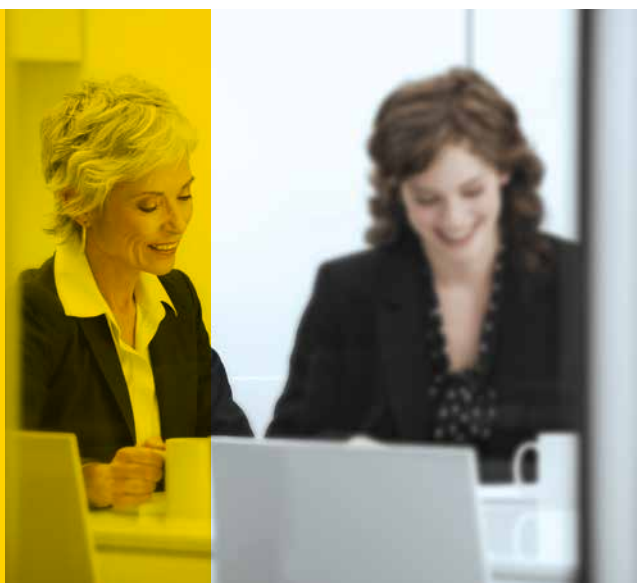


FOCUS ON INSURANCE COMPANIES



**THE HIDDEN VALUE OF SPECIALISTS -
TRANSITION AND BETA MANAGEMENT
FOR INSURERS**



BNY MELLON

MODERATOR:

Kate Anderson, Client Management UK

PANELLISTS:

Mark Dwyer, Mellon Transition Management; Sam Lundqvist, ConvergEx

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:

- Seeking alpha on Insurers' efficient investment frontier
- Cash investments in a turbulent world
- Managing your securities financing & derivatives collateral for optimum result
- Transparency: gaining an understanding of your market and counterparty risk exposures
- Using your Global Markets Counterparty to manage risk

Kate Anderson: Sam and Mark, thank you for sparing your time. How do you think you can help the Insurance Industry given how the markets are faring and what is on the horizon for Insurers?

SAM LUNDQVIST: From a general perspective everybody is affected to some degree by the European crisis and it is fair to say nobody really knows how this crisis is going to be solved. From a more insurance specific perspective the implementation of Solvency II regulations is going to have a significant impact on Insurers, most likely leading to changes in their portfolios. Changes may include asset allocation switches from equities to fixed income and this in turn may also lead to changes in their investment management line-up. It is likely Insurers will find Solvency II changes complicated and may have to dedicate more resources to controlling the cost and risk of these changes. This is where Transition Management can assist by making implementation of whatever changes an Insurer deems necessary as low cost and risk controlled as possible.

MARK DWYER: Transition Managers make the risk and cost transparent. This is an important 'value-add' that only a specialist Transition Manager can provide. It is clearly important to understand the cost and the risk of any significant portfolio changes before they are executed. The cost is one of the factors to consider when looking at alternative portfolio configuration. Further sources of risk need to be identified so they can be effectively controlled during the transition. Identification of risk during portfolio change and techniques to manage this risk are again specialists skills developed by Transition Managers. Another area of specialist expertise delivered by Transition Managers is portfolio trading. An Insurer will be experienced at building positions in particular securities. A Transition Manager

has specialist portfolio trading systems and expertise, for example a Transition Manager will use portfolio trading algorithms to order security execution in such a way as to optimally manage risk.

Kate Anderson: What do you do to help a client in asset transition?

SAM: Most transition management assignments involve a full outsourcing of a particular change in a client's assets. As such the Transition Manager acts as the overall project manager and makes sure that all involved parties such as investment managers, performance measurers, custodians and the client are fully aware of what they need to do and when. In addition the Transition Manager creates a detailed implementation plan to make sure that costs and risks are minimised. Finally the Transition Manager also provides detailed pre and post event reporting.

A good example of how cost is minimised is the process that a Transition Manager follows for maximising what is called in-kind transfers. It is often the case that the legacy portfolio have stocks and bonds that are wanted by the target portfolio. However if these are not identified unnecessary trading will take place. A Transition Manager is well placed to see all of the moving parts during the event to make sure that all of the in-kind transfer possibilities are maximised, hence minimising trading and reducing cost.

MARK: The value of high-quality reporting in the pre and post trade should not be underestimated. The pre-trade reporting provides the cost and risk transparency discussed earlier. The post trade provides the results of the transition and a estimation of the cost of each component of the transition.



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Kate Anderson: Specifically how do you manage risk during transitions?

SAM: There are two main risks during a transition: operational risk and investment risk. Operational risk is a broad category and covers a lot of areas such as miscommunication, settlement issues etc. I believe the best way to manage this risk, which can turn out to be very costly if not managed well, is proper project management. By having a central party coordinate all the necessary activities, operational issues can be minimised.

From an investment risk perspective the Transition Manager first aims to ensure unwanted risk is not introduced during the implementation period. For example if the legacy portfolio is made up of UK equities and the target portfolio is also made up of UK equities at no point during the implementation period should the client be exposed to anything else but UK equities. However unless carefully planned, unwanted cash exposure can easily be introduced, and depending on market movements, can create a negative drag on client performance. It should be noted that futures (and other such instruments) can be useful tools for managing exposure.

In addition there are techniques that we use that minimise risk as soon as possible. Ideally you trade everything immediately as that would get you into the target portfolio right away. That is not always possible however and as such we want to target the most risky securities first. When we refer to a risky stock, or security, we are looking at how the legacy and target perform relative to each other. A common metric for this is the tracking error between the two portfolios. We can determine, at a stock level, what stocks contribute most to the

overall tracking error. Within the overall implementation plan we then aim to trade these stocks as soon as possible to minimise the risk, or difference, between the legacy and target portfolio. With the risk reduced we can then trade the majority of the portfolio in a patient manner to make sure market spread and market impact is minimised.

MARK: As Sam notes, the transition manager will identify the securities with the highest marginal contribution to risk and trade these first. However, let us take a step back and look not at the relative portfolio risk during the transition, but the asset allocation risk. In any portfolio the most significant contribution to investment return is the asset allocation. Given this, in a transition process involving a change in the asset allocation, the largest risk will probably be the asset re-allocation performance divergence risk. For an insurance company that is likely to arise from reallocations from equity to fixed income, or from a move to reduce duration. This raises the question of when risk should be measured. A Transition Manager would traditionally consider risk to start at the first trading day of the transition. As an insurance company looking to change the allocation however, you may consider risk to start at the point that the decision is made to change the asset re-allocation. Clearly the relative value of the asset classes will be a factor in the decision making process. Given that the relative value of the asset classes is one of the important decision making factors it logically follows that a change in asset class value is a risk.

There is however a solution which is often referred to as Beta Overlay. Using derivatives the asset re-allocation can be made at any time, or indeed 'averaged' over a period of time, to reduce 'key excitation date risk'.

Kate Anderson: What role do you play if an Insurer already manages their assets in-house but wants to rebalance their portfolios?

SAM: Insurers are clearly very capable, however implementing a large complicated transition project, which involves not just a large amount of trading but also project management, may create strains not anticipated by the day-to-day operation.

A Transition Manager is staffed for just these types of projects and is used to trading large lists of securities while managing the overall risk of the event. A Transition Manager also provides anonymity, to help deliver the best possible price. If we trade or do a transition for a client, the market does not, in most cases, know who the client is. They will just see ConvergeX or Mellon Transition Management as the counterparty.

Kate Anderson: Can you help with the transition management of each asset class? Should Insurers only use Transition Managers if they are changing investment managers?

SAM: Yes. A Transition Manager needs to be able to deal with all of the asset classes that a client may want to sell out of, or invest in. In fact I believe this is a strength of transition management in that we can deal with all of this in one place, rather than the client having to go to a number of firms.

It has actually been a long standing misperception of the use of a Transition Manager that they should only be used when an asset manager is hired or fired. In fact we are seeing more and more transitions where managers are not hired and fired but the client wants to make an asset allocation change, or an inter-asset

change, to diversify the allocation mix. This creates a lot of asset movements where we can help to smooth the transition from A to B and lower cost.

Kate Anderson: There is talk suggesting Solvency II will force high levels of trading activity towards shorter-dated fixed income. What can you do to help clients address this?

MARK: Transition Managers can not trade away market volatility. But we have tools and techniques for dealing with it. The bigger problem is all Insurers will be 'facing the same way', so liquidity is likely to be an issue. That's why Insurers should consider starting early. It should also be noted that the fixed income issues market is efficient. Consequently, as Solvency II starts to have an impact on demand for particular securities, the fixed income issuers will specify securities that meet this demand.

SAM: The whole insurance market is likely to move from longer-dated credit to shorter. If all Insurers move at the same time there could be liquidity concerns, in particular on the longer dated bonds, and sellers may need to discount in order to be able to trade. Insurers may want to run scenario analyses to assess how much that discount could be. Solvency II activity should also be planned carefully rather than simply saying 'I need it done

by next Tuesday'. You could run into liquidity and volatility issues if there is volatility in the market that day, and as just mentioned if you move when everybody else is moving that may have an impact on the prices you will achieve in the market. A game plan allows you to assess the mood of the market and work out when to trade.

MARK: Some of this trading risk can however be managed, or 'hedged', using derivatives. The longer-dated the security is, the higher its risk and sensitivity to interest rate movements. But we can manage duration risk by selling longer-dated paper and buying shorter-dated derivatives.

The credit risk, however, is more difficult and expensive to hedge. A Transition Manager can hedge anything providing there is an underlying liquid derivative instrument. It's got to be competitively priced, it has got to be accessible and transparent.

Kate Anderson: What help can a Transition Manager provide to long-term investors with a large team of in-house investment expertise?

SAM: In addition to the aspects already mentioned I wanted to re-emphasise that transitions can be extremely complicated and time consuming

projects with nuances between each event. A transition is also a project that covers many different aspects rather than just trading or just portfolio.

MARK: Transition Managers have done every conceivable shape of transition over 10 years. Yet there are always new issues to consider, whether it's Brazilian taxation or information leakage in some particular market.

Kate Anderson: With increased regulatory pressure for transparency, what reporting does a Transition Manager provide as part of the service?

SAM: I strongly believe reporting is a key benefit of transition management. Before a transition event, a client gets a report which is clear, easy to read, says this is what we think it is going to cost you and here are the risks. We are continually getting better at creating these reports as there is more electronic data than ever to help estimate the costs. The ability of models to assess market impact has also substantially improved.

MARK: We have huge amounts of data – it's one of the advantages of using a Transition Manager. There may not be a simple answer to an Insurer's needs but your Transition Manager can supply the relevant data to help Insurers make the right decisions.

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05/2013



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