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Meeting the investment challenges of Solvency II

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Solvency II - background

- Review of the capital adequacy regime for the European insurance industry.
- Establish consistent set of EU-wide capital requirements and risk management standards
- Adopted by all 28 EU Member States
- Applies to all (re)insurance firms with gross premium income exceeding €5m or gross technical provisions in excess of €25m.
- Solvency II came into force on 1 January 2016

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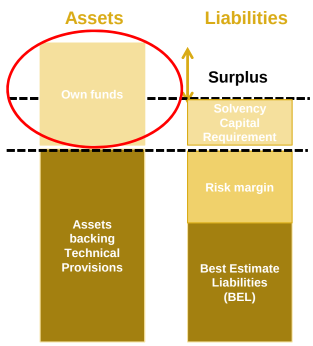
Solvency II Balance Sheet

SII introduces balance sheet items relevant for investment management

- The Best Estimate Liabilities (BEL) are a provision for insurance liabilities, valued on a market-neutral basis.
- The Risk Margin (RM) is an additional provision held to reflect the cost of absorbing “non-hedgeable” risks intended to ensure that technical provisions reflect a realistic, arms-length transfer value.
- The Solvency Capital Requirement (SCR) is a risk-based minimum capital requirement to cover losses with 99.5% confidence over a 12 month horizon.

Value of the RM and SCR are expected to be sensitive to interest rates, credit and equity market movements.



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ALM Strategy in Context

ALM Strategy forms a part of an insurers wider risk management framework

- As part of ERM framework set Risk Appetite Statements, which in turn drive target risk balances.
- Maintain a Capital Management Policy, which defines target capitalisation ranges
- Provides the framework to enable Investment Decisions to be made, ensuring that these decisions are consistent with the risk appetite and capital management policy.

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ALM Objectives and Investment Strategy

Objective - Maximise risk-adjusted return on capital subject to risk appetite

ALM strategy provides framework to assess alternative investment decisions.

Typical plan compares options using a Risk-adjusted return on Capital metric.

- Capital includes SCR.
- Higher risk investments can add to the SCR and dilute expected return.
- Diversification can help optimise risk-adjusted return
- Return on Capital target does not override the need to remain within Risk Appetite and capital targets.

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Liability Portfolios

We propose to define matching asset portfolios separately for the following portfolios

Portfolio	Scope	Objectives
Non-Profit Liabilities	• Immediate Annuities subject to Matching Adjustment • Deferred annuities • Protection	• Eliminate interest rate risk by close matching. • Optimise return through illiquidity premium • Maintain Matching Adjustment to eliminate spread risk
Unitised Liabilities	• Unitised Life and Pensions business • Platform	• Invest policyholder money in selected funds. • Address fee income volatility from market risks • Note value of future premiums and fixed expenses are not subject to market risks.
Surplus Assets	• All surplus assets including those covering SCR and Risk Margin • Includes surplus units (VIF)	• Ensure sufficient capital to cover Risk Margin and SCR. • Minimise RM and SCR wherever possible. • Minimise volatility of solvency position

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Asset Universe

For the purpose of analysis, we classify the available universe of investments into three high-level categories

"Cash"

Any investment with a degree of capital security and not subject to interest rate volatility.

- Cash and money market funds
- Short dated fixed coupon bonds
- Longer date floating rate bonds
- Absolute return strategies

"Fixed Income"

Investments subject to long-term interest rate exposure.

- Gilts
- Corporate bonds, ABS and other fixed income
- Index linked bonds
- Swaps and swaptions

"Equity"

Real assets and associated instruments

- Direct equity
- Property
- Unit-linked funds and other collective investments
- Forwards, options and other equity derivatives.

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Target Matching: RM/SCR

	SCR Allocation				RM Allocation			Total	Benchmark Portfolio			
	Non-Profit	Unitised	Surplus	Total	Non-Profit	Unitised	Total		Fixed Interest	Equity	Cash	Total
Credit	300	100	50	450				450		50	400	450
Equity	0	300	0	300				300		200	100	300
Interest Rates	20	50	20	90				90		50	40	90
Longevity	200	-	-	200	150	0	150	350	350		0	350
Persistency	0	150	-	150	0	25	25	175		75	100	175
Expenses	10	20	-	30	15	10	25	55			55	55
Other	15	20	-	35	0	5	5	40			40	40
Diversification				-300			-100	-400			-400	-400
Total				955			105	1,060	350	375	335	1,060

SII Benchmark Portfolio

We have analyzed the components of the Risk Margin and SCR in order to derive target asset allocations.

- SCR and RM arising in respect of **market and persistency risks** from unitised business are expect to rise in line with the value of the underlying units, and so are best matched with the units themselves.
- SCR and RM arising from longevity risk is expected to be exposed to long term interest rates, and so should be matched using fixed-interest.
- Other risks should be covered with cash

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"Cash" Exposure Options

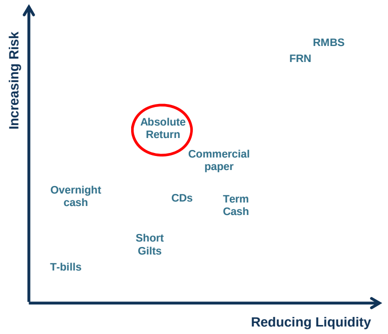
Assets not earmarked for "Equity" or "Fixed Income" invested in "Cash" i.e. any asset offering a degree of capital stability.

This reduces the SCR and stabilise solvency.

Earning a reasonable return on these assets will be a key objective, and subject to a range of other risk appetite constraints.

- As well as capital constraints we will have minimum liquidity requirements.

Currently invest in Absolute Return Funds as a cash alternative. We would expect to continue with this strategy under SII.



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Survey of European insurance companies

Q: What is your top priority?

	% of respondents
1. Proactively managing capital to improve returns	28%
2. Strengthening distribution model	23%
3. Enhancing product offerings	22%
4. Expanding into new geographic markets	16%
5. Optimising business lines and products	12%

Solvency-capital-intensive asset classes being replaced by less intensive instruments

Q: Which portfolio risks are you most concerned about?

1. Low yields	54%
2. Credit spreads widening	28%
3. Rising interest rates	15%
4. Equity market volatility	4%
5. Liquidity risk	0%

As insurers diversify to meet regulatory pressures and search for yield, allocations to non-core strategies will increase

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Source: Spence Johnson , 'Deeper Perspectives': Number 27, 2015

Absolute return strategies – risk vs. return

Low	Performance target and risk	High
Market neutral		**Market directional**
Aspires to be neutral	**Market exposure**	Longs and shorts
Typically low	**Volatility**	Can be significant
Fundamental	**Managing downside risk**	Manager judgement
Should be low	**Market correlation**	Can be significant

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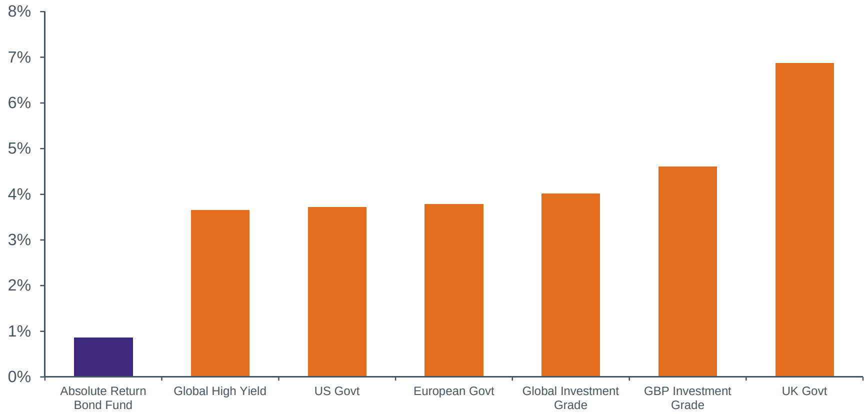
Lower volatility opportunity with focus on alpha over beta

Fixed Income asset classes - annualised volatility



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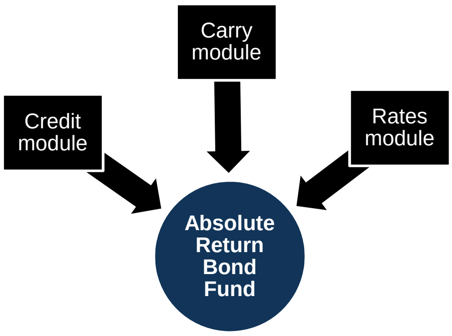
Source: Kames Capital, Bloomberg, BoA Merril Lynch, as at 31 March 2016.

- Strictly investment grade quality bonds
- Strictly max 2 years to final legal maturity only

- Primary alpha focus on credit neutral relative value positions
- Underlying duration removed



- Primary alpha focus on duration neutral relative value positions
- Neutral position of 0 years' duration (range: -2.5 to +2.5 years)

Positive returns + low volatility + uncorrelated to underlying

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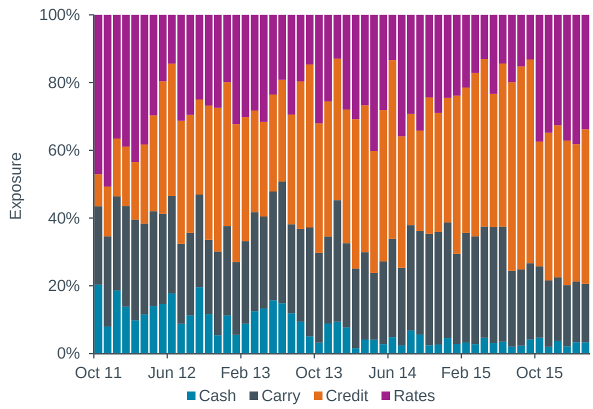
Flexibility to add value



Three Module approach

- Flexibility to allocate across modules
- Scope to add value in volatile market conditions
- Increases ability to achieve performance target

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As at 31 March 2016

Balancing need to maximise yield and diversify risk with an attractive cost of capital

As at 31 December 2015	Absolute Return Bond	5-year Gilts	10-year Gilts	30-year Gilts	10-year BBB Credit	Property	Type 1 equity**	Type II equity**
Total Standard Formula SCR*	6.2%	4.4%	9.0%	20.7%	21.2%	25.0%	39.0%	49.0%
Illustrative yield / target return	2.5%	1.1%	1.8%	2.6%	4.1%	5.0%	6.0%	6.0%

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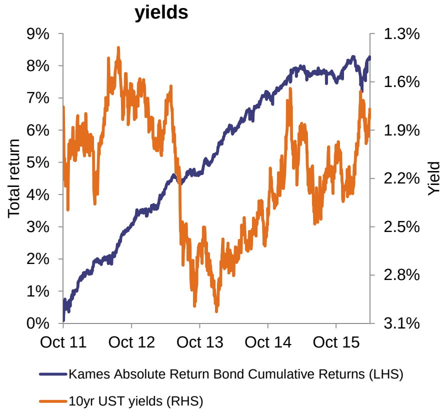
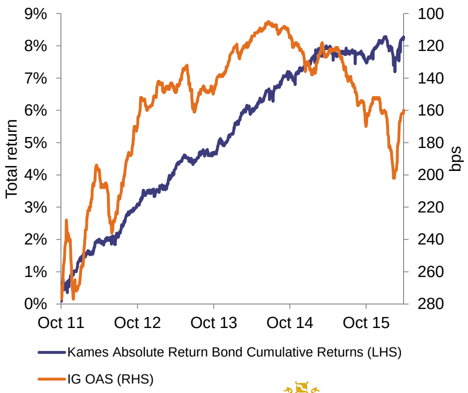
*1% parallel shift in yield curve. ** +/-10% adjustment depending on current market levels relative to previous 36 months.

Delivering returns uncorrelated to the underlying market



Correlation = 0.12



Correlation = -0.16

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Source: Kames Capital, Bloomberg and BoA Merrill Lynch as at 31 March 2016. Kames Absolute Return Bond Fund B (Acc) GBP shares. Past performance is not a guide to future returns.

Helping insurance clients to meet their investment

1.	**Attractive investment characteristics**	✓ Stable profile of returns relative to cash ✓ Diversified portfolio ✓ Low correlation to underlying bond markets ✓ Attractive liquidity compared to alternative investments
2.	**Attractive Solvency II characteristics**	✓ Low absolute duration and predominately investment grade holdings reduces the capital requirement ✓ No active currency risk, with all exposure hedged back to base currency ✓ No equity holdings ✓ Ability to meet data and reporting needs ✓ Attractive SCR per unit of risk/return and relative to alternative investments

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Summary

- As insurers diversify to meet regulatory pressures and search for yield, allocations to non-core strategies will increase
- Solvency-capital-intensive asset classes being replaced by less intensive instruments
- Absolute return strategies can balance the need to maximise yield and diversify risk with an attractive cost of capital

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