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# Investing in alternative assets: considerations for a general insurer

## GIRO Conference 2016

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# A challenging economic backdrop

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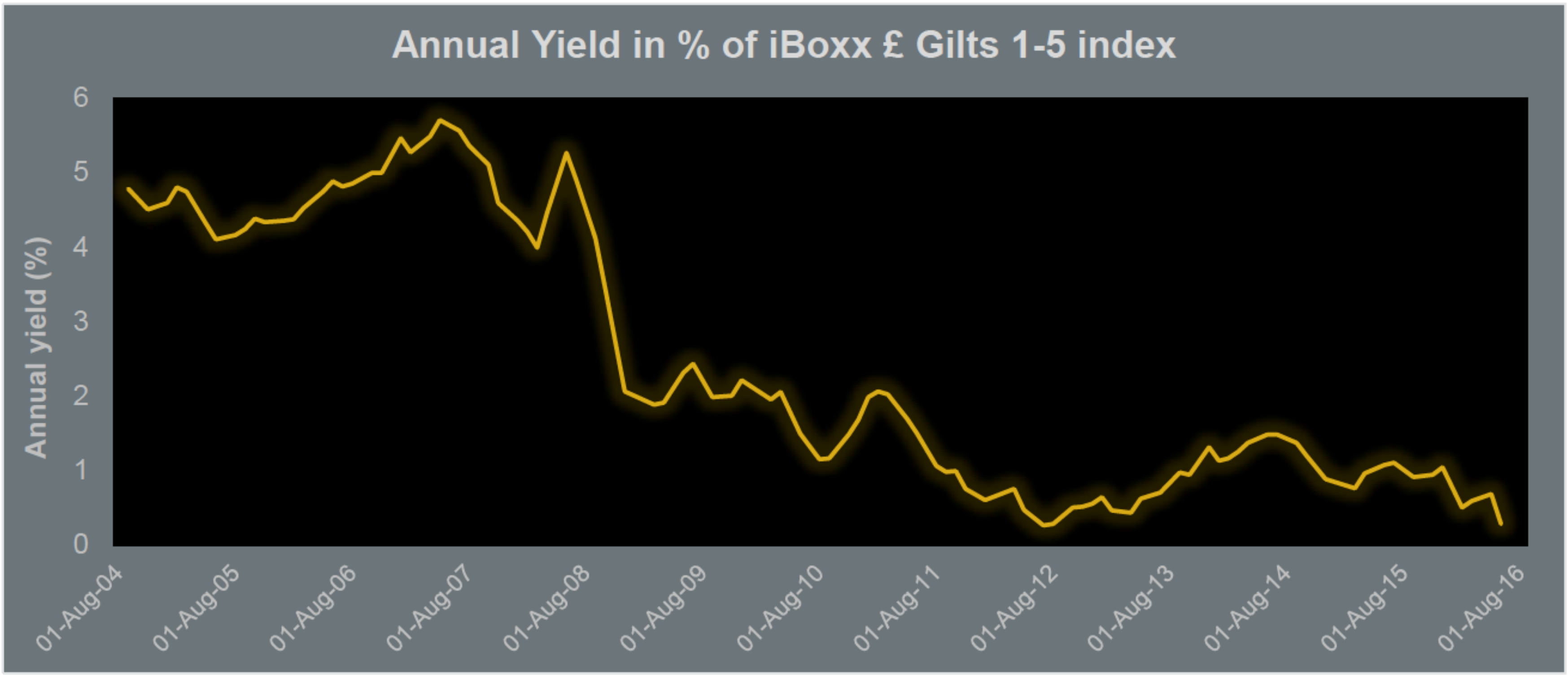
# The search for yield continues amidst a challenging economic backdrop




The fall in the annual gilt yield emphasises the need for firms to search for yield

**Source**: Markit, iBoxx £ Gilts 1-5 index

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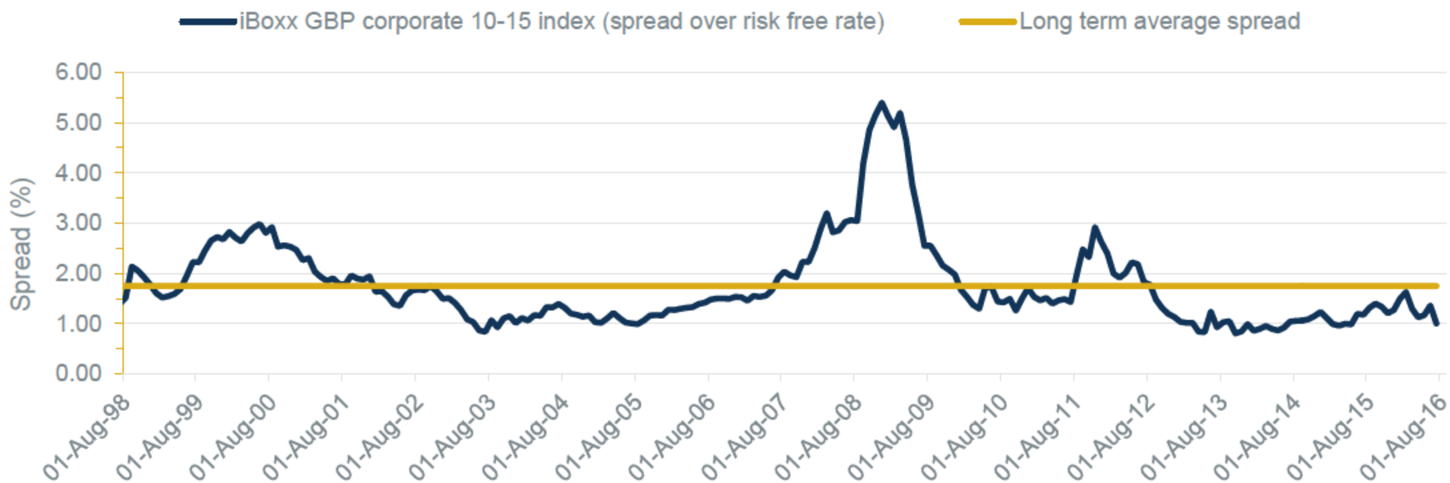
# The search for yield continues amidst a challenging economic backdrop




Spreads are below long term averages

**Source**: Markit

## FTSE 100 historical data


Recent volatility in the equity market

**Source**: Markit

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# Possible methods for optimising insurance investments

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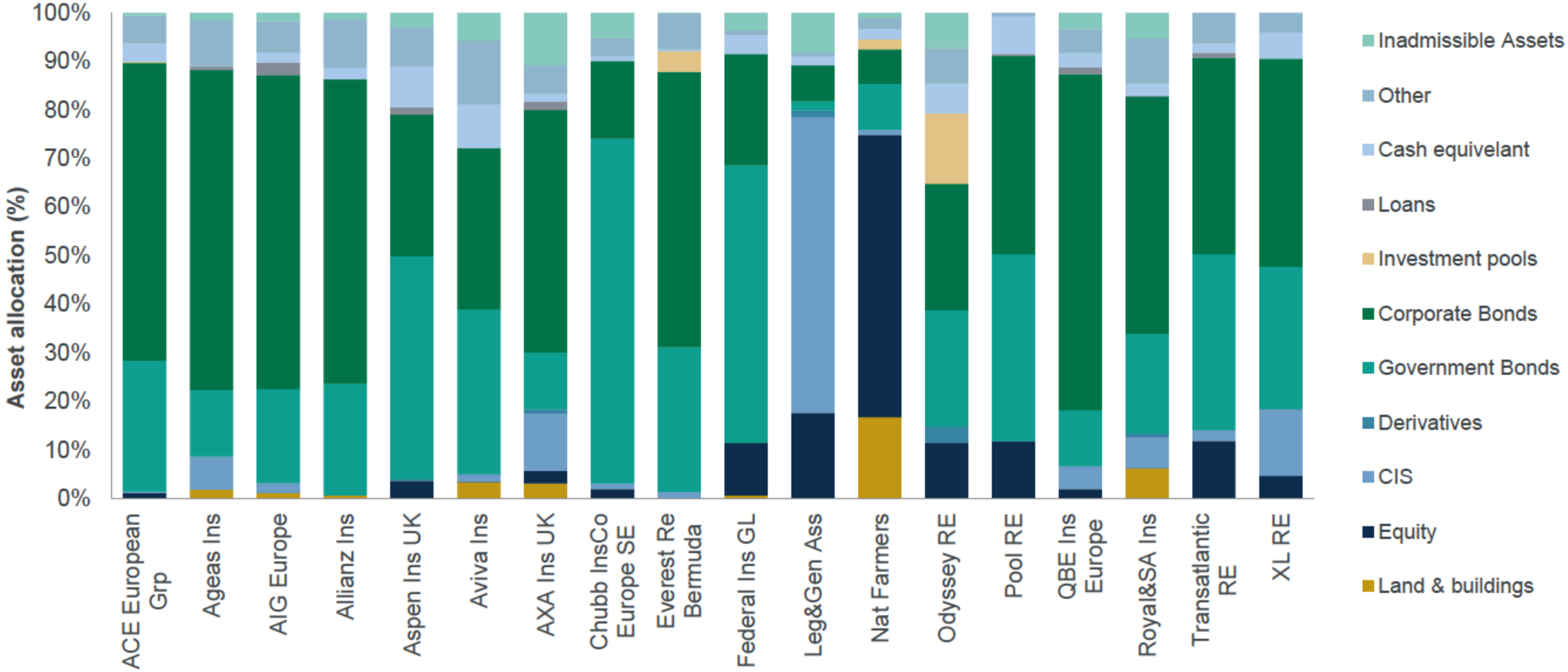
# Current asset holdings

## Asset allocation in the general insurance space (YE15)

**Source: YE15 PRA forms**




- On average, corporate bonds and government bonds form 41% and 28% of total asset allocation respectively. These bonds are expected to be either short term or very high quality and liquid in nature.
- Despite corporate and government bonds constituting the majority of average current asset holdings, it appears that major players in the general insurance space remain willing to invest in alternative asset classes in a search for adequate return and diversification.

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# Possible methods to improve return on capital

Non-life insurers have traditionally favoured vanilla asset strategies to satisfy liquidity demands, but as a result typically achieve low returns. It may be appropriate for insurers to consider alternative asset strategies to improve their return on capital.

| Option | Considerations |
|---|---|
| **Investment in alternative assets to pick up an additional illiquidity premium** | • Illiquid assets often pay a higher return than their liquid counterparts, however firms may face valuation and operational difficulties |
| **Invest in assets of greater duration** | • Firms should consider the steepness of the interest rate curve, extra capital requirements, their risk appetite and an economic view of rates staying low |
| **Assume extra credit risk / equity risk** | • Deliberately move into more risky assets to achieve higher expected returns, whilst balancing this with additional capital requirements |

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# Investment in alternative assets to pick up an additional illiquidity premium

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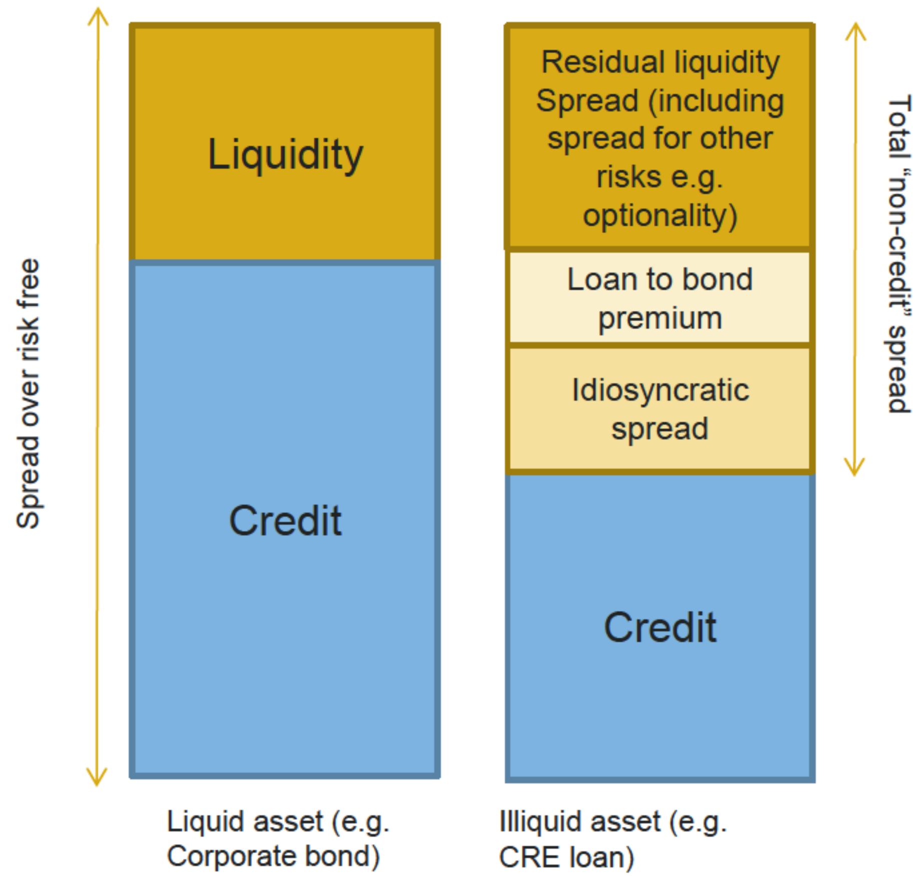
# Achieving greater yield - higher risk and less liquidity?

- General insurers need not be satisfied with languishing total returns
- Economic opportunity for general insurers to extend their reach into the alternative investment market
- Changing the total asset allocation should be balanced with the capital treatment of these investments under Solvency II
- Increased interest in securities lending, private placements and commercial mortgages

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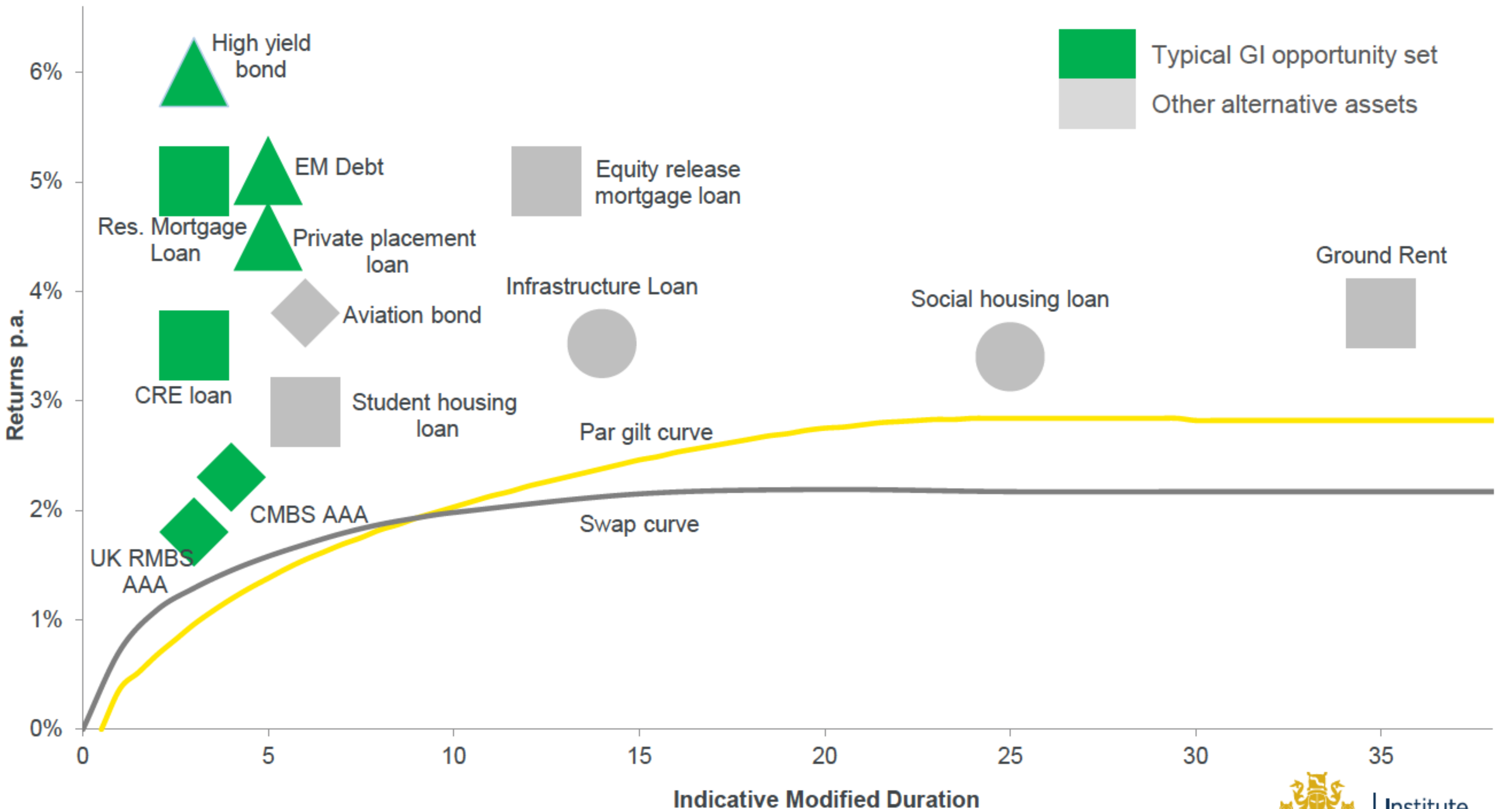
# Alternative assets could provide the risk-adjusted return to satisfy insurance investor requirements




**Source:** EY with template from IFoA non-traditional working party

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# Life insurers are already participating…

British insurers commit £25bn to UK infrastructure
The Telegraph, 4 December 2013

Prudential plans to plough nearly £300m into the construction of around 1,000 new (affordable) homes.
The Telegraph, 25 January 2014

L&G plans to begin lending to larger SMEs
The FT, 23 February 2014

AXA raises €2.9bn for European real estate debt fund
IPE Real Estate, 3 August 2015

Insurer Aviva has completed the purchase of around 7,000 solar photovoltaic systems, totalling around 23MW
Solar Power Portal, 13 August 2012

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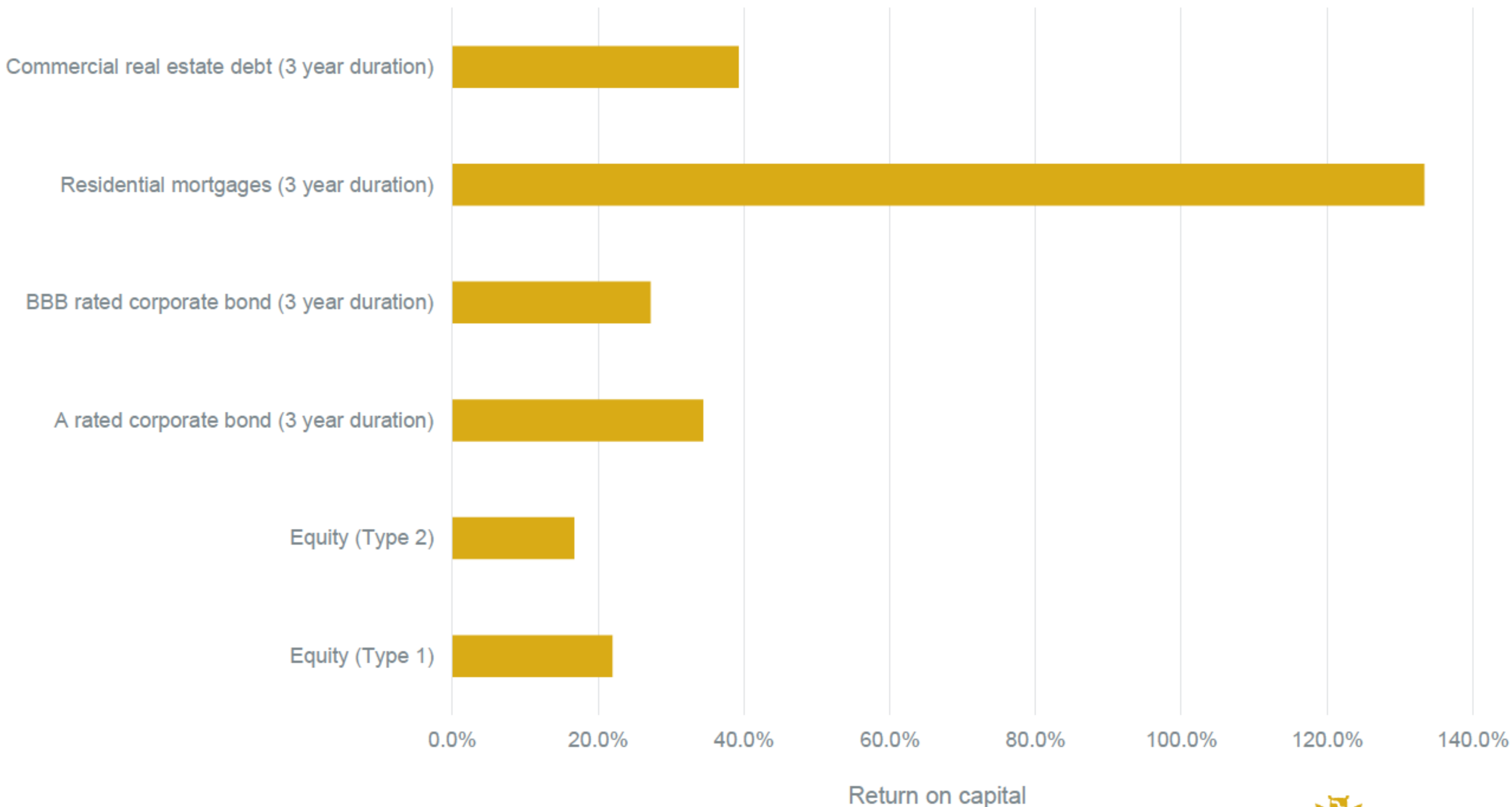
# An attractive return on capital opportunity

## Example of return on capital for sample of assets

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# Further considerations when investing in alternative assets

- The potential to achieve more attractive returns needs to be balanced with a number of risks which may arise:
  - **Interest rate risk**
  - **Operational risk**
  - **Liquidity risk**
- Other operational considerations are discussed in later slides

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# Lengthening liability profiles and the use of effective duration

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# PPOs and an evolving liability profile

## An introduction to PPOs and the motivation for their optimisation

- The incidence of claim awards in the form of Periodic Payment Orders (amongst other things) is lengthening liability profiles
- Compensation is paid to claimants at regular intervals, rather than in a single lump sum award
- Appropriate that general insurers should look to optimise their assets backing PPOs
- Unlikely that PPOs would be eligible for the matching adjustment

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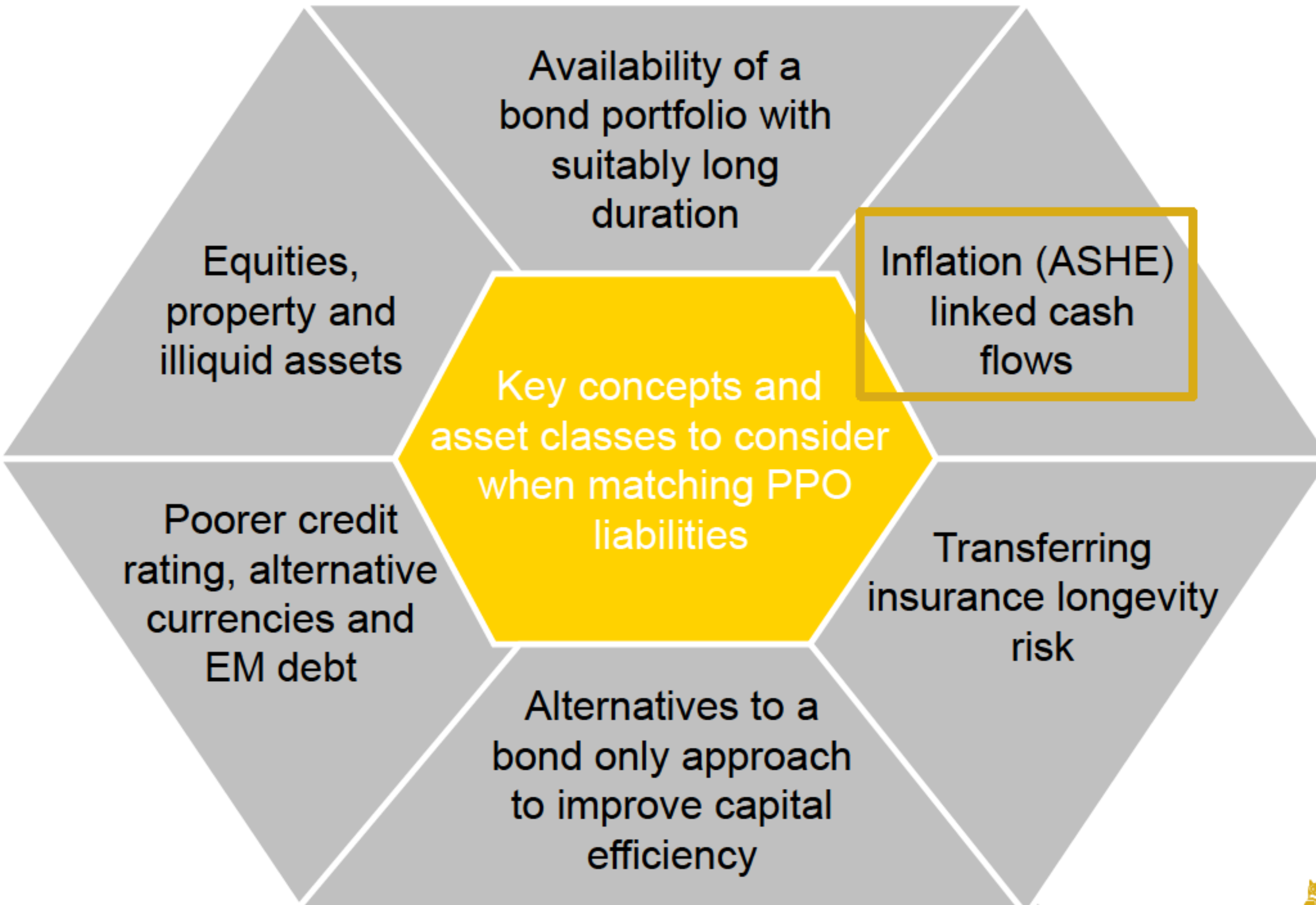
# PPOs and an evolving liability profile

## Considerations when matching PPO liabilities

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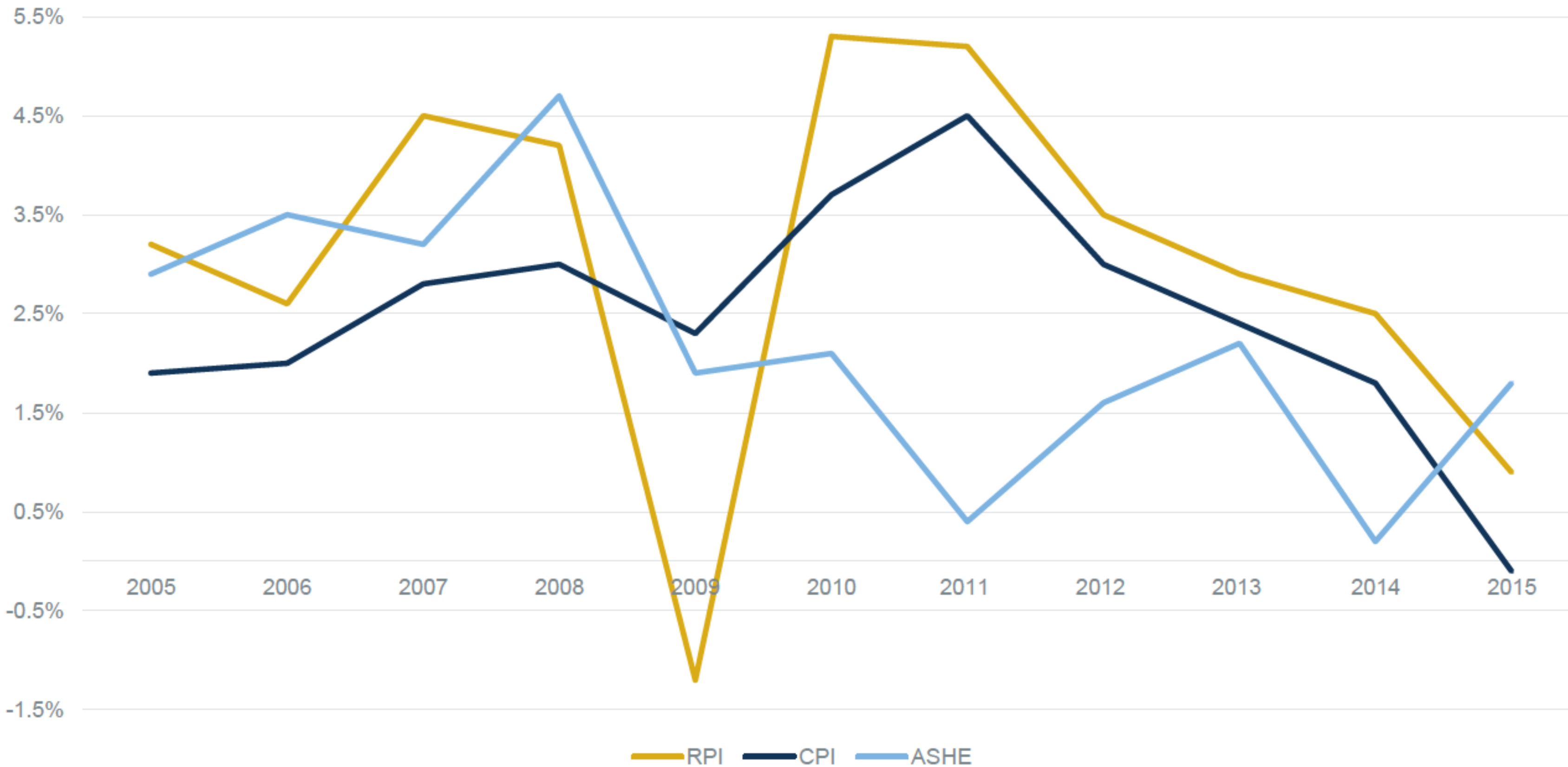
# PPOs and an evolving liability profile

## The different measures of inflation




ASHE has not historically been perfectly correlated with RPI (or CPI)

**Source:** Office of National Statistics

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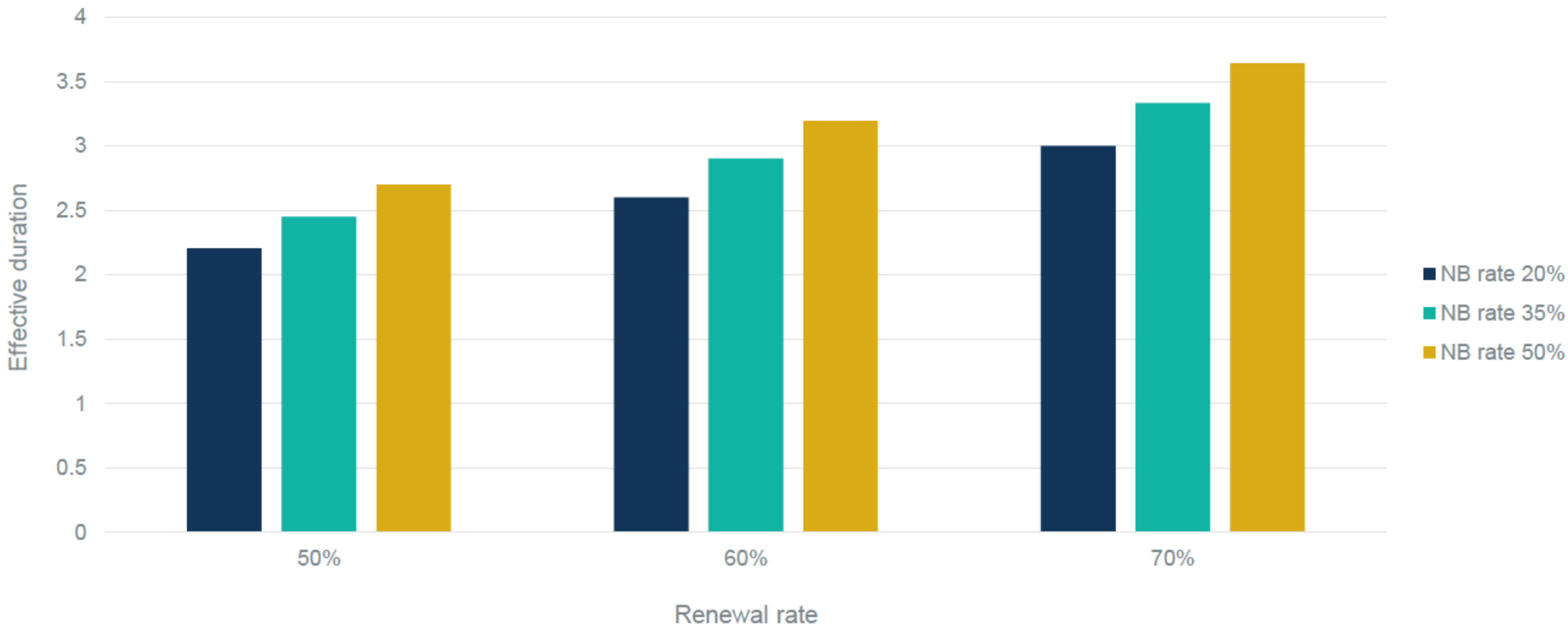
# Using effective duration within large renewal books

## Can a proportion of premiums be considered to be consistent and invested longer term?




- One could effectively back a large portfolio of yearly renewing motor (or other personal lines) policies with long-dated assets
- Increased interest rate risk as a result of asset and liability mis-matching

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# Practical and operational considerations

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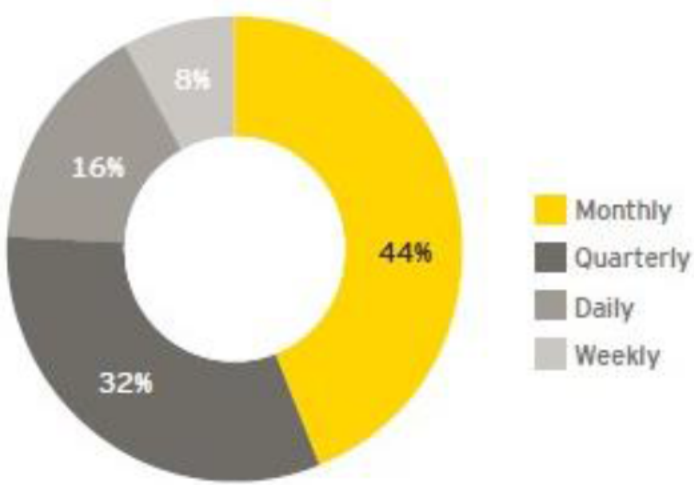
# Liquidity risk management

## Why is it important and how do firms typically approach it?

- Liquidity management is crucial for general insurers looking to invest in alternative asset classes
- Firms typically perform stress and scenario analysis to assess their liquidity position, validate contingent funding plans and identify available mitigating liquidity options




**Source:** EY Global Liquidity Risk Management Survey 2016

- Firms typically report on a monthly or quarterly basis, where automated processing and better reporting platforms may be required to increase this frequency

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# The operational journey

## The process when moving into a new or alternative asset class

Difficulties with mark-to-model assets, including the setting of internal assumptions

Possible issues regarding data and treatment under the Standard Formula of more complex exposures

1. **Origination**
2. **Valuation and modelling**
3. **High level capital and accounting analysis**
4. **Risk identification and analysis**
5. **Detailed capital and liquidity modelling**
6. **Integration into business as usual**
7. **Regulatory approval**

Requirement for investors to be able to demonstrate expertise in the assets which they have invested in

The Prudent Person Principle is an overarching principle to take into account

Important for firms to demonstrate effective liquidity management procedures.

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# Questions

# Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.

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