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Investment strategy trends in the UK life insurance sector

Ross Evans and Emily Penn of the Insurance ALM Advisory team at RBS share some of the main observations from their annual review of the UK life sector

Current key themes

One of the key themes from our review of the UK life insurance sector over 2011/2012 was 'Solvency II paralysis'. There was clear evidence that many firms had elected to hold off from making investment decisions due to the uncertain future regulatory treatment under Solvency II.

Roll forward to 2012/2013 and we see very much the opposite story. With delays to the Solvency II timeline and uncertainty over the final form of the rules, management are no longer prepared to sit on their hands and let sound economic investment opportunities pass them by.

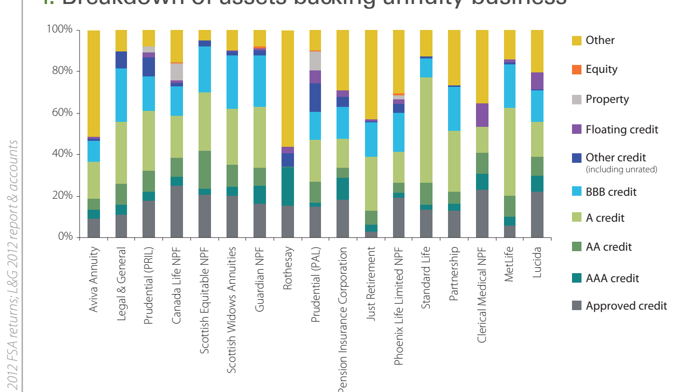
Annuity companies

The majority of this pick-up in investment activity has taken place in the annuity space.

Observations show that the flow of new business has remained strong, particularly from bulk annuity deals and 'enhanced annuity' sales. Assets need to be sourced to back this business.

Asset portfolios backing UK annuity business have always been dominated by long-dated fixed income – an approach driven by the current Solvency I rules in the UK.

1. Breakdown of assets backing annuity business



Note: Approved credit includes government bonds, supranationals, agencies, etc.

Source: 2012 FSA returns; L&G 2012 report & accounts

For a number of firms, we saw a material increase in the proportion of credit-risky assets on the books (relative to approved fixed income) at the end of 2012.

Some of this increase in risk profile was simply a reallocation from government bonds into corporate bonds. For example, this was evident for Scottish Widows, Pension Insurance Corporation (PIC), Phoenix and MetLife.

But perhaps more interesting is the increased volume of 'non-traditional' – or 'other' – assets that were on the books at the end of 2012 (represented by the yellow bars in figure 1).

A key driver for this is the reduced appetite from banks to provide long-dated financing, due to more stringent capital and liquidity requirements. Annuity firms with long-dated, illiquid liabilities are arguably more natural providers of long-term funding – and indeed we are seeing evidence of annuity firms stepping into some of these long-dated debt deals that have traditionally been financed by banks. Figure 2 indicates the range of non-traditional asset classes insurers are investing in and some particular deals of note over the past 18 months include:

- Lloyds syndicated c.£500 million of housing association loans to Scottish Widows
- PIC implemented the first-ever UK publicly listed solar finance bond
- The Bank of Ireland sold a c.€200 million portfolio of infrastructure loans to Aviva Investors
- The Unite Group announced a c.£120 million, 10-year debt facility with Legal & General
- Friends Life awarded a £500 million mandate to Pricoa to provide UK commercial property loans.

2. Annuity firms investing in non-traditional assets

	Social housing	Commercial real estate	PFI/infra-structure	Equity release	Collateral-ised funding
Aviva	■	■	■	■	
Legal & General	■	■	■		
Prudential	■	■			
Canada Life		■			
Scottish Widows	■				■
Rothesay					■
Pension Insurance Commission	■		■		
Just Retirement				■	
Partnership				■	
Friends Life		■	■		

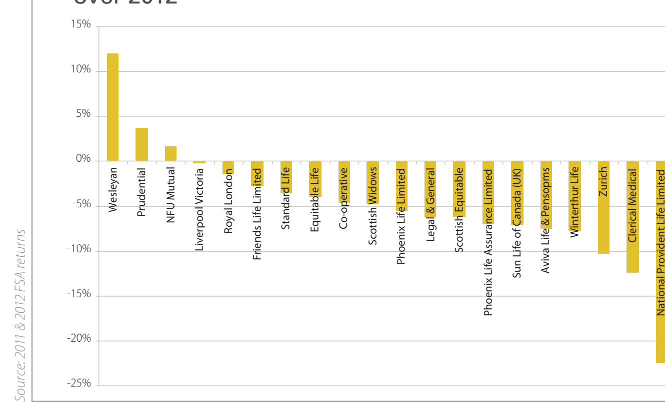
Source: 2012 FSA returns; internet sources

Existing back-book assets, held by banks, are typically short-dated, floating rate and have prepayment risk – features that are not desirable for matching fixed-rate, long-dated annuity liabilities.

Consequently, activity has largely been focused in the primary space. Banks are beginning to adopt more of an originate-and-distribute model, and insurance companies are building up expert teams and/or awarding mandates to specialist managers.

This has been something of a chicken-and-egg story, with the structure of deals needing to develop to accommodate the particular asset/liability management (ALM) needs of insurance companies. However, now that the egg has finally hatched, we expect to see the trend to diversified lending by annuity firms continue to gather pace over the next 24 months.

3. Change in value of assets backing with-profits business over 2012



Source: 2011 & 2012 FSA returns

With-profits funds

With relatively little new with-profits business being written across the UK industry and a steady stream of Part VII transfers taking place, the with-profits landscape continues to contract.

Investment returns were generally strong over 2012. All assets were compellingly bid, driven to a large extent by the loose monetary policy of central banks across the globe. However, even after allowing for positive investment returns of between 7% and 8%, on average, we still saw the total volume of assets backing with-profits business decline by around 6%, as illustrated in figure 3.

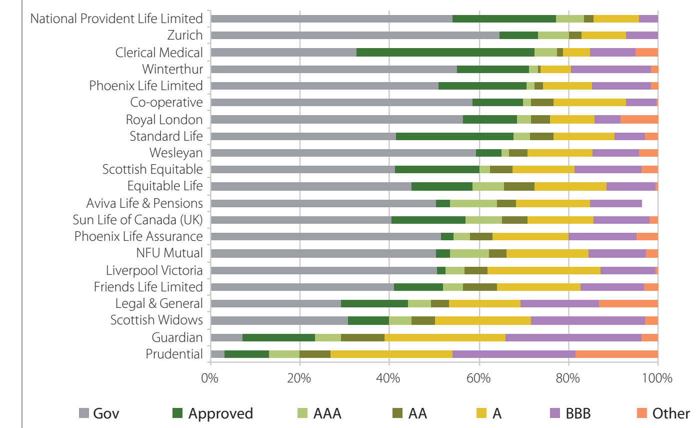
This implies an average run-off rate in the region of 13%–14% per annum, which will bring interesting challenges for with-profits funds in the years ahead. In particular, firms will need to consider possible changes to the asset allocation over time, estate distributions, as well as exploring options for blocks of annuity and other non-profit business held within the funds.

Traditionally, equity-backing ratios (EBRs) have been thought of as the key driver of return for with-profits funds. However, at the end of 2012, the majority of with-profits funds had an EBR between 40% and 60%. This is a relatively tight range, and has changed only slightly over the past few years.

EBRs are no longer the big differentiator between funds. Instead, there are significant variations in the fixed-income strategies, as shown in figure 4.

This variation in strategy is in stark contrast to the annuity space, where the

4. Breakdown of fixed-income portfolios for the main UK with-profits funds



Note: Approved credit includes government bonds, supranationals, agencies, etc.

Source: 2012 FSA returns

vast majority of funds target an A/A- rating for their fixed-income portfolios. This is driven by a number of factors, including available working capital, the nature and volume of guarantees, and also legacy strategies, which have remained unchanged for a number of years.

While we are not seeing the same 'bank deleveraging' theme playing out in the with-profits space, there was plenty of ALM activity over the course of 2012.

We saw modest changes to the composition of fixed-income portfolios, in particular:

- some funds shortening the duration of their credit assets and/or moving into higher credit quality assets to reduce credit risk exposure; and
- some of those funds that are discounting on a swaps basis reviewing their approach to duration management.

We also witnessed a raft of changes to derivatives portfolios over 2012, including:

- 'recouponing' of heavily in-the-money interest rate swap positions;
- rebalancing of guaranteed annuity option hedges; and
- greater use of interest rate swaps to manage duration.

With the Solvency II focus shifting towards Pillars II and III, effective risk management becomes evermore important. We expect to see continued use of derivatives as an efficient means of mitigating risks, managing capital and immunising with-profits funds against volatile financial markets.

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