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Can an Eye on Investment Markets Smooth your Balance Sheet?

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River and Mercantile Solutions

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About us

Questions we will answer

Can insurers improve stability of profits by looking through other lenses?

Should insurers include dynamic asset allocation as part of their investment mandate?

How can insurers develop a more holistic approach that considers assets and liabilities in tandem?

Can investment return be improved without taking additional economic risk?

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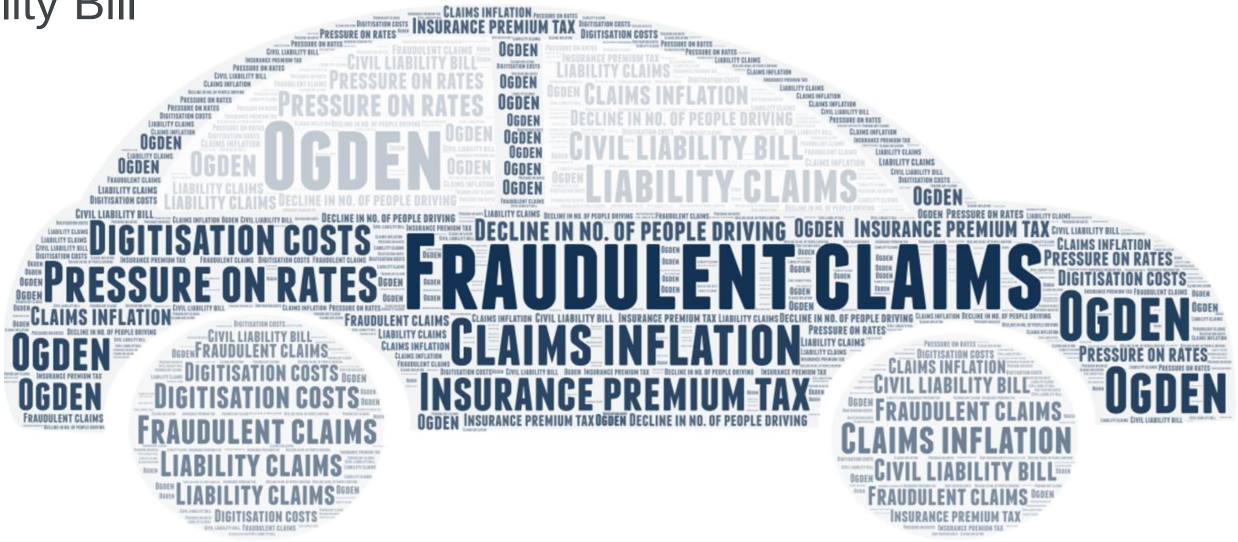
Background

Challenges of underwriting non-life insurance

Themes in underwriting personal lines insurance

- Underwriting personal lines insurance continue to face challenges
- Some recent good news for motor insurers with Ogden revisions and the Civil Liability Bill



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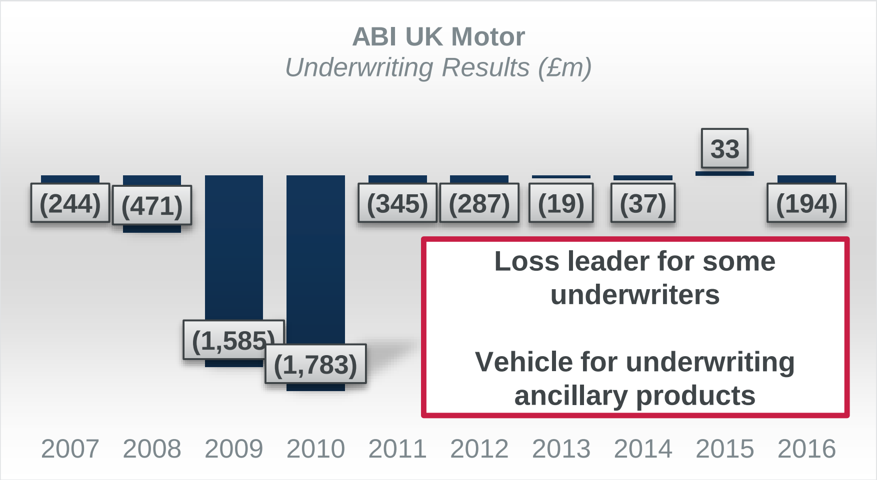
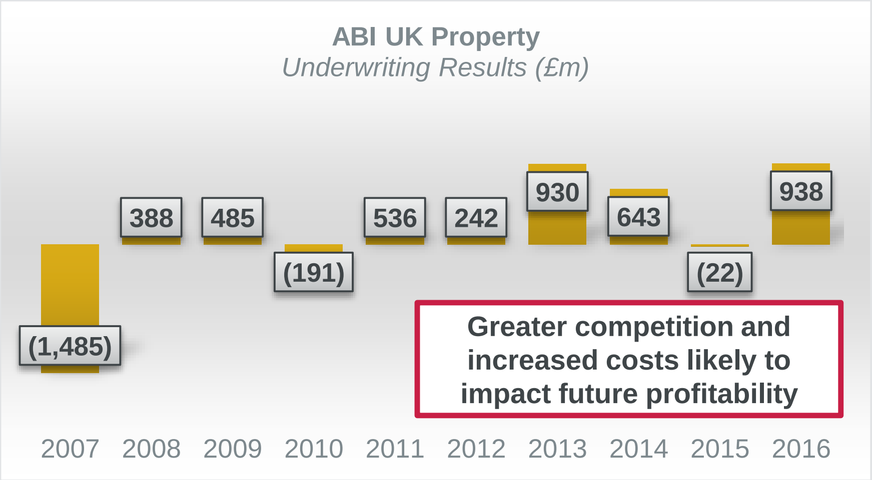
Poor historical market performance

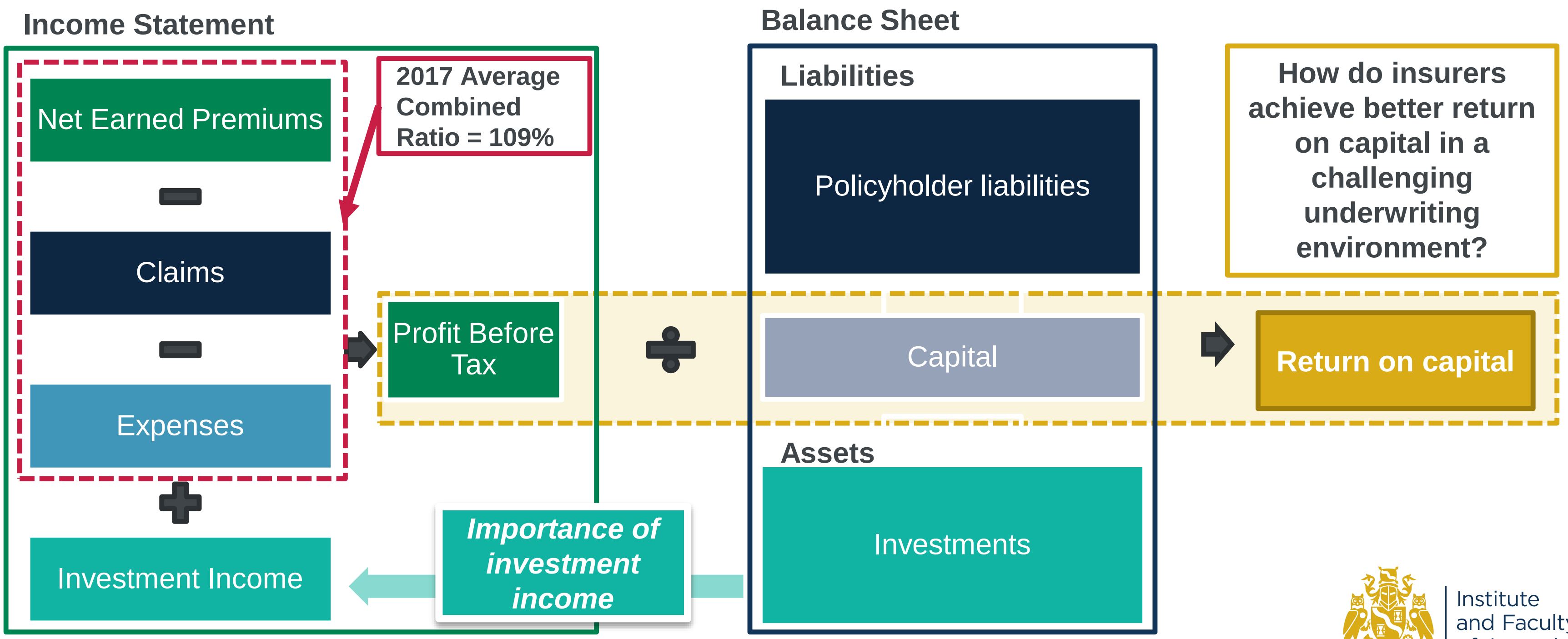
- Motor insurance is increasingly competitive with tight margins, but provides insurers with premium volume
- Home insurance is facing greater challenges around rates and digitisation





Source: ABI General Insurance Overview Statistics

The importance of investment income



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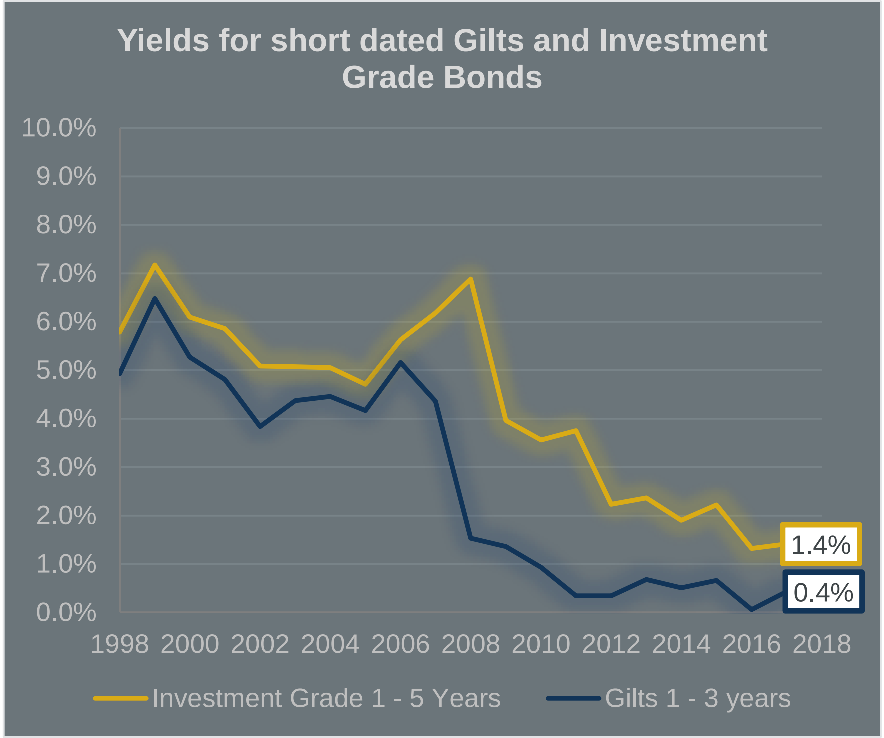
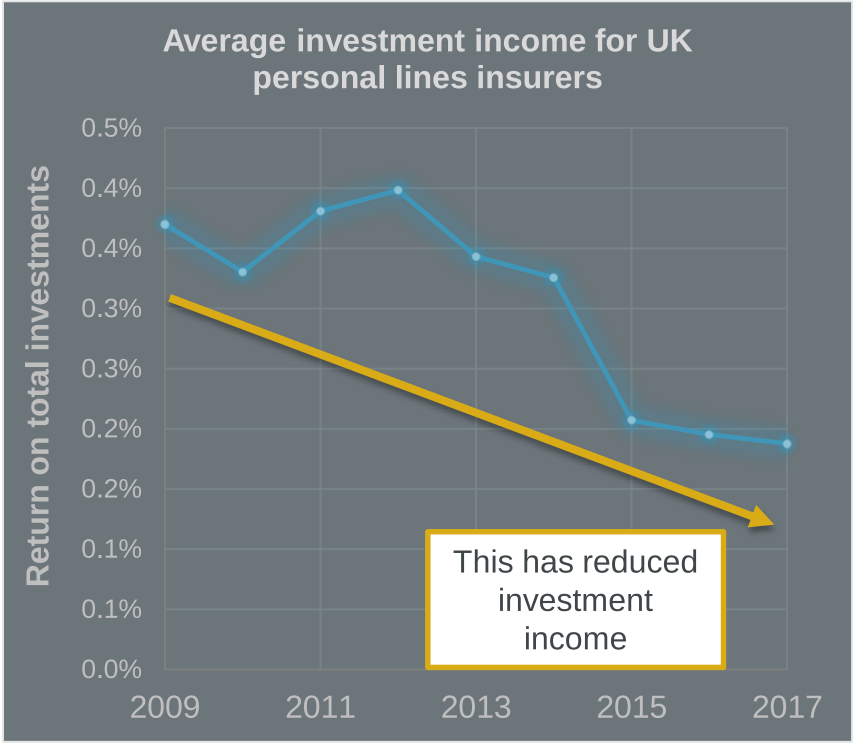
Traditional asset classes are low yielding today





Source: Bloomberg – Average investment income for UK personal lines insurers based on sample of six personal lines insurers from FTSE non-life insurers

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Dynamic Asset Allocation

Inclusion of flexible investment mandates

Should insurers rethink their investment mandates?

Typical considerations for setting investment mandates

Solvency Capital Requirement

IFRS Volatility

Liquidity

Optimising under these constraints may not always provide the best outcome

Static investment mandate

If we take SCR then it does give you the benefit of a "price" for risk

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Case for dynamic asset allocation

- Consider an insurer with an investment portfolio comprising entirely of investment grade bonds.

	Corporate Bonds	High Yield Bonds
Historical Compound Annual Return	3.3%	7.2%
Annualised Volatility (Actual)	1.8%	10.0%
Maximum Drawdown	-1.7%	-33.6%
	Standalone Market Risk SCR = 11%	Standalone Market Risk SCR = 35%

Over the same period High Yield bonds provided nearly twice as much return.

But we cannot ignore the huge increase in volatility or drawdown!

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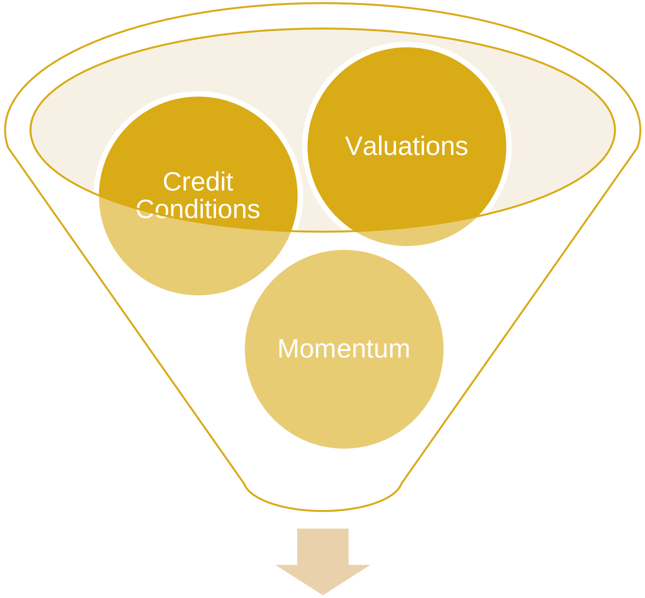
Source: Merrill Lynch Sterling Broad Market Investment Grade Bonds 1 -5 Years and Global High Yield indices for the period Jan 2007 to Jun 2018
Note- Standalone SCR have been estimated assuming 10 year duration bonds with A and BB ratings for Corporate Bonds and High Yield respectively

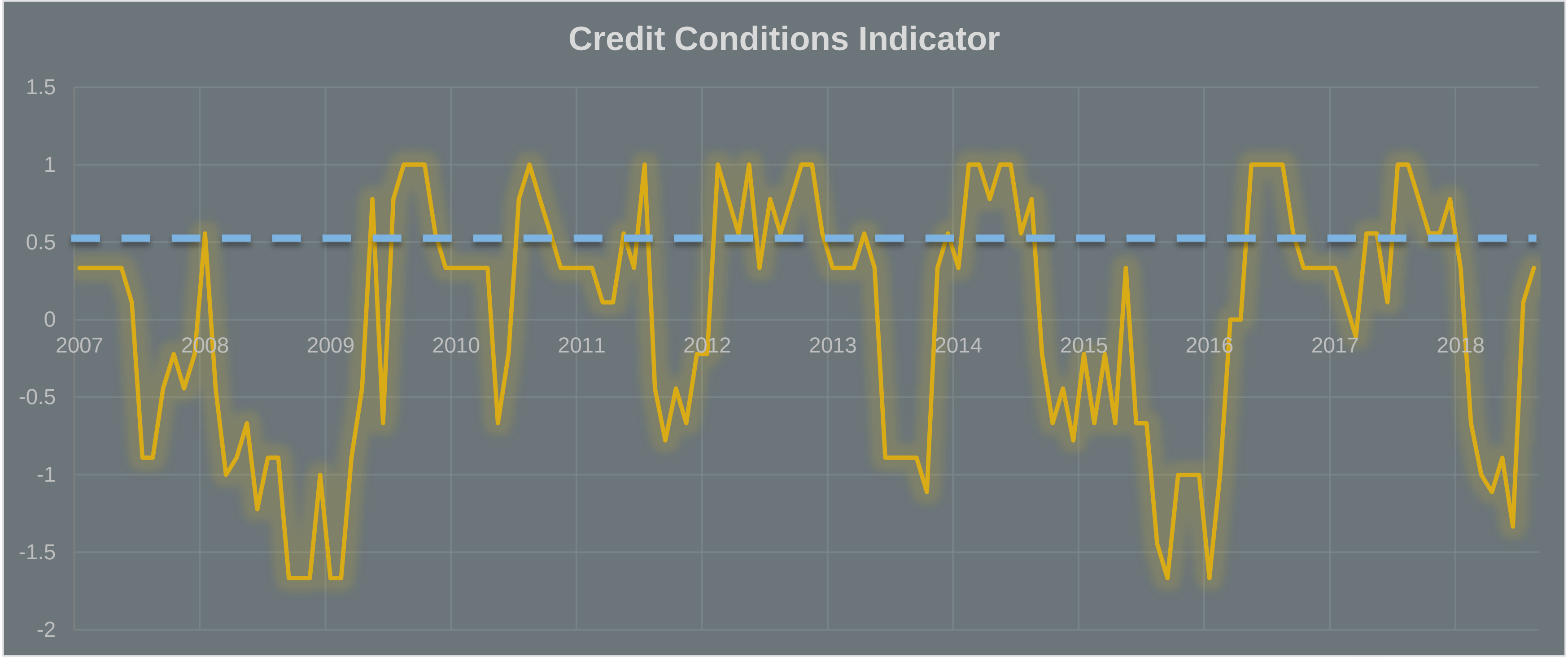
Case for dynamic asset allocation

- How can insurers access a riskier asset class like High Yield without increasing risk?



Credit Conditions Indicator

Case for dynamic asset allocation



Case for dynamic asset allocation

- Inclusion of a dynamic mandate allowing up to 25% allocation in High Yield:

Through allocation to High Yield Bonds at opportune times investment return and risk characteristics improve significantly, compared to investing only in High Yield Bonds

	Corporate Bonds	High Yield Bonds	Dynamic Allocation
Historical Compound Annual Return	3.3%	7.2%	4.5
Annualised Volatility (Actual)	1.8%	10.0%	2.1%
Maximum Drawdown	-1.7%	-33.6%	-1.7%

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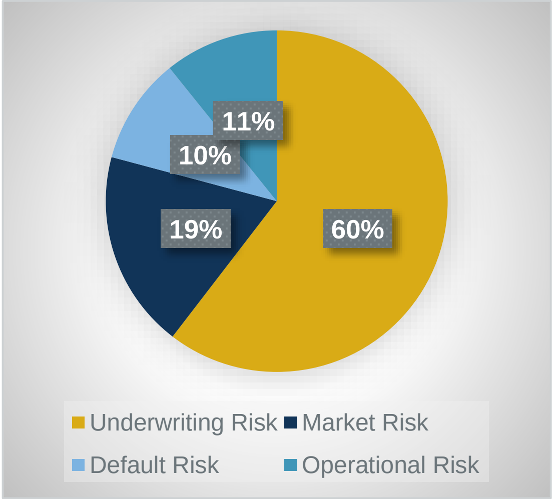
Source: Merrill Lynch Sterling Broad Market Investment Grade Bonds 1 -5 Years and Global High Yield indices for the period Jan 2007 to Jun 2018

Case for dynamic asset allocation – impact to profits

- Assuming that an insurer has the following income statement and risk profile:



Total SCR = 20%

Net Earned Premium	£750m
Claims	-£600m
Expenses (25% of Net Earned Premium)	-£188m
Underwriting Results	**-£38m**

Investment Income Corporate Bonds on £1bn Investment Portfolio	**+£33m**

Total Profit	**-£5m**

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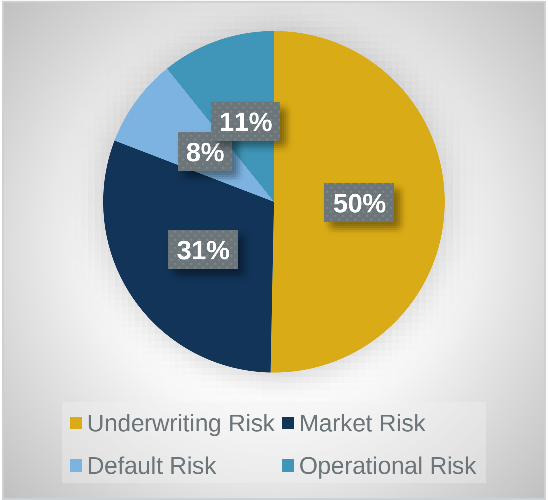
SCR expressed as a percentage of total investment portfolio. Total SCR reflects total diversified SCR calculated under standard formula, assuming approximate industry average standalone SCRs for underwriting, default and operational risks.

Case for dynamic asset allocation – impact to profits

- Assuming that an insurer has the following income statement and risk profile:



Total SCR = 23%

Net Earned Premium	£750m
Claims	-£600m
Expenses (25% of Net Earned Premium)	-£188m
Underwriting Results	**-£38m**

Investment Income Corporate Bonds on £1bn Investment Portfolio	**+45m**

Total Profit	**+£8m**

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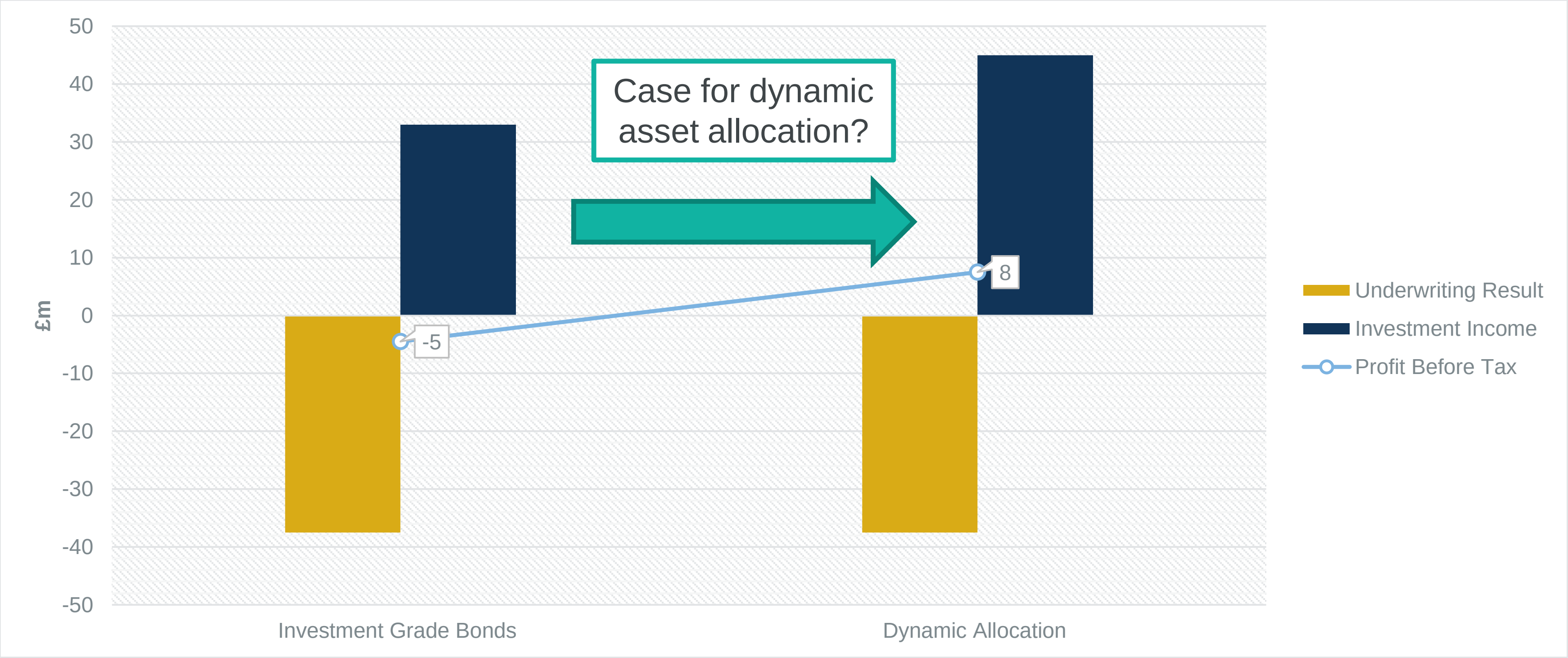
SCR expressed as a percentage of total investment portfolio. Total SCR reflects total diversified SCR calculated under standard formula, assuming approximate industry average standalone SCRs for underwriting, default and operational risks.

Allowing for dynamic allocation can improve profits



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Developing a holistic approach to asset allocation

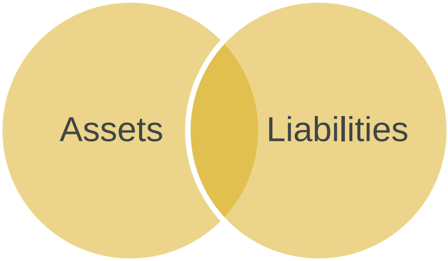
What does a holistic approach mean?

Economic risks within investment portfolios?

Reserve risk, underwriting risk, economic risk?

Traditional framework

What risks impact assets and liabilities and how are they really correlated?



For example, what economic risks can impact both sides of an insurers balance sheet?

How does this relationship change over time?

Holistic approach

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Correlations between assets and liabilities

1. **Solvency II suggests market and underwriting are positively correlated**

	Market	Default	Life	Health	Non-Life
Market	100%				
Default	25%	100%			
Life	25%	25%	100%		
Health	25%	25%	25%	100%	
Non-Life	25%	50%	0%	0%	100%

*EU Commission Level 2 - Delegated Acts

2. But to paint a different picture…

**	Motor Underwriting	Property Underwriting	FTSE 100 Returns	Corporate Bonds Returns	Property Returns
Motor Underwriting	100%				
Property Underwriting	12%	100%			
FTSE 100 Returns	-32%	10%	100%		
Corporate Bonds Returns	-48%	-3%	72%	100%	
Property Returns	-4%	20%	49%	19%	100%

**Historic correlation from 2007 – 2016 for ABI statistics vs Bloomberg asset returns

Some assets classes can exhibit negative correlation to underwriting risks, but this relationship will change over time

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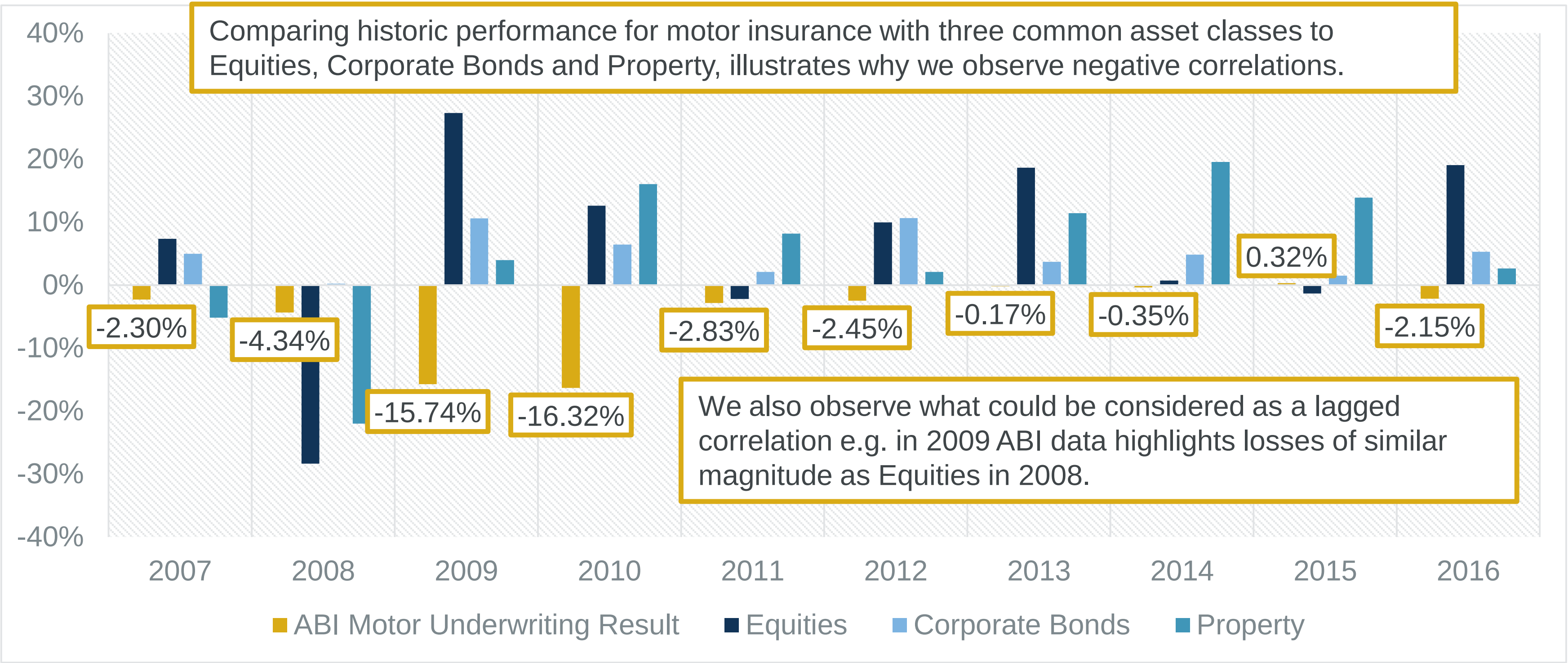
Source: ABI General Insurance Overview Statistics and Bloomberg

Historic asset class and underwriting performance



Source: ABI Data and Bloomberg – Equities = FTSE 100 Total Return; Corporate Bonds = ML Corporate Bonds Index; and Property = CBRE UK All Property for the period 2007 to 2016.

Power of diversification

- Diversification benefit between asset and underwriting performance can be greater than diversification with investment portfolios.

Standalone Volatilities			Diversified Volatility	Diversification Benefit
		Equities		
Motor UW	6.2%	+ 15.5%	= 7.3%	3.6%
Corporate Bonds	3.5%	+ 15.5%	= 9.5%	0.4%
Property	12.1%	+ 15.5%	= 12.0%	1.8%

Should insurers consider underwriting as an asset class?

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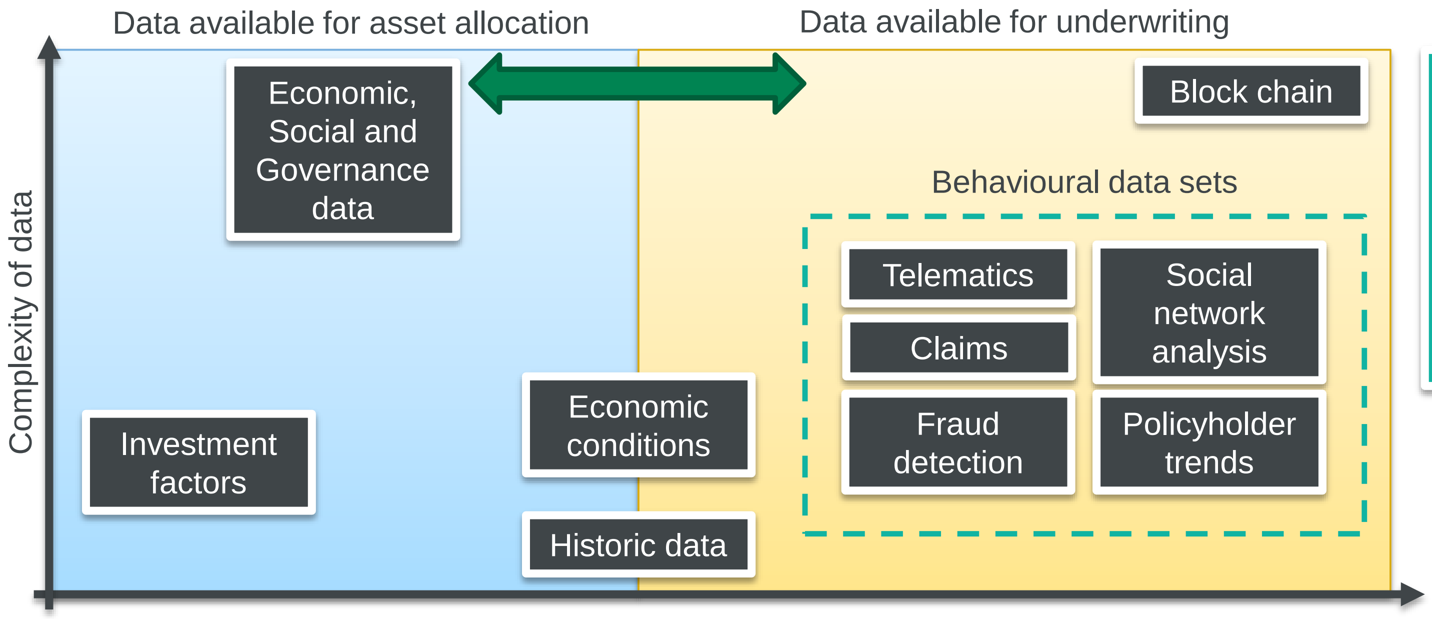
Source: Bloomberg - Merrill Lynch Corporate Bonds Index, CBRE UK All Property and FTSE 100 Total Returns for Jan 2007 to December 2016.

Harnessing underwriting data for asset allocation

- How can insurers link their big data to their investment allocation?



Underwriting should be another asset class insurers compare to investment assets

Conclusions

- Underwriting personal lines continues to be challenging, as such, insurers should prioritise investment income to aid profitability.
- Asset allocation should consider the broader relationship between asset classes and underwriting returns, in turn allowing for non-traditional asset classes to be considered.
- Insurers should develop a holistic process for evaluating their investment allocation decisions taking into account relevant metrics, such as returns, capital and risk.
- There is always scope for making investment portfolios work harder for insurers, particularly if a dynamic approach to portfolio allocation is used.

Questions

Comments

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