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The Trend Towards "Non-Traditional" Long-dated Investments by Life Insurers

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

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Introduction to the opportunity

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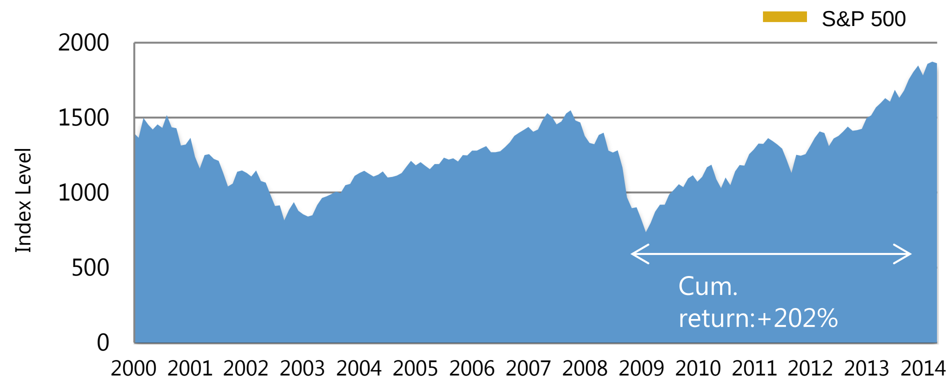
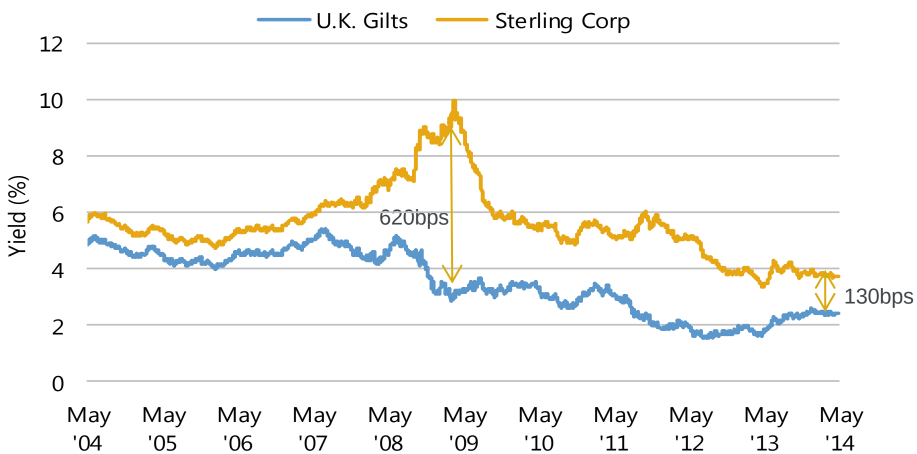
Thought leadership
Progress
Community
Sessional Meetings
Education
Working parties
Volunteering
Research
Shaping the future
Networking
Professional support
Enterprise and risk
Learned society
Opportunity
International profile
Journals
Suppo

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)

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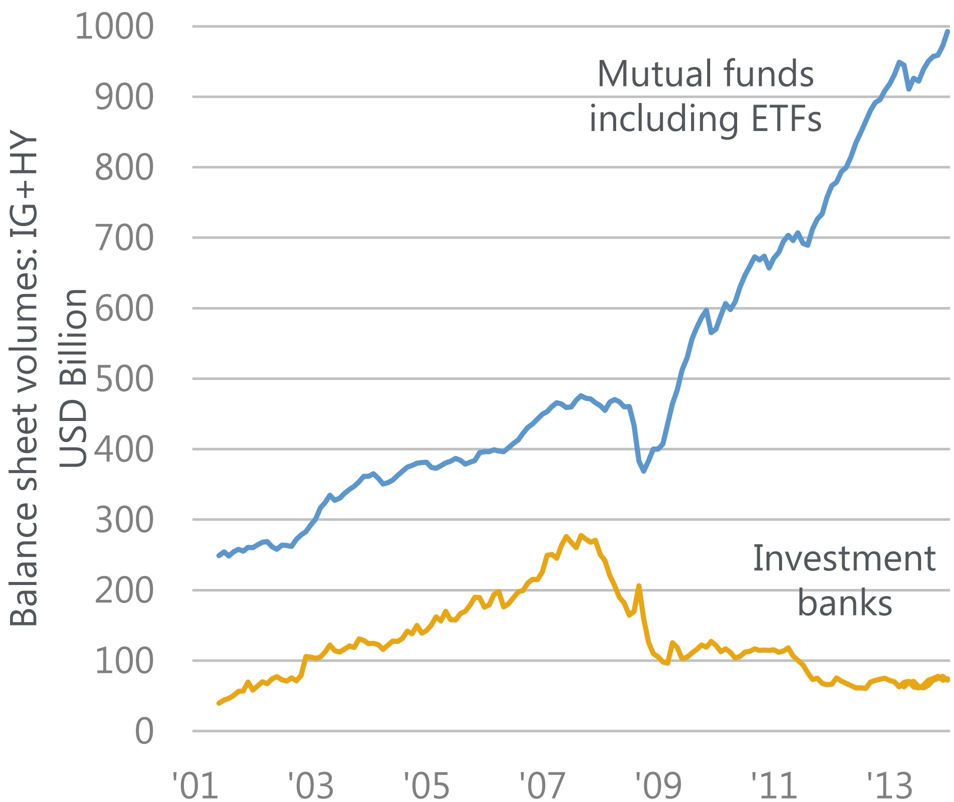
The Changing Complexion of Fixed Income Investing



- **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 investment opportunities for insurers?

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

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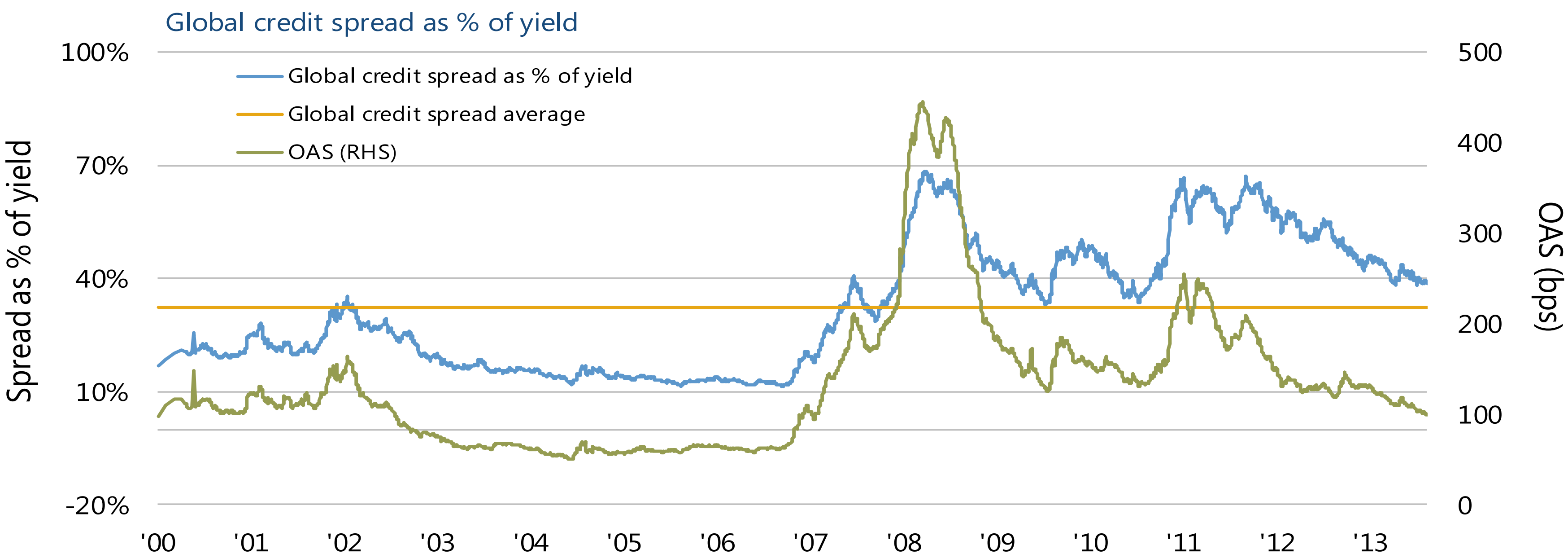
Credit selection becomes more important than ever



Credit spread today represents 40% of overall yield compared to 13% in 2007

As of 12 May 2014
SOURCE: PIMCO

Key 2014 trends in European insurance investment management

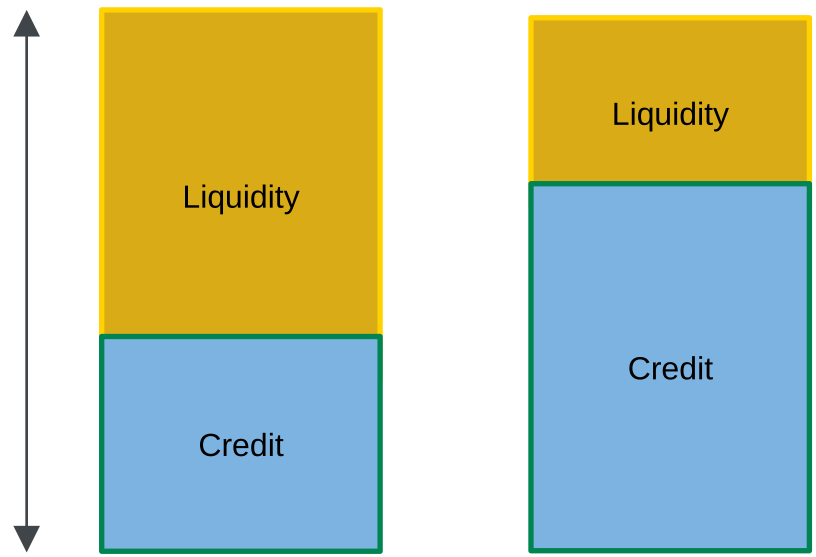
- The trend to diversify away from euro government bonds and to go global remains intact
  - More global credit, including U.S. credit
  - More emerging market debt
  - Peripheral credits such as Spain and Italy are increasingly acceptable
  - Renewed interest in financials as a source of reasonable 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

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

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

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		

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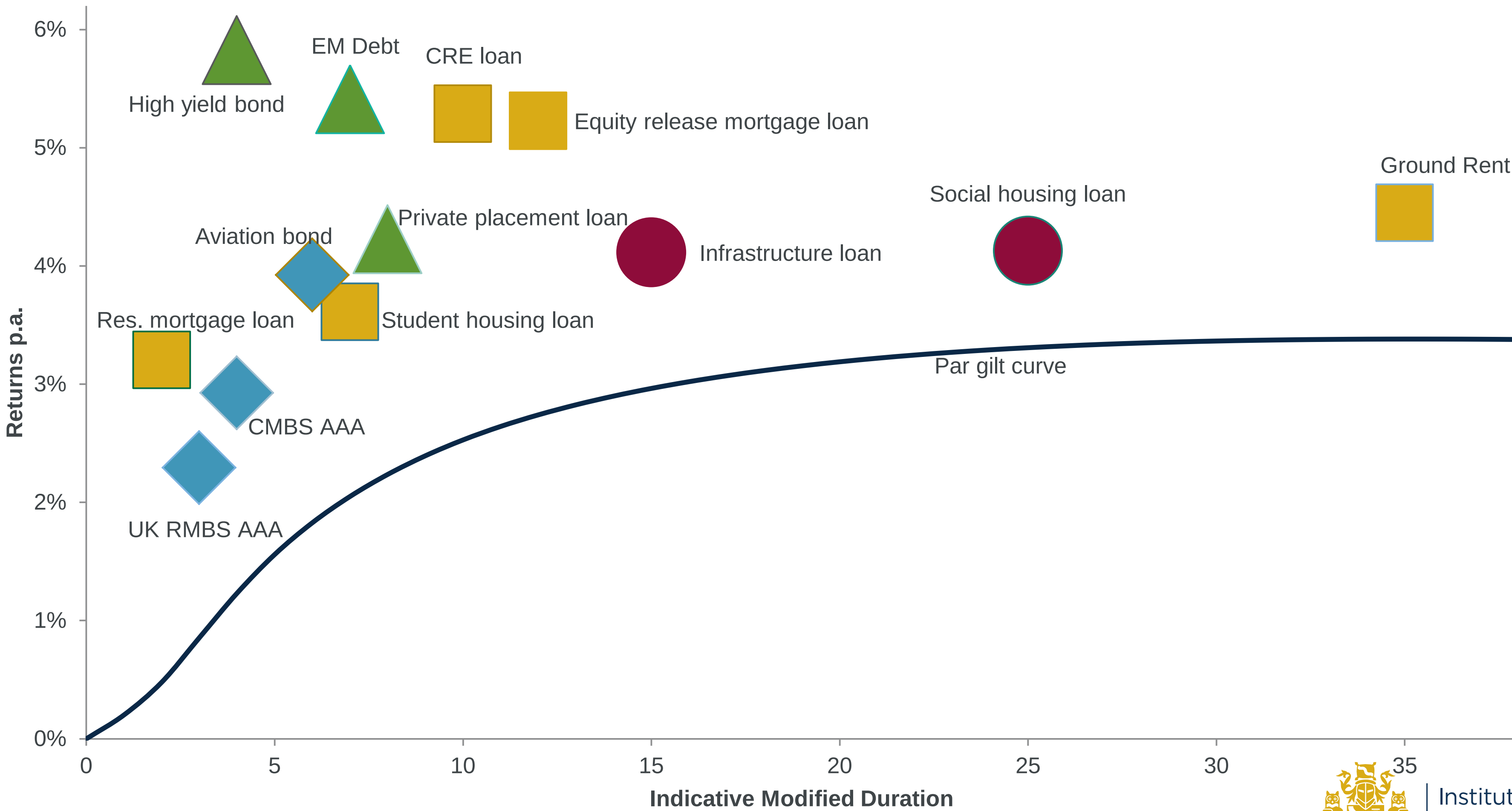
Asset classes considered

Asset classes considered

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

Potentially interesting asset classes - returns



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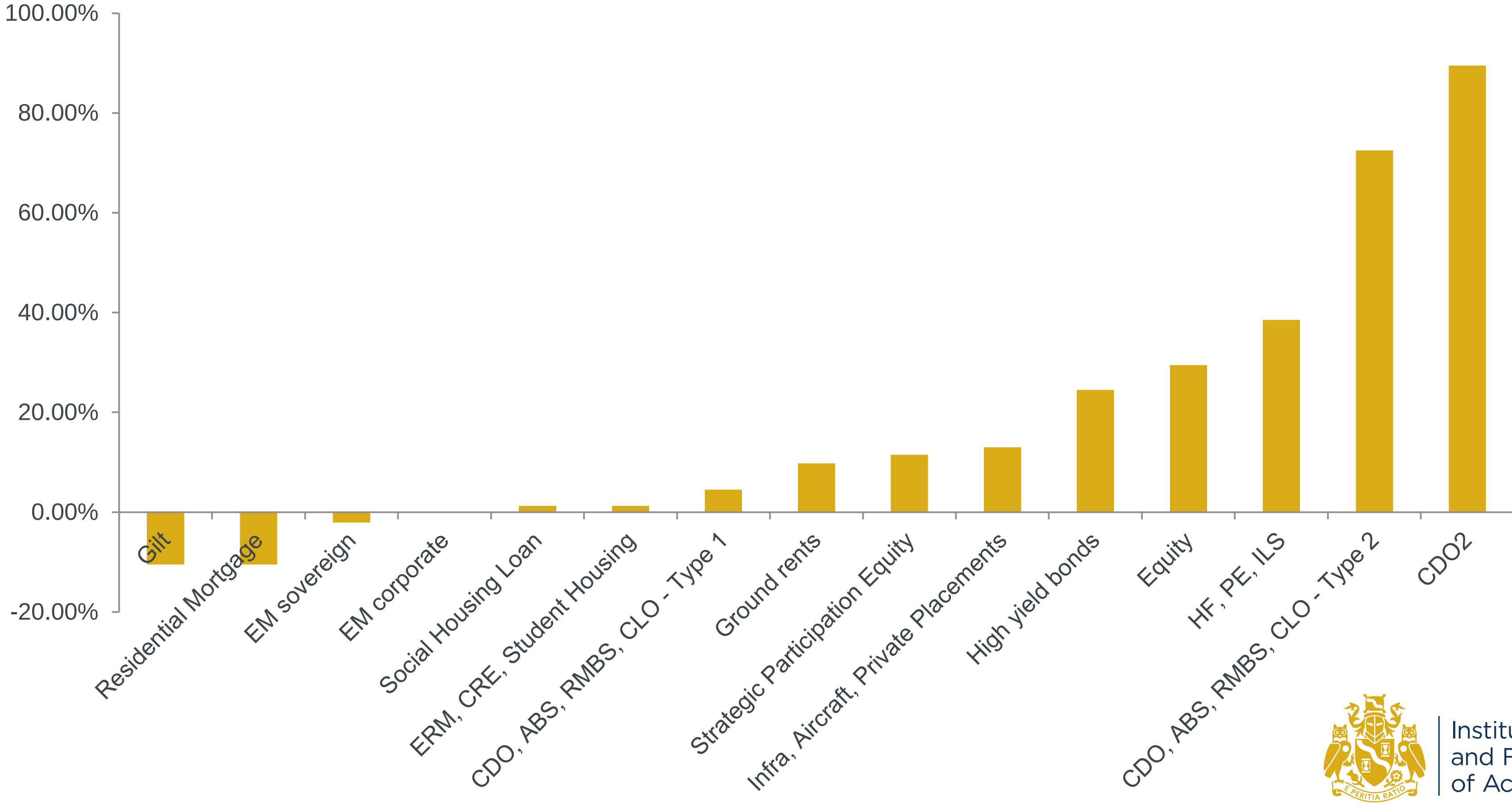
As of 31 March 2014. SOURCE: Institute of Actuaries Non-Traditional Working Party, PIMCO
Refer to Appendix for additional investment strategy, issuer and risk information

Potentially interesting asset classes - 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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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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Challenges and constraints to investment

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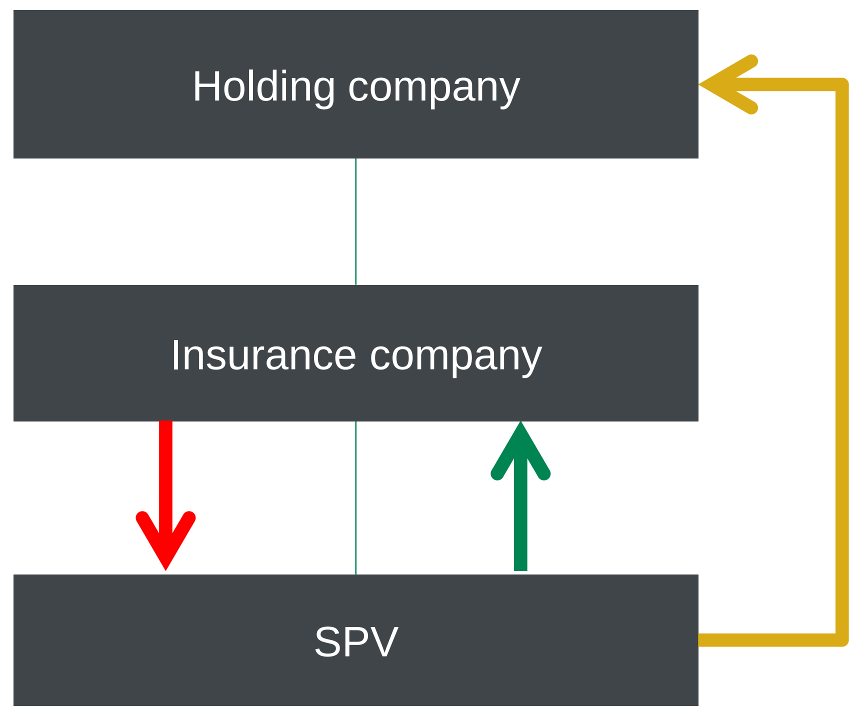
Challenges – cashflow certainty

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

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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Challenges – currency hedging

Will my current currency hedging strategies work under Solvency II?

	Pros	Cons
No hedge	• No obvious pros	• No risk mitigation; currency charge is expensive
Cross currency hedge	• Risk mitigating and provides certainty on cashflows	• Market value volatility through cross currency basis risk • Geared exposure to overseas default risk • Expensive
Rolling forwards	• Mark to market protection • Relatively inexpensive	• Doesn’t fix cashflows (so problematic for MA)

Challenges - operations

- Key considerations?
  - Set criteria for viewings
  - Current condition vs. personal value
  - Due diligence / lawyers
  - Surveyors
  - Exchange and completion
  - Redecoration
  - Future sale
  - Leasehold / Freehold
  - Ongoing maintenance
  - Rates and taxes
  - Managing agents

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Final thoughts

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- Research will continue to be focused in this area- this is of strategic importance to
  - insurance industry,
  - UK government
  - our profession
- Sessional paper published on 19th January with sessional meeting at Staple Inn
- Thoughts, suggestions and contributions for future research are very welcome

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