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Insurers as long term lenders

Gareth Mee & Eugene Dimitriou (on behalf of the non-traditional assets working party)

2 June 2014

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Introduction to the opportunity

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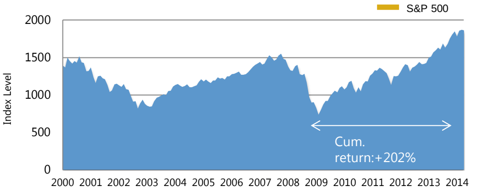
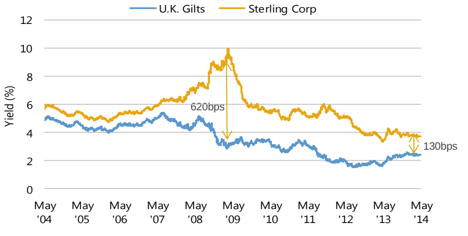
Economic backdrop- are the markets overheating?

- The stock market has delivered strong returns …





- Meanwhile, spreads in fixed income markets grind in tighter and tighter

As of May 2014 SOURCE: Bloomberg, BofA Merrill Lynch (BofA Merrill Lynch Sterling Corporate Index and BofA Merrill Lynch UK Gilt Index)

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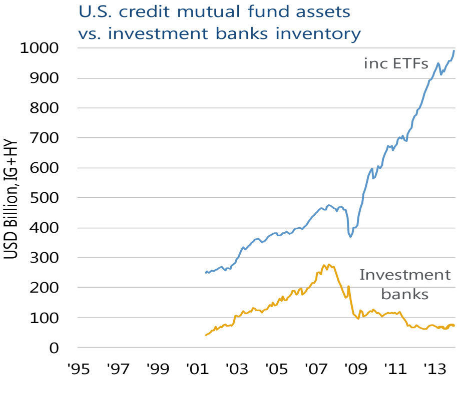
The Changing Complexion of Fixed Income Investing



- **Challenges for Insurers as Investors:**
  - Need to invest as a function of liabilities
  - Wide number of Constraints (regulatory, rating agency, tax, etc)
  - Perceived inability to act quickly
- **Advantages of Insurers as Investors**
  - Size of balance sheets
  - Ability to divorce funding from risk taking activities
  - Low liquidity requirements/ability to be patient

Does this create opportunities for more nimble investors like insurers?

As of 28 February 2014. SOURCE: Haver, PIMCO.

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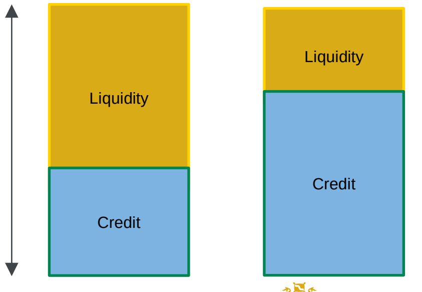
Illiquidity in the market

In a sustained low interest rate environment illiquid assets are becoming more and more appealing investments, providing insurers with predictable and stable cash flows over the long term.

- For example, annuity business cannot be commuted and requires a matched asset portfolio that can be held to maturity.
- Other institutional investors with long term liabilities, e.g., with profits providers, general insurers with long tailed business, and pension funds, will similarly require a long term investment horizon.
- To date institutional investment in illiquid assets has been quite limited. Insurers have traditionally tended to be holders of liquid assets (gilts, cash and highly rated corporate bonds).
- However, the highly collateralised nature of certain illiquid assets compared with the liquid equivalent implies a lower credit risk and therefore a favourable capital treatment.
- In summary illiquid assets may provide insurers with a higher risk adjusted return on the assets used to back long term liabilities.



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Key 2014 trends in European insurance investment management

- The trend to diversify away from euro government bonds and to go global remains intact
  - More global credit, including U.S. credit
  - More emerging market debt
  - Peripheral credits such as Spain and Italy are increasingly acceptable
  - Renewed interest in financials as a source of reasonable yield and liquidity
- Secular interest in income generating high quality substitutes for bonds:
  - Asset classes with attractive yields / low default risk
  - Secured lending, e.g. commercial real estate, aircraft leasing
  - Infrastructure debt
- Some appetite for private equity and hedge funds as alternatives to equities
- Ongoing evidence of hedging the tail risk in rates (both rates up and down), equities and credit
- Some loosening of portfolio management constraints (e.g. increased manager discretion)
- Increasing buy and hold orientation, prompted in part by regulation e.g. Solvency II

The dominant current trend is the search for yield

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The scale of the illiquid asset opportunity

British insurers commit £25bn to UK infrastructure

Friends Life… announces a new £500m mandate … to the commercial mortgage business of Pramerica Investment Management Ltd

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

L&G plans to begin lending to larger SMEs

Insurer Aviva has completed the purchase of around 7,000 solar photovoltaic systems, totalling around 23MW

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Working party

- Working party formed in October 2013 to:
  – educate insurers on the types of alternative assets and their characteristics and risks
  – work with regulators / other professional bodies on behalf of the profession
- Research so far focused on
  – Development of research material on five subgroups of alternative assets, with a focus on fixed income
  – Development of research material on potential constraints and issues for insurers investing in alternative assets

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Working party members

Gareth Mee (chair)	EY		Grisha Spivak (vice chair)	Blackrock
Justin Grainger	Alpha Real Capital		Ross Evans	Hymans Robertson
Ed Conway	Goldman Sachs		Eugene Dimitriou	Pimco
Irina Kendix	Aviva		Niall Clifford	Mercer
Russell Ward	Milliman		Thomas Gormley	Assured Guaranty
Jelena Strelets	Nomura		Eamon Comerford	Milliman
Nick Sinclair	Standard Life		Gareth Jones	MGM
Brian McCormack	Aviva		Keli Zhang	Towers Watson
Lucian Rautu	BNP Paribas			

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Asset classes considered

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Types of investment opportunities

Type of inves-tment	Examples	Pricing Trans-parency	CF certainty	Ability to source	Ongoing mgment
Infra-structure	Social infrastructure, economic infrastructure, energy (including renewables)	Low	High	Medium	Complex
Real estate backed	Residential & commercial lending, social housing, student accommodation, equity release, ground rent	Low	Medium	Medium – difficult	Complex
Other asset backed	Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing	Medium - High	Medium	Easy	Simple
Other un-secured	Private placements, SME lending, high yield, overseas (including emerging market) debt	High	High	Easy	Simple
Other	Private equity, hedge funds, insurance linked securities	Low	Low	Easy - Medium	Medium

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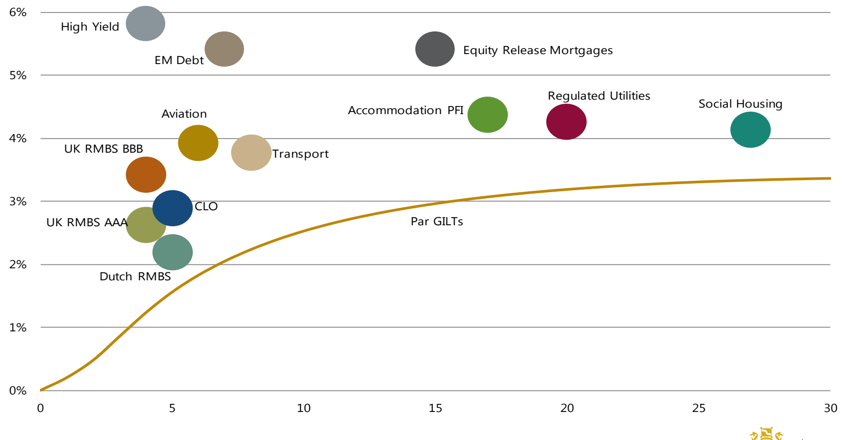
That’s all very well- what are the returns?



As of 31 March 2014. SOURCE: Institute of Actuaries Non-Traditional Working Party, PIMCO
Refer to Appendix for additional investment strategy, issuer and risk information

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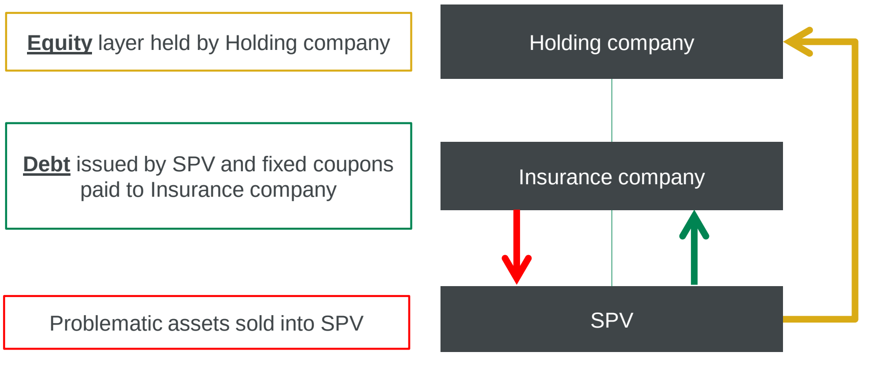
Challenges and constraints to investment

Challenges – cashflow certainty

Given the matching adjustment, can I create certain cashflows from my illiquid assets? Do I need to create a new structure?



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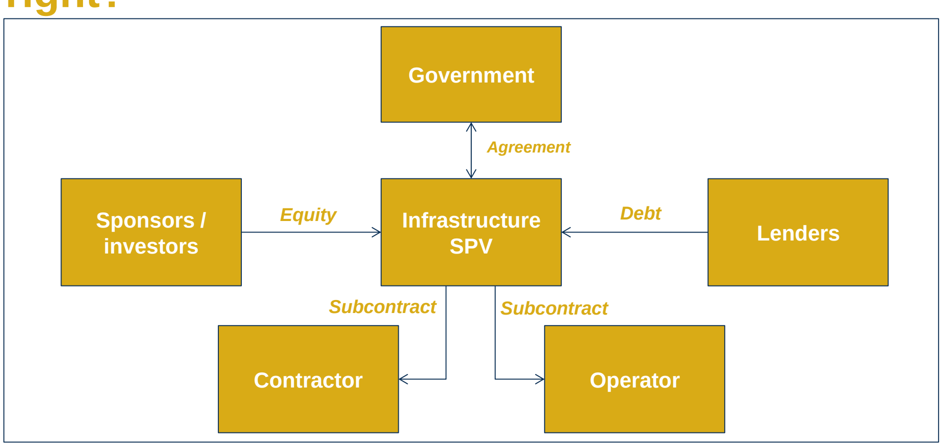
Challenges – securitisations

What is a securitisation?
Tranching of credit risk, with different tranches having different probabilities of default (and also likely different losses given default)

The securitization capital requirements for European insurers under the proposed Solvency II rules are also more than 10 times higher in some cases than those for global banks under the most recently-proposed revisions to the Basel securitization framework.

S&P credit analyst, March 2014

Infrastructure investment – sounds simple, right?



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Future trends

Five bold predictions regarding insurers future investment activity - discussion

- Securitizations will make a comeback and European insurers will participate
- Infrastructure debt will remain a niche area
- Insurers will grow to appreciate asset liquidity
- Emerging markets have emerged and will continue to increase as a proportion of insurance company assets.
- Insurers will begin to use macro tail risk hedging as a risk and capital management tool

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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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