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A regular analysis of strategic
issues in the institutional
investment business

Deeper Perspectives

Opportunities in insurance asset management



The search for yield in a low interest rate environment and regulatory pressure are factors driving outsourcing opportunities in insurance asset management

Insurance companies are facing several pressures: low interest rates, the imminent implementation of Solvency II and reduced underwriting margins. As a result they are now having to think more creatively about how to achieve yield from their investments.

This provides an opportunity for asset managers seeking third party mandates. In our latest Insurance Asset Management Market Intelligence annual report we predict that by 2023 European insurance companies will outsource management of 10% of their general account assets to third party unaffiliated managers (currently: 7%).

In this edition of Deeper Perspectives we look at how insurers' need for diversification brings to the fore niche asset classes which in turn means that they need to have access to wider investment skills than their in-house teams can deliver.

We look at how insurers perceive the pros and cons of outsourcing investment functions. We show that entry to this market is difficult because experience of managing insurance company assets is considered essential for asset managers looking to win business.

And we show how other challenges face asset managers: client servicing for insurance assets is demanding.

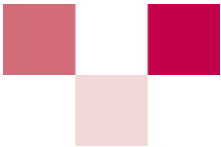


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Spence Johnson provides five research-based services to asset management and insurance companies. Our clients use us to help them identify or retain clients in five key sectors within their institutional investment businesses



Enhancing capital returns a priority for insurers

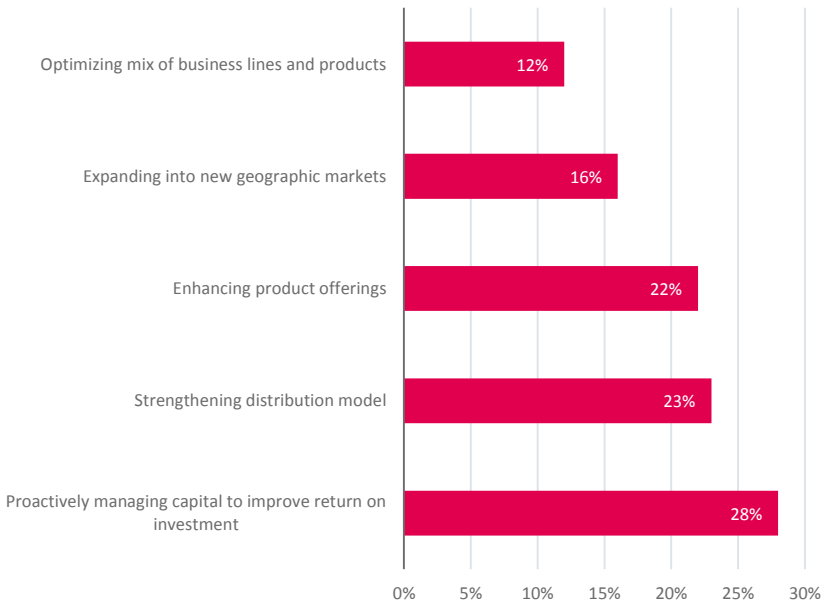
Insurance companies have a number of challenges to face in an environment of relatively slow economic growth, continued low interest rates and regulatory change. A top priority in this environment will be enhancing return on investments.

Insurance companies in Europe are facing a number of challenges in the current environment of relatively slow economic growth and continued low interest rates together with regulatory change. This environment is forcing insurance companies to look for different routes to profitable growth.

This is leading to existing business models, insurer investment strategies, product mix, business processes and operating structures all being challenged.

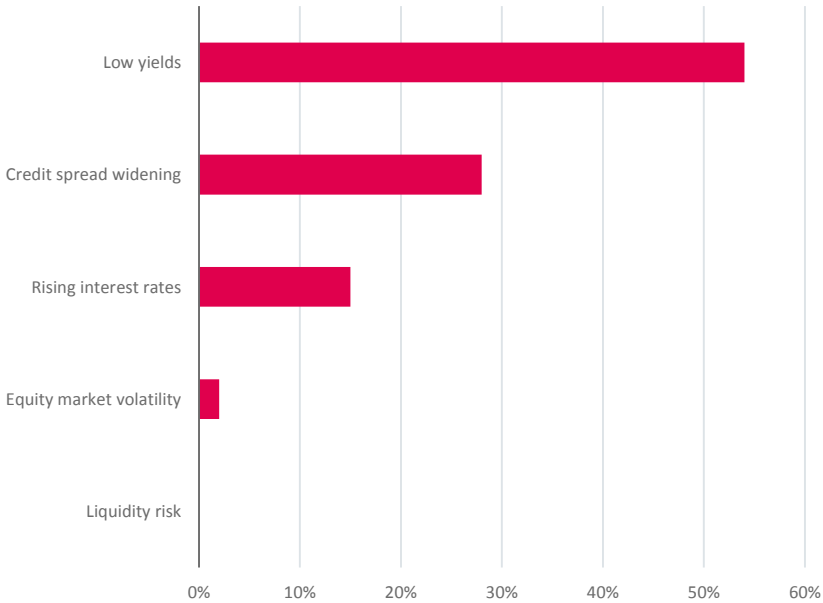
For nearly 30% of insurance companies proactively managing their capital to improve returns on investment is a top priority. This will lead to changes in asset allocation and changes in investment management behaviour. As a result there will be more opportunities for third party asset managers to manage insurance company assets.

Top priorities for European insurance companies
Percentage of respondents



IAM208

Portfolio risk most concerned about
Percentage of respondents



IAM164



We focus here on ‘general account’ assets

An insurance company balance sheet contains a wide variety of assets, and the proportions can be quite different from one insurer to another. Our focus is on those assets contained in what is generally referred to as the ‘general account’.

An insurance company balance sheet contains a wide variety of assets. We focus on assets in what is generally referred to as the ‘general account’, which is coloured in blue in the diagram to the right. The general account contains investments and other assets of an insurance company available to pay claims and benefits to which insureds or policyholders are entitled. The investment strategy in the general account is determined by the insurer and its investment return is a direct source of profit for the insurer.

It is sometimes said that the general account has two compartments, which identify the source of the assets and the type of policies they relate to. Each may require to some extent separate investment strategies:

- Non-participating general account assets – these are assets derived from business where the policyholders are not entitled to receive a share of the insurers profits or surplus, but instead are given certain guaranteed benefits. This covers for example term annuities, term insurance and critical illness cover.
- Participating general account assets – these are assets derived from contracts where policyholders receive in addition to any guaranteed benefit, a supplementary benefit based on factors such as investment performance. This covers for example what are sometimes called ‘with-profits’ policies.

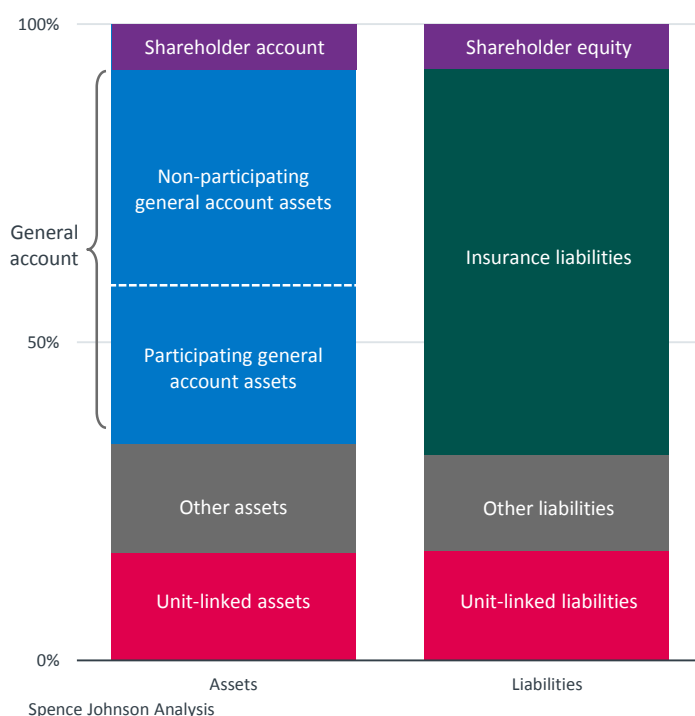
A third compartment within insurers balance sheets is the shareholder account – this portion of the assets matches the shareholder equity, and is managed very conservatively. In much analysis of insurance assets, the shareholder account is combined into the general account. We have used this wider definition of general account assets at several points in this report.

The fourth compartment for the investment assets of an insurance company is shown in red on the chart to the right: the unit-linked investments. These are assets in products where the policyholder bears the risk and benefits from the yield. Investments in this category are made for the benefit of policy holders and are selected as part of the product choice of the policy holder. Although the unit-linked assets are generating returns which belong to the policyholder, these assets will still be shown on an insurers balance sheet.

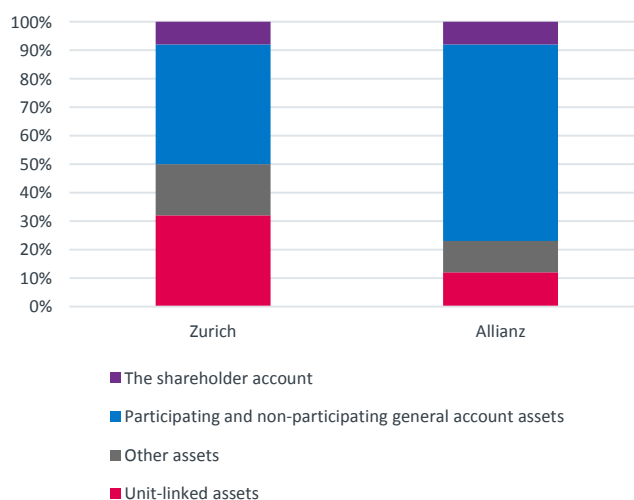
Insurers vary widely as to the proportions of these various elements in their balance sheets. We have shown at the bottom two examples from 2013.

A typical insurance company’s balance sheet

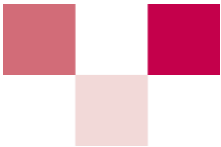
Proportions of assets and liabilities of a typical European insurer



Examples of balance sheet structures: Assets 2013



SNL, Spence Johnson Analysis



Outsourcing – the considerations

The benefits and challenges for insurers largely impact the topics of yield, cash flow and risk.

Pros and cons of outsourcing investment functions
A summary of the positives and negatives of outsourcing

Pros	Cons
Access specialist knowledge	Lose control over investments
Leverage larger research capabilities	Lose pricing knowledge for own product management
Eliminate in-house bias	Fear irreversibility of decision
Access new asset classes efficiently	Fear of dependency upon third party
Benefit from competitive bidding among asset managers	Fear loss of interest and attention by the third party after transaction is concluded
Move from fixed to variable cost base	Time taken to outsource sizable and complex portfolios
Reduce cost	
Benefit from world class technology with maintenance as the partner’s responsibility	
More focus on core business activities	

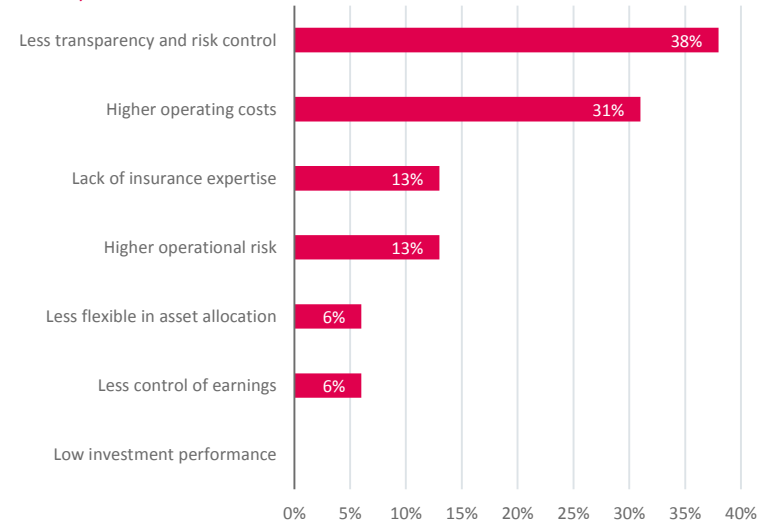
IAM104

While there are many reasons for insurers to outsource, there are key barriers which need to be tackled. Insurers consider the lesser transparency and risk control to be the greatest of these barriers with 38% highlighting it as a concern. Following this is the higher operating costs associated with finding, selecting and operating with an outsourced provider with 32% listing this as an barrier.

'Investment management outsourcing initiatives can have a negative return on investment during the transition phase because two platforms may be running for a short period of time (legacy and outsourced).'

IAM176, PWC

Insurers key barriers to outsourcing
Insurers concerns in outsourcing investment management (multiple responses allowed)



IAM208



Satellite asset classes likely to be outsourced

As insurers continue to diversify in order to meet regulatory pressures and search for yield, allocations to more esoteric asset classes will increase. These are more likely to be outsourced as internal teams and affiliated managers do not have the required capabilities.

Increased diversification of general account assets by insurance companies as they strive to meet both the regulatory pressures of Solvency II and the need for investment returns means that more esoteric asset classes will become part of their portfolios in the next ten years. Just as defined benefit pension funds have had to diversify to meet their funding gaps, insurance companies are having to diversify to counteract the low yield environment which is forecast to continue in the medium- to long-term.

This diversification is likely to be one of the main sources for assets for third party asset managers seeking insurance company assets to manage.

Assets will come direct from insurance companies and from the affiliated managers of insurance companies. Neither the insurance companies or their affiliates will have the capabilities in-house to manage some of these satellite asset classes.

It is likely that alongside diversification into more esoteric asset classes there will be a move to lower margin investments within the core asset classes, such as passive, quant and beta products.

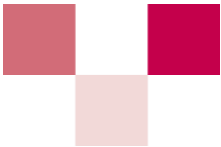
Asset classes insurers expect to outsource in the future
Percentage of respondents



IAM101

'We're seeing demand across lots of asset classes. There is both increasing movement towards lower cost investments, so increasing amounts are going to passive, quant and smart beta for instance, and interest in infrastructure debt and loans and real estate debt.'

Affiliate asset manager
Spence Johnson interview non-disclosed respondent



Experience managing insurance assets essential

Experience of managing insurance company assets is essential for asset managers looking to win business. Alongside fees, track record and well defined investment processes, insurance specific investment management and reporting capabilities are critical.

Historically asset managers and insurance companies have spoken a different language. Investment managers have traditionally managed assets to a benchmark but insurance companies are more concerned about their risk capital than performance against a benchmark. As such investment managers need to show that they have the specific investment management capabilities to meet an insurance company’s needs.

In addition to insurance specific investment management capabilities, insurance companies need to demonstrate the ability to meet the stringent reporting requirements to which insurance companies are subject.

“I don't think it is relevant whether you manage money for an internal insurance company or not, it is about whether you manage any money for any insurance companies. If an asset manager is going after the general account of an insurance company, it needs to be able to demonstrate a real focus on insurance asset management. If you do, then you can show that you can speak the same language, produce the right reports, etc..”

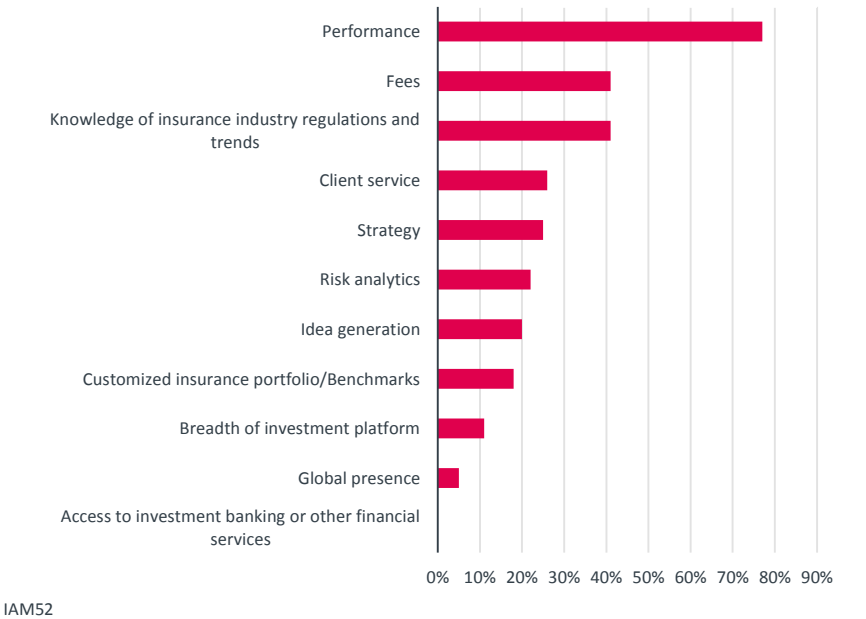
Affiliate asset manager
Spence Johnson interview non-disclosed respondent

“Asset managers need to show insurers they know their business model inside out. Having a team dedicated to the insurance business greatly helps in achieving this kind of credibility in front of the client.”

David Walker
Associate Director, Cerulli Associates

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The most important factors to consider when selecting a third party asset manager
% of respondents considering outsourcing





More demanding client servicing from insurers

Insurance clients are looking for a closer working relationship than a typical institutional client. This need stems from the accounting, regulatory and reporting requirements of insurance providers.

Insurance clients are looking for a closer working relationship than a typical institutional client. This need stems from the accounting, regulatory and reporting requirements of insurance providers.

The complicated nature of liabilities, cash flows, investment approach, regulatory restrictions and reporting requirements means that insurance companies demand a great deal of any asset managers they use, whether affiliated or third party.

In particular asset managers need to be very aware of the need for look through to the underlying investments and the need for timely reporting.

'We're an insurance business and there are complications, particularly around liabilities and cash flows related to liabilities. So, we needed to find a partner who can understand that side of our business so they can match an asset strategy to that.'

Composite insurer
Spence Johnson interview non-disclosed respondent

'Insurance companies are much higher maintenance than pension funds. They can be quite complex in their investment approach as well as having to cope with numerous accounting restrictions, regulatory constraints and reporting requirements.'

Affiliate asset manager
Spence Johnson interview non-disclosed respondent

'We are seeing an increase in our clients' need for data transparency. Providing the investment data simply isn't enough. Increasingly, insurers want confirmation of underlying data sources, and want to know what the process is, and whether there is reconciliation and benchmarking of investment data compared with multiple sources.'

Jeff Benevides
Vive President and Client Operations Manager, Wellington Management Company

IAM185

'Our dedicated client operations team is responsible for packaging the investment data and working directly with insurers on the delivery and formatting of the data. We found that early dialogue between the insurer and providers to address investment data needs is helpful.'

Jeff Benevides
Vive President and Client Operations Manager, Wellington Management Company

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Previous editions

Previous editions Available from <http://www.spencejohnson.com/>

March 2015 - Number 26 - Excellent Client Management Provides Tangible Added Value

In this edition Spence Johnson reveals what it is that makes for excellence in client management.

February 2015 - Number 25 - Opportunities across the map

We look at how asset concentration and distribution issues are related in Europe.

December 2014 - Number 24 - The year of the master trust

As with target date funds, master trusts also offer a less intermediate channel than those for more traditional trust or contract-based schemes, especially in the large scheme sector.

November 2014 - Number 23 - European growth opportunities for US asset managers

The European Institutional market is a market going through transformation. As this transformation takes place, we have identified 3 growth opportunities that US managers could take advantage of.

October 2014 - Number 22 - Opportunities in a transformed market

Retirement Income is now predominantly an investment based fund market. Both the life & pensions and asset management sectors are facing major challenges to protect and grow their strategic interests in this £1.7 trillion opportunity.

September 2014 - Number 21 - Solutions will win in the end game

Not only will the specialist third party asset manager share be greatly reduced but the source of assets greatly changed. Specialist providers in the future will look to solutions providers for nearly 40% of their assets.

May 2014 - Number 20 - DGFs still room for new players

The speed of adoption by DB schemes witnessed in 2013 was much faster and more significant than expected. The market grew by £10 billion from this source in 2013, off a previously estimated base of only £30 billion.

April 2014 - Number 19 - Smart Beta the new alternative

Alternative index product flow is estimated to be largely from UK clients, unlike flows into advanced beta and advanced index products which are estimated to emanate more from European clients.

December 2013 - Number 18 - The three spirits of pensions, past, present and future

In this holiday edition of Deeper Perspectives we evoke the Three Spirits of Pensions – Past, Present and Future – to enlighten and inspire our readers about the exciting world of pension investment.

November 2013 - Number 17 - New opportunities for asset managers in workplace pensions

In this new edition of Deeper Perspectives we make four predictions of the future of workplace pensions that could have a significant impact on your strategic planning today.

October 2013 - Number 16 - New opportunities emerge in Insurance Asset Management

We describe how the management of insurers' general accounts is a growing and changing revenue opportunity for European asset managers

June 2013 - Number 15 - Growth of US OCIO reveals one clear winner

We share some high level findings of our OCIO Market Intelligence report, and we describe one very clear winner emerging in this market

Nov 2012 - Number 14 - Growth in DC assets

DC assets will grow at 11.6% pa to triple in size over the next 10 years, we say.

Nov 2012 - Number 13 - Fiduciary Management starts to mature

Throughout 2012 we have uncovered growing evidence that the European Fiduciary Management market is maturing. This will continue to have a significant impact on the wider institutional investment landscape