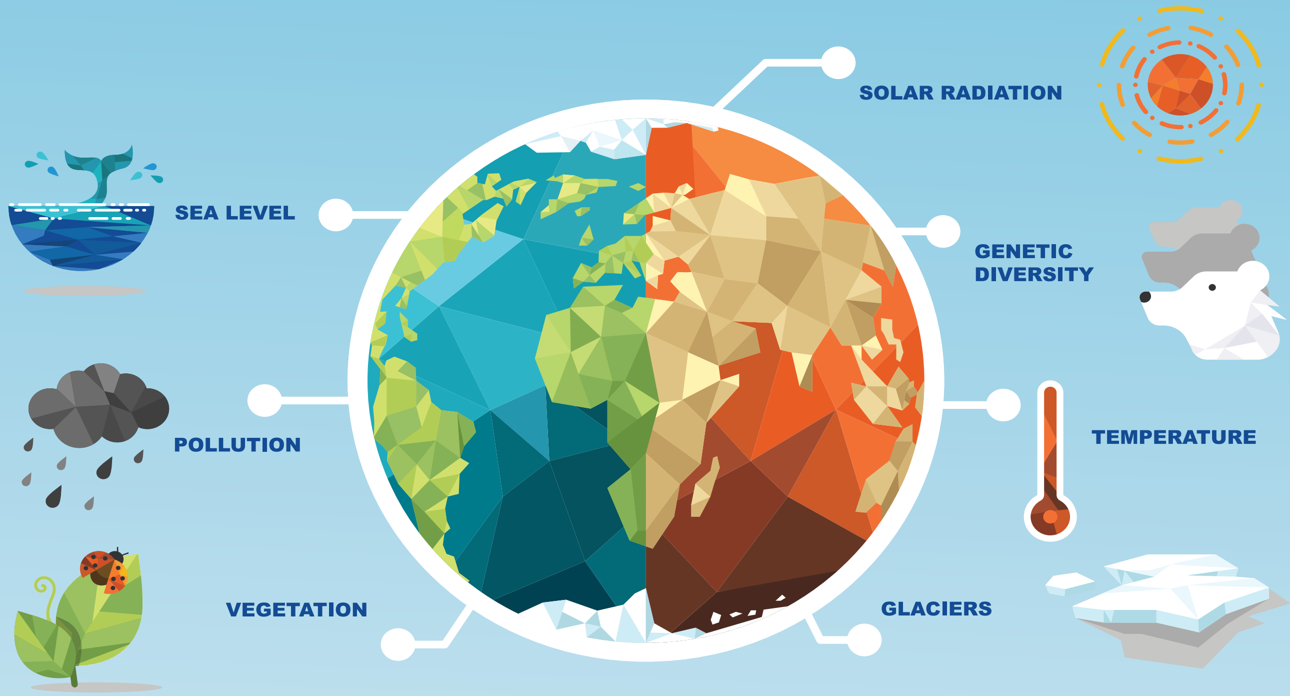
His speech followed publication earlier in the year of the TCFD's Status Report for 2019, which identified a need for more clarity on the potential financial impact of climate-related issues on companies. The report said most companies using scenario analysis to inform strategy were not disclosing information on the resilience of their strategies. It also showed that the insurance sector is lagging behind other sectors, including banking and energy, in terms of the quantity and range of climate-related disclosures.

But if too many insurers have yet to do as much as they should or could in terms of climate-related disclosures of physical and transition risks facing them, their assets and the companies in which they have invested, how realistic were the requests being made of the sector by Carney in his speech?

Realism?

Roger Jackson is a general insurance partner who leads on the climate change agenda at KPMG, coordinating climate change-related actions for clients. "I think our view [on Carney's request for action] would be, it's definitely something that needs to happen, but there are lots of challenges," he says.

Insurers will have to take on these challenges, in part because of growing pressure being applied by regulators. In April 2019 UK regulator the Prudential Regulation Authority (PRA) published a supervisory statement outlining its expectations of how banks and insurers should manage financial risks related to climate change (SS3/19). These include an expectation that firms use the TCFD framework and to engage with other firms to share best practice. The PRA also said firms should prepare for "the increasing possibility that disclosure will be mandated in more jurisdictions".



Meanwhile, in July 2019, the UK Government unveiled a Green Finance Strategy that includes an expectation that all listed companies and large asset owners should disclose in line with TCFD recommendations by 2022. Elsewhere, further EU regulation tightening disclosure requirements seems inevitable, as the Commission continues to focus on sustainability and on transparency in financial reporting.

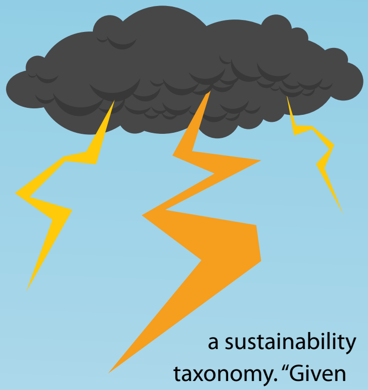
Jamie Armour, policy assistant in the prudential regulation team at the Association of British Insurers (ABI), points out that many insurers are already working alongside the TCFD, but he reiterates how difficult it is for insurers to identify and evaluate the data needed to inform disclosures. "It's, technically, incredibly challenging, especially around scenario analysis," he says. "Trying to work out how certain transition pathways might impact individual companies is really difficult."

John Scott, head of sustainability risk at Zurich Insurance Group, is optimistic about the ability of the industry to improve the way it uses disclosures. "As people get used to understanding what these disclosures mean, the disclosures will get better and more people will disclose," he says. He draws attention to findings in the TCFD Status Report showing that by 2018 insurers were performing reasonably well on disclosures on governance and some aspects of risk management. Between one in three and one in four insurers surveyed were disclosing on governance issues, on risks and opportunities related to strategy and on the impact on the organisation. About one in three were making disclosures in line with TCFD recommendations on risk identification and assessment and on risk management.

"But how do you take that and integrate it into your processes and existing taxonomy of risk?" Scott asks. "It's difficult to put climate change risk into that taxonomy, because it cuts across all those risk types."

In November 2019 a statement and a position paper from Insurance Europe addressed this question, within a response to EU proposals for

> Changes in climate policies, new technologies and growing physical risks will prompt reassessments of the values of virtually every financial asset



a sustainability taxonomy. "Given that insurers have large and diversified investment portfolios, performing the sustainability assessment in the current taxonomy is complex and may lead to inconsistent results across different investors," the statement warned. "Therefore, a reliable assessment should be made directly by investee companies instead."

While awaiting the data needed to complete these processes, the statement continued, "investors should comply with proposed disclosures on a best effort basis to avoid unnecessary liability and compliance risks".

"One issue insurers face in improving the quantity and quality of climate-related disclosures is the availability and quality of ESG data for large parts of their investments," says Cristina Mihai, head of prudential regulation and international affairs at Insurance Europe. "Given insurers' large and diversified investment portfolios, providing detailed investment disclosures is complex and unfeasible unless such ESG information is directly provided by investee companies themselves. However, currently, the ESG data needed is often either not available or poorly standardised, unreliable and inconsistent between data providers."

Despite these challenges, some insurers are producing what constitutes best practice today. Armour recommends reading Aviva's TCFD report, which contains, he says, "really good content, particularly on scenario analysis".

Scott says Zurich was working on climate change-related disclosures well before the TCFD published its recommendations in 2017, with the insurer seeking to develop a strategy suitable for a large and varied investment portfolio. "The challenge has been, how do you build that into your investment and underwriting portfolios in a way that achieves the outcome we're looking for, in line with the Paris Agreement goals?" he asks.

> If in the next few years we fail to make progress that is one reason why regulation might tighten

"We talk about the total amount of impact investments and how these reduce carbon emissions. We've done some great work on how to reduce real estate energy consumption and around our real estate investment carbon emissions. We're also part of a working group looking at thinking through and trying to better understand the TCFD recommendations. We want to create some really good analytical tools. Once we do that, we'll be in a better place to support our customers and to produce the outcomes we need."

Jon Williams is a partner at PwC, specialising in sustainability and climate change; and is an expert member of the TCFD. He thinks the way insurers will have to integrate thinking on mitigation of climate-related physical and transition risks with other risks will be very valuable to industry in general.

"Looking at transitions and thinking about their impact on both sides of the balance sheet is an area where the insurance industry could play a leading role, because they have the skills required," he says. "[Insurers] have a vested interest in … working out how they can develop new products to help their clients manage risks related to climate change."

Outlook

It is clear that insurers really could play a key role in using disclosures to help businesses and societies create low carbon economies; and that they will be able to enjoy significant commercial benefits as a result. But Williams adds that Carney's speech is also a warning about the consequences of insurers failing to make the improvements in use of disclosures that will be needed.

"If in the next few years we fail to make progress that is one reason why regulation might tighten," says Williams. "He's saying, 'I want to see more progress'." Carney himself will be leaving his post soon, but his successor and other regulators are certain to keep the pressure on, to encourage and compel the insurance industry to rise to this challenge.

Immersed in Diversified Private Credit

Insurance Asset Management Editor Adam Cadle talks to BNP Paribas Asset Management's head of pension solutions, Julien Halfon, about the advantages of investing in diversified private credit for insurers

WRITTEN BY **ADAM CADLE**

Q What exactly is diversified private credit?

JH: In a diversified private credit portfolio, we refer to a portfolio that has essentially invested in fixed or floating rate unlisted debt and loans. They are not listed on bond markets; they are simply private placements or private debt. Categories include corporate lending, SME funding/financing, infrastructure and real estate debt, but also social housing and, sometimes, long-dated mortgages are included. All of these categories are covered by private credit and when you say diversified, it is because they have different types of risk and return features.

Q Why should investors consider a private credit approach? What are the characteristics of a diversified private credit portfolio?

JH: First of all, it is a very large universe. More unlisted private debt exists in comparison to listed debt. As an investor therefore, you have more choice. You can really pick and choose what meets your investment return and your volatility risk requirements, and you can spread this between junior and senior debt, and other different drivers. Fundamentally, because it is an illiquid investment - a private investment - you get an illiquidity premium. Depending on the asset class you are looking at for example, you can get between 100bps and 300bps for something that looks like investment grade, or up to 400-500bps for something that is a bit riskier, like SME lending for example. At the same time, what is interesting is the fact that because those instruments are not listed, they are not impacted by the general volatility of the market, as a traditional listed bond would be. Normally, the volatility of a bond is driven by the volatility of the market. That is not the case here. So, in effect, your private debt portfolio would be less volatile which is very healthy for insurers. Insurers will want something less volatile, because they will end up with a lower SCR (solvency capital requirement). They tend to invest a lot of their capital in private debt.

Q So what is the difference between diversified private credit and a cashflow matching investment?

JH: In effect, diversified private credit is focused around the idea of creating a return engine. Although in terms of costs and SCR, it is very similar to what you get for cashflow driven investing (CDI), the other dimension that you get with cashflow driven investing is that the obligations of the insurer, usually the life insurer, will be matched by specific cashflows emanating from the illiquid or private credit investment. You also see that many of those investments produce coupons, so they create an abundance of cashflows that can be used and structured in a way to cover your liabilities.

Q So how do investors go about implementing diversified private credit?

JH: In practice, you will follow a traditional risk budgeting exercise. You will try to understand how much return you are expecting and at what level of volatility. This will help you split the portfolio between different asset classes. If you are long-dated, for example, you would usually take mortgages. If you are short dated, potentially something like SME loans. If you want more returns, you maybe will try to have more mezzanine or junior debt. If you want something more stable, you will probably want something more senior. So that will be the first step. The second step is, if you want this to become not only diversified private credit but also CDI, to understand the shape of the liabilities and the shape of the cashflow requirements of the balance sheet of the insurer. Putting all of those things together - the return dimension, the volatility dimension and the cashflow dimension, if required - allows you to find all the drivers you need to decide what portfolio you design.

Q Why BNP Paribas Asset Management for diversified private credit?

JH: We are backed by the second largest banking balance sheet in Europe and the fifth in the world. We can mine the BNP Paribas Group's balance sheets and find good quality illiquid debt or private debt. This gives us an edge compared to our competition. Secondly, we also have a split structure. One is purely linked to origination and the other is managing the portfolios themselves. The origination teams are powerful: our private debt and real assets team have more than 30 dedicated people, with access to multiple origination opportunities. It is an outstanding source of good quality private debt. On the other side, we have our cashflow management and LDI (liability driven investment) team, who also manage a portfolio themselves, which allows them to optimise the cashflow management and reduce the time, for example, it takes to manage cash allocation. This also gives us an advantage on all of the competition.

> **You can really pick and choose what meets your investment return and your volatility risk requirements, and you can spread this between junior and senior debt, and other different drivers**

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

In association with

BNP PARIBAS ASSET MANAGEMENT

A Coming Storm?

The European Insurance and Occupational Pensions Authority (EIOPA) has recently proposed extensive reforms for the SII 2020 review. *Insurance Asset Management* explores the main reforms and their potential impact on the insurance industry

WRITTEN BY **PETE CARVILL, A FREELANCE JOURNALIST**

On 15 October, the European Insurance and Occupational Pensions Authority (EIOPA) released its Consultation Paper on the Opinion on the 2020 Review of Solvency II. The move was a response to the European Commission (EC), in February 2019, requesting a 'broad-based review across nineteen different areas'.

In general, the review looked at three areas, which were the review of long-term guarantee measures, the potential introduction of new regulatory tools in the Solvency II directive, and potential revisions to the existing framework.

At first glance, Consultation Paper on the Opinion on the 2020 Review of Solvency II is a behemoth—878 pages of dense, insurance-based, highly-specific text—and even its authors admit that its length is an issue, writing, "The consultation paper is a long document. This reflects the unprecedentedly wide number of topics on which advice is sought as well as EIOPA's desire to be transparent on the basis for its proposed opinion by for example including significant amounts of analysis of different policy options."

Clearly, there is a lot to digest in EIOPA's work. *Insurance Asset Management* reached out to a number of people within the industry for their initial thoughts and takes on the proposals. For this article, Societe Generale's insurance equity analyst Nick Holmes, River and Mercantile's director Stuart Irwin, Insight Investment's head of insurance solutions Simon Richards, and London & Capital's executive director Shadrack Kwasa were interviewed. Each was asked about their immediate thoughts on the proposals, whether there were any surprises in what EIOPA had come back with, whether the proposed reforms were too much or too little, and how they believed the industry would respond.

Initial thoughts

Holmes says that four areas stand out, particularly if you are a listed company using internal models rather than standard formulae. These, he says, would be the unchanging of the risk margin, the moving of the last liquidity point for the ultimate forward rate (UFR) from twenty years to fifty years, the volume adjustment, and the no change in the matching adjustment.

After these, he says: "The biggest other item is the proposal to include the calculation of the impact of negative interest rates, which is not part of the standard formula. And if an internal model is being used, it's not known precisely which of these are modelling negative interest rates and which aren't. I've heard that practises differ but if you're using standard formulae, there is the proposal there that negative interest rates should be part of that model. For those doing that, that's a big deal."

Holmes says that while the unchanging risk margin has its largest effect on UK insurers, his second point—the changing of the last liquidity point in the UFR—would have much greater effects on the continent, effects that he foresees would receive great pushback from the EC. Regarding this proposed change—one of five in the report—he says:

"EIOPA have said that the impact of this would be pretty big. In Germany, it would result in Solvency II ratios falling from 457 per cent to 274 per cent. And in Holland, from 212 per cent down to 92 per cent. That would be a big impact on Germany and Holland, and I can't imagine that the European Commission would accept that."

Kwasa says he was disappointed that the proposals do not go far enough in certain respects. He adds: "The first thing that came to mind was the previous review in 2018. There were some changes then that had been agreed to be implemented in 2020. I was hoping to see some of the gaps closed that I thought existed in previous reviews. Some had been, and others not so much."

These gaps, he says, include such items as the spread risk charge. "When you apply it to bond portfolios and any eurozone government bond, the charge is essentially zero. I don't think that's a fair reflection of the market and the level of risk. I thought some of that would come into play in the first review, not in this one, and now it seems like it's something that won't be dealt with."

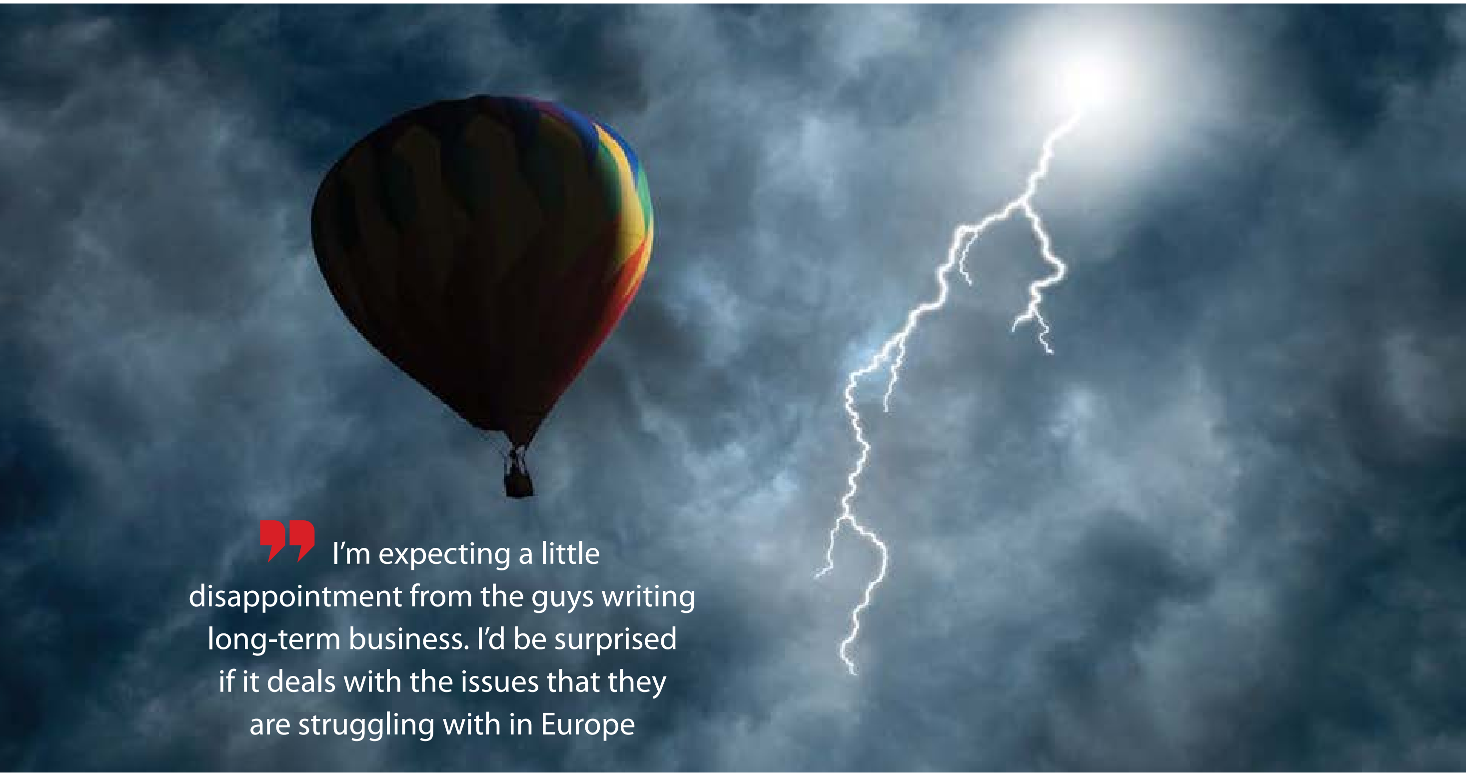
Richards says that the interest rate stress is the most-significant proposed change, and that this has been 'on the cards' for a while. Discounting its impact on liabilities, he nonetheless says that its implications are more urgent. "When Solvency II was launched," he says, "a negative risk-free curve was not in anyone's mind. So we now have this situation where if the curve is negative, you don't hold capital against it becoming more so. That's not something that makes sense."

> Solvency II serves a useful purpose in that it provides a risk management framework for the industry. That's a positive thing because it stops the insurers from writing long-term interest rate guarantees

Surprised or not?

Holmes says there were no big surprises in EIOPA's work, but adds that there has been some disappointment from UK insurers that the risk margin has remained unchanged. But when pressed about whether there is too much or too little reform in the proposals, he outlines three areas.

"Firstly," he says, "Solvency II serves a useful purpose in that it provides a risk management framework for the industry. That's a positive thing because it stops the insurers from writing long-term interest rate guarantees. The second thing is that



it's far too complicated and its objectives could be a achieved in a simpler way. And, lastly, I don't see these proposals from EIOPA as being a simplification. Solvency II does need to be simplified, but with the preservation of the risk management discipline as its central objective. Unfortunately, these proposals are incredibly complicated and are not simplifying the regime."

Irwin offers a more-granular perspective, saying that there were some pleasant surprises in the proposed reforms. He says that River and Mercantile particularly welcomed the revisiting of how interest rate risk was calculated, especially in the current negative environment. He also singles out the streamlining of reporting for smaller insurers as a welcome change.

He goes on. "One standout piece that did resonate with the former Solvency I regime was around macro-prudential policy, which discuses the potential provide national supervisory bodies with powers to ask insurers to hold more capital for identified systemic risk. It's similar to old Solvency I internal capital guidance framework that allows regulators to put on different capital loading for different risks. It's another lever for them to add capital where they think there may be undercapitalisation."

January responses

This issue of Solvency II being too complicated is one that Holmes expects to see in the January feedback. Alongside this, he says the other key objective will be consistency. Put simply, the industry does not want to go through the disruption created by the implementation of new rules. "This," he goes on, "is where the UFR is relevant. To move it to fifty years is a shock impact for certain insurers. The German regulator has been vocal on this. Germany has a lot of risk in this area and they will be at the forefront of saying that any regulation should not bring a crisis with it."

Richards adds his voice to this, saying that going for a fifty-year last liquidity point would be significant for many of the insurers. "If EIOPA goes for that," he says, "the impact will be significant. I can see many insurers would be pressing for some sort of mitigation to help with that, especially in the short term."

Kwasa takes a slightly-converse point, saying that the depth of response will come from those insurers dealing with long-term liabilities and strategic investments such as bonds and equities. "Depending on what has been changed—and don't expect big changes—I'm expecting a little disappointment from the guys writing long-term business. I'd be surprised if it deals with the issues that they are struggling with in Europe. So the feedback, I think, will be to ask EIOPA for more on certain areas rather than less."

A healthy future

Adam Cadle discusses sustainability in the global insurance industry with Butch Bacani, programme leader, UN Environment's Principles for Sustainable Insurance Initiative

WRITTEN BY **ADAM CADLE**

Q Can you provide a brief overview of your day-to-day role?
I lead UN Environment's Principles for Sustainable Insurance Initiative (PSI), which entails shaping and implementing the PSI's global strategy and overseeing its portfolio of initiatives and activities. As the largest collaborative initiative between the UN and the global insurance industry, no one day is the same. One day I could be on a conference call or a webinar with insurers from around the world discussing risk management, insurance and investment solutions to global sustainability challenges such as climate change, ecosystem degradation, human rights violations and financial exclusion. The next day, I could be speaking at a major event promoting PSI initiatives and advancing the sustainability agenda for the insurance industry in a particular country or region. It's intense and there's a lot of responsibility, but deeply exciting and fulfilling. My role gives me a crystal clear and compelling purpose, every day.

Q Are insurers doing enough to support economic, social and environmental sustainability—in other words, sustainable development? Do insurers have a bigger role to play?
A growing number of leading insurers are stepping up to the plate and raising their sustainability ambition across their risk management, insurance and investment activities. The PSI has become a leadership initiative and a global community of practice aimed at moving the sustainability needle. Whether it's tackling climate change, building resilient cities, protecting World Heritage Sites, or combating illegal fishing, tobacco risks and plastic pollution, many PSI member insurers are demonstrating sustainability leadership and taking action.

However, many in the insurance industry—and the wider financial sector for that matter—are not doing so yet. We're facing a climate and ecological emergency, and there is growing social inequality. This is why despite real progress made by insurers over recent years, we can't stand still and be happy with the current overall situation. The insurance industry's sustainability journey is gaining momentum, but the industry can and must do so much more.

Q What would you say has been the biggest ESG achievement so far this year in the insurance space?
At the ESG level, the most important achievement this year is the PSI's release last February of the public consultation version of the first global ESG guide for various lines of insurance business. The reason is simple. ESG must be embedded in core business strategies and operations, which is what Principle 1 of the PSI is all about. While there has been much ESG guidance for investment management over the years, there has been none for insurance underwriting until now. The PSI's ESG guide for insurance business will serve as an ESG anchor for the insurance industry, enabling it to have a more holistic and integrated view of sustainability risks and opportunities across the asset and liability sides of the balance sheet. All insurers are investors, but not all investors are insurers. This is why an ESG guide for the insurance industry's core insurance business is absolutely essential and agenda-setting.

At the thematic level, insurers are continuing to drive greater climate action and ambition. The PSI has now assembled over 20 of the world's leading insurers and reinsurers who will collectively pilot the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) in the context of insurance portfolios, particularly with respect to scenario analysis, across physical, transition and liability risks. Furthermore, through the United Nations-convened Net-Zero Asset Owner Alliance, leading insurers, along with pension funds, have joined forces to commit to transitioning their investment portfolios to net-zero greenhouse gas emissions by 2050 consistent with a maximum temperature rise of 1.5°C above pre-industrial levels and the aims of the Paris Agreement on Climate Change.

Q What would you say to those asset managers and CIOs concerned that they might not reap the same returns through ESG investing compared to their current asset portfolio?

One can choose to debate this question until the cows come home. There have been many studies and indicators over the years which make the case that the systematic integration of ESG issues into investment analysis, decision-making and ownership practices is part and parcel of good risk and opportunity management, of fiduciary duty, and of the process to deliver superior risk-adjusted returns.

I think one of the most important signals out there is that more and more countries and jurisdictions are developing sustainable finance roadmaps—from the EU, UK and Norway, to Australia, Canada and China. These roadmaps seek to address ESG risks and opportunities in financial decision-making and align financial systems—across banking, insurance and investment—with the aims of global policy frameworks on sustainable development, notably the UN Sustainable Development Goals and the Paris Agreement.

Central banks and financial supervisors are increasingly understanding the key role they have to play in promoting sustainable finance through initiatives such as the Network for Greening the Financial System (NGFS). The purpose of the NGFS is to strengthen the global response required to meet the goals of the Paris Agreement and to enhance the role of the financial system to manage risks and to mobilise capital for green and low-carbon investments in the broader context of environmentally sustainable development.

> **We can't stand still and be happy with the current overall situation. The insurance industry's sustainability journey is gaining momentum, but the industry can and must do so much more**

Over the years, financial markets have assumed that it can consume natural capital without limit. However, science is showing us that our natural resources are finite, not infinite, and that we are now exceeding planetary thresholds, creating unprecedented financial and economic risks. Ultimately, all finance will need to become sustainable finance out of necessity. We just need to look at the science to understand why sustainable finance is really about enlightened self-interest. The question is whether we can act fast enough and ambitious enough to avoid catastrophic climate change and environmental degradation. Time is non-renewable.

Q What are your aims and ambitions over the year ahead?

The PSI's work to tackle illegal fishing, climate change and plastic pollution is really important. Therefore, as part of our individual and collective responses to the climate and ecological emergency we are facing, I believe we need to do so much more to protect the ocean. The ocean's health and integrity is critical to providing oxygen, food and other resources; absorbing carbon emissions and heat; and building coastal resilience. But the ocean is under immense pressure from climate change and unsustainable development. Simply put, we can't solve climate change without protecting the ocean, and we can't protect the ocean without solving climate change.

In the coming year, we also look forward to shaping and delivering sustainable insurance strategies, roadmaps and action plans at the national and sub-national levels that would harness the full role of the insurance industry as risk managers, insurers and investors for sustainable development. We are already working with leading insurers, insurance associations and insurance regulators and supervisors in certain jurisdictions such as Australia, Brazil, California, Canada, Costa Rica and Egypt to make this happen. This is the next-stage development necessary to deepen sustainability thinking and practice across insurance markets and advance sustainable development.

Building interest

Lynn Strongin Dodds explores why German insurers are increasing allocations to infrastructure and whether this trend is set to continue

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

Infrastructure has been on the European insurance radar screen for a few years but allocations are rising as interest rates remain stubbornly low. German players increased their exposure by almost a third to €32 billion last year and they are far from alone. Market participants are not only scouting out opportunities outside their borders but also beyond the traditional realm to more sustainable investments.

"German insurers' behaviour is emblematic of increased interest not just in infrastructure but how real assets can be incorporated to meet funding challenges and optimise capital efficiency," says Aviva Investors Investment Strategist, Global Income Solutions Nikki Chandra. These trends are reflected in the group's latest real assets survey which showed that 51% of insurance and 37% of pension fund executives are set to boost their allotments to real assets in general. On the infrastructure front, 52% of insurers have plans to invest more in equity while 47% have similar objectives for debt.

Qualities

The benefits of infrastructure are well documented but they have taken on a new shine against the current uncertain economic backdrop. "There is a sense of unease in the world with trade tensions, growth slowing, negative bond yields and equities not generating the returns that they were in the past," says Chandra. "Real assets such as infrastructure have qualities that make it attractive such as an illiquid premium even if it has narrowed and overall low default rates compared to corporate bonds of similar ratings."

Aberdeen Standard Investment, investment director for infrastructure debt Alex Campbell, agrees, adding infrastructure also generates long term, more predictable cashflows that are not correlated to other asset classes as well as better credit outlooks. "The longer investment horizons are also a good match for insurers who have long term liabilities," he says.

> Infrastructure also generates long term, more predictable cashflows that are not correlated to other asset classes as well as better credit outlooks

Image by: U.J. Alexander

Research by Moody's Investors Service, which rates $2.7 trillion of infrastructure securities globally, found that infrastructure debt remains less likely than nonfinancial corporate issuers (NFCs) to incur credit losses - especially over longer horizons. On average, infrastructure ratings have been 62% more stable than NFCs over 1983-2018, which is mainly due to the inherent stability of the US municipal infrastructure sector. In addition, about 92%, or the vast majority of Moody's infrastructure ratings are investment grade compared to 40% of NFC ratings.

Although infrastructure's attributes have been a pull for many insurers, there has also been a political push for them to raise their collective ante and fill a gap left by capital constrained banks. This is reflected in government initiatives such as the UK's Infrastructure and Projects Authority and the European Commission's Investment Plan for Europe.

Regulation such as Solvency II, which came into force in 2016, has also paved the way with more favourable capital treatment. Over the past year, there have been two significant amendments - the introduction of "qualifying infrastructure investment" criteria for investing in infrastructure "projects" and "corporates" respectively. They have widened the scope further, enabling insurers to identify infrastructure assets with preferable risk characteristics and benefit from reduced capital charges for debt and equity.

"The changes are being incrementally made to make it more opportune for insurers to invest in infrastructure across the board," says DWS global head of infrastructure Michael Straka. "Insurers are hunting for yield and there are few asset classes left to invest in that can generate returns with a low risk profile. The unlisted infrastructure space, for example, is less volatile than for example, high yield bonds."

In terms of assets, insurers have favoured utilities, transportation, telecommunications and public buildings such as hospitals, schools, student accommodation and social housing. As Allianz Capital Partners head of infrastructure asset management Andrew Cox notes as a buy-and-hold investor, the emphasis has been on investments that provide stable, preferably inflation-linked cash flows generated over the long term. "We focus on assets that have a strong market position which provide essential services to the public and that are often supported by regulated or contracted revenues," he adds. "Infrastructure is the backbone of our society and a prerequisite for social well-being."

ESG

To this end and along with many other pockets of the investment industry, social as well as environmental and governance have become important criteria for judging the suitability of an asset or project. The Aviva study found that nine in 10 respondents consider ESG to be important in investment decision making and of these, 40% of insurers consider a 'favourable ESG impact' of real assets to be integral. Insurers were farther ahead of the journey than their pension fund counterparts with 50% versus 40% stating that they consider the 'transparency of asset managers' ESG investment approach' when looking at external investment providers.

Although sustainable investing has risen to top of the agenda, policymakers would like the pace to accelerate. In September, for example, Bank of England governor Mark Carney addressed the UN Climate Action Summit and called for providers of capital including insurers to step into the breach and improve their understanding and management of climate-related financial risks as well as to raise their investments.

Different approaches are being adopted depending on the region, according to the Aviva study. Three-quarters of insurers in Southern Europe think 'energy-efficient real estate' is particularly important, while 52% of Nordics look to 'renewables. This is eight percentage points higher than Europe overall, and 15 percentage points more than Western European insurers.

Some of the larger German insurers have also been at the forefront. As Cox notes Allianz is committed to sustainable investing as one of the signatories to the Science-Based Technology initiative. This requires the firm to reduce the green-house gas emissions from its investee companies and discourages investments in sectors that are not in line with the 1.5°C limit put in place by the Paris Climate Agreement.

"ACP invests in wind and solar plants and on the infrastructure side of the business, it also invests in gas networks (with the potential to carry green gas / hydrogen), water, electricity and fibre networks, all of which contribute to a more sustainable future over the long-term," he adds

Aberdeen Standard, on the other hand, also concentrates on energy, transportation and water. "I think the investments will become more sophisticated over time," says Campbell,

> Infrastructure is the backbone of our society and a prerequisite for social well-being

pointing to smart metres as an example. The data generated can help people better manage the supply and demand but also inform distribution network operators regarding peak charging times for charging electric cars. This would enable them to modulate their rates depending on usage.

Columbia Threadneedle senior portfolio manager, infrastructure investments Ingrid Edmund believes that insurers should not just focus on renewable energy to the exclusion of everything else. "In our view investors need to look across the board," she says. "The important question to ask is where can you make the biggest impact as we move towards a de-carbonised world. Transportation and building related issues, like heating, are the next frontier. For example, we engage with airports to make them more sustainable and energy efficient."

One of the challenges with an ESG approach, as highlighted by Carney and the Aviva study, is the absence of readily-available and consistent information. There are a multitude of definitions, metrics, reports and documents on the market. This not only paints a confusing picture but as the Aviva report notes, it makes integration more complex and "something that must be undertaken on a case-by-case basis."

Industry participants though are working on solutions. Natixis and EDHECinfra have recently teamed up to launch a new three-year research chair, directed by the same team that created an unlisted infrastructure indexing platform. The aim is to create useable, comparable documented measures of the impact and risk profile of social and environmental factors on infrastructure investments.

The ultimate goal is to develop an infrastructure social acceptability index, as well as one measuring economic impacts and climate risk exposure.

Sitting down with Foresters

Adam Cadle speaks to Foresters Friendly Society chief investment officer Corrado Pistarino about the insurance company, its aims and ambitions and investment structures

WRITTEN BY **ADAM CADLE**

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

Foresters Friendly Society (FFS) operates mainly in the with-profit segment. Different portfolio allocations have been designed for each of the funds, based on their loss absorbing capacity and their resulting solvency position. Traditionally, Foresters have been invested in liquid assets with a domestic focus (gilts, linkers, corporate credit, equity, property). Over the past couple of years, FFS have revisited the Strategic Asset Allocation alongside the re-brokering of the investment manager mandate. AXA IM have been selected to manage the biggest portion of the asset portfolio and provide tactical overlays to improve returns generation. The funds structure have been simplified, and the Strategic Asset Allocation has shifted towards global propositions, away from a purely domestic focus, while retaining exposure to the traditional liquid segments to facilitate alpha generation. At the same time, FFS has started a journey to broaden the investment universe (private credit; private equity; infrastructure debt and equity; CRE debt and equity; high yield bonds; convertibles), with some of these asset classes already allocated to our portfolios. At present, the overall allocation is split as follows: gilts and linkers: 17.5%; corporate credit: 26.1%; global equity: 21.3%; property (directly held): 24.4%; private debt: 2.8%; convertibles: 2.3%. The relative exposure to alternatives is destined to increase steadily over time, considering the strength of the liquidity position of the Society and the growth in new business underwriting.

Q How have allocations changed, say, over the last five years?

The asset allocation underwent radical changes with the onboarding of the new manager. FFS leveraged on AXA IM's portfolio construction capabilities within their financial engineering team to design a new set of fund-specific portfolio allocations with the view of maximising expected returns for a given level of solvency consumption, or reducing solvency while preserving expected returns. Return and solvency volatility is maintained within strict boundaries, as an overarching constraint to the new portfolio allocation. This constituted a significant improvement from the approach followed beforehand, in terms of risk measurement and on-going monitoring. The allocation to (directly held) property has steadily reduced over time. A process of disposals is in progress, allowing the redeployment of risk capital towards a more diversified spectrum of alternative assets. New asset classes (private debt; convertibles) have already been included in the Society's portfolios, with more to follow as funds become available. The domestic focus has shifted towards a global focus, in particular for equity exposure, leading to an improvement in the portfolios' diversification profile. Gilts and linkers are retained as a primary tool for nominal and real duration hedging. At present, the FFS does not have yet in place a hedging program for interest rate, equity, credit or currency risk using derivative overlays. A number of operational options are being considered.

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

SII regulation is a main driver in the asset selection process. Solvency capital is a precious resource for any regulated business, and optimising its deployment is one of the core constraints behind any portfolio construction activity. While in the past assets that were discouraged by the Regulator (e.g. CDO's in the aftermath of the financial crisis) tended to dominate the market discourse, there have been a shift in focus driven by an increased appreciation of the structural role in the economy that long-term investors like insurance company are best placed to play. One example is the "benign" treatment of infrastructure assets that qualify under a set of criteria set out by the Regulator in 2015 and subsequently amended in 2017. Another example concerns private equity investments, for which a new set of solvency rules have been recently introduced (March 2019). These changes are likely to lead an increase in capital formation within the EEA for this type of assets, and an increased awareness within the insurance sector of the investment and diversifying opportunities available in those areas. At FFS both infrastructure debt and equity, as well as private equity assets are currently being scrutinised in order to identify suitable, solvency-efficient additions to the Society's investment portfolios.

Q What are the main aims over the coming year for Foresters and yourself as CIO?

I joined FFS in October 2017. The last two years have been transformational, in terms of strengthening the internal investment team, producing explicit statements on investment beliefs, defining the Society's risk appetite, broadening the investment universe, assessing the performance of the investment managers, re-brokering the mandate for liquid assets, designing a new investment strategy for each of the Society's portfolio, selecting and appointing a new custodian bank, implementing the investment strategy with the help of AXA IM, creating new reporting standards for senior managers and the Board, and ensuring the smooth run of the day-to-day operations. These achievements have been recognised by the industry. The focus for 2020 will be to consolidate the results of the transformation process, and use it as a platform to improve the quality of the investment services we provide to our members by increasing the wealth-generation potential of the Society's portfolios, with a primary focus on alternative sources of investment return. This will go alongside strengthening the risk taking and risk monitoring capabilities, as part of the duty incumbent on the Society in its stewardship over the members' assets.

Q What do you see as the greatest risks for insurers in general, and at Foresters Friendly Society?

From the perspective of an asset specialist, valuation levels are a major concern. This might not necessarily translates into a market crash, but years of extra loose monetary policy, unprecedented growth in the central banks' balance sheets, direct market interventions in the market by the policymaker, combined with subdued levels of inflation and a growth trajectory which, at least in the Eurozone, has been less steep than expected, have created an environment where asset prices and the persistent quest for yield pushes investors towards segments of the market which they either ignored in the past, exposing them to non-quantifiable risks and significant information asymmetries (do they have the right capabilities to make sound investment decisions?), or they used to invest into, but at much more attractive yield levels, even considering the negative shift in the term structure of interest rates (do credit spreads fairly compensate for expected losses)? Furthermore, the landscape is unprecedented from the perspective of the economic theory (the late '90s research on the zero boundary of interest rates was perceived to be more of an academic topic than a practical tool for policy making, Japan being the odd outlier at the time). This creates a new set of unforeseen, unfamiliar risk in the real economy as central bank will try to establish a new long-term equilibrium for policy rates while unwinding the enormous stock of assets they have accumulated since the outset of the financial crisis.

Q In your role as CIO what would you say has been your main achievement?

Leading the transformation described above, and ensure that even a small insurer like FFS has the capabilities of making well-informed investment choices across the full asset spectrum, while keeping a strong focus on risk management and performance monitoring.

Solvency capital is a precious resource for any regulated business, and optimising its deployment is one of the core constraints behind any portfolio construction activity

The relative exposure to alternatives is destined to increase steadily over time, considering the strength of the liquidity position of the Society and the growth in new business underwriting

Current ponderings on industry themes

On the role of the reinsurance market in the climate emergency

Over half of reinsurance companies still provide coverage for single coal-fired power plants or coal mines and continue to have clients that insure power suppliers generating significant proportions of their electricity from coal. A wise reinsurer would be moving away from insurance companies that are offering or providing coverage to coal projects – new and established – due to the economic and ecological risks attached. There is no insurance on a burnt planet.

ADAM PAWLOFF
Climate and energy campaigner at Greenpeace Central and Eastern Europe

ALBERT BENCHIMOL
AXIS President and CEO

On AXIS Capital's new policy addressing thermal coal

We believe insurers have an important role to play in mitigating climate risk and transitioning to a low-carbon economy. This policy is in line with our broader strategies such as reducing investments in lines that do not align with our long-term approach; investing in growth areas, such as renewable energy insurance where we are a top five player; and growing our corporate citizenship program, a core focus of which is creating a positive environmental impact.

On Tokio Marine buying Pure Group

We have been pursuing organic growth and strategic M&A initiatives in both developed and emerging markets in order to capture growth opportunities in the global insurance market and to build a further diversified business portfolio. The acquisition will contribute to sustainable profit growth and capital efficiency of Tokio Marine Group through Pure Group's continued high growth potential in the world's largest P&C insurance market, as well as its stable fee-based business and low capital intensity.

TOKIO MARINE

On the first insurance industry guide for protecting UNESCO World Heritage Sites

PSI LEADER AT
UN ENVIRONMENT

Protecting World Heritage Sites for present and future generations is not an option, but an obligation for all. Losing these treasures means losing sources of life, inspiration and human well-being, and losing the war against unsustainable development. This guide will help insurers protect our world's most prized assets in their risk management, insurance and investment activities, while curbing carbon emissions, building disaster resilience, and ensuring healthy ecosystems. We call on insurers around the world to unite behind the science, show decisive leadership, and take ambitious action in insuring a sustainable future.

On Beazley investing in Hong Kong coverholder Pegasus

JAMES EATON
Beazley head of specialty lines

Our successful partnership with Pegasus has created a robust proposition and efficient distribution channel for both brokers and commercial customers. We are excited about the opportunities this provides us, to build out our financial lines offering in Hong Kong and Greater China, and complements our existing underwriting hub in Singapore. The investment is part of our long-term commitment to this region.

On Canopius's merger of AmTrust at Lloyds

The merger provides Canopius with significant additional underwriting expertise and a broader product offering, creating a leading Lloyd's insurer of increased scale and enhanced relevance to its clients and brokers.

CANOPIUS GROUP

KATHLEEN HUGHES
Global head of liquidity solutions global business

On Clearwater Analytics launching new portal for liquidity management

Liquidity management is a highly-fragmented space with a number of inefficiencies for our clients. This partnership will provide a consolidated dashboard across short-term portfolio holdings, combined with the fund trading and risk analytics of a leading execution platform. We're excited about the opportunity this partnership represents for our clients and look forward to driving further innovation with Clearwater.

On green and sustainable bond issuance

Although insurers currently account for a very small proportion of the total issuance of the ESG bond market, given the strong reception these issues have had, other insurers around the globe may begin issuing more such bonds.

MICHAEL DUNCKLEY
AM Best associate director

JOACHIN WENNING
Munich Re chairman of the board of management

On Munich Re investing $250m in US start-up Next Insurance

This investment emphasises Munich Re's commitment to be the leading provider of digital insurance solutions. It also helps Munich Re expand its footprint in the promising insurance market for small and medium-sized commercial customers in the United States. We are confident that building on our proven collaboration will benefit both Munich Re and Next Insurance.


Invest in the world you live in
OUR CAPABILITIES INCLUDE
TRANSPORT • REAL ESTATE • PRIVATE EQUITY
HEDGE FUNDS • PRIVATE CREDIT • INFRASTRUCTURE
LET'S SOLVE IT.®
JPMORGAN.COM/ALTSOUTLOOK