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Insurance Day: Insurers need to boost investment strategies

Insurers, by their very nature, are established not only to survive but to thrive over different economic cycles and through evolving risk scenarios. However, today's environment presents a particular challenge as insurers seek to manage their assets and liabilities. With a backdrop of protectionism, the unwinding of quantitative easing and the UK's impending departure from the EU, interest rates have finally begun to move upwards. However, it will be some time before the impact is seen in company earnings, given that reinvestment rates remain very low. In the meantime, it remains very difficult to cover the cost of equity.

These issues are illustrated by the Aon Benfield Aggregate (ABA), our proprietary study of global reinsurers and specialty insurers. In 2007, the return on common equity exceeded its cost by a comfortable 6% margin. After a few turbulent years, the next period 2012 to 2016 returned to positive margin, but at a much lower level, around 2.5%. 2016 was almost breakeven and 2017 showed significantly negative margin, due to natural catastrophes. Over the period, economic value creation (return on common equity above cost of equity) was achieved only half of the time.

Total investment return (including capital gains) was slightly below 4% in 2017, broadly stable since 2010. But this apparent stability is hiding a decreasing investment return, reaching a low 2.6% in 2017.

Reacting to these two trends, insurers and reinsurers need to actively manage their capital and define a more sophisticated investment strategy. An active capital management strategy will simultaneously reduce the overall amount of capital required and the share of common equity in the capital mix.

Bespoke strategy

Under Solvency II, reinsurance can efficiently reduce the Solvency Capital Requirement (SCR) via Premium Risk (quota share, stop loss, cat XL), Reserve Risk (ADC, LPT), and both simultaneously via a whole account accounting year protection. A bespoke strategy needs to be defined for each situation, considering in particular the diversification benefit and the target solvency ratio.

The efficient capital mix will include, in addition to common equity, sub debt and third-party capital. Third party capital is accessed through side cars, Cat Bonds, collateralised reinsurance, or various forms of Funds at Lloyd's structures for Lloyd's syndicates. This will reduce the overall cost of capital well below the cost of common equity.

The combination of a reduced capital amount and a better capital mix allows for significant economic value creation, especially if the investment returned can also be enhanced.

Equity valuations are expensive but, on a risk adjusted basis, are still likely to outperform bonds, so insurers that have capital adequacy to retain equities should keep neutral on global equities for now. While valuations were expensive this time last year and the markets posted returns in 2017 that were well into double digits, a similar outcome is less likely than last year. Additional non-repeatable boosts include the higher oil prices that took markets by surprise in 2017 and the US tax cut plan, where the uncertainty has ended.

With a weak overall outlook for both equities, bonds and credit, and volatility creeping back into the market, diversification and return protection should be high up on any insurer's agenda. A strategy to reduce the reliance on the traditional markets to generate portfolio returns will ensure that elements within the overall portfolio behave independently. Notably, Solvency II-efficient alternative asset classes provide greater diversification. Insurers, especially European, tend to look more at environment, social and governance (ESG) investing strategies as active factors that contribute to more robust portfolios.

Property opportunities

One asset class certain firms can exploit is UK property which still offers a yield advantage over bonds. While Brexit uncertainty has led to some slowdown in capital values, the sector has been remarkably resilient so far. Although Brexit uncertainty will remain a headwind for UK property in general, some areas look attractive. One such example is the private rented sector, which includes student accommodation. Debt secured by such property in particular has a favourable Solvency II capital-adjusted return.

Another focus is on private debt asset classes which can provide higher returns to capital to similarly rated public bonds. Margins on private debt can exceed those of public bonds by as much as 100 basis points per annum while incurring similar capital charges. Managing a portfolio of private debt can be challenging so insurers need to ensure that implementation is straightforward and low cost to capture the improved investment returns with limited capital outlay and a best in class risk control and oversight and investment framework.

While looking at Solvency II capital requirements and determining capital-adjusted returns is important, another key consideration for insurers is the absolute amount of capital available. Insurers are often looking to reduce the amount of capital they must hold and sometimes capital budgets can mean that even more "efficient" asset classes can be difficult to implement because of limitations on the amount of capital to back the investment portfolio. This is where diverse risk tolerances and investment needs will make an impact.

A holistic view of a firm's overall risk including both underwriting and asset risk has never been more important to fine tune the different elements within the business. Simply diversifying your underwriting risk or asset risk is no longer enough. Firms need to assure that every part of the business that absorbs risk capital contributes to the overall profitability of the firm.

This article first appeared in Insurance Day on 13 August 2018 and was written by Eric Paire, Head of Capital Advisory at Aon's Reinsurance Solutions business, and Gerard-Jan van Berckel, Head of Delegated Investment Solutions for Insurers at Aon.

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