European Insurance Investment Survey

Unprecedented Pressure and Change

Society of Actuaries in Ireland, 2 March 2016

Standard Life Investments

Craig Turnbull
Investment Director, Insurance Solutions

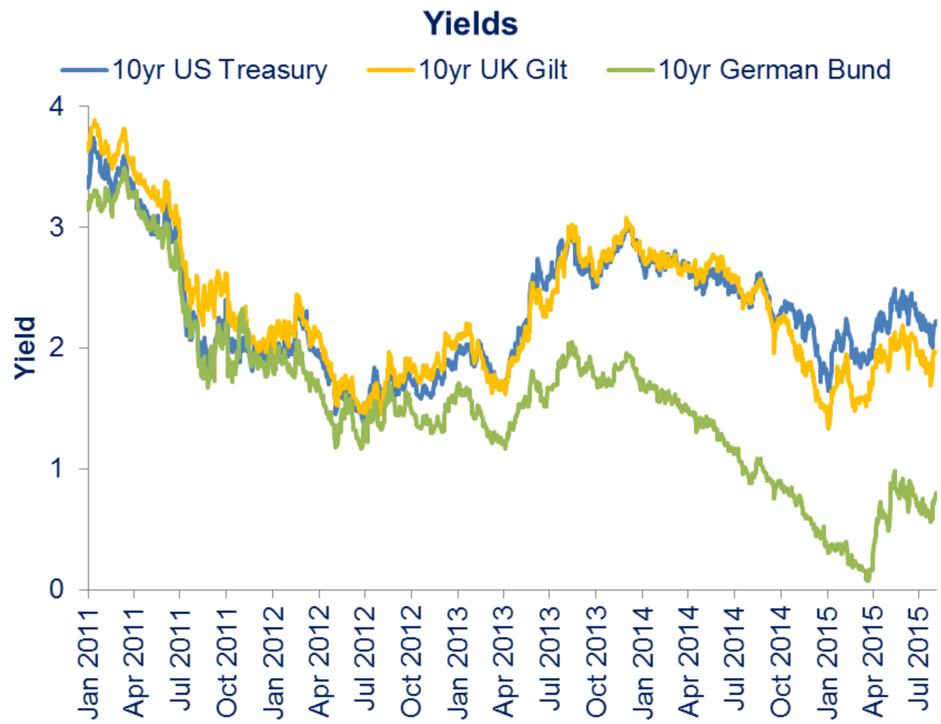
Iain Forrester
Investment Director, Insurance Solutions

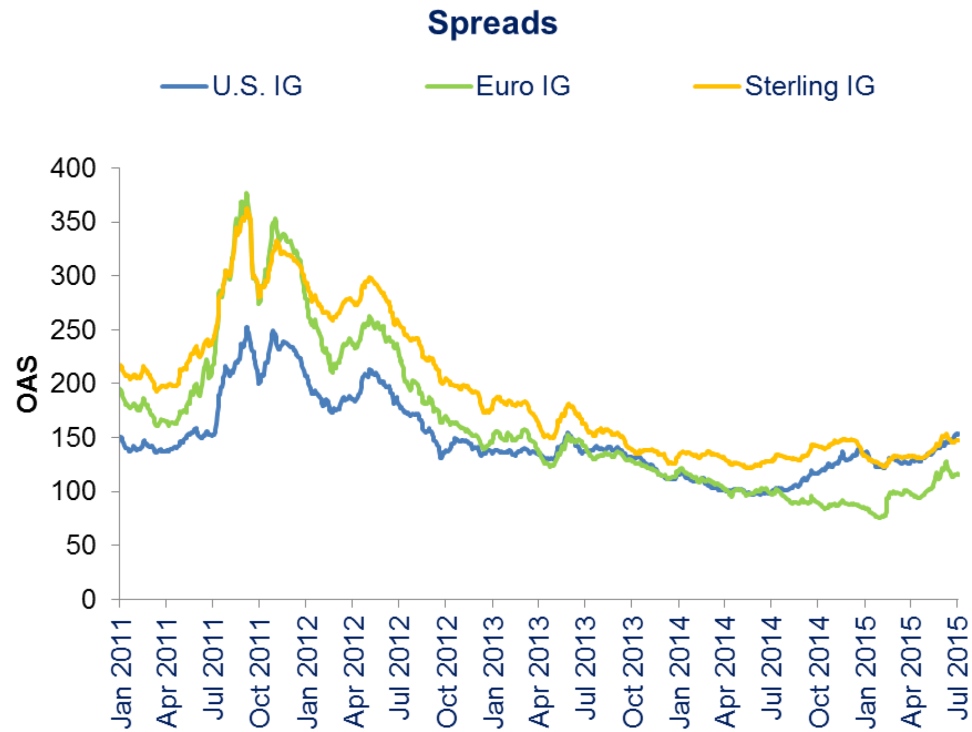
European Insurance Investment Survey

- Investment and Regulatory Context
- Structure and Scope
- Key Themes
- Recent Changes and Future Plans
- Conclusions

Investment and Regulatory Context

Investment Context





Sources: Bloomberg, Barclays Life, Standard Life Investments, February 2016

Regulatory Context – Solvency II

- Risk-based capital regime, with mark-to-market valuation of assets and liabilities.

- Prudent Person Principle

- Capital support provided in respect of long-term liabilities:
  - Volatility Adjustment and Matching Adjustment
  - Yield curve construction (Last Liquid Point, Extrapolation Period, Ultimate Forward Rate)
  - Transitional arrangements for in-force business

- However, this capital support will unwind over time.

- How are European insurers planning on adapting their investment strategies to this environment?

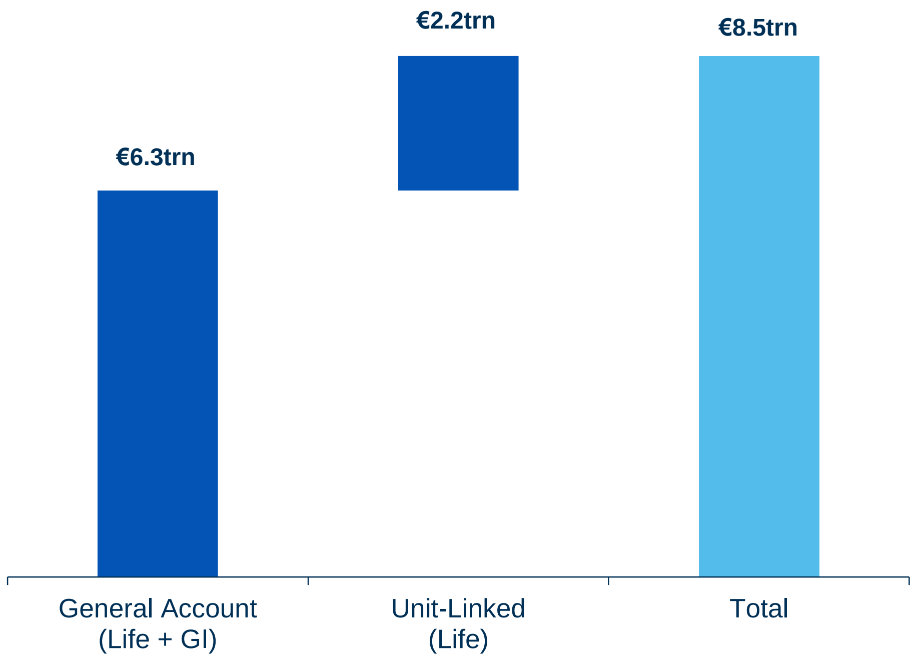
Source: ECB, December 2015

Structure and Scope

Good Coverage by AuM

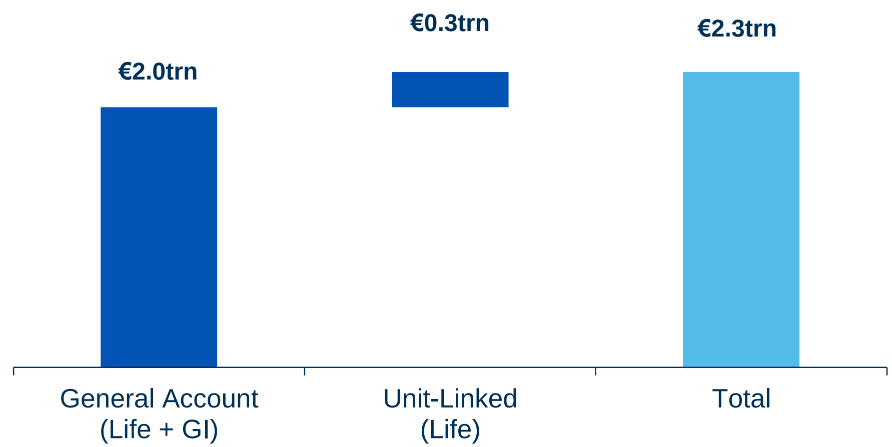
- The study covers:
  - ***27% of all European insurance assets (29% including Standard Life assets)***
  - ***Over 50% of externally managed European insurance assets***

Assets under management – Market



Insurer assets under management – Sample coverage

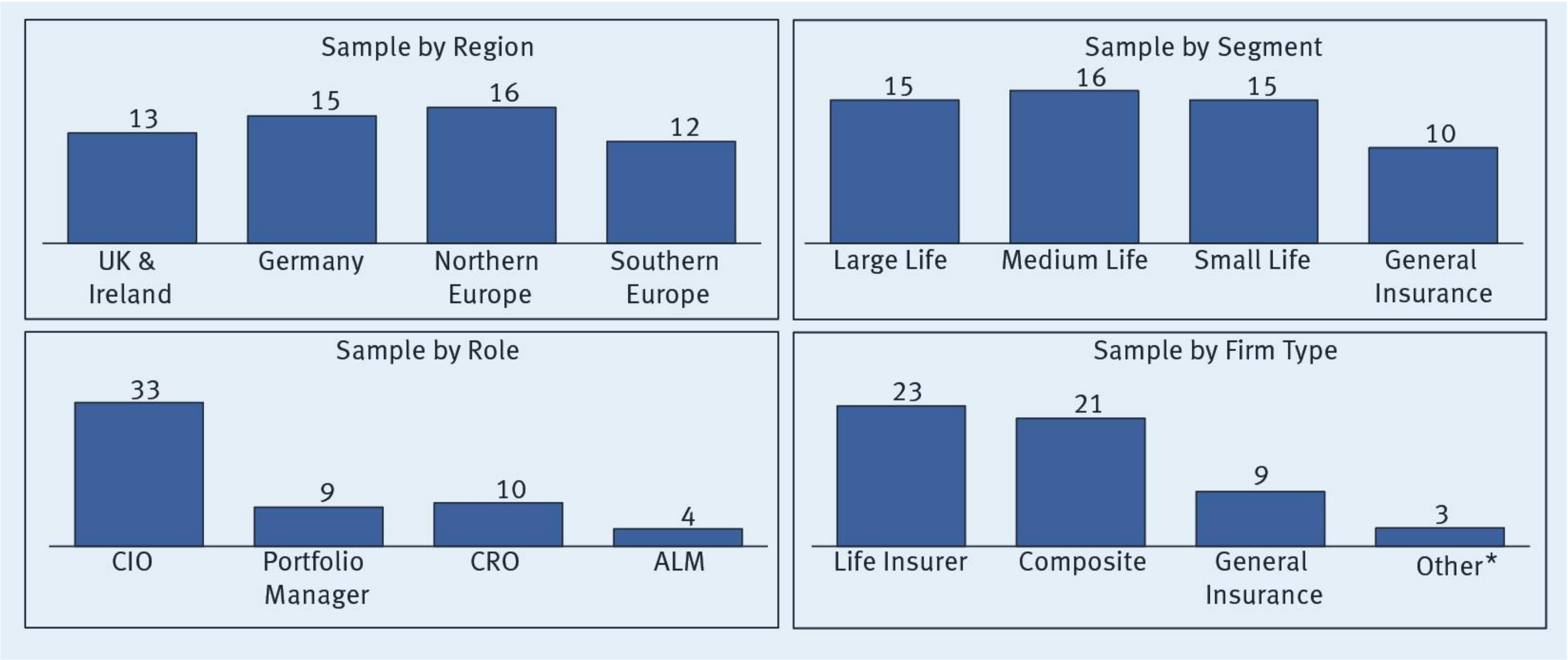
Market coverage		
32%	13%	27%



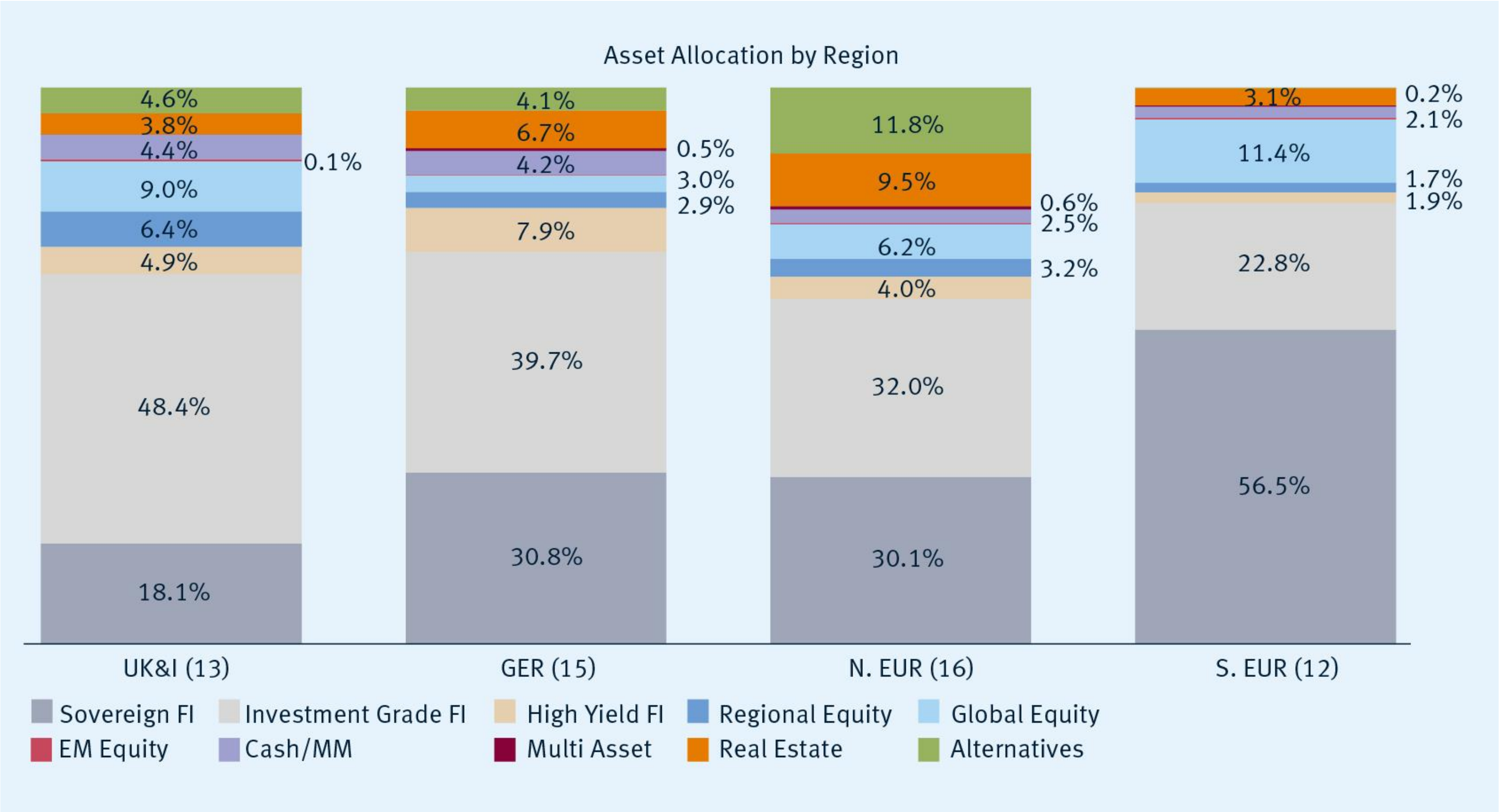
Source: LHS: IAM European Asset Management 2013 (Spence Johnson); RHS: Standard Life Investments European Insurer Study 2015

Good Coverage by Segment

Role of Interviewee, Region, Size and Type of Insurer



Asset Allocation by Region



Key Themes

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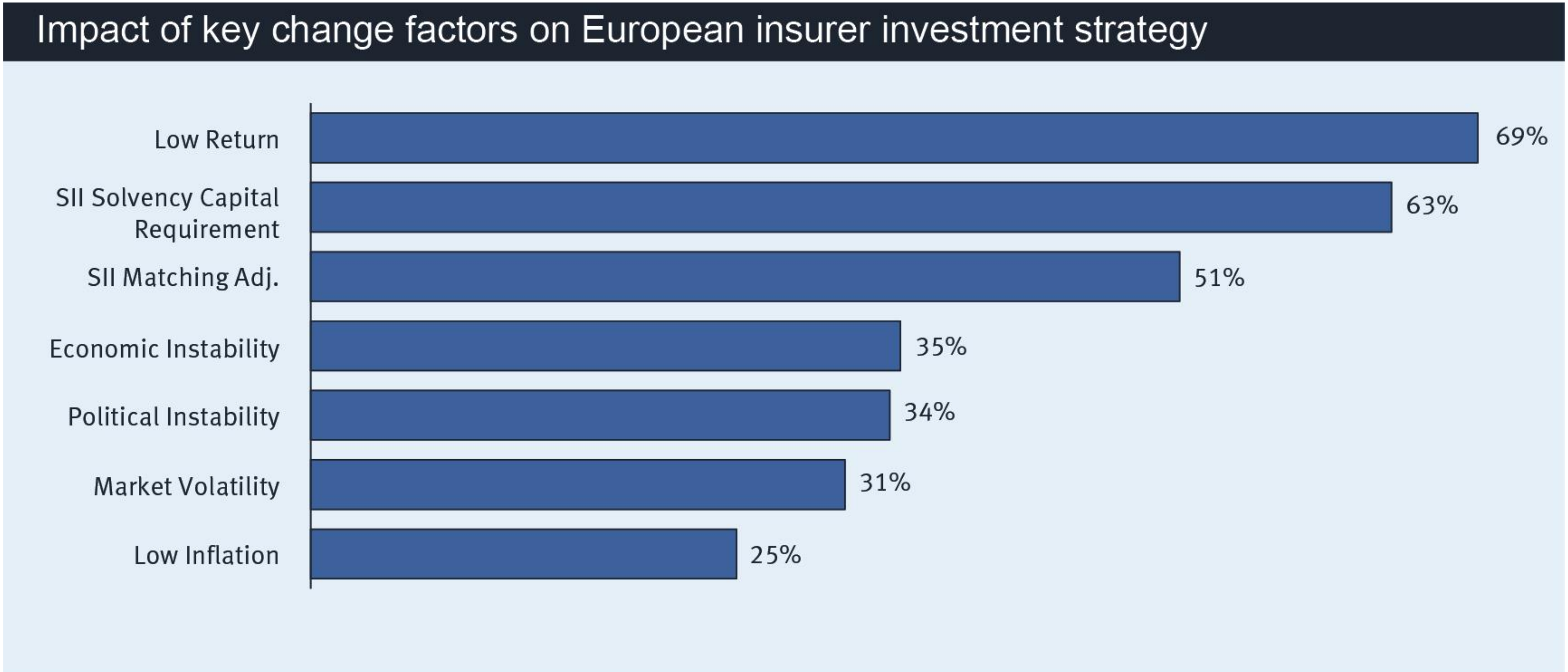
- Low investment returns are challenging the European insurance industry
- Significant SAA activity expected going forward to generate additional returns
- Some insurers feel “constrained” by Solvency II and risk-based regulation
- More outsourcing of assets expected, though complex insurer requirements may limit asset manager choice
- Traditional insurance business models under pressure and significant change expected

Theme 1 – Inability to Generate Sufficient Returns

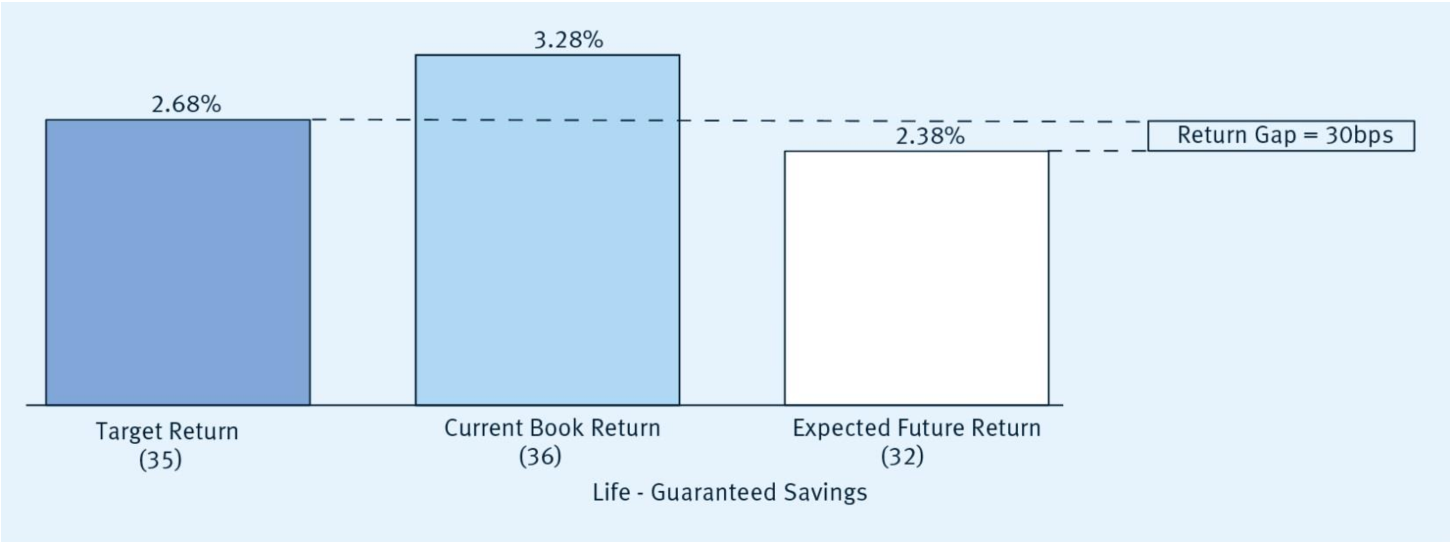
Low Returns the Most Significant Investment Factor



Theme 1 – Inability to Generate Sufficient Returns

Low Returns a Challenge, Especially for Life Insurers

Increasingly, European insurers are no longer able to generate sufficient returns to meet guaranteed rates to policyholders.



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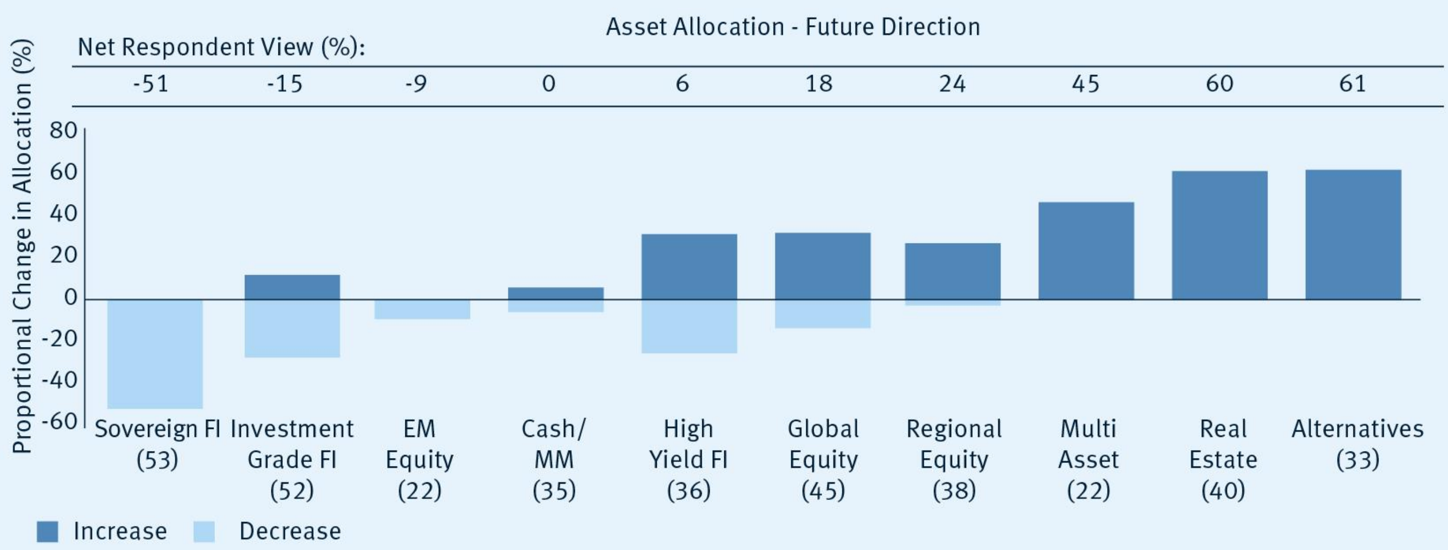
Theme 2 – Focus on Strategic Asset Allocation

Significant Asset Allocation Shifts Expected

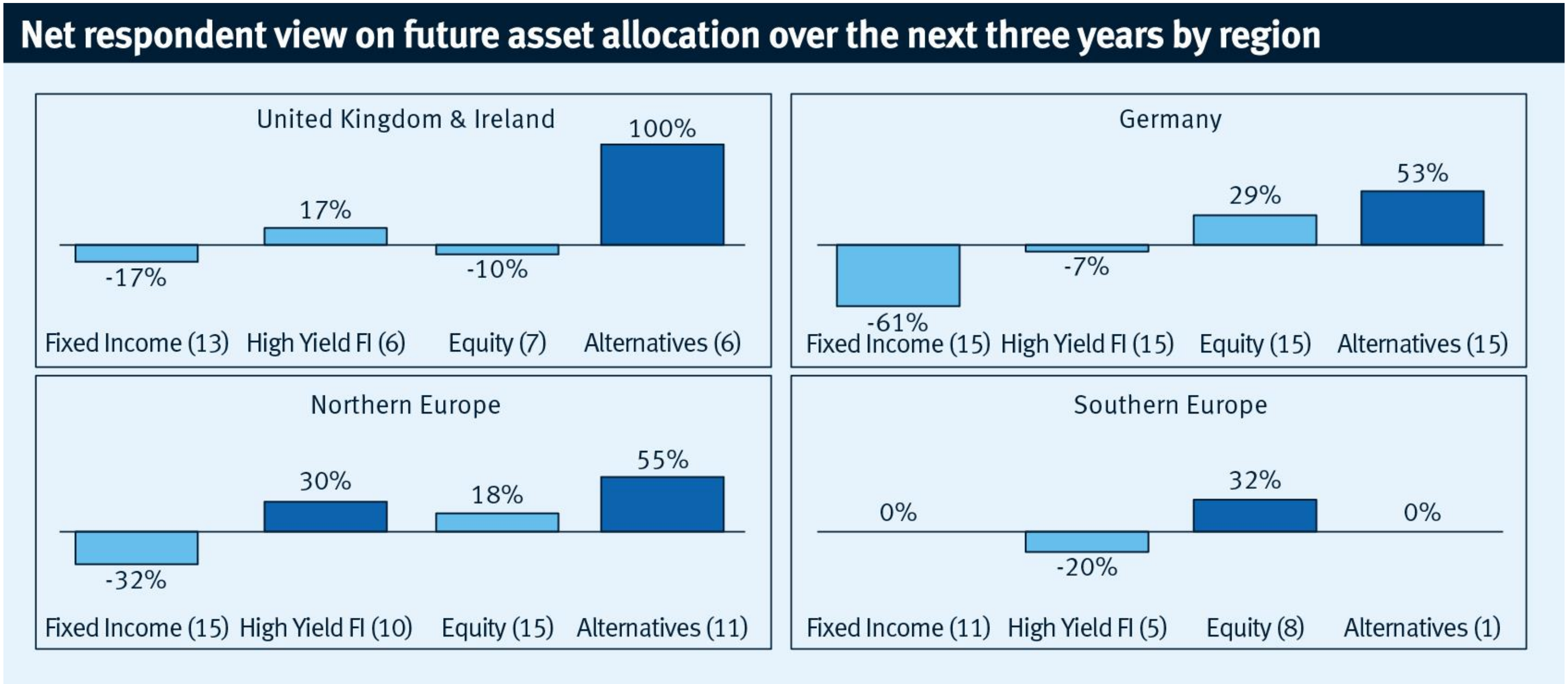
In response, many European insurers are undertaking significant strategic and tactical asset allocation changes, expanding their traditional investment horizons as they seek to maximise returns.

- 50% of insurers are expecting to decrease sovereign fixed income exposure
- 43% expect to increase their investment risk appetite, and
- Over 60% of insurers expect to increase allocations to real estate and/or alternatives.



Alternatives: infrastructure, commercial real estate loans, hedge funds, private equity, commodities

Theme 2 – Focus on Strategic Asset Allocation
With Regional Differences



Theme 2 – Focus on Strategic Asset Allocation

What are Alternatives?

- At a very high level, there are two forms of strategy in the Alternatives bucket:

- Monetise illiquidity premium via investment in illiquid credit
  - Commercial Real Estate Lending, Infrastructure Debt, Debentures, etc.

- Seek risk diversification through investment in liquid assets that are low or zero beta
  - Absolute return strategies, hedge funds, etc.

- Both of these types of strategy receive broadly more favourable capital treatment under SII relative to SI…

- …but may require significant work in order to obtain attractive regulatory treatment
  - And support from asset manager

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Theme 3 – Insurers May Feel Constrained

Seeking to Increase Risk-adjusted Returns

European insurers' investment freedom is constrained by Solvency II. This affects asset allocation as they seek to take on more risk while also trying to optimise capital charges and the diversification benefits of the new regulatory regime.

- 89% confirmed that Solvency II is impacting asset allocation decisions, and
- 73% of insurers explained that Solvency II is limiting design of investment portfolios
- 38% suggest that Solvency II has made it harder to hedge their liabilities.

Diversification versus higher capital charges

Heightened complexity

Delays to SAA changes

Theme 3 – Insurers May Feel Constrained

Seeking to Increase Risk-adjusted Returns

"We are not looking to take on more credit risk to enhance returns because Solvency II punishes us for that. Instead, illiquidity risk premiums will be our focus."

Large UK life insurer

"For the next 18 months we will be focusing on regulatory compliance, then from 18 months to five years we will focus on maximising returns within that regulatory environment."

Medium-sized UK life insurer

"The next step for us is to develop a robust internal model for Solvency II and move away from the standard model."

Large south European life insurer

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Theme 4 – More Outsourcing
Lack of Credible Insurance Asset Managers

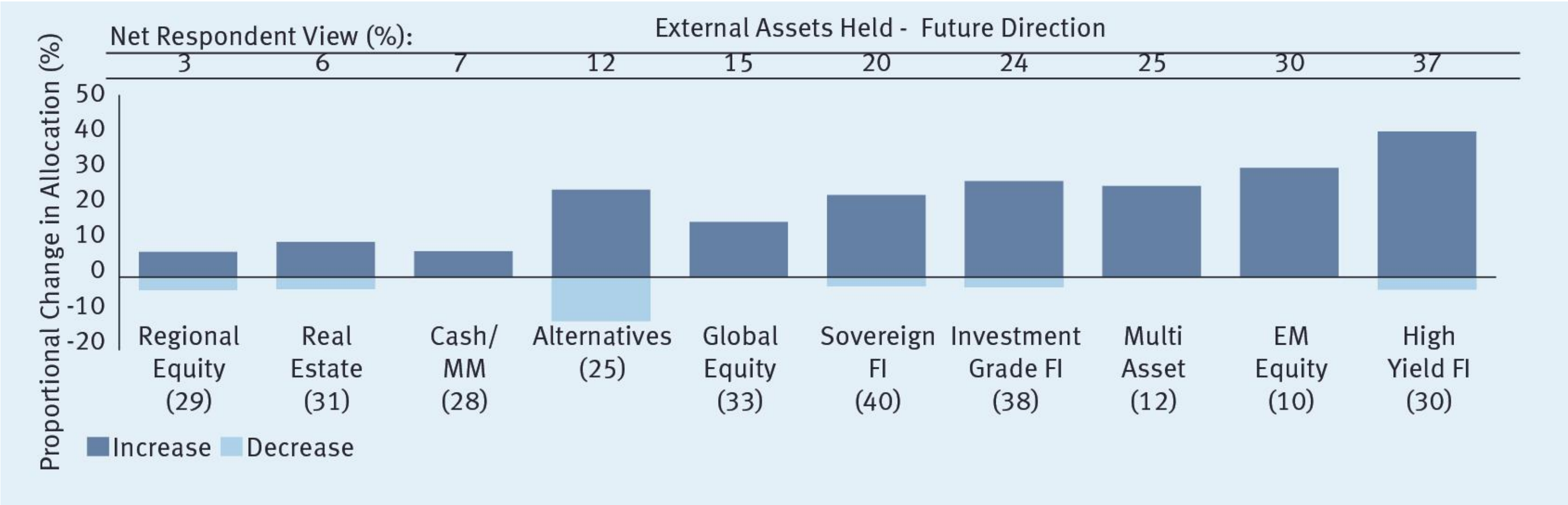
Outsourcing all or part of asset management activity is becoming increasingly attractive, but concerns exist around industry capacity as the number of asset managers able to meet complex insurer requirements is expected to decline.

- 44% of insurers are looking to outsource one or more asset classes
- 45% of European insurers suggest the low-return environment makes it more likely that they will outsource to external asset managers
- 43% of insurers are keen to access hedging services and 39% are keen to access greater SAA from asset managers, and
- 41% of European insurers identify investment reporting as a key area for improvement.

> **"Larger managers tend to have dedicated Solvency II and insurance resources that are value adding and bring a consultative capability. We are looking to partner with these managers."**
> *Large south European life insurer*

Theme 4 – More Outsourcing

Across all Asset Classes and Especially the Specialised Classes



> **"Asset managers will increasingly need specialised skills to work with insurers, understanding how our liabilities and balance sheets work, which plays to larger managers and those owned by insurers. Having said that, there is some internal reluctance to work with asset managers owned by direct competitors."**
>
> ***Large UK life insurer***

Theme 4 – More Outsourcing

Asset Management Services for Insurers under Solvency II

- Asset Data Reporting
  - Pillar 1 look-through and Pillar 3 QRTs
  - Line-by-line
- Capital analytics and capital-efficient investment solution design
- Insurance-specific support in specific asset class areas
  - e.g. Internal credit ratings for unrated assets
- Developing asset capabilities that are demanded by new regulatory constraints
  - e.g. Use of cross-currency swaps for overseas bonds in Matching Adjustment business

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Theme 5 – Business Model Challenges

Traditional Guaranteed Life Insurance Savings May Decline

Broader insurer business strategies and profitability are under pressure from the structural shift away from guaranteed savings to unit-linked structures, creating new challenges.

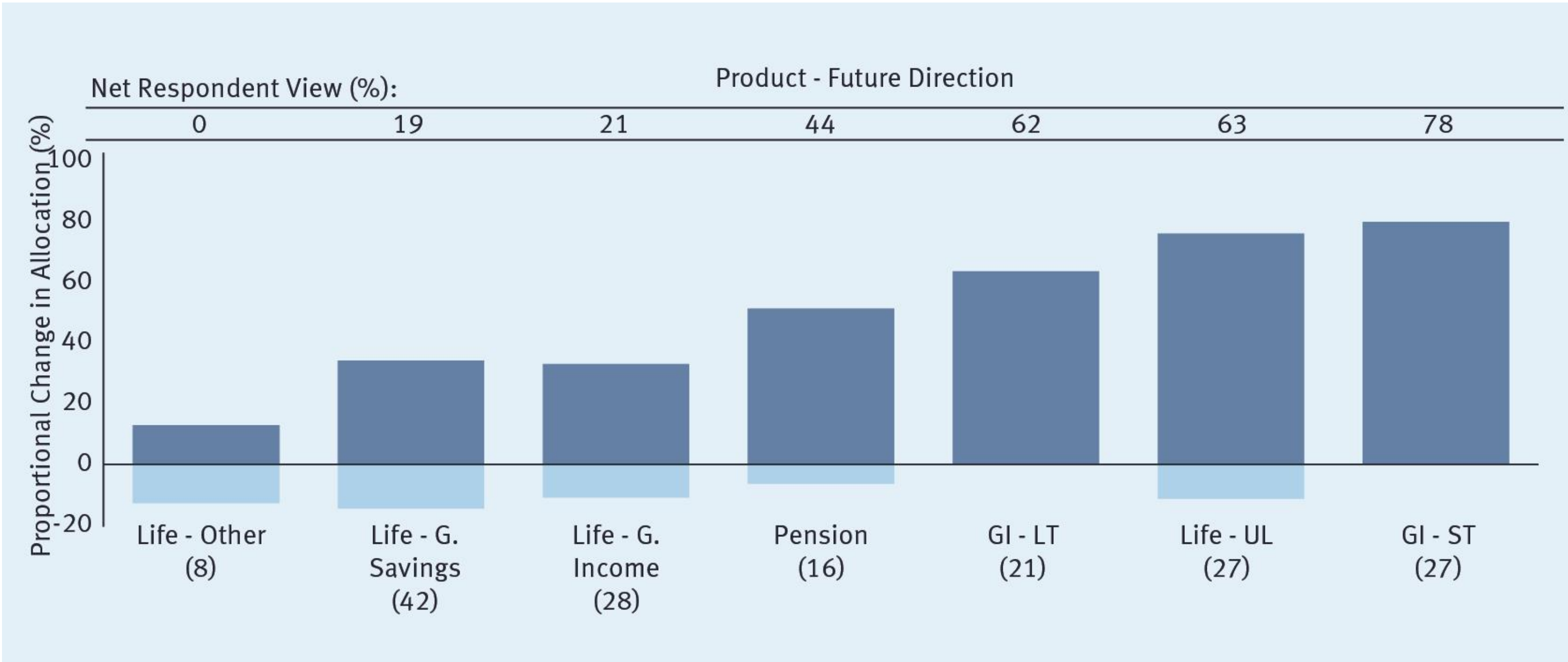
- 43% of insurers explained that they were unable to price new guaranteed investment products at competitive rates.

> **"We are struggling to design attractive new guaranteed savings products due to the low interest rate environment."**
> *Small German life insurer*

> **"We do not develop new products with guarantees - we have a clear strategic focus to diversify from guarantees!"**
> *Medium-sized German life insurer*

Theme 5 – Business Model Challenges

Asset Growth Areas are Unit Linked, Asset Management, General Insurance



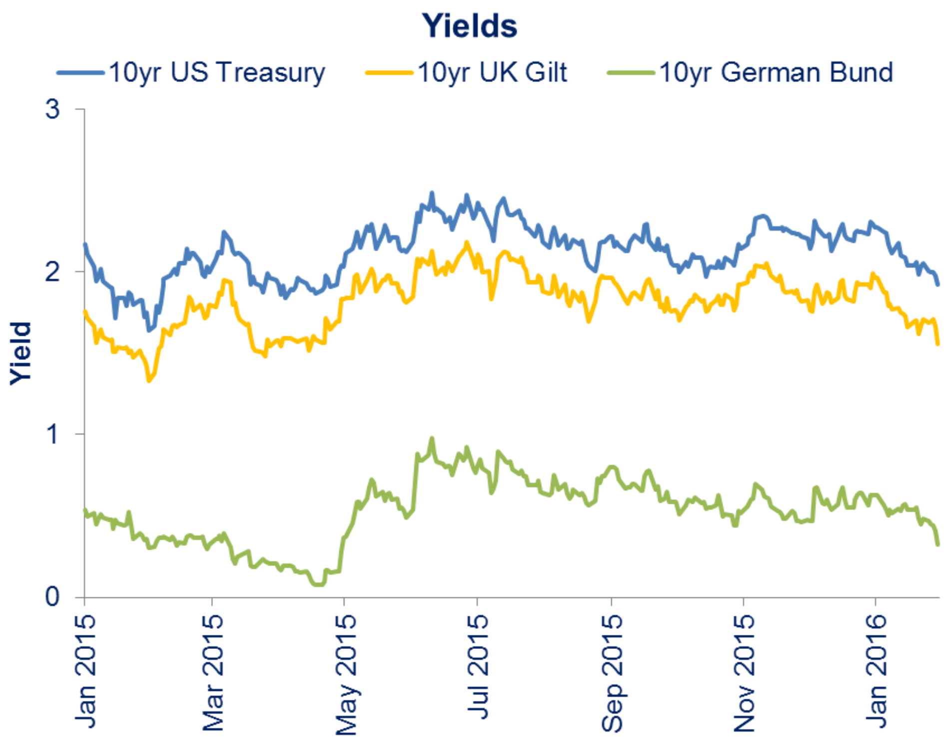
> **"MiFID II is of concern as the life and wealth management industry is still heavily dependent on commission."**
>
> *Large north European life insurer*

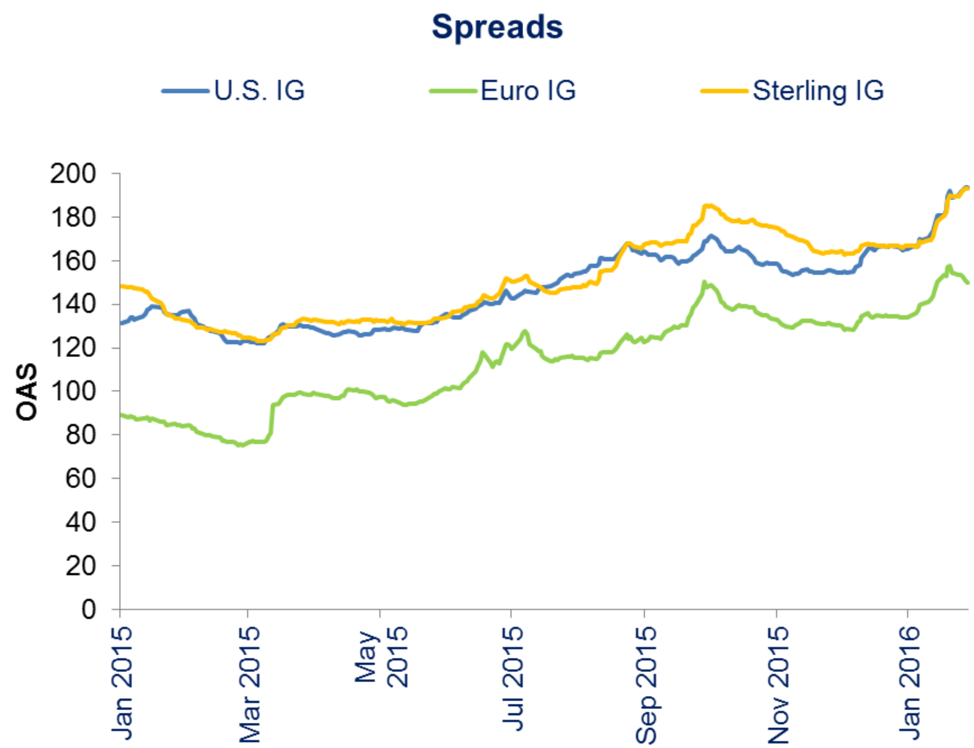
Unit-linked products have their own issues

Risk transfer from insurers to customers may have policy issues

Recent Changes and Future Plans

Investment Markets – Update

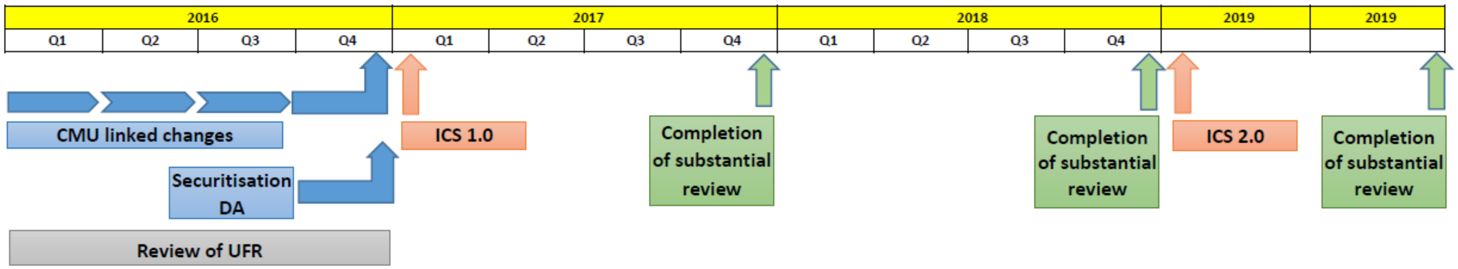




Source: Bloomberg, Barclays Live, Standard Life Investments, February 2016

Future Plans – Solvency II

Solvency II - Post-implementation timeline



Capital Markets Union (CMU) consequences – short-term

The EC has/is preparing a number of legislative changes to SII capital requirements (through Delegated Acts) to encourage long term investment:

- ***Infrastructure asset class*** (DA already published – awaiting EP scrutiny period to finish);
- EC call for evidence – to extend infrastructure asset class to ***corporate assets***;
- ***Securitisation***:
  - High level changes to S2 to allow for future DAs (under EP/Council scrutiny)
  - DA expected to be published by end 2016.

(On going) EC is open to further suggestions to support CMU objectives.

Third country equivalence – ongoing

The EC has published equivalence delegated decisions for: Bermuda (under EP/Council scrutiny), Switzerland (agreed).

Provisional equivalence (group): Australia, Bermuda, Brazil, Canada, Mexico and US (agreed); Japan (under scrutiny).

Temporary equivalence (reinsurance): Japan (under scrutiny).

Further DAs will come forward as new jurisdictions are considered and assessed.

Decisions on provisional equivalence needs renewing every 10 years; temporary available until end of 2020.

Substantial review planned – longer-term

By end of 2017, EC to complete an assessment of:

- ***Application of group supervision***.

By end of 2018 EC to complete an assessment of:

- ***Standard formula for SCR*** (methods, assumptions, standard parameters) – specifically on market risk, non-life premium and reserve risk, mortality risk, operational risk and USPs;
- ***Enhancing group supervision and capital management within a Group***.

By end 2020 the EC to complete an assessment of:

- ***Standard formula for SCR (wider review*** – based on experience of using the standard formula for SCR during the transitional period;

AMENDMENTS TO SOLVENCY II ARE HIGHLY POSSIBLE AT EACH REVIEW STAGE

Other short-term activity

EC open to revising any <u>**harmful**</u> measures that arise following implementation.
By end of 2016:

- Review of ultimate forward rates
- Assessment of the EU financial services regulations impacts on the economy and global competitiveness of European businesses.

External influences on SII reviews

ICS 1.0: Reporting for IAIGs begins in 2017

ICS 2.0: Adoption of ComFrame, incl. ICS (+ replaces BCR) in 2019.

Other potential regular updates/review(s) - no fixed dates:

- Cost of capital rate
- Lists of own funds
- Correlation parameters of the SF

Other regular reviews

Annual until 1 Jan 2021: EIOPA report on application of LTG package (EC then reports to EP and Council in 2021).

Source: Association of British Insurers

Conclusions

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- Low investment returns are challenging the European insurance industry
- Significant SAA activity expected going forward to generate additional returns
- Some insurers feel “constrained” by Solvency II and risk-based regulation
- More outsourcing of assets expected, though complex insurer requirements may limit asset manager choice
- Business model pressures
  - Guaranteed life insurance savings business model looks unsustainable
  - Expected transition to a unit-linked model

Unprecedented pressure and change

http://www.standardlifeinvestments.com/Insurance_Survey_Europe_UK_TCM/getLatest.pdf

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