Insurance Asset Management

Winter 2018

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The importance of the credit cycle in the shaping of investment strategies

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The effects of natural catastrophes on insurers' balance sheets

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Editorial Comment

It's all very well to talk a good game, but how are insurers' incorporating sustainable investing strategies in their businesses, when let's be honest the world's environment is being affected by the actions of human beings

Following the success of the first print edition of *Insurance Asset Management* in June this year, I am delighted to be providing you with our November edition, packed full of new exclusive comment, news and features, keeping up to date with the current trends within the global insurance sector.

This issue covers a wide range of investment themes including the word on the tip of everybody's tongues at the moment – cryptocurrency. Whether you are an advocate for the usage of this asset class within an insurance portfolio or not, we look at the pros and cons of this investment option and whether it will grow in popularity over the coming years.

In addition, we look at the rise of US municipal bonds for the insurance sector, particularly as a way of investing in America's modern infrastructure, whilst incurring low capital charges at the same time.

This edition also provides a review of our two roundtables on the issue of ETFs and the private debt market – plenty to keep you thinking about what your next move might be in the structuring of your investment portfolio(s).

The issue of sustainable investing within the insurance sector is something that I wanted to really home in on in this issue though. My inbox is full of ESG and responsible investing coverage arriving on a daily basis, far more so than a year ago. So much so that our daily newsletters could be solely on this one issue! Just how far into the ESG and sustainable investing project are insurers, compared to other institutional investors? This is indeed what our cover feature analyses. It's all very well to talk a good game, but how are insurers incorporating sustainable investing strategies in their businesses, when let's be honest the world's environment is being affected by the actions of the human being?

As we continue to deal with natural catastrophes across the world, this month *Insurance Asset Management* looks at the impact of these on insurers' balance sheets, stress test reporting and the strategies in place to combat a dent on performance.

On a final note, the Insurance Asset Management Awards 2019 are being held on the 29 November, and I look forward to seeing a number of you there, to recognise outstanding achievement in the UK and global insurance spaces.

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Winter 2018





RISK

News focus

Total European direct gross written insurance premiums rise by 4.7%; global insurance M&A up €37bn

Life premiums grow 5% to €710bn, P&C 4.4% to €371bn and health 3.9% to €132bn

Written by **Adam Cadle**

Total European direct gross written insurance premiums totalled €1,213bn in 2017, a rise of 4.7% on 2016, with life premiums growing 5% to €710bn, P&C 4.4% to €371bn and health 3.9% to €132bn, according to latest figures published by Insurance Europe.

Of the total GWP, €710bn were life premiums, €371bn were P&C premiums and €132bn were health premiums.

In 2017, insurance penetration increased by 0.14 of a percentage point to 7.53% and ranged from 0.9% in Latvia to 12.2% in the UK.

An average of €2,030 per capita was spent on insurance in Europe in 2017, compared to €1,947 in 2016. Of the per capita spent in 2017, €1,189 was on life insurance, €621 on P&C and €221 on health.

European insurers paid out €1,022bn in claims and benefits to insureds in 2017, an 8.6% increase on 2016. Life insurers paid out €668bn — an 11.4% increase — in benefits to insureds, providing them with capital and/or annuities. P&C claims paid increased by 3.5% to €248bn and health claims paid increased by 3.4% to €106bn.

In 2017, the European insurance industry had more than €10trn invested in bonds, company shares and other assets on behalf of millions of life and non-life insurance customers. This was an increase of 2% on 2016.

France, Germany, the UK and Italy jointly account for 80% of all European insurers' investments. Life insurers' investment holdings account for more than 75% of the total and increased by 2.2% in 2017 to €7,453bn. The investment portfolio of non-life insurers grew 1.9% to almost €1,600bn.

In 2016, the latest year for which a breakdown is available, the total portfolio was made up of 3.7% in loans and mortgages and 25.4% in index-linked and unit-linked funds. The remaining 71% was in other investments, of which 64% was in bonds.

On the issue of risk, the risk exposure of the European Union insurance sector remains stable overall, with macro risks continuing at a medium level amid continued economic recovery and less expansionary monetary policy, according to EIOPA's latest Risk Dashboard.

However, "a potential future deterioration in the assessment due to political and international trade tensions cannot be excluded", the body added.

Bond market volatility declined since June and overall Credit Default Swap (CDS) spreads remained broadly stable at low levels despite adverse developments in foreign bond markets in some countries. Liquidity and funding risks increased due to a higher average coupon-to-maturity ratio of a limited number of bond issuances.

Profitability has been overall stable and Solvency Capital Requirement (SCR) ratios are above 100 per cent for most insurers. Market perceptions were mixed with insurance stocks outperforming the market, but at the same time concerns increased as regards the market mispricing of risks.

The Risk Dashboard data is based on financial stability and prudential reporting collected from 98 insurance groups and 2,904 solo insurance undertakings.

On the merger and acquistion side of the insurance market, deal value for global insurance M&A was up €37bn in the first six months of 2018, driven by a slew of megadeals which pushed value to its highest first-half total since the financial crisis.

Research from Towers Watson and Mergermarket said the first half of the year saw 14 deals worth over €500m taking place in this sector; although total deal volume was down to just 84 deals, the lowest number since 2009.

Key deal drivers behind this surge in value relate to the changing nature of business models. As regulatory pressures become the norm, new models are emerging and more businesses are seeking to return to their core strategy.

Describing the impact of Solvency II implementation, Willis Towers Watson senior director Fergal O'Shea said: "As the processes, reporting and monitoring have become increasingly business-as-usual, executives have taken back their 'bandwidth' and got on with the job of strategically guiding their companies."

"A growing trend for companies wishing to take this approach has seen them divesting unwanted parts of their business, meaning that valuable assets are once again on the market."

As the processes, reporting and monitoring have become increasingly business-as-usual, executives have taken back their 'bandwidth' and got on with the job of strategically guiding their companies

News in brief

- Moody's Analytics and PwC have teamed up to offer end-to-end actuarial, accounting and business expertise solutions to help insurers align with IFRS 17. Moody's Analytics will provide solutions that process IFRS 17 calculations and address the data governance and accounting challenges introduced with IFRS 17. PwC will offer actuarial and accounting advisory services as well as business, functional, and technical implementation consulting.

- DWS Group and Generali Group have agreed to expand their existing cooperation on unit-linked products. The two groups will further strengthen their relationship globally, making DWS one of the insurance group's selected asset managers eligible for being selected by Generali's subsidiaries in key European markets.

- Talanx Group has set itself an ambitious target for 2019, increasing its return on equity (RoE) target from 750 basis points to at least 800 basis points, while also raising its earnings per share by an average of at least 5% per year by 2022.

- AXA has signed an agreement with Canadian firm Fairfax Financial to divest its entire insurance business in Ukraine. It will mark the exit of AXA from the Ukrainian market.

- The Standard Club is withdrawing from underwriting at Lloyd's from 2019. In 2015, the club established a syndicate to underwrite marine and energy risks, representing one strand of the club's strategy to provide its members with a wider range of insurance covers.

SII clarity should come before harmonisation of IGS, body argues

Any further work at European level urged to be 'outcome-orientated'

Written by **Oliver Wade**

The effects of the European Union's (EU) 2016 Solvency II regulatory regime for insurers on policyholder protection needs to be better understood before considering any harmonisation of insurance guarantee schemes (IGS) at EU level, Insurance Europe has argued.

In its response to a discussion paper from EIOPA on resolution funding and national IGS, Insurance Europe argued that rather than considering new rules for IGS, the existing tools and powers provided by Solvency II should be "used to the their fullest extent and be properly enforced".

However, the federation acknowledged that "adequate protection of policyholders is at the core of Solvency II", it noted that its discussion paper lacked any assessment of how the risks of insurers are affected by Solvency II, and how this, in turn, might affect existing national IGS.

Insurance Europe highlighted that EIOPA's paper refers to insurance failures and near misses that occurred before the Solvency II regime and, therefore, deeming them irrelevant.

If minimum harmonisation in the field of IGS is to be pursued at EU level, Insurance Europe suggested that national authorities should be allowed significant flexibility to choose features most suitable for their market.

> The functioning and funding of IGS should be left to the discretion of member states. This is to reflect the substantial differences between the social welfare systems, winding-up processes for insurers and insurance product lines in member states

"To satisfy the EU's principles of proportionality and subsidiarity, the functioning and funding of IGS should be left to the discretion of member states. This is to reflect the substantial differences between the social welfare systems, winding-up processes for insurers and insurance product lines in member states," Insurance Europe said in its response.

The federation concluded that any further work at European level should be "outcome-orientated", rather than seeking to harmonise the organisation or funding of IGS.

Regulatory talks have also occurred around the issue of IFRS 17. At a meeting in October, the International Standards Board (IASB) agreed that changes to the accountancy standard, would be "narrow in scope", with a number of members arguing against compromising core principles of the standard. The board also debated alternatives to postponing the implementation date, such as removing the requirement for comparatives, and differentiating between listed and unlisted companies.

However, both options prove disadvantageous to insurers, with them facing uncertainty around investment, and whether to accelerate or delay their timetables.

Commenting, Willis Towers Watson senior director Roger Gascoigne said: "Having spent 20 years preparing the standard, as ultimately issued, there is evidently no appetite for knee-jerk reactions.

"The Board is clearly alert to the consequential impacts, particularly on insurers who have already invested significant amounts on implementation." At the meeting, it was concluded that changes should not result in less useful information for investors, disrupt existing planning processes, or risk undue delays to the 2021 implementation date.

Willis Towers Watson stated that insurers should assume that the 2021 date remains, but also added that a delay would allow firms to adopt a value-add approach, rather than struggling to achieve minimum compliance.

"One practical short-term step may be to revisit the project plans, considering what key aspects would change if the date were delayed by a year or two," added Willis Towers Watson senior director Kamran Foroughi. "This would reduce project risks, enable more contingency time, and enable more testing of processes and systems."

Global reinsurance industry expected to consolidate

Distinction between insurers and reinsurers becoming increasingly blurred

Written by **Oliver Wade**

An executive of the Swiss Re group has said that it expects the global reinsurance industry to consolidate, as the distinction between insurers and reinsurers becomes increasingly blurred.

Swiss Re market executive for Northern, Central and Eastern Europe Frank Reichelt spoke at an industry conference in Baden-Baden, Germany and said: "We are at the beginning of a wave of consolidation."

Reichelt added that, as insurers expand in the reinsurance business, reinsurers have started underwriting more classical insurance business to retain access to certain markets.

He added that a series of deals, such as AXA's acquisition of reinsurer XL Group, have accelerated the trend of blurring lines between insurers and reinsurers, which offer to share risks insurers take on in return for a portion of the premiums customers pay.

The reinsurance industry is ailing under overcapacities as new entrants such as hedge funds have started to underwrite reinsurance business, weighing on margins.

Reichelt stated the reinsurance industry currently "does not earn its cost of capital".

The "reinsurer of the future" will need to embrace third-party capital and the insurance-linked securities (ILS) space, according to Everest Re executive vice president (EVP) and international department head Ron Diaz.

> They are here to stay, they aren't going anywhere and last year kind of proved that

"They are here to stay, they aren't going anywhere and last year kind of proved that," he said.

FCA launches general insurance market study

Regulator sets out issues to focus on around how GI firms charge customers

Written by **Adam Cadle**

The Financial Conduct Authority (FCA) has today set out the issues it will focus on as part of a market study into how general insurance (GI) firms charge their customers for home and motor insurance.

As part of the FCA's 2018/2019 Business Plan, it said it would conclude a piece of supervisory work on insurance pricing practices, the results of which it published in October. The FCA has decided that a package of measures is necessary following this initial work. These include addressing conduct by firms; a market study on general insurance pricing practices and a wider discussion paper on fairness of pricing in financial services.

GI plays a key part in the UK economy, generating over £78bn in premiums for UK insurers.

FCA chief executive Andrew Bailey commented: "Our initial work has identified a number of areas of potential consumer harm. We want to make sure that general insurance markets deliver competitive and fair prices for all consumers. This market study will help us examine the outcomes from general insurance pricing practices and inform how, if necessary, we should intervene to improve the market."

Insurance industry leads way with fossil fuel divestment

A total of $3trn worth of coal, oil and gas investments being sold off

Written by **Adam Cadle**

The funds committed to fossil fuel divestment now total more than $6trn (£4.6trn), with nearly 1,000 institutional investors pledging to leave the asset class alone, according to a new report from Arabella Advisors.

The insurance industry is currently leading the way, with $3trn worth of coal, oil and gas investments being sold-off. However, Ireland has also pledged to divest, marking it as the first nation to do so, along with major cities such as New York and key medical organisations. Furthermore, major oil companies such as Shell have labelled divestment as a material risk to its business.

Fossil fuel divestment began in 2011 on university campuses. However, it has now spanned across 37 nations around the world, and supporters of divestment have said "existing fossil fuel resources are already far greater than can be burned without causing catastrophic climate change", so exploring for and producing more fossil fuels is morally wrong.

Despite this, some investors have argued that remaining as shareholders and persuading fossil fuel companies to change can be more effective, but a further report has found that this method has not delivered any significant change.

The report has estimated that investors with $6.2trn in assets under management have committed to divest from fossil fuels, a significant increase on the $5.2trn in the previous report in 2016.

> It could have a material adverse effect on the price of our securities and our ability to access equity capital markets

The Arabella Advisors report highlighted that the American Medical Association (AMA) and the UK's Royal College of General Practitioners had both divested from fossil fuels.

Furthermore, divestment appeared to be concerning for oil and gas companies, particularly Shell, which stated in its latest annual report that: "It could have a material adverse effect on the price of our securities and our ability to access equity capital markets."

The PRA has recently published a consultation paper on a draft supervisory statement (SS) relevant to all UK insurers setting out expectations regarding firms' approaches to managing the financial risks from climate change.

The expectations centre on how managing the far-reaching and foreseeable risks from climate change requires a strategic approach which considers how actions today affect future financial risks. Areas include governance, risk management, scenario analysis and disclosure.

The PRA will embed these expectations into its existing supervisory framework and expects firms' responses to be proportionate to the nature, scale and complexity of their respective businesses.

The consultation period ends on 15 January 2019.

Aegon Nederland has decided to sell its interests amounting to €7m in palm oil after 15 years, stating that the sector "is unable to implement improvements, keep to existing rules and bring in sanctions". The sector is regularly linked to land grabbing, deforestation and human rights violations as well as climate change, and are the reasons for the insurance company's decision to pull out.

European Insurance and Occupational Pensions Authority

EIOPA to assess illiquidity characteristics of insurance liabilities

Body asks stakeholders for feedback around investigation

Written by **Oliver Wade**

EIOPA is asking stakeholders for feedback on the envisaged approaches to assess the illiquidity characteristics of insurance liabilities, the actual holding periods of assets of insurers as well as the risks of holding assets over a longer term.

Launched in October, the Request for Feedback on illiquid liabilities and running until Friday 7 December, will contribute to EIOPA's further assessment whether the risks connected to illiquid liabilities and the assets covering long-term liabilities are adequately reflected in the current regulatory regime.

A dedicated EIOPA Project Group on illiquid liabilities had previously been set up.

"The illiquidity characteristics of liabilities may contribute to the ability of insurers to mitigate short-term volatility by holding assets throughout the duration of the commitments, even in times of market stress," EIOPA stated.

EIOPA has reinforced cooperation in the supervision of cross-border insurance distribution by publishing a Decision on the cooperation of national competent authorities (NCAs), replacing the former Luxembourg Protocol.

The Decision with regard to the supervision of cross-border insurance distribution activities of insurance undertakings and insurance intermediaries replaces the former Luxembourg Protocol which has to be substantially revised as a result of the new regulatory framework for insurance distribution activities under the Insurance Distribution Directive (IDD) and the recent supervisory experience with cross-border insurance distribution activities.

The Decision aims to strengthen cooperation between NCAs and to enhance the exchange of all relevant information.

The illiquidity characteristics of liabilities may contribute to the ability of insurers to mitigate short-term volatility

Concerns raised around plans for EU and US insurance deal

RAB writes to NAIC over draft implementation structure for bilateral reinsurance agreement

Written by **Oliver Wade**

Insurance Europe's Reinsurance Advisory Board (RAB) has written to the US National Association of Insurance Commissioners (NAIC) expressing concerns about NAIC's draft implementation plans for the bilateral agreement on reinsurance prudential measures that the EU and US concluded in 2017.

The agreement eliminates the requirement to post collateral placed on EU reinsurers writing business in the US.

However, the RAB has argued that the current draft NAIC proposals do not appropriately reflect the bilateral agreement. The board said it predicts a more limited scope of application of zero collateral than in the agreement and provides US state supervisors with a "significant amount of discretion" in areas that were stipulated in the agreement, such as all EU member states receiving all agreed benefits.

Significant improvements are still required for ICS - Insurance Europe

Body says Version 2.0 needs to properly reflect business models and identify/measure risks

Written by **Adam Cadle**

Significant improvements are still required for the global Insurance Capital Standard (ICS) version 2.0 to properly reflect insurers' business models, and for it to correctly identify and measure the risks that insurers face.

In its response to an International Association of Insurance Supervisors (IAIS) consultation on the development of the ICS 2.0, Insurance Europe welcomed several improvements made to the ICS since the beginning of its development four years ago.

However, further significant refinements are needed, it said.

"Given that the IAIS wishes to have the framework ready to begin the next stage — which is confidential reporting by insurers — by the end of 2019, those improvements are required even more urgently to ensure the results of the confidential reporting are meaningful. In fact, the more progress that can be made now, the more likely it is that the adoption of an implementable version of the ICS will be achievable.

"Continuous dialogue and exchanges with the industry in the coming months will be key to allow these improvements to be discussed thoroughly, so that decisions are well-informed and flaws are minimised."

With respect to valuation, Insurance Europe said a market-adjusted valuation approach is supported, but only if the discounted rates for liabilities reflect the long-term nature of the insurance business model and the ALM techniques employed by insurers.

"Significant improvements continue to be needed to develop an adjustment to the risk-free curve which achieves the IAIS's objectives of developing an adjustment to reflect the long-term nature of insurance contracts and mitigate potential excessive volatility on capital resources.

"The IAIS should undertake extensive testing of any proposed valuation approaches to ensure that they work as intended both in the current economic climate but also in stressed market environments. Testing against periods of financial stress should be performed by the IAIS, with no additional burden on companies.

Insurance Europe said the current design of the equity risk submodule requires improvements. The equity segmentation should take into account existing evidence that a tailored calibration of capital charges is more appropriate where the nature and risk profile of a particular asset differs from the "basket" that it is placed in. Furthermore, it said "the prudential treatment of equity infrastructure investments and long-term equity should be aligned to the true risks to which insurers are exposed via the introduction of separate sub-risk modules tailored to these asset classes".

On 2 November 2017, the IAIS announced a unified path to convergence of group capital standards in furtherance of its ultimate goal of a single ICS that achieves comparable outcomes across jurisdictions. The agreement clarifies that implementation of ICS Version 2.0 will be conducted in two phases, a five-year "monitoring period", during which ICS Version 2.0 will be used for confidential reporting to the group-wide supervisor (GWS) and discussion in supervisory colleges and the "implementation of the ICS as a group-wide prescribed capital requirement (PCR)".

Implementation of ICS Version 2.0 will have two equally important components: mandatory confidential reporting by all IAIGs (and other interested Volunteer Groups at the option of the GWS) of a "reference ICS"; and additional reporting, at the option of the GWS, of ICS based on GAAP Plus valuation and/or other methods of calculation of the ICS capital requirement.

UNEP FI partners with global insurers to help them understand climate change impacts

16 of world's largest insurers join forces to develop new generation of risk assessment

Written by **Oliver Wade**

UN Environment's Finance Initiative (UNEP FI) has announced a partnership with 16 of the world's largest insurers, to develop a new generation of risk assessment tools designed to allow the insurance industry to better understand the impacts of climate change on their business.

The insurance industry represents approximately 10 per cent of the world's premium and holds around $5trn in assets under management.

The pilot group will develop analytical tools that they will use to pioneer insurance industry climate risk disclosures that follow the recommendations of the Financial Stability Board's task force on Climate-related Financial Disclosures (TCFD). This will require the group to utilise the latest climate science, including some of the most advanced climate scenarios available.

Commenting, UN Environment chief Erik Solheim said: "For generations, the insurance industry has served as society's early warning system and risk manager by understanding, reducing, pricing and carrying risk. Its message now is loud and clear: climate change risk is intensifying and is a serious threat to the insurability of communities and economies around the world.

"An uninsurable world is a price that society could not afford. This is why UN Environment is working with leading insurers to understand and reduce risk, to seize unprecedented business opportunities in climate action, and to ensure an insurable, resilient and sustainable world."

The tools and indicators that will be jointly developed and piloted by the insurer group will incorporate the latest scenario analysis to assess climate-related physical and transition risks in insurance portfolios. The benefit of insurer coverage is that it incentivises risk reduction, puts a price tag on risk, de-risks investments, while also serving as a financial shock absorber for communities, businesses and governments.

> The more insurers understand climate risks facing the economy, the more they can make prudent decisions in managing risk and serving clients

"The more insurers understand climate risks facing the economy, the more they can make prudent decisions in managing risk and serving their clients, and the more efficient and stable our markets will become," Task Force chair Michael Bloomberg said.

"The pioneering work of this group will pave the way for greater climate risk transparency and climate action by the global insurance industry, and it's great to see that it's consistent with our Task Force's recommendations."

The leading insurers that will work together with the UN are all signatories to UNEP FI's Principles for Sustainable Insurance, a global best-practice sustainability framework and the largest collaborative initiative between the UN and the insurance industry.

The Insurer Group includes: Allianz, AXA, IAG, Intact Financial Corporation, Länsförsäkringar Sak, MAPFRE, MS&AD, Munich Re, NN Group, QBE, Sompo Japan Nipponkoa, Storebrand, Swiss Re, TD Insurance, The Co-operators, and Tokio Marine & Nichido.

> 9.1 million EEA30 policyholders might face uncertainty and delays in receiving payments

Action called for as 124 insurance undertakings at risk over service continuity

Lack of contingency plans in place to ensure service continuity in case of no-deal Brexit

Written by **Adam Cadle**

A total of 124 insurance undertakings from the United Kingdom and Gibraltar with cross-border business in EEA 30 jurisdictions have no or insufficient contingency plans in place to ensure service continuity in case of a withdrawal without an agreement between the UK and the EU.

According to EIOPA, in case of a withdrawal without an agreement, 9.1 million EEA30 policyholders might face uncertainty and delays in receiving payments. This is significantly down from the total 38 million EEA30 policyholders with a cross-border contract, which shows the extent of action by UK insurers with large cross-border business.

The residual cross-border business concerned have insurance liabilities of €7.4bn. The residual cross-border business concerned have insurance liabilities of €7.4bn. The residual business of insurers from the UK and Gibraltar without sufficient contingency plans represents only 0.16 per cent of the overall insurance business in the EEA30 countries.

The majority of the business (with insurance liabilities of €5.4bn) relates to a handful of insurers in the United Kingdom. The remaining business has mainly low value and short-tail liabilities. Overall, 75 per cent of the contracts concerned belong to portfolios with average written premiums of less than €100 per year.

On average, the remaining duration of liabilities of 76 per cent of the contracts is less than two years. The majority of the contracts are with non-life insurers. Only 3 per cent of the potentially affected policyholders have a contract with life insurers.

EIOPA is working with the national competent authorities to address the residual risk.

By law, insurance undertakings have to ensure continuity and regularity in the performance of their activities, including the development of contingency plans. Supervisory authorities have to ensure compliance respectively. To avoid disruptions in service continuity, immediate and reinforced actions from undertakings and supervisory authorities are required. Insufficient contingency planning that may result in consumer detriment is a severe governance failure.

EIOPA said policyholders of cross-border insurance contracts with undertakings from the United Kingdom and Gibraltar should be informed by their insurer about the relevant contingency measures they are taking and the impact on their contractual relationship and services.

Based on the data collected through the monitoring of the contingency planning and in particular due to the nature and scale of the business concerned, EIOPA's assessment is that the service continuity issue does not give rise to financial stability risks. However, EIOPA will continue to closely monitor and assess potential financial stability risks.

People on the move

TANGUY VAN DE WERVE

EFAMA director general

The European Fund and Asset Management Association (EFAMA) has announced the appointment of Tanguy van de Werve as its new director general. He will take up his position on 1 January 2019 and will be responsible for the implementation of the Association's strategic agenda, and the leadership and management of the EFAMA secretariat in Brussels. He has also worked at AFME as managing director and head of the Brussels office.

ANGELA SUMMONTE

State Street Corporation head of asset owner and official institutions sector solutions

Angela will be responsible for leading the firm's sales strategy for the asset owner and official institutions sectors across EMEA. She will work closely with the product development team to further enhance State Street's current product offering across the global exchange, global markets and global services businesses for new and existing clients.

MATTEO ANDREETTO

State Street Global Advisors senior managing director and head of the SPDR ETF business for EMEA

Andreetto will be responsible for developing, leading and executing all aspects of SPDR's ETF business strategy in EMEA. He will lead the ETF sales teams, working with colleagues across product development, marketing, capital markets and infrastructure to deliver ETF products and services that meet client aspirations.

PED PHROMPECHRUT

Schroders, Solutions Manager

Ped Phrompechrut has joined as a solutions manager, a new role, based in London. He will report into Neil Walton, head of investment solutions. Ped will work with clients globally to provide investment strategy and portfolio construction advice, with a particular focus on delivering private market solutions. He was previously a director at Willis Towers Watson where he was head of private market solutions.

ADRIAN SWEENEY

RSA chief underwriting officer, UK and international business

Adrian Sweeney joined RSA on 1 October 2018 as chief underwriting officer for RSA's UK and international business. Sweeney brings significant experience in underwriting and pricing for commercial and personal lines, having spent the majority of his career working across Zurich's international businesses in senior underwriting and operations roles.

RAMLA KACEM

Moody's Associate Director

Ramla Kacem will engage with insurers on the firm's IFRS 17 proposition. Ramla has extensive experience with regulatory compliance solutions, having spent time implementing them in Europe for Solvency II, and more recently in Asia out of the firm's Singapore office. Andrew Waters, senior director, will lead the market strategy and business expansion in the Asia-Pacific region.

Opinion

On the need for asset managers to reconsider business models

"Being an asset owner can be incredibly complex and we don't expect life in the next ten years to become any easier. There is an overarching need for asset owners to better understand the world in which they operate, if they are to manage risk, exploit opportunities and thrive through the Great Acceleration. All situations for asset owners are different and the art to their future success will be understanding and evolving best practice principles and applying them to unique circumstances. As a result, there is an overarching need for them to understand the world in which they operate through a model that connects all the dots."

Roger Urwin
Willis Towers Watson global head of investment

On Lemonade becoming the first US insurer to commit to never invest in coal

"We're calling on our industry - our reinsurance partners, our competitors, and our colleagues in health and life insurance companies - to join us. For insurance companies in the business of underwriting polluting projects we have a simple ask: please don't."

Daniel Schreiber
Lemonade CEO and co-founder

On AXA IM boosting its ESG integration efforts

Matt Christensen
AXA IM global head of responsible investment

"This new step to integrate RI throughout the business will ensure that ESG integration combines the need for common views on thematic engagements, voting and ESG scoring, while bolstering investment teams with detailed ESG corporate analysis. This will lead to increased transparency and clarity for our clients on the ESG footprint of their investments, allowing us to better engage with them and help to direct their funds into those companies that have a positive impact on society."

On InvestEU proposal around suitable long-term investments

insurance europe

Insurance Europe

"The availability of a wide range of investment assets is key to meet insurers' investment needs. The InvestEU programme has the potential to address the investment gap in the EU and to stimulate additional long-term viable assets that insurers can invest in.
"It is key that public support is provided only when actually needed, and intervention by national/multilateral development banks should not create the unintended effect of crowding out private investment. It is equally important for the prudential rules defined in Solvency II, which play a key role in investment decision making, to correctly reflect the risks and economics of the business".

On Marsh & McLennan purchasing JLT

Dan Glaser
MMC president and chief executive officer

"The acquisition of Jardine Lloyd Thompson creates a compelling value proposition for our clients, our colleagues and our shareholders. The complementary fit between our companies creates a platform to deliver exceptional service to clients and opportunities for our colleagues."

Soapbox

The growing headache

Written by **Adam Cadle**

Brexit, Brexit, Brexit. A piece of legislation that I would be surprised if any national newspaper hasn't mentioned this year, and one which continues to be surrounded in confused politics, arguing, unknown costs, and the cause of a great deal more work for the country and most certainly financial institutions. Indeed, on a personal note, the whole concept of Brexit has suddenly become rather tiring as we continue to argue whether a re-referendum should be carried out.

One thing for certain is that the insurance industry still has a great deal of work to do, in order to class itself as 'Brexit-prepared'. Yes, we have the positive stories, examples being non-life insurance activity in Luxembourg surging by 28.73% over the first six months of 2018, from companies choosing the country as a new place of installation, but when you have leading associations urging the insurance industry to agree a Brexit deal as a 'matter of urgency' as the ABI did recently, then you know things are serious.

The government recently issued a notice stating "in the absence of action from the EU, EEA-based customers of UK firms currently passporting into the EEA, including UK citizens living in the EEA, may lose the ability to access existing lending and deposit services, insurance contracts (such as a life insurance contracts and annuities) due to UK firms losing their rights to passport into the EEA, affecting the ability of their EEA customers to continue accessing their services."

Yes we know, but it is how UK and EU regulators cooperate around this. The option can be fixed if both agree to do this and put consumers at the forefront of their planning ideas. Contingency plans are in place around the implementation of new subsidiaries for some insurers but the ongoing issue around reporting requirements and contract continuity is one that fails to disappear at this moment in time.

Kennedy's Law LLP stated recently that the transferral of contracts "can take over two years". How many within the insurance industry are actually aware of this I ask? Legal certainty on how these contracts will be enforced post-Brexit is needed without any further delay.

The industry must realise that it is a sprint and not a snails game to have sufficient operations in place to navigate this Brexit maze

Having worked as a journalist in the pensions space for six years, before getting my teeth into the insurance investment market, I know only too well about the importance of speedy legislative approval to deal with an imminent issue. It's right to get the legislation right in the first place, don't get me wrong, but sometimes consultation after consultation doesn't work and legislation just needs to be enforced without going round and round in circles. In the same way, the insurance industry needs to act now and not put the issue of Brexit on the back burner.

With the deadline of 29 March 2019 in place, the industry must realise that this is a sprint and not a snails game to have sufficient operations in place to navigate this Brexit maze. If there is a 'no-deal' scenario, well the headache just continues. Get those paracetamol at the ready!

An insight from within


Photo by: www.martinjoppen.de

Adam Cadle gathers the thoughts of EIOPA chair Gabriel Bernardino on the European insurance industry

WRITTEN BY **ADAM CADLE**

Q How would you describe the state of the general, life and reinsurance sectors in Europe at this present time?

Overall, the European insurance sector is adequately capitalised and insurance companies deliver positive profitability despite the low yield environment. As outlined in our latest Financial Stability Report (June 2018) the Solvency Capital Requirement ratio for the median company is 223 per cent for the life insurance sector and 207 per cent for the non-life sector.

The reinsurance industry, too, appears to have sufficient capital to absorb global insurance industry catastrophe losses that were considerably higher in 2017 than the long-term average.

While the persistent low yield environment remains the main risk for the insurance sector, new types of risk are emerging, such as those related to climate change or cyber attacks.

Digital technology continues to bring opportunities for insurers and new entrants, through improved customer interaction, risk modelling, streamlining of information systems and more efficient claims handling. Consumers could also benefit through more personalised products and lower costs, although consumers could also be at risk from exclusion of products and eventual price discrimination.

Q How much of a success has Solvency II been in the insurance space, nearly three years after implementation?

The introduction of Solvency II in 2016 was a big step forward for policyholder protection and market stability, undoubtedly the biggest change to the European Regulatory framework in the insurance sector in the latest years. The implementation of this risk-based regulatory regime was a significant improvement compared with the previous framework and brings a number of benefits for the insurance industry and for consumers.

With Solvency II, the insurance industry has better aligned capital to the risks it runs, uses a risk-based approach to assess and mitigate risks and can therefore better price them. This was an important element in the adaptation of business models in particular in face of the low interest rate environment.

Insurers have significantly strengthened their governance models and their risk management capacity, by putting in place a number of key functions and ensuring that Boards consider risk and capital factors in the strategic decision making.

With Solvency II, insurers throughout Europe use harmonised templates for supervisory reporting, instead of a patchwork of national templates, and publicly disclose much more relevant information creating the basis for market discipline. This is a big step towards more transparency.

A big regulatory change like Solvency II requires appropriate monitoring to understand what the areas that deserve further reflection are in order to maintain it "fit for its purpose" and to achieve indeed the fundamental objectives, the protection of policyholders and of market stability.

We should not forget that the post-crisis regulatory agenda was put in place to restore citizens' confidence in the financial sector. Reviewing the Solvency II framework is an essential element of good regulation, to ensure that it remains effective, both in terms of its principles and its implementation.

Q How successful are insurance companies' implementation of internal model structures and where can EIOPA help with this?

Within Solvency II, European insurers can use full or partial internal models to determine their Solvency Capital Requirement and while internal models allow undertakings to better reflect their specific risk profile, they can be large and complex, in particular for cross-border groups.

Based on findings from visits to

national competent authorities and through participation in colleges of supervisors, EIOPA has identified some risks and inconsistencies regarding the application of internal models. These include divergent practices in the establishment and approval of internal models, threatening both the level playing field and policyholder protection. EIOPA directly supports national competent authorities in dealing with the application and supervisory review of internal models, through bilateral visits focussing on the supervisory review process of internal models and participation in internal model reviews.

EIOPA also runs consistency projects, jointly with national competent authorities to assess consistency in key areas. Stemming from these, EIOPA has published an opinion on the supervisory assessment of internal models including a dynamic volatility adjustment (DVA), underlining the key principles for modelling risk assessment and disclosure with a view to improving prudency and consistency in modelling the DVA.

More recently, EIOPA published its first comparative study on market and credit risk modelling, as a first step in the development of a European supervisory tool in this area that will support the supervision of internal models. In order to ensure more consistency in the supervision of internal models EIOPA should be able to receive all information needed, to perform independent analysis and issue recommendations to the national competent authorities.

Q How much more simplification does there need to be around the calculation of capital requirements for insurers?

In the context of reviewing Solvency II EIOPA's goal is to simplify the supervisory regime to remove technical inconsistencies and at the same time to ensure that Solvency II remains fit for purpose, proportionate, technically robust, risk-sensitive and consistent. In this context, EIOPA provided advice to the European Commission the review of the Solvency Capital Requirement based on an in-depth analysis of 29 different elements. The advice focused on increasing proportionality, removing unjustified constraints to financing the economy and removing technical inconsistencies.

Regarding proportionality, the advice included recommendations to simplify further calculations for a number of sub-modules of the Solvency Capital Requirement, such as natural, man-made and health catastrophes, in particular fire risk and mass accident; to simplify the use of external credit ratings in the calculation of the SCR (an issue especially relevant for small insurers); to reduce the burden of the treatment of look-through to underlying investments, and to develop simplifications in the assessment of lapse and counterparty default risks.

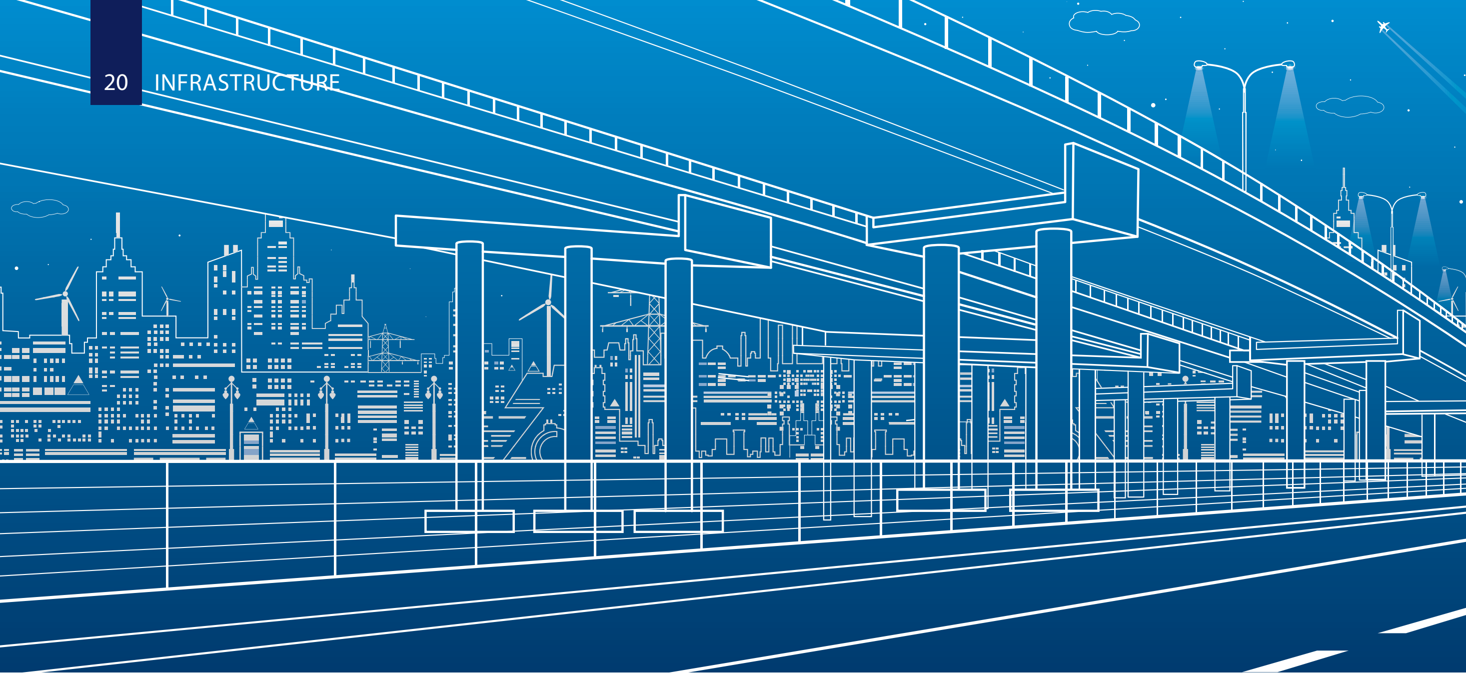
EIOPA also recommended to adjust the methodology used for the calculation of interest rate risk using a method already adopted by internal model users and, given the material impact on capital requirements, suggested to implement the methodology gradually over three years. To remove unjustified constrains to financing the economy, EIOPA analysed the treatment and the evidence available on unrated debt and unlisted equity and proposed criteria for a more granular treatment, with the use of financial ratios. EIOPA will continue to monitor the implementation of Solvency II so that the framework continues to bring benefits to the insurance industry and to consumers.

Q How important is it that EIOPA remains a standalone authority and how content are you with its governance structure?

Since its inception, EIOPA has worked to ensure sound and robust regulation of the insurance and pension sectors as well as high-quality and consistent supervision. To achieve this, EIOPA strongly believes in a holistic and integrated approach towards European prudential and conduct of business supervision.

> **EIOPA will continue to monitor the implementation of Solvency II so that the framework continues to bring benefits to the insurance industry and to consumers**

In the face of increasing cross-border activity, only strong European responses will counter cross-border threats and safeguard consumers. In a single market with cross-border activities and a passport system supervised by the home country, the supervisory system is as strong as its weakest link. That is why ensuring high quality and consistent supervision is fundamental to the proper functioning of the single market. The Solvency II harmonised regulatory framework creates the conditions for this supervisory convergence. EIOPA devotes a high priority to supervisory convergence and has been actively working to foster a common European Supervisory Culture and to ensure consistent supervisory practices. This a marathon not a 100 meters race.



Navigating the INFRASTRUCTURE cycle

WRITTEN BY **DWS HEAD OF INFRASTRUCTURE HAMISH MACKENZIE**

DWS explores the role infrastructure can play to provide cash flow visibility to support income based return

INVESTORS see infrastructure as a defensive asset class. This may be the case also in the current market, where liquidity has driven up prices in all asset classes: the fundamentals of infrastructure should remain strong whatever the market environment, as businesses are asset-backed and highly cash-generative, offering stability in a downturn. However, the previous cycle has taught us some important lessons that we should keep in mind at this point in the cycle.

Today, as with the pre-GFC period, the bull market generates very high levels of activity, and to achieve target returns, it is critically important to select the right asset at the right price. Managers should remain focused on which assets they pursue and how much they pay. This means appropriate due diligence, asset selection and price discipline are very important, because there's an increased risk of overpaying.

As the previous cycle has demonstrated, in the current market environment it is important to have a fundamental view on valuations throughout a cycle, taking a more realistic mid-cycle approach and applying alpha to discount rates, to keep a fairly consistent and stable view of value across a portfolio. By avoiding auction processes, you may avoid paying unreasonable prices, but even in bilateral processes, you are having to pay a reasonable but fairly full price. So, particularly today, actively managing investments to deliver growth and to deliver target returns for investors is key.

A valuable experience from the previous cycle was understanding which assets performed well and which assets didn't throughout the latest downturn. Identifying assets that provide cash flow visibility to support income based return rather than just seeking capital appreciation is key. It is

> Identifying infrastructure businesses supported by resilient business profiles and some flexibility to protect and grow the P&L will be key also in the next cycle

also very important to have the skillset to manage assets during the downturn – and to focus on assets that provide flexibility on both sides of the P&L, to be able to manage the cost base against a lower revenue line. This can help managing cash flow stability in a changing market environment.

Identifying assets where there is the flexibility to introduce new revenue streams and reduce costs can be an important driver of value for assets that are more exposed to GDP, and in our case helped us avoiding a reduction in EBITDA, even during the trough of the crisis in 2009. Identifying infrastructure businesses supported by resilient business profiles and some flexibility to protect and grow the P&L will be key also in the next cycle.

From a portfolio perspective, regulated assets are beneficial to balance systematic risk in portfolios, but they are currently expensive, since they are perceived as lower-risk, low-volatility assets. More importantly, with these sorts of businesses when the

> We believe that also in a gradually increasing interest rate environment, we will continue to see strong investor interest in infrastructure

environment changes, you've actually got limited ability to adjust quickly, as they do not offer us the same degree of operational flexibility.

A recession may not seem like the best time to invest, but in terms of capital expenditure and providing a platform for growth into a recovery, the last recession was a good time to invest for some of the assets in our portfolio. Also in this environment with a lot of deal activity is conducive to buy-and-build strategies, we're buying businesses with the intention to add to them through M&A and to support growth through-the-cycle into different business areas or different geographies.

From a financing perspective, today's low-interest environment is a good time to lock in financing for capital expenditure as well as M&A. Interest rates have already started to increase in the US and the UK and we believe that they may continue to increase gradually, and that would push up yields. That said, our view is that interest rates may continue to remain below the long-term historical average, which underpins the importance of infrastructure as a yielding asset class.

We're in a relatively low interest-rate environment, so investors should continue to see comparatively lower returns from traditional asset classes, and will therefore look to alternatives like unlisted infrastructure as a way of complementing their portfolio. Therefore we believe that also in a gradually increasing interest rate environment, we will continue to see strong investor interest in infrastructure.

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Ahead of the game?

Despite being more advanced than most of the globe when it comes to sustainable investment, UK insurers are looking to up their ESG thinking. Marek Handzel explores

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

AS a theme, sustainable investing has been simmering away for some time in the UK insurance sector.

Many insurers have been signatories to the United Nations Principles for Responsible Investment for close to a decade, a commitment that has also either led to, or been instigated by, a responsible investment committee. This, in turn, has led to concrete action rather than mere platitudes. Royal London's investment subsidiary now runs five multi-asset sustainable funds and has identified ESG "leaders and laggards" as one of its core areas of engagement with the companies it invests in. And in March this year, Aviva Investors called for extractive mining companies to protect world heritage sites by designating them as no-go areas.

Within a global context, these type of initiatives have propelled the UK to near the top of the rankings when it comes to sustainable — or impact — investing, as it is increasingly being referred to. BlackRock's *Global Insurance Report for 2018* recently revealed that 91 per cent of European insurers or reinsurers view having an ESG investment policy as very important or extremely important, compared to 90 per cent in APAC and 67 per cent in North America.

The driver behind the UK's adoption of the issue is clear, according to Simon Howard, the chief executive of the UK Sustainable Investment and Finance Association (UKSIF). "Insurance companies and actuaries are really getting to grips with the issue of sustainable investing," he says. "They recognise the risks their assets are exposed to and increasingly recognise the opportunities that lie in mitigation of sustainability risks."

Not yet at boiling point

Nevertheless, the UK picture remains somewhat mixed. HSBC Global Asset Management responsible investment specialist director Stephanie Maier explains: "There have been a number of interesting developments in the past few years at the industry level around climate change, such as the establishment of Flood Re and a number of initiatives supported by industry bodies such as the ABI. Certain UK insurers have become more vocal about ESG and are looking to establish their approach as a differentiator.

On the other hand, the ESG related

requirements in the mandates we manage for UK insurers tend to be in line with those of insurers in other European countries, rather than being ahead of the game."

Insight Investment head of insurance Heneg Parthenay believes that the UK is behind the Dutch and the Nordic countries, who are rightly perceived as global leaders due to a stronger demand from policyholders for ESG compliance in all areas of an insurer's business. France is also home to a widespread focus on impact investing. After hosting the 2015 Paris Climate Conference and becoming the first country to pass a law introducing mandatory extensive climate change-related reporting for asset owners and investment managers, its insurers now have a strong focus on climate change and carbon reduction.

"The UK is catching up though," Parthenay says. "From the beginning of this summer I haven't been to one investment committee meeting where the topic hasn't been mentioned.

"Before it was the exception. We usually had one or two questions about ESG when we would bid for business, but now it's discussed at meetings, so it feels like we are at a tipping point."

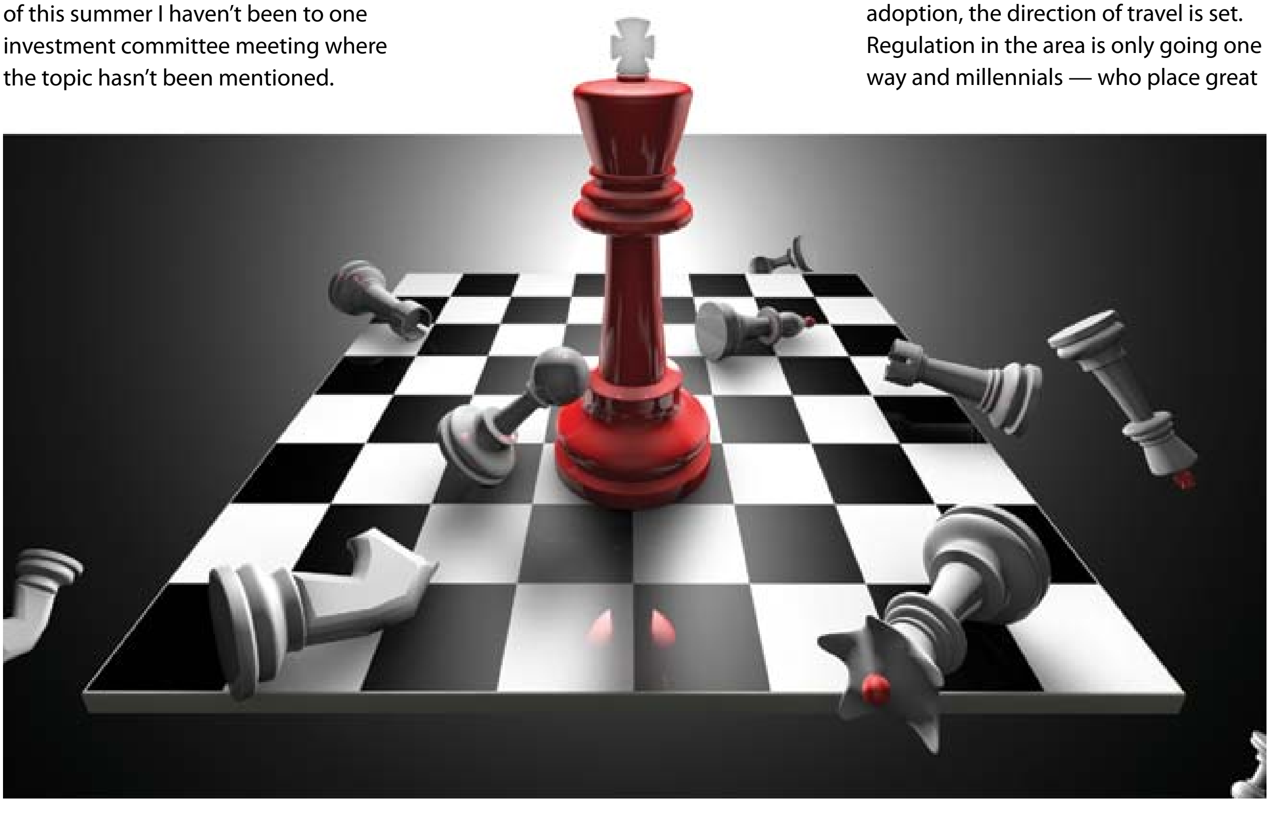
Lombard Odier Investment Managers head of pensions and insurance solutions Ritesh Bamania argues that the pace at which interest is increasing could be improved. He points to how the UK's Pensions Regulator has asked all pension fund trustees to consider all investment risks, including ESG, in their portfolios.

"Another area where we would like to see improvement is the application of sustainability beyond stewardship and active engagement," Bamania states. Although both stewardship and active engagement are important aspects seeking to improve company behaviour and company performance, he believes there are a number of additional signals that can be derived from business practices to run asset mandates that can influence asset outcomes.

Bamania also stresses that the speed at which sustainable investing is implemented can depend on the link between the insurer and their customers. "Life insurers with savings products are a lot closer to their customers in terms of investments, leading to some insurers adopting upcoming trends a lot faster than, for example, some general insurers where the investment strategy connection between the insurer and their customer is low."

Despite the varying levels of adoption, the direction of travel is set. Regulation in the area is only going one way and millennials — who place great

> Insurance companies and actuaries are really getting to grips with the issue of sustainable investing



store in sustainability — will not be shy when it comes to voting with their feet should they get a whiff of any insurers that are behind the curve on ESG.

A natural fit

In terms of sectors, a number of reinsurance companies have taken the lead in the UK, which, as Maier says, makes sense given their exposure to catastrophe risk.

Generally speaking however, insurers should be the most comfortable of all institutional investors with sustainable strategies, Parthaney says. "When you think about it, especially on the non-life side, it's something they've been doing on the liabilities side for a long time."

"I don't think it's a major cultural shift for insurers, it fits well with their mindset and how they think about their business and who they're ready to insure. They can re-purpose some of that framework from the liability side to the framework for the investment side," he adds.

I don't think it's a major cultural shift for insurers, it fits well with their mindset and how they think about their business and who they're ready to insure

Effect on returns

There are still, however, some lingering doubts about the efficacy of sustainable investing. According to Bamania, there is still some pushback from insurers due to a fear of short- to medium- term negative returns, exacerbated by an unclear future date from which they can expect positive results.

He argues, however, that there is too much uncertainty and risk associated with ignoring sustainability. That in itself should be a good reason to at least consider a sustainability framework as an input to asset liability management. "Those who adopt such a framework may find they have a competitive edge over their peers in future years," Bamania comments.

Parthenay has some sympathy for those who are reticent when it comes to throwing their weight behind impact investing.

"It's a very difficult topic," he admits. "Long term you can argue that ESG parameters help you get better returns, but there is limited evidence around that, with conflicting studies."

One of the main problems in measuring ESG's influence involves extracting ESG parameters, as well as other external factors, from an investment portfolio in order to gauge its force on returns. But this can be somewhat mitigated by adopting state-of-the-art and constantly updated ESG parameter tools.

"If you start applying blunt filters on your investable universe then yes, I agree, you're very likely to have a drag on performance, because you are very likely fishing off a smaller investable universe," Parthenay outlines.

"But if you look at any advanced ESG framework then you go far beyond any blunt assessment. It's far more subtle, so usually you can avoid the systematic drag you would get on performance if you limit your investable universe.

The more sophisticated and developed your framework will be, the less likely it would be to a have a direct or systematic negative impact on performance that any direct screening would have."

Building this framework should be done by clearly defining sustainability in the context of a driver of investment returns, Bamania says.

Lombard Odier's own model incorporates "the three pillars" of sustainability —sustainable financial models, sustainable business practices and sustainable business models.

"This allows us to consider both direct impact investments — such as green bonds — and traditional equity and bond investments that incorporate sustainable business signals, including ESG and controversies."

By incorporating similar methods insurers could soon find their sustainable investment strategies bubbling over, to the benefit of their policyholders and their bottom line.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The right call

David Adams looks at the importance of the credit cycle to the shape of insurers' investment strategies and the actions being taken

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

In this strange post-crash era, while some old assumptions about finance and economics have been swept away, the importance of the credit cycle to the shape of insurers' investment strategies is as strong as ever. In recent months the number of voices suggesting that we may be approaching the end of the cycle has grown. Interest rates are rising, in the US and elsewhere and many observers also now expect to see some form of recession in the US at some point in the near future, which would have more widespread consequences.

A report published by Moody's in October suggests that investors in Europe, in particular, may not be well-placed to cope with a severe market correction and/or an unexpectedly swift rise in interest rates.

"As large fixed-income investors, insurers' asset quality would deteriorate if, as a result of the increasing debt burden, the underlying credit quality of sovereigns, corporates and utilities deteriorated," write the authors of the report entitled *Five vulnerabilities will deepen the impact in Europe of the next downturn*. They note that over the past decade European insurers have increased their exposure to more speculative grade securities in search of yield, making them more sensitive to a credit shock than was the case in 2008.

Zurich Insurance Group chief market strategist and head of macroeconomics Guy Miller says the company first started to prepare for trouble in relation to the credit cycle in 2017. "We felt credit had been an asset class that performed very well, but when we looked at the amount of leverage in the system we became increasingly concerned," he says. "We felt that the cycle was getting to the late stages, particularly in the US."

But judging when the cycle will reach its end has been complicated by central banks' use of quantitative easing (QE) since the financial crisis. "Clearly they are trying to apply a soft landing,"

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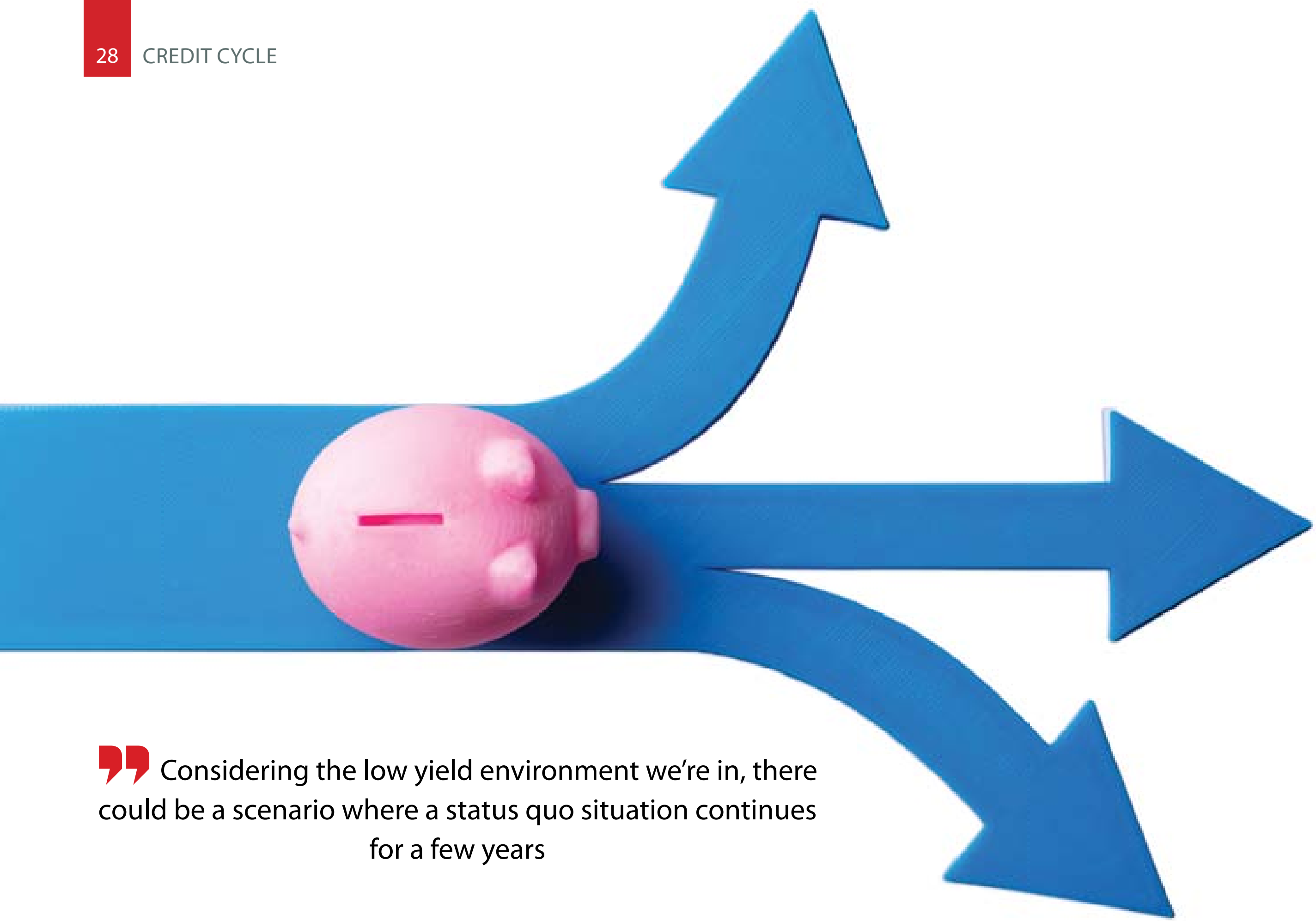

> Considering the low yield environment we're in, there could be a scenario where a status quo situation continues for a few years

Insight Investment head of insurance Heneg Parthenay says.

"We are watching carefully what central banks do, looking at their QE programmes and the impact that has on markets. Uncertainty or negative external events tend to slow down unwinding of central banks' QE programmes."

AXA Investment Management global head of buy and maintain Gilles Dauphine highlights other positive forces acting in the markets. They include pension funds benefiting from improved funding ratios, so selling equities to realise gains, then investing the proceeds in fixed income. Solvency II rules around matching liabilities have also limited many insurers' exposures to the likely consequences of the credit cycle reaching its conclusion. "Is this going to lead to dramatic repricing and widening of spreads?", Dauphine asks. "I don't think so, because of those stabilising forces."

BNY Mellon Investment Management head of institutional distribution Oliver Cassin wonders if the end of the cycle could become drawn out. "Considering the low yield environment we're in, there could be a scenario where a status quo situation continues for a few years," he says.

Willis Towers Watson head of insurance investment solutions Keith Goodby takes a similar view. "We still see some momentum being left in the US economy over the next 12 to 18 months," he says. "Although US spreads have widened a bit in the last few months, given that we still see momentum over the next few months, spreads could narrow again."

So, if the cycle is indeed entering its late stages but timings remain uncertain, what actions should insurers take?

Schroders insurance ALM director Wojciech Herchel makes the point that insurers should be in a stronger position than some other investors, because a general buy to hold policy for investment grade bonds builds portfolios able to withstand short term market volatility. He suggests that a downturn would also offer opportunities to reposition the portfolio, although Solvency II rules might prevent the purchase of some 'fallen angel' assets.

Parthenay suggests some insurers may want to use structured credit investments, based on floating rates, as a way to manage rising interest rates, although Solvency II rules again make this complicated. Insurers will also need to consider the implications of the new EU regulations for Simple, Transparent and Standardised (STS) securitisation, which come into force in January 2019; and are designed specifically to encourage banks to transfer risk exposures to institutional and long-term investors such as insurers.

Goodby says insurers should be reducing exposure to high yield assets and increasing diversification. "Insurers should be looking to diversify credit as much as possible – across geographies and sectors, and to look at more use of illiquid assets where you can negotiate covenants and security," he says.

But Cassin feels optimistic about insurers' ability to cope with difficult conditions in the months ahead. "Are insurers prepared for a crash, or at least for a widening of credit spreads?" he asks. "I think they are. Overall, insurers continue to be conservatively positioned." He cites insurers in Germany that have lowered their exposure to high yields during the past year; and insurers in various locations that have moved to short duration high yield assets.

Dauphine says insurers investing in credit are taking a bottom up approach, avoiding investing in certain sectors, such as retail, media and healthcare; or in companies with a strong exposure to emerging markets.

"We're also seeing insurance

Insurers should be looking to diversify credit as much as possible - across geographies and sectors

companies entering more and more into the illiquid space, where risk premia are still attractive," he adds.

The most prominent trend in insurers' investment strategies at present is diversification, says Cassin; and the primary means of diversification is private debt, such as bank loans and private lending. "Is that a worry?" he asks. "No. So long as the allocation is limited, and it has been – exposure to private debt has been two, three per cent – although they will be exposed by any massive defaults, they will they be able to support that shock."

He notes that some insurers have also used other types of low risk assets to increase yield and risk-adjusted returns as well as diversification, such as low risk municipal US bonds. Recent research from Invesco suggests that about 93 per cent of US municipal bond issuers are rated single A or above, compared to only 25 per cent of corporate bonds. Default rates are also very low compared to corporate bonds.

Herchel says he sees insurers moving slowly away from the cyclical sectors and typical bonds and into a range of various private and fixed income alternative asset classes, including emerging markets, infrastructure, SME lending; and real estate.

At Zurich the core of the investment strategy rests on matching assets to liabilities, says Miller. "That allows us to have exposures that move with our liabilities, so we don't feel the need to constantly chase markets," he explains.

He says Zurich expects to see a recession in the US during 2020. "The reason is actually because growth has been so good and is likely to remain good in 2019," he comments. "That means you have more companies looking for employees than there are potential employees available. Those full capacity constraints limit growth.

"The Eurozone economy is not immune from that slowdown, although the ECB is keeping QE in place and interest rates will remain very accommodative for some time. But while the Eurozone may avoid recession, growth trends will fall."

Miller says equities are now the primary focus within Zurich's strategy, but it continues to monitor bond yields closely. "We still think equities have more upside in the short term, but the bond market is getting more interesting," he says. "But if you believe that the end of the cycle is now on the horizon, then we're unlikely to see bond yields surge higher, as many have feared.

"We can cut back on US credit [exposure] relative to equities, but that's unlikely to help significantly were the credit markets to really tank. So we've been thinking about counter-cycle methods we could adopt, while taking care not to disrupt the ALM process that has worked for so many years. If we think a credit slowdown is coming we should be able to put something in place to help mitigate that." Other insurers will certainly be hoping that the actions they have already taken, or are taking now, will mean they can make similar claims.

Setting an example

Adam Cadle interviews J.P. Morgan Asset Management's Head of International Global Insurance Solutions Mark Oldcorn, who explains the levels of expertise and excellence within the firm's insurance business

WRITTEN BY **ADAM CADLE**

SITTING in the offices at J.P. Morgan Asset Management, adjacent to the Thames, chatting to J.P. Morgan Asset Management's Head of International Global Insurance Solutions Mark Oldcorn, it quickly becomes clear as to how advanced and sophisticated the firm's insurance capabilities are, particularly within the fixed income and extended fixed income spaces.

"J.P. Morgan has invested to build a centre of excellence in our team of 21 insurance fixed income specialists globally running money exclusively on behalf of our insurance clients," Oldcorn states.

"We leverage off the buy-side research resources that we have built, as well as the economic and risk management teams we have. Dedicated technology resources also come in to play to enable us to conduct advanced analytics. IT systems have been developed so that once we have taken on the management of the money on behalf of the client, analytics and portfolio management can be carried out directly on desktops. That relates to risk management and scenarios around adding or exiting a particular security, and the impact this would have on the portfolio pre-trade."

Every extra basis point helps capital optimisation, which is why J.P. Morgan Asset Management prides itself on actively managing money with systems allowing it to carry out analytics right up front to see what the impact is on the Solvency Capital Ratio (SCR).

Momentum and evolution

Oldcorn is proud of the momentum currently taking place within the business, and the complimentary nature of the skillsets throughout its Global Insurance Solutions franchise.

"I was a banker in the industry for 20 years before I moved over to asset management, so having that perspective over what is important to the industry is valuable when advising insurance clients on asset and liability matters" he underlines.

"Essentially what we have seen is an evolution of the sell-side analyst community and insurance company management teams. If you were to go back 10 years everyone was looking for growth. They were making acquisitions in Asia, Latin America, Central and Eastern Europe. The argument was, if you could show greater growth than peers you trade at a premium, but you had to pay high multiples to enter those markets. It was quite difficult to integrate those businesses, manage them efficiently and generate that growth on a profitable basis.

"What has transpired post-crisis is much more discipline around strategy, around M&A and capital management, with the latter being the most important thing that analysts and investors are focused on. Those companies that exhibit those characteristics now trade at a premium as opposed to the ones that historically were generating higher levels of growth. This notion of capital discipline around both the liability and asset side of the balance sheets is very important. All the things that we can do on the asset side of the balance sheet, and trying to optimise asset liability management (ALM) and increase return per unit of capital is very useful for them when thinking about risk budgeting and allocating towards underwriting versus assets, communicating to the market and sharing the returns to policy holders and shareholders."

Standing out

This whole framework is where J.P. Morgan Asset Management differentiates itself versus a generalist asset manager. It is able to elevate both the level and calibre of the dialogue with the clients it talks to, and it can engage with its insurance clients' CFOs and CEOs on the topics that are important to them.

"We can have discussions around the asset management function which can result in business opportunities for us or the sector more broadly," Oldcorn notes.

"In addition to advising strategic industry players, we are increasingly also working with potential financial buyers that are active in the insurance sector. This includes assessing a target company's capital efficiency and their earnings capacity pre- and post-transaction, to maximise returns through various ALM and investment strategies."

While the ability to engage in strategic dialogue is important to be relevant to insurance company management teams, ultimately specialist investment capabilities are often necessary when implementing a client's investment objectives. One key area we work on is around specialist requirements for UK and European insurers, particularly matching adjustment (MA) capabilities. Companies try to take advantage of this liquidity premium. Given that life insurers have liabilities that are long in nature they can afford to take this liquidity premium and therefore use that incremental return to discount liabilities at a higher rate. In order to do so, however, they have to get the regulator to sign off the eligibility of the underlying securities and are required to continue to affirm that the securities remain eligible for MA treatment. That has informed a lot of work that we have done around our analytical framework and some of the systems we have developed. This allows us to conduct pre-screening to identify the pool of eligible securities based on their underlying structural features. "No UK insurer is going to hire you for an MA mandate unless you have the ability to support them on that front in terms of identifying the eligible securities up front, and making sure that they remain that way over the life of the mandate."

Fundamentally, whether it is our proprietary technology, insurance expertise or approach to partnering, we seek to put the client first

On the unit-linked side, there is not as much flexibility because the policy holder is ultimately deciding which underlying fund that the investment component of the premiums is going into, but there is some flexibility that the company can retain, i.e taking the benefit of the so called embedded value of future profits in a unit linked book to be a little bit more flexible in the investment approach that they take and not necessarily backing 100 per cent of the liability with unit-linked assets. That is a capability that we are working with clients to optimise."

Oldcorn says often there is a multi-asset type overlay on the investment management piece, where the manager will allocate across the suite of funds on behalf of the policyholder in both unit-linked as well as participating-type policy / with-profits type policies. He accentuates: "Given you cannot have someone allocating across asset classes without understanding the insurance industry Solvency II reg cap and Solvency capital ratio constraints, we feel it is also necessary to have dedicated insurance-specific resources on the Multi-Asset Solutions side."

SCR optimised strategies can be used around shorter dated high yield and shorter dated EMD, "asset classes which are very efficient under SII", Oldcorn comments, "as they result in a material pick-up versus high grade corporates or even cross over corporates".

"These SCR optimised strategies analyse the company's situation, their liability profile and identify how these asset classes fit into the strategic asset allocation (SAA). After we have identified the asset class as being appropriate we can to do a tactical asset allocation (TAA), a security level optimisation and portfolio construction of each underlying bond. By doing this you are identifying the universe of available bonds and then filtering it for the best risk/return premium and technical elements.

"This is all done by our teams utilising our proprietary optimisation engine, PrISM. This system is a front office resource which allows the portfolio managers to do the optimisation work themselves.

"Fundamentally, whether it is our proprietary technology, insurance expertise or approach to partnering, we seek to put the client first. We start with the shape of an insurer's liabilities and business objectives, working backwards to devise a suitable asset and partnership model."

J.P. Morgan Asset Management's expertise is apparent in my discussion with Mark, and his understanding of the challenges facing insurers. Looking back to the Thames, concluding the conversation it is clear insurers need a strong partner navigating the tide of complexity in operating a successful business and investment strategy.

Photo by: Fredy Thuerig / Shutterstock.com

A year of disaster?

Oliver Wade looks at the effects of natural catastrophes on insurers' investment strategies and balance sheets

WRITTEN BY **OLIVER WADE**

LAST year the world's insurers had to pay out a record amount following the hit of 710 natural catastrophes, including the hurricane trio of Harvey, Irma and Maria, resulting in the overall economic, or uninsured, cost of disasters amounting to $340 billion, according to research from reinsurance giant Munich Re.

Following a number of relatively benign years, the overall loss of $340 billion in 2017 marked the second-highest annual loss ever and, when compared to the figure posted in 2016, the amount had almost doubled. The only costlier year to date was 2011, when the Tohoku earthquake that occurred in Japan contributed to overall losses of, what would be, today's equivalent of $354 billion.

Insurers, however, bore the brunt of these losses in 2017, paying out a record $138 billion.

Capital management

Commenting on how reinsurers are managing their capital this year on the back of last year's events, Fitch Ratings director Graham Coutts says: "All four large European reinsurers maintain high-quality investment portfolios with fixed-income investments, split between corporate and government bonds, representing the largest portion of the investment portfolio for each."

Coutts highlights that the world's third-largest reinsurance firm Hannover Re liquidated its entire equity portfolio in the third quarter of 2017, realising gains of €226 million, with the sale "partly in response" to the tremendous losses suffered during the period. However, he notes that the move was further prompted by the desire to realise gains as a result of the "increases in the value of the equity portfolio".

Despite this, Coutts emphasises that, aside from Hannover Re's sale, "the investment strategies of the large European reinsurers have remained broadly stable".

"The losses for the large European reinsurers were manageable and did not have a big impact on capital as property and casualty (P&C) underwriting losses were more than offset by favourable earnings from life underwriting and investments," the Fitch Ratings director adds.

Coutts commends the four major European reinsurers for being "comfortably above" the regulatory minimums and within stated risk appetite for Solvency II coverage, when commenting on how the directive affects the firms' ability to regain capital.

"They [the reinsurers] were also able to maintain their share buyback and special dividend policies, despite the losses, which indicates that they maintain ample headroom under Solvency II," he stresses.

Also commenting on last year's losses, London & Capital senior consultant David Osborne says: "There is a risk of thinking that last year was a really bad year and that insurers suffered a loss as a result of the catastrophes, when in fact last year was not, in a sense, bad enough to do serious damage to the industry.

"The reckoning is that insured losses from hurricanes Harvey, Irma and Maria were somewhere in the region of between $80 billion and $90 billion. I think, from an industry perspective, if you really wanted to do serious damage to the industry, you would have to be looking at $150 billion to $200 billion of insured losses to do the sort of damage that we have seen from some previous events. It just was not big enough to put anybody out of business."

Osborne states that "for things to change in the insurance market and for insurers to really feel the pressure" of the losses, it needs some firms to go "bust".

Photo by: LTRG / Shutterstock.com

Overhyped?
When questioned on whether he thought the effects of the natural catastrophes were portrayed to be more severe than they actually were, Osborne responds "there is always a danger that people will inflate how bad things are".

"The insurance industry at the moment is going through a fairly tough time. Interest rates are low. Nobody is making much profit from underwriting and, equally, nobody is making much money out of their investments because rates are, in historic terms, pretty low, despite being a little higher than what they have been recently. So, everybody is hoping there will be some nasty losses, and there is a tendency to inflate bad news when it comes, in the hope of persuading other people that things really are bad and that, as a result, rates ought to go up."

Osborne reiterated that last year "rates did go up a bit" in the immediate aftermath but, since then they have seemed to come back down again to a "considerable extent", adding that the improvements in longer term rates that "everyone is hoping for, just has not happened yet".

"Until the interest rates increase, the global insurance industry is going to feel pretty unhappy because they are just not making any money," he says.

Echoing what Coutts said, Osborne believes that, "to a considerable extent", insurers have been ploughing on and it has been "business as usual", emphasising that the purpose of the insurance industry is to "help cope with the aftermath of hurricanes, and other natural catastrophes".

However, he highlights that some firms were not able to continue "business as usual", indicating that those smaller firms who suffered from losses had to "go and top up their capital from somewhere", as a consequence of the high number of natural catastrophes seen throughout 2017. Osborne reminds us that, fortunately, the insurance industry finds it "relatively easy" to obtain new capital if the need arises, particularly while the industry is still very competitive.

Osborne notes that, due to the ease of being able to do so in countries such as Bermuda, "a lot" of new insurance companies are being created and then being acquired by larger insurance firms, with the end result being "too much capital" in the market. The London & Capital senior consultant suggests that a catastrophic event large enough to eat considerably into the industry's capital will convince people to "get back out of the insurance industry and find something else to do with their cash", which in turn will drive interest rates up.

Further commenting on the low interest rate environment, Moody's Analytics senior director of insurance modelling and analytics Phil Mowbray argues that insurers across the globe are being encouraged to increase their investment in higher yield credit. Mowbray adds that commercial

> The losses for the large European reinsurers were manageable and did not have a big impact on capital as property and casualty (P&C) underwriting losses were more than offset by favourable earnings from life underwriting and investments

considerations are "now influencing asset strategies" and provides the example of how UK insurers are beginning to make more bulk annuity transactions, such as pension buy-ins, buy-outs and the transfer of annuity business.

The Moody's director draws attention to the fact there is "significant value" to be gained from holding alternative illiquid assets (commercial real estate, infrastructure, equity release and structured securities) for many insurers with longer-term liabilities, while also allowing them to seek increased credit exposure.

"Market data suggests that transactions in these asset classes are taking place at spreads of 1 to 2 per cent per annum over the yield on equivalent duration investment grade corporate bonds. Moody's Analytics has seen a rapid increase in demand from our insurance and asset management clients for data and analytics solutions to understand credit and liquidity risk for these asset classes," he reports.

Taking into consideration what the industry experts have reported, it seems as though the grand losses insurers endured last year following the unexpectedly high number of natural catastrophes, did not impact the insurance industry as severely as many may have first imagined.

The view from the top

Insurance Europe director general Michaela Koller gives her views on the insurance industry

WRITTEN BY **ADAM CADLE**

Q What is the societal role of insurers?

Insurers play many important roles in our society. The products we provide protect European citizens and businesses, and the advice we offer can encourage better risk management. We also help people to save for the future with long-term savings, life insurance protection and pension products. To match those long-term liabilities, we make significant long-term investments that support the wider economy.

Insurers are also there to help their customers deal with the effects of climate change by offering them protection against the related risks. In addition, many insurers support national authorities in this area, through their involvement in initiatives such as risk awareness campaigns, risk mapping and zoning tools to identify high-risk areas, risk modelling to examine the financial cost of localised risks and information-sharing databases on adaptation measures. These adaptation efforts go hand in hand with efforts by policymakers to mitigate climate change. Insurers also play a variety of roles in promoting sustainability more generally and invest in a wide range of sustainable projects.

Q What is the importance of the insurance industry for the European economy?

First of all, the protection we provide to individuals and businesses allows the economy to thrive. Secondly, our need to invest premiums and capital means that insurance companies are Europe's largest institutional investor. In 2017, for example, insurers had over €10 trillion of assets under management, most of which backs our life business with long-term investments that play a vital role in promoting stability and growth in our society. To give you an idea of the scale of our contribution, our assets under management are equivalent to around 60 per cent of Europe's GDP.

Q What kind of challenges do Europe's insurers face?

Insurers face an array of challenges and opportunities. A timely example is cyber risk. Recent cyber attacks have shown how exposed we are to online criminals. A recent report suggested that a major global cyber attack could trigger losses of over $50 billion. While insurers need to protect themselves against these risks, they are also part of the solution, and a number of insurers are already responding with products to protect customers. However, this is only the beginning and the market is expected to grow in the years to come. Having said this, providing insurance against cyber risks is complicated. Unlike natural catastrophes, cyber risks have no geographical boundaries. This raises questions about accumulation and aggregation, and is one reason that insurers tend to be cautious with cyber risks.

Moreover, a key factor limiting the development of cyber insurance solutions is the lack of data available for insurers to analyse. This makes cyber risks, which are also unique because they are constantly evolving, difficult to understand and price.

However, recent EU legislation that obliges companies to provide authorities with information should there be a cyber breach, most notably the EU General Data Protection Regulation, can create an opportunity for this vital information to be readily available to insurers underwriting cyber risks.

Therefore, if policymakers wish to shift part of the risk away from society, they must make information on the nature of cyber attacks available to insurers - on an aggregated and anonymised basis. This would enable insurers to refine the protection they offer to clients and help boost the EU cyber insurance market.

Insurers also face several regulatory challenges. Well-designed regulation can protect consumers, our industry and the rest of the economy. However, even well-intentioned rules can have unintended consequences if they are not well designed and calibrated.

For example, an increasing challenge connected to regulation is compliance risk. Insurers dedicate substantial amounts of money and resources to correctly implementing the many rules that govern us.

In 2018 alone, European insurers must implement the new Regulation on Packaged Retail and Insurance-based Investment Products (PRIIPS); the new Insurance Distribution Directive (IDD); and the new General Data Protection Regulation (GDPR).

Well-designed regulation can protect consumers, our industry and the rest of the economy. However, even well-intentioned rules can have unintended consequences if they are not well designed and calibrated

The objective of these initiatives is to provide additional protection for consumers, an aim that insurers fully support. However, the rules are both challenging and expensive to implement and the information they require insurers to provide customers is sometimes not useful or easy to understand.

Q How would you improve the Solvency II framework?

Solvency II — the prudential regulatory framework that governs our industry — is the most sophisticated in the world and Europe's insurers truly appreciate its high standards of governance, risk management and reporting, and the consumer protection it provides. However, as with any large piece of legislation, there are several issues that need to be addressed.

A particularly important one impacts insurers' ability to provide guarantees to customers and how insurers invest. Since the insurance industry is Europe's largest institutional investor, it is vital for the region's economy to get this right. Despite this, combined with the current challenging economic environment, Solvency II has been pushing insurers away from offering long-term products and guarantees, which are underpinned by those long-term investments.

This is happening because Solvency II treats insurers as if they were short term investors — which they clearly are not — and leads to capital requirements that are far too high in relation to the real long-term risks faced by insurers. This creates unnecessary barriers to the provision of long-term insurance products and restricts insurers' ability to make long-term investments, just at a time when the European Commission wants to boost investment and growth in the EU.

Fortunately, when Solvency II was set up, it was recognised that such ambitious new regulation would need to be adjusted and improved to get it really working as planned and to avoid unintended consequences. The planned reviews, the first which is due by the end of this year, with a second, more comprehensive one by the end of 2020, must be used to improve Solvency II and in particular improve how it deals with long-term business and investment.

Q Looking ahead, what role do you see Insurance Europe playing in the insurance space?

Our role is to represent our members – the national insurance associations – at a political level, both in Europe and on the international stage. We have a robust and constructive relationship with our members and provide them with insight and updates on regulatory developments, as well as platforms for exchanging views. We work highly effectively with our members, who provide excellent input into our positions. We can truly say that we are the voice of the European insurance industry in Europe and beyond.

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CHAIR

ANTOINE LESNÉ

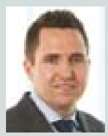
Head of SPDR ETF Research and Strategy, EMEA, State Street Global Advisors

Prior to SPDR, Antoine was a fixed income portfolio strategist for State Street Global Advisors and global fixed income beta strategies. Antoine joined SSGA in 2006 from SunGard Reech where he was responsible for selling advanced pricing and risk analytics with a focus on structured fixed income derivatives. He started his career at Societe Generale.

RIMA HADDAD

Head of UK institutional – SPDR ETFs, State Street Global Advisors

Rima is a vice president at State Street Global Advisors and leads the coverage of asset managers, hedge funds, pension funds, insurance companies and consultants for the UK SPDR ETF business. She joined SSGA in January 2017. Rima previously headed up the UK institutional business at ETF Securities and also led its Swiss and Middle East distribution.



STEPHEN YEATS

Managing Director, Head of Fixed Income Beta Solutions, APAC and EMEA, State Street Global Advisors

Stephen is a managing director and head of the fixed income beta solutions team for APAC and EMEA. He heads a team of portfolio managers providing clients with a broad range of fixed income strategies including investment grade credit, global rates, high yield, convertible bonds and emerging market debt.

ATANAS CHRISTEV

Head of Investment, Direct Line Group

Atanas joined Direct Line Group in 2012 to help establish and run the investment function as the company was being prepared for separation from RBS. After graduating from the European Business School in London in 1994 he started his career in capital markets as a fixed income bond analyst for ABN AMRO Hoare Govett and later worked at S-E-Banken.

VISHAL SHAH

Head of Investment Operations, Brit Insurance

As head of investment operations, Vishal looks after the back and middle office functions at Brit Insurance with AUM of $5 billion. In total he has 11 years' experience in the insurance investment management space, seven years of which performing various investment and economic roles at XL Catlin. Vishal is also a chartered accountant.

ANKIT SHAH

Investment Manager, Antares Managing Agency

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

Analysis and implementation of ETFs in the insurance space

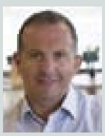
HADDAD: On the ETF front there have been some significant developments in the industry. Last year was a record year for growth, with assets reaching a record high of $4.7 trillion under management. As of the end of April we are now at $4.9 trillion under management. In addition to this, we have also seen a record amount of inflows with $664 billion coming into ETFs, and for the first time a large part of this has been in fixed income. Well publicised was the distinct shift from active to passive management; however in addition to this new investors from the institutional space have begun to utilise ETFs, some of whom manage portfolios directly - in direct equities or bonds. This institutional use of ETFs is a continuing trend we are also seeing throughout this year.

The other interesting point is that the number of products has grown considerably. In Europe alone there are over 2300 ETFs across different exchanges, not just in traditional equity or fixed income, but also in infrastructure, real estate and the hedge fund space. We have seen substantial growth in the number of insurers using ETFs as one of many vehicles they can utilise, and this has been particularly pertinent in the US. In a ten-year period, ETF assets from US insurers has grown from $4 billion to over $24 billion today. Most of this was historically in equities, but what you will see is that fixed income ETF holdings have grown three-fold over the last three years. Talking to our UK and European insurance clients, ETFs were traditionally used in growth or surplus portfolios; however because of the abundance of exposures and liquidity of fixed income ETFs, they are also being used in reserve asset portfolios.

LESNÉ: Looking at the US ETF market, we can see that the number of US owned assets by insurance companies has grown relatively quickly. Interestingly, the growth of ETFs in the US has not initially come from institutional investors but more from the retail and IFA side. If we look at Europe however it is the reverse. Today the industry estimates that between 70 and 80 per cent of total assets which are in European domiciled ETF are held by institutional investors.

So, how are investors using ETFs? We like to see ETFs as a new type of financial instrument. It is a fund that has the advantage of trading on an exchange. It is taking a basket of securities, making it into single security that trades like an equity, even if it is a packaged basket of bonds. It can be used to replace an actively managed portfolio, a complement of active management and can also be viewed as an indexed strategy. ETFs can come as a replacement of derivatives like futures or credit default swaps. ETFs can be used as either strategic or tactical asset allocation. You may be surprised to hear that the average holding period of an ETF in Europe is around two and a half years.

Insurance companies are now also using ETFs first as a tool for cash/liquidity management, sometimes focused on short duration fixed income. Each insurer will certainly be able to find an ETF that can match their strategy benchmark thanks to the wide variety on offer. It also fits in well with the return portfolio for insurers'. What is interesting is the sheer increase in the diversity of ETFs. Indeed in 2002, the first fixed income ETF was focused on government bonds and generally narrowly defined benchmarks. It is fair to point out that before the financial crisis in 2007/2008, there were not a lot of tools on offer in the ETF market and often the authorised participants were generally equity desks rather than fixed income desks. As we have



MICHAEL LEONARD
Head of Insurance Solutions Group, LV=
Mike has led a multi-award winning team for the past seven years. He has a multi-disciplinary background with over 23 years of experience. He has an actuarial background but the vast majority of his career has been in investments both as a credit portfolio manager and trader. His specialisms include ALM, illiquid assets and multi-asset derivatives.

ELLIE SIVA
Strategic Investments Manager, Phoenix Group
Ellie Siva is in investment strategy at Phoenix Group, the UK's largest specialist consolidator of closed life assurance funds. She sources assets for annuity funds, with a focus on equity release mortgages. She has been at Phoenix since 2016 and prior to that worked in investment banking in residential mortgage-backed securities structuring at Citigroup.

As we have gradually moved into a low yield environment, we have seen investors going heavily into fixed income markets - today the global fixed income ETF market surpasses $850 billion

gradually moved into a low yield environment, we have seen investors going heavily into fixed income markets – today the global fixed income ETF market surpasses $850 billion. This is not insignificant, but certainly not big enough to be the cause for alarm that some has sometimes been portrayed in the press. There is nothing more transparent than an ETF which is one of the main advantages. The exposure is also key. You can focus on the asset allocation or you can focus on selecting the right active manager or reshaping the portfolio by putting your efforts on the allocation.

YEATS: One of the issues that runs through many peoples' heads is the liquidity of fixed income. Anyone involved in fixed income knows that the bond market is not perfect in many ways. There are too many bonds. We have a very big fixed income book, about $350 billion, which is index related investments. Our clients are typically looking for us to give remove and gain market exposure efficiently for them. Market structure is something we care a lot about, we understand the market liquidity from both ends – we manage an ETF book but we also trade cash bonds. At a very basic level, ETFs are one of those asset classes which can attract quite strong views on both sides. An ETF takes a basket of bonds and concentrates liquidity of those bonds, but if you have a single equity trading on an exchange and there a lot of different investors trading that equity, at a very basic mathematical level, if someone holds that ETF they are more likely to find liquidity in that security than if they were trying to trade the entire basket of underlying bonds. An ETF is a wrapper and you really have to think about what is in it. As a provider we are very careful about what sort of exposures we would put in an ETF wrapper.

I'd also like to outline the 'multi-billion dollar plumbing problem'. There is a huge amount of fixed income out there, but the problem is that there are way too many bonds. There is also a regulatory drive to greater transparency and this is a challenge. However, there is still a lot of bond market trading going on and there is a lot of money being made out of this. There is a motivation that draws other players into this space. ETFs are now part of this landscape. Historically you have ETFs running off an equity desk at a bank and then you would have a bond trading desk and they didn't speak to each other. If you have an equity trading desk which is trading fixed income ETFs, why wouldn't they when making a price on their equity ETFs, why wouldn't they take into account what the bond desk was holding. Banks are now addressing this as well as institutional clients.

The final aspect is technology. Technology is changing the way that financial markets work. That helps, because there are too many bonds, and matching buyers with sellers is difficult. Large data sets can now be handled with technology, and this helps to improve the transparency of data so market participants can consume that data and match buyers with sellers. For many broker dealers in bonds who are also active in the fixed income ETF market, they understand what bonds go in on an ETF basket and they understand what their balance sheet holds, so whenever you go in for a price on a cash bond it takes into account the liquidity elsewhere and this is same with the ETF.

Bonds that are in ETFs that are liquid tend to be more liquid. Bonds that are not, tend not to be and there may be an illiquidity premium attached to these – if investors don't require liquidity then buying off the run bonds may work well, but for those who do ETFs can make sense. ETFs are becoming part of the eco system among banks and institutional investors.

LESNÉ: Let's now talk about the macro-economic environment. We are now coming gradually towards the end of the economic cycle and from a fixed income standpoint we are also living in a gradually normalised monetary policy environment. Trade wars are an unexpected element from the Trump administration and have had a clear impact on currencies and assets across regions. So how do you manage these developments in your portfolios?

V. SHAH: At the moment, we are trying to see whether there is anything concrete surrounding trade wars as it may well be just bluster. We believe we are well hedged on currency on an ALM basis.

LEONARD: We have a general insurance portfolio which we use to have a reasonable holding in UK equities. We have now reduced this and have a capital hedge in place for the remaining holdings. This allows us to clip the dividend which is yielding far higher than any credit bonds. We remain concerned about complacency in the market and this goes back to 2006 where we could see structural change in the market, but the desire for assets and the chase for assets meant that people were not paying attention to the structural changes. As a result, we saw a massive unwind of leverage of the markets. Again, we are seeing similar trends with increased leverage in certain parts of the market. I think there is a large element of stagnation through procrastination in the market where people are not sure what will

"Trade wars are an unexpected element from the Trump administration and have had a clear impact on currencies and assets across regions

> Inflation is one of those things that hasn't happened for a long time, but now, if it materialises it could be a massive disruptor

happen so think it is easier to not make a decision than make a decision.

SIVA: As long term investors we are more concerned with the implications, if any, of political events on the fundamentals of the economy, rather than day to day market sentiment. Rate normalisation could indicate strong underlying economic growth, which could be positive for credit. Rising rates though can impact businesses with unsustainable levels of leverage, which would be at increased risk of downgrade and default. Good individual credit selection is therefore key.

A.SHAH: We are watching this, but it is not impacting actions. On the fixed income side we try to stay as short a portfolio as possible to mitigate some of the volatility risk.

CHRISTEV: We have already seen some retaliation to the imposition of US tariffs and the threat of further escalation. However, I am relatively optimistic: while certain credits will suffer, I don't expect a material negative impact on the credit markets. The major problem around US exposure currently is the hedging cost which is putting into doubt the whole idea of being in US credit. That is something that we are looking to address. At the same time, as a UK-based insurer we have a relatively high concentration in sterling credit and would be reluctant to simply add more exposure in a relatively small market. Another issue is the direction of UK rates. It is still far from clear how Brexit will turn out and the risks to the economy are not negligible. In terms of longer term issues, I wouldn't be as worried about trade wars as about the secular trend of which Trump, Brexit or the result of the recent Italian elections are the manifestation. More protectionism is one thing, but could there be some sort of bigger political 'revolution'?

YEATS: To me, inflation is the biggest question out there. It is always the thing that you are not pricing that comes up to bite you. Inflation is one of those things that hasn't happened for a long time, but now, if it materialises it could be a massive disruptor.

LEONARD: We do not take any interest rate or inflation risk as we don't think it is rewarded. Predominantly we have sterling liabilities. With the introduction of Solvency II, especially for an annuity provider, we have seen a huge increase in our interest rate and inflation exposures and that is typically through the risk margin, so the longevity aspect of the market bringing in greater exposure to interest rates. That creates a big problem for the life business because you get a recalculation every two years or you get a recalculation if the ten year interest rates drop by 50 basis points or increase by 50basis points but have to have sufficient free assets to manage this interest rate volatility.

CHRISTEV: Our approach in dealing with the periodic payment orders (PPOs) which are linked to a specific type of wage inflation, is based on macro-economic reasoning as duration calculations would be of little use in this case. The broader question is what other investments would give us broad protection against inflation. We are backing those liabilities with two types of assets – infrastructure loans and commercial property. The former pay Libor plus, while a large chunk of the property portfolio tenancies are RPI-linked. In addition, these two asset classes provide diversification to what is predominantly a corporate bond portfolio.

LESNÉ: In this low yield environment, how are you trying to find additional sources of return?

SIVA – We are focusing on diversifying through accessing private debt and the illiquid markets, where we look for complexity and illiquidity premium in addition to compensation for credit risk. Firms are seeking diversification in terms of both geography and asset classes. Given we are in the second longest credit cycle in history, we are not willing to compromise on credit quality for yield. We are quite cautious in our credit exposure, particularly to long dated 'BBB' credit.

V.SHAH – As part of the Fairfax group the philosophy is to be value investors. That is where we see more opportunity in private placements. In terms of the credit cycle, we have been very short duration for a long time now and now we are taking the opportunity to increase our duration.

LESNÉ: Looking at Solvency II, did this force you to change the type of instrument you are using to invest in fixed income?

LEONARD: In our GI business, we never discounted our liabilities prior to Solvency II and now we do. That means we have a curve exposure. So we use swaps to hedge this in line with the EIOPA discount curve. If we use gilts we introduce swap spread risk , which is less volatile than interest rate movements but still can cause material movements in your balance sheet.

CHRISTEV: The punitive treatment of some asset classes forced us to reconsider our investment in securitised credit. In a more indirect manner, insurers are now using models which can have deficiencies, for example not always reflecting the full diversification benefits of investing in new asset classes, and that could affect the final investment decision.

HADDAD: We have been talking to a number of insurers who wanted that equity exposure but didn't want the punitive capital charges associated with it. They looked at convertible bonds are a solution to that. Looking at just the SII calculations on convertible bonds, it tends to carry half the capital charge of developed equity markets. In our convertible bond strategies, our assets have over doubled in the last 12 months from insurance investors wanting to get exposure to equities but through a less volatile instrument.

LESNÉ: Have any of you used ETFs or think about using them as a result of these regulatory changes?

LEONARD: For me the interest around an ETF would be from a hedging perspective and being able to short. Credit hedging is a real problem for the market.

A.SHAH: We have just inherited a book and there are some ETF exposures in that and that kind of forced us to have a look at what is happening in this space, and see if we can adopt that in our larger portfolios as well.

HADDAD: There is shorting taking place in European ETFs. We see that quite strongly from the hedge fund space, both in US and European listed products. ETFs are lendable as well and there is quite a large premium to be earned if you are able to lend out. There is also a really active options market on ETFs in the US.

All views provided in this roundtable were correct at the time it was held in June 2018.

> We are focusing on diversifying through accessing private debt and the illiquid markets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The right timing

Price volatility, regulatory and other uncertainty plus well-publicised scams have made cryptocurrency investment a 'no-go' area for many insurance asset managers. What are the chances of it becoming mainstream over the next few years?

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

A year ago the cryptocurrency market was a party in full swing. Pack leader bitcoin began 2017 by falling 30 per cent to $750, but once more demonstrating the price resilience that has characterised it over nearly a decade the crypto climbed over subsequent months to peak at $17,900 by mid-December.

Despite predictions that the $20,000 price level would next be broken, the fizz has left the crypto market since then. By February this year bitcoin was back at $6,200 and in recent months has moved in a comparatively narrow price band.

Inevitably, comparisons have been made with the dotcom boom-to-bust of the late Nineties. The upward trajectory of the market last year meant the concept of state-backed cryptos was not a fanciful one – for example Japan's banks were reported to be developing their own crypto, J-Coin, to wean consumers off cash.

More recently, that sense of urgency has lessened. In September, European Central Bank president Mario Draghi dismissed speculation that the ECB had plans for a digital token alternative to the euro. He cited price volatility, a lack of robustness in the blockchain technology supporting crypto transactions and the lack of sustainable infrastructure for developing a crypto economy.

While China has cracked down on crypto exchanges and crypto trading, many regulators have a more sympathetic attitude and regard cryptocurrencies as a potentially huge source of new business, says Adam Grimsley, head of investment solutions for Prime Factor Capital, a long-only, buy-and-hold cryptocurrency fund set up by former BlackRock fund managers.

The UK's regulatory stance has been among the friendlier to crypto, although both the Bank of England governor Mark Carney and the Prudential Regulatory Authority's (PRA) chief Sam Woods have warned financial institution CEOs of the potential reputational risk of getting involved in crypto assets.

In an exercise similar to that conducted by the Financial Conduct Authority (FCA), Woods issued a letter stating that businesses should consider the potential liabilities before becoming involved in crypto. "In their short history, crypto-assets have exhibited high price volatility and relative illiquidity," he warned.

"Crypto-assets also raise concerns related to misconduct and market integrity – many appear vulnerable to fraud and manipulation, as well as money-laundering and terrorist financing risks."

Early days

Given the mixture of uncertainty, volatility and caution surrounding cryptocurrencies, is there any potential for them to become a mainstream asset class for insurers and to be incorporated within an investment portfolio?

A number of investment managers appear reluctant to give an opinion, although Schroders' chief digital officer, Graham Kellen, says: "Schroders is continually reviewing the development of cryptocurrencies. The regulation and governance of cryptocurrencies is going to be an area of significant interest to policymakers and regulatory bodies and Schroders will continue to monitor how this evolves."

In March this year, the firm announced the launch of its in-residence programme for tech start-ups, Cobalt, in which Schroders will collaborate with and assist financial services-focused tech start-ups that have grown beyond the conceptual or early-growth stage and "offer solutions relevant to investment management."

"The cryptocurrency market is still too immature for mainstream institutional adoption," notes Romal Almazo, cryptocurrency lead and principal consultant for the global business and technology consultancy Capco.

"However, many global financial institutions have set-up crypto working groups to explore opportunities. Some have even taken it a step further and are trading over-the-counter (OTC) and regulated crypto futures. This is largely being driven by client demand, so can't it be ignored.

"For institutions to adopt cryptocurrency they will need to see two things; firstly regulation and, secondly, safe digital asset custody solutions for the store and transfer of assets."

> The cryptocurrency market is still too immature for mainstream institutional adoption

Almazo notes that as with any technological innovation, from the development of the railways in Victorian times to the dotcom bubble the market gets ahead of itself before a sharp correction. It then recovers and consolidates, assuming a more stable growth trajectory over time.

"I would expect another seven to 15 years before we see mainstream adoption, but institutions such as insurers should start looking at it now," he suggests. "They have a large role to play especially around custody and insuring digital assets.

"From a retail perspective, the real game changer will come about when acceptance of bitcoin and other cryptos become mainstream when buying goods and services. Retail adoption will drive future growth and economies will decrease their reliance on fiat currency. People will also start receiving part of their salary in crypto, which is already happening in Japan."

Grimsley believes that the ebbing of the crypto price frenzy is no bad thing. "It has enabled people to understand blockchain better and its potential impact on their business. Many are looking at the operational side and areas such as counterparty risk.

"There has been significant spending on the infrastructure, which is predicted to grow further. That has helped the markets, as people look at how the technology might best be adopted into their day-to-day activities."

Grimsley predicts that as new fintech disruptors emerge, the adoption of both crypto and blockchain will accelerate. The main obstacle is that while the decentralised nature of crypto lends itself to a globalised economy it is less accommodating to regulation and undermines the ability of central banks to influence the economy.

"From the perspective of insurance asset managers, the first question regarding crypto is "are we allowed to do it?" as there are various restrictions on how they develop their investment portfolio," he suggests. "It's likely that at some future point they will make crypto part of their investment portfolio, but over the next couple of years they will first look for greater clarity on how these assets are regulated before investing significantly."

Assessing the value

What should managers be looking for? The first question to ask when reviewing crypto, as with any digital asset, is what are its fundamentals and what does it add in the way of value?", Willis Towers Watson senior economist Magda Ramada Sarasola suggests.

"There are a wide variety of tokens, but only a certain number

> It will probably be at least five years before we get a clear picture and it will take regulators at least another three years to get fully up to speed

of cryptos that actually provide value in delivering decentralised transactions. The differences between the various protocols are unclear, while the noise surrounding crypto generates capacity and the opportunity to do bad things. But certain cryptos and certain protocols will prevail – even though they're currently popping up like fungi.

"As it's still early days, we don't really know just how big the eventual value will be. Rather like Netflix and its initial experiments in streaming content online, we don't know how big an appetite will develop for decentralised transactions. It will probably be at least five years before we get a clear picture and it will take regulators at least another three years to get fully up to speed – so we're probably talking the mid-2020s.

"If you're an institutional investor, such as an insurer, then you need a model to understand a model. There's not yet any agreement on which economic model is most accurate and neither do we have a model that can be used to gauge the value of crypto assets."

So should insurers sit on the sideline pending these developments, or could they begin to incorporate an element of crypto in their investment portfolio? Almazo suggests that by using trusted third parties they could invest safely. "I would steer clear of crypto exchanges, as none of them are yet of institutional grade despite their claims, although this will slowly improve over time however," he notes

"There are already a number of start-ups that will be catering for institutional clients by providing a regulated trading platform and safe custody solutions, but the safest way to invest right now is through regulated crypto futures. Regulated security tokens could also be an option, although the market is still very immature and illiquid, and will take at least another year to evolve properly.

Almazo adds that regulated exchange traded funds (ETFs) are just around the corner. "Applications have been rejected by the US Securities and Exchange Commission (SEC) to date, but it is inevitable that they will preside eventually.

"My advice for insurers is to look at your options, carefully. I would take a closer look at what is happening in the digital custody space, as there will be some big name insurance announcements in coming months."


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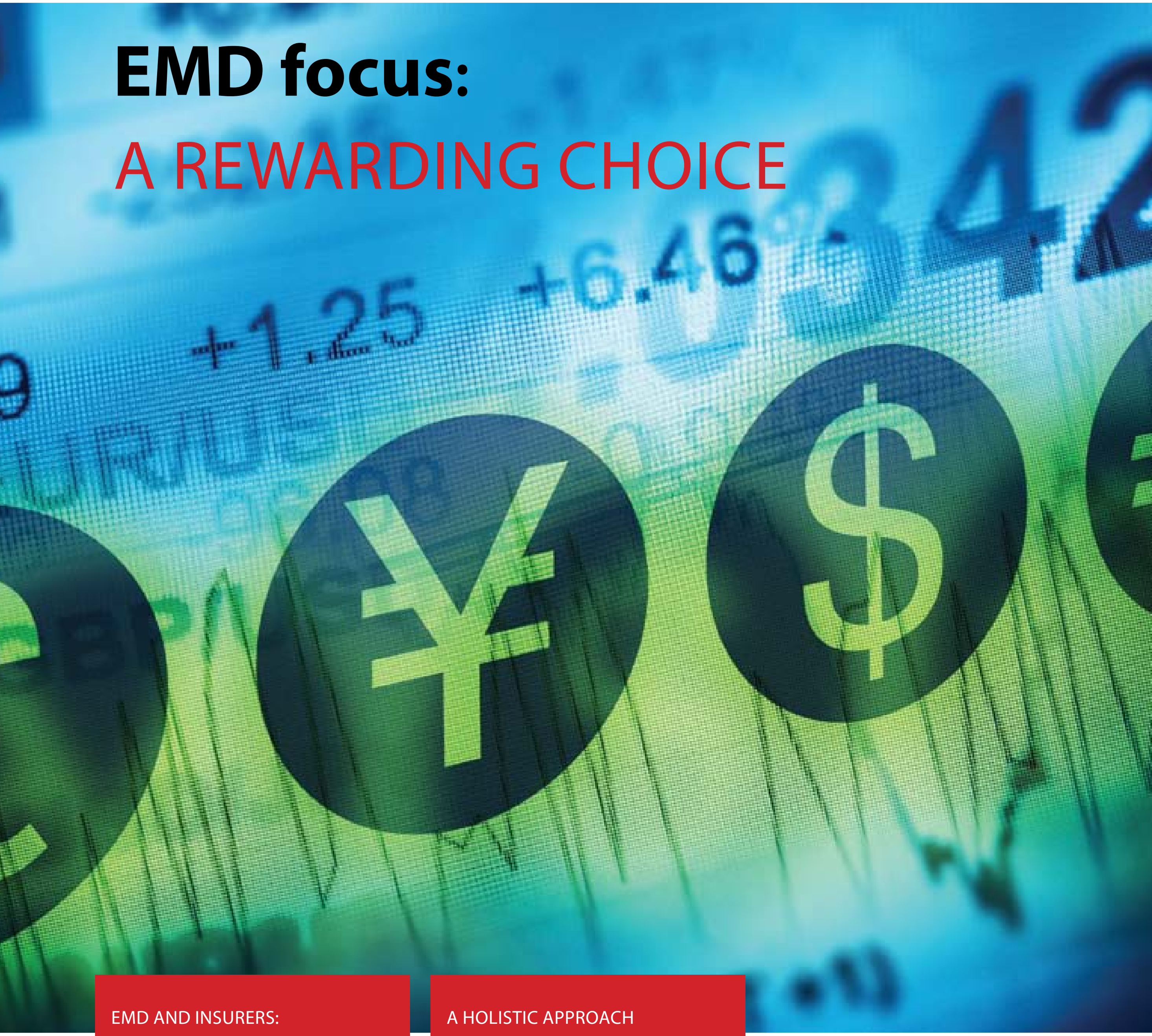

EMD AND INSURERS: STRANGE BEDFELLOWS?

Emerging market debt strategies can offer a range of benefits to insurers, say Uday Patnaik and Mehdi Guissi of Legal & General Investment Management

A HOLISTIC APPROACH

Adam Cadle looks at the importance of insurance companies implementing a holistic framework when outsourcing actively managed EMD mandates to third party asset managers

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EMD and insurers:
STRANGE BEDFELLOWS?


Emerging market debt strategies can offer a range of benefits to insurers, say Uday Patnaik and Mehdi Guissi of Legal & General Investment Management

WRITTEN BY **LEGAL & GENERAL INVESTMENT MANAGEMENT HEAD OF EMERGING MARKET DEBT UDAY PATNAIK AND CO-HEAD OF SOLUTIONS STRATEGY, EMEA & ASIA, MEHDI GUISSI**

EMERGING market debt (EMD) is still not seen as a core asset class for many European insurers, due to concerns over its risk/return profile, credit spectrum and market capacity. We believe these concerns are misplaced.

EMD strategies can actually, in our view, help life and general insurers meet some of the challenges they face today, as a building block within liquidity, liability-driven investing (LDI) and growth portfolios.

Our research suggests that the astute deployment and implementation of the asset class can help to achieve excess returns versus conventional investment grade (IG) credit, enhanced diversification and balance-sheet efficiency.

Ratings and spreads

Investors understandably focus primarily on the risks when considering whether to hold EMD, prompted by memories of sovereign defaults and shaky economic fundamentals.

But the credit rating differential between emerging and developed market sovereigns has compressed by about six notches over the past 20 years, with global spreads tightening as a result.

This move has been partly driven by an increase in the ratings of emerging economies such as China, Chile, Slovakia, and the Philippines; indeed, around 50% of the $3.1 trillion or so in the hard currency, emerging market (EM) corporate and sovereign bond universe is now IG. There has also been a deterioration in developed-market risk in the wake of the global financial crisis – of which Italy's recent travails serve as a timely reminder. At the same time, prudent fiscal policies adopted by many emerging economies have helped to keep public debt/GDP ratios from expanding at the fast pace seen in developed markets following the crisis, in a clear structural break from past behaviour.

This break is also reflected in the paradigm shift seen in the way emerging markets, led by China, contribute to global growth. In the 1980s, their economies generated 30% of global GDP growth, versus 70% for developed economies; today those numbers have flipped, with emerging markets now contributing 70%.

There are, of course, marked variations in the credit quality and economic positions of individual emerging markets. However, we believe that these idiosyncratic risks can be addressed – and turned into opportunities – through the analysis of issues such as corruption, income inequality and national politics and elections. As a result, we believe that an active implementation of the asset class can add significant value.

Against this backdrop, and given the potential excess returns offered by yield spreads, the EMD universe offers a compelling risk/return profile and the potential to enhance total returns on a multi-year horizon, in our view.

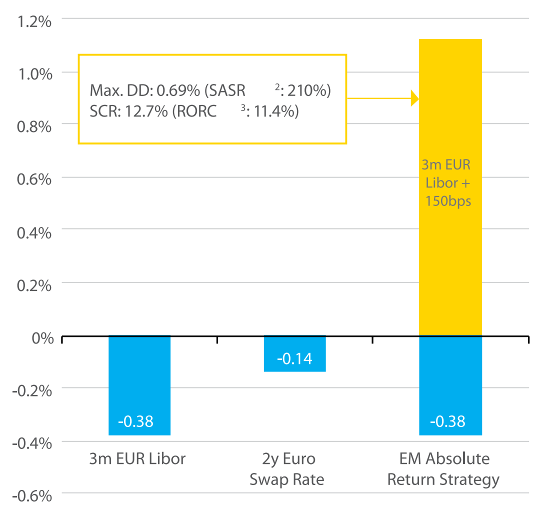


Figure 1: Enhanced returns and efficient balance sheet characteristics. *Source: LGIM. For illustrative purposes only (using data between 31/01/2013 and 28/02/2018)*

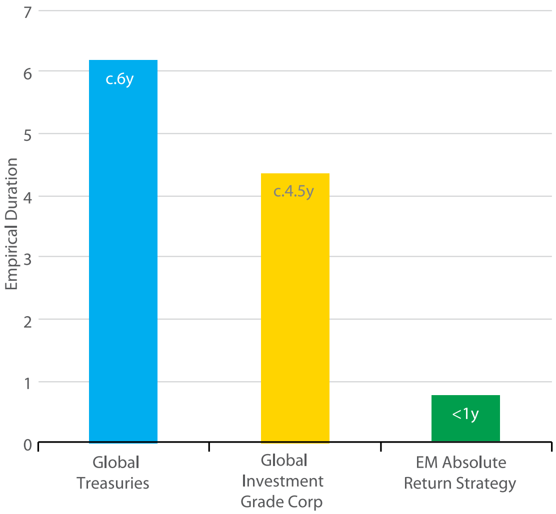


Figure 2: Empirical duration of absolute return strategies. *The results are based on a regression analysis from which annualised returns are regressed against a total return swap index (data between from 31/01/2013 and 28/02/2018). Source: LGIM. For illustrative purposes only*

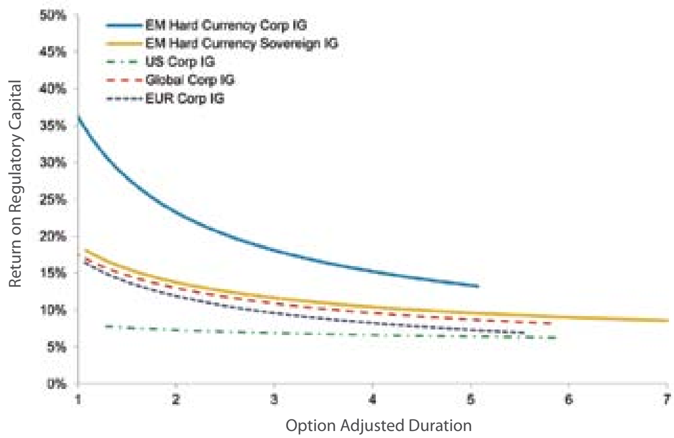


Figure 3: Return on Regulatory Capital of EMD IG strategies as at 31/08/2018. *All strategies are FX-hedged into EUR. Source: LGIM. For illustrative purposes only.*

Hitting the liquidity buffers

Insurance liquidity buffers are usually required to meet short-term operational expenses, as well as the liquidity risks underpinning technical provisions. The latter could perhaps arise from the lapse of policyholders across with-profit and non-profit books, or the volatile nature of actuarial claims in healthcare and property and casualty insurance.

In the current low yield environment, we believe EM absolute return strategies could prove a valid alternative to increasing asset duration, and moving down the credit curve, within liquidity buffers. Indeed, these latter moves have led to situations whereby some general insurers seeking to boost operational profits have ended up with higher asset than liability duration – and were forced, following rising yields, to sell assets at distressed prices to meet their liquidity needs. This resulted in reduced profitability and Solvency ratios. EM absolute return strategies can:

> The EMD universe offers a compelling risk/return profile and the potential to enhance returns on a multi-year horizon

- Offer excess returns over conventional liquidity strategies; e.g. money markets, short-duration sovereign bonds and investment grade corporate bonds
- Offer the potential for strong Solvency risk-adjusted returns also known as Solvency Adjusted Sharpe Ratio (SASR)1 , and strong regulatory capital-adjusted returns also known as Return on Regulatory Capital (RORC)2
- Avoid structural duration biases – which may appeal to general insurers seeking to boost operational profits without increasing asset duration

Enhanced LDI

In the past, most European insurers have relied on euro-area sovereign debt and swap strategies to meet financial guarantees (life business) and non-life claims for which there are a strong cash-flow visibility.

Yet central banks' monetary stimulus – not least the introduction of negative interest rates – have pushed insurers to include larger amounts of IG corporate bonds and private credit as core components of LDI portfolios.

In addition, an increasing number of players have been further expanding the boundaries of traditional LDI portfolios by investing in IG, hard-currency EMD strategies. Beyond a solid credit profile, we believe such strategies could offer:

- Excess returns versus conventional LDI strategies; e.g. higher yields (net of FX-hedging costs) across the term structure than IG credit in more developed countries

> An active implementation can help insurers seeking to align with Pillar 2 of Solvency II

- Diversification benefits through exposure to new geographies, a variety of economic models and countries at different stages of development

- The potential for superior RORC and SASR, which have been higher for IG emerging market corporates versus sovereigns as the excess returns usually compensate for additional market risk SCR (under Solvency II) and economic risk

- Potential matching-adjustment eligibility (under Solvency II) for annuity books, subject to the outcomes of the eligibility criteria – albeit implemented via a buy-and-hold approach, which does limit the opportunity set

Our analysis is based on a passive implementation of EMD strategies. However, we believe that the idiosyncratic risks posed by the asset class allow for significant value to be added by ongoing monitoring and risk-management. The skills, knowledge and experience of credit analysts, macro strategists and portfolio managers are critical to assess risks and opportunities across individual EM countries.

In addition, an active implementation can help insurers seeking to align with Pillar 2 of Solvency II, which requires companies to provide adequate governance, structure and processes to measure and manage balance sheet risks on a forward-looking basis.

Growth diversifier

Insurers' growth portfolios are usually utilised to generate growth on behalf of policyholders (with-profit business) and shareholders – as well as a buffer to fund future strategic projects.

Conventional growth portfolios typically include equities, high yield credit, private equity and other alternatives. We believe that EM total return strategies could be an attractive diversifier within growth portfolios by offering:

- Investment returns in line with insurers' targets. Depending on investors' risk appetite, a typical EM total return strategy could target an excess return in the range of 350-500bps over Libor

- Enhanced diversification and de-correlation versus traditional risk premia. Our analysis suggests that EM total return strategies tend not to lead to structural exposure to traditional risk premia over the long-term. Furthermore, correlation with traditional risk premia tends to be low and relatively unstable over time

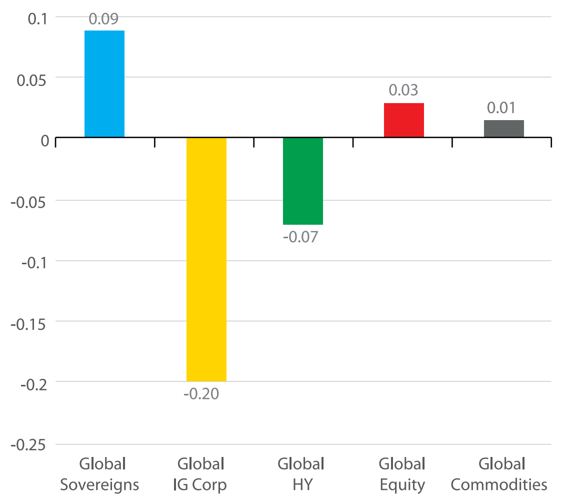


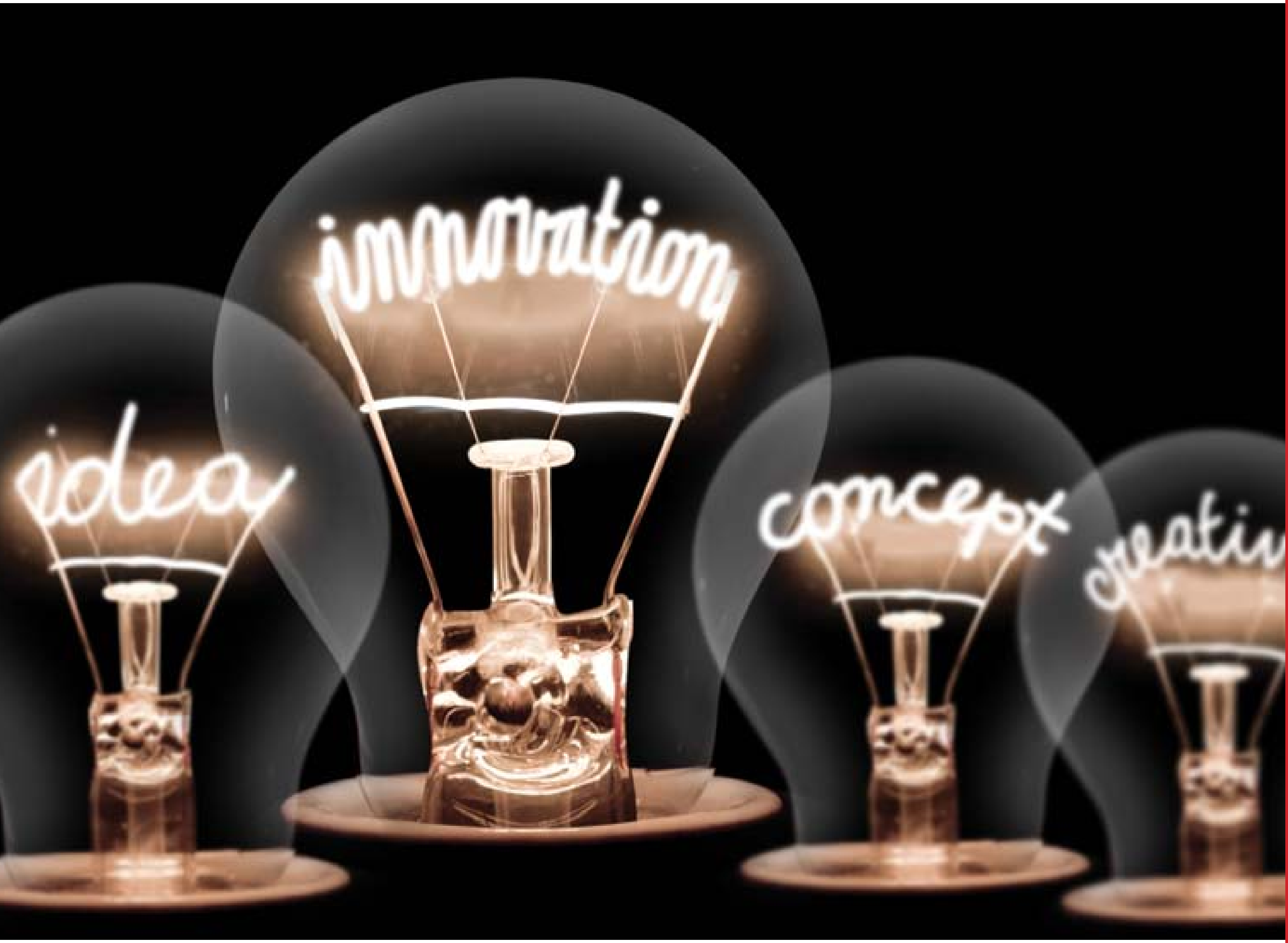
Figure 4: Long term market exposure of EMD total return strategies.
Source: LGIM (based on data between /01/2013 until 28/02/2018).
For illustrative purposes only

- The potential for strong RORC and SASR

Taken together, we believe these points show that EMD strategies can offer a range of benefits to insurers, whether they are looking to meet their financial guarantees, boost medium-term operational profits or generate growth for shareholders.

1. The ratio between the excess return (over the liability benchmark) of an investment strategy and its contribution to surplus volatility

2. The ratio between the excess return (over the liability benchmark) of an investment strategy and its contribution to market risk SCR



A HOLISTIC APPROACH

Adam Cadle looks at the importance of insurance companies implementing a holistic framework when outsourcing actively managed EMD mandates to third party asset managers

WRITTEN BY **ADAM CADLE**

VOLATILE economic environments over the years have aggravated problems of declining portfolio returns for insurance companies, already complicated by Solvency II prudential regulations favouring less risky assets and the evolution of European IFRS accounting rules that stiffen management. The importance of establishing a holistic framework therefore when outsourcing actively managed fixed income mandates to third party asset managers is rising all the time, as insurance companies look to reap the highest returns possible with the ultimate aim of being able to pay out to clients and have a strong financial backdrop.

LGIM quantitative strategist Tristan Dhert highlights the benefits of integrating Emerging Market Debt as part of LDI portfolios, "where certain efficiencies can be generated for insurers in terms of excess returns over conventional IG credit strategies and return on regulatory capital".

A lot are not doing so he adds however, and are therefore not able to "measure the success of these strategies for their outcome orientated objectives".

Efficiencies

So just what are the efficiencies involved for insurers? Insurance companies through a holistic framework and strategic asset allocation framework can determine the level of risk and capital budget to allocate to EMD. J.P. Morgan Asset Management head of international fixed income insurance Prashant Sharma says more widely "an investment approach that incorporates not just expected returns but also other considerations such as asset/liability management, return on regulatory capital, risk appetite and accounting considerations (e.g. investment income) will ensure an investment outcome that meets the requirements of all key stakeholders in the insurance organisation – whether that be the actuarial, finance, risk or investment functions".

"Additionally, a holistic framework would not only look at investment risk in isolation but have an overall enterprise risk approach that incorporates investment and insurance/underwriting risk," he comments.

For Aberdeen Standard Investments global insurance solutions investment director Bruce Porteous it is important to consider fixed income mandates in the context of the whole balance sheet of the insurer and the risks associated with the assets in the mandate – for example, currency risks with EMD assets.

"That way," he underlines, "it is possible to recognise and manage diversification benefits that might otherwise stay hidden and eliminate risks that may, in practice, be unrewarded, such as currency risks. With active mandates, there are also efficiencies to be gained by recognising that assets may no longer be attractive in one part of the balance sheet, may have uses elsewhere, therefore avoiding unnecessary transaction costs from buying, selling or tax.

> Insurance companies through a holistic framework and strategic asset allocation framework can determine the level of risk and capital budget to allocate to EMD

Consequences

Insurance companies not implementing a holistic framework in this area can be faced with a number of consequences that at times can hampen portfolio construction and investment strategy in a big way.

Looking at a specific single sleeve mandate (e.g. EMD) that is outsourced

to a manager on the basis of a more traditional performance versus benchmark or total return basis, changes in portfolio composition could impact regulatory capital utilisation (e.g. increase in high yield exposure), and turnover could give rise to transaction costs and crystalise realised gains/losses impacting P&L volatility. Sharma states that these aspects could be mitigated however "through carefully thought out mandate design with specific guidelines and constraints and investment and risk teams using historical and forward looking data to be aware of the potential impacts of such a mandate on the overall metrics of the insurance company (P&L, B&S, Capital) and incorporating them in the risk budget".

"The more flexibility a manager has the higher their ability to express a variety of investment ideas in the portfolio, leading to potentially higher alpha opportunities."

Sharma warns that a non-insurance EMD manager may simply invest to the benchmark agreed.

"An insurance focused manager can perform security selection to work precisely within the client's SCR budget and select a bespoke mix of securities that will optimise their risk and capital adjusted return. This will give a superior outcome for the client and fit precisely into the holistic framework they have defined. Applying this approach could generate significant regulatory outperformance relative to following a benchmark driven approach."

Communication, cost and regulation

Communication between asset manager and client is crucial when outsourcing such a mandate however, to ensure return targets are met, but regularity can differ on each individual case.

The more flexibility a manager has the higher their ability to express a variety of investment ideas in the portfolio, leading to potentially higher alpha opportunities

"For some of our most important and proactive clients, we would discuss and agree every trade to ensure that the trade satisfies the risk and outcome objectives of the client," Porteous accentuates.

"For others, and where we have more discretion, communication would be at least monthly through formal governance processes set up to facilitate communication and subject to satisfying pre-agreed metrics."

Another issue entering the equation when look at investment strategies and decisions is regulation. Regulation controls all that goes on in with high-end investment decision making and one only needs to see the effects of Solvency II regulation on infrastructure investment at the beginning to see how it can potentially constrain to a high degree.

According to Porteous, regulation hits a holistic approach in this area from both sides. "To the extent that regulation is broadly aligned with the true underlying economics, regulation is a helpful driver and encourager of holistic frameworks."

"On the other hand," he adds, "old fashioned, risk sensitive and uneconomic regulations can hinder and discourage a holistic approach".

A holistic approach seems to get even better around the issue of costs as well. "The costs come from establishing fast, proactive and insightful reporting plus governance processes," Porteous argues, but "in reality, this is actually best practice and pays for itself through increased economic value generation."

As the needs of insurers become greater and greater in the current economic environment and a range of investment strategies weave their way through portfolios, in-house teams do not often have the manpower to manage such sophistication within EMD mandates. Outsourcing is crucial therefore but needs to be monitored carefully.

Indeed, the certain parts of the industry have predicted that there is to be a doubling of outsourcing over the next ten years due to natural increases in asset bases and equities being worth more.

There is also a propensity to have a higher proportion of assets outsourced either because of the increasing complexity or because there is more and more of these exotic and illiquid strategies that are being used by insurance companies. Furthermore, the argument that small to mid-sized insurers having the ability to move from a fixed cost based scenario, for example having an internal function, to a variable cost based one when outsourcing also adds weight to the situation.

It seems though that a holistic approach is now becoming more engrained into insurers thinking when looking to outsource fixed income mandates. "It is only a matter of time before it becomes the market standard when outsourcing assets," Porteous concludes.

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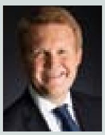
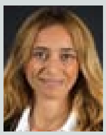
CHAIR

NEIL HOLMES
Director, Client Consulting UK & Ireland
Neil joined bfinance in early 2018 to focus on the insurance market. He has has a long career in the banking and asset management industries, including 20 years covering insurance clients. Neil has also worked for Conning Asset Management, Credit Agricole Corporate and Investment Bank, Fortis Bank and Barclays.



PHILIPPE DELOFFRE
Head of Real Estate Debt, BNP Paribas Asset Management
Philippe is head of real estate debt in the alternative debt management team. He joined in March 2017 from Acofi, where he was head of CRE debt funds. Previously he worked at CBRE, where he set up the debt advisory business for France. He began his career at a structured finance banker for Commerzbank and then for ABN Amro.



KAREN AZOULAY
Head of Infrastructure Debt, BNP Paribas Asset Management
Karen is responsible for the infrastructure debt division in the alternative debt management team. She joined the firm in April 2017 from SCOR Investment Partners, where she was infrastructure manager from 2012 and developed the infrastructure debt strategy. She has also worked at Dexia in project finance.

RUSSELL LEE
Head of Client Solutions, Legal and General Retirement
Russell's team leads on product innovation as well as tailoring solutions to specific client needs. They work with pension scheme sponsors, trustees, and other insurers who wish to remove or reduce pension risk from their balance sheets. He has led a number of landmark transactions and has worked in structured finance and banking.

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

GARETH SUTCLIFFE
UK lead investment advisory team, EY
Gareth is the UK lead for EY's investment advisory team, which advises financial institutions and asset managers. Gareth has 17 years of experience across private equity, consultancy and insurance investment strategy and treasury. In addition, he also has a wealth of experience in a number of illiquid asset classes.

PRIVATE DEBT FOR INSURERS

CHAIR: What are the challenges faced by insurers in the private debt market? My company bfinance is seeing more and more interest in private debt as an asset class, as insurers are looking for opportunities for extra yield and diversification. In order for it to be properly executed, does this require strong expertise, and as asset managers and insurers, how are you tackling that?

LEE: I think the short answer is yes it does require strong expertise. You require that extra knowledge in order for your regulator to actually allow you to invest in those assets. Yes, you can have an outsourced model, but the assets are hard to come by, and so it feels like there is a need to have an in-sourced, in-house knowledge of these asset classes. But it's not just about the traditional asset management approach. It is also about understanding the way that the capital works for these deals particularly around pre-payment risk and all the technical details. Also I think it is about the sell-structuring capability, the ability to work early in the process and not just being an end-taker. It makes a big difference if it's a triple-B or single-A asset under firms' internal models, for example.

CHAIR: For an ideal in-house team, what sort of people are you looking to recruit?

LEE: I guess a bit of everything. People who have got a background in securitisation are useful. Also people who have worked in banking, and who know about the origination of the assets. Then it is about having the people who have got the technical knowledge around the asset class, because you don't want to lose sight of the economics around if it is a good deal or if it is a bad deal.

MATHUR: I think private debt is the flavour of the day. There are a lot of economics to be delivered on the public debt side, and we're working on that as well. Private debt is increasingly a focus for the regulator. The asset manager can only be liable for the investments they make on our behalf from a financial conduct perspective. The asset owner is ultimately responsible from a Prudent Person Principle (PPP) perspective. We need to clearly demonstrate our ability to collectively (across asset manager and owner) manage the asset from a downside risk perspective (including internal ratings, workout, etc). There is a strong requirement for us to build capability to ensure that credit underwriting is happening appropriately by the asset owner. Further, we're always on the hunt for interesting opportunities to diversify through deepening existing capability or newer markets. We spend a lot of time enabling these opportunities.

CHAIR: So, it sounds like you're using a mix of building up an internal team as well as still using external expertise as and when you find it?

MATHUR: Yes. So, I think we have to, because in order to invest in a private debt asset, you need to start out with the origination expertise, and the necessary contacts to be able to generate those opportunities. Then, once you've acquired the assets, one needs ongoing capability to manage the asset over a long duration, which could be 50 years or even longer in a lot of instances. That requires good infrastructure to be build. You really need to know where your resource constraints are, and delegate responsibilities across asset owners and managers accordingly.

CHAIR: So, if I can turn to the asset management side, Karen, how have you found your interaction with insurers? Are you finding that they are making you work harder in terms of helping them originate, manage, and also understand the asset?

AZOULAY: I would say that, compared to a few years ago, insurers are now very well-educated on the private debt market. Having said that, they clearly understand that to be able to invest directly they need to have the internal capabilities to deeply understand the asset class and the overall risk. There needs to be a team able to originate transactions, and then assess the underlying credit quality of each asset, with processes in place in order to monitor transactions. This clearly means a lot of resources are needed internally, which is why, for insurers, they often find it appropriate to outsource this externally.

> ” It feels like there is a need to have an in-sourced, in-house knowledge of these asset classes

CHAIR: So, you need access to quality assets, and we've concluded that you're going to probably need assistance in that until you build up your own capabilities. But I get the feeling there's always going to be a need for a bit of assistance.

LEE: The UK is a limited market and very property-dominated. We like

Insurers are now very well-educated on the private debt market. Having said that, they clearly understand that to be able to invest directly they need to have the internal capabilities to deeply understand the asset class and the overall risk

property but there is a concentration risk. And as the opportunity set here on the annuity side is £2 trillion-worth of liabilities, most of which are probably going to end up with insurers, that's an awful lot of money to be invested if the allocation to illiquid assets is close to even 50 per cent of that. It might be more, and that's a huge amount of lending. If you don't have the asset management capabilities there, it takes a long, long time to build it.

CHAIR: How do L&G go and source assets? From a current market perspective, are there very attractive assets out there, or are they not so attractive anymore? What's your current view on sourcing them and making sure they're the right assets for you?

LEE: There are still some very attractive assets out there and it is still essential to make the price work. Have yields and spreads come in this year? Yes, they have, even while the liquid markets have been going a little bit wider, the illiquid credits have been coming in a bit tighter. You have more and more competition for those assets, and probably no let-up in that because pension schemes, the large ones in particular, are looking to allocate in that asset class. Soon, everyone will be competing in the UK for the same asset classes.

CHAIR: Prasun, are you getting pressure from above, shall we say, to invest in assets like private debt as well?

MATHUR: I don't think pressure is the right word. I'd say that the business case for going into private assets is very strong, and so there is a desire for us to go for such assets instead of a push from above. I think we are reasonably well-agreed that it's a very important part of the investment strategy to go into private assets for multiple reasons - security being one of them and being rewarded for the illiquidity premium the other. I think there are two sides of the balance sheet, the capital side and the return side, and these private debt assets actually support you on both sides of the balance sheet. They typically have a lower capital requirement, and they typically offer a higher return for it as compared to public debt assets. From just a risk-return perspective, because of that double whammy, it makes a compelling case as long as the credit underwriting is good. In theory, even if the illiquidity premium is not there, the risk-adjusted return may still be. That's what is attracting a lot of cheap money in these assets. Reporting metrics incentivise you differently. IFRS, more focused on the best estimate risk-adjusted return, whilst Solvency II metrics that bring in 1 in 200 risks into the equation. Subject to credit underwriting, investment decisions are usually a question of what metric the organisation is more focused on.

SUTCLIFFE: I think, for listed firms where you're effectively promising the market a certain amount of IFRS return in dividend, then if you promise that it will go up next year, the escalator of dividends, then you've got to get that return from somewhere. The asset side is one of those places.

CHAIR: From the asset management side, there has been a drive to source new assets which will see a greater demand over supply. How is that developing? Concerning infrastructure, there has always been a feeling that there's a small supply relative to demand. Are you having to cast your search further afield? How are you helping the insurers?

AZOULAY: We know there is an illiquidity premium between 100bps to 150bps depending on the credit cycle. We see our role as optimising the relative value on a transaction basis. We create value on the debt side by choosing the transaction that would offer the best relative value. We have a proactive sourcing through our existing network, thanks to the track record we have had for many years in the market, and through the relationships we have with banks, financial and industrial sponsors and financial advisers. It is also about having structural capabilities in the team in order to be able to better assess the credit quality of the transaction and have an influence on the terms. When you combine the geography, the sector, the contractual and regulatory frameworks, and which financial structure you would expect from a specific type of transaction, then you can optimise relative value on a transaction basis.

CHAIR: But, at what stage are you engaging the insurance company to understand the limitations on what they can invest in depending on structure and capital?

AZOULAY: The insurance companies that invest through a fund have to share the same investment guidelines. Some insurance companies might be willing to invest with very specific investment criteria in terms of underlying risk, geographies or sectors. The benefit of being part of a private debt platform is that we are able to provide tailor-made solutions for each investor that may have specific needs.

CHAIR: Russell, at what stage are you looking to be engaged? Or, are you finding that those who are sourcing assets for you are much more mindful of your potential needs?

LEE: It's a balance, isn't it? So, you have a limited team working within the insurance company, looking at the opportunity.. So, you need to have the right balance because, if everyone comes to you really early with a half-baked deal, then that's not a good use of your time. At the same time, if people don't engage you early, then you lose the opportunity to craft a deal structure that is optimal from an insurance perspective. So, I don't think it's an easy thing to answer. I think there's a need for insurers themselves to increase the number of people they have looking at these opportunities and who are engaging with the asset originators, because it feels that insurers can't have their cake and eat it.

CHAIR: Prasun, do you think the insurers now hold the whip hand, and are starting to move the dial? One of the other things I'm interested in is how Solvency II friendly they are? Do you feel that you have a particular set of circumstances, and can influence asset managers in finding appropriate assets? Or do you think it's just still early days, as Russell said?

MATHUR: We can certainly influence. I think one of the key drivers for our ability to influence is the size of the

> The benefit of being part of a private debt platform is that we are able to provide tailor-made solutions for each investor that may have specific needs

ticket that you can write, and that often is a barrier to entry as well. If you can write, let's say, a £250 million cheque for an infrastructure transaction, that carries a lot more weight than a £25 million ticket, and that opens more doors for you, especially in private debt. It can help you structure a deal.

Are we extracting the best risk return in a competitive market? I think we can do more to extract more value. One of the easiest examples that I have when it comes to extracting value is getting access to inflation. Take bulk purchase annuities as an example. A large proportion of the bulk purchase annuities market is inflation-linked. So, naturally, we have a strong desire to invest in inflation-linked assets, and if there are private credit assets in the UK that have revenues that are inflation-linked, we want them to structure debt that is sized to the inflation revenues that they have. This is where banks have not necessarily been as aligned as institutional investors, where banks typically try and structure deals as fixed liabilities coming out of the borrowing vehicle. They provide inflation swaps as a hedge for their revenue stream, whereas we are natural takers of that inflation-linked revenue stream. We always try and influence the quantum of the inflation linkage that comes out of the debt, because that, to us, is good credit risk management and for us, we are a natural home for those revenue streams.

DELOFFRE: Well, it's a two-way process. On one hand, considering the recent lending market as an example, you would probably see that the European market is not growing back. Opportunities are increasingly attractive as the banking system retrenches and seeks the support of institutional investors. One certainly can sense that Basel IV is already creating more room for alternative lending platforms. On the other hand, as the cycle is maturing and the opportunities for investors are changing, especially for those who are largely exposed to equity real estate in their home market. Are we seeing more buying pressure from alternative lenders, and how does that affect margins? Overall, my assessment is that the impact is quite limited. The European market, as it is a bank dominated market, has shown fewer signs of the buying pressure affecting loan risk metrics and returns. In the UK the competition is still moderate, despite a pick up since Q2 this year, and loan margins are under control. There are opportunities in both currencies, but my perception is that the insurance sector is not really willing to go ahead of the curve and take more risk in order to secure their investments. In that, institutions are aligned with traditional lenders.

LEE: One of the risks for insurers is just the cliff risk in terms of rating downgrades. It's all very well having attractive new triple-B yields, but you've much higher balance- sheet risk, because if it falls to double-B then your capital requirements increase significantly. That kind of risk makes insurers want more of a cushion before they invest. That's just really to do with Solvency II. It's very ratings-based.

AZOULAY: I think at least for infrastructure, my impression is that investors first began investing in this asset class as an alternative to

> If you can write, let's say, a £250 million cheque for an infrastructure transaction, that carries a lot more weight than a £25 million ticket, and that opens more doors for you, especially in private debt

government bonds with PPP-type of transactions. As they became more and more educated they began investing in more complex strategies, so taking more risk, but most of them still in a secure debt environment. Some of them may be willing, currently, to invest in mezzanine, but the market is still relatively small in terms of volume at this stage. Generally speaking, I would say that as the market is dominated by banks, the influence of institutional investors is still limited in terms of margins. However there are some sectors where institutional investors are bringing a lot of liquidity which is putting downward pressure on margins. The off-shore wind market is a good example. Back in 2012, very few investors were able to consider this sector in their investment strategy, however in today's market offshore wind transactions are being commoditised. As a consequence, their margins decreased by around 100bps to 150bps in 3 to 4 years. So, in some sectors, the large amount of liquidity coming from investors may indeed affect the price and margins.

> I think at least for infrastructure, my impression is that investors first began investing in this asset class as an alternative to government bonds with PPP-type of transactions

Solvency II

CHAIR: From a broader private market, private debt perspective, how Solvency II-friendly are the assets out there at the moment that you could potentially invest in? And if, under Solvency II, they're not fit for purpose and they don't truly reflect the risk, how is the regulator viewing this?

MATHUR: Up until 2015, before the advent of Solvency II, insurers were investing in assets that they felt were suitable to back the liabilities that they thought they had, and those assets had characteristics which were a lot more flexible as compared to post-2015 Solvency II era. Up until 2015, UK insurers spent a lot of time divesting assets that were not Solvency II-efficient. After 2015, the effort has been to get back into those assets again, in one shape or the other. It's basically recovering what you lost as a consequence of going into Solvency II, and getting back to the same playing field that you had pre-Solvency II. Insurers and financial engineers are always finding ways of structuring and securitising to make them Solvency II-efficient, and that's where that capability, that requirement from an insurance perspective, comes very much in handy as Russell was saying from a resourcing perspective. A clear example of that technology being put to work are the equity release mortgages that insurers have traditionally invested in. They were deemed to be Solvency II-inefficient, and the PRA supported structuring them and securitising them to make them Solvency II-efficient. Whilst it's not considered obvious to the PRA that you could use the same technology for other assets, there are examples of other MA inefficient asset classes that have gone through the same regulatory approval process successfully. If an asset feature is not efficient in the Solvency II space, then structuring them is a path that a lot of insurers are increasingly taking, with varying levels of success.

CHAIR: You're saying that you're having to adapt to the Solvency II regime, rather than getting the Solvency II outline to change? The second point, granted, takes a while.

MATHUR: Yes, but the ABI and other working parties engage with the regulators to influence the Solvency II outline as well.

CHAIR: Is the regulator looking to help the insurance world?

SUTCLIFFE: The regulators have changed the approach to infrastructure, and there is a review that the European regulators go through every two years around Solvency II and figure out if they might like to change it.

> As a private debt instrument, real estate debt is uncorrelated to the financial markets and does not show volatility

They've also started going through a process of consulting and changing the rules around securitisation. Lots of financial services markets are interested in having a better-functioning securitisation market. I suppose it is a bit slow, but there is a gradual shift.

LEE: You have the PRA, and you have the insurers with their internal models. You have got a limited number of people in the insurers and a limited number of people in the PRA. Approaching the PRA and saying I'd like to change my internal model, that's quite a process in itself.

CHAIR: Are we seeing that the interest or the ability to structure some of the private debt assets is a good defensive mechanism against the risks in the cyclicality of the financial markets?

DELOFFRE: I think what's interesting about these assets is that basically the cycle component of the property debt is very much connected to property liquidity and banking liquidity, because of the medium-term nature of this type of debt. As a private debt instrument, real estate debt is uncorrelated to the financial markets and does not show volatility. Given that real estate senior debt is highly structured and monitored, and as it is backed by tangible assets with long term value, one can appreciate that it is immune to the cycles.

AZOULAY: I agree with that. Infrastructure is usually seen as resilient to economic cycles, and it's uncorrelated to traditional asset classes. This is due to the fact that those financings are structured in a standalone basis, taking into account defensive features. The favourable Solvency II capital treatment compared to corporate debt, is explained by the fact the debt is secured through an exhaustive security package and set of covenants. So, the structuring protects the asset class itself, and that's why it's resilient to economic cycles.

CHAIR: Prasun, are those some of the factors involved in the ultimate decision to invest in these particular assets?

MATHUR: Yes, to some extent. I think different private debt assets behave differently from cycle perspectives. Real estate behaves is more cyclical, whilst Infrastructure is less exposed to GDP cycles. The risk side is equally important - in fact, even more so from a credit cycle perspective. One could carry on investing in different assets as long as the underwriting criteria is not compromised.

ESG

CHAIR: Let's have a look at ESG. I think it's probably fair to say that ESG's becoming more mainstream within investment thinking and decision-making. In the private debt world how much ESG thinking is there? How are the asset classes adapting to ESG? I think the interesting bit for me is, is it E, is it S, or is it G that investors view as important? Are we seeing any innovations coming in to make assets more ESG-friendly within your particular sectors?

AZOULAY: We have the same approach within the private debt platform, and actually we have put a strong ESG policy in place. The first step is based on BNP Paribas' group exclusion policy, with specific sectors excluded such as coal or mining. We have taken this a step further by including ESG in the investment process, with an ESG assessment based on an internal taxonomy provided by our internal ESG team. A taxonomy is a sector mapping. So, on each sub-sector, we would have a certain level of due diligence specific on ESG, and that would be based on the due diligence package we have before investing in infrastructure debt assets. Then, the last step of this policy, going even more further down the road, consists in having mandated an independent expert who is able to assess the environmental and climate impact on the portfolio, and on each transaction.

DELOFFRE: Historically, real estate lenders used to rely on a property environmental survey. It was the responsibility of the property owner to make sure the remediation to pollution was financially covered during the loan life. Debt managers have changed this paradigm and gradually it has contributed to raise awareness on sustainability and we ensure properties now comply with ESG principles. At BNPP AM we fulfil an ESG assessment in the same way we do credit and real estate assessments, with a view to capture the extra value out of property debt strategies. Our approach combines bespoke qualitative and quantitative requirements that go beyond the acceptance of a property environmental label such as BREEAM, or the property benchmarks such as GRESB. The good news is that there is gradually a consensus that ESG is creating value to property owners, occupiers and lenders. Our mission is to give investors access to this benefit.

CHAIR: So, from an investor point of view, Russell, I'm assuming you have strong ESG policies in place?

LEE: We do. If you look at Legal and General overall, and the way we deploy our shareholders' funds through Legal and General Capital into things like under-supply of UK housing or urban regeneration, there's a strong social ethos there around deploying capital. We want to do good in local communities. At the same time, you're delivering value for your shareholders. That's very much a part of the ethos. Then, in terms of the environmental side, you want those houses to be built to the most efficient, highest possible standard. So, there's the lending opportunity, but also the question of who are the people coming into these houses? Is it later living? Is it someone who's already a policyholder and a customer of ours? You have to think about all sides of the experience.

CHAIR: I suppose the interesting thing with ESG is that it was often conducted on an exclusion basis. Now, we also have investors interested in impact investing.

MATHUR: We think ESG is really important. We've done a lot of work together with Aviva Investors. Aviva Investors has been one of the leaders in thinking about ESG broadly, and not necessarily just in private markets. There are so many angles to this. One is the regulatory aspect of it, where the regulators are trying to come up with a consistent framework that it can deploy industry-wide, for demonstrating ESG in your investments. That's much-needed. What's missing right now is a consistent framework. That ESG data needs to be captured when you actually invest in assets. The second area is how ESG fits in from a fixed-income perspective? A lot of research on ESG has been done purely from an equity perspective. How fixed-income players do the ESG assessment and influence when actually investing is quite important. We encourage more research on this subject. The research does suggest that E, S, and G, all three, contribute differently in fixed income. You may have negative screening for, say, E and S, but a lot of positive screening for the G, as an example.

SUTCLIFFE: I think there's clearly a groundswell of opinion that sees this as a very positive in all sorts of areas, but how does it manifest itself? A framework may be the best way to at least benchmark it, for want of a better phrase.

DELOFFRE: From a fixed-income perspective it has probably taken seven to 10 years to get the ESG initiative to come to a quite standardised and assessable framework that benefits investors. I believe that in private debt we may revisit the question in just a few years.

> Our approach combines bespoke qualitative and quantitative requirements that go beyond the acceptance of a property environmental label such as BREEAM, or the property benchmarks such as GRESB

EUROPEAN LOANS focus:
LOANING A PRESENT

FIVE REASONS TO OWN EUROPEAN LOANS

Wells Fargo Asset Management senior portfolio manager, head of European loans and high yield bonds Jens Vanbrabant looks at the advantages of investing in European loans

THE LONG ROAD TO LOANS

Institutional investors have absorbed a booming supply of loans since 2010. Either rising interest rates or a recession could prove their investment case, Alastair O'Dell says

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WELLS FARGO ASSET MANAGEMENT

Five Reasons to Own European loans

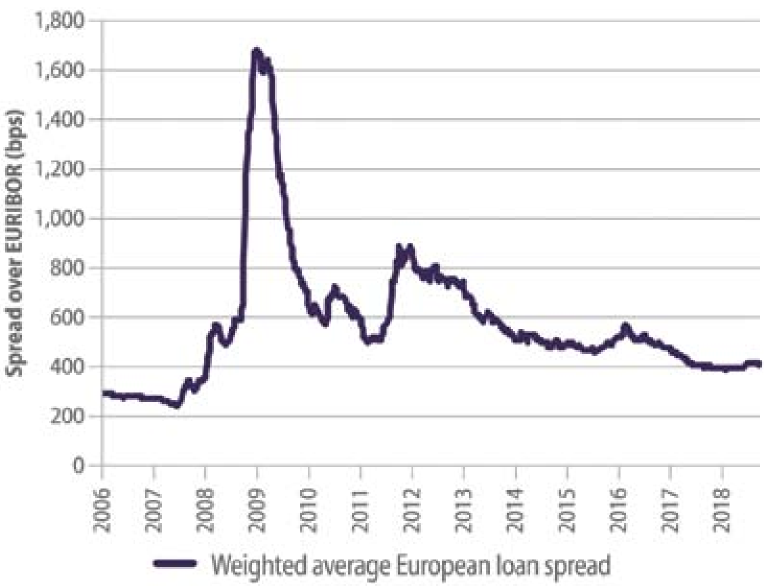
WRITTEN BY WELLS FARGO ASSET MANAGEMENT'S HEAD OF EUROPEAN LOANS AND HIGH YIELD BONDS, JENS VANBRABANT

Wells Fargo Asset Management senior portfolio manager, head of European loans and high yield bonds Jens Vanbrabant looks at the advantages of investing in European loans

In a world where interest rates are rising in the US and the European Central Bank (ECB) is on the cusp of ending quantitative easing, investors remain torn between seeking yield and preserving capital. European loans stand out as an asset class that can potentially benefit investors in this challenging environment.

Unlike government bond yields, which continue to trade close to multi-century lows, credit spreads on European loans represent attractive value. Figure 1 shows that despite unprecedented central bank quantitative easing, current loan spreads are approximately 400 basis points (bps) over the Euro Interbank Offered Rate (EURIBOR) and remain substantially higher than they were before the start of the global financial crisis.

Figure 1. European loan spreads are higher than before the global financial crisis



Sources: Bloomberg and S&P Leveraged Commentary & Data as of 30 September 2018.

Meanwhile, European loan default rates have dropped from between 4% and 5% per annum from 1999-2009 to between 2% and 3% per annum from 2010 to 2018. Although the ECB has never bought sub-investment-grade bonds or loans, loan investors continue to benefit from the accommodative monetary environment. That's because it has allowed borrowers to refinance at advantageous interest rates, resulting in lower default rates.

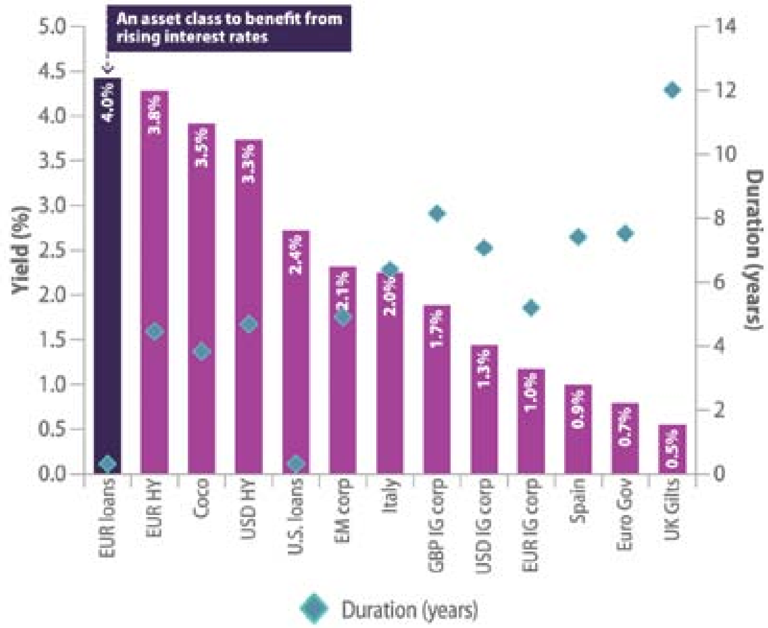
European loans are our most favoured credit asset class over the next 12 months because they look attractive both from a return and risk standpoint. There are five key reasons for this thesis:

1. The senior secured status of the asset class provides strong creditor protection

As a result of being senior and secured, loan investors typically benefit from the following advantages:

- Stronger protection than high yield bond investors in the legal

Figure 2. Loans are floating-rate instruments



Sources: Bloomberg L.P., ICE Bank of America Merrill Lynch credit indices, S&P Leveraged Commentary & Data and WFAM Credit Europe as of 30 September 2018. All yields EUR-currency hedged.

documentation. A typical example is the use of maintenance covenants, which are tested regularly throughout the life of the loan, as opposed to incurrence covenants, which are tested just once at inception of the transaction.

- The credit rating of a loan is typically one to two notches higher than that of an unsecured or subordinated high yield bond.
- Stronger recovery rates.

2. European loans provide investors with diversification benefits and a good hedge against higher interest rates

A key characteristic of loans is their ability to act as an effective hedge against interest rate increases. Together with floating-rate notes, European loans are unique in the fixed income space because these are instruments that can deliver positive returns when short-term interest rates rise. Figure 2 shows the current attractive yield afforded by European bonds relative to other asset classes and their low duration.

3. European loans offer strong risk-adjusted returns

Loans can offer attractive risk-adjusted returns compared with a broad set of other credit asset classes. (see Figure 3 on the following page). The attractive risk-adjusted returns also reflect the asset class's strong fundamentals. Although leverage multiples have gradually increased, the debt stack remains supported by healthy equity cushions provided by private equity sponsors, which have resulted in loan-to-value percentages in line with the long-term average of 50%.

4. The European loans market benefits from favourable supply and demand dynamics

The loans market has grown significantly since the CLO market sprung back to life in 2013 and is currently at an all-time high size of €177 billion, as measured by the S&P European Leveraged Loan Index (ELLI). At the end of September 2018, the ELLI was composed of 278 issuers and 335 loan instruments.

Demand for loans has been given a boost by the current regulatory framework for CLO issuance. Under these rules, CLO sponsors need to co-invest alongside CLO investors to ensure they have got skin in the game.

The supply of loans has similarly been very strong. Given the choice, private equity sponsors prefer loans rather than high yield bonds as a funding instrument because of the less-restrictive call protection.

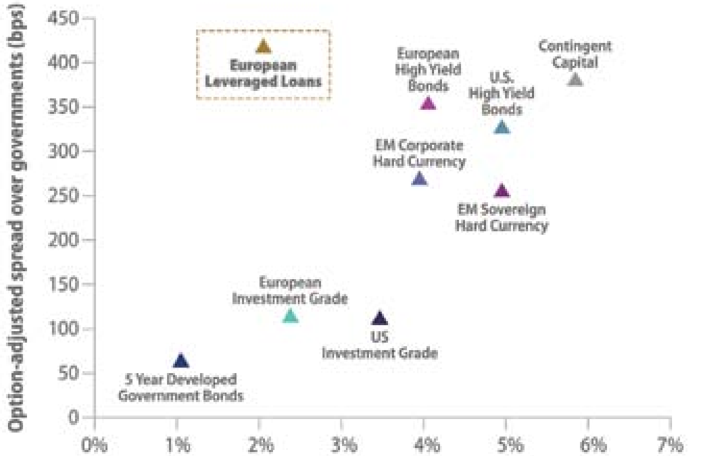
5. European loans offer an attractive alternative to an investment in US loans or private debt

Since the start of the global financial crisis in 2009, the European loan asset class has exhibited higher returns and lower volatility than US loans, therefore producing stronger risk-adjusted returns.

When assessing the relative value between the two markets, investors should bear in mind the following:

- US regulation is becoming more relaxed when compared to Europe which may cause higher default rates and lower recovery rates for the US in the future, impacting investors returns.
- European risk assets, including loans, will continue to benefit from the ECB's more accommodative monetary policy environment. This policy will likely continue to

Figure 3. Loans offer good risk-adjusted returns



Sources: ICE Bank of America Merrill Lynch credit indices, S&P Leveraged Commentary & Data and Bloomberg L.P. as of 30 September 2018.

be a supportive factor for the foreseeable future.

- Last but not least, for those investors whose base currency is not the US dollar, the cross-currency hedging costs are currently high for US-dollar-denominated assets. For example, European investors looking at US loans on a currency-hedged basis should subtract approximately 3% from the yield expressed in US-dollar terms to convert it to a euro-equivalent yield. After hedging currency risk, an investment in US loans offers a lower yield compared with an investment in European loans.

When comparing European loans to European private debt, two crucial differences exist. First, the closed-end nature of private debt vehicles and second the absence of a secondary market in the notes issued by these vehicles means that a private debt allocation is much less liquid than an investment in European loans, which is typically accessed via open-ended fund structures. Investors should consider carefully whether the 100- to 150-bps liquidity premium offered by private debt is large enough to compensate for this.

Second, unlike the European market that has gone through two default cycles during the last 10 years (the 2008–2009 global financial crisis and the European sovereign and banking crisis in 2011–2012), private debt managers have not yet had to contend with a default and restructuring cycle.

To summarise

Because yields remain low on a historical basis, investors are searching for a way to add return without undue risk.

Investors may want to consider an allocation to European loans. Evidence has shown that the asset class has experienced compelling risk-adjusted returns, helped in part by strong fundamentals. Looking ahead, we expect this thesis to remain in place over the next 12 months.

To recap, European loans offer investors several advantages along with their yield. From a credit perspective, they have the advantage of being senior in the capital structure. In terms of diversification, they have shown less correlation with other asset classes. Finally, market technical factors such as supply and demand trends are supportive of this asset class.

Why loans may be a good strategy to consider

Who may benefit	Why
Pension funds	For pension funds, European loans offer attractive yields and can provide benefits in rising rate environments. These loans also offer diversification from many traditional asset classes. Due to the relatively consistent income that the asset class has historically provided, loans can be used in cash-flow driven portfolios.
Insurance clients	European loans offer appealing risk-adjusted returns for Insurance companies, especially those that have capacity to benefit from some illiquidity. European Loan can be used to enhance yield, diversify exposures, and potentially improve the capital position.

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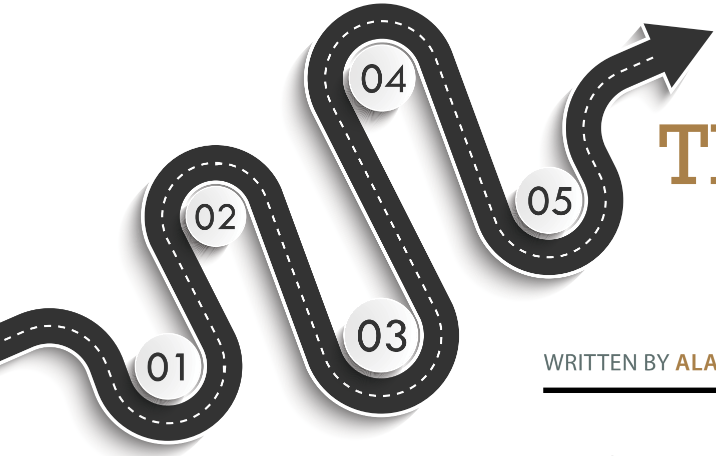

The long road to LOANS

WRITTEN BY **ALASTAIR O'DELL, A FREELANCE JOURNALIST**

Institutional investors have absorbed a booming supply of loans since 2010. Either rising interest rates or a recession could prove their investment case, Alastair O'Dell says

INSURANCE companies have never been more heavily invested in loans. They have been tempted to allocate away from fixed income over the past decade by the promise of superior risk-return trade off and the ability to absorb their intrinsic illiquidity.

The US market has expanded very strongly and the European one is following in its wake. A reversal of the interest rate cycle and/or rising default rates should play to the asset class's strengths so demand is expected to continue increasing.

NN Investment Partners surveyed 100 institutional investors last December and the majority either planned to invest or increase their allocation. "Alternative credit is clearly on the mind of insurance companies' board members," NN Investment Partners head of specialised fixed income Han Rijken says.

Pre-crisis European insurers made only small allocations to local loans but since then there have been two strong drivers: historically low interest rates and risk-based capital regulation.

"The biggest problem is that for more than 30 years interest rates have been trending downwards," Invesco global head of insurance client solutions Alexandre Mincier states. "Insurers had to look for alternatives."

Supply was transformed by post-crisis Basel II regulation, which pushed banks to de-risk. Rijken says: "It created the opportunity for other investors to take over that role. It tends to be longer dated, which fits the balance sheet of insurers."

There has been a succession of loan types. Around seven years ago infrastructure loans paid a spread of 400bps, "which was really appealing," Mincier adds. "But when it became very popular spreads tightened very quickly to 100bps. Five years ago we saw a rush into senior secured real estate loans but the same story played out. This influenced the trend to go into other types of loans."

Portfolio construction

Insurers are able to capture an illiquidity premium if they maintain a pocket of liquidity. "There are opportunities to put them together, to maintain some liquidity while investing in illiquids where the yields are much higher. It makes a lot of sense," Mincier says.

Big insurers use liquidity ratios to gauge their vulnerability to stress. "The most advanced approach is to give each asset a liquidity score and combine them in weighted average," he says.

Rijken describes the approach as integrated LDI. "Public instruments are mixed with project finance, real estate loans and private corporate debt to create a much more optimised LDI portfolio."

While senior bank loans are somewhat liquid, for export agency or infrastructure loans "you might be able to find a buyer but you cannot call it liquid. It must be a buy-and-hold strategy," he comments.

AXA Investment Managers head of structured finance Deborah Shire says: "The UK is leading the herd with multi-asset products, where institutions have access to public and private asset classes with the ability to seek relative value between those them."

Fixed income replacement

A key attraction of loans is their floating rate feature. "Borrowers get floating rate exposure to a credit asset class, which is quite unique," Wells Fargo Asset Management head of high yield bonds and loans Jens Vanbrabant underlines. "Not many fixed income instruments benefit from rising rates – this one potentially does."

Diversification is enhanced by loans being driven by very company-specific dynamics. "Macro trends have a limited effect on loans whereas bond portfolios can be heavily affected by rate sensitivity," he adds.

There is also an additional benefit at the borrower level. AXA Investment Managers leveraged loans senior portfolio manager-head of European loans portfolio management Yannick Le Serviget, says: "The overlap with high yield bonds is between 30 per cent or

40 per cent, depending on EU or US, so loans increase diversification."

All else being equal, loans pay a higher yield than bonds. The AIFMD-regulated products contain assets with greater seniority but illiquidity means they need to be marked-to-model.

"There should be an additional return versus plain vanilla public credit," Rijken says. "Complexity can be a hurdle but it also creates an opportunity to fit liabilities even better. We prefer more complexity – you need an additional skillset to invest so there will be fewer players competing."

Credit assessment

"As loans are subject to different legal structures and fundamentals than bonds, a dedicated loans team is required," Vanbrabant says: "Loans are not securities. The lender effectively takes on the traditional role of a bank with a bilateral contract and this is entered onto the loan registry." Very large insurers have their own teams while mid or small ones depend on asset managers and invest in pooled funds or segregated accounts. "It's quite a hurdle for insurance companies to step into this market," Rijken comments. "It's expensive if you only do it for your own balance sheet."

Shire adds: "Whether an insurer has in-house abilities is hugely dependent on its size. "Across Europe a lot of global fixed income assets are managed in-house – but when it comes to loans only the really big ones, a very limited number, tend to have internal skills. The huge majority externalise and even the very large ones want vehicles for specific needs."

Interest rates

The biggest story in global markets is the impact of rising US interest rates, especially for long-term bonds not held to maturity. It is important to understand why interest rates are rising, according to Vanbrabant. "As we have seen in the US, if Treasury interest rates go up because the economy is performing, credit spreads tend to tighten because in such an environment companies can generate cash and deliver." However, if rates are increased by central banks to stop inflation from spiraling then the value of bonds and loans would drop. "But that is not what we are faced with," he says. "Today rates are rising because the economic situation is normalising."

A big proportion of the loan market is floating rate. While this protects investors from rising rates the opposite is true for borrowers. Rijken says: "The borrower would pay a higher coupon, which could be a risk for default. You would want the borrower to hedge this interest rate risk." Le Serviget adds that "the borrower normally has to hedge half of the debt" and details would be set out in the documentation. "You should allocate depending on your expectation for interest rates."

Default rates and recovery

Insurance companies normally invest till maturity so the real risk is in defaults. Default rates fell from around 6.5 per cent to 2.5 per cent when central banks cut base rates close to zero but "we believe they are likely to edge up again, as we move further into the era of quantitative tightening", Vanbrabant says.

While the default rates of loans and bonds are similar, loans are senior to unsecured debt. While vary with the economic cycle, the recovery rate for investment grade bonds is around 35 to 40 per cent while for loans it is 75 to 80 per cent. The recovery rates of loans are determined by documentation and a security package, which may provide a claim on physical assets or pledges on shares. Higher recovery rates make loan "price volatility historically half that of high yield bonds" Le Serviget says.

However, loans may provide false confidence. "There is artificial stability in the price of illiquids during a crisis," Mincier comments. "Insurers are interested in stability for their accounts – but, by definition, illiquid assets cannot be converted into cash without a potentially substantial cost. Any asset can become illiquid in certain market conditions."

Covenant lite

Collateralised loan obligation (CLO) managers have surged since the EU required managers to retain 5 per cent of each tranche. Vanbrabant estimates that CLO funds account for about 55 per cent of European loans and 65 per cent US loans: "CLOs have been a big driver behind the loans market really picking up from 2013." Increasing demand has reduced lenders' negotiating power. "Protections that we traditionally benefited from have been getting hollowed-out. Covenant-lite deals advanced first in the US but now about 80 per cent of European loan deals are also covenant-lite. It would be foolish to say we're not impacted. The only thing that might change this trend is if demand for loans dries up - but right now money continues to find its way into the asset class.

Le Serviget says that investors should not be overly concerned by covenant lite as financial ratios are still tested when an event such as an IPO or major acquisition takes place, just not quarterly. "It does not mean that the legal terms are weaker – just that you do not test in the same way and, on top of that, lenders benefit from limitations and negative pledges in the loan documentation," he adds.

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US muni bonds for all

US municipal bonds offer an attractive investment opportunity for European insurers', providing opportunities to invest in America's modern infrastructure, are highly rated and incur low capital requirements. Lynn Strongin Dodds explores the case for investing in this asset class further

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

Municipal bonds may seem like an unlikely investment for European insurers but this very American asset class has been gaining favour over the past two years. The asset class' higher risk adjusted returns stands out in the region's prolonged low interest rate environment but the exposure to US infrastructure has also grabbed their attention.

Municipal bonds or munis are far from being a new feature on the US investment landscape. They made their debut in the 1800s when they were first issued to fund the City of New York's canals from the Hudson River to Lake Erie and Lake Champlain. Fast forward to today and these state and local issued debt bonds finances around three quarters of the country's infrastructure needs including schools, hospitals, universities, airports, bridges,

highways and water and sewer systems.

Although they are often not seen as the most glamorous of investments, munis have been rocked by bouts of volatility due to concerns over economic uncertainty and rising rates as well as isolated credit events in Puerto Rico and Detroit. Puerto Rico defaulted on constitutionally guaranteed general obligation bonds, the first such default by an American state or commonwealth since the Great Depression while Detroit went bankrupt three years prior.

However, these incidents are rare and today the bonds have become more affordable as yields have fallen from their highs. Historically the market has been dominated by the retail investor particularly high net individuals who wanted to take advantage of the interest income tax-exemption. However, institutional investors, such as banks and insurance companies, have become more prevalent and now comprise around 30 per cent of the market. By the end of last year, data from the Federal Reserve revealed that foreign buyers including German, UK and French insurers had increased their holdings to about $104 billion, more than double the figure held a decade earlier.

> Including taxable munis with corporate bonds greatly expands the universe of longer dated maturities which can better match a European insurer's long-term liabilities

European insurers though are primarily looking for prospects in the taxable over the tax-exempt section. They were first introduced as part of the US Tax Reform Act of 1986, as a way to give municipalities the flexibility to finance a wider range of projects, including those that might not qualify for tax-exempt status under the various caps and restrictions imposed by the US Treasury. The sector received a further boost after the financial crisis with the launch of the Build America Bond (BAB) programme, which was part of the 2009 American Recovery and Reinvestment Act and provided subsidised US government funding for qualified municipal borrowers for infrastructure spending.

Taxable munis are a much smaller universe comprising around 12 per cent or $400 billion of the total $3.85 trillion municipal arena. To date, it is home to 3000 issuers who have tapped the market for a variety of issues such as access to a broader investor base, the flexible use of proceeds and the fact that the financed activity is not considered tax exempt.

Advantages

One of the main advantages of taxable munis over their tax-exempt counterparts is their higher risk adjusted returns. Recent numbers crunched show that by the end of September 2018, the Bloomberg Barclays U.S. Aggregate Bond Index was yielding 3.46 per cent, which was higher than the 2.86 per cent return of the Bloomberg Barclays Municipal Bond Index but lower than the 4.83 per cent tax equivalent yield of the taxable segment. Looking at a ten-year picture, the Bloomberg Barclays Taxable Municipal Bond Index generated a total return of 6.2 per cent per year through 31 December 2016, compared to 4.3 per cent for the Bloomberg Barclays US Aggregate Bond Index and 2.6 per cent for the Bloomberg Barclays Global Aggregate Bond Index.

Diversification is another attraction, according to J.P. Morgan Asset Management global head of fixed income investment specialists Gregory Tell. "Including taxable munis with corporate bonds greatly expands the universe of longer dated maturities which can better match a European insurer's long-term liabilities than some other fixed income securities," he adds.

For example, roughly 70 per cent of the ICE BofAML Broad US Taxable Municipal Securities Index have a maturity after 2028 compared to 27% per cent of the ICE BofAML US Corporate Index.

Another benefit is that they are not as aligned to other fixed income securities. For example, Schroders portfolio manager US multi sector Julio Bonilla notes they have a 0.59 correlation to investment grade corporate bonds, 0.44 to global aggregate bond indices which includes investment grade debt from twenty-four local currency markets and 0.10 to high yield.

Equally as important are their lower default and higher recovery rates as well as predictable long-term income, according to Invesco global head of insurance client solutions and co-head of a recent white paper Alexandre Mincier. For example, the Invesco study shows that the ten-year average cumulative default rate for high yield corporate bonds is more than three times higher than the high-yield municipal bond. The figure is even more pronounced for the investment-grade universe minus 27 times greater than for the muni equivalent.

Separate research from Moody's Investors Service shows that between 1970 to 2016 cumulative 10-year

> The high quality profile is one important reason why some US municipal bonds are very attractive for insurers regulated undr Solvency II

average default rate for all rated muni bonds was 0.15 per cent, a fraction of the 10.29 per cent of the all rated global corporate bonds.

One reason for the low default rates is the large number of stellar credits sitting in the taxable category. The majority of state and local governments are highly rated which is not the case in the corporate arena where credits tend to be farther down the spectrum. Figures show that up to 93 per cent of US municipal issuers rated by Moody's are currently rated single-A or higher compared to only 25 per cent of US corporate issuers. For the taxable category the figure is over 55 per cent.

"From a credit analysis perspective, it is difficult to know how a company will perform in 10 to 20 years' time because business models are changing so fast," Mincier states. "A successful company today may not be successful in the future. However, local authorities will be there in 10 to 20 years' time and the infrastructure projects are long term."

Solvency II

As for exposure to infrastructure, the US not only offers a wider opportunity set than in Europe but under Solvency II, which came into effect in 2016, it is more advantageous to invest in the asset class because of the favourable capital treatment. In other words, insurers are allowed to put aside less in capital for holding infrastructure debt than corporate bonds.

According to the Invesco white paper, the spread risk module in the regulation assigns a capital charge based on the duration, rating (credit quality step) and risk factor of a bond for different sectors. For example, European government bonds have a risk factor of zero – regardless of rating – and therefore do not incur a spread charge while Aaa/Aa covered bonds have a lower risk factor than standard corporate bonds and benefit from a lower capital requirement. In contrast, securitisations have been assigned a high-risk grading.

The White Paper said that "given the impact of the rating on the calculation of the spread risk charge, the high-quality profile is one important reason why some US municipal bonds are very attractive for insurers regulated under Solvency II. This is especially true for insurers searching for "cheap" source of duration to match longer-dated liabilities."

Mincier notes though that insurers need to look closely at the fine print. "While Solvency II in general provides better capital treatment overall for infrastructure investments, insurers also need to check with their local regulators because jurisdictions have different interpretations," he adds.

Bonillo also advises European insurers to focus carefully at the sectors to invest in. "Projects have different risk profiles with water and sewer systems and transportation for example on the lower risk spectrum while healthcare tends to carry more of a corporate bond risk," he adds. "This is because there are some elements that are driven by the Federal mandate and are out of the control of the local authorities. For example, revenue sources are driven by Medicaid and Medicare."

SOLVENCY II focus: BEING PREPARED

THE REAL IMPACT OF SOLVENCY II IS STILL TO COME

Lyxor Asset Management director within the global investment solutions team Rudyard Ekindi explains how European insurance companies can position themselves to benefit from this fundamental shift to their business models, and how Lyxor specialises in investment and hedging techniques that help insurance companies address their balance sheet risk

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The Real Impact of Solvency II Is Still To Come

Lyxor Asset Management director within the global investment solutions team Rudyard Ekindi explains how European insurance companies can position themselves to benefit from this fundamental shift to their business models, and how Lyxor specialises in investment and hedging techniques that help insurance companies address their balance sheet risk

WRITTEN BY **RUDYARD-EKINDI, DIRECTOR WITHIN THE GLOBAL INVESTMENT SOLUTIONS TEAM, LYXOR ASSET MANAGEMENT**

THE SOLVENCY II DIRECTIVE came into effect across the European Union in January 2016. Solvency II regulates the amount of capital the region's insurance and reinsurance companies must hold, with the objective of ensuring those companies' fi nancial stability. Solvency II also sets minimum standards for governance, risk management and reporting. Although the Directive is now over two years old, in Lyxor's opinion the real impact of Solvency II on insurers' business models and internal structures is still to come.

The Resources Devoted to Solvency II Have Been Enormous

Solvency II was the largest change to European insurance regulation in thirty years and was nearly a decade in the making. The Directive was fi rst proposed in 2007 and its fi rst draft was published in 2009. However, it only came into effect at the beginning of 2016 after an intensive process of reviewing and redrafting. Solvency II is organised around three central themes, or "pillars", which set risk-based capital requirements for insurance companies, specify internal governance and risk management standards and formalise reporting requirements. Undoubtedly, the efforts devoted to preparation and compliance with Solvency II by regulators, accountants, actuaries, lawyers, insurance companies, asset managers have been enormous. But is it time to forget about the impact of the Directive, now these efforts are largely behind us? Although Solvency II is a topic to which most insurance company executives would gladly devote less management time, I'd argue that there is still plenty of relevant work ahead.

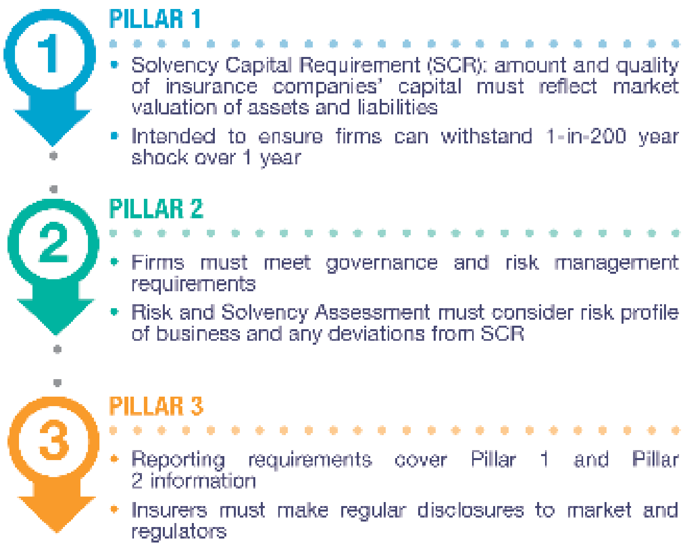
Yet The Market Impact Of The Directive Has So Far Been Relatively Subdued

Many analysts predicted in response to the arrival of Solvency II that we'd see a mass of restructurings and corporate deals across the insurance sector, in particular involving European insurance companies. For example, early last year[1] KPMG forecast that almost every insurance company would be involved in some form of deal making during 2017: they predicted that 84 percent of insurance companies worldwide would make 1-3 acquisitions over the year, while 94 percent would make at least one divestiture. But these predictions failed to materialise. In fact, data published late in the year showed that global mergers and acquisition activity in insurance had slowed relative to 2016[2]. Lyxor's conversations with clients and potential clients suggest that the number of insurance companies that have put into place comprehensive hedging strategies is still low. And the volumes of assets placed by insurance companies in dedicated Solvency II open-ended mutual funds, designed specifically to help them manage their regulatory capital and liquidity requirements, remain small.

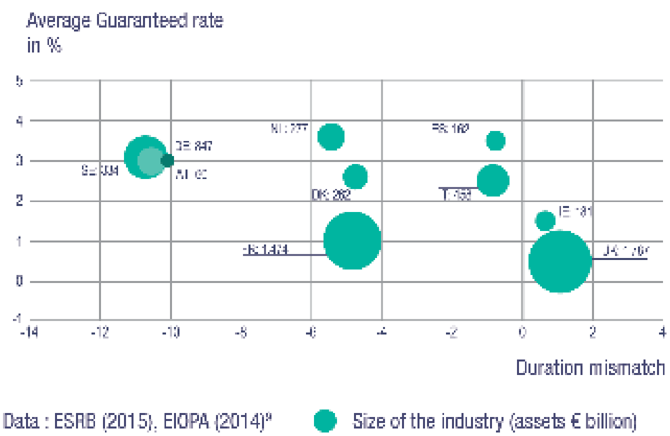
This Could Reflect A Delayed Reaction, As Well As Industry Diversity

One explanation for the relatively slow recent pace of insurance sector M&A activity could be that insurers have so far largely been focusing on internal

The three pillars of Solvency II



Duration mismatch and average guaranteed rate by country, European life insurance sector



restructuring in response to Solvency II. Setting up or modifying internal management structures to meet the governance, risk management and reporting requirements set out in Pillars 2 and 3 of the Directive will have been an operationally intensive project for many insurers. But the heterogeneity of the European insurance industry could also have played an important role.

For example, life insurance companies in some large European countries have significant mismatches between the duration of their liabilities and the duration of their assets. In the case of Germany and France, two of the largest European life insurance markets, the average duration of assets is significantly lower than that of liabilities, creating a negative duration gap. In the UK and Ireland, by contrast, the duration gap is smaller in absolute terms but positive[3]. The extended period of low interest rates we've seen since the financial crisis has exacerbated the potential riskiness of these duration mismatches. Not only are insurers in countries with a negative duration gap potentially exposed (if a structurally higher level of liabilities is not matched by a similarly higher level of asset values), but there could also be accounting and tax complexities to deal with. For example, low interest rates may have created a cushion of unrealised profit, especially in bonds, such that insurers' hedging requirements may be determined more by the accounting treatment and tax-efficiency of gains than by a strict asset-liability modelling approach (which would imply taking a view on credit spreads or on the slope of the interest rate yield curve). On the asset side of the insurance company balance sheet, there's also a great diversity in investment approaches. While government bonds represent half of the average European insurance company's investments, this percentage varies

[1] https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/03/the-new-deal.pdf
[2] https://www.consultancy.uk/news/15043/insurance-industry-ma-sees-decline-in-volume-counterbalanced-by-mega-deals
[3] See European Systemic Risk Board, https://www.esrb.europa.eu/pub/pdf/reports/161128_low_interest_rate_report_annex_c.en.pdf
[4] Source: 2016 EIOPA Insurance Stress Test Report

from under 20 percent to over 90 percent, depending on the country concerned[4]. There's a similar variety in holdings of other assets, such as corporate bonds, equities, hedge funds, private equity, infrastructure, and so on.

The Governance Challenge

Article 41 of the Solvency II Directive stipulates that insurance companies must have an effective system of governance in place to help ensure the sound and prudent management of their businesses. However, if we consider the professional objectives and concerns of senior insurance company executives, we can see that they are not fully aligned. Take the Chief Risk Officer, for example: his or her primary objective is to ensure regulatory compliance with the Solvency Capital Ratio set out in Pillar 1 of the Directive. The head of Asset/ Liability Management is perhaps less concerned with meeting the SCR target than with keeping the duration gap within acceptable parameters. Meanwhile, the Chief Investment Officer is likely to be focused on meeting risk-adjusted portfolio outperformance targets. These objectives and concerns overlap, but they do not coincide entirely. Meanwhile, it's difficult to optimise the insurance company's accounting treatment, the SCR and the firm's financial results simultaneously.

Finding the Right Investment Approach

For an asset manager, designing an investment solution that recognises the inherent diversity of the European insurance business and the existence of potentially competing management objectives may seem like an impossible task. But I'd argue that it is possible to help insurance companies address these commercial and regulatory challenges simultaneously. The asset management approach must recognise that the adjustment to Solvency II is likely to be ongoing—we may only be at the beginning of the reorganisation of the industry that many have predicted. The asset manager must be flexible enough to recognise the inherent trade-offs facing insurance companies when they aim to meet the goals of the new regulation. These trade-offs can be managed through well-designed internal governance structures. From the perspective of the insurance company, a commitment to transparency is a prerequisite. In other words, the company needs to be prepared to provide the level of detail to an external partner to allow the third party to design appropriate investment solutions or construct an effective hedge.

> Although Solvency II is a topic to which most insurance executives would gladly devote less management time, I'd argue that there is still plenty of relevant work ahead

How Lyxor Can Help

Our solutions can help both the Chief Risk Officer and the head of Asset/ Liability Management to help reduce balance sheet volatility and thereby to reduce variations in the Solvency Capital Ratio. This then allows the Chief Investment Officer greater flexibility in accessing return-producing asset classes. If the Risk and Asset/ Liability Management teams have a sufficient understanding of the risks associated with particular assets, they will be more prepared to grant the CIO a risk budget sufficient to generate the returns needed for the insurance company to meet its commercial requirements. All this helps insurance company executives to plan ahead and to achieve greater predictability in the management of their companies' business operations. Ultimately, if all the steps in this process are well-aligned, a virtuous circle of improved efficiency is the result.

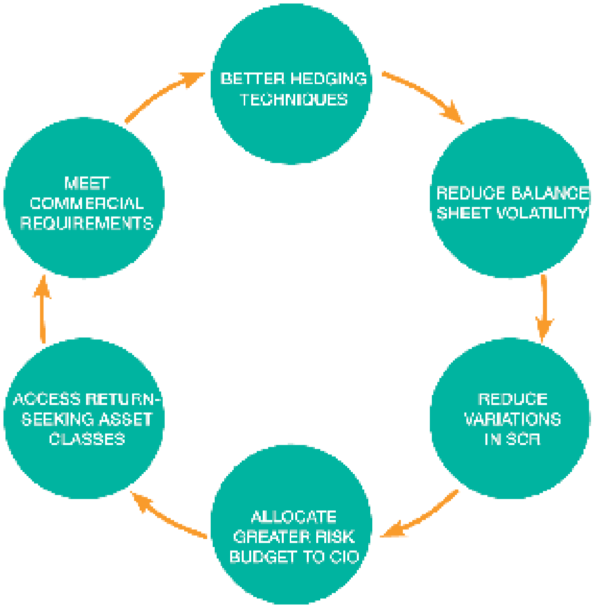
Hedging Policies Must Be Simple, Transparent And Dynamic

The hedging techniques used by the asset manager on behalf of an insurance company client should be simple to understand and implement. In Lyxor's view, wherever possible it's better to use publicly listed, vanilla hedging instruments rather than complex, overthe-counter derivatives to meet the risk reduction goal. However, we are scrupulous in aiming to find the best listed proxy for the particular balance sheet risk. In other words, rather than using derivatives on major market indices as hedging tools just because they are available, we model the sources of balance sheet risk and address those as directly as possible using the proxy. And it's important to manage hedges actively and in consultation with the client. The objective should not be to offset market risks at a moment in time and then forget about exposures until the same time next year. Through an active analysis of the hedging strategy in partnership with the insurance company's risk management team, the responsibility for the strategy is effectively placed entirely under the governance of the insurance company.

Objectives and concerns of insurance company executives

Insurance Company Executive	Primary Objective	Primary concern
Chief Risk Officer	Maintenance of Solvency Capital Ratio (SCR)	Investment risk, regulatory non-compliance, solvency concerns
Head of ALM	Management of asset/liability mismatch within acceptable parameters	Asset/liability mismatch leading to balance sheet pressure
Chief Investment Officer	Risk-adjusted outperformance relative to benchmark (e.g. SCR) within risk budget	Underperformance relative to benchmark, exceeding of risk budget

Creating a virtuous circle through investment and hedging solutions



Finally, the asset manager should help the client evaluate each potential asset class in terms of its contribution to the insurance company's overall balance sheet risk. A holistic approach is better than looking at the volatility of individual asset classes in isolation.

> Our solutions can help both the chief risk officer and the head of asset/liability management to help reduce balance sheet volatility and thereby to reduce variations in the Solvency Capital Ratio

Time To Take Advantage Of The Fundamental Changes In Insurance

We believe the real impact of Solvency II on European insurers' business models and internal structures is still to come. This represents a significant advantage for those prepared to view regulatory change as an opportunity, rather than a burden. By taking a holistic view of their investment requirements and designing an appropriate management approach, European insurance companies can position themselves to benefit from this fundamental shift to their competitive landscape.

Having the solution

Moody's Analytics senior director Adam Koursaris talks to *Insurance Asset Management* about its asset allocation solutions, ESG software and hedging technology

WRITTEN BY **OLIVER WADE**

Q What criteria does Moody's Analytics asset allocation solution use to identify risk-return efficient portfolios?

We have a range of solutions which are tailored for distinct asset allocation challenges, and how an insurer or asset management team uses our software will depend on the specific metrics that are important to their investment decision making. Our solutions are most commonly used where there are longer term (usually between five and 50 year) horizons, and complex objective measures linked to the liabilities or needs of the portfolio. In these situations, our combination of economic analysis and asset-liability insight becomes critical to finding a sensible and robust solution. Some examples of work we have done for clients / services we offer constructing efficient portfolios for retail investment proposition and we use risk and return metrics linked to the specific needs of the end client, for example to buy an annuity in X years time, to draw a minimum level of income from retirement savings without running out of money, etc.

In addition we construct optimal portfolios for life insurance asset allocation. Risk/return metrics are generally insurance focused and company specific, for example optimising the present value of future profits from an insurance portfolio, optimising the return on capital over a one year horizon subject to some constraints, constructing efficient portfolios for pension fund investment and maximising returns subject to some minimum funding position over the projection horizon.

In some cases we do this work ourselves but in other there are multiple calculation systems involved and clients may only use some components of our solutions in their framework. Often we help clients to set up a process to create the portfolios that can incorporate all these metrics in a coherent, efficient way.

Q How can your Economic Scenario Generator (ESG) software benefit insurers and allow them to prepare for stress tests, such as the Swiss Solvency Test?

Insurers all over the world use our ESG software to prepare for and calculate risk and capital on regulatory and internal economic bases (including Solvency II, Swiss Solvency Test, US RBC, HK RBC, C-ROSS and others).

The main users in this context are insurers' risk and / or actuarial functions. Our ESG has two main uses in these regimes. Creating scenarios to form real world distributions of market risk (consistently across multiple asset types, economic drivers and economies). In particular where insurers have Solvency II Internal Models. Furthermore, creating scenarios to value liabilities where there are complex options and guarantees offered to policyholders (e.g. with profits / participating products) in a way that is consistent with asset / financial markets.

We supply both software and economic calibrations for these users, helping them understand, measure and manage economic risk.

Our ESG is also frequently used by asset managers, especially those who manage assets linked to long term liabilities such as insurance companies, pension funds or retirement savers or retail investors. Asset managers typically use our ESG to test different investment strategies. For example will the income or returns of a portfolio be sufficient to cover the liabilities? What is the worst funding or capital position my pension fund or insurance company might be exposed to over some time horizon? What is the trade-off between expected return and risk for an investment strategy given the complex liabilities and long terms dynamics of the asset-liability portfolio?

We differentiate ourselves from more traditional asset management solution providers by taking a longer term view of economic risk / return, incorporating more detailed liability considerations into our analysis and providing economic calibrations that are supplemented more by expert judgement, economic analysis and narrative overlays, rather than being purely implied by short term market observations.

Q Is Moody's Analytics technology designed to work in cooperation with insurers' hedging strategies?

Yes, many insurers use Moody's Analytics technology to develop their hedging strategies. They also use our software to project the overall asset-liability position of their portfolios including the effect of the hedging strategy.

Some uses may be as simple as measuring the value of assets and liabilities after one year including the effect of some derivatives held at the start. Other uses are more complex – for example some users want to project how a hedging strategy will dynamically change over time based on the scenario dependent value of assets and liabilities and how the overall long term asset-liability position will evolve.

Some clients do the full end-to-end calculation with our software, while some clients use only some components within a process incorporating their own/other vendors' software.

Q What challenges are insurers facing when it comes to regulation, and how can they be overcome?

For the most part European insurers have the tools in place for their Solvency II capital calculation and reporting, and this is working relatively well. The challenges now being faced relate to how to incorporate these regulatory regimes/models into decision making and business planning. For example, what is the best asset allocation to optimize return on Solvency II capital, given the capital model and assumptions used by the group? Or to project the capital requirements or balance sheet according to the regulatory model, over multiple years, incorporating realistic management decisions and policyholder behavior, so that the company can easily and accurately test different multi-year economic stresses and see the effect on the business as a whole? In a hard Brexit scenario, what will my required capital be every year? What decisions will I take? Will my dividend be affected?

In other regions, capital regimes are only developing now, for example HK, Japan, ICS, China C-ROSS and ALM regulations, SST. And there is a lot of work for insurers and regulators to do to understand and embed these systems.

Q How do you recreate the "what-if" scenarios when providing financial planning solutions, and what factors are tested?

For our Monte Carlo stochastic scenarios, we create thousands of scenarios of the path of asset returns and economic variables over a given time horizon. Time steps may be from daily to annual, and time horizons may be up to 100 years or more and we have built sophisticated mathematical models that describe how different economic variables behave and interact. We also calibrate these models to target certain characteristics based on long term historic data over many economies and asset types; current market data like market yield curves, asset prices and implied volatilities; expert opinions (such as central bank forecasts); economic theory such as theories about the relationship between interest rates and GDP and expert judgment (internal or external). Then the distribution of scenarios generated by our models will match our targets and behavior driven by the mathematical models and the calibrations

For stress test scenarios, these are typically a handful of hand-crafted narrative economic scenarios – say 10 to 12, each one of these scenarios typically have more judgement about how the economy will behave and interact and there are models and data behind the scenarios to help our economists think about underlying structural relationships.

Clients may use one or the other type of scenarios for particular uses or may use them in combination. For example in this particular deep recession scenario, in year 5 I would like to know if my solvency ratio will be above x%. So I run the single stress scenario up to year five and then run a Monte Carlo scenario from that point to measure my asset and liability value and calculate the capital position that would apply at that time.

Current ponderings on industry themes

PATRICK HAYWARD
Altus Consulting consultant

For general insurance companies, the outlook is mixed but ultimately positive, with tough market conditions coinciding with a wave of tech innovation, partnership opportunities and the prospect of new, profitable customer propositions. Key challenges for the industry include continuing low (but rising) interest rates impacting investment income, the impact and ongoing uncertainty around the Ogden Discount Rate, unlocking the potential of technologies, and competition from insurtechs that can operate efficiently without the usual legacy issues. Lemonade, for example, uses the ratio of customers to employees as a metric for its level of automation, and is in this regard operating with a far more efficient workforce than its larger US competitors. Insurers are having to navigate these hurdles, whilst ensuring that they remain compliant in an ever-changing regulatory environment. This combination of factors has, however, given insurers greater impetus to focus on underwriting discipline, and to design innovative products where both the customer and the insurer benefit from an improved digital experience and approach to risk.

LARRY SCHIFFER
Squire Patton Boggs partner

The global insurance industry, similar to almost every industry, is facing a challenging outlook, predominantly driven by two factors: (1) technology/innovation and (2) alternative capital. The insurance industry is changing rapidly as new, insuretech-focused companies (often funded by the capital markets) are disrupting the space. Consumers of insurance (both individual consumers and commercial buyers) are looking for faster, secure and more efficient ways to protect against risk and transfer risk. The challenge for the traditional insurers is keeping up with new developments and innovating to stay relevant and competitive. Blockchain and other disruptive technologies are becoming more available to insurers and those who do not innovate and change their models will be left behind. Another significant challenge to this sea-change of technological innovation is the regulatory environment in which the insurance industry operates. There are serious concerns whether insurance regulators have the personnel and knowledge to keep up with innovation and allow insurance companies to innovate without violating outdated and irrelevant regulatory and statutory mandates.

FRANCK VIORT
MUFG head of non-bank financial institutions

A year ago, Solvency II was at the forefront of everyone's minds, but the uncertainty that a new and complex regulatory regime inevitably carries has somewhat eased. The degree of volatility that SCR would experience was one of the "unknown" and it has been fortunate that recent market dynamics have helped strengthen solvency positions despite the remaining low yield environment. The reinsurance sector at the moment is challenged in two ways which are somewhat related. Firstly, capacity has prevented prices from adjusting, following the losses from last year hurricane season. This a significant departure from previous cycles which suggests that reinsurer should consider deploying their capital into new areas to seize growth opportunities. There is a shift towards specialty lines to increase the share of more added-value, less competitive segments in the business mix, but the real challenge is the cover of new forms of risks. Cyber risk is one example and while it is a big opportunity, it also requires insurers to develop the appropriate underwriting methodology and pricing tools. This leads to the second theme – excess capital and consolidation in the sector. There have been a number of high profile M&As over the course of 2018: AIG and Validus, AXA's purchase of XL, Cigna's takeover of Express Scripts, and more recently, March & McLennan's buyout of Jardine Lloyd Thompson Group. The addition of reinsurance capabilities to the existing platform has been identified by both AIG and AXA as sources of efficiency and value creation through a better access to deep sources of alternative capital.

GARON ANTHONY
Squire Patton Boggs partner

Cyber insurance is a relatively mature product in the USA. But in the UK and Europe insurers have been extremely active in the past 12 months selling it to corporates who have become increasingly alive to the on line threat to their businesses and crack downs by governments on misuse of personal data. Inevitably this leads to potential financial exposure for insurers which may not fully play out for a few years yet. And the question is have insurers, especially in Europe, bitten off more they can chew in their haste to sell cyber insurance? GDPR have massively increased the level of fines that can be imposed by governmental agencies in the wake of a data breach. Consumers have increased rights to bring class actions against companies even if they have not suffered financial loss from compromises to their data.

AMY KESSLER
Prudential Financial head of longevity risk transfer

Two additional factors are keeping prices affordable in the longevity reinsurance market. The first is the addition of new asset strategies, such as the use of new illiquid asset classes, including the securitisation of wind and solar energy. The second is that longevity has been improving at a slower pace than the historic average. The current slowdown in longevity improvement is due to several health advances occurring simultaneously between 2000 and 2010 (smoking reduction, stents, statins, etc.), a confluence of improvements that made the pace of longevity gains in subsequent years harder to match. But the current, slower pace of longevity improvement is unlikely to persist as there are several possible health advances that could re-accelerate the pace of longevity gains in the years ahead.

We started the year with some very low yields, thanks to a fantastic 2017 for credit, and since then, we've seen a lot of repricing. Timing the markets is notoriously difficult but there is a lot of bad news in the yields currently, and as we can see from the £ HY index, when you build in bad news, you can take more and still be positive for the year. Food for thought if you are sitting on cash, and certainly worth considering if you have stayed invested and have already taken a lot of pain

EOIN WALSH
TwentyFour Asset Management partner, portfolio manager

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The Boston Consulting Group partner and managing director

Many insurers have to date been doing a patchwork of solutions to meet the tight deadline of IFRS 17. The extension will mean they can benefit from taking a more holistic look at finance transformation. Whilst many insurers have been burnt by this in the past, changes in technology and the implementation of agile ways of working suggests this is much more achievable now. A set of well integrated adviser teams that are able to span the wide breath of capabilities for such a transformation is the key for success.

FITCH RATINGS

We believe there is significant longer-term growth potential too given the gradual reduction of state pensions and the relatively low penetration of insurance into the Spanish market. Spain is one of the most profitable insurance markets in Europe, with return on equity averaging 13 per cent over the past ten years, despite pressures from the Eurozone crisis and then subsequent low interest rates.