Focus on Insurance Companies

SEEKING ALPHA ON INSURERS' EFFICIENT INVESTMENT FRONTIER

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Introducing BNY Mellon's Insurance Industry Roundtable Series

A panel of our insurance industry experts offer their insights on the evolving European insurance industry. This document provides an overview of the transcript derived from one in a series of Insurance Industry Roundtable discussions in which our executive team and industry and product experts explore key trends and issues facing our insurance industry clients.

Our Insurance Industry Roundtable series considers the challenges facing Insurers in EMEA and how by accessing BNY Mellon's comprehensive Investment Management and Investment Services solutions we can help them achieve their business objectives. Other topics include:

- Cash Investments in a Turbulent World
- Investing in Illiquids: Challenges for Insurance Firms
- Managing Your Securities Financing & Derivatives Collateral for Optimum Results
- Transparency: the Data Management Challenge Facing Insurers
- T2S: Opportunities for Insurers arising from Europe's New Post-Trade Landscape
- Using Trusts and Securitisation within Insurance Company Finance
- Using Your Global Markets Counterparties to Help Optimise Your Risk Profile

PAUL TRAYNOR: Solvency II has had a major impact on the investment strategies of insurance firms in Europe in recent years. Is it still the predominant factor or are there now more significant other forces at play?

HENEG PARTHENAY: Solvency II is still being digested and acted upon, but the major players have largely worked their way through the implications. From an investment perspective, a critical factor is the impact of the European Central Bank's (ECB) quantitative easing (QE) programme on interest rates in the euro-zone and surrounding economies, including the UK.

As major investors in European government bonds, life insurers will have been pleased by the ECB's smooth management of interest rate moves to date, but will still be concerned about how the bank exits from the programme. If QE carries on for a long time, insurers will suffer a prolonged period of falling yields in their investment portfolios; but if rates rise sharply, insurers will face a wall of redemptions as their customers move to new policies to benefit from higher-yielding assets. It's possible to mitigate the latter risk with interest rate swaps, but only if you feel confident about the timing of the next interest rate hike in the Eurozone. In response to lower rates, some insurers have been re-risking their portfolios in search of higher yields and running mismatches despite the capital costs.

PAUL: With the US further along the interest rate curve, what are the main investment challenges for insurers in your home market?

MICHAEL GORDON: Sustained low interest rates have certainly been a concern. Because of its impact on their primary source of income, i.e. investment yields, a prolonged low interest rate environment can slowly bleed an insurance firm to death. But a rapid spike could lead to a quicker demise because of the redemptions and subsequent market value losses from selling off bonds.

As an insurance firm, you have three main concerns: matching assets and liabilities to obtain an appropriate spread, taking into account duration, yield and convexity; optimisation of capital; and securing distribution, through how you price, underwrite and manage your distribution network.

Those latter choices become much harder when yield is low, capital requirements are high and levels of risk and uncertainty are greater.

In response, asset managers should offer special situations arising from the deleveraging and retrenchment of banks and the availability of alternative sources of liquidity and capital, for example sovereigns that need to support elements of their banking systems. Asset managers should look to provide solutions based on the move into direct lending and other banking functions, both short-term financing in the repo markets activity for the treasury function and long-term financing for general account portfolios.

There is also scope for asset managers to develop capital relief vehicles, to provide not only additional capacity but also more capital structure optionality, for example if an insurer wanted to vary asset risk versus insurance risk in accordance to their ability to access to capital via traditional means. Asset managers should help insurers to tap new inflows of capital that seek to exploit insurers' lower correlation

MODERATOR:
Paul Traynor

PARTICIPANTS:
Michael Gordon, Tobias Mensing, Heneg Parthenay

Paul Traynor
Managing Director, European Pension and International Insurance Client Segment Leader
+44 (0)20 7163 3213
paul.traynor@bnymellon.com

with other available investment returns – particularly where insurers are exposed to incidence risk, more than interest rate risk. Such inflows offer an opportunity to create structures that will provide insurers with more balance sheet and strategic flexibility as they wait to see how capital regimes evolve, potentially making them more competitive today, and giving them capacity for the future. Finally, asset managers should be helping insurers to develop products around innovative investment solutions that would expand distribution.

HENEG: In Europe too, there is definitely an opportunity for long-term investors such as insurers to harvest the 'illiquidity premium' by providing capital for the types of lending activity for which banks have a reduced appetite. In contrast to the US, the securitisation market has not yet recovered to pre-crisis levels, but this potentially offers insurers a further opportunity to become an alternative source of funding. We're also seeing sophisticated clients focusing more closely on cash flow matching when considering their investment options, compared with duration matching. This is partly due to heightened concerns about liquidity conditions in the fixed income markets – even in government bonds – but also because of regulatory changes which are demanding more reporting and transparency on how insurers manage liquidity.

PAUL: How are these European and US trends changing the product range being offered by asset managers?

TOBIAS MENSING: We're offering a number of alternative products that can provide both diversification for the insurers but also help them harvest the illiquidity premium better than fixed income products, for example products that offer exposure to loans, infrastructure debt and private equity.

HENEG: One of the challenges is that there is no standard way to address cash flow mismatches. You have to add a swap overlay to a classic fixed income portfolio, perhaps widening your instrument universe to achieve returns, but the solution has to be bespoke, based on a clear understanding of the client's liability profile.

MICHAEL: In future, I think we will see a move away from traditional products to designed solutions that can match the evolving needs that we've highlighted earlier in the discussion.

PAUL: How are today's investment challenges impacting different types of insurers?

MICHAEL: Life insurers are very focused on interest rate risks and have appetite for alternative sources of capital. Annuity providers are under severe strain from trying to grow their businesses at a time when market / longevity covariance risks are placing particular restraints on their capital. To support growth, even the most profitable are increasingly looking for structures that offer capital relief.

Property and casualty (P&C) insurers are generally further advanced than life insurers, both in terms of accessing alternative sources of capital and risk decomposition. To a large extent, insurance is a series of under-priced options. The question is: are they under-priced for good reasons? When helping insurers to find the most efficient 'homes' for those decomposed risks, we need to make sure those providers of capital understand the risks, are appropriately compensated for taking them on and that the structures we create do not encourage adverse selection in the long term, which could subsequently cause those capital sources to dry up.

PAUL: P&C firms in Europe have engaged in a re-risking of their balance sheets and hold a much wider spread of investments now. What other changes do you see?

HENEG: They've also reconsidered their liquidity needs. Historically, non-life firms have tended to be more liquid than strictly necessary from an investment perspective, but in the low-yield environment, those with the appropriate internal governance and headroom have taken the best available risk/return option by taking on a higher proportion of illiquid assets.

On the life side, greater use of hedging strategies can help to decompose risk. Regulatory reforms are already forcing insurers to separate out their risks into 'buckets', which can then potentially be further added to or split for effective risk decomposition purposes, enabling insurers to manage risk components one by one. Another beneficial impact of regulation is that the OTC derivatives typically used to offset these risks are becoming either more heavily collateralised or exchange-traded, which gives the user more security that the derivative will provide efficient protection even in stressed market conditions.

PAUL: Are the investment challenges, priorities and styles of insurance firms converging, both across Europe versus US, and beyond?

Michael Gordon
Global Head of Insurance Solutions
+1 212 922 8592
michael.j.gordon@bnymellon.com

Tobias Mensing
Senior Product Strategist
+44 (0)20 7163 5110
tobias.mensing@bnymellon.com

Heneg Parthenay
Head of Insurance, Insight Investment
+44 (0)20 7321 1376
heneg.parthenay@insightinvestment.com

HENEG: The underlying economics are the same but other common factors can have different impacts, such as the nature of longevity, the timing of macro-economic recovery and therefore interest-rate rises, plus of course regulation. For example, US insurers are invested in asset-backed securities (ABS) but Solvency II is making this progressively harder in Europe. Conversely, Europe is more flexible in allowing investment in un-rated securities, provided you can demonstrate expertise in credit risk, while US regulators require more dependence on external ratings.

MICHAEL: The underlying risks are the same and so should be the objectives of the solutions provided by asset managers. But providers such as BNY Mellon have to ensure that we structure solutions and vehicles so that they are acceptable in the relevant regulatory environments.

PAUL: In terms of current investments, US insurers have a greater allocation toward corporate debt, while European insurers tend to favour sovereign debt. This may be caused by deeper US corporate debt markets compared to Europe, where a higher proportion of debt funding is sourced from banks traditionally. The prolonged low-yield environment in Europe has led insurers to take on more credit risk, by switching out of sovereign into corporate debt. What other changes and opportunities do you see for insurers?

MICHAEL: Insurers might face lots of pressures but in other respects they are in a position of strength. Given prevailing economic uncertainty, firms that can support long-term investments are really valuable. Because insurers offer a rich source of long-term flexible permanent capital, they have a lot of leverage over borrowers to structure cash flows according to their liquidity needs. As such I see increase overlap between the interests of insurers and the private equity (PE) world. PE firms are finding it increasingly difficult to deploy capital in a way that meets the investment horizons and returns expectations of their clients. But they do have the flexibility and sophistication to structure cash flows from their investments to meet the cash flow needs of insurers.

HENEG: The attributes of insurance firms are very valuable to PE firms that have substantial reach in terms of the money they can raise but cannot offer the same kind of long-term commitment. PE firms are now effectively in the credit space. Their clients are less risk averse than most, so are on the higher-risk side of the market, while insurers can provide the capacity to take up the senior, secured part of the trade. Combined, PE and insurance firms have an opportunity to replace withdrawn bank lending capacity.

MICHAEL: When PE firms started insurance businesses, the PE arm might have been the stronger arm, but as the insurance units generated more float, had less need to mark to market, and had greater access to flexible permanent capital, they have begun to support the PE arm. As such, insurance firms are playing an ever bigger role in providing real money to the economy. They have an unprecedented opportunity to shape the outcomes in the wider economy.

HENEG: In Europe, investment in a leveraged PE vehicle attracts high capital charge under Solvency II, requiring an alternative approach to help insurers tap into PE opportunities. A more capital efficient route for insurers to participate into private equity funding is through fixed income instrument, for matching and regulatory reasons.

MICHAEL: Insurers have the ability to attract and deploy substantial amounts of capital. Historically, they have had outstanding discipline in how they manage their assets and liabilities. As these new opportunities emerge, it is important that firms with the requisite expertise and experience take the lead, rather than retreating to let more aggressive players grab the initiative.

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