Insurance Asset Management

Winter 2020

Hiscox
The latest insights from within the insurance company

Phoenix Group
Achieving excellence and recent developments

Aviva
In the spotlight with Aviva UK Life's chief investment officer

The next chapter?

The UK insurance industry enters a crucial Solvency II regulatory stage and the right reforms must be made

IMPACT INVESTING
The latest impact investing trends in private markets for insurers

LIBOR
How the insurance industry is dealing with the transition to alternative rates

ABSOLUTE RETURN FIXED INCOME
The significant opportunities on offer within the ARFI market

Editorial Comment

The 'new normal' in which we currently find ourselves in has brought with it a number of unfamiliar elements and changes to our lives. This could be popping back and forth to the office as and when the government allows, working from home for a longer period than would normally be permitted, or largely conducting business on a 'virtual' scale.

Whilst working from home, I often have the radio on in the background or maybe the television (I hate silence!), and during this time I have been struck by just how many news bulletins and the increasing number of programmes there have been on the issue of climate change, and the need for long-term investments in our economy. We are at a crucial stage at dealing with these aspects, and as ever the focus on institutional investors such as insurers to do something about this has never been more fierce. Indeed, Solvency II regulation has a big part to play in this and our cover feature this issue (p. 20) looks at HM Treasury's call for evidence as part of a review into Solvency II. It is of paramount importance that the right reforms are made within Solvency II regulation for the UK insurance industry, so as to support insurance firms in providing long-term capital to boost economic growth, as well as other long-term productive assets and investment consistent with the government's climate change objectives. Will it be the next chapter in the development of Solvency II for UK insurers, or will the amendments that eventually become concrete regulatory policy not be enough? It's a defining moment and one not to be missed.

> It is of paramount importance that the right reforms are made within Solvency II regulation for the UK insurance industry

Also in this issue, we look at just how prepared insurers are for the London Interbank Offered Rate (LIBOR) transition and the operational and legal challenges that this poses. The transition from LIBOR to the Secured Overnight Financing Rate (SOFR) will affect both sides of insurers' balance sheets, as it affects assets and liabilities, and calls are growing for insurance supervisors to perhaps do more to help insurers with this move.

It's a busy time as always in the UK and global insurance industries. Our impact investing and absolute return fixed income roundtables are also covered in this issue, providing deep insight into these all important investment areas.

Enjoy the read.

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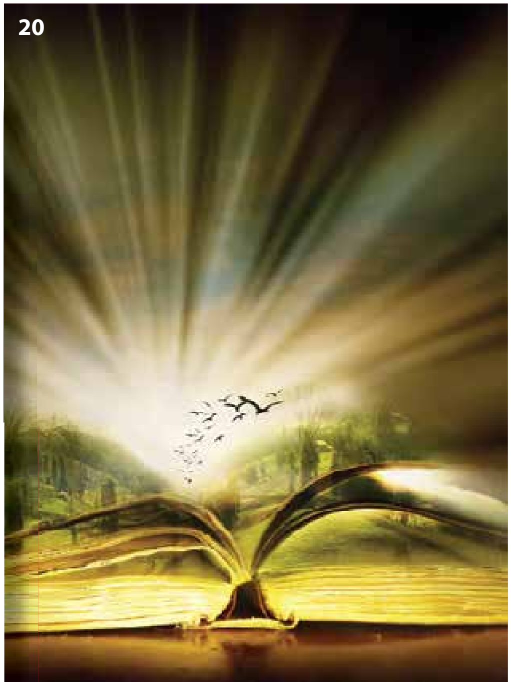
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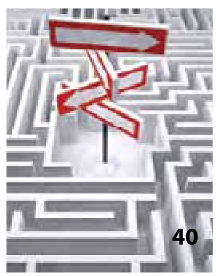
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Winter 2020

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News focus

HM Treasury issues call for evidence as part of review into SII regulation

Different prudential SII regimes could create a 'papal schism'

Written by **Adam Cadle**

HM Treasury has issued a call for evidence as part of a review into Solvency II (SII).

The call for evidence is the first stage of the review of SII and is underpinned by three objectives. These include spurring a vibrant, innovative, and internationally competitive insurance sector; protecting policyholders and ensuring the safety and soundness of firms; and supporting insurance firms to provide long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, as well as other long-term productive assets and investment consistent with the government's climate change objectives.

> We need a regulatory system that enhances UK international competitiveness

The government seeks views on how to tailor the prudential regulatory regime to support the unique features of the insurance sector and regulatory approach in the UK.

The call for evidence will be open for responses until 19 January 2021.

ABI director general Huw Evans said: "We welcome the government's review of SII. As we leave the EU transition period we need a regulatory system that enhances UK international competitiveness and allows insurance and long-term savings companies to invest for the long-term to help tackle climate change and rebuild the UK economy post-COVID.

"The long-term liabilities of insurance and long-term savings companies make them natural investors for the long-term but the current SII framework discourages investment in sustainable assets and is overburdened with reporting requirements. This review is an important opportunity to make sure that the UK's future regulatory regime works for the UK economy and does not place unnecessary constraints on the ability of firms to invest. In particular, a more flexible approach to SII is critical in order to unlock more of the £250bn assets that back UK annuities and could be used for investment in infrastructure and sustainable technology."

> The long-term liabilities of insurance and long-term savings companies make them natural investors for the long-term

The ABI's director of regulation Hugh Savill said different prudential regimes in the EU and the UK could create a "papal schism" for SII.

Addressing the government's review of SII, Savill drew on the learnings from history to discuss what the process could mean for insurers.

"I believe it is always helpful to draw lessons from historical precedent. In 1378, after a number of unseemly episodes, the Catholic Church found itself with two Popes, Urban VI in Rome, and Clement VII in Avignon. The Schism lasted till 1417, and for the final seven years there were even three Popes. Will this happen to SII, with identically named but slightly different prudential regimes developing in the EU and the UK?", he said.

"Clerical circles in Brussels are quick to mutter about "divergence" from the true faith of SII as set out in Brussels. And nobody could deny the key role played by Cardinal Karel van Hulle in finalising the text. But there are good arguments that the SII credo was first established in London. The initial thinking around SII was done by Paul Sharma, the revered FSA theologian, with his 2002 Encyclical. And SII was based on the British ICA discipline. By this logic, it is in fact the Brussels 2020 Review that is diverging from the true faith.

"But what about the faithful? Who are they to believe? Pope Gabriel in Brussels, or Pope Samuel in London? Will they denounce each other from their pulpits and excommunicate each other for failure to ensure equivalence? This would be very worrying for devout insurers. My practical advice would be not to bother too much about the high theology, and to continue to make your confessions in private to your supervisor."

News in brief

■ The New York State Department of Financial Services (DFS) superintendent Linda Lacewell has announced a settlement worth $6m with Principal Life Insurance Company for annuity replacement violations. DFS's investigation found that Principal failed to properly disclose to consumers income comparisons and suitability information, causing hundreds of consumers to exchange more financially favourable deferred annuities with less favourable immediate annuities.

■ Government bonds formed 52.9% of total investments made by Italian insurers in H1 2020, compared to 52.7% in H1 2019. In a statistical bulletin published by Italy's Institute for the Supervision of Insurance (IVASS), figures showed that corporate bonds formed 19.7% from 20% the year before, and UCITS rose from 12.2% to 13% of total investments.

■ AIG is to separate its life insurance arm from its larger property and casualty (P&C) business. In a statement, AIG said "a simpler corporate structure will unlock significant value for shareholders". The life insurance and retirement services arm accounts for about one-third of revenue at AIG, which has a $27bn market capitalisation.

■ MetLife's net investment income was $4.7bn for Q3 2020, up 2% from the third quarter of 2019, driven by higher private equity returns.

49% of insurers expect to increase allocation to real assets investment strategies

Study also shows that 54% of insurers identify real estate long income as their preferred asset class

Written by **Adam Cadle**

> Cashflow-matching continues to be the key criteria for insurers and pension funds around the world

Forty-nine per cent of global insurers are expecting to increase their allocation to real assets investment strategies over the next 12 months, a new study has revealed.

The study from Aviva Investors is based on responses from over 1,000 decision-makers at insurers and pension funds representing over €2trn of assets under management, and found that 54% of insurers identified real estate long income as their preferred asset class.

Beyond this, insurers highlighted the desire to increase their exposure to debt strategies with infrastructure debt (48%), real estate debt (46%) and private corporate debt (46%) all expected to see increased investment.

Aviva Investors chief investment officer, real assets, Mark Versey said: "Cashflow-matching continues to be the key criteria for insurers and pension funds around the world, as these investors increasingly recognise the resilience that real assets can offer their portfolios. This is being seen not only through consistent – and often inflation-linked – cashflows, but also via enhanced yields relative to more traditional asset classes and lower volatility. With central banks looking set to keep base rates low for the foreseeable future, our expectation is that institutional investors will increasingly turn to real assets for yield, returns and diversification."

Fifty-nine per cent of insurers view the transparency of ESG investment approaches as the most important thing they look for in an asset manager. The study also revealed a continued increase in focus on social responsibility by real assets investors. Including healthcare assets in portfolios was a factor for 55% of insurers; investments in social housing (51% of insurers) and education (46% of insurers) were also seen as important.

Given the increased efforts of investors to align their portfolios with net zero emissions targets, there was continued support for investments that make a positive environmental impact. Fifty-eight per cent of insurers looked towards 'energy-efficient real estate assets'.

The research also said that 44% of insurers see financial instability as the most likely concern for their investments over the next 12 months. Asked when they expect their own economies to recover to 2019 levels, global institutional investors broadly agree on the end of 2022 or the beginning of 2023, with European investors the least optimistic by favouring spring or summer 2023 and those in North America at the other end of the spectrum, predicting June 2022.

FCA and PRA urge UK insurance providers to build on post-Brexit plans

Regulators send letter to CEOs to ensure readiness at end of transition period

Written by **Adam Cadle**

The FCA and the PRA have sent a letter to the CEOs of insurance providers in the UK concerning their contingency plans once the Brexit transitional period finishes in 2021.

In the letter, both regulatory bodies said "it is imperative that insurance firms continue to build on their preparatory work to ensure that they are ready for a range of scenarios at the end of the transition period".

Parliament has also legislated for a Part VII "saving provision" which will provide two years from the end of the transition period for "parties to obtain a UK court order sanctioning the transfer of insurance business", the regulators said.

"It will apply where that insurance business transfer scheme is already underway at the end of the transition period and has met two conditions: payment of the regulatory fee and approval of an independent expert."

The FCA and PRA warned that the mutual recognition framework part of the Solvency II Directive will not apply to business transfers sanctioned by the UK courts after 31 December 2020. In such cases, recognition will be based on national regimes in each European Economic Area (EEA) jurisdiction.

> It is essential that insurance firms continue to build on their preparatory work

NAIC poised to add new GCC for US insurers

Insurers urged to monitor possible new reporting requirements

Written by **Adam Cadle**

The National Association of Insurance Commissioners (NAIC) is proposing to add its new group capital calculation (GCC) requirement to the existing Insurance Holding Company Systems Model Act (Holding Company Act).

On 20 October 2020, the NAIC's GCC Working Group circulated the latest version of these Holding Company Act amendments to interested parties for review and comment. These include amendments to the regulations issued under the Holding Company Act (the Insurance Holding Company Systems Model Regulation, or Holding Company Regulation).

Insurers, in particular groups of insurers with operations that straddle the US and other countries, are being urged to monitor these amendments and consider the new reporting requirements that could be imposed by them. The new amendments to the Holding Company Act would require the ultimate controlling person of every insurer to file concurrently with the registration an annual GCC as directed by the lead-state commissioner. The GCC Instructions have been the subject of long discussions by the GCC Working Group, against the backdrop of the ICS 2.0 capital standard currently being developed for international insurance groups by the IAIS.

Total AuM at world's largest asset managers exceeds $100trn for first time

Latest figure of $104.4trn represents an increase of 14.8% on previous year

Written by **Adam Cadle**

Assets under management (AuM) at the world's 500 largest asset managers exceeded $100trn for the first time in 2019 – totalling $104.4trn, according to new research published by the Thinking Ahead Institute.

The latest figure represents an increase of 14.8% on the previous year, when total AuM was $91.5trn and an almost three-fold increase from $35.2trn in 2000. A growing concentration exists among the top 20 managers whose market share increased during the period to 43% of total assets, up from 38% in 2000 and 29% in 1995.

According to the research, passively managed assets in the survey grew to $7.9trn in 2019, up from $4.9trn in 2015.

Roger Urwin, co-founder of the Thinking Ahead Institute, said: "The investment industry has always been dynamic, but the pace of change is speeding up, manifested notably through consolidation. In addition, rapidly advancing technology is changing the shape of mandates and producing products that require less governance and are more streamlined. This has led to the growth of passive and index tracking, factor-based strategies and solutions. Private markets have also continued a significant growth trend in the last decade, during which investors have sought higher returns involving higher risk.

"Most asset management processes – including investment, operating and decision-making – are also having to evolve. This is being driven by, in particular, asset owners seeking the benefits of outsourcing; the increased use of the total portfolio approach, especially when targeting absolute return; and the use of index tracking in ETFs, where there is an active choice of the index."

> The investment industry has always been dynamic, but the pace of change is speeding up, manifested notably through consolidation

The world's largest money managers ranked by total assets under management, in US millions, as of 31 December 2019 are as follows:

1	BlackRock $7,429,632
2	Vanguard Group $6,151,920
3	State Street Global $3,116,424
4	Fidelity Investments $3,043,134
5	Allianz Group Germany $2,539,842
6	J.P. Morgan Chase $2,364,000
7	Capital Group $2,056,991
8	BNY Mellon $1,910,000
9	Goldman Sachs Group $1,859,000
10	Amundi France $1,617,280
11	Legal & General Group $1,568,891
12	Prudential Financial $1,550,982
13	UBS Switzerland $1,413,000
14	BNP Paribas France $1,257,603
15	Northern Trust $1,231,300
16	Invesco $1,226,173
17	T. Rowe Price $1,206,800
18	Wellington Mgmt. $1,154,735
19	Morgan Stanley $1,131,824
20	Wells Fargo $1,091,100

Sustainable investment driven by active engagement/stewardship - study

59% of institutional investors believe this to be the case, up from 38% a year earlier

Written by **Adam Cadle**

Active engagement and stewardship have leapt in importance as a way for asset managers to drive sustainable change, Schroders *Institutional Investor Study 2020* has found.

The study, which spans 650 institutional investors encompassing $25.9trn in assets, identified that 59% of institutions said active company engagement and stewardship was a key approach to integrating sustainability. This was a significant rise on 38% a year ago. Furthermore, investors' focus on an inclusionary investment approach – essentially the positive selection of 'best in class' companies or investments' - had also risen in importance to 61% from 44%. In contrast, those that opted for an exclusionary approach fell by the same margin to 36% from 53%.

The results suggest that engagement and voting are now increasingly being viewed as an important aspect of achieving change, rather than simply divesting. Investors said that transparent reporting, tangible outcomes and consistently voting against companies in order to drive change were the three key signs of successful engagement. For the second consecutive year, environmental issues remained the most important engagement issue for investors. They also pointed to national governments and companies as the two key stakeholders most responsible for mitigating climate change. This broad dynamic was also reflected more broadly in investors' continued belief in sustainable investing. Just 12% of investors said they do not invest in sustainable investments, significantly down on 19% a year ago.

> Greenwashing has emerged as a new challenge

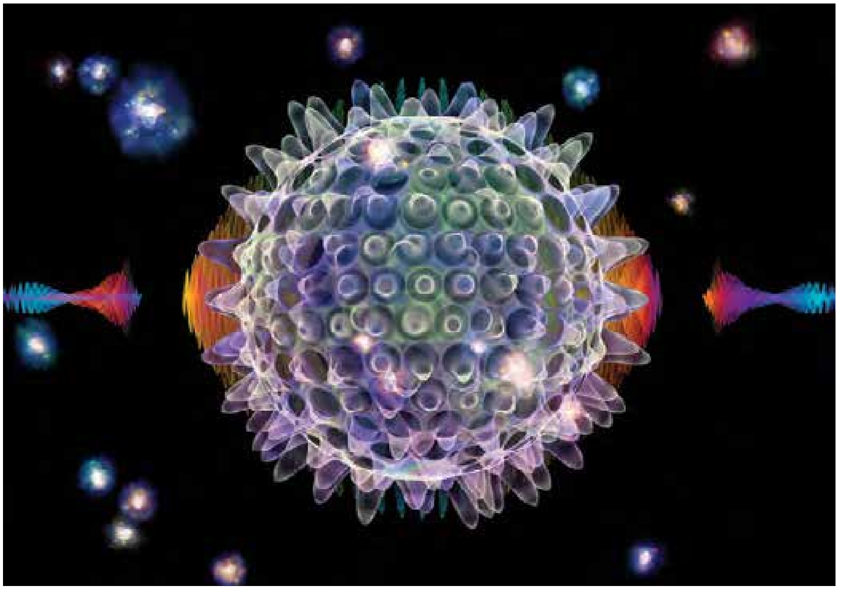
This trend is expected to continue. In total, 68% of investors globally said they expected investing sustainably to grow in importance over the next five years. Driving this focus were institutions looking to align their investments with their own corporate values, responding to regulatory and industry pressure, and, positively, the belief that investing sustainably can drive higher returns and lower risk.

However, as sustainable investing has become an increasingly mainstream investment consideration, the study found that greenwashing has emerged as a new challenge. Some 60% of investors felt greenwashing i.e. 'a lack of clear, agreed sustainable investment definitions' was the most significant obstacle to their sustainable investment intentions. Alongside the investment challenges related to greenwashing, almost half of investors (48%) said that a lack of transparency and reported data was restricting their ability to invest sustainably, an increase on 40% a year ago. Encouragingly, however, performance concerns have continued to diminish. Just under half (45%) of investors cited performance concerns related to investing sustainably, down from 48% a year ago and 51% in 2018.

COVID-19 accelerating over three quarters of insurers' ESG focus

Over 50% have invested in this area in the last year

Written by **Adam Cadle**



More than three quarters of insurers (78%) have said the impact of COVID-19 is accelerating their focus on ESG.

According to a new report published by BlackRock capturing the insights of 360 senior executives across 25 major insurance markets, over 50% of respondents have invested in specific ESG strategies in the last year, and a further 52% have made ESG a key component of their investment risk assessment for new investments. Nearly one in three (32%) have turned down an investment opportunity in the last 12 months due to ESG concerns.

Over 60% of insurers are worried about negative portfolio performance and potential COVID-related pay-outs. Nevertheless, nearly half of all insurers say they are looking to increase risk exposure over the next 12-24 months, with alternatives and equities being the favoured asset classes. At the same time, insurers are looking to increase cash holdings, with many waiting for the right investment opportunities.

In the face of prevailing uncertainty and prolonged low rates, close to 60% are looking to reposition their portfolios to combine a focus on higher quality assets with more diversification, as well as increasing portfolio flexibility with strong governance. Risk appetite is robust with 47% looking to increase risk. The macro and market risks insurers are most concerned about include geopolitics (57%), asset price volatility (64%) and liquidity (58%). Persistent low rates across developed markets are leading insurers to embrace meaningful allocations to illiquid alternatives and higher yielding emerging market assets.

Anna Khazen, head of BlackRock's financial institutions group for EMEA, noted: "Resilience and diversification are at the heart of insurers' investment approach, with the recent environment re-enforcing the importance of both. Whilst we see a continued desire to diversify, in particular into private assets, almost two thirds of companies are focused on the quality and resilience of their credit portfolios, combined with nimbler decision making."

> Resilience and diversification are at the heart of insurers' investment approach

On the asset management front, almost 80% of global asset managers now explicitly incorporate qualitative or quantitative ESG factor assessments into their investment processes, an increase of 5% compared to last year, it has been revealed. Russell Investments' sixth annual ESG manager survey analysed the practices and views of 400 asset managers globally across a broad range of asset classes (including equity, fixed income, real assets and private markets) to assess attitudes toward responsible investing and how firms are integrating ESG factors into their investment processes.

Almost all regions surveyed as part of the study showed progress in the extent to which ESG considerations are regularly embedded into investment processes. The US (+11%), Canada (+15%) and the UK (+11%) show the most growth since last year's survey.

Governance remains the critical consideration for asset managers, with 82% of respondents identifying this as the ESG factor with the most impact on their investment decisions, reflecting the importance of company management in delivering long-term enterprise value.

> We have invested SEK 425m in the government's first green bond

Skandia ups sustainable investments as AuM rise amid 'stable' recovery

AuM increase to SEK 690bn from SEK 664bn

Written by **Adam Cadle**

Skandia has upped its commitment to sustainable investments, after its portfolio showed signs of a "stable" recovery during Q3.

The group's assets under management (AuM) rose to SEK 690bn during Q3, increasing from SEK 664bn at the end of the first half of 2020, as its financial accounts for Q3 revealed a "stable" recovery following previous market volatility amid the COVID-19 pandemic earlier this year.

AuM for the group life insurance company amounted to SEK 505bn, which, whilst still lower than the SEK 508bn recorded at the start of the year, is an improvement on the SEK 492bn reported in July.

The group said it has boosted its sustainable investment offering in order to meet its customers' "growing expectation" of Skandia as a sustainable company, and to contribute to a "sustainable transformation" in the industry.

Skandia President and CEO Frans Lindelöw said: "During the year, we launched several actively managed funds with a focus on sustainability, and during the third quarter, fossil-free index-linked funds were launched with the market's lowest fees in the sustainability category. Furthermore, as part of the work to increase the share of climate investments, we have invested SEK 425m in the government's first green bond." At the end of the quarter, Skandia launched a "climate roadmap" supporting the two-degree goal.

Lloyd's insurer Apollo drops Adani's coal project

Cover to cease in September 2021

Written by **Adam Cadle**

Adani's insurer and Lloyd's of London syndicate Apollo has dropped Adani's coal project after pressure from climate campaigners.

Apollo confirmed the insurer will not provide cover for Adani's coal mine, rail project or coal port after their current construction terminates in September 2021.

This news comes as over 500 people from around the world joined a successful online rally calling on Lloyd's to stop insuring Adani's Carmichael coal mine through a number of actions.

The syndicate also revealed that Adani is still looking for insurance for the port and rail elements of their Carmichael coal project. In an email to Market Forces, Julian Cusack, chair of the board of directors of Apollo Syndicate Management, said: "I can confirm that we participate in one construction liability policy in respect of Adani Carmichael. Construction policies are generally taken out for single fixed periods and as such are not subject to renewal. This particular policy terminates in September 2021 after which we will no longer provide any insurance cover for this project."

People on the move

TONY RAI

Head of AIUK and AMAL, Aspen

Aspen has appointed Tony Rai as head of Aspen Insurance UK (AIUK) and Aspen Managing Agency Limited (AMAL). Rai will join Aspen in early 2021 from Hiscox, where he has been head of London market claims since 2009 and responsible for the management and leadership of claims for three business units, Hiscox London Market Insurance (including Hiscox MGA), Hiscox Re, and Hiscox Special Risks.

MATT CHRISTENSEN

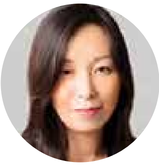
Global Head of Sustainable and Impact Investing, Allianz Global Investors

In this role, Christensen will accelerate the growth of impact investing as part of the company's growing private markets platform; lead the continued integration of ESG factors across AllianzGI's existing range of public markets products, including stewardship activities; and support the development of new SRI products. He will join Allianz GI in December 2020.

SÉVERINE PIQUET

Head of Corporate Credit Research, BNPP AM

Piquet will be responsible for the management and oversight of all corporate credit research functions globally covering developed markets for BNPP AM, as well as enhancing the value-add of the credit research function. She will also help to transform the research process to make greater use of alternative data, artificial intelligence and automation.



CLARA YAN

Head of Insurance Analytics, Robeco

In this newly created role, Yan will further develop, enhance and coordinate Robeco's insurance analytics capabilities, and serve the needs of existing insurance clients as well as prospects. In addition, she will advise insurers on areas like asset allocation and capital management while managing accounting, regulatory, rating agency and ALM considerations. Yan joins from Schroders.

PETER ZAFFINO

CEO, AIG

The AIG board of directors has named Peter Zaffino chief executive officer of AIG, effective 1 March 2021, in addition to his current role as President of the company. Zaffino has also been appointed to serve as a director, effective immediately. Current CEO Brian Duperreault will become executive chairman. Douglas Steenland, currently independent chairman of the board, will become lead independent director.

TRACY BLACKWELL

Board Member, ABI

The Association of British Insurers (ABI) has appointed Pension Insurance Corporation (PIC) CEO Tracy Blackwell, Rothesay CEO Addy Loudiadis and Phoenix Group CEO savings and retirement UK & Europe and group director Scotland Andy Curran to its board. Blackwell has been PIC CEO since 2015, before which she was chief investment officer. She is a member of Wellcome Trust's Investment Committee.

Opinion

On its call for the cancellation of all new thermal coal projects as part of its Thermal Coal Position

"Participation in activities and projects that are not aligned with these principles is incongruent with our net-zero goals and the aspirations we have in respect to the different decarbonisation strategies of the companies we invest in. Together, investors, governments and companies all have a responsibility to act on global emissions reduction."

Members of the UN-convened Net-Zero Asset Owner Alliance

On EIOPA/ESRB SII review approach

"It would create unnecessary additional capital and operational burdens for insurers. This would make it harder for insurers to make the long-term investments that are needed to boost economic recovery and growth in Europe.Instead, the review of SII should focus on improving existing instruments to fully reflect insurers' long-term business models, to mitigate artificial volatility and to reduce unnecessary operational burdens. This would avoid unnecessary costs for customers and help insurers to support the Commission in delivering on the objectives it has set out in the EU Green Deal and the CMU."

Insurance Europe

On the global green bond market set to hit €2trn

Bram Bos

NN IP lead portfolio manager green bonds

"Investors must do their homework and not blindly trust the green label. The projects financed by green bonds should deliver clear environmental benefits that can be assessed and quantified wherever possible. Unfortunately, companies can issue green bonds without having any intention of addressing their own core sustainability issues. A thorough evaluation of a company's activities, future plans and intention to improve business practices is needed."

On its call for insurance sector to complete preparations for end of UK transition period

eiopa European Insurance and Occupational Pensions Authority

European Insurance and Occupational Pensions Authority (EIOPA)

"The insurance sector needs to be prepared for the consequences of UK and Gibraltar insurance undertakings becoming third-country undertakings and no longer benefiting from the SII authorisation to provide services in the EU. There are moreover other legal repercussions concerning insurance contracts, insurance disclosure and group supervision."

On US insurers' investments in emerging market bonds and stocks totalling $48.4bn

National Association of Insurance Commissioners (NAIC)

"The largest emerging markets country bond exposure for US insurers was Mexico, at 28% of total emerging markets bonds; the largest emerging markets country stock exposure for US insurers was China, at 34% of total emerging markets stocks. The largest emerging markets bond type was corporate; the largest sector within the emerging markets corporate bond exposure was energy, at 12% of total emerging markets corporate bonds."

Soapbox

Here to stay

Written by **Adam Cadle**

There's not much good news stemming from COVID-19, but if you dig around you can find a few positive snippets. According to a report recently published by BlackRock capturing the insights of 360 senior executives across 25 major insurance markets, more than three quarters (78%) of insurers have said the impact of COVID-19 is accelerating their focus on ESG. Countering this, I've received press releases recently saying ESG is no longer fit for purpose. I believe this couldn't be further from the truth and clearly the insurance industry is having none of it either.

"ESG investing makes economic sense as it delivers better risk-adjusted returns in the longer term, but also downside protection during periods of high volatility. Our responsible investing approach supported us in weathering the COVID storm better, resulting in outperformance over the standard benchmark," Swiss Re chief investment officer Guido Fürer said in the report.

> The government wants it, the regulators want to amend policy to make investments in this area easier, and the world needs it

The report goes on to say that over 50% of respondents have invested in specific ESG strategies in the last year, and a further 52% have made ESG a key component of their investment risk assessment for new investments. Nearly one in three (32%) have turned down an investment opportunity in the last 12 months due to ESG concerns.

Clearly this is only one report of market perception on ESG, and I'm sure there are many spokespeople who would argue why would they turn to ESG investments yielding less return than say a more traditional investment. That is indeed an argument, but I firmly believe the majority have some sort of ESG investment thinking at the back of their minds. At the end of last year, Schroders announced a commitment to integrating ESG across all its investments by 2020. News covered recently has seen Varma expanding its sustainable equities portfolio to up to €1bn, the Dai-ichi Life Insurance Company (DLIC) announced it is to introduce an ESG index as its benchmark for foreign equity investments managed in-house, and Nippon Life has invested approximately JPY 11.4bn in sustainable development bonds issued by the International Bank for Reconstruction and Development (World Bank). These are just a few examples of recent activity, and I could go on.

The widening focus of ESG is also reflected in the actions taken by AIA as CIO Mark Konyn explained in the report: "We have adopted ESG principles within our portfolio management processes and have significantly increased our focus on investee company engagement in the past two years. The most recent engagement directly with 1400 investee companies has centred on company actions to support their staff and communities through the COVID-19 crisis."

ESG is here to stay and COVID-19 has accentuated the need to explore this investment thinking. The government wants it, the regulators want to amend policy to make investments in this area easier, and the world needs it.

In the spotlight

Adam Cadle catches up with Aviva UK Life chief investment officer Ashish Dafria

WRITTEN BY **ADAM CADLE**

Q Could you provide an overview of Aviva UK Life and your day-to-day role?
Aviva is an international savings, retirement and insurance business serving over 33 million customers. Aviva is the leading UK insurer offering annuities, equity release, savings and retirement, as well as general insurance solutions for both individual customers and businesses.

As chief investment officer for Aviva's UK businesses, I am responsible for investment strategy, delivery and performance across Aviva UK's shareholder and customer assets. This involves setting the investment strategy and asset allocation, in accordance with customer expectations and Aviva's investment beliefs; working with asset manager partners (principally Aviva Investors) to define investment mandates; making the appropriate individual investment decisions; measuring, monitoring and reporting investment performance; and ensuring responsible investing and thorough risk management are embedded into the investments we make.

Q What is your overall investment portfolio structure and what are your main asset allocations targeting?
The largest part of Aviva's shareholder portfolio is the annuity matching adjustment portfolio. This is invested in a diversified portfolio of high-quality, long term fixed income investments to closely match our liabilities.

There is a significant allocation to secured, private credit investments across multiple asset classes, including commercial mortgage loans, infrastructure, equity release, private corporate debt and structured investments.

Q HM Treasury has issued a call for evidence around SII regulation, with the aim of boosting investment in infra, and meeting climate change objectives. What do you think needs to be changed within SII and how will this affect your investment thinking at Aviva UK Life going forward?
Aviva has long been committed to supporting infrastructure development in the country and has invested over £15bn in UK infrastructure. Aviva has the funding, long-term investment horizon and the strategic ability, to invest in strategic projects in the UK - this is precisely the sort of approach to investment that the regulatory regime should be promoting. Our ability to make such strategic investments can be enhanced by suitable changes to the SII regime in the UK context. Some alternatives that should be discussed include (a) providing flexibility in matching adjustment rules around rigid cashflow matching to encourage and accommodate investment in long-term infrastructure assets, (b) better recognition of the fundamental distinction between equity held for trading purposes and strategic equity to support UK infrastructure and development projects, and (c) addressing the currently excessive and volatile risk margin.

Q How has the firm adapted to COVID-19 in terms of its investment thinking and direction?
Our approach to managing insurance investments is anchored in robust risk management, and those risk management practices shone again during the COVID environment.

However, it hasn't been solely an exercise in risk reduction. Capitalising on market opportunities, we net added to investment risk over 2020, underlining our role as liquidity provider to the markets during periods of dislocation. The strong policy support since the onset of COVID has supported the risk asset performance as well as helped the broader economy, however, for individual businesses in some cases we expect further stress to come. There are pockets of the investment universe where we have had a cautious appetite and, in many cases, COVID has accelerated the structural changes in different segments of the economy.

Q What is your ESG investment thinking at the business?

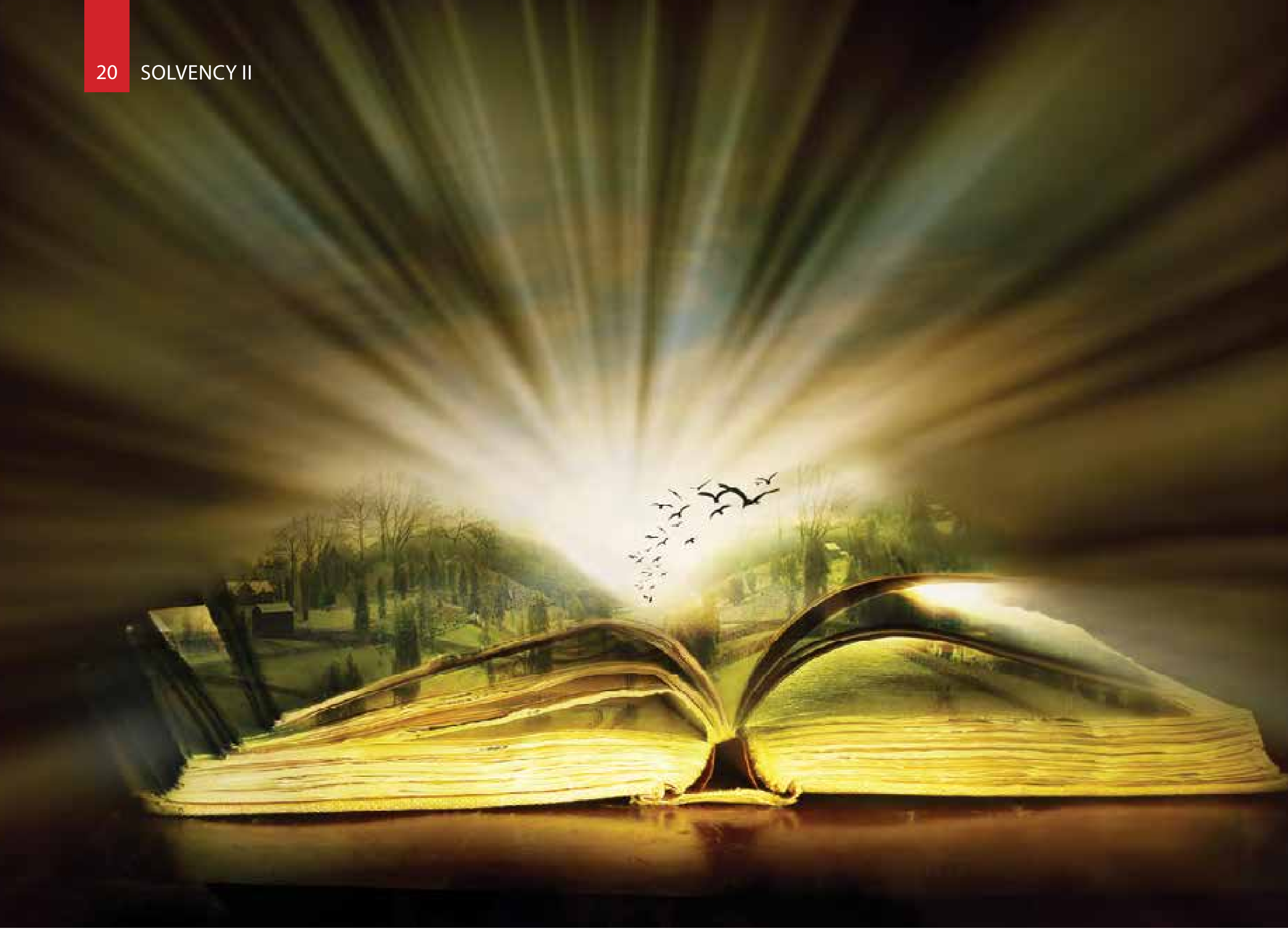
Aviva, via Aviva Investors, is a UK pioneer of responsible investing, dating back over 26 years, when we published our corporate governance voting policy. Aviva Investors is a founding signatory of the UN Principles for Responsible Investment. Aviva is also a founding signatory to ClimateWise and Accounting for Sustainability Principles, as well as a founding signatory of Principle of Sustainable Insurance. We are a signatory to the United Nation's Net Zero Asset Owners Alliance and are committed to achieving net zero emissions in our investment portfolios by 2050.

More broadly, our approach to responsible investing is based on actively engaging with our investments, and on integrating ESG factors right into investment decisions. We view ESG factors as material sources of both investment risk and out-performance opportunities. When designing and overseeing investment strategies, we ensure that an active mandate, underlying active fund, or teams originating investment on our behalf, fully integrate the ESG requirements into the decision-making process.

> **We expect even greater emphasis on responsible investment factors, including climate risk, as well as on active engagement with our investment companies**

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

Our main aim is to continue to deliver value to our customers by delivering strong investment outcomes in the volatile times. We are continuing to enhance the investment propositions offered to customers to provide solutions meeting their needs over the life cycle. We expect even greater emphasis on responsible investment factors, including climate risk, as well as on active engagement with our investment companies. For our annuities and shareholder portfolios, further diversifying our investments is a key objective, as are supporting UK development investments and playing an active part in carbon emission reduction. Navigating challenges presented by COVID – both from an investment perspective and from a personnel/social perspective – has become an important part of the forward-looking agenda.



The next chapter?

The UK insurance industry enters a crucial Solvency II regulatory stage and the right reforms must be made. Adam Cadle explores

WRITTEN BY **ADAM CADLE**

The proverb, 'If it ain't broke, don't fix it', is one which is commonly used even today. American businessman Thomas Bertram "Bert" Lance was actually the individual credited with popularising the phrase in 1977, whilst working under President Jimmy Carter as director of the Office of Management and Budget. Defined as describing something which is 'in a satisfactory state, and there is no reason to try to change it', the phrase can be applied to a number of situations surrounding us in everyday life, however, its usage is unfortunately limited when analysing different areas of financial regulation. Solvency II (SII) fits perfectly within this bracket.

The UK insurance sector is one of the largest and most important in the world and plays a critical role in the UK economy. It provides a wide array of vital products and services for households and businesses that facilitate the management and reduction of risk. SII is generally an appropriate regime for the insurance sector and underpins its ability to fulfil its important role. Indeed, it was only recently that Bank of England (BoE) executive director of insurance supervision Charlotte Gerken praised SII for effectively mitigating the pro-cyclical effect caused by the disruption to financial markets from COVID-19. Strong praise was given to the role the matching adjustment played during March, in particular shielding insurers from market dislocations. Gerken also said the transitional measure on technical provisions (TMTP) and the PRA inviting firms to apply to recalculate their TMTP through a symmetric adjustment in light of significant changes in interest rates, allowed insurers to build capital buffers when markets were rising, and then allowed them to be released when markets fell.

However, despite all of this, fixes do need to be made to SII regulation. The UK insurance industry is entering a crucial stage, one of paramount importance, as it looks to reform SII regulation for UK insurers, and HM Treasury's review is timely. "We are undertaking this review to ensure that SII properly reflects the unique structural features of the UK insurance sector," Economic Secretary to the Treasury John Glen said. "By design, the current regime is tailored to the EU insurance sector as a whole but, in several important ways, the UK insurance sector is different. The review will be guided by our objectives: to ensure a vibrant and prosperous insurance sector, to provide long-term capital to support growth, and to uphold high standards of policyholder protection and promote the safety and soundness of firms."

Turning the page

So can this be the 'next chapter' for SII and the UK insurance sector, and how certain is the industry that SII can be tailored appropriately?

Aberdeen Standard Investments global head of insurance specialists Bruce Porteous is confident the industry can indeed make this work. "Firstly it is important to remember that this is a UK initiative and that the EU's version of SII will persist in the EU. However, we are very optimistic that the initiative could lead to a more pragmatic and less prescriptive version of SII making it easier for insurers, supported by their asset managers, to invest in a wider range of specifically and environmentally worthwhile long-term investments, for the mutual benefit of the UK economy and long-term savers in the UK. We will need to wait and see the detailed recommendations, which will emerge later in the process, before we can comment specifically. However, the direction of travel looks very encouraging."

> This is a UK initiative and the EU's version of SII will persist in the EU. However, we are very optimistic that the initiative could lead to a more pragmatic and less prescriptive version of SII

And, it's the recommendations around the risk margin, matching adjustment (MA) and solvency capital requirement (SCR) which make up some of the crucial elements around the SII proposed reform for UK insurers. In its Call for Evidence, HM Treasury said the government intends to work with the PRA to reform the risk margin. "Reform could reduce the volatility and pro-cyclicality of insurance firms' balance sheets and enable them to increase the choice and affordability of products available to businesses and households," HM Treasury outlined. "It could also release additional resource over the medium term which insurance firms could use to provide long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets." Feedback around the impact of the current design of the risk margin and the benefits and costs of any proposed changes to the methodology to calculate the risk margin must be addressed if things are to improve in this area.

On the issue of the MA, the government is currently seeking views on whether this is operating optimally including the criteria used to determine the eligibility of assets and liabilities. Moreover, the government seeks views on the role that the matching adjustment could play to better support delivery of its climate 'levelling up' and long-term investment objectives, including investment in appropriate infrastructure or other long-term productive assets. Again, an area that could be fixed to help address climate issues.

The other main area covered in the Call for Evidence is around the SCR. The government is seeking views on the role that the determination of the SCR can play to support insurance firms to deliver long-term capital to support growth, including to invest in infrastructure venture capital and growth equity, and other long-term productive assets. In addition, the government seeks views as to the role that the determination of the SCR could play to support delivery of its climate change objectives, the delivery of its Green Finance Strategy and to address the risks

> Given the lack of suitable sustainable investment opportunities, the right incentives are needed to stimulate a sustainable transformation leading to increases in the volume of such investments in the economy

posed by exposure to 'stranded assets'.

Boosting investment in infrastructure is a key theme within this review and Hiscox chief investment officer James Millard emphasises improvements around maturities at issuance of municipal bonds need to be made.

"SII incorporated incentivising capital charges for infrastructure that met specific criteria. This has resulted in increased demand for the likes of qualifying taxable municipal bonds. The charges for bonds meeting the infrastructure criteria are 30% lower on average than for similarly-rated corporate debt. That said, we are not a natural holder of infrastructure bonds as they tend to be long dated and do not suit our relatively short dated liability profile. A wider range of maturities at issuance would help encourage insurers like us to invest in the asset class. While that is primarily in the hands of the project issuers, SII could make special provision for the issuance of shorter maturities."

Aviva Investors investment strategist Moiz Khan says the risk margin and MA eligibility criteria could be considered "disproportionately rigid or inefficient for UK insurers".

"Therefore, potentially reviewing some of these rules could improve the UK's attractiveness as a country for doing business, particularly in a post-Brexit world," he added.

On the issue of climate objectives, Khan said revisions to the current regulatory framework can be made by making long-term investing more attractive, "or considering ways to penalise investment activities which do not support positive change or in meeting sustainability goals".

"A more holistic way could be to consider insurers' entire portfolios and incentivising them to move onto a more sustainable footing. On the whole, we see policymakers appearing to have both the will and the way to make progress in both long-term infrastructure development and climate change. Further evolving regulatory requirements on disclosure around climate and ESG considerations will force companies to consider these factors more, or risk losing popularity among both their customers and shareholders. Our expectation is that the most agile insurers will be positioning themselves to take advantage of the exciting investment opportunities and challenges that this will bring, both for their own businesses but also in supporting the UK's climate agenda."

Following the 'next chapter' theme and picking up on the sustainability angle of the review, Rebecca Lea, policy adviser, prudential regulation at the ABI, believes that this review does represent a "significant opportunity" to enable insurers' significant volume of assets to be 'unlocked' into sustainable assets, but warns over the potential for valuation bubbles and artificial risk/return trade-offs scenarios.

"The current SII framework limits insurers' ability to invest in more sustainable assets, instead leaving insurers with little choice but to invest in corporate bonds and government gilts. The availability of sustainable assets with appropriate levels of capital requirements does not currently meet the demand for such assets. Given the lack of suitable sustainable investment opportunities, the right incentives are needed to stimulate a sustainable transformation leading to increases in the volume of such investments in the economy. However, changes to prudential requirements must have risk-based justification in order to avoid creating artificial risk/return trade-offs, undermining good risk management and leading to valuation bubbles.

> Changes to prudential requirements must have risk-based justification in order to avoid creating artificial risk/return trade-offs, undermining good risk management and leading to valuation bubbles

"The UK insurance industry fully supports the transition to a more sustainable economy and is committed to integrating sustainability further into its business model. We are therefore proactively engaging with the current HMT consultation. This is a timely review, with the potential to unlock investment to contribute to 'building back better', as we face the challenges of both COVID-19 and climate change."

Sentiment and outlook

Recent research published by LCP of SII reporting from the top 100 UK and Ireland non-life insurers showed that climate change is leapfrogging Brexit as a key risk for the insurance industry. Forty-nine per cent of firms think that climate change is a key risk, a significant increase from last year when only 13 per cent of firms thought this was a priority. Just 42 per cent consider Brexit as a key risk, compared with 65 per cent last year. The importance and timing of this review into SII cannot be underestimated, and the general sentiment within the UK insurance industry appears to be one of positivity. Industry figures believe the right policy can indeed be implemented, and a more flexible approach to SII is critical in order to unlock more of the £250bn assets that back UK annuities and could be used for investment in infrastructure and sustainable technology. In 2019, the ABI warned there is a shortage of high-quality and consistent ESG data in the financial system, making it difficult to identify the best green investment opportunities. Some insurers are indeed developing their own approaches around this and specialist teams, but it is feared that a piecemeal approach could take an unnecessarily long time.

The ramifications for missing this opportunity to improve SII regulation for the UK insurance industry could be catastrophic and the 'next chapter' of SII could be lost.

"It would be a real shame and a lost opportunity as it is not likely that the policy would be looked at again in a generation," Porteous concludes.

"The UK economy and long-term savers would be deprived of many attractive socially and environmentally worthwhile investment opportunities and a no-brainer win-win opportunity would be lost for generations to come."

A view from Hiscox

Adam Cadle speaks to Hiscox chief investment officer James Millard about exercising caution, adapting and taking action

WRITTEN BY **ADAM CADLE**

Q Could you provide an overview of Hiscox and your day-to-day role?
As chief investment officer I am responsible for overseeing the management of Hiscox Group's $5.5bn of investment portfolios, implementing overall investment policy and directing all portfolio management, research, trading and strategy, and managing our central investment team of four people.

Our experienced investment team manages our asset portfolios across several regulatory regimes and jurisdictions, including the US, Bermuda, Europe, the UK and Canada. We aim to optimise the mix of assets within our portfolio to best navigate the markets ahead, while overseeing our investment programme that utilises world class expert third party investment managers for security selection across a wide array of public and private asset classes.

The role is extremely varied; from day-to-day implementation, manager selection, dealing with individual buy and sell decisions on individual investments, setting out our longer term asset allocation strategy to enhance the risk and return profile of the portfolio and adapting to a changing market environment. Stakeholder management is an important aspect of the role, working with our entity and group boards as well as our investment committee.

Q What is your overall investment portfolio structure and what are your main asset allocations targeting?
Whilst aiming to deliver strong risk adjusted returns, the overriding investment philosophy is to ensure there is sufficient liquidity to pay claims while managing the portfolio to maintain and provide capital to support the underwriting business.

As a result, assets are typically invested conservatively in high quality investment grade corporate and government bonds with a similar maturity profile to those of our liabilities. These core investments are complemented by selected diversifying and return generating exposures to other asset classes, including equities, alternatives and higher risk bonds.

Q HM Treasury has issued a call for evidence around SII regulation, with the aim of boosting investment in infra, and meeting climate change objectives. What do you think needs to be changed within SII and how will this affect your investment thinking at Hiscox going forward?

SII incorporated incentivising capital charges for infrastructure that met specific criteria. This has resulted in increased demand for the likes of qualifying taxable municipal bonds. The charges for bonds meeting the infrastructure criteria are 30% lower on average than for similarly-rated corporate debt. That said, we are not a natural holder of infrastructure bonds as they tend to be long dated and do not suit our relatively short dated liability profile. A wider range of maturities at issuance would help encourage insurers like us to invest in the asset class. While that is primarily in the hands of the project issuers, SII could make special provision for the issuance of shorter maturities.

On the objective of addressing climate change, there is nothing today in the capital charge structure that specifically addresses it. If sustainability principles could be acknowledged in the SII capital charge structure that would clearly encourage investment. Having lower capital charges on green assets would encourage investment and allow investors to accept lower yields. Having more specific incentives for issuers to meet climate objectives could encourage both issuance and demand and be a lever to change corporate behaviour.

Q How has the firm adapted to COVID-19 in terms of its investment thinking and direction?

Across investment markets, COVID-19 drove huge uncertainty, volatility and illiquidity in markets in Q1 2020.

Our conservative risk positioning going into the crisis allowed us to take advantage of the uncertainty in markets; we added incrementally to risk assets in March and April.

Unprecedented policy responses from central banks and governments quickly followed. Interest rates became effectively zero across the developed world, with little sign that will change until the impact of the virus has passed. Moreover credit spreads on higher quality bonds are now back to pre COVID-19 levels.

> **Having lower capital charges on green assets would encourage investment and allow investors to accept lower yields**

Our additions to equities, high yield and emerging market debt have performed strongly since.

Forward looking yields of high quality short dated bond portfolios across most major currencies are now close to all-time lows. This provides insurers like us with real challenges as to where to position portfolios to drive returns without taking on materially higher risk.

We continue to average into positions where valuations present attractive long-term risk and capital adjusted outcomes. These actions should help to incrementally improve expected returns, improve diversification and enhance capital efficiency without taking on materially higher illiquidity risk.

Outside of investments, giving back to the community has long been a feature of our business and one which our people care deeply about. Recognising that the COVID-19 pandemic is at its core a human tragedy, we wanted to do more, working with our communities to deliver help where it is most needed. Our pledge to support the global response so far stands at more than $7m, with contributions from our business and also from our charitable foundations in the UK and USA, the Hiscox Foundation.

Q What is your ESG investment thinking at the business?

At Hiscox, we take our role in the world seriously, which is why we continue to evolve our ESG practices.

Our Responsible Investment policy sets out our approach to ESG issues. We believe that ESG factors can have a material impact on risk and returns across asset classes, sectors, geographical regions and companies, and should be integrated into the investment process.

Our investment partners are selected based on a number of factors including performance, process, people and reputation but ESG integration is now a material part of the manager selection and monitoring processes of the team.

We expect transparency, sustainable business practices and good governance in the investment firms that manage our assets. We also expect our asset managers to invest in companies that have sound ESG practices and

> First and foremost, I aim to be a prudent steward of the group's assets, ensuring that we continue to maximise risk adjusted returns while supporting the ability of the group to underwrite business

engage with firms in which we invest to help improve practices over time.

All of our managers are signed up to the UN affiliated PRI or equivalent, and two of our chosen managers have recently been commended in the PRI Leaders Group for 2020, which recognises their excellent disclosure and efforts in this year's Leaders' Group theme: climate reporting.

Hiscox is a signatory to the Paris Pledge for Action; a supporter of the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD); and a founding member of ClimateWise, the global insurance group which helps the industry to better communicate, disclose and respond to the risks and opportunities associated with the climate-risk protection gap. These commitments help to inform our long-term investment strategy, as well as how we monitor, measure and report on our progress which we do through our annual Climate Report.

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

First and foremost, I aim to be a prudent steward of the group's assets, ensuring that we continue to maximise risk adjusted returns while supporting the ability of the group to underwrite business.

With ever-changing market conditions, navigating the right course through choppy and turbulent waters is not straightforward, demanding that we continually review our position and adapt as required. In this low rate environment, the pressure on picking up marginal gains intensifies. The regulatory landscape also continues to change rapidly and we must adapt accordingly. This will include further integration of ESG issues into our investment approach, including our investment strategy, decision making processes, training and reporting, while ensuring strong engagement on ESG issues with firms in which we are invested.

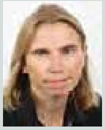
Our team is also important to me, and I am focused on ensuring we nurture our talent; investing in our capabilities and also our development. We also have some terrific long term investment manager partners and I will continue to look to deepen these partnerships to better leverage their tremendous insights and resources.

In association with

CHAIR

BRUCE PORTEOUS
Global Head of Insurance Specialists, Aberdeen Standard Investments
Bruce develops ASI's global insurance proposition and business. Over his career with Standard Life Aberdeen, Bruce has gained experience in marketing, corporate finance and international business development, especially the early development of the Indian life insurance business HDFC Standard Life.

NALAKA DE SILVA
Head of Private Market Solutions, Aberdeen Standard Investments
Nalaka is the portfolio manager for ASI's flagship Global Private Markets Fund and the head of private markets solutions. He is responsible for developing and implementing strategies across the private markets spectrum. This includes investments across private equity, infrastructure, real estate, natural resources and private credit.



SWENJA SURMINSKI
Head of Adaptation Research, Grantham Research Institute on Climate Change and Environment
Swenja oversees research projects that investigate climate adaptation, risk management and resilience strategies through a mix of inter-disciplinary approaches. She has published widely on these topics, working closely with industry and policymakers.

EMILY PENN
Capital Initiatives and Investment Director, LV=
Emily has responsibility for capital & liquidity management, investment, ALM and unit pricing. Recent successes include execution of an innovative, award winning solution to reinsure a £1bn with-profits deferred annuity book, and the design and implementation of the revised strategic asset allocation for LV='s smooth managed fund range.

PRASUN MATHUR
Head of Private Assets, Aviva
Prasun joined Aviva in October 2016 where he is responsible for investing in private assets and delivering associated P&L for Aviva UK. In his current role, Prasun focuses on investing optimally across a variety of fixed income asset classes. This involves market entry analysis into new asset classes and asset allocation insights by identifying key risk drivers.

CORRADO PISTARINO
Chief Investment Officer, Foresters Friendly Society
Corrado has more than 20 years experience in capital markets. Previously to his current positions, he was head of insurance LDI at Aviva Investors, responsible for over £10bn of insurance funds and £30bn of derivatives exposure. His previous employers include the likes of Deutsche Bank, Dresden Kleinwort and ABN AMRO Ban.

IMPACT INVESTING TO BENEFIT SOCIETY AND THE ENVIRONMENT

OUR PANEL OF EXPERTS DISCUSS THE LATEST IMPACT INVESTING TRENDS IN PRIVATE MARKETS FOR INSURERS

CHAIR: By definition, impact investing refers to the investments made into companies, organisations and funds with the intention to generate a measurable, beneficial, social or environmental impact alongside a financial return. How do you and your organisation think about impact investing?

DE SILVA: We think of impact investing and ESG as a spectrum. In terms of framework, where financial return is being traded off for impact, we genuinely believe there is a part of that middle ground where sustainable investing or responsible investing can generate market returns as well as produce positive outcomes.

The framework that we use is based on the three ABC principles of our impact management project. This is firstly about avoiding harm at one end of the spectrum, so this could be negative screening or screening out investments from a procurement standpoint. Benefits to stakeholders is the second, which is around proactive ESG management – looking at environmental, social and governance issues that can be improved. The third is about contributions to the UN Sustainable Development Goals (SDGs). You can't invest directly in the SDGs, there's not an immediate overlap there, so we've broken down the 17 SDGs into key principles to deal with the issues. That allows us to have sectorial bets that we can put in place.

The major difference from an impact standpoint for us is the measurement point. What are the KPIs that you put in place? How are those outcomes measured over time? These things aren't delivered in 24 or 48 hours, so there's constant monitoring and management around that. We have a range of tools, some of them proprietary, that we've developed. Others are built on frameworks that are used in the marketplace. The Sustainable Accounting Standards Board essentially gives us a starting point from a materiality matrix perspective. The KPIs around impact are then measured because irrespective of your asset, they have intended or unintended consequences, and then positive or negative impacts. The question is measuring it.

From a private market standpoint, we've always had the view that to generate the highest degree of impact is when you're allocating capital directly to projects, or controlling management teams, or making decisions in terms of behaviour. We have the benefit of getting KPIs in place early and measuring them. Through that, building portfolios that have a lens of ESG and impact considerations is something we've been moving closer to. Clients are demanding more of that now as a norm in terms of reporting, and we're doing more in that space to work across that spectrum.

SURMINSKI: An area I currently see opportunities, but also challenges, is around climate resilience. Usually, you hear climate change and you think mitigation and reducing emissions. I think there is a lot of focus on impact investing in that context, but as we see climate change progressing, and as we also see our efforts to reduce emissions not necessarily hit targets, it is really important to consider climate resilience and dealing with climate impact as an investment area. Too often it is simply regarded as a cost, not as an investment that can generate many benefits now and in the future.

I'm working with the Zurich Flood Resilience Alliance, which is a big partnership with Zurich Insurance, non-governmental organisations (NGOs), and researchers, and we're looking at creating investment opportunities in resilience: we know that there is a strong economic case for climate resilience, for example when building new infrastructure or regenerating neighbourhoods. What is less clear is how to measure the resilience impact that my investment might have? How do you define or measure that? Our project looks at engaging communities, local governments and businesses in measuring the resilience impacts of investments, it's very much that question that impact investors are asking: how to know what matters on the ground, what impacts are being generated?

Another aspect is the work I'm doing with the UK government as part of the Third UK Climate Change Risk Assessment, where we're looking at climate risks and possible opportunities for businesses in the UK. There is clearly an expectation by government and by others in the real economy that investors will play a stronger role in dealing with climate -

and we are looking at how the market is picking up opportunities in terms of impact investment.

The last aspect that is relevant is the SDG context. As part of the Development Corridor Partnership we're working with several partners in the UK, China and Africa to explore how SDGs are being considered by public and private investors. In particular we look at the investment decision process - what role do SDGs play when appraising investment options, and how do we measure what happens on the ground? How can we prove that a particular investment which is supposed to deliver on two or three SDGs actually does the trick on the ground? There are many frameworks out there that can help investors, but I know that there is also confusion and lack of transparency.

PISTARINO: Terms like ESG, sustainability and impact investing are often used interchangeably. It is a fast developing area, and some confusion and overlaps are inevitable. There are established practices - think for instance of corporate engagements in public markets – that are closely associated with a particular investment discipline, and others that are still in their infancy and more difficult to categorise. Impact investing is an approach that has been championed by state agencies and development banks for a long period of time. Their scope of action is broader than what is usually understood falling under the remit of ESG criteria, including climate change, and it's better outlined by reference to the UN Sustainable Development Goals. It often includes operating within a framework that allows concessionary returns, especially when the objective function is to create positive externalities that cannot be immediately or entirely monetised. As private investors enter this space,

> Building portfolios that have a lens of ESG and impact considerations is something we've been moving closer to

from a taxonomy point of view the issue is how to identify with clarity those thematic approaches that are expected to generate a genuine positive impact. This will rest on the industry's ability to reach a consensus on the definition of "impact" and to agree on robust measurement and reporting frameworks. Yet, at a more fundamental level, we will have to identify segments that are truly investable in terms of return opportunities, as we discharge our fiduciary duty primarily towards our stakeholders.

PENN: We outsource our asset management, predominantly to one asset manager and prior to this year responsible investing has been handed off to them. It has been similar for a number of smaller mandates for specific assets in place as well.

With an increased focus both internally and externally on responsible investing we felt it was important to set out our own beliefs and expectations around responsible investing and so this year, we've taken an RI framework through governance. In this we set out our core belief that ESG factors must be considered in investment decisions as they have a material impact on performance and understanding the risk in any investment. Impact investing is a subset of the whole spectrum of responsible investing.

We haven't spent a huge amount of focus specifically on impact investing, even less so on impact investment within private market assets. We invest in some private debt assets, commercial real estate mortgages where we see ESG as a key component of understanding risk within that asset. However, we haven't looked to invest specifically in impact strategies within the commercial real estate sector.

One important aspect is that we outsource a lot of our asset management. There's a powerful message in being able to go to your customers or stakeholders and say we're investing in XYZ and it's having this impact. However, when you're doing that via an outsourcing arrangement, it's much harder to do as well as articulate.

MATHUR: From our perspective, as Emily said, this belongs in the area of responsible investment approaches. We have an appetite to invest where impact can be demonstrated qualitatively and/or quantitively. The problem we face with impact investing is that, by definition, evidencing it requires you to measure social and environmental return. That is extremely hard. There may be some frameworks out there, but have they been tried and tested adequately enough for us to start relying on them to make investment decisions? This area has not trickled into our institutions in investment decision making adequately enough for us to have strong opinions.

We are pressing ahead with determining how we think about climate through our portfolio strategies, we've made some investments that we think can qualify for impact investing, but we can't quantify it right now.

PISTARINO: On this point, I think we could take the lead from DFI's, which have a firm presence in the impact investing space. There are at least three established frameworks that DFI's use for measuring impact: the target approach; the rating approach;

and the monetisation approach. There is plenty of literature describing pros and cons of each of these methodologies. These approaches can also be blended, leading to hybrid reporting frameworks. If this is the direction of travel, how do we compare between different managers?

MATHUR: When we think about selecting an asset manager, ESG and sustainability is a key criteria that we measure them on. It is one of our investment beliefs that we achieve value by factoring in ESG/sustainability. This trickles down to all our investment decision making, including our approach for selecting asset managers.

The challenge we have always faced on ESG and sustainability, is that every asset manager has a different approach. This is unhelpful because collective action that benefits society is best reliant on an "open source" assessment framework. I hope that ESG and sustainability frameworks will converge with time, and expect the national regulators to sponsor consistent approaches.

For now, we ask asset managers about the different tools they have at their disposal to do various ESG analyses. The more tools/approaches they have, the more flexible they can be to adopt our internal views. We always try to find asset managers who can incorporate our views through the tools they use.

PISTARINO: As a portfolio discipline, impact investment builds on the ESG approach, of which it represents a natural evolution towards a clearer output-controlled framework. Its determinants are explicitly expressed: a statement of intent; a convincing narrative on how a particular investment is designed to deliver on that intent; and a framework for tracking and verifying that intent over the whole life of that investment. It is

> The types of impact or outcome issues that are environmental or social are now much higher than those that are purely financial

a departure from "sustainability" claims that can be often unsubstantiated, or way too generic to be measurable. From what I can see in terms of engagement and awareness, we are at the very beginning of this evolutionary process, at least in the private sector, and certainly amongst investors.

CHAIR: What about the point we heard on the difficulty of selecting an asset manager in this particular space?

DE SILVA: From a range of clients, whether they are insurers or pension fund investors looking at the space, they need to have a view and then they need to interpret that view through the implementation method they use. From the principles that are out there, looking over the last 10 years, there's been a small club of foundations coming together at that end of the spectrum to try and broaden out the principles. The climate agenda has accelerated that and there's a lot of focus on transition and things like net-carbon zero.

When we're looking at financial outcomes that might reside from mainstream portfolios – this idea of ESG and the discipline around understanding its risks – the types of impact or outcome issues that are environmental or social are now much higher than those that are purely financial. Dealing with those issues has become a bit more of the mainstream.

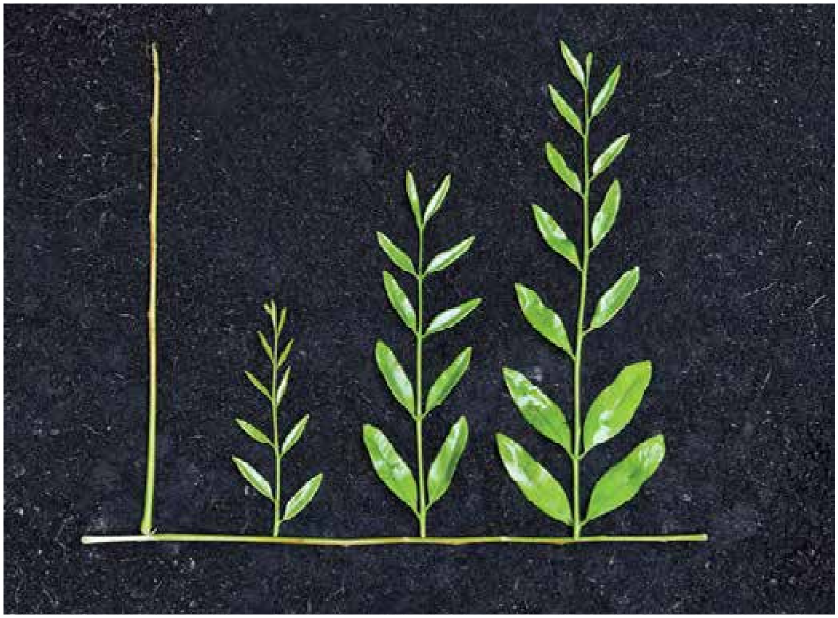
Trying to boil this down into investment strategies that can tackle those things, alongside the risk and reward frameworks that insurers have, is very difficult as we have alluded to. The way we have tackled it is to try and address each of these on a standalone basis. Providing a framework, such as our ABC approach from the impact management project, and saying that if you want to map your portfolio you can put it within a framework, we can look at types of assets and how that implementation and measurement of those type of assets can give you confidence that it is meeting an outcome, but also provide the risk and reward characteristics within your portfolio.

The really hard thing when we talk about impact spaces is the social aspect. These types of issues are very difficult to wrap financial measures around. I think this is where impact investing requires a bit of a leap of faith.

SURMINSKI: I would challenge that ESG and its sub-categories have become mainstream. There is certainly much more happening in this space and the public discourse has changed, but is this mainstream? I think this relates to the ambition, the scope and how governmental regulation can play a bigger role in facilitating more ESG investment.

I share the challenge – this isn't about a lack of tools or standards for investors, in fact there are probably too many that people are using in a different way. There is a myriad out there all serving different purposes that have been designed in different contexts. There needs to be a degree of harmonisation, standards and also transparency about what actually goes on. It's harder than just coming up with numbers that can track performance. Talking about co-benefits can help. If you say an investment serves different purposes – of course you want to make a profit but you also want to achieve X, Y and Z – one way of doing it is by focusing on co-benefits and measuring those. That takes a little bit away of the impact, which is such a loaded term, because there's a level of interpretation and judgement in it. I think this could be a way of providing a bit more clarity.

PISTARINO: Are we not playing a linguistic trick here? By referring to co-benefits are we not ducking the issue of what impact investing really is? Wouldn't we be faced with the same set of questions, irrespective of the terminology we choose to adopt?



> You need engagement with those who are experiencing change or are implementing it, including local communities, businesses or civil society

SURMINSKI: There is a question about the narrative. I've noticed that people tend to be more comfortable looking through a cost-benefit lens. That could be through building different types of infrastructure, or in terms of a deprived area having more jobs. Recognising co-benefits and co-costs is a way of getting more clarity about what happens through your investment, but uses a language and the tools that people might be more familiar with because a cost-benefit analysis is often more common, and people might offer more trust when they see these numbers. With impact, you are looking at what you eventually want to achieve on the ground, and the outcome of achieving change. For that you need engagement with those who are experiencing change or are implementing it, including local communities, businesses or civil society.

PENN: Asset manager selection is one of the key drivers that made us feel we needed to develop our own framework for responsible investing. We now have a clearly articulated set of views so that when we speak to asset managers with a view of engaging them, we know what to measure them against, and therefore we can see the degree of overlap offered versus our intentions and aspirations. Also, it helps us look at our current asset managers and see where they are on that framework versus where we want them to be, and work with them to get them up to that level in the areas we invest.

There's a high degree of overlap between the comment about ESG being mainstream. My personal view is that every asset manager and the industry is talking about ESG, but the crux of the question is whether they are truly integrating it from the top to the bottom within the firm, and within the portfolios they're managing. There's quite a big distinction between the firms that are really driving that culture from the top, where it is being embedded throughout the organisation, and others where it is not. Until you start to see ESG factors being considered in all investment decisions, I don't think you can really have confidence it is integrated across the portfolios as a whole.

CHAIR: That's really interesting that you say it seems to be pretty transparent if there is no ESG substance behind an asset manager, you can spot it quite quickly. Is that correct?

PENN: Certainly. If you are having detailed conversations with asset managers as to how a particular fund has performed or why they've made an investment decision, you can start to see where ESG factors are being considered as part of that investment decision, or whether they're not. In our experience it is within these conversations with portfolio managers that we really see how they're investing and considering ESG.

MATHUR: From a governance perspective, the investment decision making process for the asset manager must require the originator/credit analyst to perform an ESG analysis and escalate issues to an ESG team where necessary. Further, voting rights for ESG teams in investment committees gives us more confidence on how strongly integrated ESG is within the asset manager's DNA.

PENN: I totally agree with that. We see best practice where the ESG research team are integrated into the wider research team, so in decision making you're getting a view from a more traditional analyst and then an ESG analyst, to form the wider decision making process.

DE SILVA: It also depends on your investment activity as well. Manager selection is one thing, but I think there is also an extra level down you can go to, in terms of the operational managements of some of these assets, that are interesting to see how they're being dealt with.

> Impact will ultimately become mainstream in the future in the same way that ESG has started to get that dialogue

I don't quite believe it's mainstream. I think there's a lot of rhetoric but when you look at all the investment activity that goes on, you can still ask whether it's something that is becoming more mainstream. I think this journey is only at the infancy of getting all asset management businesses to get fully integrated, and I think others are further than some in delivering that. Impact will ultimately become mainstream in the future in the same way that ESG has started to get that dialogue. The end marketplace is becoming more aware of these issues, and asset managers have to be in a position to provide transparency and explain their frameworks.

As an industry, we're going to be forced to explain where our capital is being allocated, the type of impact happening, and find a way to quantify that, so that allocators of capital can be confident. I think impact is still very niche but the ESG conversation is getting more attention. The environmental part of that is the most acute, where we're seeing environmental stress testing going on, and all the types of analysis of where returns are going. On the social side of things, we're trying to elevate the emphasis.

Have people seen moves to deal with societal issues that are more pervasive in the global economy and are these becoming more prevalent? Also the allocation of capital to those types of issues, I'm curious to see how people are thinking about those.

PISTARINO: If one thinks of ESG, the E element, usually focusing on climate change, tends to be predominant in the quest for new investment opportunities. To me, the area where impact investing can bring added focus is around the S of ESG. In a way, you don't need to create more interest around climate change by way of a new - certainly more advanced - investment discipline. The buzz is already there.

That said, I go back to my previous comment: will the industry be able to come up with investable propositions that target the S in ESG? One may argue that some infrastructure projects have in fact those attributes. Asset managers might succeed in developing increasingly creative solutions. As investors, blunt as it may sound, we have a duty to generate returns. Even in situations where fiduciary duty can be interpreted in a broader sense, and the notion of societal welfare can be a determinant behind portfolio decisions, returns are an inescapable constraint.

SURMINSKI: In the projects I've been engaged with, the S is usually in terms of job creation, looking at improved living conditions for people in a particular local area. The problem with that is scalability, because it is very context specific. As an example, in the Zurich Flood Resilience Alliance we are working in Indonesia with NGOs and local government to come up with an investment vehicle. The idea was

> Regulation will help force the issue, and I believe more onus should be placed on insurers to educate policyholders and shareholders alike on this subject

that this investment addresses several problems –bad water quality, regular flooding due to rivers clogged up with waste and lack of jobs in that area. The idea is to design a bond that funds interventions designed to address all three problems at the same time while also generating a profit. That is possible in a way on a very small scale, but for investors this is often too small-scale, this is a significant challenge.

PISTARINO: One of the principles of impact investing is about managing impact at a portfolio level. A small-size project is not necessarily unviable, if efficiencies of scale in the origination channel or in managing the assets can be found. Not to mention the improvement in risk diversification.

MATHUR: That is an interesting observation, that a lot of impact investing projects could be small scale, for the sake of argument let's say under $1m of an investment enabling or creating the impact. For us, the average ticket size is a multiple of that to make it worthwhile for us to invest. There is a bit of a disconnect here. We can't go about looking at every $500,000 investment in frontier markets. That would need a lot of feet on the ground and we don't have that.

DE SILVA: I think we are seeing a bit of movement on that front. Perhaps it's been driven over the last decade by the societal discourse around some of these issues. The larger private equity firms have launched impact arms, and I still think this idea of institutionalising the impact market needs a marketplace to happen. The UN have been pretty proactive around that in trying to solve some of these issues.

The interesting thing for asset managers is how to get the economics to work. DFIs have historically taken the first loss position to be able to provide an economic position for more mainstream capital to get the risk adjusted return they need. If there are groups that are willing to take that first loss position because there's an equity upside, or they are able to have a lower rate of return, that could allow for capital transition into more mainstream projects. You then have to solve the issue of procurement; how do you get the range of projects at the scale you need to deploy all that capital?

I still feel we don't have a capital transition mechanism yet because everyone is having this debate about the return they are receiving, what the risk is, and in private markets the difference between the highest performing asset and the lowest performing asset is really wide.

It needs a leap of faith from some large allocators to be able to say they're prepared in a lower returning and low inflation environment, who wouldn't be getting a lot of return from an economic point, to say they want to get more out of the S and G and potentially the E, and find a place in their portfolio to do it. Then you could get some momentum because the market will typically innovate around that. As soon as the market is made, you would have people coming to that marketplace and providing projects.

We've seen a little bit of that in micro financing. That's one area that seems to have been a mechanism to attract capital. If we can find other mechanisms, where do you think this kind of capital could come from, and what would its minimum constraints look like?

MATHUR: The DFI space is interesting and something we have invested in the past. It offers access to investing in emerging/frontier markets with an investment grade counterparty via the DFI. The challenge we currently see in the DFI space is finding which DFIs are creditworthy and which aren't, and there are plenty of them out there. Strength of the DFI's governance, their balance-sheet, strength of the covenants with the shareholders are all standard ways by which you can rate and rank DFIs.

PENN: From LV's perspective, we don't have the scale or resources to put together an impact programme. It is something much further down the horizon for us. This is not to say we wouldn't go there but if we're looking at an impact fund for instance, and because we don't have a dedicated amount of capital to put aside for impact investing, it has to stack up on a risk-return basis versus any other asset class we're looking at.

Any new investment requires us to commit to resource to do the appropriate due diligence and governance. For a small firm, there's quite a big hurdle in terms of introducing any new asset class, let alone it being an impact investment.

CHAIR: You said at the start that LV= is having difficulty sourcing appropriate investments so how are you going to square that circle if you are not able to build the in-house expertise?

PENN: We have mandates out there in terms of the amount of commercial mortgages we want to originate per year, and we're not necessarily seeing the loans coming through to meet those mandates on a broad perspective. If we were to go a step further and say we want loans that are particularly targeted towards a specific social impact, I'm struggling to see where we'd be able to meet our business targets if we can't meet them with a much broader universe at the moment.

CHAIR: Are insurance companies feeling pressure to get more involved in impact investing? And is there pressure coming from policyholders, regulators or other peer insurance companies?

MATHUR: There isn't any more pressure than we have on climate change and ESG issues. Regulation will help force the issue, and I believe more onus should be placed on insurers to educate policyholders and shareholders alike on this subject.

Analysts now demand insurers to talk and disclose more about climate and ESG. Regulators are demanding us to do more scenario analysis, stress testing and reporting. Activist groups that probe us on anomalies in our investments and query us on very specific issues. Essentially, we see challenges from all stakeholders and that's why we find ourselves very keen on making progress.

SURMINSKI: Pressure from the outside is an issue, but I think there is also a huge strategic opportunity which is all about protecting your business model. I often start that conversation with where you see your business in 20 years. If you continue investing in risk creation, or continue harmful investments, you are basically reducing your own opportunities there. The challenge with insurers is that there is a much better understanding about future risk on the underwriting side than on the investment side. There is a disconnect in terms of sharing this knowledge.

> There is an opportunity to create instruments or mechanisms that can transition capital

PISTARINO: Another aspect worth considering is regulation. If anything, one may argue there is not enough pressure from regulators to steer the investment discipline towards achieving measurable impacts. I can see though why this is a difficult call.

The existing regulatory construct looks at risk over a one-year horizon, with both assets and liabilities priced at fair value. It is difficult to create exogenous incentives without tinkering too much with that framework. That same conundrum also emerges in respect of climate change, with the impact of both physical and transition risk on financial stability likely to manifest itself over a significant length of time, far beyond the 1-year survival horizon.

CHAIR: On climate I agree. There's been a lot of activity in the industry, but it's been a regulatory driver, and from Mark Carney in particular. In a way it's a bit disappointing that insurance companies and the financial services industry have not been more proactive.

DE SILVA: The pressure question is mounting and I think that's coming from a range of places. Institutionally, perhaps it's a bit more muted, but we're still seeing a shift. Regulation will come because of what's happened on the climate side, which will probably start permeating into the social and governance side. We're likely to see more scrutiny on asset managers to disclose and display that. I still feel from the insurance market standpoint, there is an opportunity to create instruments or mechanisms that can transition capital.

The insurance market has always been quite innovative in using structured finance products to create credit enhancement, to be able to match liabilities, to create things that have long duration. If they can innovate and use asset managers to implement, I think there will be a really interesting dialogue because that will move the agenda further forward. Getting insurers to start is probably the hardest part, and getting people to join the journey will take time, but being able to push that agenda forward is really important.

Achieving excellence

Phoenix Group chief investment officer Michael Eakins speaks to *Insurance Asset Management* about the latest developments within the insurance company

WRITTEN BY **ADAM CADLE**

Q Could you provide an overview of Phoenix Group and your day-to-day role?

Phoenix Group, a FTSE 100 company, specialises in the acquisition and management of life and pensions insurance business. Phoenix Group is the UK's largest long-term savings and retirement business, and Europe's largest life and pensions consolidator, employing over 7,500 people. As of 30 June 2020, Phoenix Group has £324bn assets under administration and circa 14 million policies.

- **Heritage** – where we are the market leader in providing a safe home for customers in product lines no longer actively marketed,
- **M&A** – we are also the market leader in M&A, and successfully integrating those businesses we acquire, and
- **Open** – we are building a thriving and growing Open business through our capital light workplace and retail pensions businesses, and through BPA.

We have a broad core social purpose with sustainability at its centre, in the way that we run our business and how we invest a third of a trillion pounds, on behalf of our customers.

Since the acquisition of ReAssure, Phoenix Group has formed Phoenix Asset Management, which comprises a team of capital markets and asset class experts, to drive through positive outcomes for policyholder and shareholder assets.

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

Phoenix Group has diversified asset portfolios, with high credit quality split by liquid and illiquid assets.

- **The Illiquid Asset Portfolio** – is well diversified with allocations across (i) equity release mortgages, (ii) private placements (iii) UK local authority loans, (iv) commercial real estate and (v) infrastructure debt. Phoenix seeks to increase the diversification of the illiquid asset portfolio in terms of:

  – **Asset Class** – through the deployment of new asset classes to further expand the scope of investable universe of illiquid asset strategies.

  – **Geography** – reducing the UK concentration risk.

- **The Liquid Credit Portfolio** – is weighted towards exposure in defensive sectors, whilst rotating out of 'at risk sectors' such as energy and consumer cyclicals. The group seeks to maintain its defensive position and pro-actively manage the portfolio in terms of:

  – **Rating** – specifically, proactively managing BBB exposure through rotation into

  (i) Illiquid Assets (ii) A-rated USD Investment Grade (IG) credit and (iii) A-rated GBP credit.

  – **Sector Allocation** – specifically, (i) diversified sector allocation, (ii) largest exposure to defensive sectors and (iii) minimised exposure to sectors sensitive to COVID-19 impact.

Q HM Treasury has issued a call for evidence around SII regulation, with the aim of boosting investment in infra, and meeting climate change objectives. What do you think needs to be changed within SII and how will this affect your investment thinking at Phoenix going forward?

Phoenix welcomes the call for evidence and sees a valuable opportunity to ensure that the solvency regime is tailored to the specifics of the UK. One of the features of the UK insurance industry is the significance of the annuity market which provides a natural home for assets with a long-term investment horizon. Therefore, the industry is well placed to support infrastructure and other long-term projects, with an opportunity for the solvency rules to provide a broader and more flexible approach to allowing these sorts of assets, while still ensuring appropriate risk management and policyholder protection.

Q How has the firm adapted to COVID-19 in terms of its investment thinking and direction?

Phoenix Group has defensively positioned its investment strategy and proactively managed the numerous challenges caused by the pandemic, through investing primarily in defensive sectors, with minimised exposure to sectors that are sensitive to the COVID-19 impact.

Phoenix's investment strategy through the COVID-19 pandemic as it relates to the assets backing policyholder funds has been to protect and grow those assets. The aim of the policyholder investment strategies has not changed – deliver good financial outcomes consistent with the customer risk appetite. COVID-19 has led to many challenges for the policyholder assets, with increased market volatility, sectoral risks and liquidity challenges which have guided the action Phoenix has taken. Asset allocations, liquidity and sustainability have been at the forefront of Phoenix's response, ensuring our policyholder funds are invested in line with policyholder expectations and deliver on our promises.

Q What is Phoenix Group's ESG investment thinking?

Phoenix Group is committed to having a positive impact on both environmental and social considerations through its investments, and to aligning the investment portfolios with its evolving beliefs those of its customers. Phoenix Group focuses on four key areas of commitment as part of our sustainability strategy to ensure that we manage our business in accordance with our core social purpose. The key areas of the group's sustainability strategy are as follows:

- **Deliver for Our Customers** – we aim to provide the right products, solutions and services to our customers to help them enjoy a secure financial future.
- **Foster Responsible Investment** – we aim to make responsible investment decisions and consider the sustainability of our investments in safeguarding the interests of our customers, shareholders and stakeholders. Responsible Investment is a strategy and practice to incorporate Environmental, Social and Governance (ESG) factors in investment decisions and active ownership.
- **Reduce Environmental Impact** – we aim to minimise our impact on the environment and promote good environmental practice.
- **Be a Good Corporate Citizen** – we aim to be a diverse, engaged and enabled workforce and good corporate citizens in the communities which we are based.

> **Implementing this vision will help the group achieve its aim of establishing the best in-class asset management team within the European insurance sector**

To help achieve these goals, a new sustainable investments team has been formed within Phoenix Asset Management providing the group with a platform to implement its sustainable investment strategy. Additionally, Phoenix Group is participating and supporting the work of the IIGCC and its 'Net Zero Investment Framework' to help maximise the contribution the investment community is making towards the decarbonisation of the global economy. This project has given the group valuable insights into what the net zero journey for our investment portfolios could look like and recommends a framework that will help everyone make the progress that is vital. During 2020, the group has become a formal supporter of and signatory to the Task Force on Climate-related Financial Disclosures. We aim to publish our first report in March 2021. We are also members of the Green Finance Institute and committed to becoming a signatory to the United Nations -supported Principles for Responsible Investment (UN PRI) by the end of this year.

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

As a group, Phoenix will continue to develop its newly formed asset management function, with the aim of becoming the best in-class asset management team amongst European insurance companies.

It is key that Phoenix as a group integrates sustainable objectives for the benefit of policyholders, shareholders and society. Phoenix is united behind its sustainability vision of "committing to a sustainable future", focusing on four key areas of commitment, these include: (i) delivering for our customers, (ii) fostering responsible investment, (iii) reducing our environmental impact and finally (iv) being a good corporate citizen. Following these four key areas of sustainability will ensure that Phoenix as a group manages its business in accordance with our core social purpose.

Implementing this vision will help the group achieve its aim of establishing the best in-class asset management team within the European insurance sector.

A tricky path

With LIBOR set to cease at the end of 2021, Michael Griffiths explores how the insurance space is negotiating the transition to alternative rates

WRITTEN BY **MICHAEL GRIFFITHS**

There are many acronyms that scatter the insurance space. It loves to abbreviate. One rather familiar acronym, COVID-19, has dominated the headlines of every space over the past 12 months, but as talk of a vaccine slowly gathers pace, could 2021 be about to offer something alternative in the acronym stakes?

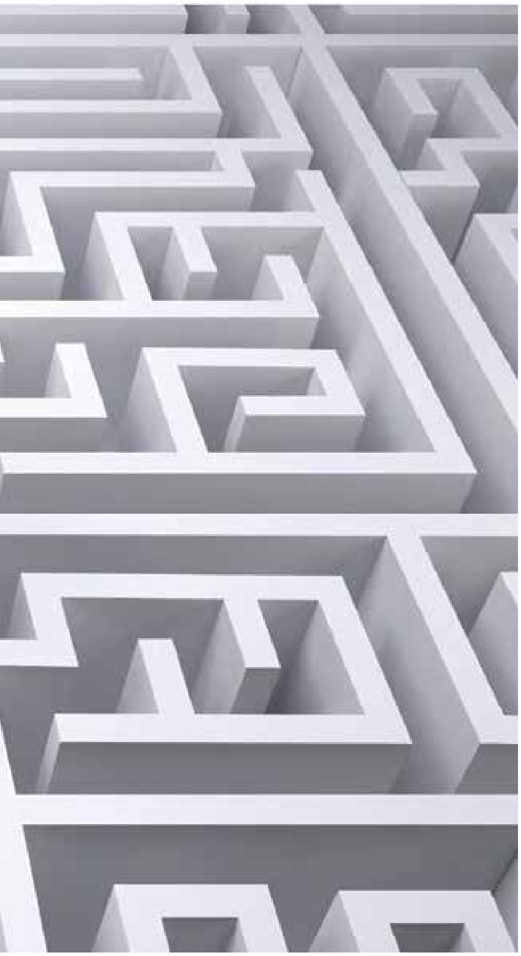
The London Interbank Offered Rate, known better to insurers by its acronym LIBOR, is the measure of the average interest rate at which banks are willing to borrow wholesale unsecured funds, and it is published in five different currencies. This interest rate benchmark is expected to cease at the end of 2021, by which point firms must have moved to use alternative rates.

Even with over a year to go, the transition poses a question that should already be in the minds of insurers; are firms adequately prepared? AFAP, the insurance space must abbreviate, then ask itself.

When he was FCA chief executive in 2017, Andrew Bailey suggested that while significant improvements were being made to LIBOR, an absence of active underlying markets meant the future sustainability of the benchmark rate could not be guaranteed. At the time, Bailey's speech highlighted that support of the panels for LIBOR was needed until a transition could be made to alternative rates. Ever since then, the FCA has been working with the panel banks to finalise an agreement for banks to remain on the panels they submit to, until the end of 2021. But as the clock keeps ticking, how much change has the insurance sector made?

EY global financial services IBOR lead, Simon Woods, advises large multinational financial services and private equity clients on IBOR. He believes preparations for phasing out the rates across the sector are mostly underway, but suggests that work remains ahead of the LIBOR transition deadline.

"Insurers are for the main part prepared but there are still some key deliverables outstanding to complete in 2021," Woods says. "Given insurers' asset liability management considerations, we have seen some activity deferred until there is greater clarity on the



timing and nature of changes to the regulatory capital discount curve.

“Insurers need to transition any asset or derivative portfolios with reliances on LIBOR. After that, it is more of a back-office exercise to get valuations, systems and capital models updated for the new rates and the different compounding.

“For those firms yet to transition any residual LIBOR reliant portfolios in 2021, pricing and liquidity of legacy positions may become more acute, or firms could be forced takers of economic outcomes through fallbacks. In the long-term, insurers may be faced with a fundamentally lower risk-free curve for their capital requirements, putting any market supply or dynamics of the rates to one side.”

As the benchmark rate edges into its final year, and as Woods highlights, LIBOR currently embedded in firms’ operating models, this means transitioning to alternative rates will affect how contracts are priced, as well as how risk is managed.

Global asset manager, Robeco, offers an extensive range of active investments, from equities to bonds, and as of June 2020 has €155bn assets under management. Head of insurance analytics, Clara Yan, believes the benchmark reform is a good step for the swap markets. She tells *Insurance Asset Management* that new benchmark regulation requires the use of both “robust methodologies” and “sufficient and reliable data” for alternative benchmark rates, as well as decent fallbacks for these rates.

“This benefits the stability and future-proofing of the swap market in the long-term and is therefore also good for insurance companies,” Yan says, who proceeds to outline five key areas that insurers need to consider as a result of the impending changes.

“First, firms would need to identify LIBOR references in the contractual agreements across all areas of business, and it’s not always immediately obvious where the LIBOR references may come up. For example, this may span from exposure to cash and floating rate bonds, to International Swaps and Derivatives Association (ISDA) contracts in derivative arrangements on the asset side, to insurer’s own bond issuance and reinsurance contracts on the liability side. Significant work is involved in checking for fall back language within their contracts should LIBOR not be available, and renegotiate the contractual terms with Alternative Reference Rates (ARRs).”

Another area that Yan believes insurers must consider as part of their LIBOR transition surrounds the Solvency II (SII) discount curve, as was touched upon by Woods. Yan notes that this structure, post LIBOR transition, is under consultation by EIOPA but has not as of yet been finalised.

“However, we expect that the revision in the SII curve is likely to result in a fall in the discount yield and an increase in technical provision,” she adds. “Insurers would need to plan and consider the likely impact on their solvency coverage without full view of the final arrangement. In addition, post Brexit UK regulators may depart from the EIOPA methodology, leading to a different impact for UK insurers.”

Insurers need to transition any asset or derivative portfolios with reliances on LIBOR

Yan pinpoints operational systems as a third area to be aware of during LIBOR transition, and also highlights new discount rates as a means to neutralise the valuation impact as a fourth factor for insurers to consider.

“Insurers would need to ensure that all operating systems – including risk management, asset liability management, accounting and other valuation systems – are sufficiently well prepared to take on new discount curves,” she says. “Changes to the systems should be applied consistently to avoid unintended mismatch errors.

“Clearing houses prepare a smooth transition to the new discount rates to neutralise the valuation impact on cleared swaps that results from changing the discount rate. A compensation payment is brought in place which settles at the same time as the new rates are implemented. For bilateral swaps, the story may be different.

"There is no defined timeline yet for the transition, but at least in the eurozone the deadline is the end of 2021 due to the European benchmark regulation. Just as the current discount rate in a bilateral contract is often not strictly defined, neither is the use of a new discount rate, or a potential compensation for differences in market value. The incentives clearly differ. The current market value of the impacted swaps may influence the outcome of the negotiations."

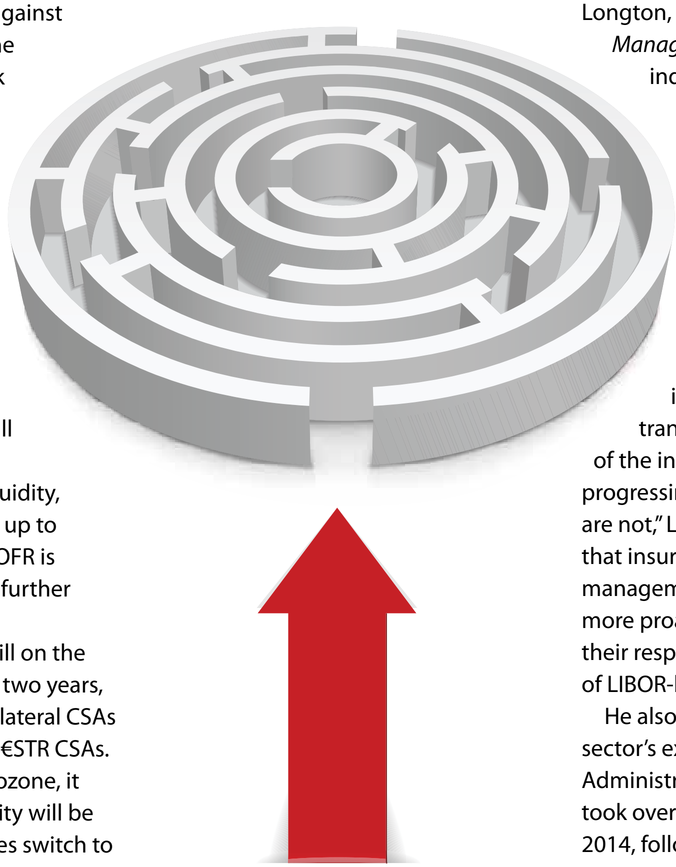
A fifth and final point for firms to prepare for amid the benchmark reform is on liquidity, Yan says. She suggests that insurers must decide on when to transition existing swaps and trade new swaps away from LIBOR, and also highlights LIBOR's liquidity against activity across the ARRs in the Sterling Overnight Interbank Average Rate (SONIA), Secured Overnight Financing Rate (SOFR), and Euro Short-Term Rate (€STR).

"In terms of liquidity, in the UK's both reformed SONIA and LIBOR, both have a liquid market," Yan says. "In the US, the LIBOR reference is still leading, although SOFR is developing more liquidity, especially on the short-term up to 10 years. More issuance in SOFR is expected, which will help in further developing market liquidity.

"Most activity in €STR is still on the short end of the curve up to two years, and the first EONIA-based bilateral CSAs are beginning to be reset to €STR CSAs. For both the US and the eurozone, it is expected that more liquidity will be present when clearing houses switch to €STR and SOFR."

LIBOR is calculated based on submissions from selected panel banks and as mentioned before is published in five currencies. Internationally, Working Groups have been setup in all jurisdictions, and as discussed by Yan, alternative rates selected for all currencies. The Bank of England has selected SONIA in the UK, the Federal Reserve Bank of New York has selected SOFR in the US, while the European Central Bank has selected €STR, which Robeco notes are the rates that financial institutions are expected to adopt.

> There are some aspects of the insurance offering that are progressing well, while other aspects are not



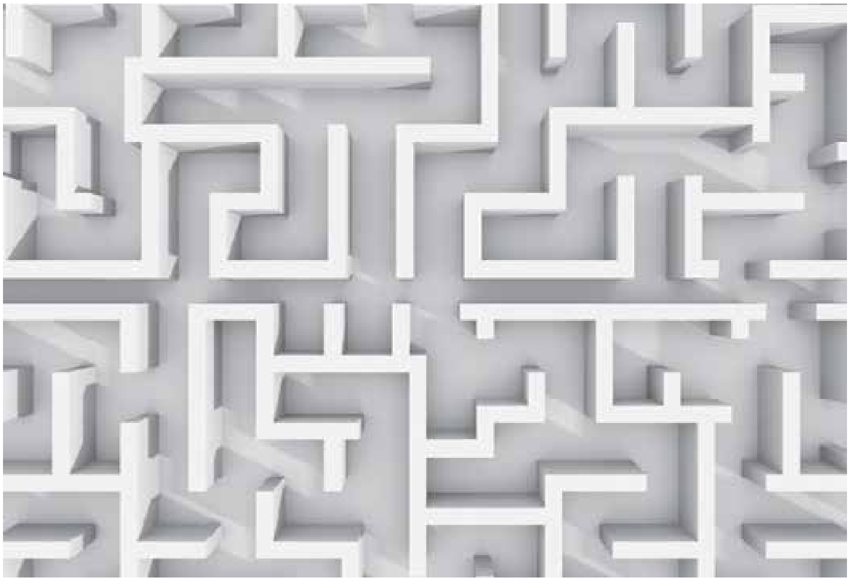
The remaining two currencies that LIBOR is published in look set to be replaced by the Swiss Average Rate Overnight (SARON) by the SIX exchange, and also the Tokyo Overnight Average Rate (TONAR), by the Bank of Japan.

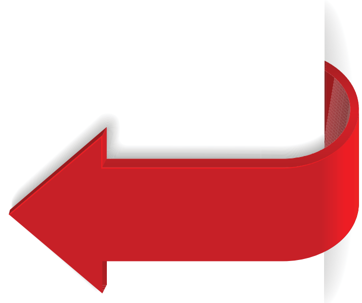
The message emanating from the insurance space, amid the overload of acronyms, is that much work still exists to prepare for the cessation of LIBOR. However, with all the factors outlined by Robeco to be considered, and several changes required to be made over the next 12 months, can insurers still take some comfort in knowing that they are not alone?

From the view at global management and technology consultancy firm Capco, principal consultant, Murray Longton, also tells *Insurance Asset Management* that the insurance industry is "not as advanced as we'd like to see", given the impending deadline. He suggests, however, that insurers with in-house asset management functions have been "more proactive" in making changes.

"Like most sectors impacted by the LIBOR transition, there are some aspects of the insurance offering that are progressing well, while other aspects are not," Longton says. "We have seen that insurers with in-house asset management functions have been more proactive in their approach, given their responsibility for transitioning out of LIBOR-based instruments."

He also highlights the insurance sector's exposure to ICE Benchmark Administrator (IBA), the entity that took over administration of LIBOR in 2014, following a scandal in which





> It is highly important that insurers move from high level hypothesis to quantified impact assessments

bank traders were found to have rigged the LIBOR to benefit their own trading positions. IBA itself is a unit of the Intercontinental Exchange (ICE) – which would makes LIBOR's official acronym ICE LIBOR, if there wasn't already enough abbreviating in the acronym minefield of interest rates – and Longton notes that IBA adds multiple operational and legal challenges.

He continues: "Insurers face a particularly large exposure to IBA and thus the impacts of the forthcoming change, as they have invested heavily into LIBOR products. They also act as the counter-parties to many financial products that will reference LIBOR as the benchmark for applicable interest rates, and the trigger for hedging contracts and swaps long past 2021.

"From an operational perspective, this means insurers will have to embark on a costly and complex journey to ensure that all systems are updated properly to capture and reference these new products.

"Legally, while it is a similar story to the wider financial services industry, underwriting risk is particularly specific to insurers. Consideration should be given to whether certain underlying risks might be higher than perceived. If a risk has insured exposures which themselves could be increased by underlying contracts referencing LIBOR, this could lead to higher claims, or a line of claims that was not expected.

"In addition, insurers may insure trade credit arrangements where the underlying financial contracts use LIBOR, or another benchmark which will be amended or replaced. They are insuring financial institutions which, as the issuers of financial instruments, may have their own exposures arising from this. These exposures and any attendant will need to be identified and assessed."

While the insurance sector is always filled with debate and different ways of thinking, it seems to be united over LIBOR. As we approach a new year, 2021 looks set to pose a very different set of challenges for insurers, and surely more terms for the insurance space to abbreviate. The current view on LIBOR appears to be that while the transition may be a uniform move across the whole insurance sector, the transition itself is filled with intricacies ready to trip insurers at any moment.

It certainly leaves an interesting 12 months ahead, as Longton concludes: "Although some value creation opportunities for insurers do exist, the LIBOR transition is more about change management, operational readiness and transformation strategy.

"That said, it is highly important that insurers move from high level hypothesis to quantified impact assessments – which will be driven in part by heavier involvement in the sell-side – and here, the challenge is very real and very complex.

"A good starting point for insurers would be to establish a baseline now for 'what good looks like' and then continue to build a fresh, forward-looking view that will drive changes to their core modus operandi, while also triggering a revaluation of their service offering across the investment products, investment vehicles and assets they insure."

EXPLORING ABSOLUTE RETURN FIXED INCOME

OUR PANEL OF EXPERTS DISCUSS THE SIGNIFICANT OPPORTUNITIES ON OFFER FOR INSURERS WITHIN THE ABSOLUTE RETURN FIXED INCOME MARKET

CHAIR

DANIEL BECKER
Head of Insurance Investment & ALM, Hymans Robertson

Daniel is head of insurance investment & ALM at Hymans Robertson. He is an experienced actuary with a background in industry and consulting. Daniel's insurance industry experience includes the role of head of capital management at L&G Capital, as well as four years in the group investments team at Friends Life.

ELLA HOXHA
Senior Investment Manager, Global Bonds, Pictet Asset Management

Ella joined Pictet Asset Management in December 2018 as a senior investment manager on the global bonds team, focusing on global rates and FX. Ella joined Pictet from Wellington Management where she was a managing director and fixed income portfolio manager for over seven years. Prior to that she worked at Invesco Asset Management.

TIM BIRD
Senior Business Development Manager, UK Institutional, Pictet Asset Management

Tim joined Pictet Asset Management in 2017 as a senior business development manager. Based in London, Tim focuses on developing the institutional business in the United Kingdom and Ireland. Tim joined from Allianz Global Investors where he was, director, institutional business development.

WILLIAM GIBBONS
Senior Consultant, European Insurance Investment, Mercer

William is a principal within Mercer's insurance investment team. He is responsible for advising insurers on asset allocation, investment strategy and portfolio design, and building investment solutions for them. He joined Mercer in July 2020 from PwC, where he was a director in the ALM and investment advisory business.

CATHERINE BERMINGHAM
Senior Investment Analyst, Brit Insurance

Catherine is the senior investment analyst at Brit Insurance. Her role incorporates all aspects of the management of the group's assets. Prior to Brit, Catherine was a senior investment consultant, in the Mercer insurance investment team, providing customised advice to institutional investors including asset allocation and investment strategy.

CHAIR: How does current market sentiment feed into your thinking Ella, and more specifically your investment allocation within absolute return fixed income (ARFI)?

HOXHA: In a year where we have been hit with such a large economic shock, the biggest since the Second World War effectively, on a global scale one can look at fixed income returns and think 'what's the problem?'. So it's not necessarily been such a bad year for a bond manager, but there have been some sleepless nights however. A lot of the moves we have seen this year in fixed income have been mostly driven by core duration, Treasuries, the Fed cutting rates and new quantitative easing programmes launched across the board. In addition, we have had other Central Banks joining the more loose Central Banks, such as the ECB or the Bank of England, which have been on the loose side for quite some time. Places like New Zealand and Australia have also joined the yield curve control experiments.

We are seeing things that we have not grown accustomed to in fixed income markets despite the very bullish run that we have had over the last three to four decades, and certainly over the last 10 to 12 years. In excess return terms, emerging markets have actually not had a very steady year, despite the recovery we saw in Q2 and Q3, and ditto for US high yield, and European high yield to some extent. We are seeing an increase in debt levels and a collapse in interest rates at the zero bound. In fact, a lot of the macro discussion now is around what happens next? The macro community has two sides of debate within it at the moment. One side expects more of the same, so, deflation, loss of output, loss of capacity, unemployment and even

> We tend to think thematically about how we allocate risk in our portfolios

more piles of debt across both the public and the private sector. Counter-intuitively, that tends to drive interest rates even lower, and effectively you are talking about more of the same except in regions such as Europe where you are actually starting to tick more of the boxes with regards to a Japanification. If you look at regions such as the US or the UK, where we are seeing a greater embrace of larger fiscal expenditure combined with very loose monetary policy, you bring in the other side of the debate and those who think well maybe something has shifted, maybe this is the end of the great bull run for fixed income, and maybe we will start to look at interest rate pricing very differently. We tend to think thematically about how we allocate risk in our portfolios. We have four key structural themes. The first is rates lower for longer. So that would embrace this deflationary path and basically looks at interest rates staying low because of this challenging growth environment, challenging debt dynamics and challenging demographic dynamics that we have across the world. The second theme is the European crisis which is an unresolved not fully formed structure, and one which will be tested across the different cycles as we have seen this year around April to May. The third theme is the Chinese transition. This is the shift in the Chinese growth model and one which is moving up the chain in terms of GDP per capita and one

deep market that is likely to be the second largest bond market in the world and therefore keep attracting inflows.

BIRD: Chinese debt also has a great diversification benefit. Is that still the case within broader fixed income markets as well?

HOXHA: The correlation factor is what has made it more attractive for us. It has tended to be a little bit counter cyclical, certainly in this crisis, mostly because China emerged from the pandemic crisis before the rest of the world, and therefore the recovery there was more expedient and rates moved up. That gave us the opportunity to buy the sell-off, whilst rates elsewhere were moving lower. Chinese rates effectively outperform in a market where interest rates elsewhere were actually selling off. It does have good properties in terms of a diversification point of view. Chinese real estate is also an area that we have been invested and we have increased allocations during the sell-off. Why? Because the policy setup in China is quite favourable to real estate bonds and the real estate sector in general. Real estate is too important a savings tool for the Chinese citizen, so therefore it makes it a good policy target for government support. We like the valuation argument here.

In terms of Europe, we were able to increase our allocations around March and April to Spain, Portugal and Italy. The only country we have left at the lower risk level is Italy, where we are overweight. The ECB is taking away a lot of the funding needs for governments, so we have very positive net supply dynamics in Europe over the course of this year and next. In Germany, we have a preference for the long end of the curve, however in terms of the two to five year part of the curve in Germany, the valuations are starting to become increasingly difficult.

which looks at more internally focused growth models, less export oriented and one which is moving up in terms of technology, R&D and innovation etc. The last theme is Abenomics which came to the fore in 2013, which is the idea of running loose fiscal policy with reforms, with loose monetary policy, which so far has failed to generate inflation and solve the big structural problems that Japan faces.

For us, the pandemic has accelerated these trends that are key to our four structural themes, the demographic issue and the growth concerns etc. We favour duration when allocating capital. In the US particularly, the curve still has the potential to collapse lower and we have seen a little bit of that play out recently as we engage in the second wave of the pandemic. That makes us want to own investment grade credit. We are running a fairly stimulative set up of policy that should keep supporting credit, equities and fixed income more broadly, and that makes us find value in emerging markets in dollar-denominated terms. A lot of the debt within those emerging market countries is actually coming via the IMF, so via the public sector, therefore leaving an attractive pool for private debt investors such as ourselves. It makes us like Chinese bonds in local denominated terms. We like the duration in China in unhedged currency because the policy setup in China is one which has effectively been running slightly tighter monetary policy YTD, but faces the same challenges as the rest of the world - peaking inflation, challenging demographics and increased debt. Relative to other interest rate markets, China is very attractive especially in terms of positive real rates and it's a

The way we use FX in our portfolios is as a hedging mechanism. The dollar plays a huge role in hedging a portfolio that's running spread risk and duration risk. Not only it is proven quantitatively speaking, it tends to have a counter trend effect. We maintain our dollar longs, mostly versus emerging market shorts, and this has been our position in line with our Chinese transition theme for a long time now. We like to have allocations to the anti-fragile currencies, again with the idea of hedging the portfolio to unforeseen risks. Therefore we like Swiss francs, Japanese yen and over the last three to four months the Euro as well.

Going forward we are very alert to this newfound experiment which is basically the Central Bank directly funding new issues from the government in order to boost demand. We have been told it is short term here. All this debate around the new monetary theory, which has basically been occurring between economists and central bankers for the last two to three years, has in reality played out and in the space of a couple of weeks we saw big policy shifts. Policymakers on the government and the central banking sides actually took hold of this idea of easing fiscal policy and monetary policy simultaneously. We don't think this is a game changer for long-run trends in rates at the moment, but if this becomes increasingly popular going forward as we deal with the aftermath of this pandemic, it can shift the pendulum for fixed income, and hence why we are alert.

CHAIR: Do any of these broad themes resonate with you William in terms of the solutions you are putting together for your clients?

GIBBONS: We very much recognise this picture drawn out by Ella here, around low yields and Japanification, which has been talked about for around 10 years now. Coming out from the global financial crisis it has been a theme, and some people thought yields would start to rise gradually as we move towards a recovery and a reversion back to pre-2008 days, but that clearly for whatever reason hasn't happened in Europe. It does feel as if we are stuck in this lower rate scenario for a while. Our thinking on fixed income is broadly similar, although there are some differences. We are a bit more sceptical about global sovereigns in terms of whether they will continue to perform and we see potential for inflation to increase. The yields are where they are because that's where the market has priced them and there are two ways of looking at this. One scenario is where yields stay low or indeed fall, and you have another scenario where yields will start to rise. There is a bit of risk around inflation picking up. Credit spreads have tightened from where they were. The interesting question now is what happens going forward. Have credit spreads tightened sufficiently at investment grade? High yield is an interesting one perhaps where spreads are a bit more elevated, so maybe there is more spread income there, but equally you have risks. You have the risk of a second COVID-19 wave, you have the US election and in the UK you have the context of Brexit as well which will affect some assets. The picture for credit seems somewhat uncertain overall. The challenge of having to earn a return in your portfolio is absolutely there and clients are very focused on this, but at the same time, logically, a lot of people would say we don't want to increase our risk budget versus where we were. Some clients are even saying they may want to take less risk given the uncertainty.

> China is very attractive especially in terms of positive real rates and it's a deep market that is likely to be the second largest bond market in the world

CHAIR: Catherine, how do you see the risk/return trade-off at the moment in relation to your own portfolio?

BERMINGHAM: We look at it, and we think are you getting paid appropriately for the risk that you have taken. If we take extra risk are we getting paid for it, and it is very difficult to see that from a long term perspective. We have risks from COVID-19, risks from the US elections, risks from the geo-political approach from US/China and wider tensions from other nations with China. The influence of Central Banks and fiscal policy has really been driving where spreads and yields are.

CHAIR: Has that led to any changes in your portfolio over the year or is it a case of sitting tight?

BERMINGHAM: There's two bits to it really. Early on in March when you saw yields decrease but saw credit spreads move out quite substantially, that made us think there are opportunities in credit, but obviously then that came back quite quickly, and with risks where they are at the moment, you have to think will there be better opportunities coming up?

BIRD: One of the benefits of thinking about global bonds as we do, is the ability to be quite nimble in terms of how we express these in the portfolio. Are we entering a world where nimbleness and making quick decisions is becoming more relevant or is holding true to a longer term strategic asset allocation view still going to persist?

HOXHA: The ability to be nimble is now more important than ever. We are in an environment where we could be

> The ability to be nimble is now more important than ever. We are in an environment where we could be faced with a lot of volatility

faced with a lot of volatility. If anything shifts over the next three to six months, like for example a vaccine development or a combination of that and a removal of some tail risk on the election in the US, we will have a more pro-cyclical set-up going in to 2021. In that environment we have a re-pricing of rates, so clearly being nimble and managing duration accordingly is a huge advantage. It is slightly harder to do when you are purely invested in a sectoral basis in credit, but in a portfolio that has the ability to take market rates risk and FX risk, you can actually exploit those volatility mispricings and we have been doing this certainly in FX and in rates markets as well via options predominantly. In terms of this inflation expectation component, we have been buyers of Treasury Inflation-Protected Securities (TIPS) over the last couple of months in the US. So far the market is giving the Fed the benefit of the doubt. Our only reservation on inflation is that it is a bit of a mysterious creature. It takes time to creep up and we think it is a multi-year process. We can get swings around the cycle, but are not convinced that we actually will see a three to four per cent inflation going forward persistently but it is difficult to say for certain. We are prepared when the change comes, but for the time being the problems around growth and the macroeconomic setup we have is very challenging. That will take a couple of years at least to play out with a big push from the Central Bank.

CHAIR: For insurers, it is always desirable to be nimble, but obviously they are regulated entities and have their own internal governance. Catherine, is it easy for a regulated insurer to take advantage of these opportunities, and are there any trends in where regulation is going which is making that harder or easier to do?

BERMINGHAM: As a Lloyd's insurer we have a number of different regulations that we have to sit under. We have a lot of assets that are held in US trust funds which have their own rules and their own regulations, as well as then having assets at Lloyd's which fall under Solvency II type regulation and also Bermuda regulations. Having these different regulations can make it difficult to be as nimble as you might want to be. Within our operating model we are able to have areas where we take advantage when opportunities arise. If mandates have been set up correctly you can leverage the ability to take advantage, but if you don't have flexibility it becomes very difficult to invest in a new asset class quickly. Where I think some of the messaging out of the PRA from a regulatory perspective has been helpful, is increasing focus on ESG and understanding different ESG risks in portfolios.

ESG

CHAIR: William, has ESG been rising up the agenda among your clients as the regulator places more attention on it, along with focus on TCFD disclosures?

GIBBONS: It has been, but I'm not so sure it is solely regulatory driven. A lot of the focus on ESG we are seeing is about firms trying to figure out what is the right thing to do. If you wind back 10 years, did firms think about how their fixed income or equities were invested in the context of ESG? Only in a more limited way. Firms now know that they need to put into place their own thinking on this. Regulation does feed in to this, but there is definitely something bigger going on about what is the right thing to do.

CHAIR: Ella, how do you express ESG thinking in your ARFI strategies?

HOXHA: This has been a big objective for us since the 1990s. We have had the setup in place for all the ESG screening that we have needed. For us, when we think about ESG in terms of our process in global bonds, we monitor it constantly and we filter through it. When we think about ESG, we try not to just look at the scores and the parameters of the holdings that we have present, we try to think beyond this. On the sovereign side, we have increased allocation to Chinese duration. China would score as a sovereign under a more concerning element. Why? Because one of the big factors that's driving that scoring is the democratic system. Clearly this is something we value very highly in the West, however it's less of a concern in China. So for us it is about are we getting compensated for this risk and how do we think about a country that is now part of the majority of the bond indices and likely to be the second largest bond market in the world. This is not something we can afford to be completely out of. You become part of the solution by participating and broadening your investment knowledge and expertise in that region. On the corporate side, if you take the example of financials, it tends to be a little backward looking because banks got severely punished for the 2008 financial crisis and since then a lot of reforms have been carried out in the banking sector and a lot of the balance sheets are now not the same proposition as your ESG screens would suggest. For us, we know about ESG scoring, but we have a value proposition to bring to the table. We don't see it as a defined science in our eyes, we are still figuring it out. We must understand why we have an allocation relative to ESG screening and that is important to us.

CHAIR: Does the engagement angle echo with you as well Catherine? That it is not just about screening out assets, but also about taking the opportunity to be at the table one way or another.

BERMINGHAM: It does. I think we can be far more impactful by integrating ESG thoughtfully into our portfolios rather than just screening out. We want to invest in sustainable, 'good' ESG companies but are also willing to look at investments that are not currently 'good' from an ESG perspective but are improving. There are many conversations out there at the moment talking about the cost of capital and adjusting the cost of capital for different ESG perspectives. On our insurance side you hear industry conversations that are taking place

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about whether you should adjust insurance pricing for ESG risks, and obviously insurance is about pricing risk. If you are not at the table how can you have the discussion?

ARFI opportunities

CHAIR: We have talked quite a lot now about risks and constraints. It would be good to talk about specific opportunities for insurers investing in ARFI. What does ARFI offer at the moment?

HOXHA: Our ARFI proposition was designed with an insurance client in mind. The idea being, give me a product that will try to capture most of the upside available in bond markets, but try to allow me to sleep at night when times are bad, for example March 2020 and June to December 2018. Our proposition to try and provide 3-4% returns annually but minimise the bad times has been reflected by the performance of the strategy and we have a good six to seven years' experience and performance behind this strategy now. It isn't a strategy that performs in all fixed income markets but it is a strategy that will give you a cushion because we balance the portfolio for different outcomes and we hedge exactly with this view in mind. We try not to predict the future. We try and build portfolios that will withstand the test of time and the shocks that the markets will bring.

BIRD: We talk about ARFI as if it is a homogeneous asset class but actually there are very many different styles of ARFI. Some absolute return funds are credit beta focused but we take a broader approach. It is a balanced portfolio and we offer clients in this strategy daily liquidity and therefore we know we have to be able to provide that.

CHAIR: The point that resonates with me through this discussion is around not necessarily trying to predict the future. There is such a diversity of opinion around future outcomes, and just in term of interest rates, no one can really predict what will happen.

HOXHA: The reason we follow a thematic approach is so that we are not prone to short term noise. If you take a look at the big trends in the US 10 year part of the curve, it has been clearly downward trending for a long time. If you took smaller slices of time from that 10 year part of the curve, you would have a lot of noise around it. That's why we do this, so we don't get distracted by the noise of 'will or won't there' be a deal on Brexit for example. We care about probability weighted outcomes and we care about value. This is how me minimise the error in outcomes. The absolute return strategy is actually an evolution. It is an evolution of the global ag strategy and that's why it tries to capture most of the bond market's upside. The diversification in the strategy is the key differentiator. It is allocating top down across a broad array of alpha streams so you can capture opportunities where they may lie. A strategy that uses FX as well as spread and interest rates is effectively a more robust strategy that can give you better protection but also has the agility to manage duration. As we entered the recent crisis nearly 70% of our portfolio was in government bonds giving us the ability to exploit the opportunities created by markets during the sell off. We could take advantage of the repricing in spreads in EM and credit.

BERMINGHAM: The low yields and low spreads do make it difficult at the moment. Your forward looking returns are lower as you have lower income components, so you have to think do I have the flexibility in the portfolio to gain additional bits of return from different areas. Appropriate liquidity is also very important to us.

CHAIR: William you must be working with a range of insurers. Are there any key objectives you are pulling out with regards to what ARFI can achieve?

GIBBONS: Clearly firms are struggling with low returns on cash and low returns on 'safe' assets like short duration core fixed income in Europe. ARFI is one potential solution to this.

> We try and build portfolios that will withstand the test of time and the shocks that the markets will bring

You also have multi asset credit and there are various short duration bond funds as well. The question is how should you weight these? People are looking to see how much they should have in ARFI versus multi asset credit, versus investment grade, versus something more vanilla. There is also a key point around the diversification of ARFI strategies. Some managers are predominantly more carry driven and some managers are more active in the market. One approach is to do all of that in one fund, but another approach is to identify funds which are best in class in each of these areas and pull them together, taking advantage of diversification.

CHAIR: What are the key characteristics of ARFI versus MAC?

GIBBONS: ARFI will be more Solvency II friendly in terms of the capital requirement and it's more towards investment grade. MAC will perhaps be a little bit riskier, so maybe towards the high yield end of the market and towards securitisations which would be less favourable under Solvency II but nevertheless can offer attractive returns.

BIRD: Our ARFI strategy which we speak of has had a low SCR score of just under 10% under a standard model and has reached as high as 22%, but more generally sits around the 14-17% range. The thing that changes it is the fact that it is a high yield weighting in the portfolio. This is a framework, a fund within a strategy but we recognise for many insurance companies they want to have more visibility. We have the flexibility to turn down certain parts and turn up certain parts. MAC strategies are framed around a cash plus type return. There is an ability to compare both from a performance perspective but also from a risk return profile as well.

HOXHA: Just a third of the alpha in the ARFI strategies for us come from spread which would be quite different to MAC.

BERMINGHAM: No two ARFI strategies are the same, so you really need to think about what can I have in the strategy. If I wanted to place it as a segregated account within funds at Lloyd's, I would have to say well you can't do any of your FX trading or have any of the heavy derivative strategies. If I wanted to place it outside of that, then I might say I'm ok having some derivatives in it but I also need to be cognisant of how that adds up from a capital perspective and what risks I'm adding to the portfolio.

GIBBONS: The start point for us is finding best in class managers and we rely on our dedicated global research team for this. Then it becomes a question of implementation. Clients can choose to access that research directly (either by using our proprietary research tools or taking advice), or we can implement for them either via funds or bespoke solutions.

When it comes to implementation, our portfolio management team look to build diversified portfolios by allocating to high quality managers with complementary styles and skill sets. We think that is important for asset classes such as ARFI where the opportunity set is broad and there are distinct differences in management style.

CHAIR: Catherine, we have talked a lot about quantitative factors, are there any more practical considerations, perhaps on the relationship side, that make the manager relationship work well for you?

> We recognise that transparency is key. We build a strategy that is transparent, and we put all of our funds through a standard SCR model and make that available to clients

CHAIR: How easy it to tailor these ARFI portfolios and how much of a knock-on impact on other factors does that have?

BIRD: We have the flexibility. The size of the opportunity dictates this as well. This is in part due to the fact it's fixed income, derivatives are in there and these are difficult mandates to run sometimes. They use the full remit of all the instruments, so custody costs and operational costs are all baked in, but they do have the flexibility.

CHAIR: William, what principles do you apply when you are thinking about how to select an ARFI manager and how to measure performance?

BERMINGHAM: We look at the value the manager can add. That includes the value through the investment process, and how robust and repeatable that value is. In something like ARFI, it is very important that a manager is able to articulate how they add that value. Then there is the point around how you add value on the reporting side. Are you able to provide transparency and can that feed in to the insurance company systems? As insurance companies we like to be demanding of our investment managers.

BIRD: We recognise that transparency is key. We build a strategy that is transparent, and we put all of our funds through a standard SCR model and make that available to clients, but likewise we are very happy to share information.

HOXHA: It is very important to offer a strategy that is doing what it says on the tin for insurance companies.