Standard Life Investments

New frontiers in investment strategies
Combatting the low interest rate environment

Standard Life Investments' Bruce Porteous uses a case study to illustrate the potential benefits of absolute return investing

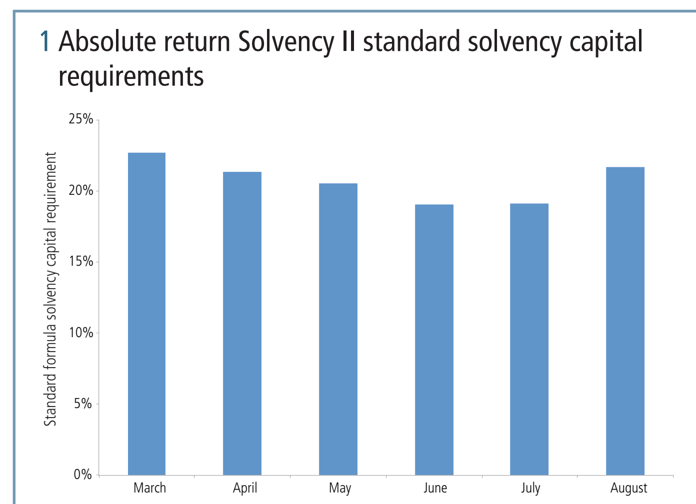
As the current low interest rate environment shows no sign of abating in the foreseeable future, and with the imminent implementation of Solvency II and the prevalence of high investment guarantees offered by continental European life insurers, absolute return asset solutions are increasingly being considered by insurers to help them navigate the very strong headwinds they face. In this short technical article, we illustrate the potential benefit of absolute return investing to Continental European insurers, which we believe to be real and highly relevant. It is a complex topic, and the description provided in this article is, by necessity, high level.

Asset-only Solvency II standard solvency capital requirement calculations

Figure 1 presents an example of one absolute return fund from the Standard Life Investments stable, which has a target return of cash +500 basis points (bp). We have calculated the Solvency II standard solvency capital requirement (SCR) on this fund using a full lookthrough approach and applying the usual Solvency II rules.

For this cash +500bp fund, in terms of expected long-term return, a comparable traditional asset class might be global equities, where the corresponding capital charge would be at least 39%. We can conclude from this graph that this absolute return fund is both highly efficient from a capital perspective under Solvency II and also stable, as illustrated here in figure 1.

1 Absolute return Solvency II standard solvency capital requirements



Continental European insurer absolute return case study

We describe a simple case study that we feel is broadly appropriate for the continental European life insurance market.

Investment and guarantee assumptions

Our high-level investment and policyholder guarantee assumptions, designed to be broadly reflective of European insurance markets, are as follows:

- Allocation of assets backing traditional participating with-profits business.
  - o Ninety per cent in 10-year fixed-income assets, split 50/50 between A rated corporate and sovereign debt.
  - o The remaining 10% of assets is allocated to global equities.
- Duration of the participating in-force liabilities.
  - o Twenty years.
  - o The 10-year duration mismatch between assets and liabilities is deliberate and is designed to reflect the situation in a number of insurance markets around Europe.
- Investment guarantee.
  - o Three per cent per annum, with the guarantee applying at maturity in 20 years' time.
- A single premium contract with assets and policyholder funds equal at the point of valuation, which is policy inception for the purposes of this case study.

Estimated guarantee costs and Solvency II capital charge

Based on our modelling of this very simple continental European life insurer, we estimate that, under Solvency II, the cost of the guarantees provided by our simple insurer is circa 38.1% of the underlying assets at the point of valuation. This is clearly a large sum, especially bearing in mind that this level of guarantee is relatively light in terms of what is currently being offered in many markets around Europe. We estimate the Solvency II standard SCR for this insurer at circa 12.8% of the underlying assets at the point of valuation. So, in total, the investment guarantee costs and Solvency II capital requirements for this very simple insurer amount to circa 50.9% of assets.

Benefits of switching out of equities into absolute return

Although continental European life insurers invest relatively small proportions of their assets in higher-risk/higher-return assets such as equities, the high guarantees embedded in the policy liabilities can still generate high-guarantee costs and Solvency II capital requirements, as we have seen.

We now investigate the potential benefits of switching out of equities into euro-denominated absolute return funds that, historically, have generated equity-like returns, although with less volatility and downside tail risk, as a consequence of the in-built diversification strategies they run.

We have remodelled our simple continental European life insurer, having switched out of its 10% equity holding and into the absolute return fund discussed previously with a target return of cash +500bp. We find:

- There is negligible impact on the estimated Solvency II cost of guarantees. This is because the guarantees are so valuable that their cost to the insurer is almost independent of underlying asset volatility.
- Solvency II capital requirements are estimated to reduce by around 8% compared to the pre-equity switch requirement.
- For a small insurer with, for example. €10 billion of assets of this type of business, this equates to a potential and very precious capital saving of circa €100 million, all of which results from a relatively small asset switch. In fact, the bigger the insurer, the larger the benefit in capital saving.
- Very roughly speaking, therefore, each 1% of total assets switched out of equities into absolute return generates a capital saving of 0.8% and that feels attractive.

Conclusion

This article has touched on the fact that relatively small asset switches out of traditional growth asset classes into absolute return funds can generate very material capital efficiencies.

An even bigger prize we believe awaits, however, from the use of absolute return as an alternative to the traditional fixed-income asset class that still dominates continental European insurers' balance sheets, despite the prospect of low and negative future returns and the Solvency II capital inefficiencies of this asset class.

INSURANCE ENTERPRISE RISK MANAGEMENT ABSOLUTE RETURN Q&A WITH THE AUTHOR

Why is absolute return suitable for insurers?

Bruce Porteous: It is very attractive for a number of reasons. However, perhaps the most important reason is that the in-built, planned diversification between the investment strategies in these funds means the funds are of low volatility and, importantly, have low and controlled downside tail risk, without compromising potential investment returns. Planned diversification between strategies in the tails of the relevant risk distributions helps to manage and control insurers' capital requirements, which are determined in these tails.

Absolute return strategies are numerous and can be quite complicated. Is this a problem for insurers to deal with?

Bruce Porteous: Not really. It is more about being very clear about the investment process and philosophy, as well as staying laser-focused on this as it is implemented. The specific strategies are really just examples of the broader investment approach and philosophy, which we try to ensure is completely transparent to our clients.

Does absolute return require more ongoing monitoring than other classes?

Bruce Porteous: Yes it does. We feel this is appropriate and presents an opportunity for asset managers with state-of-the-art risk and investment processes to evidence their capabilities. Standard Life Investments' absolute return funds are managed using rigorous risk-controlled processes based on a number of backward-looking and forward-looking metrics involving many experienced investment and risk professionals across the business. We feel that this approach is essential to help ensure that our absolute return funds are performing as intended. These processes can actually take many years to develop and mature, and are a key part of asset managers' intellectual capital.

How do you make it easier for time-stretched insurers to do their due diligence on absolute return?

Bruce Porteous: Ultimately, any investment decision by an insurer is important to ensure the best interests of insurers' stakeholders are fully taken into account. By stakeholders, we mean insurers' customers, supervisors and shareholders. Solvency II's prudent person principle also requires this. Our approach is to be completely transparent in explaining our investment philosophy and processes, as well as giving insurers full and open access to our investment and risk personnel. We regard due diligence as an opportunity for us to evidence clearly and concisely the value addition we believe we can add using the mature investment and risk processes that have developed over many years.

How do regulators view absolute return?

Bruce Porteous: This is really a question for regulators themselves, however, based on our experience, they have been keen to open the bonnet to develop an understanding of how these funds work in practice and to satisfy themselves that all is in order. Clients that invest in these funds have had no particular issues as such and, as always, Standard Life Investments is extremely keen to work with and support its regulators in the important role they play in the markets in which we operate.

Do you need an internal model to make the most of absolute return funds?

Bruce Porteous: We do not believe so, as the standard solvency capital requirement (SCR) performance of these funds is so good that the Solvency II risk-adjusted performance of these funds is still very compelling.

However, an internal model approach can be even better, if appropriate for insurers, as it allows some of the in-built prudence in the standard SCR to be reduced. An internal model approach is more economically rational and is more consistent with the absolute return fund investment philosophy used to construct these funds.

Will it be possible to have absolute return recognised as a defined asset class in Solvency II?

Bruce Porteous: We feel this is not really necessary. We provide full line-by-line asset transparency for the assets inside these funds, both for Solvency II Pillar 1 capital calculation purposes, and also for Solvency II Pillar 3 reporting purposes. This is consistent with Solvency II's prudent person principle, and this level of transparency feels completely appropriate. We have seen that insurers may wish to create a new risk appetite category for absolute return, as such funds use strategies across the traditional the risk categories to generate diversification benefits. This can make insurer risk management more straightforward and more aligned with the use of diversification as an explicit risk management tool.

Absolute return seems like an good strategy to deal with the turbulent markets and low interest rates we see today. Will it still be worthwhile if rates rise and markets calm down?

Bruce Porteous: Absolute returns aim to deliver positive returns in all markets, so we feel absolute return should always be worthwhile and relevant. As we know from recent experience, markets are volatile and always will be, especially when you least expect them to be.

What kinds of firms have invested in absolute return strategies?

Bruce Porteous: The whole gamut really – with-profits funds, general insurance firms and the shareholder funds of large insurance groups, as examples. As insurers are learning more about absolute return, and especially in the current low interest rate environment, we see only growing interest and this also feels like a global theme.