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Insurers increasingly navigate unconventional course

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Scrutiny of investment risk management intensifies as insurers boost alternatives

Alternatives gain a higher profile in a low-interest-rate environment

Though still just a slim slice of insurance company investment portfolios, alternative investments (AI) are steadily accounting for a larger portion of overall investments—and with that, more focus is being placed on insurers' investment management processes
and practices.

Insurers in the United States have doubled their investments in private equity (PE), hedge funds, infrastructure, timber, collateralized loan obligations, and other AI in the past 10 years. But even "a small allocation to alternatives can deliver large diversification benefits to portfolios heavily concentrated in investment grade fixed income."[1]

Insurers' Schedule BA investments 2005–2014 ($B)

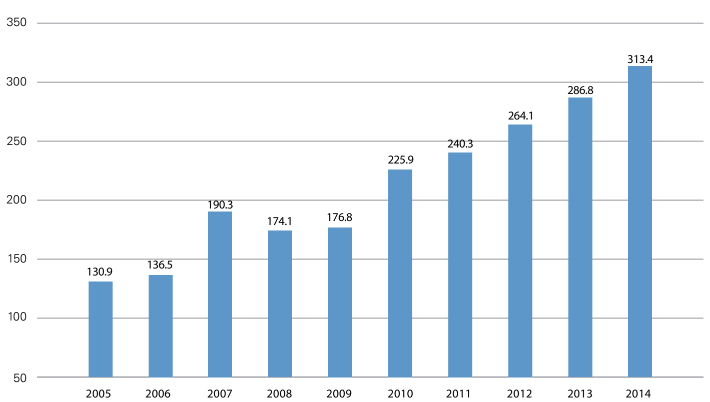


Figure 1: Insurers are increasing their "Schedule BA" assets—investments in so-called nontraditional asset classes—including long-term invested assets, such as PE and hedge funds, surplus notes, and secured and unsecured loans.

Source: National Association of Insurance Commissions (NAIC), "Capital Markets Report," July 2015; Schedule BA definition, A.M. Best, "Schedule BA Investments – Behind Their Rising Trend," July 1, 2014

Though hesitant to immerse themselves in what some in the industry have considered inappropriate investments for many years, insurers' attraction to alternatives in recent years continues to be driven by shrinking returns from investments in traditional fixed-income vehicles in this prolonged period of low interest rates.

In response to a question posed in KPMG LLP's (KPMG) 2015 Insurance Industry Survey to senior insurance industry executives, two-thirds said they would suggest increasing the level of investment in alternatives in the next year.

Given the low yields in bonds, would you suggest that your organization increase its investment in the next 12 months in certain alternatives?

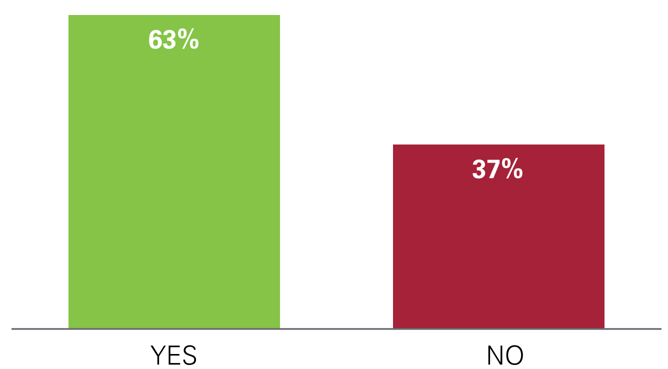


Figure 2: Source: KPMG's 2015 Insurance Industry Survey, August 2015

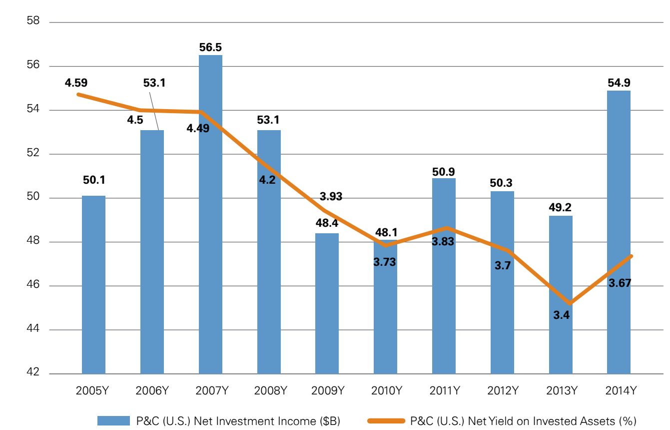
History of 10-year Treasury interest rates

Figure 3: Long considered the go-to investment among insurers, 10-year bonds have been on a steady decline for years. U.S. bonds are yielding about 2.5 percent, with Germany at about 70 basis points, and Japan at roughly 30 basis points.

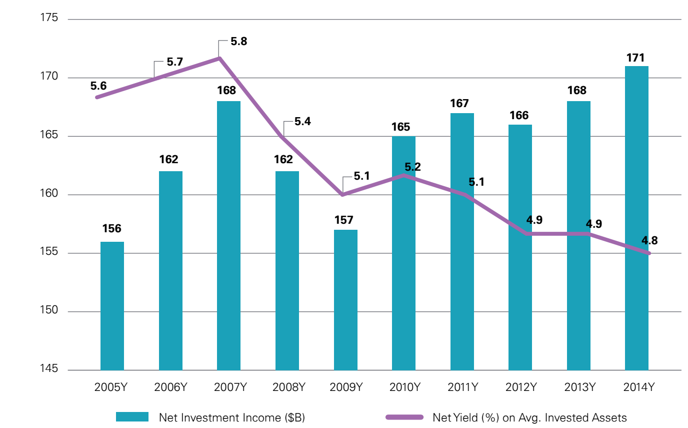
Source: DataStream, Institute of International Finance, "Capital Markets Monitor: A Fundamental 'Asset-Liability Mismatch:' Investing in a Low-Rate Environment"

[1] "*Global Insurance Solutions: Plausible Alternatives,*" J. P. Morgan Asset Management, Investment Insights, December 2014

P&C Net investment income ($B) and yield on invested assets (%) U.S. 2005–2014



Life: Net investment income ($B)/Yield (%)



Figures 4 and 5: Yields have been on a declining track for a number of years, forcing the issue of insurers trying to reach for better yield.

Source: SNL Financial, used with permission, July 2015

Though alternatives have the potential to help insurers manage investment volatility by providing a means for broader investment diversification, insurers nevertheless must enhance their ability to either manage alternatives internally or create a specific risk identification program if they decide to outsource the management of these specialized investment assets.

Illustrated in the chart to the right, respondents to KPMG's 2015 Insurance Industry Survey indicated the portion of their alternative assets that is managed by a third party.

What portion of your nonaffiliated insurance assets have been outsourced to money management firms compared to five years ago?

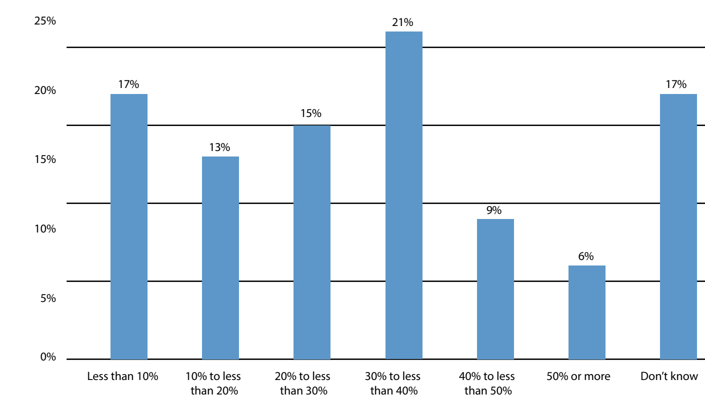


Figure 6: Source: KPMG's 2015 Insurance Industry Survey, August 2015

Questions on the table for discussion

"The proportion of alternatives in overall investment portfolios in the insurance industry is not large, by any measure. But it is important to recognize that the rate of increase we have witnessed these past few years in investments in alternative assets clearly places a special emphasis on the review of investment risk processes. In addition, there needs to be special focus not only on education about the upsides and downsides associated with alternatives, but also on processes to identify issues such as asset and liability matching and balancing value against the growth potential," said Laura Hay, national sector leader of KPMG's Insurance practice.

During the past decade, the run-up has been impressive, especially in private equity.

Selected alternative investments: Insurers ($B)

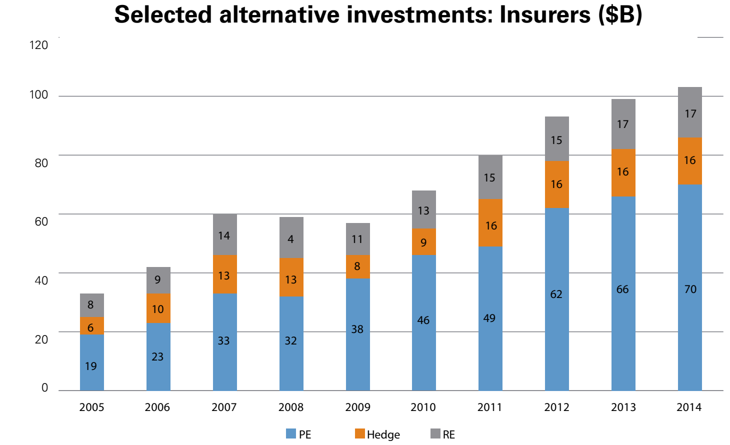


Figure 7: PE remains a strong favorite among insurers when it comes to AI.

Source: National Association of Insurance Commissions, "Capital Markets Report," July 2015[2]

In the chart above, which only indicates investments in PE, hedge funds, and real estate, it is evident that insurers are seeking to address the recent flat returns provided by fixed-income products.

In 2005, Schedule BA alternative investments accounted for 3.1 percent of the combined insurance industry investment portfolio of $4.3 trillion. By the end of 2014, 5.5 percent of the total $5.7 trillion in invested assets were in Schedule BA assets.

Among insurance industry sectors, there has been some difference in adoption of alternative strategies. According to figures published by the National Association of Insurance Commissioners in 2006, allocation to alternatives in the life/annuity sector stood at 2.7 percent of total investments. That figure rose to 4.3 percent by the end of 2014.

Insurers' AI considerations

"When an insurance organization intends to manage alternatives in-house, there would have to be a real sense of comfort that there is a high level of proficiency when it comes to making and managing these types of investments.

"An insurance organization's senior management team, as well as its board, must appreciate that these are instruments that have a totally different profiles than traditional investments, especially when it comes to issues such as liquidity or valuation.

"If the decision is made to go to a third party to manage alternatives, then there also are tough questions that need to be asked about how the insurance business can perform its oversight responsibility of these outside organizations.

"Just a couple of the key questions that need to be answered are: How do you gauge a manager's risk profile and their ability to stay on course with that profile? And, how do you match it with your organization profile?

"These questions may sound straightforward, but there are subtleties that can have a huge negative impact if they are not well thought out. It is an indisputable fact that managers who do this work can vary a great degree when it comes to their level of sophistication.

"It is like saying sailing a small boat on a small lake is exactly like racing a yacht on an ocean. Yes, both involve the techniques such as reading wind direction and managing the tiller, but there are profound differences."

— Jim Suglia
National Secotor Leader,
Alternative Investments, KPMG

[2] "Capital Markets Report," NAIC, July 2015

In property and casualty, the figures were 3 percent and 7.7 percent, respectively.

Such growth comes with more scrutiny: "Hampered by the limited transparency of the [BA] schedule, A.M. Best continues to spend additional time with companies' management, as part of the enterprise risk management review to ensure they understand the additional investment risk they're assuming. With Schedule BA assets steadily increasing, there may be less certainty in determining valuations and credit quality. A.M. Best believes at some point this could lead to insurers underestimating their investment risks."[3]

Perhaps most important in today's discussions about AI direction in the insurance industry is the future pace.

"I'm not so sure we are going to see any real decline in the next few years in the level of the use of alternatives," said Suglia. "That is because I do not believe we are going to see any appreciable boost in yields in traditional fixed-income bonds any time soon." In fact, allocation to bonds across insurer sectors has dipped slightly in the 2012 to 2014 period—from 69.5 percent to 67 percent, the NAIC reported in July 2015.

Further, the yield on Schedule BA assets has been higher than traditional bonds, making them increasingly byattractive to insurers who are under pressure to boost yields to meet asset-liability match requirements and calm nervous investors.

Or, as described in a recent industry report: "Alternative investments seem in many respects to constitute, for lack of a better term, the best alternative for insurance portfolios today. They pursue idiosyncratic alpha in an environment where the outlook for beta in traditional insurance investments seems increasingly problematic."[4]

We agree with that statement, which underscores the notion that capitalizing on the potential positive returns means that there must be both the recognition of alpha's constant evolving nature and the vigilance in due diligence that seeks out managers who have the proven abilities to produce returns.

Goldman Sachs Asset Management's April 2015 survey report on insurance industry investment professionals found that a majority of chief investment officers and chief financial officers expressed bearish sentiment about the investment environment. Consequently, many "are looking to less liquid, private asset classes to bolster returns, and intend to increase allocations to commercial mortgage loans, infrastructure debt, private equity, middle-market loans, and real estate equity."

Source: "Too Much Capital, Too Little Return," GSAM, April 2015

[3] "Schedule BA Investments – Behind their Rising Trend," A.M. Best Special Report, July 2014

[4] "Global Insurance Solutions: Plausible Alternatives," J. P. Morgan Asset Management, Investment Insights, December 2014

Key considerations for insurers considering an increase in alternate investments

In our view, in addition to staying within the regulatory limits set by the NAIC, among the top-of-mind issues for insurers considering any AI strategy is the mandate of liquidity.

Maintaining liquidity can create a particular risk in PE investments, given PE's long duration and illiquid dimensions. From a sector-specific perspective, PE investments may create specific challenges to the P&C sector, which has shorter duration liabilities. However, the PE investment position remains small relative to the overall size of the investment portfolio, PE may also offer diversity and even moderate portfolio volatility.

Conversely, life carriers, which have longer duration liabilities, may view PE's multiyear investment cycle and illiquidity premium a plus in the pursuit of idiosyncratic alpha.

With the issue of liquidity at the top of the list of risk, following are some further considerations we believe are vital as insurers seek better investment returns and higher yield by leveraging the power of alternatives in their overall investment strategies:

- Focus on people and transparency: The most important individuals involved in creating strategies involving investments in alternative products are not only those who actually make the investment product choices. Equally as important are the organization's executives who must insist on creating transparency surrounding the reasons for pursing alternatives. The strategists clarify clear the reasons why decisions are made and speak in a language that is clear and concise.
- There must be clearly articulated reasons why the work will be handled either by in-house talent or why it is necessary to go outside the organization.
- Accountability: The organization should unambiguously define the elements that make up the accountability measures among those who manage the AI portfolio.
- Create a tight chain of command with the responsibility to build and maintain open and consistent communication regarding the investment choices and ongoing decisions that inevitably will change as market conditions change.
- An organization officers and board members must be informed on a regular basis about why certain alternative strategies are being pursued or discontinued.

Final thoughts

While constantly keeping in mind the risky nature of alternatives, insurers nevertheless can benefit from deployment of an alternatives strategy through prudent preparation, execution, and monitoring.

The value of diversification in today's low-interest-rate, low-yield, and low-return environment cannot be understated, especially when contrasted against the concentrated nature of the industry's overall current portfolios. Further, the current circumstances in the industry where capital and surplus levels are high begs for a closer look at the possibilities presented by alternatives.

Still, the downside risk is both real and potentially extremely harmful if rigorous planning, matching with overall strategy, due diligence, and monitor are not carefully considered.

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