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UK Insurers Investments in Illiquid Assets – A Perspective from Supervision

CCBS – Workshop for Heads of Insurance Supervision

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UK Insurers Investments in Illiquid Assets – A Perspective from Supervision

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Agenda

- Why are insurers considering increasing exposure to illiquid assets?
  - The “search for yield”
  - Annuity Market in the UK
  - Impact on competitiveness from:
    - Low Rates
    - Increasing Capital Requirements & Changing Regulatory Incentives
    - Government Reform of Pensions Market
- What specifically are UK insurers investing in?
- Why should regulators care?
- What is the PRA doing and what challenges have there been?
- Slow realisation of ambition – Why?

What do we mean by “illiquid assets”?

- Typically non-traded assets where no clear primary or secondary market exists and that are not “traditional“ corporate bonds
- Tend to offer good returns, and can be accessed either by providing debt financing, investing in equity or purchasing the whole asset (e.g. a building).
- Property & Infrastructure investments are examples that can be suitable for backing long term insurance liabilities (e.g. Annuities)
- Property backed (e.g. CRE), asset backed (e.g. ships or loans), project backed (e.g. hospitals or toll roads), or corporate backed (e.g. private placements).

Why Invest in "illiquid assets" – The Search For Yield

- Additional investment returns, enables competition for new business and improves profitability.
- Sources of additional yield above the risk free rate include: i) market driven returns (beta); ii) the illiquidity/complexity premium; and iii) investment skills

Beta, illiquidity premium and 'skill uplift' by asset class

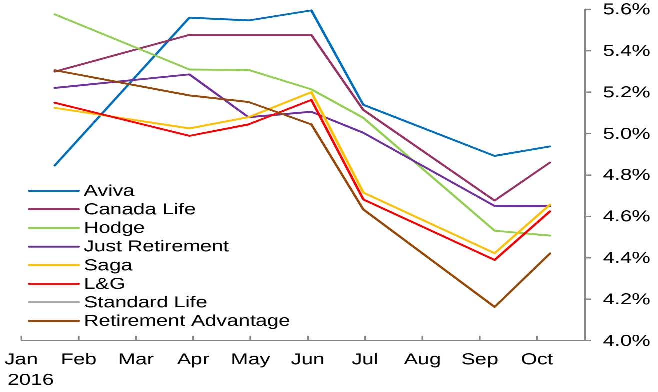
Asset class	Beta plus illiquidity premium	Skill uplift	Uplift method
Sovereign bonds	0	75	Active trading
Global IG credit	50-150	50	Active trading
Alternative income	50-400	50	Multi-asset
High yield, EMD, ABS	150-350	50-150	Global macro
Global property, infrastructure equity	300+	100-250	Active trading
Global equity	300-500+	50-250	Absolute returns

Source: Moody's

Particularly important for UK annuity market which is challenging…….

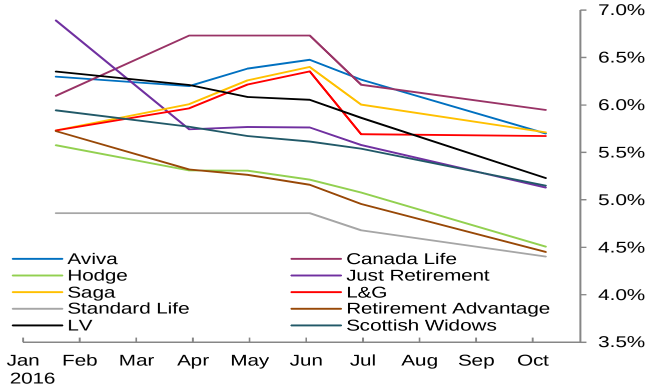
Low Rates make Annuities poor value for money

Standard annuity rates during 2016 for selected UK insurers



Sources: Bloomberg, EIOPA, The Money Advice Service and Bank calculations. Analytical 7,476,510v1.

Enhanced annuity rates during 2016 for selected UK insurers



Sources: Bloomberg, EIOPA, The Money Advice Service and Bank calculations. Analytical 7,476,510v1.

The “Risk Margin” has increased capital requirements

- UK life insurers’ are now required to hold a new liability on the regulatory balance sheet known as the **risk margin**.

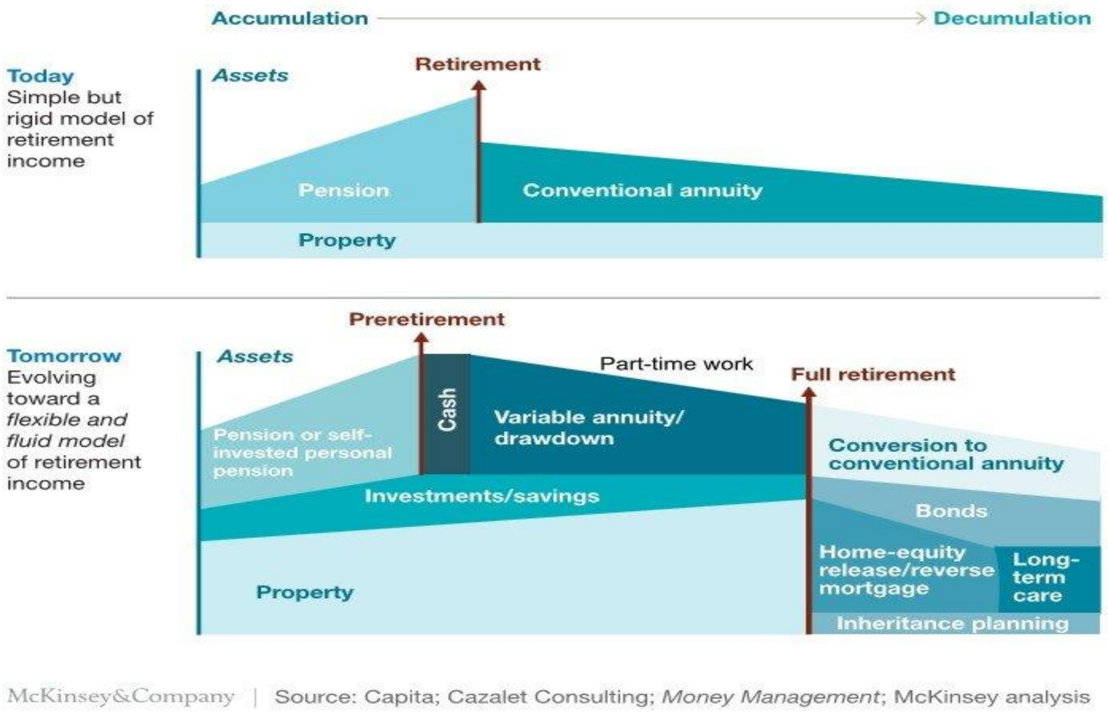
- The **risk margin** is an increase to balance sheet liabilities introduced by Solvency II to ensure the insurer can compensate a third party who chooses to acquire the business should the insurer fail.

Introduction of Risk Margin has increased Capital Requirements

- Cost of capital approach; a firm must project its capital requirements in respect of “non-hedgeable” risks, and apply a prescribed cost of capital charge of 6% pa. This is then discounted at the risk-free rate to determine the risk margin.

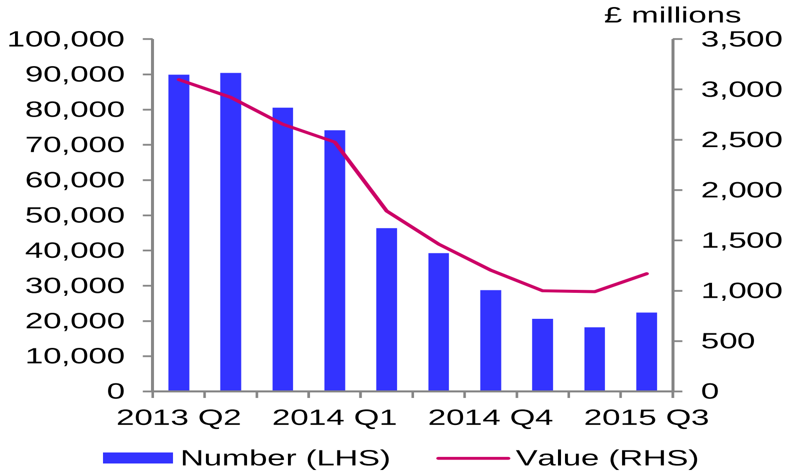
- The risk margin is relatively large, in comparison to surplus own funds, for insurers with significant non-hedgeable risks such as **longevity**, and that have a **long duration.**

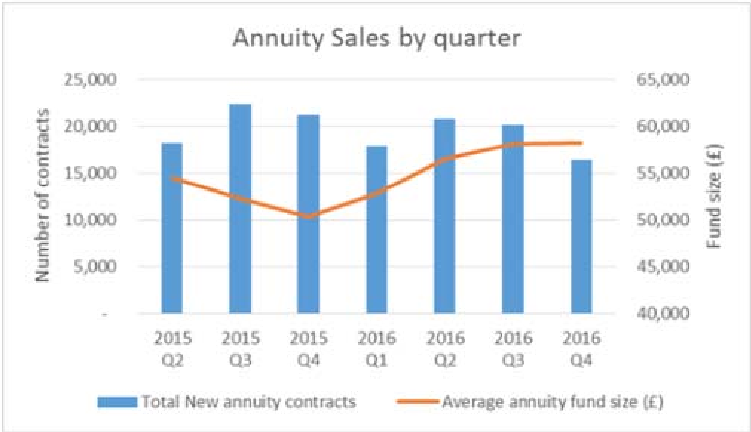
UK Government's Pensions Reforms in 2015 have shrunk the market….



Source: McKinsey

UK Government's Pensions Reforms have shrunk the market….





Quarterly Sales of personal annuities

Sources: ABI and Bank calculations

Source: ABI

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UK Government's Pensions Reforms have shrunk the market….

	First year of reforms (Q2 2015 – Q1 2016)
Pension pots fully withdrawn on first access	£3.3bn paid through 216,300 full withdrawals. An average withdrawal of just over £15,200.
Flexible income (drawdown) withdrawals	£3.9bn paid out via 1.03m income drawdown payments, an average payment of £3,800.
Flexible income (drawdown) withdrawals (new entrants)*	
Guaranteed income (annuity) sales	£4.2bn invested in around 80,000 annuities, making the average fund invested nearly £52,500.
Flexible income product (drawdown) sales	£6.1bn invested in 90,700 income drawdown products, an average fund of just over £67,500.

Source: ABI

Regulatory Incentives - SII Matching Adjustment

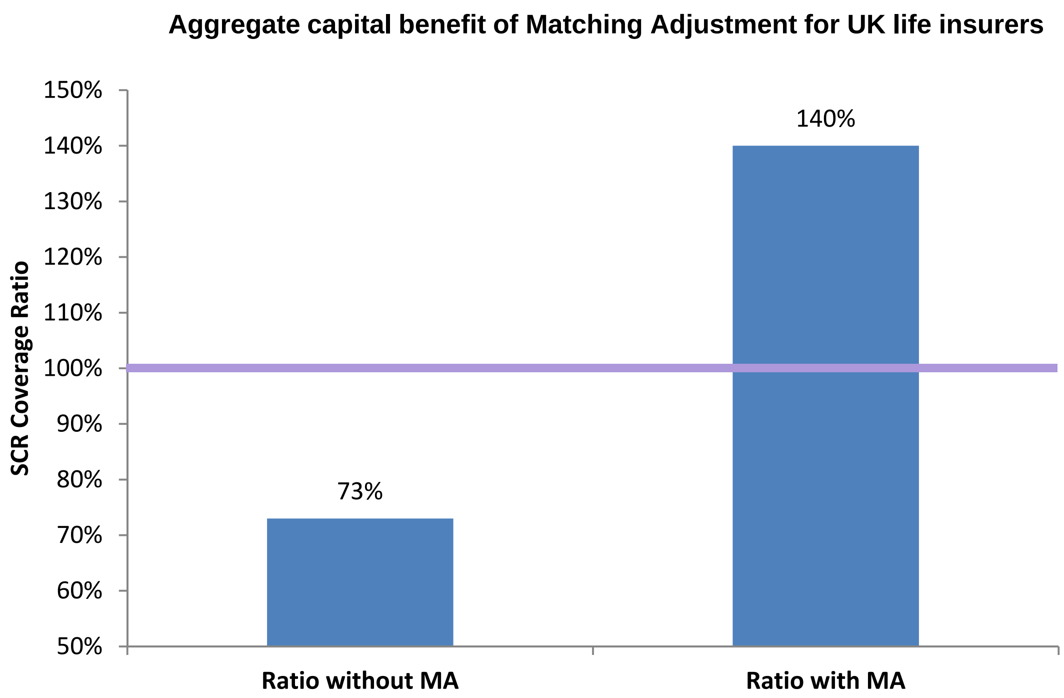
Typical spread on AA bonds[1]	57.0	38.1	33.6	30.2	34.2	102.9	342.3	111.2	138.2	143.7	87.9
Example solvency ratio[2]	185%	207%	212%	216%	212%	134%	-97%	125%	96%	90%	150%

Source: Insurance Europe

Regulatory Incentives - SII Matching Adjustment

- An addition to the discount rate used to calculate the present value of future liabilities.
- Reflects the spread on backing assets, less and allowance to reflect the expect cost of default and downgrade (c.f assets are typically government or corporate bonds).
- A higher discount rate means a lower value for the liabilities, increasing a firm's available capital or compensating for asset price falls when spreads increase.

Regulatory Incentives - SII Matching Adjustment



Source: EIOPA LTG Survey

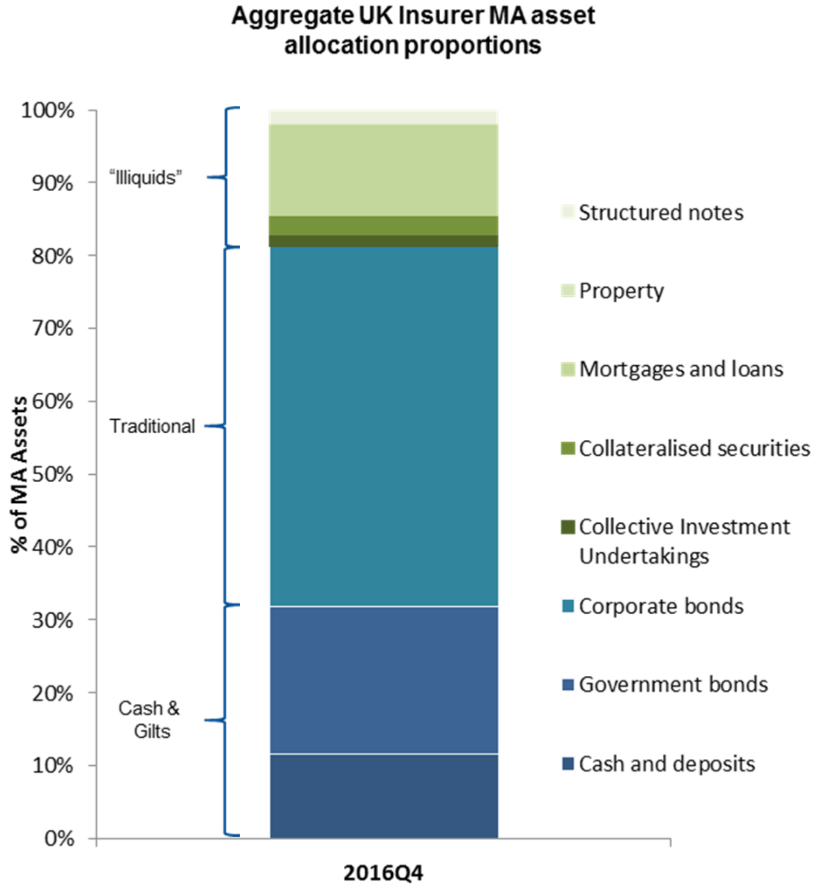
SII Matching Adjustment – Risks from illiquid assets

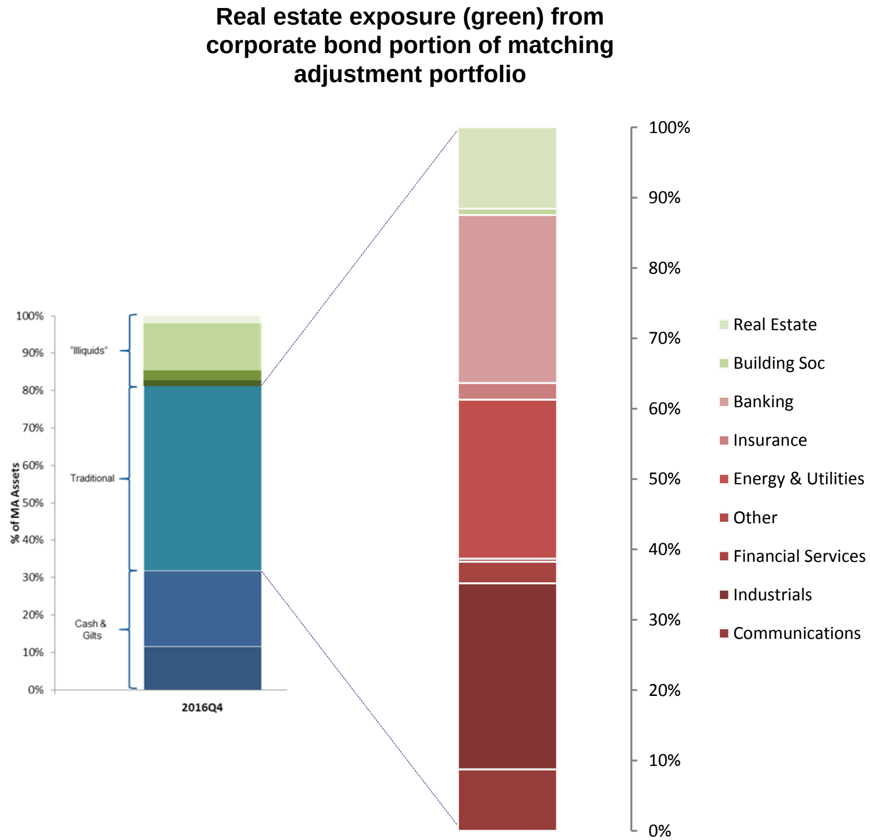
- MA calibrated from traditional assets.
  - no external ratings are available
  - internal rating "broadly consistent" with that produced by a rating agency should be used,
  - focused on the probability of default ("PD").
  - Firms effectively reduce the importance of PD by assuming higher recovery rates due to loan collateral.
  - This delivers high credit ratings and, unless the collateral values are weakened, reduces ratings transition risk.

- Are firms properly reflecting credit risk and valuation uncertainty?
- In the event of downgrade or default, can firms manage any collateral received or maintain a matched portfolio?

Current bias towards UK property exposures

directly-held property, social housing, equity release mortgages and ground rents, together with corporate bonds funding real estate.





Source: Solvency II returns data

Source: Solvency II returns data

Are insurers taking excessive concentration risks ?

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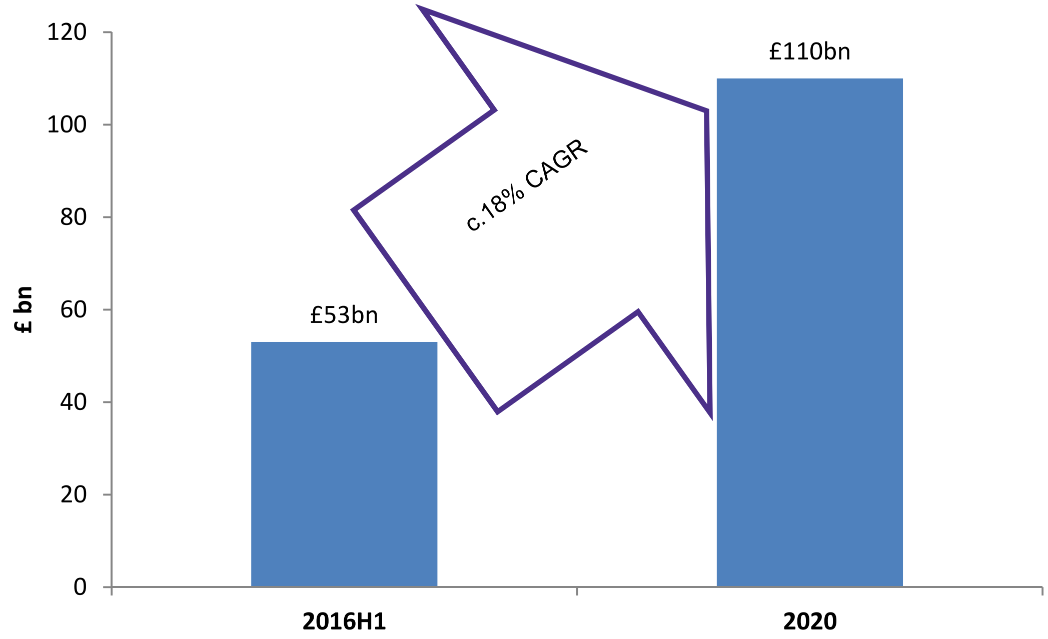
Growth Plans

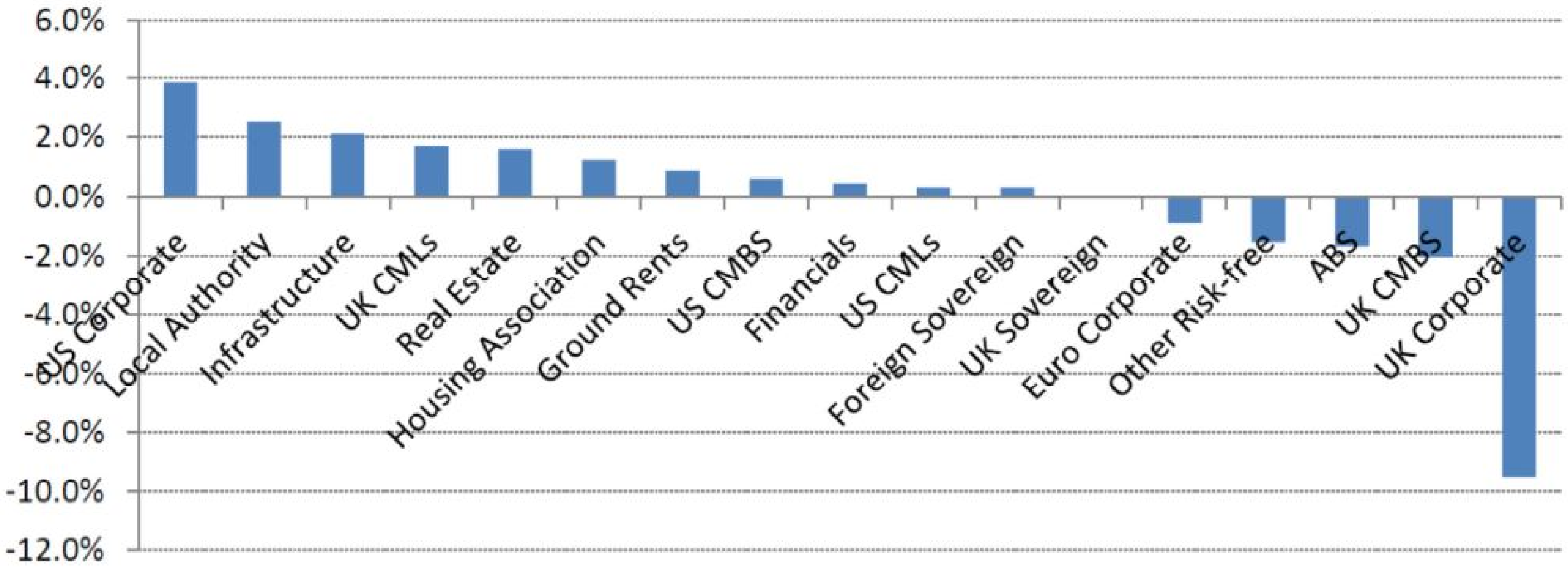
- **Based on supervisory information from firms, currently around 25% of annuities are backed by illiquid assets but firms have plans for that proportion to increase to 40% by 2020.**

Projected Illiquid Asset Investments of leading firms to back UK annuities



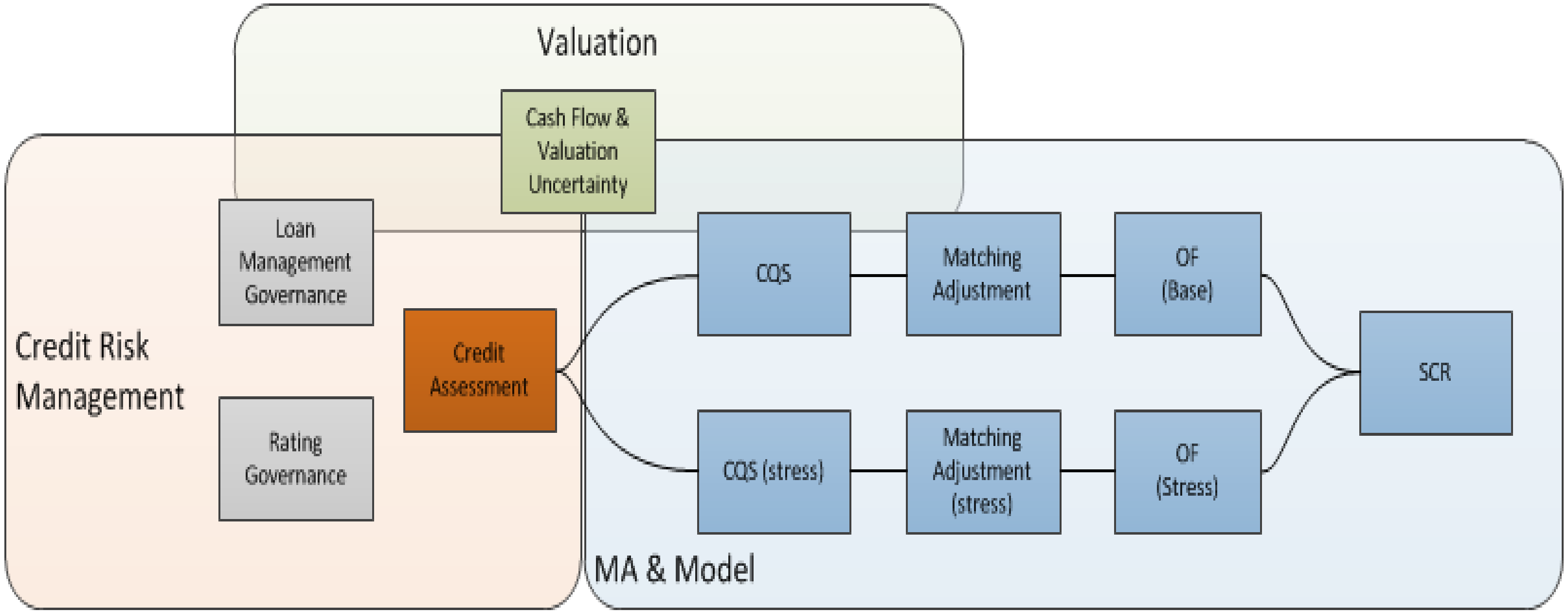
•Source: Solvency II returns data, Firm 2016 Plans

Growth Plans



Other supervisory concerns

1. Do insurers have necessary skills (in all 3 lines of defence, at all stages of lifecycle of illiquid assets)?
2. Are insurers holding sufficient capital (internal modelling of illiquid assets, matching adjustment in stress)?
3. Are insurers identifying and managing liquidity risks?



PRA response

- **We have a programme of work to examine the risks.**

- We already have general assurance over firms' internal ratings processes through SII approval process but we do not have assurance that firms takes all uncertainties into account in setting ratings or capital

- Wider programme underway including:

(1) risk monitoring questionnaires,

(2) detailed examination of significant asset classes (ERMs, CRE), and

(3) specialist review of firm credit risk management and valuation processes.

PRA Response

- Challenges:
  - Data
    - The picture we have of firms investments is highly dependent on consistent classification of the assets within our regulatory returns.
    - Miss-classification is a threat to developing a full understanding of insurers holdings.
  - Skills & Capabilities
    - Just as firms require specialist skills to successfully invest in and manage the risks from illiquid assets, so too does the regulator
      - Specialist resourcing in this area within PRA tends to come from Banking Supervision and does not perfectly overlap with the needs of Insurance Supervisors
      - Wider resources and experience of the Central Bank is useful – e.g. collateral management
      - Considering external resourcing for key reviews on larger firms

Example of Data Challenge

LONDON GATEWAY LOAN FIXED RATE 4.507 31/12/45	527530:LONDON GATEWAY LOAN FIXED RATE 4.507 31/12/45
AFFINITY SUTTON CAPITAL MARKETS 12/08.10.42	AFFINITY SUTTON CAPITAL MARKETS PLC
AFFINITY SUTTON CAPITAL MARKETS PL MTN	AFFINITY SUTTON CAPITAL MARKETS PLC
AFFINITY SUTTON CAPITAL MARKETS 12/08.10.42	AFFINITY SUTTON CAPITAL MARKETS PLC
AFFINITY SUTTON CAPITAL MARKETS PL MTN	AFFINITY SUTTON CAPITAL MARKETS PLC
AFFINITY SUTTON CAPITAL MARKETS PL MTN	AFFINITY SUTTON CAPITAL MARKETS PLC
AMICUSHORIZON FINANCE PL SR SECURED REGS 03/43 5.25	AMICUSHORIZON FINANCE PLC
AMICUSHORIZON FINANCE PL SR SECURED REGS 03/43 5.25	AMICUSHORIZON FINANCE PLC
ANNES GATE PPTY I/L 3.237 31/03/30	Annes Gate Property PLC
ANNES GATE PPTY 5.661 30/06/31	Annes Gate Property PLC
ANNES GATE PROPERTY PLC (AGPLN 3.237 03/31/30)	Annes Gate Property PLC
ANNES GATE PPTY SEMI-ANN. FLOATING 31-03-2030	Annes Gate Property PLC
ANNES GATE PROPERTY PLC (AGPLN 5.661 06/30/31)	Annes Gate Property PLC
ANNES GATE PPTY SEMI-ANN. 5.661% 30-06-2031	Annes Gate Property PLC
ARTESIAN FINANCE II	ARTESIAN FINANCE II
ARTESIAN FINANCE II	ARTESIAN FINANCE II
ARTESIAN FINANCE II	ARTESIAN FINANCE II
ARTESIAN FIN II 6 30/09/33 EMTN	Artesian Finance II PLC
ARTESIAN FIN II 6 30/09/33 EMTN	Artesian Finance II PLC
ARTESIAN FINANCE II (ARTFIN 6 09/30/33)	Artesian Finance II PLC
ARTESIAN FINANCE II 03/30.09.33 S.1 MTN	ARTESIAN FINANCE II PLC
ARTESIAN FINANCE II (ARTFIN 6 09/30/33)	Artesian Finance II PLC
ARTESIAN FINANCE II (ARTFIN 6 09/30/33)	Artesian Finance II PLC
ARTESIAN FIN III I/L 3.75 30/09/45 EMTN	Artesian Finance III PLC
ARTESIAN FIN 3.625 30/09/32 I/L EMTN	Artesian Finance PLC
ARTESIAN FIN 3.625 30/09/32 I/L EMTN	Artesian Finance PLC
ARTESIAN FINANCE PLC (ARTFIN 3 5/8 09/30/32)	Artesian Finance PLC
BISHOPSGATE ASSE 4.808 14/08/44	Bishopsgate Asset Finance Ltd

Current evidence suggests insurers ambitions slow to fulfil – Why?

- Barriers to successful investment exist
  - Pipeline (A lack of opportunity) and experience
  - Lack of transparency on historic deals inhibits assessment of risks
  - Projects tend to be loan financed as opposed to bond financed which can cause problems
  - Regulatory Barriers
    - MA eligibility difficult, prohibits optionality
    - If callable, then only cashflows up to the call date can be taken into account
    - Time taken to asses MA eligibility
    - Capital Requirements not seen to be onerous

Acknowledgements

- Andrew Bailey – Illiquid Assets
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- Thank-you for your attention.