Investing in alternative assets: considerations for a general insurer
GIRO Conference 2016

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A challenging economic backdrop
The search for yield continues amidst a challenging economic backdrop

The fall in the annual gilt yield emphasises the need for firms to search for yield

Source: Markit, iBoxx £ Gilts 1-5 index
The search for yield continues amidst a challenging economic backdrop

FTSE 100 historical data

Source: Markit
Possible methods for optimising insurance investments
Current asset holdings
Asset allocation in the general insurance space (YE15)

On average, corporate bonds and government bonds form 41% and 28% of total asset allocation respectively. These bonds are expected to be either short term or very high quality and liquid in nature.

Despite corporate and government bonds constituting the majority of average current asset holdings, it appears that major players in the general insurance space remain willing to invest in alternative asset classes in a search for adequate return and diversification.
Non-life insurers have traditionally favoured vanilla asset strategies to satisfy liquidity demands, but as a result typically achieve low returns. It may be appropriate for insurers to consider alternative asset strategies to improve their return on capital.

<table>
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<th>Option</th>
<th>Considerations</th>
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<tr>
<td>Investment in alternative assets to pick up an additional illiquidity premium</td>
<td>• Illiquid assets often pay a higher return than their liquid counterparts, however firms may face valuation and operational difficulties</td>
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<td>Invest in assets of greater duration</td>
<td>• Firms should consider the steepness of the interest rate curve, extra capital requirements, their risk appetite and an economic view of rates staying low</td>
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<td>Assume extra credit risk / equity risk</td>
<td>• Deliberately move into more risky assets to achieve higher expected returns, whilst balancing this with additional capital requirements</td>
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Investment in alternative assets to pick up an additional illiquidity premium
Achieving greater yield - higher risk and less liquidity?

- General insurers need not be satisfied with languishing total returns
- Economic opportunity for general insurers to extend their reach into the alternative investment market
- Changing the total asset allocation should be balanced with the capital treatment of these investments under Solvency II
- Increased interest in securities lending, private placements and commercial mortgages
Alternative assets could provide the risk-adjusted return to satisfy insurance investor requirements.
Life insurers are already participating...

**British insurers commit £25bn to UK infrastructure**
The Telegraph, 4 December 2013

**L&G plans to begin lending to larger SMEs**
The FT, 23 February 2014

**Prudential plans to plough nearly £300m into the construction of around 1,000 new (affordable) homes.**
The Telegraph, 25 January 2014

**AXA raises €2.9bn for European real estate debt fund**
IPE Real Estate, 3 August 2015

**Insurer Aviva has completed the purchase of around 7,000 solar photovoltaic systems, totalling around 23MW**
Solar Power Portal, 13 August 2012
An attractive return on capital opportunity
Example of return on capital for sample of assets

- Commercial real estate debt (3 year duration)
- Residential mortgages (3 year duration)
- BBB rated corporate bond (3 year duration)
- A rated corporate bond (3 year duration)
- Equity (Type 2)
- Equity (Type 1)

Return on capital
Further considerations when investing in alternative assets

• The potential to achieve more attractive returns needs to be balanced with a number of risks which may arise:
  – Interest rate risk
  – Operational risk
  – Liquidity risk
• Other operational considerations are discussed in later slides
Lengthening liability profiles and the use of effective duration
PPOs and an evolving liability profile
An introduction to PPOs and the motivation for their optimisation

- The incidence of claim awards in the form of Periodic Payment Orders (amongst other things) is lengthening liability profiles
- Compensation is paid to claimants at regular intervals, rather than in a single lump sum award
- Appropriate that general insurers should look to optimise their assets backing PPOs
- Unlikely that PPOs would be eligible for the matching adjustment
PPOs and an evolving liability profile
Considerations when matching PPO liabilities

Key concepts and asset classes to consider when matching PPO liabilities:

- Availability of a bond portfolio with suitably long duration
- Equities, property and illiquid assets
- Poorer credit rating, alternative currencies and EM debt
- Alternatives to a bond only approach to improve capital efficiency
- Inflation (ASHE) linked cash flows
- Transferring insurance longevity risk
PPOs and an evolving liability profile
The different measures of inflation

ASHE has not historically been perfectly correlated with RPI (or CPI)

Source: Office of National Statistics

23 September 2016
Using effective duration within large renewal books
Can a proportion of premiums be considered to be consistent and invested longer term?

- One could effectively back a large portfolio of yearly renewing motor (or other personal lines) policies with long-dated assets
- Increased interest rate risk as a result of asset and liability mismatching
Practical and operational considerations
Liquidity risk management

Why is it important and how do firms typically approach it?

- Liquidity management is crucial for general insurers looking to invest in alternative asset classes
- Firms typically perform stress and scenario analysis to assess their liquidity position, validate contingent funding plans and identify available mitigating liquidity options

- Firms typically report on a monthly or quarterly basis, where automated processing and better reporting platforms may be required to increase this frequency

Source: EY Global Liquidity Risk Management Survey 2016
The operational journey
The process when moving into a new or alternative asset class

- Origination
- Valuation and modelling
- High level capital and accounting analysis
- Risk identification and analysis
- Detailed capital and liquidity modelling
- Integration into business as usual
- Regulatory approval

Possible issues regarding data and treatment under the Standard Formula of more complex exposures

Requirement for investors to be able to demonstrate expertise in the assets which they have invested in

The Prudent Person Principle is an overarching principle to take into account

Important for firms to demonstrate effective liquidity management procedures.
Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.