Insurance Asset Management

Winter 2021

NFU Mutual
Latest developments at the mutual insurance composite

Consolidation
Levels of activity in the European life insurance market

Brit Insurance
An insight into the insurer's investment operations

A stable path ahead?

Insurance CIOs predict investment yields on portfolios will bottom out by 2023

DIRECT LENDING
The benefits of a direct lending investment strategy for insurers

GOVERNMENT BONDS
Why this asset class is so important when thinking about climate change

EXCHANGE-TRADED FUNDS
The role ETFs can play in the ESG journey for insurers

Editorial Comment

With the nights now drawing in, the urge to relax with a brew on the sofa becomes stronger and stronger, and with that comes some rather interesting and moving television viewing. I recently watched *Paul Merson: Football, Gambling & Me*, where the former footballer sets out to understand why his life has been so blighted by gambling, and asks if enough is being done to prevent others following in his footsteps. Fighting back tears, Merson reveals how he lost £7m, the financial stability behind his family in tatters, and still to this day battles the urge to start again.

The lack of financial stability and risk management in Merson's life got me thinking about the monetary responsibilities insurers are entrusted with. Insurance companies are essential for the stability of financial systems mainly because they are large investors in financial markets, and because they are safeguarding the financial stability of households and firms by insuring their risks. Of course, they have hurdles to jump and periods of economic unease to navigate in order to maintain healthy investment portfolios, and in this issue, our cover feature looks at how chief investment officers are predicting the investment decline to bottom out in 2023, which is welcome news for many. We look at the reasons for this prediction, how this will filter into investment decision making, and the regulatory changes around certain asset classes that need to be made if insurers are to reap the best returns and maintain stability in the insurance market.

Furthermore, we explore the high levels of consolidation being witnessed in the European life insurance market, carrying on the theme of financial stability.

> Insurance companies are essential for the stability of financial systems

Life insurers continue to respond to sector challenges including low interest rates, balance sheet pressures and regulatory burdens, by releasing capital trapped in run-off books while alleviating cost inefficiencies associated with a patchwork of legacy administration systems.

In this issue, we also interview Brit Insurance's head of investment and Treasury Vishal Shah, and NFU Mutual's investment strategist Adam Sandford, about how investment stability is maintained within both of these insurance companies.

Enjoy!

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ISSN 2516-8096


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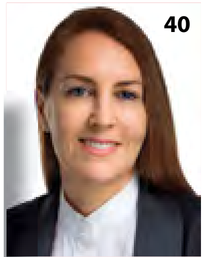
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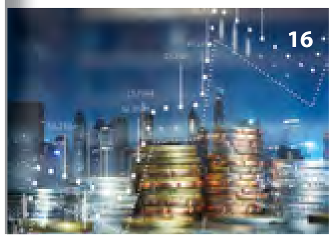
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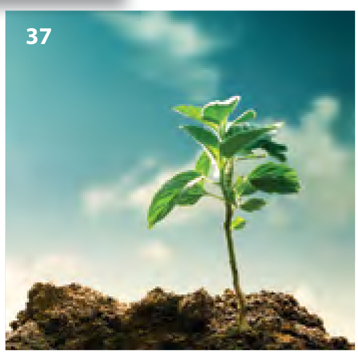
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Winter 2021

News focus

UK govt publishes new sustainability disclosure rules; EIOPA welcomes SII proposals from EC

HM Treasury believes latest requirements will streamline existing standards

Written by **Adam Cadle**

Asset managers will have to start disclosing their environmental impact under new reporting rules outlined by the UK government.

In its latest report, the Treasury explained how new Sustainability Disclosure Requirements will streamline existing climate reporting standards – such as recommendations from the Task Force on Climate-related Financial Disclosures (TCFD) – and go further.

This will include requiring every investment product to set out the environmental impact of the activities it finances, and justify clearly any sustainability claims it makes. Furthermore, asset managers will also need to explain how they incorporate sustainability into their investment strategies, allowing consumers to make informed judgements about the kind of firms they want to invest in.

> Asset managers will also need to explain how they incorporate sustainability into their investment strategies

Companies will be expected to publish their transition plans in the context of the UK's net-zero emissions target, with specific requirements to be developed after a public consultation.

Chancellor Rishi Sunak said that the new rules will "boost the economy, protect the planet and support our net-zero goals".

"We want sustainability to be a key component of investment decisions, and our plans will arm investors with the right information to make more environmentally-led decisions," he added.

Relevant companies and financial products will be required to report their environmental impact against a UK Green Taxonomy, which will create a shared understanding of which economic activities count as 'green'.

> Our plans will arm investors with the right information to make more environmentally-led decisions

On the theme of 'green' finance, a second round of guides to help financial firms manage climate-related financial risk has been published by the Climate Financial Risk Forum (CFRF).

Written by industry, for industry, the guides focus on risk management, scenario analysis, disclosure, innovation and climate data and metrics. The guides published in October, build on those published in June 2020 and will help firms respond effectively to climate-related financial risks.

On the issue of sustainability and Solvency II, EIOPA has welcomed the Solvency II proposals of the European Commission (EC) to give mandates to the independent advisory body for further action on sustainable finance.

It is convinced that these proposals would contribute "positively" to a transition into a more sustainable economy and that insurers, in their role as investors and risk managers, can facilitate that.

In particular, EIOPA welcomed the two mandates proposed by the EC regarding sustainability risks. EIOPA believes that it is important to explore prudential treatment of exposures related to assets or activities associated substantially with environmental or social objectives. Furthermore, EIOPA said a regular review of the scope and the calibration of parameters of the standard formula pertaining to natural catastrophe risk is an important step towards a more sustainable framework.

EIOPA added it is also pleased about the inclusion of climate change scenarios in the Own Risk and Solvency Assessment (ORSA), which reflects EIOPA's opinion earlier in 2021. EIOPA considers it essential to foster a forward-looking management of climate-related physical and transition risks to ensure the long-term solvency and viability of the industry.

News in brief

- The FCA said it won't stop insurer LV= from proceeding with the disputed sale of its pensions and life insurance business to US private equity company Bain Capital. LV= needs court approval to hold a members' vote on the £530m ($728.86m) sale, which would end its mutual status. "The FCA has confirmed its non-objection to LV= taking forward its next steps towards asking its members for their views on demutualisation," the regulator said in a statement.

- Premium income from new business in the German life insurance industry "could rise by 6% to €10bn" for the full year 2021, according to the German Insurance Association (GDV). In 2020, life insurers and pension funds had posted premium income of around €103bn. The GDV has estimated around 4.8 million newly concluded life insurance contracts for the full year 2021, corresponding to an increase of almost 4%.

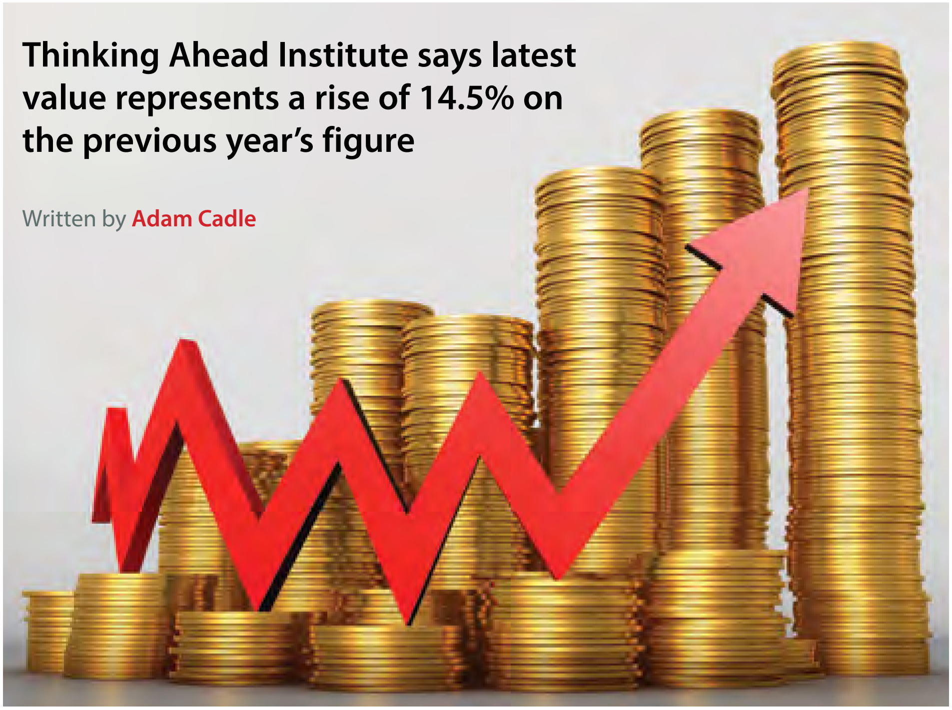
- Sumitomo Life Insurance Company has decided to outsource a portion of its investment assets to Symetra Investment Management Company, for the purpose of increasing the group's investment income over the medium to long term. Sumitomo Life said the mandate, which is planned to be more than ¥2trn, will also help to achieve synergies across the group.

- Generali is to announce a "very ambitious" new three-year strategic plan on 15 December, and continues to look at Europe and Asia for possible M&A opportunities, it said in a statement.

Top 500 investment managers see assets hit record $119.5trn

Thinking Ahead Institute says latest value represents a rise of 14.5% on the previous year's figure

Written by **Adam Cadle**



> Asset managers have always had the ambition to develop and innovate. We have seen this particularly with ESG mandates, which increased by 40% in 2020

Assets under management (AuM) at the world's 500 largest asset managers have reached a new record of US$119.5trn, according to new research from the Thinking Ahead Institute.

As of the end of 2020, this represents an increase of 14.5% on the previous year when total AuM was previously US$104.4trn.

A growing concentration has been witnessed among the top 20 managers whose market share increased during the period to 44% of total assets. Of the top 500 managers, 221 names which featured on the list a decade ago in 2011 are now absent in 2021, demonstrating a quickening pace of competition, consolidation and rebranding.

BlackRock has retained its position as the largest asset manager in the ranking, followed by Vanguard holding its second place position for the seventh consecutive year. Of the top 20, 14 are US managers, accounting for 78.6% of the top 20 AuM. On the whole, passive investments represent 26%, an increase of 16.2% compared to a 15.4% growth in actively managed AuM. Asset managers have also been addressing the growing demand from more sophisticated asset owners, for more complex and tailored investment solutions.

Outsourced CIO, total portfolio approach (TPA) and ETFs have all been popular sources of growth for the world's top managers, to meet clients' increasing requirements for returns.

Roger Urwin, co-founder of the Thinking Ahead Institute, commented: "We have witnessed unprecedented change within the investment industry – accelerated dramatically by the pandemic. In particular, sustainability is no longer just a luxury for some firms. Instead, during the pandemic, asset managers from all corners of the world have become even more aware of the interconnectedness of the financial system with society and the environment."

According to the research, passively-managed assets under management among the largest firms grew to a total of US$8.3trn in 2020, up from US$4.8trn in 2016.

Urwin added: "Asset managers have always had the ambition to develop and innovate. We have seen this particularly with ESG mandates, which increased by 40% in 2020. The biggest contributor to this was the growth in ESG ETFs."

Aggregate investment management fee levels decreased for a quarter (25%) of the surveyed managers – but fee levels increased for 21% of managers.

UK life insurers writing annuities allocate almost a quarter of investment portfolios to illiquids

Property-related assets make up majority of the sector's illiquid investments

Written by **Adam Cadle**

UK life insurers writing annuities have allocated close to a quarter of their investment portfolios to illiquid assets, using them to fund financial obligations to annuity customers, Moody's Investors Service has highlighted.

Illiquid assets account for over 20% of Moody's rated annuity writers' portfolios. Property-related assets make up the majority of the sector's illiquid investments, including real estate and commercial and residential mortgage loans. These each account for around 5% of the sector's total invested assets. Insurers are also diversifying into private corporate debt, equity release mortgages, and infrastructure loans.

Moody's said it expects their illiquid holdings to grow further, fuelled by strong demand in the UK for bulk annuities, and by government initiatives to increase investment in infrastructure.

It also added that the credit implications for these investments are skewed to the positive.

"Illiquid assets can be difficult to value and sell, and their more complex nature makes assessing their credit risk more difficult," it said. "However, they counterbalance UK annuity writers' illiquid liabilities and reduce their investment risk."

> They counterbalance UK annuity writers' illiquid liabilities and reduce their investment risk

I&P Denmark applauds new IFRS 17 accounting standard

Standard expected to create increased transparency

Written by **Adam Cadle**

Insurance and Pension Denmark (I&PD) has praised the introduction of the new accounting standard, International Financial Reporting Standards (IFRS) 17, which will be used by listed companies in the European Union (EU).

I&PD said the news brings "joy to the insurance and pensions industry" as it believes the new standard will create increased transparency for company accounts.

The new accounting standard for listed companies in the EU must be applied for financial years starting on 1 January 2023. The standard has taken 20 years to develop and another four years to gain EU approval.

"We are incredibly pleased that the EU has finally approved the new accounting standard that makes financial reporting more consistent and comparable. It will increase transparency for our investors. In addition, it will contribute to a better understanding of the insurance and pension industry's business model," I&PD CEO Kent Damsgaard said.

US insurers report mortgage loans totalling $626.5bn, up 4% from 2019

Life insurance companies hold 96% of the industry's total mortgage loans

Written by **Adam Cadle**

Mortgage loans reported by US insurers at year-end 2020 totalled about $626.5bn in book/adjusted carrying value (BACV), representing a 4% increase from $602bn in BACV at year-end 2019, according to the National Association of Insurance Commissioners (NAIC).

The NAIC said mortgage loans were about 8% of total cash and invested assets at year-end 2020. Life insurance companies held the majority, or 96%, of the industry's total mortgage loans, as "they match well with the longer-term nature of their liabilities".

About one-quarter of US insurers' exposure to mortgage loans was in multifamily/apartment properties. Furthermore, almost 90% of US insurers' total mortgage loan exposure, or $557.6bn, was in commercial mortgage loans.

Life companies accounted for about 15% of the market's commercial mortgage loans outstanding at year-end 2020, which was consistent with year-end 2019, according to the Mortgage Bankers Association (MBA). Commercial mortgage loan origination volume through Q1 2021 was down 14% versus Q1 2020 due in part to seasonality declines and COVID-19 pandemic economic effects.

The NAIC also reported that the US insurance industry has a book/adjusted carrying value (BACV)

> Almost 90% of US insurers' total mortgage loan exposure, or $557.6bn, was in commercial mortgage loans

of $455.5bn in other long-term invested assets on Schedule BA as of year-end 2020, an increase of 13.4% compared to year-end 2019.

The industry's Schedule BA exposure represents 6.1% of total cash and invested assets, an increase from 5.7% at year-end 2019.

Hedge fund, private equity, and real estate investments accounted for the majority of the industry's Schedule BA exposure at 70%.

While life insurance companies continued to account for the majority of the industry's Schedule BA exposure at approximately 52%, P&C companies' share increased to 44% as of year-end 2020 from 41% at year-end 2019.

Unaffiliated Schedule BA exposure totalled $195.7bn as of year-end 2020, or 43% of the total (consistent with prior years).

The NAIC said Schedule BA investments have been relatively attractive investments for insurers over the last 10 years, given the low interest rate environment, resulting in a doubling of dollar exposure and a 160 percentage point increase in exposure as a percentage of cash and invested assets.

Vast majority of investors will increase private assets over next 12 months

Schroders Institutional Investor Study 2021 finds private equity to be stand-out asset class

Written by **Adam Cadle**

Ninety per cent of institutional investors are aiming to increase their allocations in one or more private asset classes over the coming year, *Schroders Institutional Investor Study 2021* has found.

The growing importance of private assets was further emphasised by 47% of investors stating they will continue to diversify into alternatives and private markets and reduce their listed exposures, driven by the economic and financial impact of the pandemic. This was almost double the proportion of investors polled last year.

Globally, private equity was the stand-out asset class for future allocations, with 37% of investors expecting to build their allocations, followed by infrastructure equity (32%) and impact investing (29%).

> “Versatility within private markets is being recognised

Specifically, investors in Asia Pacific and North America were prioritising private equity, with the majority of investors in Europe looking to grow their allocations to infrastructure equity. In Latin America, corporate private debt was the stand-out asset class.

Over a third (37%) of investors also said the impact of the pandemic had increased the importance of ESG considerations, with 54% citing that ESG strategies which have a “benefit for all stakeholders” principle at the heart of their investment process are the most appealing.

Georg Wunderlin, global head of private assets, Schroders Capital, commented: “Private assets continue to take a greater share of institutional portfolios. What is encouraging is the emergence of signs that the versatility within private markets is being recognised. However, while it is clear that institutional investors value real diversification highly, we think the variety and consistency of diversification within private assets may actually be underestimated.

“The opportunity is not only to diversify across publicly listed and private investments, but also to diversify within private assets. By combining different private asset classes investors can get exposure to very different return, risk and liquidity profiles and also make use of different underlying macroeconomic and industry-specific return drivers.

“Private markets are incredibly nuanced. They offer not only a wider range of risks, such as complexity- or illiquidity-based premia than many investors realise, but a huge number of private assets focused investment solutions can be tailored depending on investors’ preferences. A growing number of our clients are taking advantage of this potential as we remain focused on working in partnership with them to meet their evolving needs amid the ongoing challenges of the pandemic and broader market uncertainties.”

Climate change could hit insurers with 50% solvency ratio drop, IAIS says

Insurers currently have 'solid' solvency positions

Written by **Adam Cadle**

Climate change impact could result in a drop in insurers' solvency ratios of 50%, according to a report published by the International Association of Insurance Supervisors (IAIS).

The report, a first such global quantitative study, assesses how insurance sector investments are exposed to climate change.

Drawing on data gathered from 32 IAIS members covering 75% of the global insurance sector, the report represents the first global deep-dive analysis on insurers' investment exposures and supervisors' views on climate-related risks.

Analysis revealed that "climate-relevant" assets within equities, corporate bonds, loans and mortgages, sovereign bonds and real estate represent more than 35% of insurers' total assets.

IAIS used the data to develop scenarios that can assess future climate change impacts, and found that compared to an orderly transition towards internationally agreed climate targets, a disorderly transition, or a scenario whereby climate targets are not met, would have a "two to six times greater adverse effect" on sector-wide solvency.

Nevertheless, considering the solid overall solvency position of the global insurance sector, IAIS stated that the sector as a whole appears able to "absorb" investment losses from all scenarios tested.

> The sector as a whole appears able to absorb investment losses

"This report underscores the importance for supervisors of assessing how climate change may affect the insurance sector and individual insurers, and of developing an appropriate supervisory response," commented IAIS Secretary General Jonathan Dixon.

"The IAIS is committed to deepening the breadth and scope of our contributions to helping insurance supervisors mitigate the effects of climate change."

In the battle against climate change, Danish pension and insurance companies have adopted a common set of measuring principles to help reduce carbon emissions from their investments.

In 2019, the Danish government launched 13 climate partnerships in order to produce recommendations on how Denmark's business community may contribute towards nationwide targets of reducing greenhouse gas emissions by 70% by 2030.

The partnership for the financial sector, led by PensionDanmark CEO, Torben Möger Pedersen, has now produced concrete measuring points for the sector's climate commitments.

The standards also include reporting rules on damage prevention, active ownership and use of paper.

"Since we handed our recommendations over to the government, our industry has worked hard to prepare an industry recommendation that can help create transparency with regard to our goals for clients' climate footprint, client interaction and project delivery, sustainability in our business models, and cutting down our own emissions," Pedersen said.

Going forward, climate footprint will be measured consistently across the board, while targets focus on reducing clients' investment carbon footprint.

> The NZAOA brings together $7trn in assets under management

FFA announces twofold initiative in fight against global warming

Endorses PRI and NZAOA

Written by **Adam Cadle**

The French Insurance Federation (FFA) has reinforced the contribution of the insurance sector to the fight against global warming by launching a twofold initiative.

It has announced that it is joining, as Network Supporter, the Principles for Responsible Investment (PRI), a global initiative launched in 2006 by investors in partnership with UNEP FI – the United Nations Environment Programme Finance Initiative – and the UN Global Compact. Secondly, the FFA is also becoming a supporting partner of the Net-Zero Asset Owner Alliance (NZAOA), which was launched under the aegis of the UN in 2019. The NZAOA brings together 48 investors representing $7trn in assets under management.

FFA chair Florence Lustman said: "The FFA's endorsement of the PRIs and the NZAOA marks a further step in the insurance industry's commitment to sustainable finance and the fight against global warming. It confirms the momentum of insurers to integrate environmental, social and governance (ESG) issues into their investment strategies and decisions. I am pleased that the FFA is contributing to such initiatives."

AXIS updates fossil fuel policy related to thermal coal, oil sands and the Arctic National Wildlife Refuge

Plans to invest $20m in BlackRock's Climate Finance Partnership

Written by **Adam Cadle**

AXIS Capital Holdings is updating its fossil fuel underwriting and investment policy related to thermal coal, oil sands and the Arctic National Wildlife Refuge.

The company has committed to phasing out thermal coal business from its insurance, facultative reinsurance, and investment portfolios. It has also committed to ending all such activities no later than 2030 in the European Union and Organisation for Economic Co-operation and Development countries, and no later than 2040 globally.

Furthermore, the insurance company said it has also included thermal coal developers within the scope of the new policy.

"The policy continues to include provisions in support of renewable energy projects and companies that are transitioning their business models away from thermal coal and oil sands," AXIS said.

People on the move

MARCUS BLOMBERG

Chief Investment Officer, Folksam

Marcus Blomberg has been appointed by Swedish pensions and insurance group Folksam as its chief investment officer, a newly-created position. Blomberg joins from his most recent role as head of strategic allocation and quantitative analysis at AP4. Blomberg also previously worked for Sweden's third largest pension provider AMF in various roles including deputy CIO and head of asset management.

CHRIS PRICE

Sales and Technical Adviser, Pacific Asset Management

Pacific Asset Management (PAM) has appointed Chris Price on a consultancy basis. Price will work closely with the firm's distribution teams to help promote Pacific Asset Management's products suitable for insurers, in particular the Pacific G10 Macro Rates Strategy. Price previously worked for Clearwater Analytics, AXA Investment Managers, and Deutsche Asset Management.

PETRA HIELKEMA

Chair, EIOPA

Petra Hielkema has started in her new position as chairperson of EIOPA. The Council of the European Union adopted on 26 May 2021 a decision to appoint Hielkema based on the shortlist of candidates for the position of chairperson drawn up by EIOPA's Board of Supervisors and following confirmation by the European Parliament. Hielkema will serve as chairperson of EIOPA for a period of five years.

VALERIA PIANI

Head of Stewardship, Phoenix Group

Phoenix has appointed Valeria Piani as head of stewardship, a newly formed position. Piani will lead the company's engagement and voting strategy, responsible for overseeing the evaluation of the stewardship capabilities of Phoenix's asset management partners, and managing Phoenix's growing in-house stewardship team. She has over 14 years' experience in the industry.

ALANNA BOYD

Senior Vice-President and Chief Sustainability Officer, Sun Life

Sun Life has announced the appointment of Alanna Boyd as senior vice-president and chief sustainability officer. In her new role, Boyd will continue to build on Sun Life's long-term economic, environmental and social commitments to design and lead greater sustainability performance for Sun Life going forward. Boyd joined Sun Life in 2016. She previously worked for Barrick Gold Corp.

MAYA BHANDARI

Global Head of Multi-Asset, BNP Paribas Asset Management

BNP Paribas Asset Management (BNPP AM) has appointed Maya Bhandari as global head of multi-asset. She will be responsible for further developing BNPP AM's multi-asset business. In particular she will focus on strengthening the investment process, and delivering consistent and strong returns for clients. She will also contribute to BNPP AM's thought leadership.

Global Climate and Social Impact

Nordea's commitment towards an inclusive Green Economy means that we look to create economic value by investing in companies that can provide meaningful solutions to meet substantial social and environmental needs.

Our history with investing sustainably dates back to 1988 and since then, we have built an enviable reputation and track record in this space. Indeed, the Global Climate and Social Impact strategy leverages on the same established investment team which has successfully managed our Global Climate and Environment strategy for over 13 years with an outstanding track record[1].

We recognize the importance of the UN SDGs as a framework to positively connect people and the planet in more efficient ways by 2030. However we believe that going beyond a purely thematic approach of investing against the SDGs will allow us to truly explore the intertwined relationship between social and environmental issues; something which has become more prominent than ever during the COVID-19 pandemic.

We take a fundamental, bottom-up approach to assess a company's ability to deliver both impact and returns and we have the ability to actively engage with each of the companies in our portfolio as part of our rigorous ESG integration process.

We are proud to be a leader in responsible investing and live by our responsibility to contribute to an inclusive green economy. We welcome you on this journey with us.

Nordea Asset Management is part of Nordea Group and manages GBP 238bn (as of 30.09.2021) of assets. The Global Climate and Social Impact Strategy is ran by a passionate and experienced team in charge of managing more than GBP 20bn invested in sustainable solutions.

1) The performance represented is historical; past performance is not a reliable indicator of future results and investors may not recover the full amount invested. The value of your investment can go up and down, and you could lose some or all of your invested money.

> Investors should look at the stability in the alternative credit market and consider adjusting their portfolios away from traditional asset classes

Market commentary

Alternative credit

Written by **Michael Griffiths**

With the search for yield prompting more investors to look beyond public markets and explore the world of illiquid asset classes, the low interest rate environment and uncertainty surrounding interest rates could be set to bolster the appeal of the alternative credit market.

Alternative credit can offer returns above those available in traditional public markets, offering a combination of yield pick-up and downside protection.

However, according to NN Investment Partners (NN IP) head of alternative credit Niels Bodenheim, the current outlook is "clouded" by a mix of factors that are difficult to read. These include the uneven reopening of economies, supply chain bottlenecks, surging energy prices, as well as worries over inflation.

"With market volatility rising, memories of last year's COVID-inspired market gyrations direct investors toward the stability of private debt, which is largely decoupled from traditional markets," Bodenheim said.

"At the same time, tighter banking regulations mean traditional lenders have pulled back from some sectors, creating a financing gap that needs to be filled. As a result, more opportunities are becoming available in alternative credit, spanning the spectrum of different credit risks and durations – from infrastructure or project finance to commercial real estate or residential mortgages to corporate loans or trade finance."

These opportunities in the alternative credit space could be at both the short and long end of the duration spectrum. Infrastructure projects are longer duration and can help match long-term liabilities.

NN IP believes this looks set to be an active sub-sector going forward, with the US about to release trillions of dollars in infrastructure spending that would create financing needs along the supply chain.

Approximately 80% of private infrastructure deals have a floating rate, which could be an attractive option for investors worried about higher inflation.

Elsewhere, trade finance opens a more naturally recurring repayment cycle to generate short-term liquidity. Due to changes in banking regulation, there is an estimated $1.5bn shortfall in coverage of trade finance by traditional banks.

"Investors should look at the stability in the alternative credit market and consider adjusting their portfolios away from traditional asset classes, and at the same time be mindful about sourcing and deployment capabilities since this will remain a crucial factor for successfully investing in alternative credit," Bodenheim said.

"In private debt, investors can see the benefits of not only yield but also stability. That can be reassuring when the next market turbulence hits."

> We anticipate investor sentiment to remain volatile and advocate for a diversified approach to help weather any potential storms

Market commentary

Equities

Written by **Michael Griffiths**

Equity markets are back on the rise as investors shrug off their recent concerns, with major indices approaching near all-time highs.

Bond yields are low but most measures of risk premiums that relate equities to bonds suggest investors are well-compensated for taking equity risk.

The expectations for earnings growth from Columbia Threadneedle over the next 12 to 24 months are strong, and as such mean equities look an attractive proposition, despite the lofty absolute valuations.

"There are two main threats, one on the earnings side and the other on the valuation side," commented Columbia Threadneedle global head of asset allocation Toby Nangle. "The supply disruptions and spikes in input costs are making for a very challenging environment for businesses to deliver earnings in line with our expectations."

After 18 months of exceptionally strong equity markets, most measures of valuations are looking high against their own absolute histories. The measure most favoured across long-time equity over the past decade has been the Shiller Cyclically Adjusted Price Earnings (CAPE) ratio.

However, according to Nangle, the measure has a "nasty habit" of jumping around without prices actually changing, taking a 10-year rolling time window of earnings and dividing their sum by today's price.

"As such, it has a habit or lurching down – signalling better valuations – when a recession recedes just beyond the decade-ago mark," Nangle said. "Putting stock in such a backward-looking measure appears curious. But there is no denying how good this has been in defining the ballpark for subsequent 10-year returns.

"The Shiller Total Return CAPE is at levels only seen in the post-war era during the dotcom boom. Warning lights are flashing."

In the US, earnings season is now underway and while it is early days, the initial flurry of earnings has been well received. According to Federated Hermes head of global equities Geir Lode, the bout of investor nervousness has proven "transitory", even as inflationary signals persist.

"The supply squeeze combined with increased demand is particularly challenging, but blue-chip companies that can prove their ability to maintain profitability in an inflationary environment are likely to be well rewarded," Lode said.

"Our proprietary risk aversion indicator corroborates this change in investor sentiment. However, inflation expectations have not fallen – if anything the argument for transitory inflation has weakened in recent days – and interest rate decisions loom.

"Investors will be watching the Federal Bank and the Bank of England closely. We anticipate investor sentiment to remain volatile and advocate for a diversified approach to help weather any potential storms."

STRATEGIC CREDIT: *a nimble approach for an uncertain world*

What are the advantages of active credit allocation in portfolios now that government bonds no longer serve their traditional purpose?

WRITTEN BY **JON MAWBY, HEAD OF INVESTMENT GRADE CREDIT, PICTET ASSET MANAGEMENT**

Governments have launched massive efforts to underpin their economies in the wake of the Covid crisis: what are the most important implications for bond investors?

Investors need to rethink the role of bonds in their portfolios, because government bonds no longer fulfil their historic role. They don't provide a steady and secure income, nor are they a safe store of value, or, indeed, a source of diversification to equities. In fact, if central banks are successful at pushing up inflation and then return policy to more normal levels, including raising interest rates, investors run the risk of suffering losses on both their bond and equity holdings. So, they need to re-think how they construct portfolios.

Is it really reasonable to fear inflation? After all, major central banks have consistently been undershooting their 2 per cent inflation targets for most of the past decade.

In considering this, it is worth bearing a few things in mind. First, although central banks introduced QE and other emergency measures after the 2008 financial crisis, their response was largely focused on underpinning the banking sector. Second, that intervention was considerably smaller than what they've done this time. Finally, and maybe most crucially, governments implemented austerity in the years after the credit crisis in an effort to fix their balance sheets. This time, deficits have blown out massively and governments have shown no indication that they intend to claw back their generosity as yet. Then, investors need to factor in that the US Federal Reserve this summer altered its monetary policy framework to put unemployment and social fairness front and centre and said it would be much more willing to allow inflation to run hot if in earlier parts of the economic cycle it was too low.

So whereas monetary and fiscal policy were pulling in opposite directions 10 years ago, this time they're working in tandem. As long as economic activity is continually interrupted by lockdowns and Covid guidelines generally, all this stimulus is only ever likely to mitigate the

> We believe an unconstrained, opportunistic approach with no underlying cognitive bias and the discipline to wait for the right entry point is vital to delivering the diversification credit portfolios have historically provided

consequent fall in demand. But a return to normal social interaction could see these huge infusions of both fiscal and monetary stimulus start to feed through to the prices of goods and services – and possibly faster than many people think.

Longer-term, all this stimulus also raises risks for social stability. Central banks' approach to monetary policy has already created disharmony by favouring capital over labour. This disharmony is likely to have profound consequences for bond investors.

If government bonds are no longer the safe haven they once were, what's the answer?

If we accept the traditional cycles of the economy and credit have largely been replaced with a volatility cycle, driven by counter cyclical monetary policy, it is important to work with this cycle and to be both contrarian and value driven in your search for returns. It makes sense to look for value after there's been a market panic – in other words when the credit markets deliver equity-type returns at bond-type risks. Of course you need good, penetrating analysis to avoid the value traps.

And then, when investor confidence gets ahead of itself, when credit starts to deliver bond-type returns for equity-type risk, it's important to rebalance and retrench until the next cycle hits. People forget volatility can return very suddenly, but these cycles are much more frequent than investors seem to recognize.

There are opportunities for investors that work with the cycle to take advantage of these periods of volatility, delivering attractive income and/or matching longer term liabilities, but in a way that uses both common sense and a contrarian mindset with a low correlation to wider risk assets. Essentially an approach that avoids the vagaries of fear and greed caused by central bank herding of market risk appetite.

Unconstrained investors can roam the markets to find sources of value. Of course, they have to be nimble and must have clear insights into what's driving a particular asset as well as the market as a whole. But get this right and they can help to give investors what government bonds no longer can. Which is a reasonable, steady return, with controlled downside and as little correlation to equity like risk as possible.

> We believe a contrarian and value driven approach is vital to protect capital and produce reasonable risk-adjusted returns taking advantage of volatility and not being captive to it

> Simply following market consensus leads to herding and being captive to fear and greed

In association with

PICTET Asset Management

Investors forced to take more risk for less return: a crocodile's jaw

The past 40 years have been characterised by steadily falling inflation, and negative yields now account for large proportions of the investment-grade universe. Over the past decade, the duration of corporate bonds has been increasing while yields have been decreasing. It looks like a crocodile's jaws opening and, to my mind, I wouldn't want my hand to be in there when it starts to snap shut.

GLOBAL CREDIT DURATION VERSUS YIELD PAST 10 YEARS

Source: Bloomberg, 9 June 2021

A stable path ahead?

The recent chapter of declining investment returns could be over as insurance CIOs continue to pivot towards alternatives and central banks prepare to raise interest rates, but the ride up won't be easy.

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

Whether it be ESG pressure, regulatory demands in the form of Solvency II, rock-bottom interest rates, the fluctuating return-risk characteristics of every asset class, or the small matter of the COVID-19 crisis, insurance company CIOs have had a tough ride since the global financial crisis.

The economic and financial market shockwaves that continue to reverberate as a consequence of national lockdowns have also prolonged the recent chapter of declining investment returns. Private equity firm KKR recently surveyed over 50 global CIOs with almost $7 trillion in assets under management and found that property & casualty survey participants had seen their average investment yield slip to 2.7 per cent from 3 per cent in 2020 and 3.9 per cent in 2017. Within life and annuity, yields remained stubbornly flat at 4 per cent, still down from their 4.2 per cent level in 2017.

But there may be relief around the corner. The same survey also found that many CIOs are confident that overall investment yields on their portfolios will bottom out by the start of 2023. Their positive outlook is understandable, says Kate Fry, an insurance investment consultant at Hymans Robertson.

"If you view government bonds as the basis for other yields [in other words] assume everything else is just a function of the risk-free rate plus a risk premium, then it does not feel unreasonable to say they are near a secular low," she says. "In fact, we have already seen rises since earlier in the year, which might suggest they are already on the rise."

Twinned with this optimism however, says KKR, is a conviction that a more innovative approach is required to sustain attractive returns on capital and meet policy holder promises.

As Fry explains, the unprecedented levels of Quantitative Easing seen in many countries have reduced yield on government bonds and led to greater investment in corporate bonds and equities. Credit markets have benefited from an increased demand in corporate bonds allowing companies to refinance or extend debt maturities, which has led to a low default rates and lower

future expected default rates.
The risks going forward for credit markets, however, are a larger-than-expected slowdown in global economic growth and the tightening of monetary policy, leading to reduced liquidity in the market.

"Even if interest rates don't rise a huge amount, it doesn't feel like credit spreads will tighten much further from here or that equity price-to-earnings multiples can rise much further," says Fry. "That leaves income the main source of return in credit markets and earnings growth (and income) the main sources of return in equity markets. A rise in real yields would likely pose valuation challenges to both fixed interest credit markets and equity markets."

This outcome, along with other scenarios that CIOs have wargamed, has led to insurers seeking new avenues of yield and diversification, says Neil Holmes, director of insurance at bfinance. Life assurers in the UK remain hungry for long-term, inflation-protected assets, notably for matching adjustment purposes. He reveals that recent bfinance infrastructure equity client searches have asked managers to show the level of asset revenues linked to inflation, the impacts of changes in inflation on the IRR, and changes in the value of the NAV from these movements.

"P&C Insurers on the other hand, continue to understand that traditionally having most of their assets in high-grade, liquid forms are no longer required and many boards are actively seeking better revenue streams away from the liability side of the balance sheet," Holmes adds.

Credit where it's due

In the search for these better revenue streams, private credit is one area that has attracted heightened interest from insurers. Head of sales for UK and Ireland at BNP Paribas Asset Management, Phil Dawes, says that insurers have a choice of rich pickings in this area — from infrastructure and real estate debt, to corporate lending, to

> Even if interest rates don't rise a huge amount, it doesn't feel like credit spreads will tighten much further from here

social housing — each of which has their own positive characteristics.

"Many of these have appealing risk-return profiles relative to equivalently-rated corporates, offering diversification, enhanced returns, lower default rates and higher recovery rates," says Dawes. "For insurers, these offer stable, secure cash-flows often with advantageous regulatory capital charges and low volatility due to their accounting treatment. Given the latitude central banks have to increase interest rates, it is unlikely even for fixed rate transactions that these advantages and yield premiums will be fully eroded in the near or even medium-term."

What is more, as some segments of private credit, such as commercial real estate debt or mid-market lending, are floating rate in nature, they offer protection against rising interest rates.

Other alternatives that have attracted attention over the last two years or so include real estate equity, corporate

> While appropriate due diligence is vital, it is currently disproportionate and excessive compared to the risk and complexity of securitisations

direct lending, emerging market debt, private equity (in the form of fund of fundsfunds), high yield and trade finance.

However, as Holmes warns, restructuring insurers' asset bases towards more alternatives involves more than simply identifying high-returning asset classes. "It must be done on an 'eyes-wide-open' basis," he warns. "What is the depth of the market, where are returns in the cycle, are terms and conditions improving, what impact is there on my regulatory capital base and does it give an acceptable risk adjusted rate of return?"

Driving growth

With some asset classes however, due diligence can be more pain than it is worth.

The pooling of various tranches of debt in securitisations is a prime example. In September of this year Insurance Europe argued that insurers' allocations to securitisations remain below their full potential due to artificial barriers.

The industry body complained that capital requirements for securitisations remain too high relative to their real risk and relative to the yield that can be earned. To tackle this issue, it said, insurers should be allowed to apply the dynamic volatility adjustment to value liabilities. This tweak would be in recognition of the Solvency II principle that extreme scenarios used to determine the solvency capital requirement should be applied to both assets and liabilities.

Insurance Europe also called for policies to focus on lowering the burden associated with the mandatory due diligence that both issuers and investors are required to undertake.

"While appropriate due diligence is vital, it is currently disproportionate and excessive compared to the risk and complexity of securitisations, as well as other alternative instruments, such as covered bonds," it said at the time in a white paper. "Due diligence requirements should therefore be simplified and allow for proportionality."

According to the group, opening up avenues to sound securitisation, in line with the objectives of the Capital Markets Union project, could help underpin economic growth across Europe.

Real value

Regulatory restrictions also exist in infrastructure. As Fry points out, there are certain regulatory constraints that limit insurers ambitions in this space. For example, in the UK, the binary nature of the matching adjustment eligibility criteria restricts what insurers can invest in.

The hope — and expectation — is there may be some relaxation of the rules in coming years. "Insurers have recently increasingly looked to infrastructure — both debt and equity — as an investment with attractive characteristics: annuity-like cash flow and the potential for the underlying asset to generate a real return," says Fry.

A loosening of the regulations could also allow insurance capital to act as an engine for economic growth through infrastructure funding, as well as contribute meaningfully to society's goals. And given the clamour from governments in the West about their ambitious net-zero carbon emission targets, there is likely to be a greater need for new and improved infrastructure in the next decade. "Given the nature of these assets, who is better placed to make these investments than the insurance industry?" Fry asks.

With infrastructure needs globally being so significant, and governments suffering from a COVID-19 crisis spending spree, there needs to be some sort of relationship, whether it public-private partnerships, or another vehicle, to facilitate private capital injection into projects.

Justin Curlow, global head of research, at AXA IM Alts, says that insurers remain perfectly positioned to fill this gap. "Insurance companies need to find investment opportunities that help them match their liabilities, and they have struggled with the low yielding environment. An asset class such as infrastructure, that has huge growth capability, and also offers a long-dated income stream is a very attractive match.

"There's a need for this from an economic standpoint to build out new infrastructure, while there is a need for insurance investors to buy these types of assets, so we're going to see much more of this activity going forward."

Didde Maria Kristensen, head of investor relations at NREP, the Nordic fund manager, has also seen a marked increase in interest in the asset class from its insurance clients. "When we talk to our investors they are looking further into real assets, and the infra segment in particular. They are definitely looking to increase that bucket."

Within real estate, clear opportunities also exist to deliver good returns, aid economic growth and make a meaningful societal impact. Huge current pressure exists on the office and retail markets, and while the logistics and industrial segment of real estate is buoyant, it is extremely competitive. As a result, Curlow says that there is a large push into real estate niche sectors, such as data centres and life sciences facilities, which are property types used by dynamic and job-creating industries. These also fit CIO income return targets and capital growth expectations, while also offering huge development opportunities.

In residential real estate, the latter characteristic is particularly evident. "In southern Europe, the Nordics and the UK, multifamily residential is only really starting to gather pace and being built up. So you've got a huge opportunity to basically build out the future yielding stock, and capture some additional developer margin by taking some of that up-front risk," says Curlow.

"You can therefore reduce your transaction costs, which in some jurisdictions around the globe can be upwards of 10 per cent, if not more. That is significant. As we see yields come down across the world across all asset classes, including real estate and infrastructure, anything you can do to be more efficient in the way that you're putting money to work, whether that's tax efficiency, or transaction cost efficiency, that's real money in your pocket. And that's also an area where we're seeing increased interest."

Real estate can also offer deliver regular cashflow-yielding assets. This is why residential, as well as logistics, which despite being expensive to buy in some regions, continue to attract insurance capital. Both sectors, says Kristensen, are also underpinned by positive macro trends, most notably urbanisation and the relentless expansion of ecommerce. Added to that, is the opportunity to secure long duration inflation-linked leases across large portfolios of assets.

It is also a very flexible asset class, and one that offers an — albeit imperfect — inflation hedge, says Curlow. "I have had conversations in the past few months with CIOs asking, 'where can I get the best inflation hedge? Which real estate asset classes should I be looking at? Which jurisdictions? And that's where you start to look towards the underlying income stream. What is your lease agreement? What is your ability to pass through inflationary costs? And that's where you do have nuances. By jurisdiction, by asset type, and by lease duration."

At one extreme of the real estate sector, investments can be made in hotels, which really mark to market overnight, given the nature of the building's underlying business. At the other, contracts can be signed for 20-year office leases, or a big warehouse lent to a dominant retailer. "Some of those may or may not include either a rent review, or an inflation link directly to them," says Curlow. "But there's also everything in between. So that's where you do have opportunities to be able to tailor and cater your real estate exposure to what you're seeking."

> "In Southern Europe, the Nordics and the UK, multifamily residential is only really starting to gather pace and being built up

He stresses however, that the starting point for any portfolio construction work in real assets, whether it's real estate, infrastructure or a combination of both, is working out exactly what a CIO is trying to achieve. "What are you looking for when you go into this asset class? Is it diversification, is it return? Is it linkages to inflation or not? And that's where it's not a one-size-fits all scenario."

Strength in numbers?

Michael Griffiths takes a look at consolidation activity in the European life insurance market

WRITTEN BY **MICHAEL GRIFFITHS**

The low interest rate environment is continuing to bring added pressures to the life insurance sector across Europe in 2021. Challenges that had already faced insurers following the introduction of Solvency II in 2016 have been further complicated by COVID-19, and with investment margins tightening, European life insurers must work increasingly harder to finance their policyholders' liabilities with capital guarantees.

With that in mind, could a return to consolidation activity allow Europe's life insurers to better respond to the sector's challenges?

According to Fitch Ratings, life insurance consolidation is considered its own business line given its specialist nature and recurring transaction model. In February this year, Fitch suggested that drivers to support growth, including strong supply from insurers with substantial closed life insurance business books, were set to see consolidation activity grow in 2021.

The credit rating agency also recently stated that it is deals of smaller scale that could drive this activity further across the life insurance sector in Europe.

Little by little

One recent example is the Norwegian group Storebrand, whose activities focus largely in life insurance and pension savings. In August, Storebrand acquired the Danish real estate manager, Capital Investment, in a deal worth €67m. The Norwegian group said the acquisition was in line with a strategy to "look for bolt-on acquisitions that complement the current business to accelerate growth".

Another example is Chesnara, which announced the acquisition of Sanlam Life & Pensions UK in September. According to Fitch, this transaction signals that conditions in the sector are "normalising", and that the key structural trends observed in the industry pre-pandemic are still intact. This includes shrinking back-books, capital optimisation challenges, and a bifurcation of business models into "capital-light" and "capital-intensive".

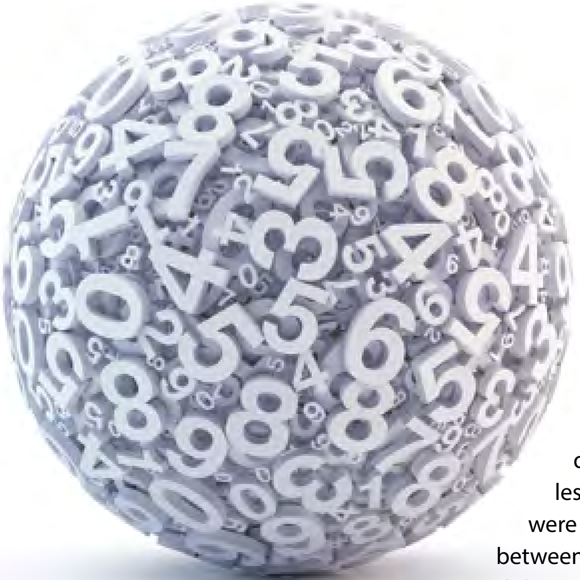
Chesnara group CEO Steve Murray says that many financial services companies have been looking more closely at their portfolios during the pandemic, trying to be more focused on assets they see as "core" to the business.

"This means there are more companies willing to look at strategic options for some of their assets including disposals," Murray comments.

"Boards and management teams have also had more time on their hands during the pandemic to consider their strategies and the actions they might take going forward. There are also new sources of capital looking for ways to get access to insurance assets as well as relatively cheap financing available for existing consolidators.

"We have seen management teams that have taken action regarding their portfolios being rewarded by the market and on the other side, activists are also looking more likely to look at insurers they don't think have taken the right steps within their business. So overall, this means a pretty active market."

In light of Chesnara's acquisition of Sanlam, does Murray agree that it is deals of this scale that can drive more consolidation activity across the whole



> An active consolidation market can only be a positive for the life insurance space

of the sector?

"I think it can definitely help," he tells *Insurance Asset Management*. "We've seen a trend for much larger deals being undertaken especially in the UK. If other companies realise that deals of a wider variety are possible and companies can recycle capital to potentially deploy on deals that are core to the business, then we will see further companies testing the market.

"We certainly see ourselves being able to look at deals of various sizes provided they create value for our shareholders.

"An active consolidation market can only be a positive for the life insurance space. It will mean new capital coming into the market potentially. It will also mean that existing players can unlock capital from non-core books and put it to work on areas that are a key focus for them as well as helping to support the very good yields we see for shareholders across the insurance landscape.

"We continue to be optimistic about the opportunities that are available in the European life market for Chesnara."

Behind Fitch's view on transaction scale, the credit rating agency had analysed a selected number of deals from the last five years that cover around €530bn worth of life and savings liabilities. It found that 53% were smaller sized transactions – which it defined as those worth less than €5bn – while 28% were medium sized, valued between €5bn and €15bn. The remaining 19% of deals that were considered larger were all valued over €20bn.

However, despite the higher proportion of smaller deals taking place, these deals only accounted for 6% of the total €530bn liabilities analysed. The medium sized deals equated to 16% of the total liabilities, but it was the larger transactions, despite accounting for just 19% of the deal activity, that accounted for 78% of the total liabilities.

This indicates that factoring in the size of all liabilities, the deal flow is still dominated by those of the larger variety.

A bigger boost

While COVID-19 had somewhat pressed pause on a lot of activity across markets last year, the life insurance sector saw one of the largest consolidators in Europe, Phoenix, complete its acquisition of ReAssure last year. The move resulted in the creation of the largest life insurance and retirement business in the UK, and left Phoenix as the only scale consolidator in the UK market.

According to a report at the end of 2020 from Deloitte, some life insurance companies had started to double down under the combined pressures of the pandemic, low interest rates, and cost inflation, to instead focus on changing their operating models, shoring up their balance sheets, and readying themselves for change in 2021.

An example of this came in the shape of LV=, which announced it would sell itself to PE group Bain Capital with the objective of securing future benefits for its members. It was announced last December that Bain Capital would pay £530m to acquire LV='s savings and retirement and protection businesses.

So while there is a case to be made that an accumulation of smaller deals can drive consolidation across the life insurance sector, is it still ultimately the largest of deals having the strongest say in how the market moves?

Another of Europe's largest consolidators, Athora, has grown dramatically since its inception in 2014, focused solely in Europe and on larger targets to support growth. Its most recent acquisition came in September, when it acquired Amissima Vita, an Italian life insurer with assets standing at €7.2bn, and annual gross written premiums totalling over €800m.

Athora head of growth, Henrik Matsen, says the group's aspiration is to be a "long-term player" in the European life insurance market, but he warns that within the sector, much like in the retail banking industry, the low interest rate environment continues to bring challenges to life insurers providing long-term savings and guarantees to policyholders.

"As one illustration, look at Germany in the days when interest rates were 5% or 6%," Matsen tells *Insurance Asset Management*. "It was straightforward to buy a German government bond and then issue a three per cent or higher interest rate guarantee to policyholders – that was an easy business model.

"With what has happened following the financial crisis in this low-for-long interest rate environment, that business model is broken. If you look at sovereign debt as an example across the EU, most of it would provide negative yields today. Fundamentally, there has been a big change in the market environment that makes this business model very challenging."

On top of this, Matsen highlights the introduction of the Solvency II regulatory regime in 2016 as another "dramatic change" for the life insurance industry.

He adds: "Taking these two aspects together, there are certain lines of business where it has become challenging for life insurers to generate attractive returns to policyholders, and also a challenge to remunerate capital provided by shareholders to support those business lines.

"There has been a shift across the traditional insurance space, and also from investors into the insurance market, towards underwriting risk. In the life insurance space, we have seen a shift towards capital light and fee generating business, and more defined contribution type savings vehicles where risks are transferred back to policyholders and the saver.

"With that big shift, you then have this big part of the market, which we see as being €6-7trn of reserves across the EU and including the UK, which is now suddenly out of flavour.

"A lot of players are now sitting there with business lines and reserves of long-dated policies that aren't deemed core anymore, and there is a shift away from that business. Selling those business lines off is often contemplated by a number of players. That could be legal entities, or portfolio transfers, sales of assets and liabilities, or increasingly reinsurance – where people are looking to divest those portfolios and those lines of business."

Natural evolution

Matsen believes that parallels can be drawn with other industries as well. He highlights that each jurisdiction in the European market has its own specificities, but argues that as a whole, the life insurance market is "fragmented".

"In a challenging business environment, you have to decide how to drive efficiencies, how to drive scale, and how to manage your costs," he adds. "Consolidation is often a necessity. If you are a large insurance company operating across multiple jurisdictions in Europe, and you want to start on this journey – first you identify the businesses that are sub-scale to you.

"Those are typically the transactions that take place first. They are easier to go through with, so you can test the water and build experience. It's the smaller businesses, smaller portfolios and smaller balance sheets where scale and cost pressures are the most acute.

"My view is that this is a natural evolution of the market. As it consolidates, and as the life insurance market is restructuring, I think you're going to see more larger transactions over time as well."

So, while Fitch's prediction may well prove true, and the life insurance sector sees smaller sized deals to comprise the bulk of transactions, it seems there is more at play in the space.

Following on might well be the "natural evolution" for deal sizes to increase and ultimately larger sized transactions to boost consolidation activity across the sector even further, as the life insurance market continues its path out of the pandemic – or as Matsen describes, its "restructuring".

One thing which is clear, is that in any shape or size, a continued rise in consolidation activity in Europe, and the freeing up of capital that comes with it, will be the life insurance sector's gain.

PODCAST: Direct lending

Adam Cadle speaks to HSBC Asset Management's Head of Investment, UK Direct Lending, Tom Green, and Deepak Seeburrun Head of EMEA insurance business about the launch of HSBC Asset Management's direct lending investment strategy

IAM: **Firstly, can you explain why HSBC Asset Management decided to launch a direct lending investment strategy?**

GREEN: HSBC Asset Management already had a very successful indirect alternatives business, helping clients to allocate across the whole spectrum of alternative asset classes. Private debt is a growing market and is highly relevant to our clients. The broader HSBC Group has a really strong heritage and significant experience in direct lending using its own balance sheet, and we felt it was time to provide our asset management clients with access to this, in the first instance via our UK Senior Direct Lending strategy.

SEEBURRUN: It's worth pointing out that we have a strong client base, and we work closely with our insurance clients in order to assess their investment needs and how we can really make a positive difference to their portfolios. So formulating an investment solution is very important to us and our clients. During our testing phase, we observed a strong appetite for direct lending, at least within the insurance sector, and with a combination of our large UK mid-market loan origination platform, came the launch of HSBC's Senior Direct Lending Strategy which also has some unique features.

IAM: **What does your UK focused Direct Lending capability involve exactly and what are the benefits of this for insurers?**

GREEN: The strategy focuses on providing senior secured loans to mid-market companies owned by private equity sponsors. Working in partnership with HSBC UK's mid-market leveraged finance team, the benefits of this approach to investors include the fact that HSBC UK is the market leader in UK mid-market transactions by volume. It also has a very strong and well established originations platform with around 50 deal originators based around the UK regions, generating a really differentiated level of deal flow for our investors. Also there is a very strong portfolio of around 300 clients already in this space that HSBC UK manages, along with very strong and long standing relationships in the market with private equity houses, advisers and borrowers in many cases spanning over 15 years. So, even though HSBC Asset Management is new to this direct lending space, we are able to leverage the HSBC UK track record and experience in this sector. This strategy is at the conservative end of the spectrum for direct lending, targeting lower leverage, larger equity cushions and tighter controls than most other players in this space. Pricing so far has been strong, and the strategy offers really good risk adjusted returns to investors and a significant uplift in yield when compared to fixed income and tradeable leveraged loans. We think that for our sweet spot loan size of £30-75m in the lower risk space, competition is lighter, and actually there is a scarcity of financial solutions for borrowers in this market. All this put together makes it an attractive strategy for insurers.

SEEBURRUN: A clear attraction is the unlevered returns of between 6-8%. One hundred per cent sterling loans means there is no FX risk for insurers which is great to have under Solvency II. The average size loans are around £35m, which is relatively small, and hence there is good diversification in there. The loss ratio is next to nothing and there is a clear focus on ESG, we worked with clients and came up with a list of exclusions and embedded that into our strategy. The low management fee is also really important, and there is no performance fee drag, again something which is very competitive in the market. Furthermore, this strategy carries a very low Solvency II capital requirement.

IAM: **The due diligence involved in direct lending can be intensive and requires specialist skills. How do you work with your insurance clients to make sure appropriate credit analysis is carried out?**

GREEN: We have a highly experienced

investment team which we have built up over the last 18 months, and we make our own decisions about deal selection independently of HSBC UK. Even though we are working in partnership, what we are doing is cherry picking the best quality deals to ensure that our portfolio really has a good balance of risk and return. The investment team is now eight strong and we have some really experienced individuals who have been recruited from the broader direct lending market and from within HSBC. We are also supported by the broader infrastructure of HSBC Asset Management. For every deal completed, investors have the assurance that it has also been through the bank's own credit approval process. We are able to demonstrate that HSBC UK has had a really excellent track record spanning more than 16 years, including the global financial crisis and the more recent COVID-19 pandemic. Loss rates across that time have been significantly lower than the broader public and private market levels.

Our process is really well established and thorough, and we have spent quite a lot of time designing a robust investment process, conducting the screening of transactions, and our due diligence process that we have in place is also very thorough. All deals are judged against tried and tested criteria focusing on really trying to identify non-cyclical business with defensive characteristics, and strong historical track records. As Deepak said earlier, we have integrated ESG into our due diligence process to ensure that we focus on businesses who engage positively with their employees, suppliers, local communities, customers and the environment. All deals are taken to our investment committee and all members have deep experience in credit markets. Also, there is a really strong independent risk oversight framework in place to ensure all decisions are made in accordance with policy and in line with risk appetite.

SEEBURRUN: We have a number of commitments from insurers in this strategy and we continue to see growing interest. The due diligence process incorporates credit but also operations, ESG and Responsible Investment, and this runs smoothly. This is mainly due to the fact that Tom's team, including Tom himself, is very experienced with a long track record.

> The pipeline continues to be extremely strong and we expect deployment momentum to continue

IAM: With interest growing in this area among UK institutional investors, where do you see the market heading and is there a market competition risk as a result?

GREEN: There is competition for our strategy as a lender, because obviously deals in this market tend to be allocated to one manager. From a deal perspective as a lender, and also from a fund perspective in terms of other fund strategies from other managers, we think that we are well protected because our strategy is genuinely differentiated from the rest of the direct lending market. Our proposition is a partnership approach with HSBC UK to underpin origination volumes and also having a lower risk senior proposition. This provides differentiation and protection to our strategy both when seeking to deploy capital but also when raising capital. HSBC UK is the largest player in the UK mid-market by the volume of deals and we've benefited from a really high level of deal introductions since the launch of the strategy leading to strong deployment and access to proprietary deals that no other lenders are seeing. Nearly half of the deals we have closed so far would fall into this category of being proprietary. For investors wanting a relatively conservative private debt strategy that seeks to offer a return premium over fixed income and attractive risk adjusted returns, we strive to offer something that is different to all the other direct lending propositions in the market.

SEEBURRUN: Assessing UK mid-market loans is not new to insurers or other investors. The HSBC Senior Direct Lending Strategy is distributed through HSBC Asset Management. This capability has been constructed based on a solid partnership with the market lead originator, HSBC Bank. A very important point to note is our ability to deploy rapidly. So the pipeline continues to be extremely strong and we expect deployment momentum to continue as investors increasingly react positively to our combined HSBC bank and HSBC Asset Management loan proposition.

In association with

HSBC Asset Management

In the spotlight: Brit Insurance

Adam Cadle speaks to Brit Insurance Head of Investments and Treasury Vishal Shah about the insurer, personal aims and ambitions, and the pandemic

WRITTEN BY **ADAM CADLE**

Q Could you provide an overview of Brit Insurance and your day-to-day role?
Brit is a leading global specialty insurer and reinsurer focused on underwriting complex risks. We are an influential and respected presence at Lloyd's of London and, in Syndicate 2987, we have one of the largest and most diverse underwriting portfolios. Through Syndicate 2988 and Sussex, we provide additional underwriting capacity backed by a diverse source of capital. In 2021 we launched Ki, the first fully digital algorithmically driven syndicate in collaboration with Google and UCL.

My role encompasses 4 core areas which are innately linked: 1) investment management and the creation of value through our investment strategy; 2) capital management for the Group and its subsidiaries; 3) liquidity management of the Group and its subsidiaries; and 4) reporting related to these roles.

Q How has the firm adapted to COVID-19 in terms of its investment thinking and direction?
Brit, in keeping with the ethos of being part of the Fairfax Group, takes a long-term view of markets. Investing is conducted based on a long-term value-oriented philosophy. This philosophy did not change over the last 18 months. We took advantage of the market dislocation in March 2020, entering into credit as spreads widened significantly, creating good value opportunities. Brit produced a positive 1% investment return in 2020 and a 3.4% non-annualised return to H1 2021.

Q What is your overall investment portfolio structure?
As per our 30 June 2021 Half Year Report, our investment portfolio remains consistently positioned, primarily invested in cash and fixed income securities with these representing 83% of the portfolio. The fixed income portfolio is short dated, with a split between government bills and corporate credit. The allocation to credit risk is primarily defensive, focused on high quality, investment grade securities. Brit's equity allocations are invested in a portfolio of both listed and private equities and funds and are c16% of the overall portfolio.

Q What has been your biggest achievement in your role?
Looking back to March and April 2020, there was enormous ambiguity around the long-term impact of COVID-19. This uncertainty created significant impact on all areas of my role given its focus on investments, capital, and liquidity management. Supporting the organisation through this period, including producing a daily picture of our financial position, regular discussions with shareholders and the Brit executive team, and outlining the actions to be taken is my biggest work achievement to date. Or perhaps coming out on the other side is!

Q What do you see as being the biggest challenges for UK insurers going ahead?
For Brit, the majority of our insurance liabilities are USD and therefore our

Brit has an important role in fighting climate change, and we firmly believe that insurance is a social good

investment portfolio is US focused. The biggest challenge continues to be the oft quoted issue of mid-cycle conditions and late-cycle valuations. With spreads remaining tight, low overall yields and high equity valuations there appears limited opportunities for a fair return for the risk taken. With the additional potential of less transitory inflation and moves by central banks it is an interesting time. For Brit our focus remains on being able to seek out incremental returns while being in a position to move efficiently during any market dislocation.

Q Could you explain your focus on ESG?

Brit has an important role in fighting climate change, and we firmly believe that insurance is a social good. There are five parts to our ESG strategy:

- Working with our clients and business partners to understand and mitigate the impact of climate change
- Putting the environment at the centre of our investments and underwriting strategy
- Transitioning to be a net-zero business
- Ensuring we manage the risks to Brit
- Placing inclusion & diversity at the heart of everything we do

We are committed to responsible business practices. Our ESG Committee, comprising members of our senior management team, oversees our approach, and reports directly to our Executive Committee.

We recognise that we're most effective by acting alongside others in our industry, which is why we're active members of ClimateWise and IcebreakerOne. We're also taking part in ESG initiatives within the Lloyd's market and the Fairfax group.

On the investment side we have worked with all our investment managers to integrate ESG into our mandates.

Q What are you excited about in the coming years for Brit Insurance and yourself?

I have been at Brit for five years now and have been involved in a significant number of new insurance and capital platforms launches in that time, including Syndicate 2988, Sussex Capital, and Ki. I look forward to growing the investment portfolios and strategies as Syndicate 2988 continues to mature and the recently launched Ki business grows. Being able to formulate the investment strategy and infrastructure from a clean slate for these new and growing businesses with differing capital providers is a significant and exciting opportunity.

Q Away from the day-to-day role what do you do to relax?

This year I started playing cricket again. I played a few games alongside my dad, who is 69 years old which was great fun. Although annoyingly he is still the better batsman! I enjoy playing football, tennis and squash and look forward to playing more regularly. I read a fair number of books, but my once favourite dark fiction novels have lost their appeal and prefer lighter storylines. I always enjoy spending time with my wife and two sons and they have been amazing company over lockdown. With bars and restaurants opening up I have definitely enjoyed breakfasts, lunches, and dinners recently. And long may that continue.

VIDEO: The role ETFs can play in the ESG journey for insurers

In this video, Adam Cadle talks to Justin Wheeler, Head of UK iShares Asset Owner Distribution at BlackRock, and Mark Guirey, Head of EMEA Insurance Segment and UK Asset Owner Client Coverage at MSCI, about the significant role that ETFs can play in the ESG journey for global insurers, drivers behind growth in this area, and how the market reacted to COVID-19

IAM: **Justin, perhaps you could outline the flows we're currently seeing in the ESG ETF market, the drivers and tailwinds behind these flows, and how the market navigated itself through the COVID-19 pandemic**

WHEELER: Demand for sustainable investment solutions has grown substantially in recent years. ESG investment risk has become top of mind for many of the asset owners we work with, and sustainable indexing is becoming one of the key tools to address and tackle these issues, with ETFs playing a major role as the implementation vehicle. Globally, sustainable ETFs make up assets under management (AUM) of around $270bn. For context that's up from $63bn at the end of 2019, so we've seen about $200bn of asset growth over the past year and a half. Sustainable ETFs account for about 3% of total ETF global assets, and again that's up from around 1% at the end of 2019. That's a big change for a $9.3trn industry.

Looking at some of the flows and trends across this asset growth, in 2021 alone we've seen about $84bn come into sustainable ESG ETF strategies, according to BlackRock. That's almost at the level we saw for the full year of 2020, which don't forget was a record inflow year for ESG ETFs. Interestingly, we've seen a growth in demand for more ESG enhanced strategies from those clients looking for that desirable stronger ESG positioning within their portfolios. With the growth of fixed income ETFs across the ESG spectrum, we've seen greater utilisation and adoption within the asset class, particularly within core fixed income portfolios. Lastly, there's been a clear drive for climate aware solutions, with strategies such as Paris alignment or low-carbon transition strategies clearly showing clients are interested in this environmental aspect of ESG.

I think investors are seeing climate as an investment opportunity and not just as investment risk going forward, and clearly ETFs are playing a vital role in helping these investors access and implement these ESG solutions within portfolios. Now there's a couple of drivers behind this, specifically within ETF adoption. Let's not forget that ETFs offer us a very simple low cost and transparent access to benchmarks, which can be quite refreshing given sustainability can be a complex topic. ETFs also offer a lot of precision and granularity which is helping investors find the specificity they are looking for when they implement ESG strategies, and this is no different to what we see across regional, country thematic or sector applications for an ETF.

One of the other big drivers I think is important is that generally stakeholders are moving in a more consistent and common direction as it pertains to ESG and sustainability. Regulators, asset managers, and index and data providers are thinking more collectively about what the industry needs and what investors need. I think that is leading to a much stronger and more structured ESG environment moving forward.

On the COVID point, I think there was a clear tailwind for ESG ETFs in 2020. Typically, we see ETF usage increase significantly in times of market volatility and this was no different for ESG ETFs. During the first quarter of 2020, 94% of sustainable indexes outperformed their non-sustainable counterparts, so any notion that ESG investing results in a sacrifice of performance was clearly debunked. Often ESG benchmarks tend to exhibit relatively higher quality and lower volatility factor tilts, which has the potential to help investors during volatile markets. Together, alongside ETF liquidity, I think investors really appreciated that as they looked to manage risk through that COVID environment.

> “ ETFs offer us a very simple low cost and transparent access to benchmarks

IAM: Concerning the actual implementation of these ETFs, how is this evolving and how does BlackRock help its clients in this transition journey? Aladdin your software-based solution is obviously a key element in this.

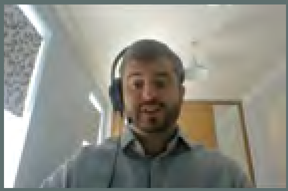
WHEELER: Absolutely. I think implementation is a real challenge for clients. So many clients are in a different place and different stage of ESG adoption, meaning there is a variety of objectives they're looking to achieve. We work with clients to help them select the right product and exposure to meet their ESG objectives as well as thinking about how implementing ESG into the overall portfolio impacts that portfolio.

Generally we've seen that UK asset owners and UK institutional clients tend to use ETFs in three main ways. First of all as a transition management vehicle as they think about how to grow, expand and evolve their ESG framework on that journey. We've also seen them use ETFs as precision tools, again to access that granularity that ETFs allow for given the breadth of ETF options in the market. Lastly, we've also seen the usage of ESG ETFs to help step out and equitise cash.For example, we run ESG ultra-short fixed income strategies that have really resonated in this space with investors that want to equitise cash but do it in a sustainable way.

Clearly, to achieve that you need the right product as well as product breadth. At BlackRock, we launched about 100 sustainable ETFs in 2020, and we've launched another 27 products in 2021, so it's really giving investors choice. Many of our recent launches incorporate factors such as MSCI ESG value or ESG minimum volatility, or a climate focus such as Paris aligned benchmarks, illustrating our collective partnership across the industry where asset managers have been able to support some of the index design that underpins evolving investor needs..

For some, it may mean screening out controversial businesses. For others, it may mean much more of a specific sustainability topic, such as climate change, net zero or low-carbon transitions. Product is one aspect of that, the other piece I would highlight is portfolio construction, and this is where data plays a key role.

When we think about portfolio construction as an asset manager, data is really fundamental to that. For a long time, ESG and sustainability from a data perspective was quite challenging but I think the likes of MSCI and other index providers have made significant improvements. Along with our Aladdin platform and technology,



it really allows us to support investors and think about ESG integration from a total portfolio perspective. We are able to analyse metrics such as ESG quality scores and carbon reduction across the total portfolio. MSCI and other data providers play a huge role, in creating more consistency and standardisation as it pertains to data and therefore the portfolio.

IAM: Mark, Could you explain how you work with BlackRock through the ESG ETF journey? Particularly with the index frameworks you provide, and how the right data is in place when implementing these ESG ETFs.

GUIREY: MCSI indexes are designed to provide institutional investors with effective and transparent tools to integrate ESG and climate considerations into their investment process and portfolios. Our indexes are designed to support investors that are seeking to align their benchmarks with their investment objectives.

To that end, MSCI categorises its ESG indexes into three main frameworks. The first is a values or screen based index, where we apply business involvement screening. For example, tobacco, controversial weapons, or faith-based screens. The second is impact index, where investors are wishing to invest in companies that align to the Sustainable Development Goals. Lastly and by no means least we have integration. This is where investors are looking to integrate ESG ratings and climate scenario analyses into index design.

It's clear that investor needs don't stay the same over time, and whilst we have these standard frameworks that exist, they can act as the basis for customised solutions for our clients. As a leading index provider, and ESG research and climate scenario analysis provider, it's our job to ensure we have the right data available for both the assessment of those needs and the development of rules-based index solutions for ETFs.

> “MSCI and other data providers play a huge role, in creating more consistency and standardisation

Investor's requirements around net zero is a great example. If we rewind two to three years, investors were beginning to demand increased data solutions in the climate space. MSCI had been looking at ways to further strengthen our climate solutions, and in October 2019 we acquired Carbon Delta, a Swiss based fintech company who specialise in climate risk and scenario analysis. It was from here that we developed MSCI's climate risk centre in Zurich, and that was formerly launched shortly after, the mandate being for continued innovation and expansion of coverage across listed equity, fixed income and into private markets. It's through this forward-looking vision, and the demand we have from our clients, that we're at the forefront of the data demands – and in this case the input from our ESG and climate indexes across the equity and fixed income space.

A recent and good example of this is the launch of BlackRock's iShares MSCI Paris aligned ETFs. This really embodies the very nature of the right data, investor criteria and client demand to deliver a solution.

IAM: How do you ensure the robustness of this data and how do you approach any regulatory impacts on index design?

GUIREY: This is paramount and very important in this regard. MSCI has over $14.5trn in our indexes globally, and it's important that we ensure the robustness, design, calculation and maintenance of our indexes. To that end, MSCI has established a robust governance framework around data gathering, around validation, and around cleansing of data. We have a number of index governance committees and functional groups whose job is to oversee the maintenance and calculation of our index values. This includes a risk and regulatory committee, a benchmark regulation oversight committee, and so on.

From a practical point of view, as example, a member of our business sat on the EU technical expert

> At BlackRock, we expect the growth of sustainable investing to continue for some time

group, providing input through development of the new EU taxonomy. Understanding the implications of the taxonomy and the Sustainable Finance Disclosure Regulations (SFDR), and engaging our clients to better understand their needs and ensure data solutions are in place as and when they need them, is an important aspect of what we do. An example here would be the requirement for reporting around Article 8 or classified Article 9 funds. Additionally, we have a dedicated regulatory affairs team, who have oversight of our responsibilities to market consultations.

Beyond that though, it's more about the role that MSCI can play to help facilitate change. At the recent G20 Summit in Venice, Linda Eling-Lee, MSCI's Head of ESG Research, announced MSCI's involvement in spearheading development of the Net Zero Financial Service Providers Alliance. This new Alliance will galvanise the world's index providers, data providers, credit and rating agencies and accounting firms to lay the track to take investors and companies to a net zero world.

As an example of this commitment, MSCI has recently published the MSCI ACWI IMI Net Zero Tracker on our website. This will enable investors to look at aggregate temperate alignment based on achieving 1.5 degrees Celsius, the level required to be aligned with the Paris agreement by 2050. The Tracker will highlight each quarter, the companies and sectors that have made most progress towards net zero. As it stands today only 10% of companies are on track to achieve net zero, leaving 90% of the investment universe that are not. It means that collectively there's a huge responsibility for us all to engage and find solutions to this problem.

IAM: **Justin, what are your thoughts on the outlook of the ESG ETF market going forward?**

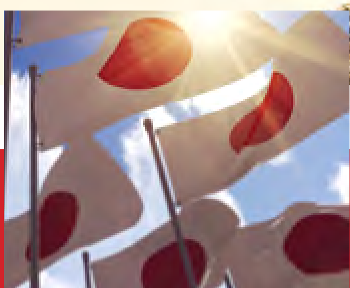
WHEELER: At BlackRock, we expect the growth of sustainable investing to continue for some time. BlackRock has forecasted that global sustainable ETFs and index mutual fund assets will grow sixfold to around $1.2trn over the next decade, so indexing is going to play a major key role as investors look to transition to a more sustainable portfolio. From a product perspective, I think there will continue to be a hard focus on the climate theme and net zero. We have to deliver solutions to the market in partnership with index providers that meet the needs of our investors.

I also expect to see a growing trend to the social pillars of ESG, particularly for those highly regulated sectors such as insurance companies. Data is going to underpin so much of the progress we're able to make, and again index providers and data providers play such a fundamental role here for the industry as a whole. ETFs are simple investment vehicles and would inherent versatility, and I believe they'll support a variety of client needs. Institutional investors face a myriad of challenges today, including a timeline for compliance with various climate and ESG regulations, which vary by country and stakeholder. There is an intensifying spotlight being shone on areas like climate, diversity, and stewardship, and while the momentum behind sustainability is remarkable, it is still the beginning of a long journey. Sustainable investing is certainly not a one size fits all trend and an indexing approach with ETF implementation is proving to be a successful strategy delivering meaningful impact.

In association with

A green world

Insurance Asset Management looks at the key sustainable/impact investment developments over recent months



1 Three Japanese insurance companies have joined the UN-convened Net-Zero Asset Owner Alliance (NZAOA), adding a combined US$1.4trn to total assets under management (AuM) and brings the total membership of the Alliance to 53. Nippon Life, Sumitomo Life, and Meiji Yasuda Life Insurance announced their membership, committing to net-zero portfolios by 2050 and establishing interim targets every five years in line with the Paris Agreement's goal of limiting warming to 1.5°C. The three new Japanese insurance companies joining the Alliance come after Dai-ichi Life Insurance Company joined in March, marking a significant expansion into Japan.

2 MS&AD has joined the Taskforce on Nature-related Financial Disclosures (TNFD). The TNFD aims to support a shift in global financial flows away from nature-negative outcomes and toward nature positive outcomes. "One of MS&AD's priorities in sustainability is to strive to improve the sustainability of natural capital," it said. "We will work to accomplish that through active participation in the Taskforce and contribute to the realisation of a resilient and sustainable society."

3 Generali has committed to investing €3bn in sustainable and green bonds by the end of 2022. The insurer's overall climate protection goal is to make between €8.5bn and €9.5bn of new green and sustainable investments from 2021 to 2025. Speaking at the EU Sustainable Investment Summit 2021, Generali Group CEO Philippe Donnet stressed the importance of public-private partnerships to successfully address climate change, as well as other global risks such as terrorism, cyber and pandemics.

Photo by: HJBC / Shutterstock.com

4 CNP Assurances has acquired its first agroforestry estate in Gers with the expertise of Société Forestière. As a responsible investor and private owner in France with 56,000 hectares of PEFC-certified forests (Programme for the Endorsement of Forest Certification), CNP Assurances has entrusted the sustainable management of its woodland assets to Société Forestière, with several objectives: security, biodiversity and anticipation of climate change.

5 Achmea is investing €4m in the Land Life Company reforestation programme which will offset the CO_2 emissions of its operations. Land Life Company will plant about one million trees for Achmea during the next three years and this will restore about 920 hectares of degraded land in Australia and Iceland. Over the next forty years, these trees will absorb about 200,000 tonnes of CO_2. Biodiversity will also be restored as Land Life Company uses a range of indigenous trees. In addition, the projects offer benefits to local communities. Achmea aims to have fully climate-neutral business operations by 2030.

> “Achmea aims to have fully climate-neutral business operations by 2030

6 Liberty Mutual Insurance has commited to a 50% reduction of Scope 1 and 2 global greenhouse gas (GHG) emissions from 2019 levels by 2030. To reach these goals, Liberty Mutual will continue to decrease its operational carbon footprint by taking actions to increase operational efficiencies and identifying renewable energy opportunities across its real estate portfolio.

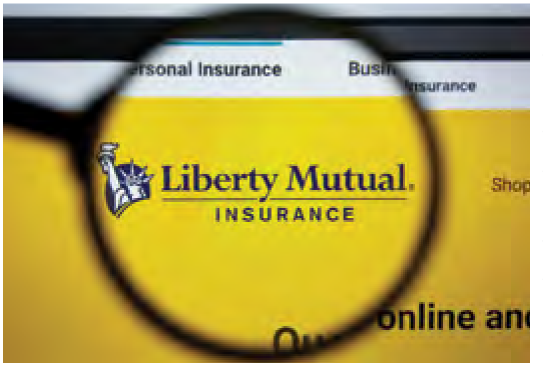
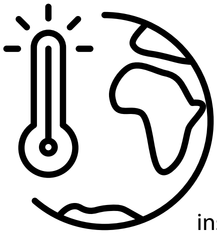


Photo by: Il.studio / Shutterstock.com

7 Baloise Group has successfully placed a CHF senior green bond for a size of CHF 200m in alignment with its newly established Green Bond Framework. The bond matures in 8.75 years and was issued with a coupon of 0.125%. The proceeds from the green bond sale will be used to finance green buildings in line with the newly established Green Bond Framework by Baloise.

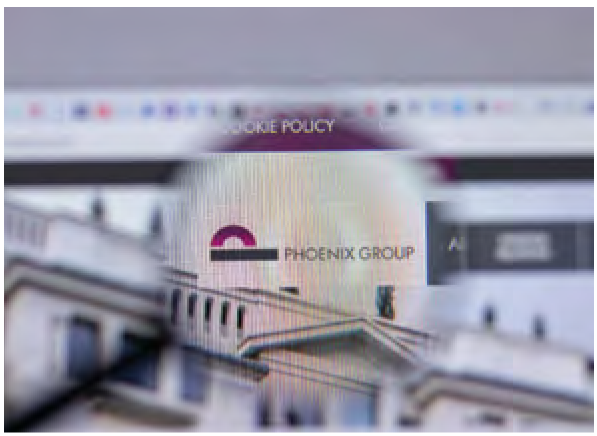


8 The French Insurance Federation (FFA) has reinforced the contribution of the insurance sector to the fight against global warming by launching a twofold initiative. It has announced that it is joining, as Network Supporter, the Principles for Responsible Investment (PRI), a global initiative launched in 2006 by investors in partnership with UNEP FI – the United Nations Environment Programme Finance Initiative – and the UN Global Compact. Secondly, the FFA is also becoming a supporting partner of the Net-Zero Asset Owner Alliance (NZAOA), which was launched under the aegis of the UN in 2019. The NZAOA brings together 48 investors. representing $7trn in assets under management.

9 The Dai-ichi Life Insurance Company has invested around JPY 11bn in green bonds issued by the International Bank for Reconstruction and Development (IBRD). The proceeds raised from these bonds will be used toward projects to reduce greenhouse gas emissions in IBRD member countries, projects with the purpose of developing infrastructure which is highly adaptable to climate change and the like. Through its investment in these bonds, the company will financially support the IBRD's initiatives to back the transition to a low-carbon society.

10 Varma has joined the UN Global Compact, the world's largest corporate sustainability initiative. The Global Compact promotes and develops the environmental, social and economic sustainability of companies and organisations. "In line with the Global Compact, we are continuing our work to promote human rights, environmentally friendly business and anti-corruption, among other things, and we report to the UN annually on our progress in these areas," Varma's communications and sustainability manager Katariina Sillander said.

Photo by: Postmodern Studio / Shutterstock.com



11 Phoenix Group has announced it is setting both 2025 and 2030 carbon intensity reduction targets for its investment portfolio. The insurer confirmed the interim targets are part of a pathway to achieving net-zero carbon for investments by 2050 in line with its science-based targets commitments, and will form a "key element" of its overall approach to responsible investment. Phoenix stated that the new targets will reduce carbon emission intensity by at least 50% by 2030, and will apply to £250bn of investments. The group estimates that once achieved, the impact of the 2030 target its setting will deliver carbon reductions equivalent to the annual emissions of heating over six million homes, or a quarter of all homes in the UK.

PODCAST: Why are government bonds so important when thinking about climate change?

Adam Cadle speaks to Dr Laura Ryan, Head of Research, Ardea Investment Management, about the importance of government bonds and climate change, and how the scope of impact and potential for change couldn't be greater

IAM: Laura, would you be able to provide a background to Ardea Investment Management and more specifically your day-to-day role please?

RYAN: Ardea set up shop in 2008 and we are a pure relative value sovereign bond investor. That means our return profile is driven by mispricing between securities rather than exposure to the level and direction of interest rates like a traditional bond fund would be. This means the strategy is a really good diversifier for bond and equity portfolios.

We have around £13bn in assets under management and I look after the research team which is responsible for building the tools and technology to bring scale and robustness to the trade idea generation process for the portfolio managers. We also publish research on portfolio construction and asset allocation themes which you can find on our website, and a lot of that research ends up in academic journals as well.

IAM: Could you outline the research you've been conducting around climate change?

RYAN: We at Ardea think that climate change and the risks associated with

climate change are not being taken as seriously as they should be by both issuers and a lot of investors as well. If you look at the literature and guiding bodies like the UN Principles for Responsible Investment (PRI), there's really not that much out there when it comes to the risk of climate change for government bond markets. There's plenty of research for equities, corporate bonds, property, and every single other asset class besides sovereign bonds. That's a problem for us because we invest in that market, so we could try and wait for the research to catch up, or we could do it ourselves.

What we've done is partner with the University of Technology in Sydney and we're currently looking at how climate change transition risk impacts government bond yields. In terms of what transition risk measures, it really measures the risk exposure that you have in terms of not being able to transition away from relying on fossil fuels to renewables.

The first risk factor we looked at was an obvious one, carbon emissions, the second factor we looked at was renewables, and then the third was natural resource rents. Natural resource rents measures the difference between the cost of digging resources up out of the ground and then how much you can sell those resources for. Those three variables give you a pretty good indication of how difficult it would be for an economy to move away from reliance on emissions and fossil fuels, and selling non-renewable resources to a net-zero emissions economy.

In terms of what we found, and this was contrary to what we were expecting, those risk factors actually are being priced into sovereign bond markets. That was something that's really important for us and something that we're going to discuss with issuers. The reason for that is because a lot of issuers globally have made statements along the lines that there is no need for them to have to disclose climate risks, because they're not being priced into markets. Obviously this research directly challenges that, so we really

want to see issuers step up and start disclosing those risks because we think they're doing a disservice to the market and to investors around the globe if they're not talking about risks appropriately.

IAM: **You mentioned government bonds quite a bit there, why is this market so important when thinking about climate change?**

RYAN: The government bond market is important for almost everything. It's where the price of your mortgage is set, it's where the government borrows money for fiscal stimulus packages, it's where people park their money if the equity market is not going so well, and it's where insurance companies must invest for regulatory requirement purposes as well.

Now we know that climate change is going to have an increasingly negative impact on economies, through bushfires, floods and other environmental disasters. Those types of disasters have direct impacts on GDP, which is one of the most important variables for driving yields, so it is a no-brainer that climate change is going to start impacting government bond markets. Most investors are probably not thinking about it to that extent since so many conversations have been about other asset classes but not the government bond market, which I think is a huge oversight.

IAM: **Turning our attention to the actual strategies involved, why are your strategies so appealing to insurers in the current economic climate?**

RYAN: I'll explain our strategy by giving you a trade example. We are a pure relative value manager. What that means is we seek out exposure to securities that are very closely related to each other, but are priced differently because of different demand and supply laws. The example that I'll give is a bread and butter trade that we put on frequently, which is a 10-year government bond and 10-year interest rate futures contract trade.

Now those two securities should in theory be priced the same, but they're not because we have very large institutions that have very different demand levels for them. For example, insurance companies prefer to invest in government bonds, often for regulatory purposes, and then we have hedge funds which often prefer to invest in interest rate futures contract because they're a lot more liquid and they also take up less space on their balance sheet.

What we've observed over time is that a 10-year government bond will trade cheaply to that 10-year interest rate futures contract. If we want to capture that mispricing, the trade that we could do is to buy that 10-year government bond and then sell the 10-year interest rate futures contract against that bond. What we've done is isolated that mispricing and stripped out any of the market risk. That means that our return profile isn't exposed to duration, to credit, to the equity market, and most of the regulatory capital charges are really about capturing your exposure to those types of risks. So by default, our strategy has a very low regulatory capital charge and it remains low in pretty much any market environment.

IAM: Thank you very much for the fantastic insight into Ardea's work around climate change and the government bond markets.

In association with

ARDEA Investment Management

In the spotlight: NFU Mutual

Adam Cadle sits down with NFU Mutual Investment Strategist Adam Sandford to talk about portfolio strategies, ESG and relaxation outside of work

WRITTEN BY **ADAM CADLE**

Q Could you provide an overview of NFU Mutual and your day-to-day role?
NFU Mutual is a UK general and life insurer owned by our 900,000+ members, underwriting over £1.5bn of annual premium. We were established way back in 1910 by a group of seven farmers and have grown to become a well-established, customer centric insurer. Whilst our nationwide member base has become fairly broad, we remain mindful and supportive of our rural and farming heritage. Our head office is based in the beautiful surrounds of Stratford Upon Avon with a customer facing extended agency network of over 300 local offices.

In terms of the investment function, we are split between an investment management team who manage asset classes allocated internally, and an investment office, which oversees external investment manager selection and monitoring as well as investment strategy. The total assets under management is c£20bn.

My role is specifically focused on the long-term strategic asset allocation of funds backing our general insurance and life insurance liabilities as well as strategic asset allocation for our multi asset retail offering. The teams remit also covers any additional asset classes we may consider adding to our multi asset portfolios to enhance risk adjusted returns. A large part of the role is therefore ensuring our capital market assumptions and other model inputs remain aligned to what is happening in the market, consistent with our long-term views and that any asset allocation activity we are taking is appropriate for our customers.

Q How has the firm adapted to COVID-19 in terms of its investment thinking and direction?
Our continued response to the COVID-19 pandemic has first and foremost been to ensure the safety of our staff and ensure we continue to give our members excellent service. Our goal across investments has always remained consistent, to provide good long-term risk adjusted returns for our members whilst ensuring we maintain an asset mix which reflects the individual portfolio risk appetite.

The volatility in asset prices in the immediate aftermath of the March 2020 lockdown and the subsequent market rally provided opportunities to tilt portfolios to take advantage of short-term dislocations, however our general long-term thesis in terms of areas of the market where we see value hasn't fundamentally changed. We still see the opportunity in long term allocations to undervalued equity regions, mainly UK equity and certain geographies within emerging markets, following COVID-19 we have seen some valuations diverge even further and we still believe a long term opportunity exists.

NFU Mutual found that, generally, the controls that were in place prior to COVID-19 to manage the overall liquidity of portfolios worked well, and we did carry out some strategic rebalancing/ repositioning at certain

points across 2020.

Like most asset allocators the above target inflation prints, flowing from the number of supply bottlenecks as well as the heightened demand following economic reopening, has made us reassess the resilience of our portfolios if inflation does become more persistent than expected and run some additional scenario tests.

Q What has been your biggest achievement in your role?

Since only having joined NFU Mutual at the beginning of April 2021 I have not had long to rack up a long list of achievements so far. I would say that a notable achievement has been assimilating into the NFU Mutual culture and leading a team remotely. I have seen a lot of mentions within my professional network on the successes of a sudden move to remote working following COVID-19, and in this same vein I have been seriously impressed by the ease at starting with NFU Mutual almost completely online. Firstly, the ability to access the right materials from an IT perspective on my first day, and secondly, to hit the ground running in terms of establishing the teams strategic priorities for the next 12 months alongside delivering on the work that is already in train. A lot of praise for this needs to go to my team as well as the wider internal investment management function. Having a team with a wealth of experience of the organisation and of the UK investment market has made a remote transition fairly seamless.

Q What do you see as being the biggest challenges for UK insurers going ahead?

Without a doubt I would say the low yield environment presents the most significant challenge for the investment strategy of any insurer. Low rates have a two-fold effect. The first is a reduction in discount rates on the liability side and the second is lower expected future returns for fixed income on the asset side. In fact at the current time we would foresee a number of years of negative real returns on investment grade bonds. The further outworking of low rates and supportive fiscal policy has been very strong equity performance, which has benefitted our investment strategy in the past, but has also reduced the opportunity set for supernormal returns going forward. Looking ahead, insurers, and asset managers more generally, are facing a market where most asset classes are looking expensive versus history. Finding asset classes that would benefit if interest rates begin to rise, aside from corners of the equity market (banks, insurers and some industrials), requires

> **Looking ahead, insurers and asset managers more generally, are facing a market where most asset classes are looking expensive versus history**

> **Currently we are significant investors in UK real estate and have ambitions to grow the suite of real assets we invest in**

in depth analysis and potentially looking at assets that have not been allocated to in the past. The traditional stock/bond portfolio may not provide the same level of downside diversification as in the past, and bonds are likely to detract from real returns in the majority of economic scenarios. Our focus, similar to many of our peers, is on alternative diversifiers to traditional bond portfolios, mainly in the real assets space as we see this as an area of long-term opportunity for additional portfolio resilience.

Q Could you explain your focus on ESG?

As a company we are very aware that non-financial considerations around ESG can have a material impact upon investment performance. We therefore believe that incorporating ESG considerations can be a powerful tool for change. Our embedded approach by our internal investment management team is based on engaging with companies rather than outright exclusions. As a major provider of capital we believe that we have the opportunity to influence the direction of companies. This includes encouraging companies to move towards more sustainable practices such as their climate impact.
Given the importance of communication with our members we are committed to being open and transparent through improved reporting around ESG considerations. We now publish our full voting history including where we have voted against management. Going forward we aim to provide additional commentary where we have influenced culture within a company or made an active decision to divest from a company.

Q What are your main aims over the coming years for NFU Mutual and yourself?

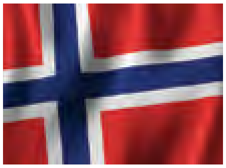
Our main focus over the next few years is to continue the good progress we have made at the Mutual in expanding our investment portfolios. Historically, as is the case for a number of UK based insurers, our investment approach was strongly UK focused. Whilst we do not plan to completely unwind this bias, as we are committed to investing in UK companies and the UK economy, where we think it makes sense we take a more global view in our approach to reduce UK specific idiosyncratic risk.
One of the key areas of focus for the next couple of years, as mentioned earlier, is to expand our real assets portfolio. Currently we are significant investors in UK real estate and have ambitions to grow the suite of real assets we invest in. We believe that now is the opportune time to expand our real assets holding and align our core philosophy of good through the cycle outcomes for members with the Governments call to institutional investors to invest in the green energy transition as part of the UK's Levelling Up initiative.

Q Away from the day-to-day role what do you do to relax?

Like a lot of people the inability over the past 18 months to travel and unwind in the "normal" ways we used to has made me more appreciative of just being able to get outdoors and explore the local scenery. My family recently relocated to Worcester and I've got back into doing a bit of running. It's a great place to run with a lot of countryside and a river navigating its way past the town centre. I've even managed to convince one of my children, who's only six, to join me for the local Parkrun each Saturday over the last few months.

Around the world

Insurance Asset Management looks at the latest developments around the globe



Norway's life insurance companies have seen their solvency capital adequacy fall to 235% as of 30 June 2021, a decrease of four percentage points from 31 March 2021 and nine percentage points from 31 December 2020, latest figures published by Finanstilsynet, the Financial Supervisory Authority of Norway, have revealed. The reduction in the solvency capital adequacy is related to the fact that total solvency capital requirements have had a higher percentage increase than the solvency capital (equity).

"Norway's life insurance companies have seen their solvency capital adequacy fall to 235%

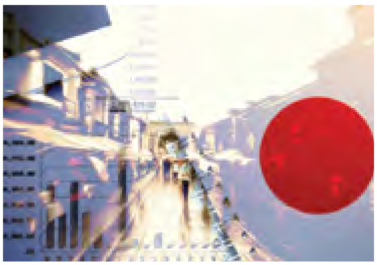
Photo by: HJBC / Shutterstock.com

CNP Assurances has successfully placed €500m worth of notes due 12 October 2053 and paying interest at 1.875% until 12 October 2033. The notes qualify as Tier 2 capital under Solvency II, and were placed with over 55 investors, 51% of whom were asset managers and 45% insurers and pension funds, mainly based in France, Germany/Austria and the UK/Ireland. The issue was oversubscribed by 1.8x with a total order book of €0.9bn, reflecting confidence in the financial strength of CNP Assurances.

Photo by: Konektus Photo / Shutterstock.com

MetLife has entered into a share purchase agreement with IGE (India) Private Limited (IGE) and Elpro International Limited (BSE: 504000; Elpro) to acquire their total combined shareholding of 15.27% in PNB MetLife India Insurance Company Limited (PNB MetLife). The Dabriwala family, through their companies, IGE and Elpro, is one of the initial investors in PNB MetLife, a leading life insurance franchise in India with access to more than 200 million customers across 15,000 sales locations nationwide. Upon completion of the transaction, MetLife's stake in PNB MetLife will increase to 47.325%.

Italian non-life insurers have reported strong underwriting profitability for the first half of 2021, Fitch Ratings has stated. However, the credit rating agency highlighted that profitability had deteriorated slightly compared to H1 2020, which had significantly benefitted from the pandemic-related fall in claims frequency. Fitch said it expects the combined ratio for the end of 2021 to remain strong.



The life insurance industry in Japan is projected to grow from JPY28.7trn (US$269.2bn) in 2020 to JPY30.7trn (US$323.6bn) in 2025, in terms of direct written premium (DWP), according to GlobalData. Japan's life insurance forecast has been revised in the aftermath of the COVID-19 outbreak. As per the latest data, Japan's life insurance industry is projected to grow at a compound annual growth rate (CAGR) of 1.4% over 2020-2025, supported by gradual economic recovery.

> "The issuance of JICA bonds is one of the specific measures for the Japanese government to achieve the SDGs

Prudential has announced a share offer to raise up to 5% of its issued share capital, or approximately 130.8 million shares, on the Hong Kong Stock Exchange (HKSE) through a concurrent Hong Kong public offer and international placing. The Public Offer, which consists of up to approximately 6.5 million new shares initially to be issued in Hong Kong, is only available to Hong Kong residents, and includes a preferential offer to eligible employees and agents of up to approximately 1.3 million shares.

Photo by: Konektus Photo / Shutterstock.com

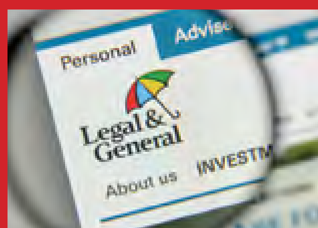
Sumitomo Life Insurance Company has invested JPY 10bn in a gender bond issued by Japan International Cooperation Agency (JICA). The gender bond finances projects that aim to promote gender equality and empowerment of women in developing countries. JICA is an organisation that is in charge of administering Japan's Official Development Assistance (ODA) and supports socioeconomic development in developing countries. The issuance of JICA bonds is one of the specific measures for the Japanese government to achieve the Sustainable Development Goals (SDGs).

Germany is set to experience the highest level of passive ETF growth in Europe, due to institutional investors' continued use of index funds and new regulation. According to research published by Cerulli, France is expected to see the second-highest level of passive ETF growth. "In Europe, index funds are used predominantly by institutional investors, which are expected to remain the biggest users of such products over the next two years," Fabrizio Zumbo, associate director at Cerulli Associates, said. "Many index fund providers are confident that retail clients' adoption of index funds will increase gradually, but we believe providers should plan to allocate more resources to financial education and marketing campaigns."

Photo by: Judith Linine / Shutterstock.com

Zurich intends to exercise its option to redeem CHF 200m of subordinated debt. The CHF 200m 2.75% Fixed Rate Capital Notes issued by Zurich in 2014, are expected to be redeemed on 30 September 2021 at par plus accrued interest. Recently, Zurich announced the successful placement of CHF 200m of senior unsecured notes.

> " UNIQA made gains from selling shares and fixed income securities



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Legal & General has set out plans to combine its retail retirement and insurance businesses in 2022. The group has five divisions: LGIM, L&G Capital (LGC), L&G Institutional Retirement (LGRI), L&G Retail Retirement (LGRR), and L&G Insurance (LGI). L&G said: "As both businesses serve retail clients, having a single interface for retail clients, whether with insurance or pension savings products, will enable us to better satisfy our customers' and distribution partners' service expectations, which have grown since the pandemic, and to work better and more seamlessly for and with them."

Beazley has received approval from Lloyd's to establish an ESG-focused Syndicate 4321. Once fully approved the syndicate will focus exclusively on offering additional capacity to businesses that perform well against ESG metrics. Syndicate 4321, which has been established under the Lloyd's Syndicate In A Box (SIAB) framework, will operate a consortium arrangement led by Syndicates 623/2623. Eligible clients that can meet the standards of the ESG rating scoring criteria will be able to access additional capacity from Syndicate 4321.

UNIQA's investment income increased by 42.8% to €307.2m in H1 2021 (January to June 2020: €215.1m). While write-downs on shares and fixed income securities pulled down investment income in H1 2020, in H1 2021 UNIQA made gains from selling shares and fixed income securities worth around €69m in a strong capital market environment. Investment income was impacted by currency effects of approximately €5m.

Current ponderings on industry themes

On global investors being bullish on Asian fixed income

BOON PENG
Head of investment strategies, Eastspring Investments

With Asia expected to remain the world's growth engine, demand for Asian bonds will continue to be fuelled by Asia's structural needs to finance and support infrastructure gaps, demographic shifts, and sustainable growth. The Asian credit market has offered investors relatively better risk adjusted returns compared to developed market bonds. Going forward, we believe that the growing size, maturity and diversity of the Asian fixed income market will continue to offer new and compelling investment opportunities, especially as the region recovers post the COVID-19 pandemic.

On tobacco divestment being complementary to achieving net-zero

DR BRONWYN KING
Tobacco Free Portfolios director

Many people are finding it really helpful to look at tobacco through the lens of net-zero and how their financial institution can work its way to net-zero. In our view they are very complementary… and while net-zero will take a very long time for organisations to get their heads around - it will take a lot of resources and ongoing refinement over a long time, one really great thing about tobacco-free is that it is one decision that you can make today. It is relatively straight forward and it's a really meaningful commitment and really meaningful symbol of a financial institution's commitment to net-zero.

On capital frameworks not being used to address climate change causes

Capital requirements seem unlikely to be the most effective tool in reducing carbon-intensive activities unless calibrated at more extreme levels. This reflects the fact that capital requirements are only one of many components driving decisions by financial firms. They face other drivers of costs and opportunities, which is why the PRA has focused its efforts on ensuring firms adopt a strategic approach to managing climate-related financial risks. Other more direct public policy interventions, for instance emissions regulations or carbon pricing, would offer better incentives for action across the wider economy.

THE PRUDENTIAL REGULATION AUTHORITY

On the classification of sustainable investment products and new sustainability disclosure requirements for asset managers

THE FINANCIAL CONDUCT AUTHORITY

Without common standards, clear terminology and accessible product classification and labelling, there is also a risk that consumers find it difficult to navigate the landscape of products and assess product suitability. We want consumers to have enough information to assess which products meet their needs and hold firms to account for their sustainability claims. We aim to build trust in the market, improve transparency for consumers and better meet the information needs of institutional investors and other stakeholders.

On the effects of an extreme scenario for life insurers

A stress scenario of a large and sudden increase in bond yields and corporate spreads could induce mark-to-market losses of 30% for insurers in some jurisdictions. This could lead to the emergence of policy surrenders, forcing life insurers to liquidate investments, which, in the extreme, could reach $1trn in the United States and Europe.

THE INTERNATIONAL MONETARY FUND

Varma solvency capital rises 'higher than ever'

REIMA RYTSÖLÄ
Varma executive vice president responsible for investments

Although the rise in the listed stock market leveled off, the strong earnings trend of our investments continued in the third quarter. All asset classes brought steady returns, and private equity returns exceptionally well. The lifting of interest rate restrictions globally supports economic growth. On the other hand, production bottlenecks and rising energy prices are slowing growth globally. Inflation is accelerating and the market is monitoring whether this is a temporary phenomenon and how central banks are adjusting their monetary policy in an environment of rising prices.

On the FCA pushing forward with LTAF investment proposals

NIKHIL RATHI
FCA chief executive

We are supporting fresh collaborative thinking designed to improve the effectiveness of UK markets while protecting standards. If this innovative fund structure, created by our rules, is taken up by the asset management industry, it may provide alternative routes to returns for investors, while supporting economic growth and the transition to a low carbon economy.

On the need for a ‘significant’ and ‘permanent’ reduction in SII capital requirements

Significant and permanent capital reduction would allow our industry to regain international competitiveness. This capital reduction can be achieved while maintaining very high levels of protection for European policyholders.

OLAV JONES
Insurance Europe deputy director general

On just 3 global insurers having policies to stop insurance for new oil/gas projects

PETER BOSSHARD
Insure Our Future campaign global coordinator

The insurance industry is abandoning climate leadership by continuing to underwrite new oil and gas projects. The scientific consensus is clear: we cannot avoid a climate catastrophe if we expand fossil fuel production. Insurance companies need to follow the science and stop insuring all new coal, oil and gas projects if they want to regain their credibility as climate leaders.

On Rothesay launching long-dated fixed mortgages

As the UK’s largest specialist pensions insurer, we are always looking for innovative ways to invest in long-term, secured and high-quality assets. Through these new products, we’re delighted to support increased home ownership in the UK, helping the government’s ambition to bring mortgages to the market which offer long-term certainty for the future.

ROTHESAY LIFE