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Proactive ALM: How an innovative, well-integrated Finance function could unlock economic value

Gareth Mee and Sam Tufts, EY

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Straw poll 1

Has Brexit created any opportunities for your firm in the investments space?

1. Yes
2. No

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Defining “proactive ALM”

What does “good” look like?

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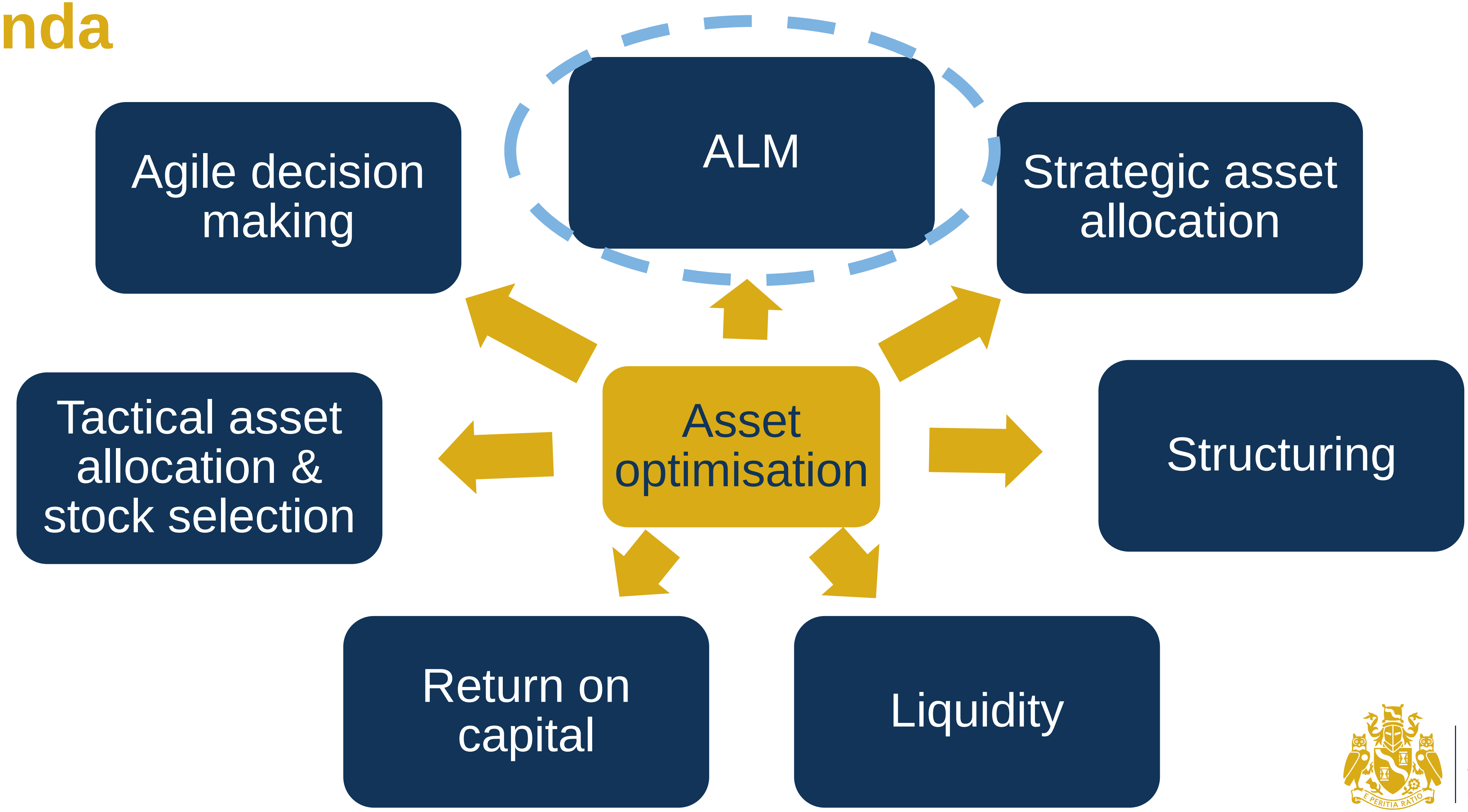
ALM is a key component of firms' asset optimisation agenda



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Proactive ALM is required to allow decision-makers to effectively run their businesses

ALM

Agile decision making

Facilitate dynamic governance

Tactical asset allocation & stock selection

Liquidity

Strategic asset allocation

Structuring

Return on capital

Achieve business objectives

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Case study 1: Deployment of assets

Understanding relative value

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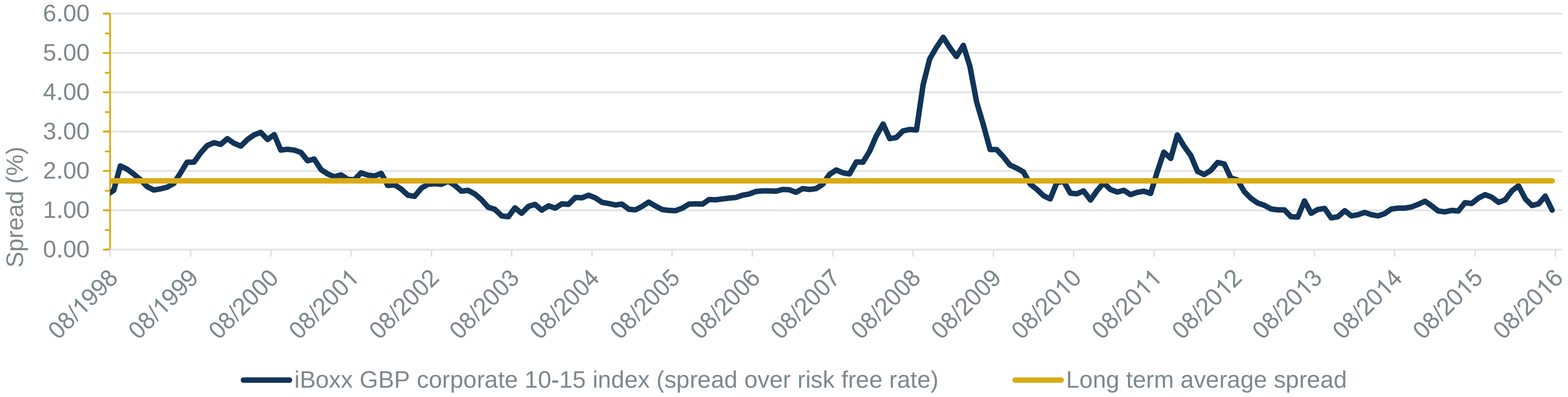
It isn't enough to understand relative value within traditional asset classes

Historical bond spreads 1998-2016



We are all aware of bond spread compression over recent years

Historical FTSE 100 index levels

Volatile equity markets are challenging to navigate

Source: Markit

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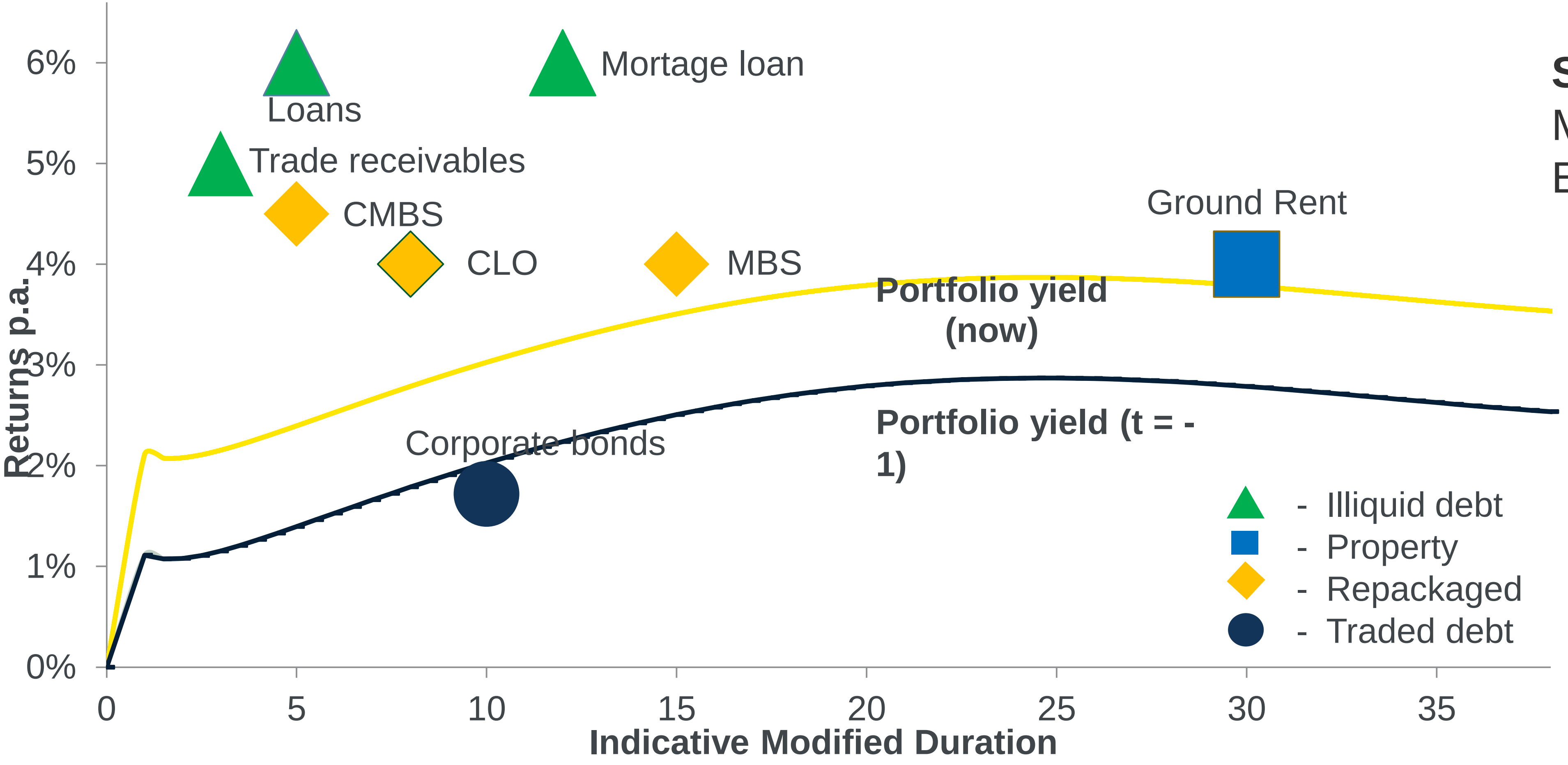
The front office needs a holistic understanding of where markets are pricing and where potential value exists



Source:
Markit (traded debt)
EY proprietary data

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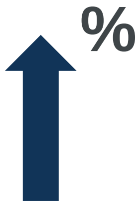
However, we all know there are other constraints on investment decisions

Insurers employ a range of investment criteria

Return/yield



Capital (SCR / EC)

Regulatory

Risk

Liquidity

Amongst others;

- Balancing income vs. capital growth
- Tax implications

This isn’t a case of ‘one size fits all.’

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Missed opportunities can occur if firms do not have the tools they need to assess relative value

Example opportunity: CPI-linked debt with AA+ guarantee

Indexed debt	• Debt payments are partly fixed and partly subject to uplift with CPI indexation
Pricing	• RPI-CPI wedge competitive relative to post-Brexit market information
Guarantor	• Finnish Government – Aa1 (Moody's) / AA+ (S&P) *via Finnish Export Credit Agency – Finnvera*
Macaulay Duration	• 9 years (using swaps, 6M LIBOR, plus 70bps)

Source: Macquarie Specialised Investment Solutions

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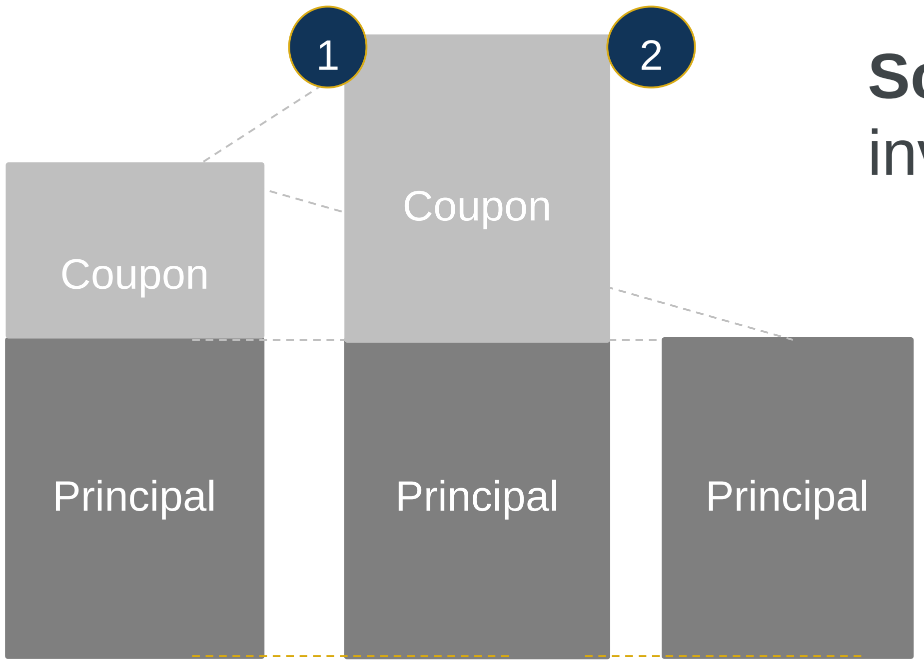
Lack of MI and operational flexibility prevented many firms from taking this attractive and rare opportunity

Scenario 1: Earn coupon above expected CPI

Scenario 2: Earn at least the principal on the investment in all circumstances



Time t = 0   Time t = payment maturity

Why is this helpful?

- Debt includes leveraged CPI-link with natural floor
- Few CPI-linked assets are in issue to match liabilities

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Case study 2: Pricing risk

What basis should an insurer hedge?

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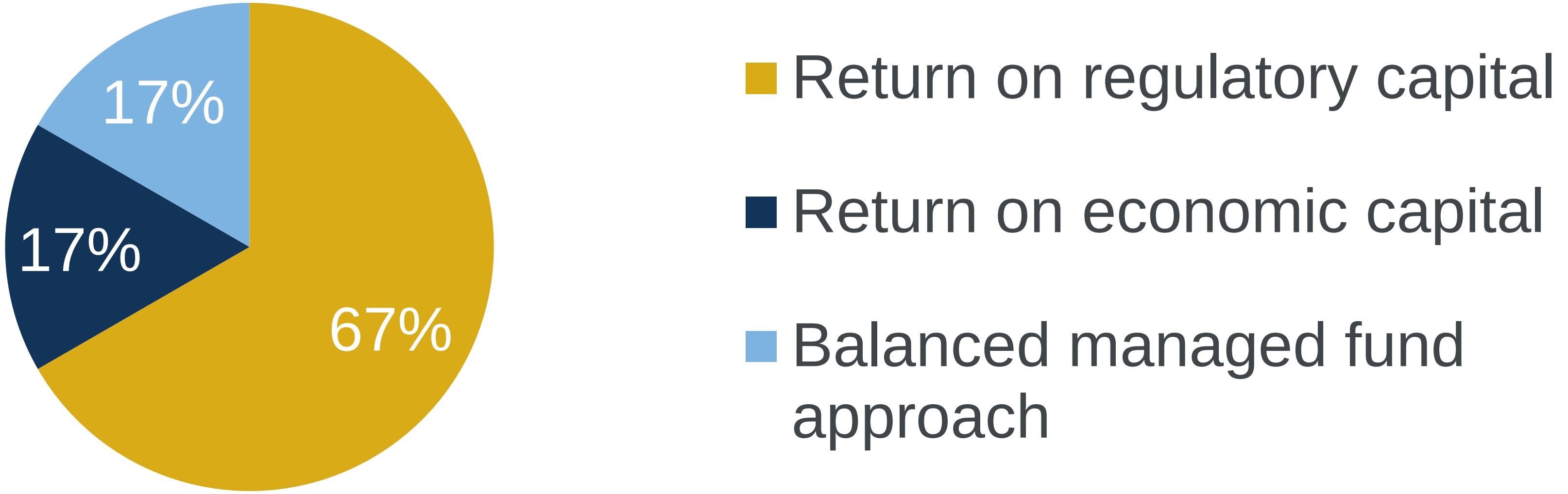
The first step to understanding risk appetite is to determine your primary business metrics

What is your primary optimisation metric for setting investment strategy?



Source: EY 2016 CIO survey

The majority of respondents (67%) manage investments based on a return on capital metric, where returns are defined in terms of IFRS profit and capital is related to the Solvency II position

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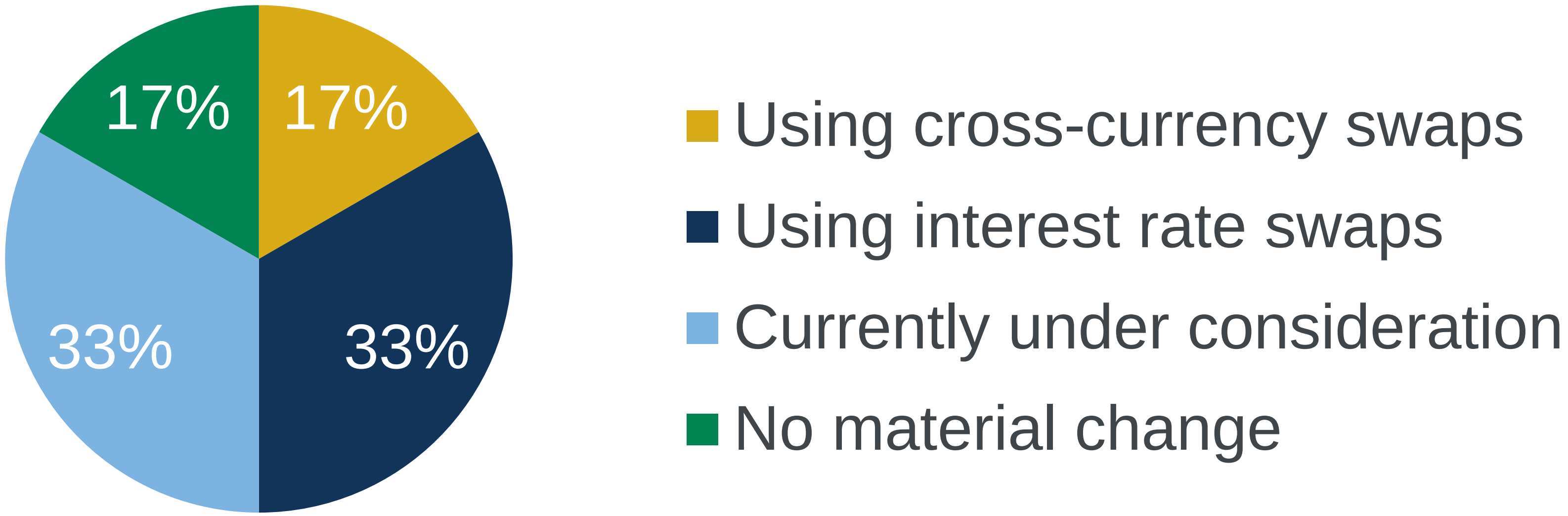
Solvency II has led firms to consider whether current strategies are appropriate

What changes are you expecting to make to your hedging strategy under Solvency II?



Source: EY 2016 CIO survey

Respondents are considering a number of changes to hedging strategies covering interest rate, currency and inflation risk

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Many firms have experienced undesirable balance sheet volatility in recent months

19th September
LV= solvency ratio drops 20%

10th August
Prudential SII ratio fell by 18% across the first half of 2016

9th August
Low interest rates behind L&G's solvency ratio 11% drop

5th August
Allianz 'freezes' Solvency II ratio at 186%

Source:
Insurance ERM

- Proactive ALM should enable a firm to assess risks being run and support with hedging decisions

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Straw poll 2

Is now a good time to hedge rates?

1. Yes
2. No

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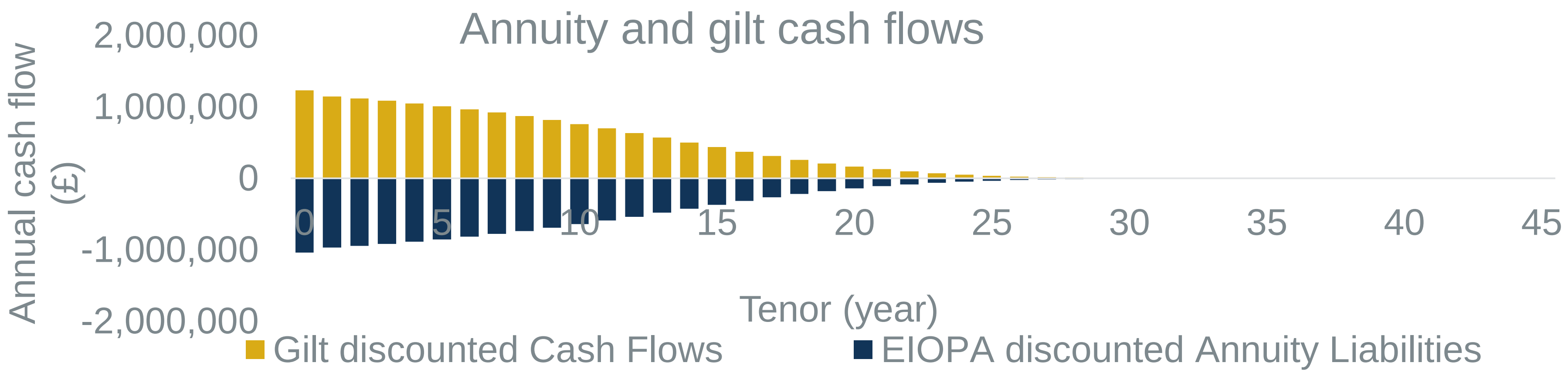
Case study: Interest rate risk in a “simple” annuity strategy

- Annuity cash-flows totaling £1,000,000 per annum
- Annuitants have an average age of 75
- Initial expenses of 5% and running expenses of 1%
- Annuity cash flows are matched with gilts without cash-flow restrictions
- Standard Formula firm, no Matching Adjustment or Volatility Adjustment
- Cash flows set to match liabilities and so solvency ratio = 100%



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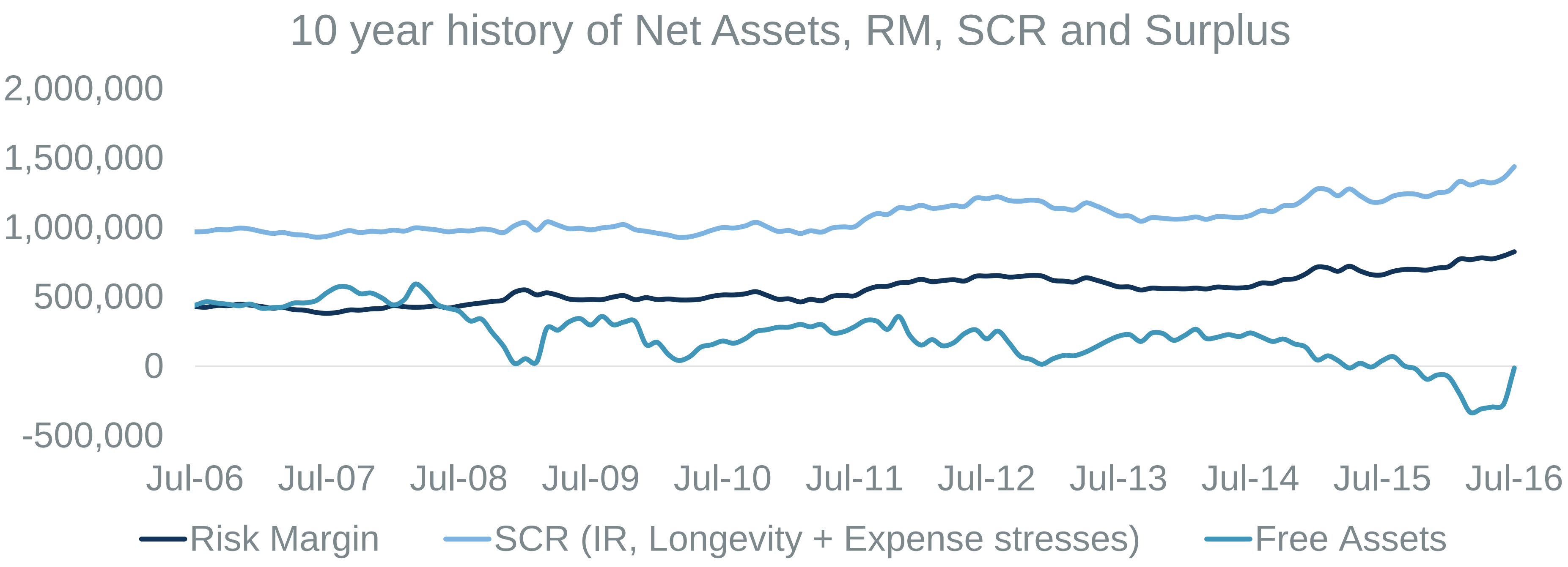
Unacceptable levels of balance sheet volatility based on 10 years of historical market performance



- Significant volatility in Free Assets
- Breaches of SCR and MCR

- **Better management of interest rate risk is required**

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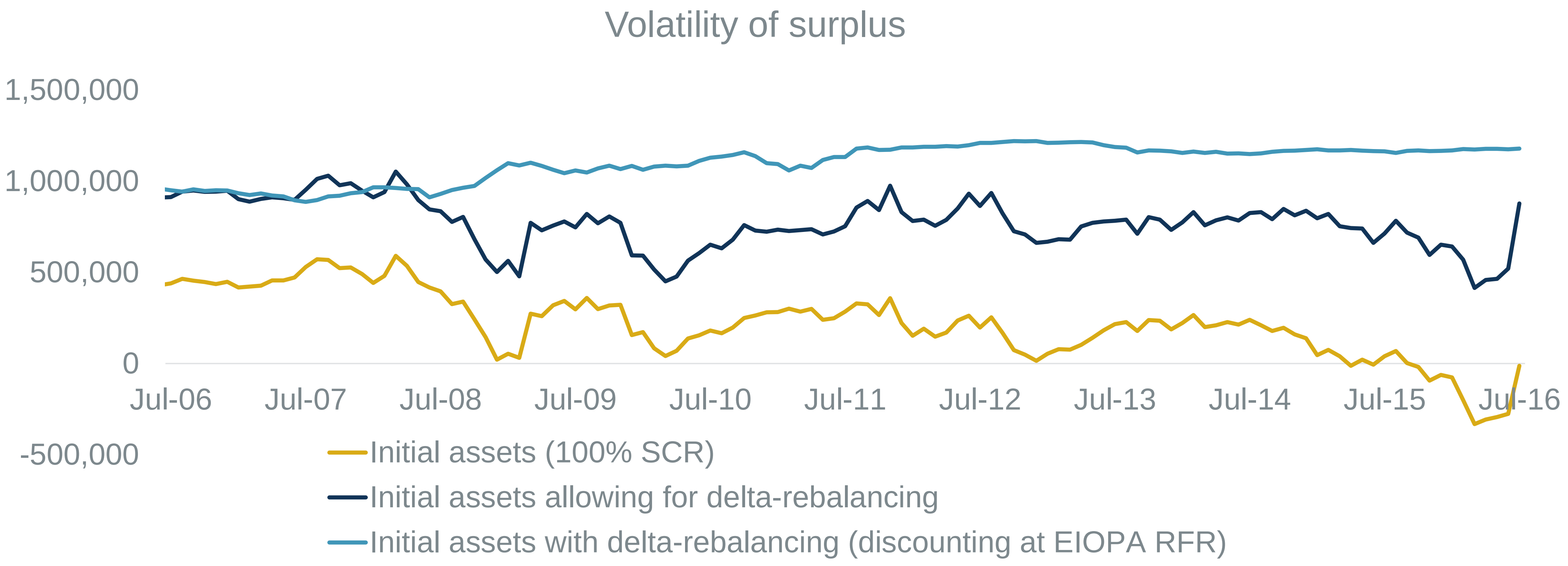
Even with theoretical hedging to the EIOPA curve, volatility still exists!



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Proactive ALM provides strong balance sheet MI to facilitate management of the business

Interest rate delta exposure (£k)

Tenor	Liabilities	RM	SCR	Assets	Net
5	1,248	124	37	1,503	95
10	2,723	355	184	3,259	3
15	3,020	475	454	3,576	373
20	2,070	395	672	2,422	714
25	848	208	574	979	650
30	191	66	270	218	310
35	21	12	66	23	75
40	1	1	9	1	10
45	0	0	1	0	1
50	0	0	0	0	0

- Risk limits can be used to trigger hedging activity
- ALM processes need to provide timely information

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Case study 3: Pricing new business

A Finance function that provides a competitive edge

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Straw poll 3

What is the most effective strategy to facilitate accurate new business pricing?

1. “Warehousing” assets to back new business
2. Pricing at the execution date on current market yields
3. Deploying assets post-trade

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New business pricing should be better than a "good guess"

- There are a number of investment bases firms might use when pricing new business:
  - "Target" corporate bond yields
  - Existing portfolio yields
  - "Live" yields in line with current investment strategy
- There are also various strategies applied to achieve deployment consistent with pricing, from:
  - "Warehousing" assets to back new business, to
  - "Wait and hope", i.e. transact after deal execution

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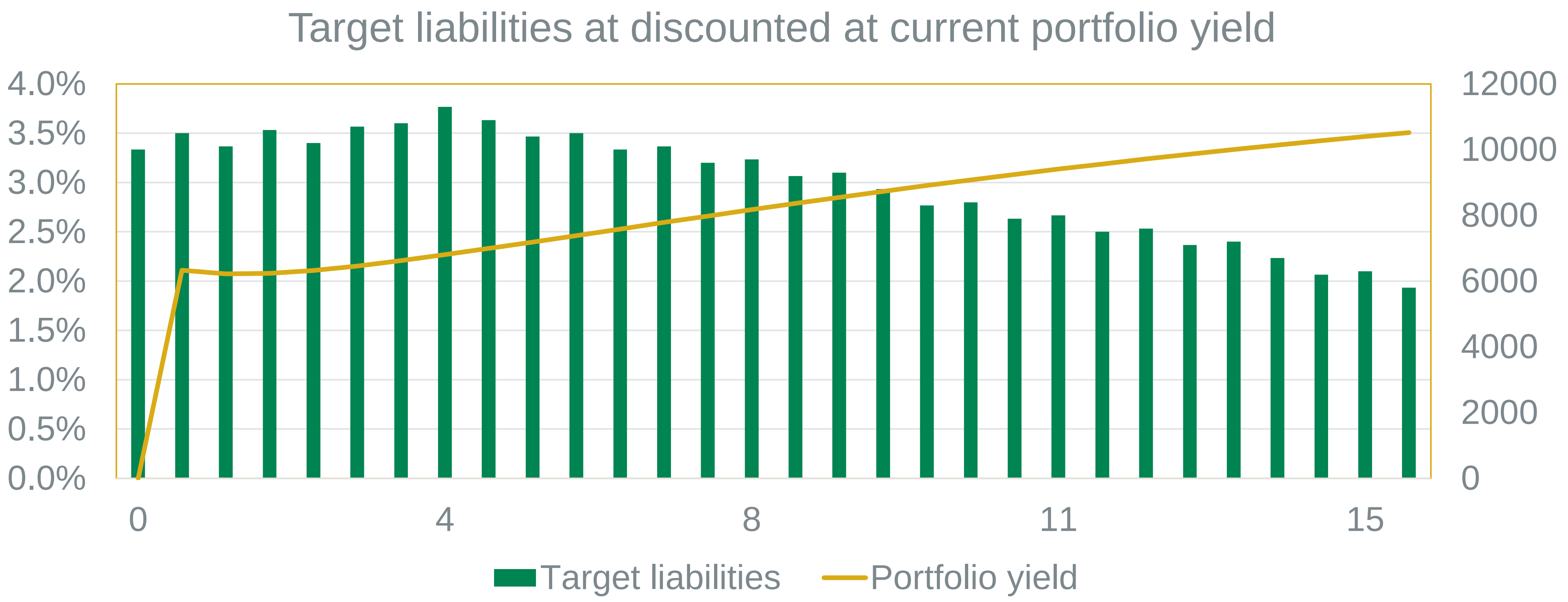
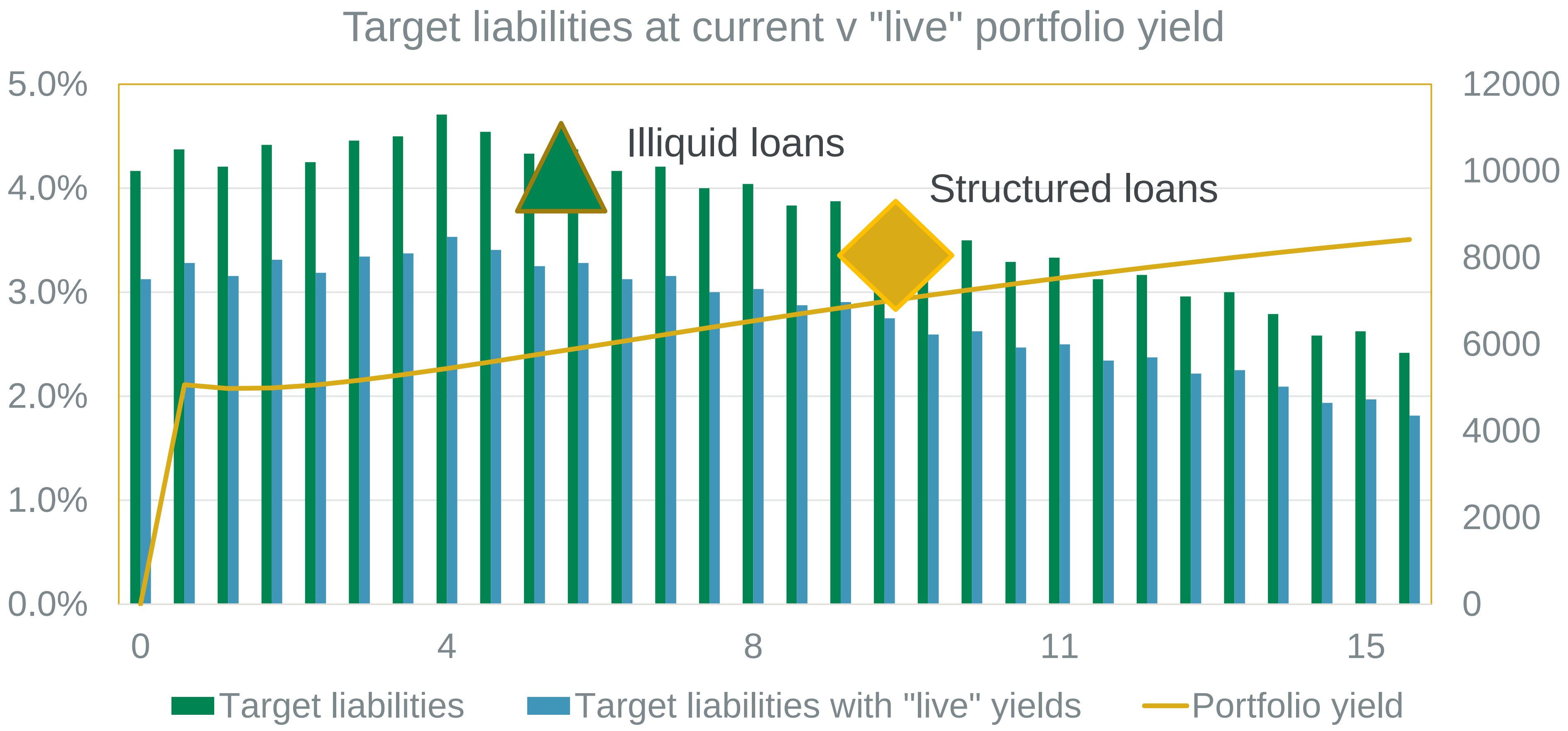
Many firms are still pricing new business based on yields on their existing portfolio

Example: Bulk-annuity transactions

- Assume Solvency II Matching Adjustment / IFRS Liquidity Premium applied



But this might be uncompetitive based on available yields in target markets



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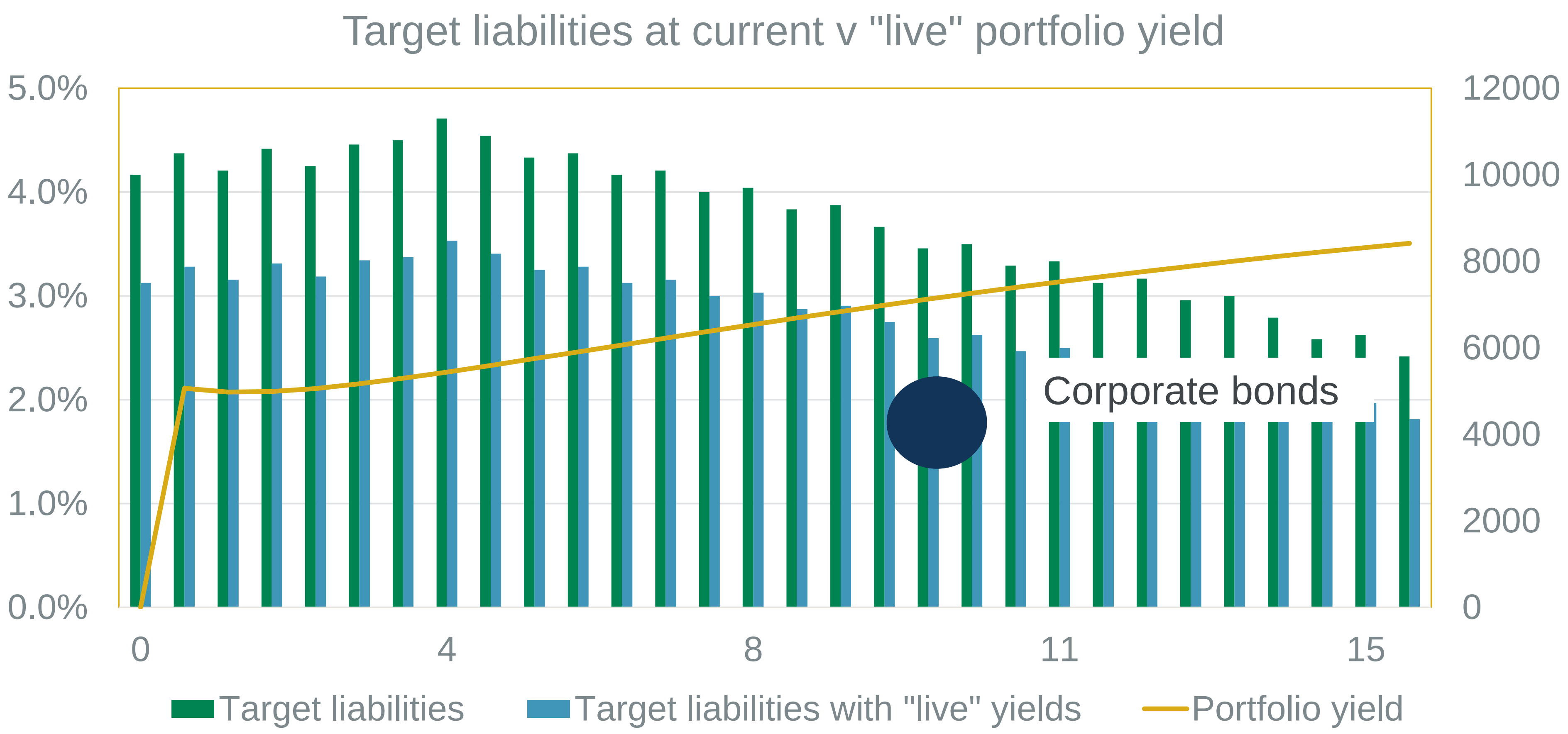
…or lead to losses if the yield is not there



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Conclusion

Proactive ALM can deliver value to your business

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Proactive ALM empowers better decision-making, delivering value to the business

Management are empowered to achieve business objectives

Deployment of assets

Competitive pricing

Hypothecation of assets to liabilities

Optimise hedging strategy

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Questions

Comments

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