Asset management for insurers
A brave new world

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Introduction

Adapting to change is one of mankind’s greatest skills, and the insurance industry’s limits are being tested by some of the most challenging changes in its history. These include:

- Demographic changes, with people on average living longer and thereby impacting the pension- and healthcare-related insurance products
- Historically low interest rates, creating a double whammy of increasing liabilities and limited income
- A number of new regulations: Dodd-Frank/EMIR, CRD4, AIFMD, IFRS and Solvency II

Solvency II introduces a market-based approach for the valuation of insurers’ assets and liabilities. At the core of the new directive is a risk-weighted assessment of an insurer’s assets and a calculation of its capital requirements. The directive requires insurers to implement process, governance, and information flows for identifying and quantifying their investment risks in a coherent framework, a framework that is embedded in strategic decision-making processes.

As the 1 January 2016 start date for the implementation of Solvency II quickly approaches, European insurers are starting to realize the full impact of this new EU directive on their investment operations, strategies, governance, and reporting practices.

This article illustrates how insurance investment management is affected and where the 4,300 European insurers with combined assets under management of €7,000 billion may need to revisit their current way of working.

Figure 1: Asset management challenges for insurers

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1 Low IR environment, in combination with capital charges and guaranteed rates leads to increased reinvestment risk. For example, Dutch life insurers have average guaranteed rates around 4 percent, which represent 60 percent of the balance sheet, and 10-year moving government bonds rates are at 3 percent and a duration gap of 5 year.

2 EMIR legislation has a significant impact on derivatives’ processing, reporting and costs. A study by Deloitte showed additional annual costs amounting €15.5 billion for OTC derivatives in the European market (see Deloitte’s “OTC derivatives—The new cost of trading”).
Three main areas will be covered:

1. Investment strategies: an integrated approach

The changing regulatory landscape and the current market environment create major challenges for insurers in establishing and managing their investment strategies. While larger European insurance companies are already familiar with market-based assessments of assets and liabilities, medium-sized and smaller insurers may be overwhelmed by the new rules of the game.

As a result, managing insurance assets and overlay requires a dynamic process that follows an integrated approach, which implies a balance sheet perspective with a mix of income, capital, and economic/market objectives. Figure 2 represents this process approach. How this affects asset managers and insurers in practice is illustrated by a real life example of TVM, which has decided to partner with an external asset manager (in this case NN Investment Partners). The same challenges apply to the internal asset management organization of insurers.

Figure 2: Integrated balance sheet management

**ALM strategy execution**

- Translate strategy into specific mandates
- Assign mandates to asset managers
- Monitor execution of mandates (risk, performance, cost) on individual and consolidated level

- Company objectives
- Risk appetite & tolerance
- Regulatory requirements
- Financial markets’ info
- Fiscal regime
- Accounting standards
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**Integrated monitoring & reporting**
- Balance sheet hedges
- Investments
- Capital
- Insurance liabilities
- Cash

**Governance and monitoring**

**ALM strategy setting**
- Define investment & hedging strategy
- Monitor effectiveness & revisit suitability of strategic decisions

**Info to stakeholders**
- Management
- Shareholders
- Distributors
- Analysts
- Rating agencies
- Regulators/supervisory bodies
- Accountants

**Asset & liability modelling**
- Model liabilities, assets and economic capital
- Revisit & adjust input regarding assets, liabilities, actuarial models (algorithms) & assumptions used (e.g. inflation, IR)
2. Governance: cross-function cooperation and clear KPIs

As the overall complexity increases, the organization’s capabilities to properly manage investment and hedging positions are also likely to evolve in a number of areas:

- The CIO, CFO and CRO will need to cooperate more intensively with regard to risk management models and tools, assessment of existing and new investment and hedging strategies, and assessment of new insurance products. The time that the Asset Liability Management (ALM) and Modeling Departments lived separately from the Investment Department is history.

- In-house investment capabilities might not be up to the challenge of actively managing new asset classes (e.g., infrastructure, private placements). In that case, outsourcing solutions must be developed, including oversight, policies, and capabilities to select, monitor, and replace external managers. Using external partners also affects the reporting processes (see next section).

- While revisiting investment strategies, insurers realize that key performance indicators (KPIs) need to evolve, too, as capital considerations are added to traditional, accounting-based, income objectives and mandate-related objectives. There is, however, no one-size-fits-all solution due to (1) company-specific characteristics, such as insurance product portfolio, international reach, objectives, and risk appetite and tolerance, and (2) country-specific demands like regulatory requirements regarding profit-sharing and local GAAP.

- Solvency II also introduces some fundamental principles that require translation into investment strategies, policies, and procedures. The “prudent person” principle, for example, states that asset risks are to be properly identified, measured, monitored, controlled, and reported. In addition, portfolio diversification is needed to avoid risk concentration, and investments should ensure security, quality, liquidity, and profitability of the overall portfolio while pursuing the best interests of policyholders.
As the 1 January 2016 start date for the implementation of Solvency II quickly approaches, European insurers are starting to realize the full impact of this new EU directive on their investment operations, strategies, governance, and reporting practices.

Interestingly, the delay in implementing Solvency II has allowed insurers to get comfortable with models for calculating capital requirements and to introduce some industry standards. However, few insurers have used the time to invest in robust data-quality management, data aggregation, and data analytics. Many still rely on manual processes with few formalized data requirements or automated checks.

The current general lack of a solid reporting infrastructure and governance for insurance asset management is likely to result in structural issues (e.g., errors, lack of confidence, workarounds, and ineffective and inefficient controls). The use of external mandates and funds will only increase these challenges in the areas of data definitions, legal entities, ultimate counterparties, look-through needs, data validation, data normalization, and data vendor costs. On the other side, the insurers and asset managers who are implementing structural data management solutions are well-positioned to meet the ever-increasing information needs of clients, management, and regulators.

3. Reporting: data management and flexibility

As the complexity and costs of the investment activities rise, insurers are beefing up their capabilities for regulatory reporting and decisions-support purposes.

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In this Solvency II world, an integrated balance sheet approach is needed. Liabilities, assets, and capital continuously interact with each other in a way that requires insurers to perform an intricate balancing act.

**Balancing objectives: solvency ratio, income, and economic value**

Solvency II introduces a market-consistent valuation approach to assets and liabilities. The difference between the insurer’s assets and liabilities is the market value-based equity, or the own funds (OF), which must exceed the solvency capital requirement (SCR). This is the capital needed to cover all risks the insurance company faces. The investment-related risks are typically measured on the back of realized market volatilities.

Hence, the solvency ratio (OF/SCR) becomes a crucial indicator for insurers’ financial strength. It is an indicator that will be difficult to manage, as many components of the balance sheet are volatile and interrelated: changing one component may have an impact on other parts and, subsequently, on the solvency ratio. For example, updates of mortality tables would change the value of the liabilities and therefore also the OF, the SCR and subsequently the solvency ratio. If the insurer wants to mitigate the duration impact of the updated mortality table, it has to switch assets, which would again impact the SCR and the future volatility of the balance sheet. Clearly, Solvency II creates the need for a fully integrated balance sheet management approach.

Solvency II adds a layer of complexity for insurers with long-maturity books, a wide variety of products, and guaranteed structures. In Europe many insurers have guaranteed structures in the range from 2.5 percent all the way up to 6 percent. With current market rates, every investment is by definition loss-making unless higher-yielding assets are added to the balance sheet. These are usually more risky and consume more capital. Economic yields and book yields differ quite a bit due to the low market rates, which discourages insurers from massively shifting assets as the related accounting effects are often undesired.

The risk/return profile within a Solvency II context is clearly different from a normal economic risk/return approach. Figure 3 shows the difference. The curve that represents the Solvency II view shows a higher expected risk for higher-yielding assets such as equities, real estate, and hedge funds than under the economic view. For lower-yielding assets like government bonds, the opposite is true.
The many factors influencing the insurance proposition provide for a turbulent environment, not only from an accounting point of view but also on the economic, regulatory, and competitive fronts. Insurers must cope with a constant balancing act between accounting results, economic value, and regulatory capital.

All in all, this calls for new in-house investment capabilities or close cooperation with external service providers who understand the insurance business, Solvency II, and how this ties together with the insurer’s specific situation.
Up your game via a partnership

“Insurers can choose one of two ways to meet the coming challenges,” says Han Rijken, Head of Insurance Investments at NN Investment Partners. “They can develop the necessary expertise in-house, or they can enter a partnership with an experienced investment manager that can assist the insurer with managing the investment life cycle.”

To determine the right asset allocation, the insurance company needs to understand the dynamics of its liabilities. Typically an asset-liability management (ALM) study will be carried out, quantifying the business model of the insurer and determining what rewards are included and what risks may exist.

This is where the asset manager picks up his role by determining the insurer’s strategic asset allocation (SAA). This starts with understanding the sensitivities of the liabilities, investment preferences, and the business model. Close cooperation with management, actuaries and risk managers is essential. Based on the risk appetite and the objectives, the asset manager is able to develop a set of preferred strategic portfolios fitting short-term and longer-term objectives. The quality of the preferred strategic portfolios depends on the sophistication of the strategic process and model. After further fine-tuning with all stakeholders, the final SAA can be set.

A client-specific implementation plan will guide the insurer from the actual portfolio toward the alternative portfolios, as illustrated by the example in Figure 4. In certain cases, this may lead to considerable shifts in asset allocation, the introduction of new asset classes, and the use of new instruments. Before executing the plan, the impact of the changes in terms of operational and financial risks, expected performance, etc. has to be clear and approved by the insurer. In addition, the strategic direction, implementation steps, and objectives must be well defined. Similarly, the insurer has to be clear on the tactical ranges and the modus operandi with regard to portfolio management (i.e. scenarios, trigger levels, governance).

“Such a model can work only if both parties invest sufficient time and energy to build a genuine partnership, to make clear and timely decisions regarding governance, risk appetite, and objectives, and, last but not least, to interact on a continuous basis,” says Rijken. “A true partnership is required.”

Figure 4: Spider web - Actual portfolio versus alternative portfolio (Source: NN Investment Partners)
Profile NN Investment Partners

NN Investment Partners, formerly known as ING Investment Management, is the asset manager of NN Group N.V., a publicly traded corporation and the second-biggest insurer in the Netherlands by assets. Our investment history dates back to 1845 through our strong roots in insurance and banking.

Headquartered in The Hague, The Netherlands, NN Investment Partners manages approximately €203 billion1 (US$218 billion) in assets for institutions (26 percent of AuM), retail investors (28 percent of AuM) and the insurance businesses of NN Group (46 percent of AuM). NN Investment Partners employs over 1,100 staff and is active in 16 countries across Europe, Middle East, Asia, and North America.

For further information see https://www.nnip.com.

1 Figures as of 31 March 2015

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Erwin Houbrechts, Deloitte
Under the new Solvency II regime, insurers will need to determine how much capital has to be reserved to protect the interests of their policyholders. It’s very likely insurers will want to implement even more robust risk management and internal controls. All this will create increased operational pressure and the need for insurers to cooperate closely with an experienced and trusted solutions provider.

“Before 2008, our portfolio had a predominantly discretionary character comprising mainly stocks and bonds,” says Dirk Jan Klein Essink, CFO of transport insurer TVM Verzekeringen. “In anticipation of Solvency II, we decided to move towards integrated balance sheet management. We appointed a consultant to select the best-suited asset manager, and NN Investment Partners was selected as the preferred asset manager based on their experience with managing insurance assets.

We particularly liked their expertise in balance sheet management, their knowledge and understanding of our insurance liabilities, and their investment experience in general and fixed income investments in particular.”

The integrated balance sheet approach requires a different kind of service model. Figure 5 outlines the value chain between TVM Verzekeringen and NN Investment Partners. TVM Verzekeringen gives the required input for risk budgeting based on the overall risk appetite and specific budgets for market risks. This enables NN Investment Partners to construct the investment portfolio based on TVM Verzekeringen’s requirements and NN Investment Partners’ investment views and experience. Customized accounting and reporting requirements are an integral part of the service model.

Figure 5: Value chain
(Source: NN Investment Partners)

Dirk Jan Klein Essink, TVM Verzekeringen

“TVM Verzekeringen is ready for Solvency II”
Lessons learned

The introduction of Solvency II will affect every aspect of how insurers manage their balance sheet, income, and capital.

“Based on our positive experience with integrated balance sheet management, we recommend that insurers seriously consider this model,” says Klein Essink, who passes on the following lessons TVM Verzekeringen has already learned:

• Start implementing; learn along the way
• Talk to insurance companies with similar challenges
• Communicate with internal and external stakeholders
• Dare to make choices

Profile

TVM Verzekeringen, a Dutch insurer with 414 employees, provides insurance solutions for road transport, water transport, and the automotive industry. The company was founded in 1962 as a co-operative of number of carriers; our policyholders are therefore also our shareholders. As a co-op, TVM Verzekeringen has a no-profit principle. Its legal structure enables it to first and foremost look after the interests of policyholders in the industry. For further information see https://www.tvm.nl.

Some key figures:

• Earned premium €199 million
• Technical reserves €353 million
• Investment portfolio €642 million
• Earnings after tax €19 million
• Shareholders’ equity €301 million
• SCR (SI: 850 percent and SII: 250 percent)

To the point

• Insurers currently face the great challenges of an evolving landscape: changing demographics, low interest rates, and new regulatory frameworks are testing the insurance industry’s aptitude for adaptation
• One of these new regulatory frameworks is Solvency II, a directive designed to identify and quantify insurers’ investment risks by valuating their assets and liabilities
• The Solvency Ratio is the ratio between market value-based equity, also known as own funds (OF), and the Solvency Capital Requirements (SCR). The directive dictates that OF exceed the SCR, thus making the Solvency Ratio (OF/SCR) a direct indicator of investment risk and of an insurer’s financial strength
• Managing the Solvency Ratio can be a difficult and tricky task, as many components of the balance sheet are volatile and interrelated and calls upon the need for a holistic balance sheet management approach to effectively integrate income, capital, economic, and market objectives
• Additional complexities are added on by long-maturity books, a wide variety of products and guaranteed structures as well as by a modified risk/return profile through Solvency II. This stormy environment throws insurers into a continuous balancing act between accounting results, economic value, and regulatory capital—a situation that demands clear governance either through in-house investment capabilities or direct cooperation with external service providers
• All in all, Solvency II demands new strategies for portfolio diversification, requires related KPIs to evolve, and provides the opportunity to revisit reporting standards through data quality management, data aggregation, and data analytics

1 2014 Annual Report