How can we rethink insurance investment to solve the complexity challenge?

The model of insurance investing has been upended since the financial crisis by a confluence of challenges. New assets, strategies and partnerships have the potential to help insurers cut through this complexity and deliver sustainable solutions

What one word would describe the environment for insurers today? Through our own experience investing as an insurance business, and through our many interactions with clients, we too often see complexity as the biggest industry challenge.

Insurance assets globally stood at approximately $27 trillion at the end of 2017, according to the OECD, one of the largest pools of capital globally. Europe accounts for approximately 40% of the total, according to data from Insurance Europe, the insurance association federation.

Traditionally most balance sheet assets have been run internally, predominantly invested in sovereign debt, investment grade fixed income and cash, with the occasional sprinkling of property and equity-like assets.

The resource devoted to management has historically been small compared with underwriting, and investment management typically a simple turnkey exercise, since the business model was straightforward: collect premiums, invest said premiums in assets with secure (preferably contractual) returns, pay out claims and live off the margin.

This careful balance has been upended thanks to a combination of factors including extraordinary monetary easing, worldwide macroeconomic and political uncertainty, and regulatory and accounting changes over the past decade.

The lengthy bull market in fixed

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income, which benefited insurers' portfolios for the best part of 40 years, came to an abrupt end after the financial crisis. Yields on traditional assets that served insurers well in the past have declined until largely they no longer meet required return targets.

At the same time, insurance premiums globally have steadily risen to approximately $5 trillion annually, compared with just over $4 trillion in 2008, according to Swiss Re Sigma. Insurers have increasing amounts of money to invest precisely when less would be preferable, and while stakeholders all require more yield, higher returns on capital and better returns to shareholders.

Finally, alongside this there has been an influx of new regulation, led initially by Solvency II but also rippling outwards, such as, for example, through the advent of the International Capital Standard (ICS). There is a trend towards risk-based capital frameworks globally, which has increased the demands on insurers' resources and the scrutiny of their decisions. Some elements are prescriptive, others less so. But it has generally required the community to look deeper into its investment decisions and map out the risks in more detail than ever before, while also holding more capital back for possible losses.

The confluence of this with the sustained low-yield environment of the past decade has been punishing for insurers, a situation potentially compounded by the new accounting changes on the horizon in coming years, notably IFRS 9 and IFRS 17. A strong underwriting environment might mask this in better times, but that is not the case today.

Rethinking the core principles

These changes have all had a tremendous impact on profitability. To address them requires rethinking the core principles of managing insurance assets.

Insurance companies have traditionally been far more focused on liabilities than assets, a natural consequence of being liability-driven businesses. The status quo has been large underwriting teams and skeletal asset management teams, thanks to the long-held perception of the asset portfolio as a low risk, stable source of return, providing a dependable series of cashflows to offset against liabilities.

Today's environment is upending that status quo. Assets and liabilities are now inextricably bound and must be viewed as a holistic whole. Asset-liability management (ALM) now becomes a delicate balancing act, founded on a renewed appreciation and proactive management of the mismatches between assets and liabilities that lie at the heart of every insurance portfolio.

Most importantly, we are seeing a move from an approach that focused historically on minimising capital to one that now seeks to maximise the return on capital.

Insurers are learning that good ALM today is not about the avoidance of risk, but rather the art of learning how to live with it. While the rest of the investment community ponders the trade-off between risk and return, insurers have to tackle a three-dimensional problem of risk, return and regulatory capital.

The three-dimensional challenge of risk, return and capital in insurance portfolios

They are wrestling with a shift towards risk-based assessment, the unveiling and active management of underlying balance sheet volatility and capital-driven asset decisions. They have begun down the road that banks took in the 1980s – towards a growing and far more complex balance sheet.

There is no 'one size fits all' solution.

Each insurer's balance sheet is unique and will require their own path through the forest. But the simple fundamental principles above are common to every journey.

Managing this means rethinking the way insurers approach their portfolios.

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A renaissance in innovation?

To overcome these challenges and adapt the business and investment models, innovation is critical, not just for insurers but also for their partners.

We have seen the advent of new asset classes and strategies, with the lines between traditional and alternative becoming increasingly blurred. Management of balance sheet volatility has moved centre stage, and thoughtful, capital-efficient solutions are arising to tackle essential issues.

However, the journey is not solitary. Collaboration and innovative partnerships between insurers, asset managers and others are key to delivering the solutions to enable investment portfolios to adapt and thrive in this complex, shifting landscape.

Insurers are fast learning that there are many tools at their disposal if they choose to look more widely. A host of advisers and service providers have sprung up to provide both the tools and advice to help manage the journey, from capital modelling to comprehensive risk solutions to data provision. The asset management industry has worked hard to move from turnkey products to solutions that meet vital needs.

This is all encouraging: collectively, we are innovating to find answers to once-intractable problems. But there is also risk, as new assets and solutions bring new exposures to understand; new challenges such as capacity and regulatory alignment; and new skills to master, such as origination and structuring.

The potential for further change also remains, particularly as new insurance business models emerge, regulation evolves and new policy priorities develop around growth and climate change, to name but two of the highest profile issues.

There has already been movement on infrastructure investments within Solvency II, for example. The European Commission has begun to put substance to its oft-expressed desire to kick-start securitisation once again, through the simple, transparent and standardised (STS) framework – an area we are active in.

The International Capital Standard (ICS) framework is even newer and still in flux, while regular and upcoming review periods across various frameworks in the next two to three years all herald opportunities for further evolution.

Arguably, insurance investment management has finally come of age. Reducing today's interwoven complexities to simple management actions and decisions brings us all closer to the industry's holy grail: a sustainable business with stable and visible returns into the far distance.

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