Alternative Investments – Insurance Company Strategies

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Building a better working world

LLOYDS BANKING GROUP

Institute and Faculty of Actuaries

Agenda

- Introduction – insurance company considerations
- Themes and case studies
  - Annuity funds
  - General insurers
  - Shareholder funds
  - With profit funds

Introduction – insurance company considerations

Insurance company investment strategy overview

- Insurance companies need to consider the nature, term and currency of their liabilities in order to determine an investment strategy
- But they also need to make money…
- This workshop considers investment strategies for
  - Annuity companies
  - With profits companies
  - General insurers
  - Shareholder funds

Insurance company investment strategy overview

Backbook or NB?

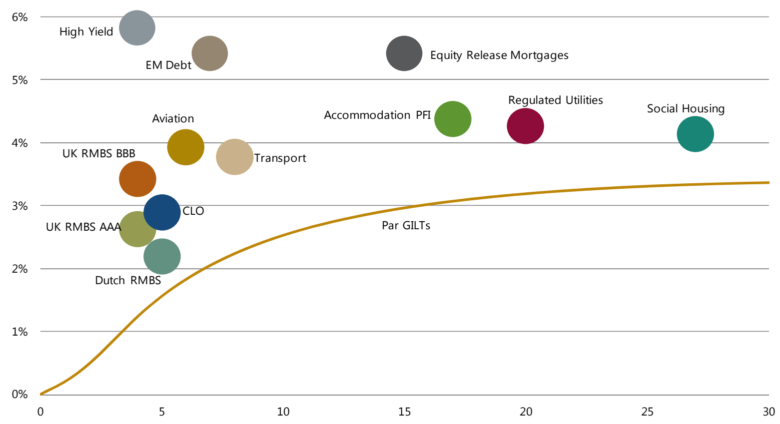
Liabilities	Key considerations
Annuity	• Yield • Low or zero cashflow volatility • (Il)liquidity
With profits	• Low volatility (for guarantees) • Yield
General insurers	• Low (or zero) cashflow volatility • Duration • Yield • Liquidity
Shareholder funds	• Shareholder risk and return metric • Yield

Diversification

Insurance investment trends

- **Focus on yield** – low yields mean that insurers are looking at investing in less liquid, alternative assets such as infrastructure and real estate loans.
- **Low volatility equity investments –** insurers (particularly the large German and UK “participating” insurance companies have investment guarantees to meet whilst the cost of these guarantees are now shown on the insurer’s balance sheet. Insurers need to develop investment strategies to generate real return whilst minimising volatility.
- **Focus on hedging strategies –** only certain hedging strategies will be counted under Solvency II, so insurers need to re-evaluate their hedging programmes. In addition to the “participating” business concerns above, “unit-linked” insurers bring the present value of their annual management charges onto the balance sheet
- **Focus on fees –** the present value of the fee stream paid to an asset manager is now crystallised on the insurer’s balance sheet. Alpha will not be crystallised, so a focus on reduced fees may push insurers towards passive investment.
- **Requirement for transparency and high frequency reporting –** in contrast to the focus on fees, insurers have become the “highest maintenance” investors on the street with requirement for huge quantities of data and more frequent reporting.

CEO's view…
Higher yields and help for the economy



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

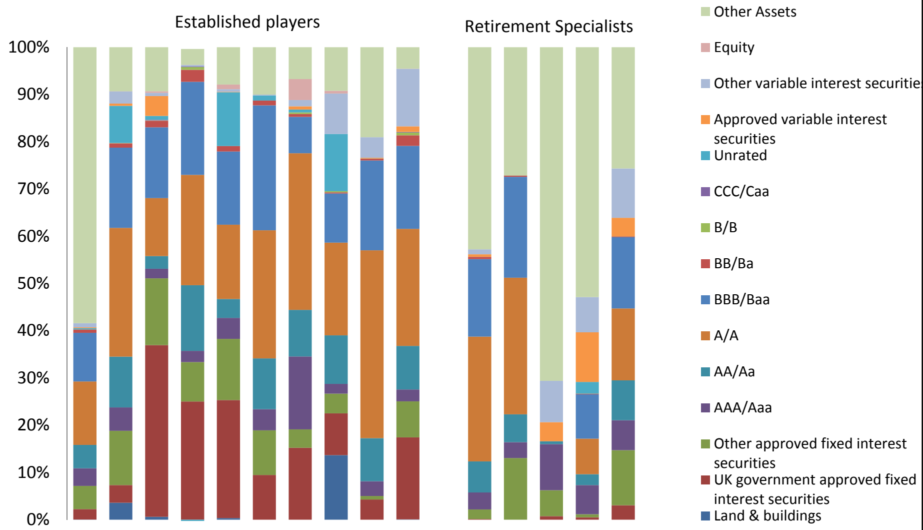
…AFH view
Complexity, credit and conduct risk!

- Pressure to do deals quickly…
- But long lead time
- Internal expertise and experience
- Governance
- Management information
- Credit rating & limit management – particularly when considered at granular levels
- Pricing, valuation and capital models
- Liquidity – management, modelling
- Optionality, hedging and collateral
- Scale – lumpy investments
- And every investment is different – no standard term sheets
- Conduct risk
- Regulatory concern
- And for annuities – Solvency II matching adjustment
- Operational risk
- Not just a project – needs to be operationally robust


Themes and case studies


Annuity companies

Annuity company asset mix



Source: FSA Returns YE 2012 (Form 48, 49)

LBG's stated aims

Pre-Budget!

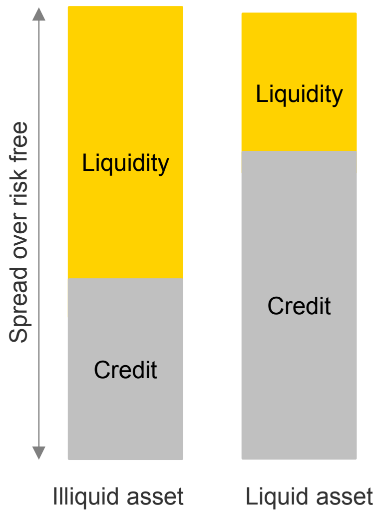
"The Group continues to practise efficient balance sheet management with a focus on investment and liquidity management opportunities. This includes leveraging wider LBG skills and capabilities where it is appropriate to do so. Activity completed in 2013 and future planned activity to invest in higher yielding illiquid assets is expected to continue to deliver significant increased investment return to the Group, without increasing credit risk beyond the Group's risk appetite. During 2013 the Group continued to invest excess liquidity in less liquid credit assets purchased from, or issued by, parties within LBG including £0.6bn of loans secured on real estate and £1.2bn of loans to finance education and infrastructure projects."

"Scottish Widows is to join forces with its parent Lloyds Banking Group to provide billions a year in direct funding to infrastructure projects, including social housing and student accommodation."

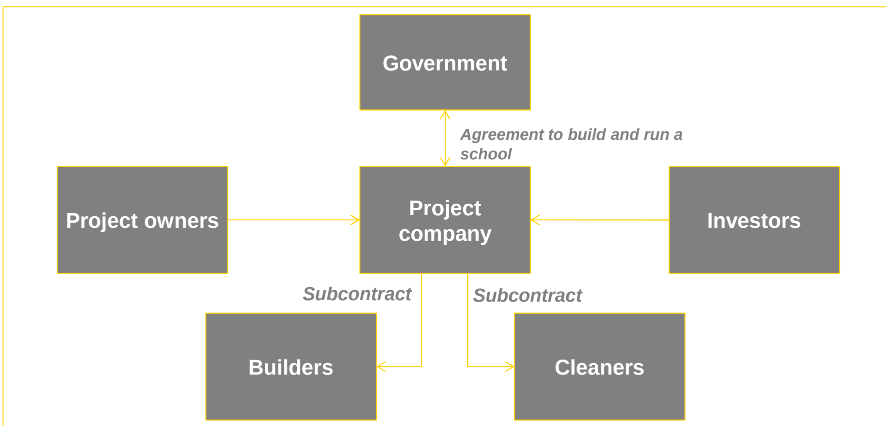
Theme 1 - Illiquidity in the market [The Return…]

- *"Private asset classes are becoming crucial to insurers' diversification strategy.*
- *Three years ago just 6% of insurers had over 15% of their portfolios in private asset classes.*
- *That figure has risen to 26% now, and in three years 46% of insurers will have over 15% of their portfolios invested in private assets.*
- *Real estate (36%) and infrastructure (34%) are particularly popular among those planning to increase their exposure to this asset class."*

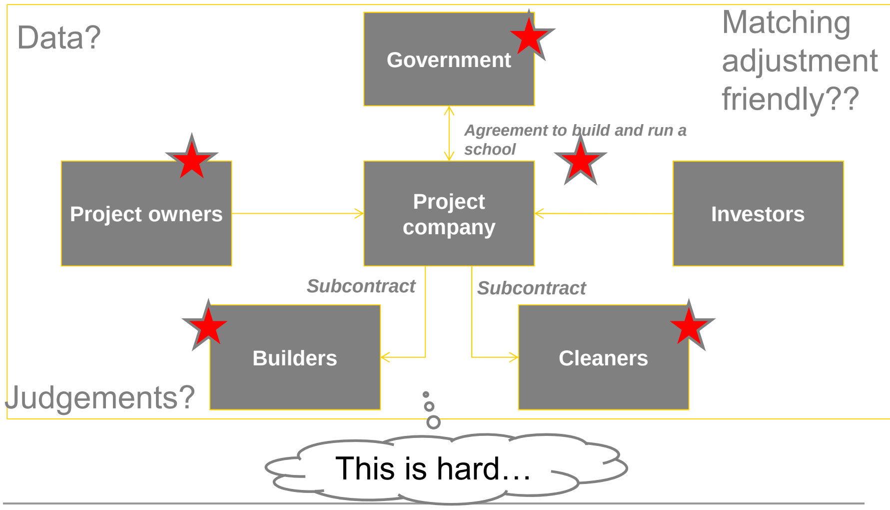
[Source – Blackrock & Economist Intelligence Unit]



Case study 1 – illiquid assets A typical school project



Where might things go wrong…
[The risks…]



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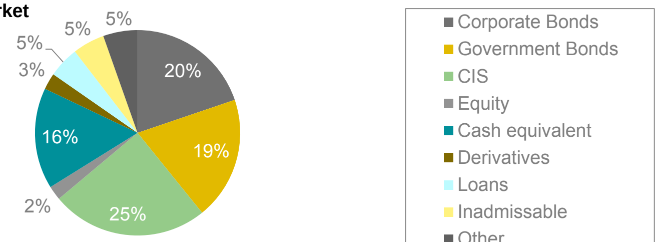
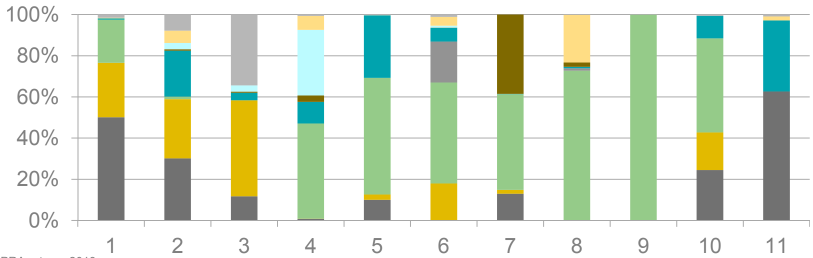
Shareholder fund investments

Weighted 2013 UK market



Individual UK insurer split

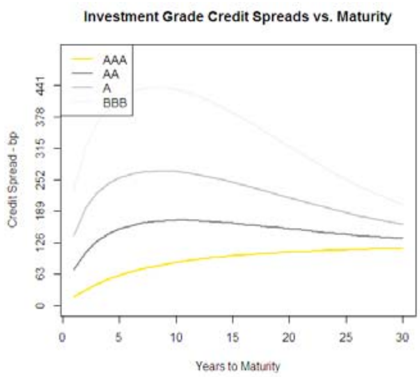


Source: PRA returns 2013

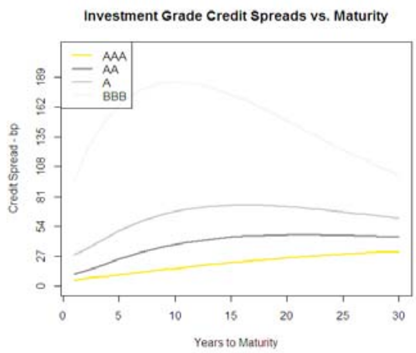
Main approaches to allocating shareholder capital

	Approach	Actual Shareholder asset mix
1	Include all excess assets	Optimise return and ROE through higher yield
2	Include all excess assets with certain group constraints	Similar to 1, but is constrained (usually) by lack of fungibility / governance issues / local regulation.
3	Assume all constrained	Invest in liquid assets

Theme 2 – asset backed securities (but beware…)



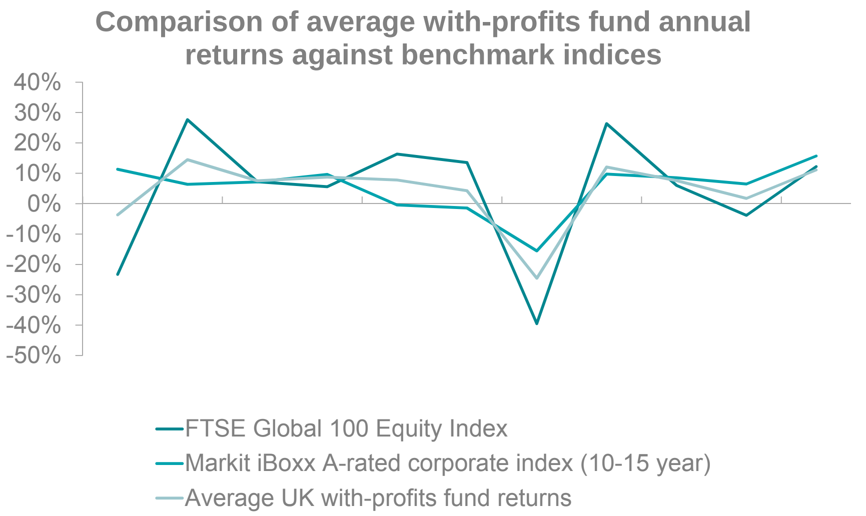
Global (mainly US)
RMBS central tendency
Spread c. 2%



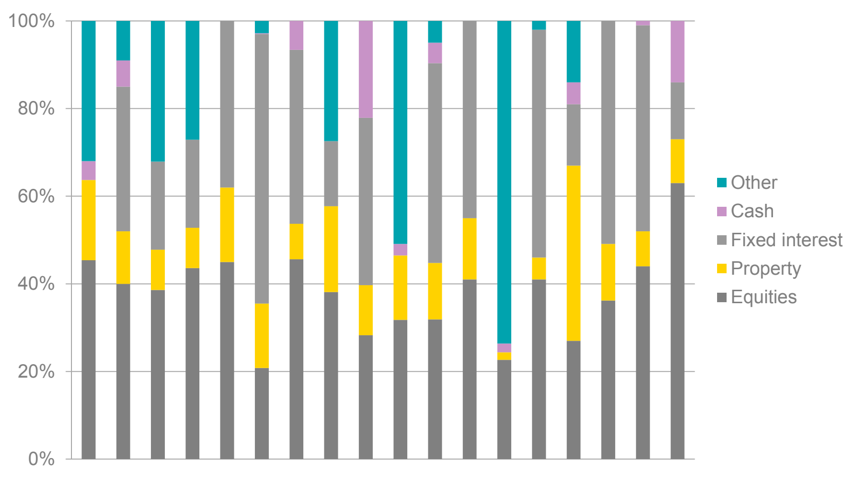
European RMBS central tendency
Spread c. 1.5%

With-Profits funds

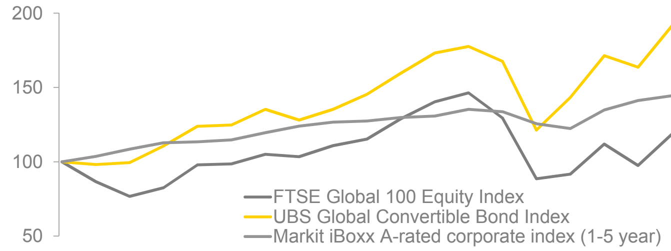
Average with-profits returns



Current asset allocation



Theme 3 – increased yield, reduced volatility



Data source: UBS AG / Thomson Reuters/ Markit iBoxx

- Drivers are not as big – no burning platform
- But there are a range of “smarter” equity like investments e.g.
  - Low volatility equity funds
  - Reweighting indices
  - Cap and collar / other hedging
  - Convertible bonds
  - Property

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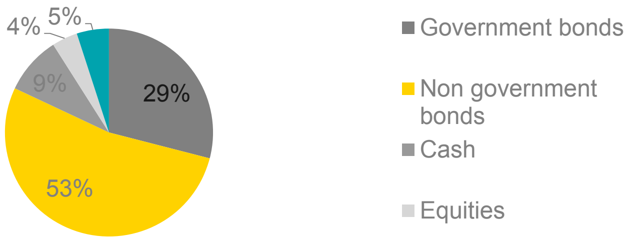
General insurer investment strategies

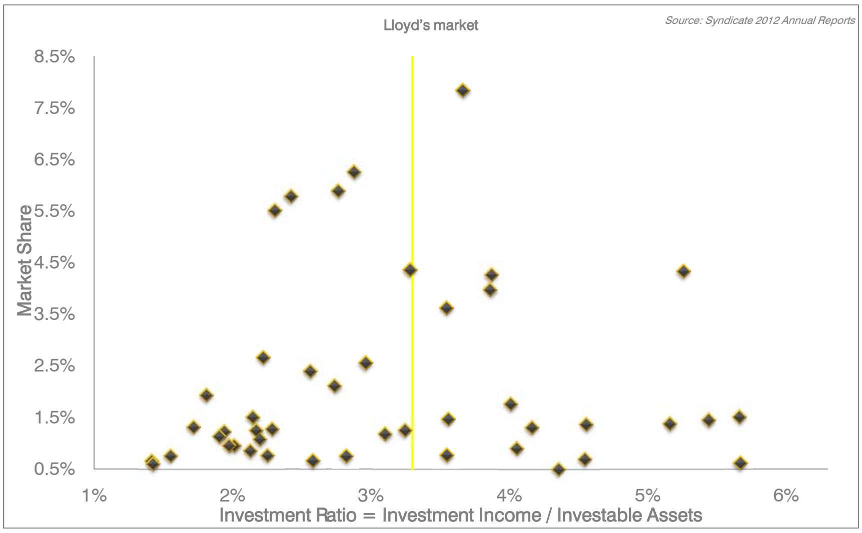
- The following table shows an average return on investment for the last 5 years for 3 major general insurers:

2008	2009	2010	2011	2012
-1.4%	5.9%	2.8%	3.2%	2.9%

- Investment strategies are seen to be conservative, erring on the cautious side of the risk to return relationship given the ongoing uncertainty in financial markets.
- Asset allocations tend to be highly focused on fixed income investments and cash as can be seen in the following breakdown of a major insurer:

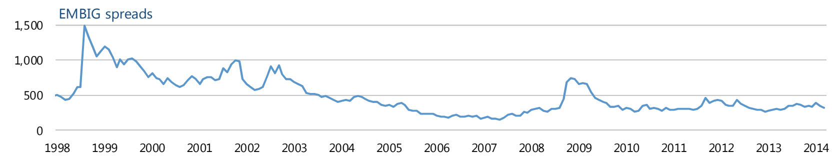


A backdrop of disappointing returns…



Theme 4 – emerging markets

1990's: "Old" World → 2000's and post-Financial Crisis: → present day: "T junction"



- General insurers need to push the envelope in terms of types of assets in order to improve the returns.
- Emerging markets debt is an example asset class which has been explored by GI insurers.

As of 31 March 2014. SOURCE: PIMCO, JPMorgan.

Summary and conclusion

- Insurers need to broaden their horizons and explore alternatives
- There's no free lunch and insurers have to be savvy investors
- There's an unequal split of time being spent on different parts of the insurance company's balance sheet, but there are opportunities to optimise in every part.

Thank you

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