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Risk and investment management

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Risk and investment management

Pension schemes vs Insurance companies

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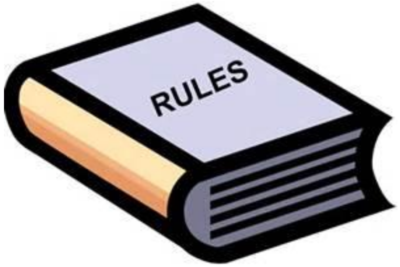
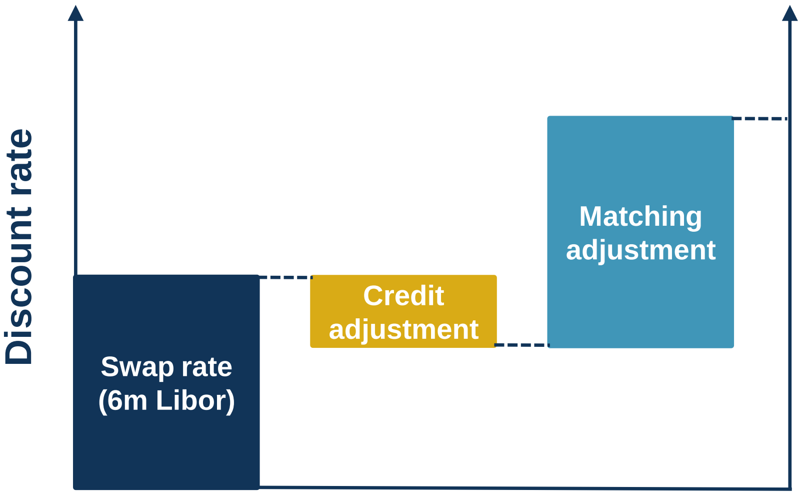
Liability discount rate

Insurance (Solvency II)





- Swap rate = 6 month Libor
- Credit adjustment = 10-35bps
- Matching adjustment = default-adjusted credit spread
- Further adjustments for:
  - Last liquid point (LLP)
  - Ultimate Forward Rate (UFR)

For illustrative purposes only.

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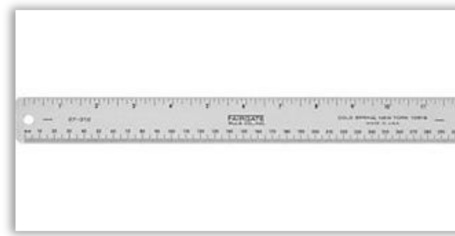
Liability discount rate

Pensions (IORP I, Pensions Act)

- Flexibility to use:
  - government bonds
  - corporate bonds, or
  - expected return on investments
- Secondary measures are usual, e.g. buy-out, solvency, swaps
- Reflect heterogeneity of pension schemes
- EIOPA has announced that it is ending its work on a solvency-based funding regime for pension schemes, although LLD and UFR introduced in other countries



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Risk management

Insurance (Solvency II)

- Solvency II encourages asset-liability matching
- The insurer must stress the main portfolio risks under a 99.5%,1-year stress scenario:
  - interest rate risk
  - inflation risk
  - credit risk
  - longevity risk
- Capital must be held against these residual exposures
- Matching adjustment requires close matching of assets and liabilities

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Risk management

Pensions

- Pension regulation allows for more flexibility
- Strength of covenant important
- Asset-liability modelling
- Pension schemes are encouraged to
  - hedge less rewarded risks (adopt LDI and high hedge ratios)
  - diversify rewarded risks (alpha and beta diversification)
- More freedom
  - encourages long-term behaviour and opportunistic investment
  - more freedom can lead to too much risk

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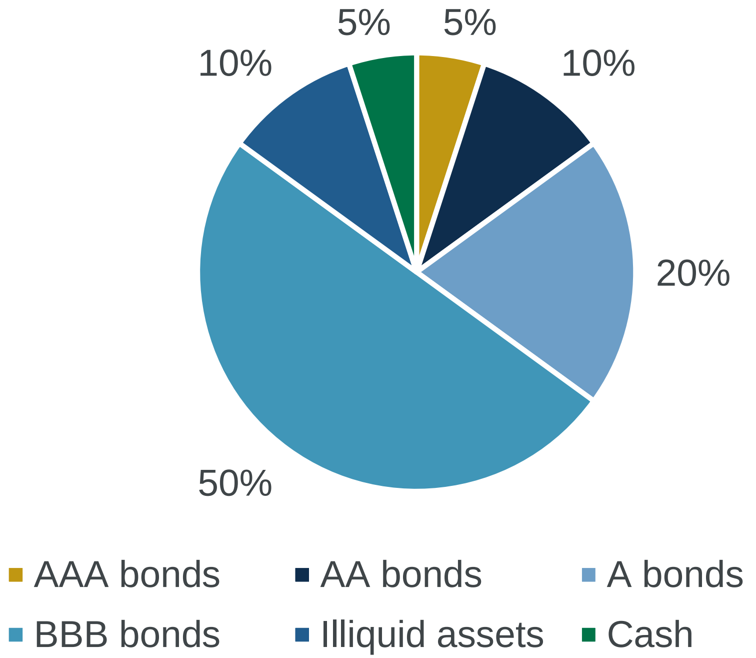
Investment strategy

Insurance (Solvency II)

- The asset portfolio is constructed to closely match liability cash flows
- Maximising risk-adjusted yield is important

Typical asset allocation for annuities



For illustrative purposes only. Typical insurance investment strategy.

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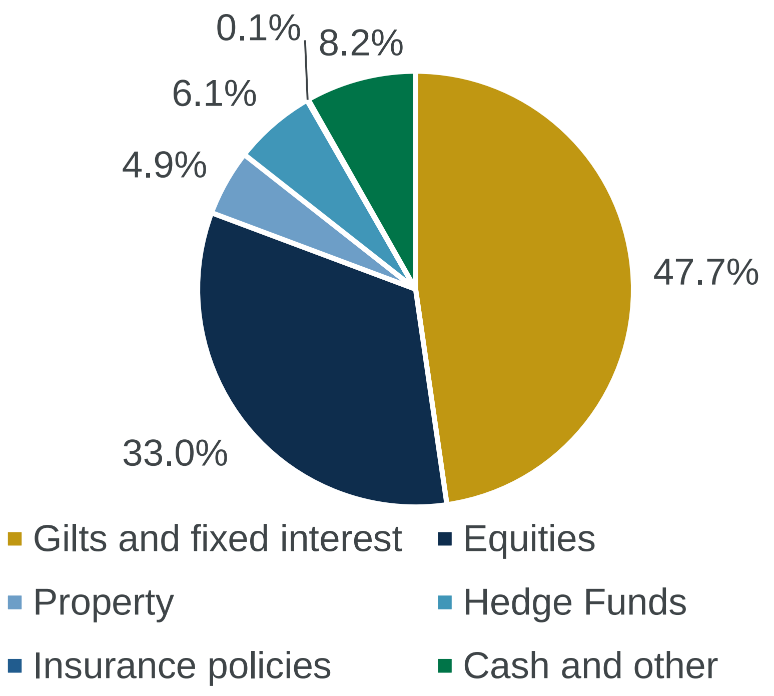
Investment strategy

Pensions (IORP I)

- Pension schemes are primarily concerned with meeting their liabilities when they fall due with an acceptable amount or risk
- Taking into account:
  - future investment returns
  - Sponsor contributions

Average asset allocation



Source: PPF / The Pensions Regulator. Purple Book 2015, page 50, average asset allocation in total assets.

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DB pension schemes of insurers

DB pension schemes of insurers:

- Insurer is required to incorporate the deficit/surplus on its balance sheet (IAS19 basis)
- For calculating the SCR, the insurer will need to stress the assets and liabilities of the schemed
- Internal model firms may need to stress longevity risk
- In the stress scenario, the liability discount rate will be affected due to:
  - changes to the risk-free rate
  - changes to credit spreads (the IAS valuation may be impacted by the spreads of high quality AA-rated corporate bonds)

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Recent developments

AEIP rejects Solvency II regime for occupational pensions

Proposals to apply a Solvency II-type regime to occupational pensions have been firmly rejected by the European Association of Paritarian Institutions (AEIP).

Source: europeanpensions.net

Pension Professionals commend EIOPA's decision not to pursue solvency regime

Critics of the pension industry have praised the European Insurance and Occupational Pensions Authority for deciding not to recommend a EU-wide solvency regime for defined benefit schemes.

Source: The Actuary

Reprieve for pensions as EU regulator shelves solvency work European pension funds are to be spared tighter solvency rules that would have increased their liabilities drastically.

Source: eFinancial News

No EU solvency regime is good news but we should not be complacent

EIOPA's decision not to impose a solvency-based funding regime on pension funds has been welcomed but has it really gone for good asks Stephanie Baxter?

Source: Professional Pensions

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Recent developments

Buyout costs could rise 10% over Solvency II capital reserves

Insurance companies could raise bulk annuity buyout pricing as deferred members will demand higher capital reserves under Solvency II, consultants warn.

Source: Investment & Pensions Europe

Solvency II 'won't blunt appetite for pension de-risking'

Last year was relatively quiet for the bulk-annuity and longevity-hedging markets compared to 2014, but appetite from both pension schemes and insurers picked up towards the year-end reports Willis Towers Watson.

Source: GT News

Driving prices down

Higher credit spreads are creating interesting opportunities for schemes looking to de-risk, says Ben Stone, PricewaterhouseCoopers.

Source: PensionsWorld

Solvency II will not impact de-risking market – Willis Towers Watson

The introduction of Solvency II is not expected to impact the pensions de-risking market in 2016, according to Willis Towers Watson.

Source: PensionsAge

Solvency II to hit buyout affordability – Aon Hewitt

The introduction of Solvency II across Europe is to hit the affordability of buyouts, Aon Hewitt has warned.

Source: PensionsAge

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Summary

- Approaches to risk management
- Regulatory framework
- Impact on investment strategy
- Governance structures

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Conclusions

- Underlying economics are similar
- Regulations have significant impact
- Insurers face significant additional constraints
- Pension scheme could adopt insurance-like approach

- Both insurers and pension schemes need to take carefully controlled risks to manage their liabilities efficiently

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Questions

Comments

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