

Insurance Asset Management

Can insurers shift from pro-cyclical investment behaviour?

July 2023

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Backdrop - Evolving perspectives and approach to asset allocation

Insurers historically relied on stable allocation to fixed-income assets as the core of their investment strategy, mainly in light of asset-liability management techniques and regulatory, accounting, and financial implications. This, though, has led to missed opportunities to profit from market volatilities. While cash flow matching as a standard, well-established approach to insurance asset management remains a key investment process component, the most recent monetary tightening cycle, which began in March 2022, altered conventional wisdom, as dislocations in the fixed-income and equity markets hurt portfolio values. This highlighted the need for a more dynamic portfolio management approach.

This article is the **first of our two-piece research** that touches upon evolving insurance portfolio investment strategies and the need for countercyclical tools in the current macroeconomic environment.

The past decade has compelled insurers to look at fresh perspectives amid ultra-low interest rates, changing macroeconomic conditions, market developments, and insurance regulations. They are making a gradual shift to alternative investments and active portfolio management to bring in efficiencies in capital usage.

Long-term investment challenges continue, given earnings sensitivity to external factors or opaque risks that investors are challenged to underwrite. In this milieu, insurers are seeking avenues to i) reduce the portfolio volatility and (ii) make risk-adjusted returns through diversification.

The significance of value creation has come to the fore amid the emergence of private capital, new technological capabilities, and evolving investor perceptions. Emerging trends here include the use of overlay strategies – strategies that seek to meet or exceed expected returns over a market cycle, while also balancing risks – for efficient portfolio management.

Furthermore, the lines between affiliated and unaffiliated investments are getting blurred with the adoption of balance-sheet-light operating models among several large, publicly traded life insurers, the increasing role of private-equity-backed insurers and reinsurers, and growing emphasis on third-party asset management.

What are Insurance Asset Managers Missing?

Over the years, insurance companies, particularly life insurers, have played the role of long-term institutional investors matching their long-term liabilities with long-duration assets, pursuing a steady investment income stream. While non-life insurers have pivoted towards a different operating strategy that focuses on maintaining substantial liquidity.

The constantly shifting market dynamics have led to a distinctive gap between the top and bottom performers, signifying a large spread, as poorer performers struggle with dynamic asset allocation and investment performance. According to a McKinsey's article published in June 2022, US life insurers with above \$50bn in general account assets had a spread of 135bps¹ over the bottom performers.

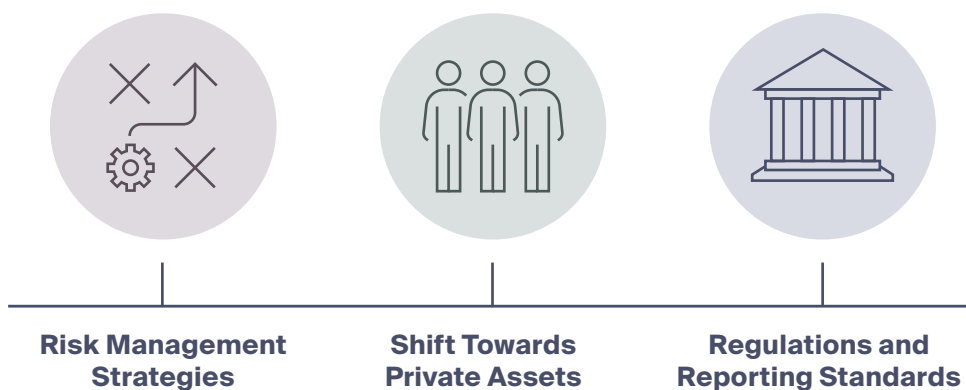
A prolonged low-yield environment in the past decade has forced many asset managers, mainly life insurers, to reconfigure their portfolios and switch focus to higher yielding alternative assets.

Investment flexibility and portfolio diversification strategies are limited by the regulatory requirement of high-risk capital charges being imposed. That said, select asset classes in private markets have

demonstrated resilience across economic cycles and offer downside protection, which prove to be natural hedges.

In the current economic scenario of high inflation and spikes of volatility, insurers need to proactively invest in quality assets while balancing capital availability and monitoring requirements. This requires conscious active portfolio positioning that provides countercyclicality with a blend of private asset class exposure and dynamic management of liquid public assets. Detailed below are the key considerations that will help shape the asset allocation trends in future.

Factors that will shape future asset allocation strategies



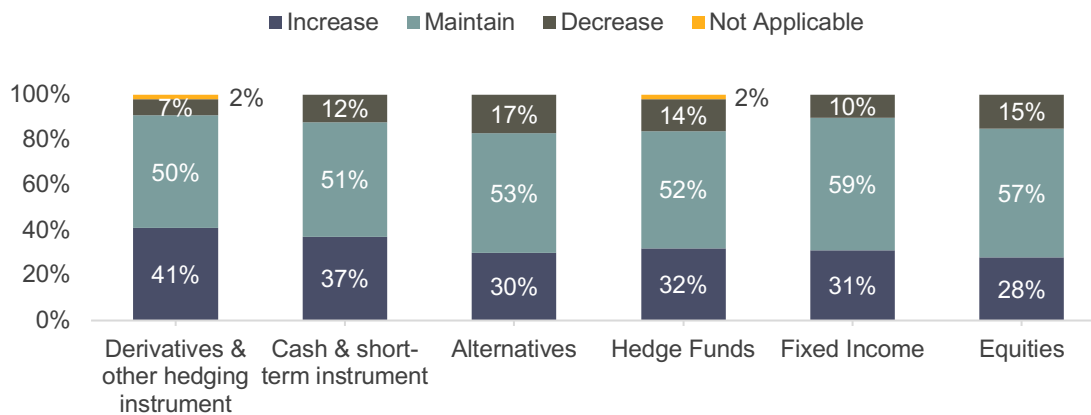
a) Risk management strategies that help optimise the portfolio

A **dynamic risk management strategy** that balances pro- as well as counter cyclical components of a portfolio can prove to be a gamechanger for asset allocators. Capturing mid-term performance across asset classes through the pro-cyclical component and managing mean reversion and portfolio risks through the counter cyclical approach will help create a resilient portfolio to overcome market downturns. Furthermore, overlay strategies that not only limit downside risks, but also allow risk taking would be crucial in enhancing portfolio performance.

b) Interest in illiquid assets continues to grow

The investable asset universe for global insurers has evolved and continues to grow rapidly. There has been a definitive shift in investor preference towards private assets, as they show a growing appetite for liquidity risk over credit risk. Over the past few years, several insurers have opted to trade incremental liquidity for incremental yields and private fund investments. In a 2023 insurance surveyⁱⁱ conducted by Goldman Sachs, insurers identified credit quality deterioration as the primary risk concern. This is a change of sentiment from the previous year, where low yields were cited as the main concern. Concurrently, as per Blackrock Insurance Surveyⁱⁱⁱ, dated July 22, 30% of respondents plan to increase their exposure in alternatives, while 41% plan on increasing derivatives and other hedging instruments in their portfolios.

Expected Asset Allocation Shifts



Source: BlackRock Global Insurance Survey June-July 2022

c) Regulatory changes and accounting rules that affect risk taking

Insurance regulators are paying close attention to the developments in the financial system and macro economy as they continue to refine their oversight of investment activities. A quick overview of the upcoming regulatory changes (region-wise) shows that various regulatory frameworks are undergoing an overhaul, which could potentially reshape investment strategy and asset allocations. Key considerations are:

High solvency capital requirement: Solvency regulations (be it Solvency II or Swiss Solvency Test) intuitively restrict insurance companies from investing in risky assets as the capital charges are high.

Valuation mismatches: Under IFRS 17, the valuation of insurance liabilities, to a large extent, will be based on the current value. However, the valuation will not be identical to the Solvency II valuation, thus presenting a major challenge to listed companies in the coming years. Furthermore, economic mismatches will continue in practice between the asset and liability side; this will reflect in accounting, with resulting volatility in the profit and loss statement. This, in turn, will deter insurers from investing in assets that are highly volatile.

EMEA

- Solvency II: Regulations are under review in both the EU and the UK and are expected to result in a release of capital. It is unlikely to be in effect before 2024.
- With IFRS 9 and 17 accounting standards coming into effect on January 1, 2023, insurers are required to mandatorily implement them (implications covered in detail below). For IFRS 9, the option to categorise certain assets (fixed-income instruments or derivatives) under FVTPL reduces 'accounting mismatch' and in turn, the complexity associated with fair valuation observed in IAS 39. While IFRS17 fosters granular accounting of business performance through its general measurement model and premium allocation approach.

The US

- The National Association of Insurance Commissioners continues to increase its focus on reducing capital arbitrage through structuring or excessive reliance on NRSRO ratings.

APAC

- Most markets are heading towards new or upgraded risk-based capital frameworks, with more consistency towards global standards (i.e., Insurance Capital Standards).
- The new regimes are expected to foster a more integrated approach across the business functions of insurance companies.

IFRS 17 impact:

Liability-driven investment considerations:

IFRS 17 will likely influence the investment strategy of insurance asset managers as they need to align their investment decisions with the cash flow patterns and duration of insurance liabilities.

Impact on asset-liability management:

Insurance asset managers must coordinate closely with actuaries and underwriters to ensure investment strategies align with the liability profiles and expected cash flows of insurance contracts.

Enhanced financial reporting:

IFRS 17 aims to increase transparency and comparability in financial reporting, which can help insurance asset managers better understand the financial positions and performance of investments.

IFRS 9 impact:

Enhanced transparency:

IFRS 9 requires more detailed disclosures on credit risk and impairment, providing higher transparency to stakeholders.

Potential impact on asset valuations:

The measurement of financial assets based on expected credit losses can lead to adjustments in asset valuations, which may impact reported profits and capital positions.

Implications for investment decisions:

Insurance asset managers may need to reassess their risk appetite and credit risk assessment processes to align with the requirements of IFRS 9.

So, what's next factoring the macro and financial market scene?

Insurance asset managers have the opportunity to change their approach in investing, refocusing on risk taking and alpha generation. It's not just about balancing the risk and reward or capitalising on new age investments, but also leveraging overlay or risk management strategies that will help capture profits from market dislocations or protect the portfolio from spikes of volatilities.

There is a conscious effort required towards:

- Active portfolio management that helps create value for shareholders and policy holders alike
- Using derivatives for dynamic positioning, which helps offset market volatility and profit from potential market dislocations
- Strategic diversification that improves performance and maximises growth

Our next article details a three-pronged approach that can serve as a framework for insurance asset managers.

ⁱ <https://www.mckinsey.com/industries/financial-services/our-insights/unbundling-value-how-leading-insurers-identify-competitive-advantage>

ⁱⁱ <https://www.gsam.com/content/gsam/global/en/market-insights/gsam-insights/2023/insurance-asset-management-survey-2023.html>

ⁱⁱⁱ <https://www.blackrock.com/institutions/en-zz/literature/annual-report/2022-global-insurance-report.pdf>