

# The ALM Challenge

Regulatory change is driving ALM awareness. Christophe Pochart of Société Générale reports

How do you see the current ALM challenges faced by European life and pensions companies?

ALM issues have been studied by insurance companies and pension funds throughout the past decade. By discovering embedded 'free' options delivered to end customers, institutions attempted to answer their needs by managing the overall risk of the asset allocation.

Two main effects have shown that a traditional approach is no longer satisfactory. On the one hand, asset performance has been very disappointing. The fall of the equity market has rendered diversification benefits, while low interest rates do not allow for a simple match of the liabilities. On the other hand, regulatory changes and accounting standards are putting pressure on companies on the valuation of embedded options, as well as the necessary capital to reserve due to potential shortfalls.

For example, discretionary bonus participation, capacity to surrender at a value different than the one of the asset, minimum guaranteed performance and minimum annuity amounts tend to create some volatility in the balance sheet because of the different behaviour of assets compared with liabilities.

New regulation and accounting norms force companies to focus on a shorter horizon whereas their business is oriented to the long term. In each country, regulatory change is driving ALM awareness: for instance, Dutch and UK pension funds are more advanced in their ALM, as are Swiss insurance companies.



Traditionally, asset management has been viewed as the preserve of fund managers and liability management as a matter for banks. Is this likely to change?

This is true. Companies have worked on strategic asset allocation, defining benchmarks for an individual asset class and outsourcing their management to asset managers under specific mandates. They only began relations with investment banks to benefit from specific hedges after

problems occurred. Options-based products can offer far more solutions to the new asset allocation challenges. In some countries, companies have entered into such investment schemes. Structured asset management can provide totally different risk profiles from the ones you can get from the combination of several asset classes. This simply allows a benefit from equity exposure, with protection against downside risk and sensitivity to interest rate evolution such as liabilities. What is needed are new players at the frontier of banking and asset management: that's what we call 'structured asset management'.

**Managers of life and pensions companies are faced with a dilemma: invest in equities with high risk or bonds with low returns. Is there a structured solution?**

To limit the volatility of the balance sheet, the need for more capital or to meet the requirement of being funded in the short term, insurance companies may look at increasing their exposure to the bond market. But

they must find solutions that provide better performances, to allow for higher bonus participation or to meet the cost of the liabilities. They look for diversification through equity markets of course, but also new classes that generate alpha, such as private equity or emerging markets. But the very objectives of an 'efficient allocation' cannot be summed up by 'maximising returns, minimising risks' while ignoring liability-related risks.

The liabilities of a life insurance company or a pension fund can be described as a combination of zero-coupon bonds and options. A natural hedge to them would be to replicate that split on the asset side, including structured solutions. As liabilities already include embedded options, insurers and pensions are already in the world of 'structured products'.

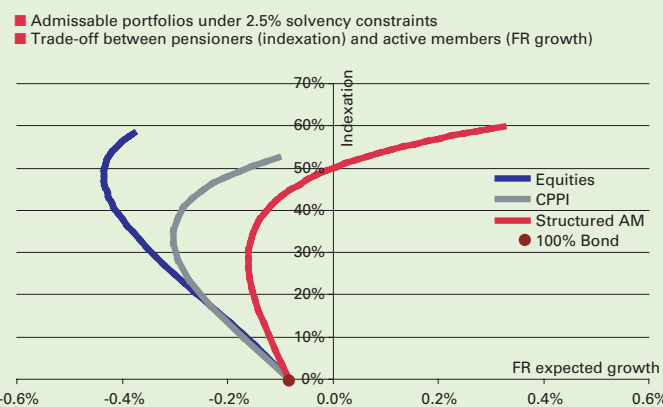
Simple derivatives such as swaps are already viewed as a novelty by managers of life and pensions companies. Aren't structured products too complicated for this sector?

Getting access to a new asset class has never been straightforward. Companies need to understand the scope of the benefits they can take advantage of from new asset types, including the performance/risk level (high-yield bonds, convertible bonds, emerging markets, hedge funds, etc.). As structured solutions are directly driven by liability risks, developing solutions with institutions educates and illustrates their accuracy. A concrete example is that some companies have simply tried to 'delta hedge' their equity portfolio. This is a way to try to replicate an option. It can be more efficient and cost-effective to outsource this management to an investment bank by buying the option. The investment bank has developed its own risk management tools to comply with its regulation. Our approach is to focus on the problem first, not on the solution. Derivatives, and swaps in particular, are hard to grasp. It is important to properly analyse the situation of the client, then build the 'good enough' solution using simple instruments whenever possible. Structured asset management is about making things simpler, not the reverse.

Performance attribution is viewed as essential in the life and pensions industry. Can structured products be broken down into alpha and beta components, and which is the dominant part?

Yes. Structured asset management not only provides protection and diversification to an existing allocation that you can call beta, but it also embeds sensitivity to some market parameters, such as volatility and correlation, which you wouldn't get access to without holding options. These investments can bring some specific alpha. Currently, volatility of equity markets is low. Buying a call option allows the investor to benefit from the positive trend of a market, as well as the increase in volatility that is following a mean-reversal process. Investment banks, such as SG, can provide information and identify trends on the 'implicit'

**Figure1.** Introduction of risky asset to a bond portfolio



parameters, like asset managers do with assets. Thus, the investor can decide whether he or she is interested in being sensitive to this type of alpha. SG calls this approach the 'hidden assets'. Investors have responded to this concept even more positively than we anticipated.

Retail structured products have a reputation for having high fees. Is this the case with institutional structured products, and how do they compare on a cost basis with active management solutions?

Any retail investment bears more charges than institutional ones, whether this is a regular or structured mutual fund. These charges are necessary to remunerate an intermediary. Retail structured products have been successful all over the world, either sold by banks or as life insurance unit-linked policies since 2000. End customers needed and still require some concrete protection or guarantees on their investment, while aiming to benefit from higher-performing underlyings. Fees on institutional solutions are very similar whether they are structured or not. Investment banks are earning money through their capacity to price and manage the risks they face by managing the global book of the positions taken via the selling of any kind of options.

Compared with actively managed funds, structured funds are not so heavily loaded. We have been in the structured product business for about 15 years. If the products did not provide real value added, distributors wouldn't be able to charge such fees.

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What questions should life and pension company managers ask providers of structured solutions?

Building accurate and suitable solutions is more a question of exchanging information, objectives, focuses or constraints. But investment banks need to educate clients on the opportunity to buy protection or exposure at a certain level.