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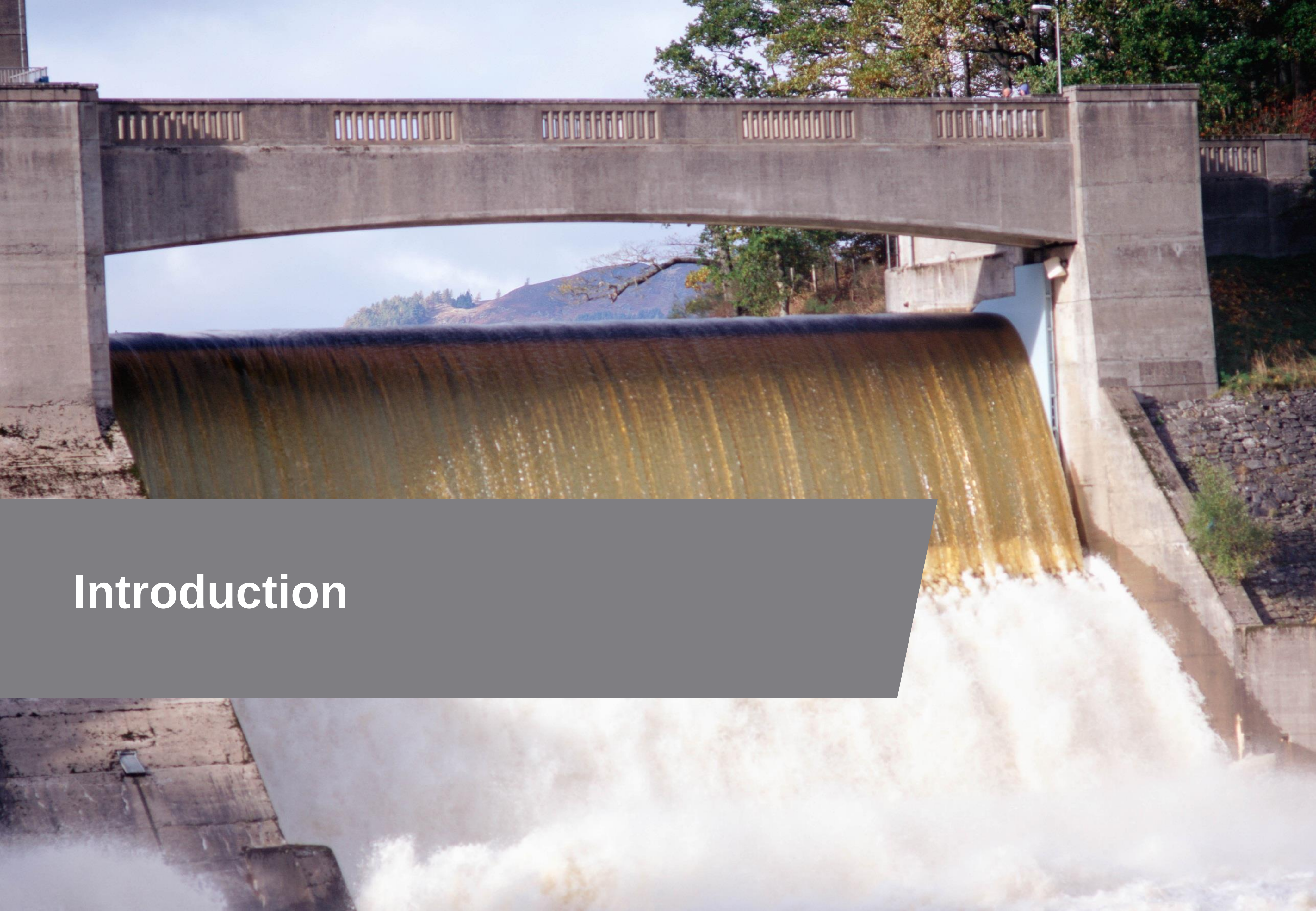
# Non-traditional investments - key considerations for insurers

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

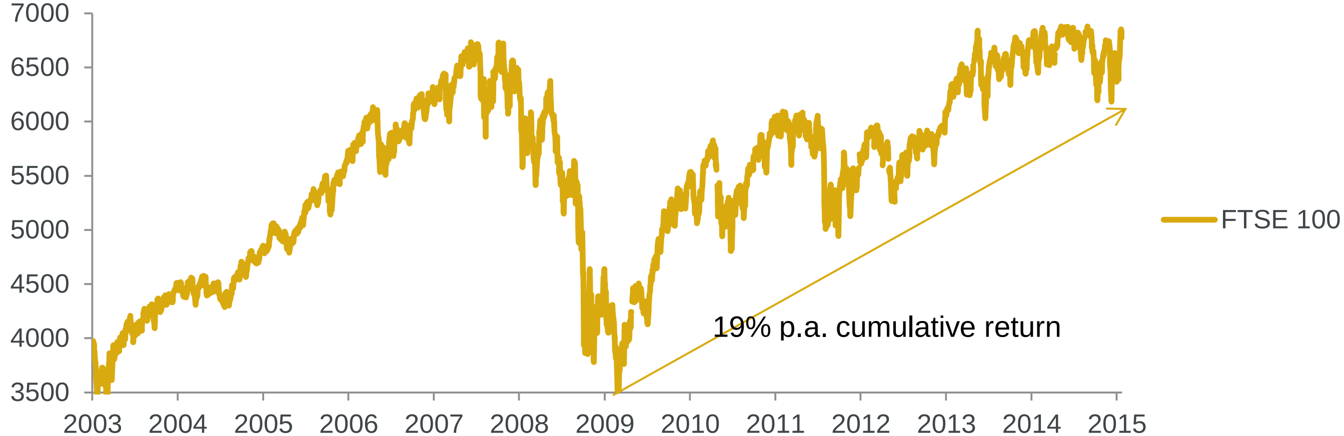
Highlights of Life Conference – March 2015

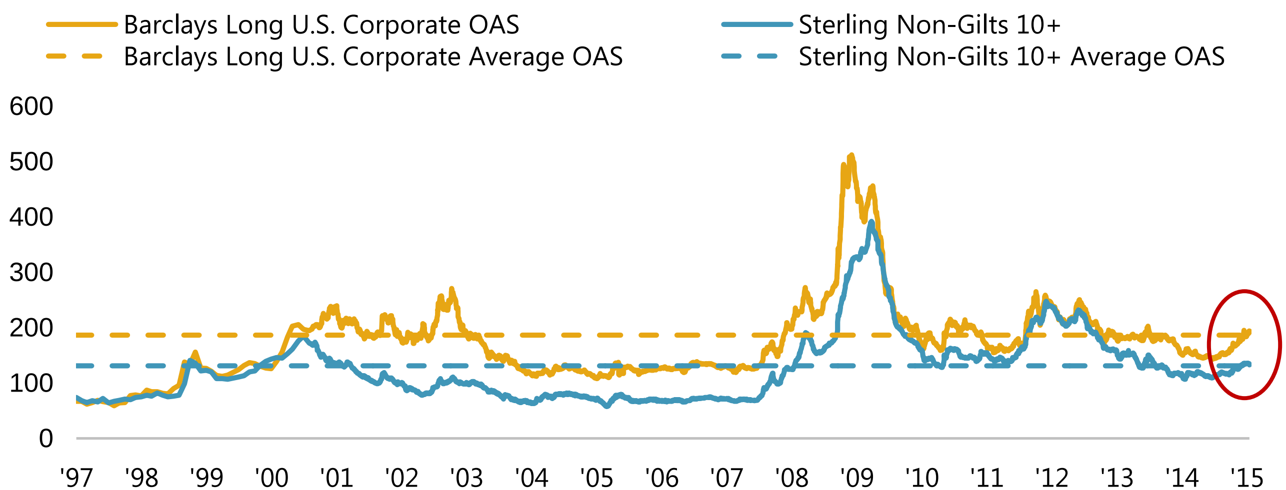


# Introduction

# Economic Backdrop - are Markets Overheating?

- The stock market has delivered strong returns …

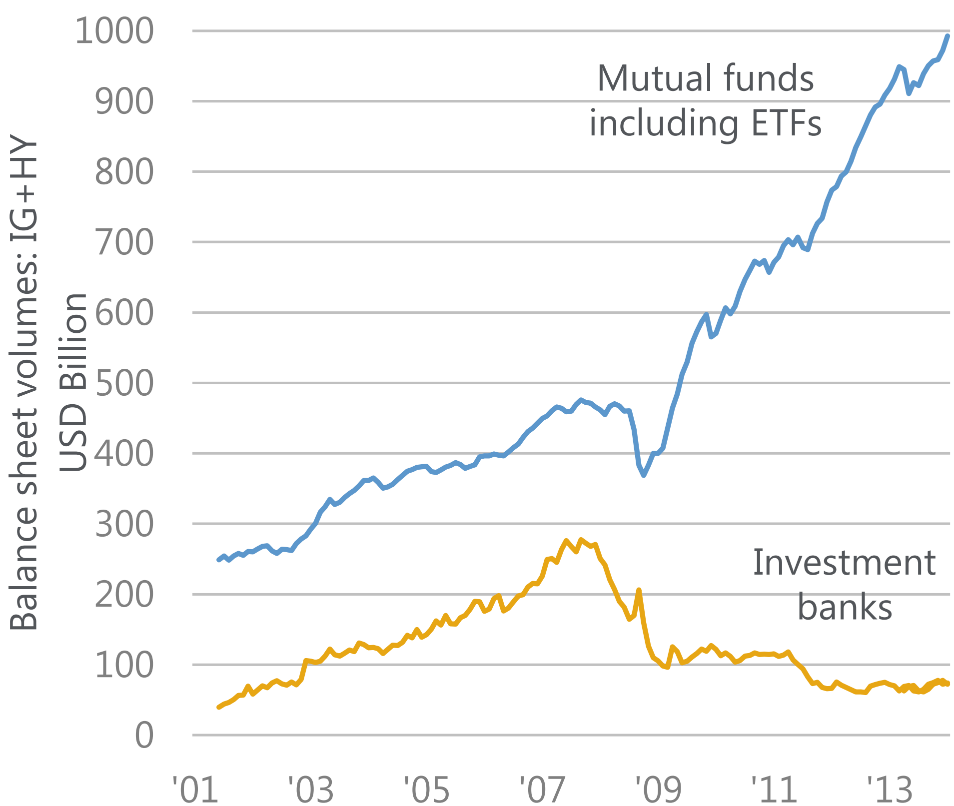



- Meanwhile, spreads in fixed income markets grind in tighter and tighter

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

# 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 investment opportunities for insurers?

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

# Key 2015 trends in European insurance investment management

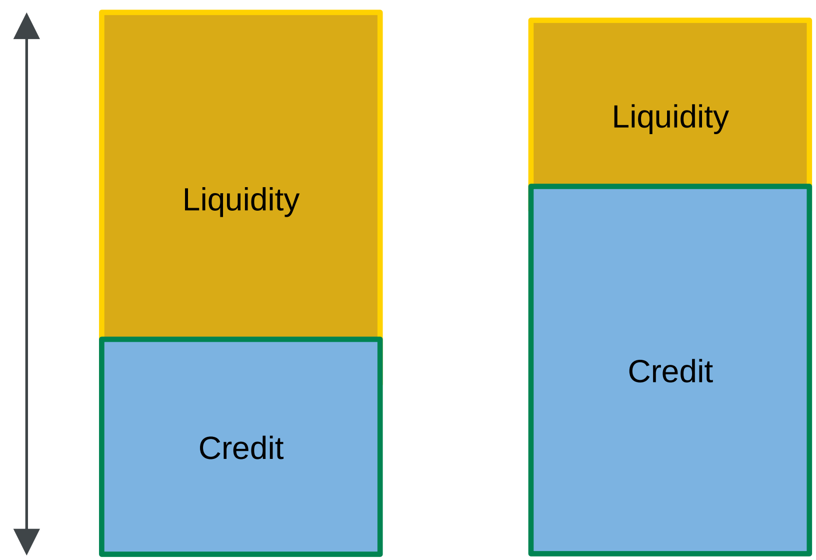
- The trend to diversify away from Euro and Sterling government bonds and to go global remains intact
  - More global credit, including U.S. credit
  - More emerging market debt
  - Peripheral credits with the exception of Greece are acceptable
  - Renewed interest in financials as a source of reasonable 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
- Increasing buy and hold orientation, prompted in part by regulation e.g. Solvency II
- Acute ALM problems for continental life insurers vis-a-vis low rates

**The dominant current trend is the search for yield**

# 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.



# The scale of the illiquid asset opportunity (pre-budget…)

British insurers commit £25bn to UK infrastructure

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

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

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

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# But are they diving in too fast?

- *"We are also alert to the possibility that financial markets may be mispricing risk. As the FSB concluded last week, "there are increased signs of complacency in financial markets, in part reflecting search for yield amidst exceptionally accommodative monetary policies…*
- *…An understandable response would be to move towards less traditional types of investments – such as infrastructure…*
- *…All these strategies bring new risks that must be well understood and prudently managed…*
- *…As supervisor, the Bank of England is monitoring closely how these new risks are being managed and how your business models are evolving."*

*[Source – "Putting the right ideas into practice" – Mark Carney, Governor of the Bank of England]*

# Working party

- Working party formed in late 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
  - Staple Inn presentation on 19th January and related paper (http://www.actuaries.org.uk/events/one-day/sessional-research-event-benefits-and-challenges-insurers-considering-non-traditional )

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# The working party

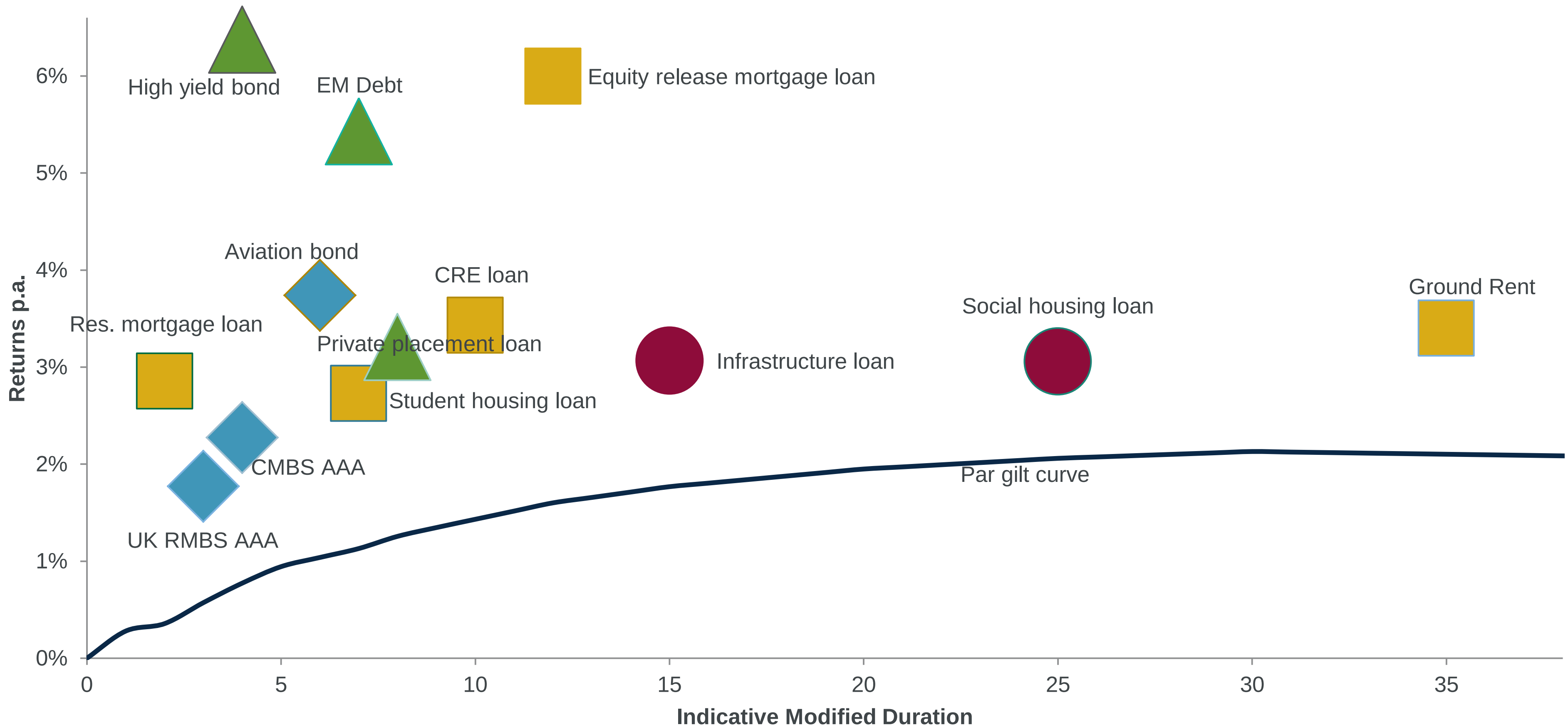
| | | | |
|---|---|---|---|
| Niall Clifford | Mercer | Irina Kendix | Aviva Plc |
| Eamon Comerford | Milliman | Brian McCormack | Aviva UK Life |
| Edward Conway | Bank of America Merrill Lynch | Gareth Mee (chair)* | EY |
| Eugene Dimitriou | PIMCO | Stephen Metcalfe | Prudential Plc |
| Ross Evans | Hymans Robertson | Lucian Rautu | Independent consultant |
| Thomas Gormley | Assured Guaranty | Nick Sinclair | Standard Life Plc |
| Justin Grainger | Alpha Real Capital | Grisha Spivak (vice chair) | BlackRock |
| Eliza Gu | Rogge Global Partners | Jelena Strelets | Nomura International Plc |
| Andrew Hammacott | Independent consultant | Russell Ward | Milliman |
| Belinda Hue | Independent consultant | Keli Zhang | Towers Watson |
| Gareth Jones | MGM Advantage | | |

# Asset classes considered

# What might be considered alternative?

| Type of investment | Examples | Key features |
|---|---|---|
| Infrastructure | Social infrastructure, economic infrastructure, energy (including renewables) | Loan to a project; no security; highly illiquid |
| Real estate backed | Residential & commercial lending, social housing, student accommodation, equity release, ground rent | Formally secured on a property; highly illiquid |
| Other asset backed | Asset backed securities, collateralised loan obligations, aircraft financing, shipping financing | Formally secured on real assets; often highly structured |
| Other unsecured | Private placements, SME lending, high yield, overseas (including emerging market) debt | Unsecured; most closely related to corporate bonds |
| Other | Private equity, hedge funds, insurance linked securities | Various risk / return profiles |

# Potentially interesting asset classes - returns




As of 31 March 2014, with updates to January 2015. 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

# Challenge 1 – how do I get hold of one?

- Unlike corporate bonds or equities, an insurer generally can't buy non-traditional assets easily. It could buy one through:
  - Pooled fund
  - Segregated mandate
  - Syndicated loan or through a "club"
  - Securitisation
- Or it could lend money directly in the "origination" market or through the secondary market
- If I find one, can I price it?
- And perform a credit assessment?

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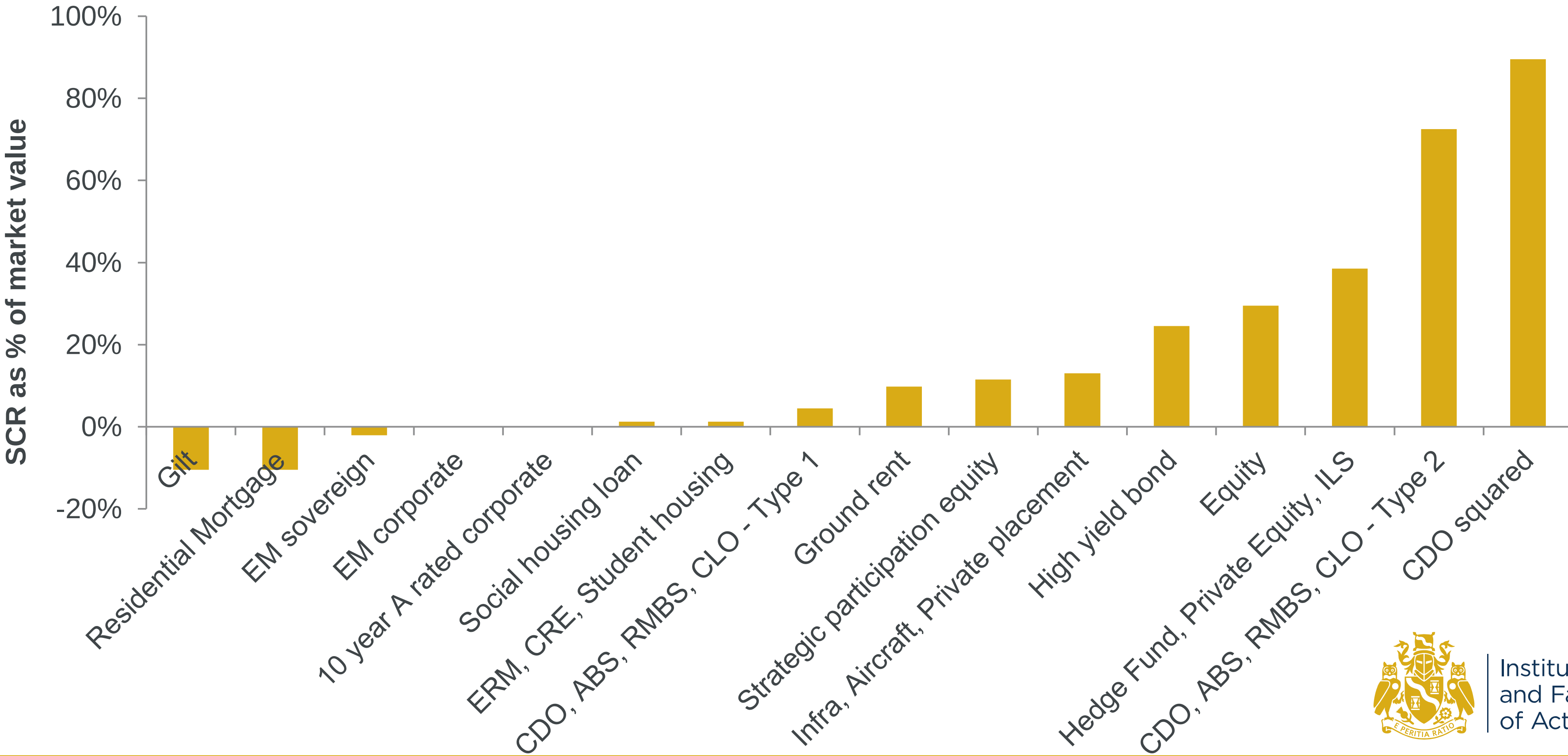
# Challenge 2 – is it going to cost me lots of capital?

This graph shows the relative capital charges for a range of assets against an A rated corporate bond (all assets have 10 year duration aside from securitisations which have 5 year duration).

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# Challenge 3 – what if the assets are not in sterling?

| | Pros | Cons |
|---|---|---|
| No hedge | • No obvious pros | • No risk mitigation; currency charge is expensive |
| Cross currency hedge | • Risk mitigating and provides certainty on cashflows<br>• Potentially useful under matching adjustment | • Market value volatility through cross currency basis risk<br>• Geared exposure to overseas default risk<br>• Still not simple under matching adjustment<br>• Expensive |
| Rolling forwards | • Mark to market protection<br>• Relatively inexpensive | • Doesn't fix cashflows (so problematic for matching adjustment) |

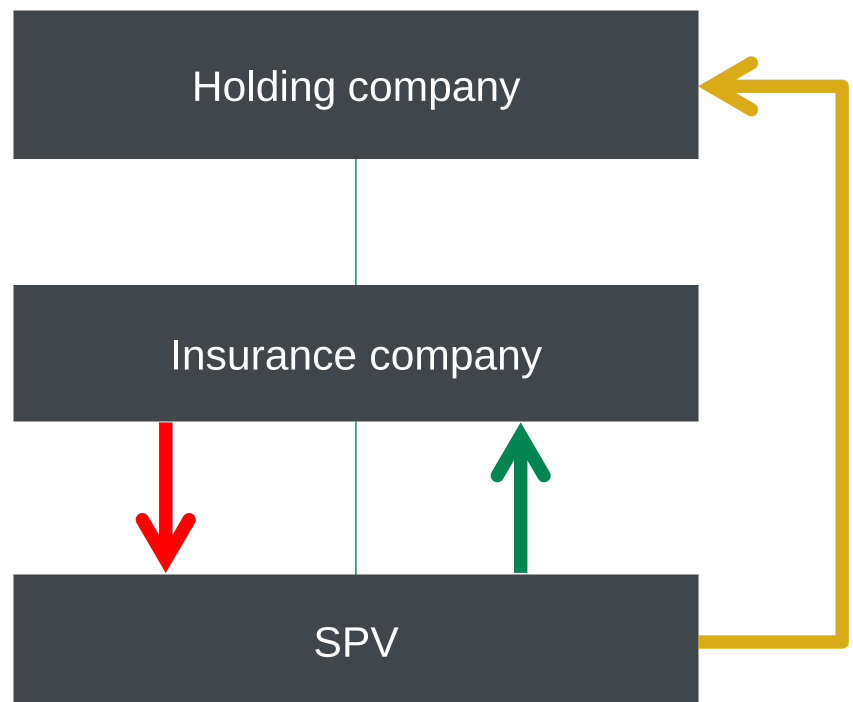
# Challenge 4 – do I need to change the cash flows?

One potential structure for fixing cash flows might be to create a fixed note from the uncertain cashflows.

**Equity** layer held by Holding company

**Debt** issued by SPV and fixed coupons paid to Insurance company

Problematic assets sold into SPV

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# Challenge 5 – how do I manage when things change?

- As the insurer has a relationship with the borrower (potentially through an intermediary), terms can be changed either contractually or on a discretionary basis through:
  - Changes in borrower circumstances
  - Borrower optionality
  - Variations (or changes to loan terms)
- As such, insurers may wish to:
  - Hire expertise in house
  - Utilise investment management (or credit insurance) expertise
  - Outsource all management

# Summary of challenges

| 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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# Final thoughts

# 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

# Final thoughts

- Insurers should continue to evaluate non-traditional opportunities, being aware of the potential benefits as well as the challenges
- Research will continue to be focused in this area- this is of strategic importance to
  - Insurance industry,
  - UK government
  - Our profession
- Thoughts, suggestions and contributions for future research are very welcome

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# Questions

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

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