

# 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 newsletter 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
- The hidden value of specialists - Transition & Beta Management for Insurers
- Transparency: gaining an understanding of your market and counterparty risk exposures
- Managing your securities financing & derivatives collateral for optimum result
- Using your Global Markets Counterparty to manage risk

**PAUL TRAYNOR:** Thank you Charlie, Jamie and Tobias for joining me to discuss the European insurance industry. What pressures do you think Insurers face and what is affecting their business?

**CHARLIE PEARS:** The implementation of Solvency II regulation means that General Insurers will need to better understand their liabilities, take more focused investment risks and hold additional capital against any mismatch with their liabilities' duration. That will be difficult as General Insurers typically hold short-dated fixed income assets and are already struggling to generate a real return in a higher inflation, low interest rate environment.

Many Mutual Insurers who are now closed to new business, are moving to sustainable business models of long-term managed risk. They need to look holistically at their business models - their administration, investment management, custody and other services - to ensure they achieve a managed run-down over 20 years. They need to source specialist investment support.

Annuity providers need to take selective investment risks to be able to compete in a highly competitive market. Under Solvency II, capital charges for holding credit may increase, but unlike for other liabilities, annuity writers will be able to take credit for the illiquid nature of their liabilities by discounting them at a higher rate, due to the allowance of a 'matched premium' approach.

In contrast to much of Europe, the UK life sector is closest to meeting Solvency II requirements as it has already been through 'Solvency 1.5'. European Life Insurers will likely find Solvency II traumatic as many are less prepared than their UK competitors.

**JAMIE LEWIN:** Insurers as long-term investors have relied on traditional investment principles to deliver returns in a liberal capital market environment. The new paradigm of tighter market regulation means Insurers must look again at how they manage risk and generate investment returns. They must review return expectations and re-think the business risks they take. There could be profound changes to asset allocation as Solvency II will impact each asset class. Insurers will have to de-risk and relinquish risk premium on higher volatility asset classes. This could generate interest in swaps against physicals within fixed income to dial down duration exposure and increase credit quality.

**TOBIAS MENSING:** Insurers are keen to find solutions. We are listening to all of our business channels and subsidiaries for feedback from the client base, so we can create the products clients need. There may be opportunities to develop segregated mandates and fixed income-based absolute return products for Insurers, as they offer a LIBOR+ benchmark.

**PAUL:** Are there other pressures, not just in managing the risk and return, which Insurers should consider?

**JAMIE:** Given current market conditions, shifting to Solvency II could force Insurers to sell risky assets cheaply and buy safe assets at high cost, to meet their Solvency Capital Requirement (SCR). Creating a client-specific optimal portfolio is also a tactical decision so they should not ignore the market environment and valuation opportunities at asset transition. The knock-on effect of removing risk could be increased cost.



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**CHARLIE:** Specialist fund managers, like Insight, adopt LDI techniques with triggers so assets are not transitioned irrespective of valuations. As well as taking into account current valuations for different asset classes, Insurers will need to consider the cost of holding capital against higher risks before portfolio re-balancing can occur.

Insurers with enough capital could overlay their asset allocation with derivatives, to deliver a sensible transition and minimise the current costs of buying and selling in illiquid markets.

An additional consideration is the move towards central clearing for many derivative products to meet the European Market Infrastructure Regulation (EMIR) and the US Dodd-Frank Act. General Insurers have historically been less active in using derivatives, so they must consider the potential cost implications and margin requirements of central clearing when implementing this type of strategy.

**PAUL:** Solvency II, regulators, shareholders and the general public all are demanding greater levels of transparency of Insurers. Solvency II, in particular, seems to require a faster data analysis of all asset valuations. How are Insurers tackling this?

**CHARLIE:** Many firms haven't even considered the huge amount of data changes and transparency Solvency II will generate. A new transparent language must be created that investment managers can manage, BNY Mellon is well-placed to handle this.

**PAUL:** Indeed, we have developed a new service which provides Pillar 3 Quantitative Reporting Templates (QRT) reporting. It also supports insurance

companies as they negotiate the data governance and data quality hurdles imposed by the new regulations.

**PAUL:** I understand Solvency II will encourage Insurers to divest long duration corporate bonds towards shorter-dated fixed income. Is that true, and has it sparked new thinking in the market?

**CHARLIE:** To some extent this pressure has already existed in the UK for some time, as spread stresses have a larger impact on longer-dated bonds. Whether this necessarily leads to a reduction in long-dated credit depends on the shape of the credit curve and their cost of capital – are Insurers being appropriately rewarded for taking long-dated credit risk? This may change in the future.

The elephant in the room is debt issued by the government of an EEA state, which is treated under Solvency II as credit risk exempt. Yet there are clearly significant economic risks to investing in some European sovereigns, as we have seen with Greece, Italy and Ireland. Solvency II says it is safe to invest, but is it?

**JAMIE:** It's where the risk maths of Solvency II just doesn't make sense. Insurers will be driven to buy shorter-dated credit and will sell longer-dated credit as it carries a higher SCR charge under Solvency II than the yield compensation. Spreads on UK long-dated debt will end up wider than justified by the fundamentals of those underlying Corporates, and it could lead to dislocation in that market.

**CHARLIE:** We're seeing a transition towards unit-linked products with a lower SCR. If you're underwriting long-dated insurance risk and holding long-dated credit then this is less capital efficient than holding credit exposure

in shorter durations and matching the long-dated liabilities with debt issued by the government of an EEA state. Firms issuing credit often don't know Solvency II is happening and there is not enough well-priced debt to buy in durations attractive to Insurers. Unless corporate issuers operate in the insurance sector they probably won't be aware of the implications for credit buyers.

**PAUL:** So which asset classes might generate efficiencies under Solvency II?

**CHARLIE:** Asset-backed securities (ABS) could be attractive but you do need a specialist to help understand the legal structure of the individual securities, has this defines its true economic risk and hence its capital charge for Insurers operating an internal model under Solvency II. Under the Standard Formula, the approach for ABS assets is very broad brush and treats all underlying risks the same regardless of their expected loss characteristics. This leads to some strange anomalies and capital inefficiencies for what are otherwise economically attractive assets. A carefully constructed portfolio could achieve attractive 'LIBOR+' returns with very low capital requirements (less than 7%).

Absolute returns deliver low volatility and an attractive return profile. I believe this will grow in popularity where Insurers have access to a 'look through' analysis to fully understand the underlying risks and exposures.

Annuity providers are using interest rate swaps as they are sensitive to interest rate movement and mismatches in duration. We think more Insurers will use interest rate swaps and swap-spread overlays as they can help them eliminate the gaps between the asset portfolio and the liabilities.

**JAMIE:** The duration and yield characteristics of emerging markets sovereign debt look attractive too under Solvency II. Even after the SCR capital charge, there is a nice yield pick-up if you don't already have exposure. Funds must provide a 'look through' to the underlying securities otherwise the fund will be exposed to a prohibitive capital charge.

**PAUL: How does Solvency II affect an Insurer holding infrastructure and property?**

**CHARLIE:** The regulations differentiate between lending to property companies, direct property and property vehicles versus an investment in an investment company engaging in real estate management and project development, with the latter potentially requiring twice as much capital. Infrastructure vehicles are often fairly illiquid assets, so even with attractive income the high capital charge under Solvency II means that these assets are less likely to be attractive to Insurers.

**JAMIE:** REITs attract a high Other Equity capital charge under Solvency II - similar to frontier equity markets. Their yield characteristics look attractive if treated as developed equity or local market equity. But it depends how the regulator decides to treat REITs within your overall equity portfolio.

**PAUL: Would Diversified Growth Funds (DGFs) be suitable for Insurers?**

**JAMIE:** A fund with a constrained long-only benchmark containing lots of equity risk is not necessarily an attractive proposition. But it is attractive if the DGF has an absolute return objective with genuine absolute return credentials in its construct, its risk management methodology, its returns capture and risk management philosophy

**CHARLIE:** We're seeing interest in diversified growth thanks to its broad investment opportunity set. Insight builds highly bespoke benchmarks reflecting Insurers' appetite for equities and other instruments based on their return objectives and capital position. These bespoke boundaries offer maximum exposures and predictability about their capital position. Insurers are recognising that a static asset allocation approach to risk assets is likely to both produce volatile outcomes and be capital inefficient.

**PAUL: What impact will Solvency II and other regulations have on an Insurer's cash versus money market funds or deposits held?**

**CHARLIE:** Insurers will have to consider their counterparty risk exposure and the duration of cash held. Direct

counterparty risk exposure (e.g. if Insurers hold 30-day cash with anyone other than AAA-rated counterparties) is capital intensive, compared with the fund alternatives. Our analysis suggests well-diversified money market funds, with a bias towards high quality debt, are more capital-efficient than a small portfolio of directly held deposits whilst providing higher expected returns.

**PAUL: So where are clients asking for support ahead of Solvency II implementation?**

**TOBIAS:** Emerging markets debt of investment grade quality is definitely of interest to Insurers. This asset class provides good returns for a relatively low capital charge. Our BNY Mellon Emerging Markets Local Currency Investment Grade Debt Fund holds at least 90% investment grade debt and will be able to provide the required security level reporting and currency hedged share classes in the future to minimise the capital charge. In general, clients are asking for full 'look through' to the holdings level for all our products. We will be able to deliver the required information. It comes down to meeting client needs. We have open ears and our attention is directed towards providing suitable solutions to our clients.

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