Dec 2017

Solving the Insurance Outsourcing Puzzle

Postscript to the Asia Pacific Insurance Survey

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Executive summary

Introduction

Standard Life Investments commissioned research to identify trends impacting Asia Pacific insurers. The companies surveyed represent an estimated 60% of the total insurance market. Published earlier this year, the survey identified the pressures facing traditional business models and analysed the investment implications.

The research was conducted in six markets across Asia Pacific, selected to ensure coverage both in terms of market size and in terms of markets at different stages of industry maturity. NMG, an independent global research consultancy, conducted one hour, face-to-face interviews with 51 senior investment professionals during Q1 2017.

Asia Pacific's insurers are shifting their asset allocation in response to twin forces: low interest rates and changing regulations. The Asia Pacific Insurance Survey identified insurers are open to exploiting investment opportunities in alternative assets and global equities. They may lack the internal expertise to do so and therefore employ external asset managers. However, they can be resistant to increasing the use of external managers.

The survey identified barriers – real and perceived – to increasing allocations to external managers. The interviews revealed that external managers must work harder to build trust: delivering alpha; demonstrating knowledge of local regulations; and providing valuable investment insight.

Summary

This paper examines the conundrum insurers in Asia Pacific face as they increase exposures in alternative assets – take on the expensive cost of pursuing such investments on their own or consider outsourcing more investment management to external asset managers.

So what are the barriers that Asia Pacific insurers say may stop them from using external managers? How can these managers adapt in response? What solutions and capabilities must they bring to add value to insurers' businesses?

The Asia Pacific insurance survey identified issues around performance and value for money were high on the list of what were termed 'perceived' barriers. Lack of asset class expertise and insurance regulatory knowledge were also seen as areas where asset managers' skills were not up to the mark.

It is also widely acknowledged within investing that the requirements of insurer asset management are more specialised and demanding than for other institutional investors such as pension funds. This is mainly due to the complicated liabilities that insurers have on their balance sheets and the restrictive regulatory environments in which they operate.

Designing and implementing effective investment solutions for insurers is a challenging problem to solve, comprising the ability to source insurer-friendly asset classes, understand the regulatory constraints involved and requiring demanding operational capabilities to support the solution.

Asia Pacific insurers face a conundrum on investments in global assets and alternatives — take on the expensive cost of pursuing such investments on their own or consider outsourcing more investment management to external asset managers.

Insurers intend to increase exposures to alternative assets, yet many may lack the internal expertise to build a diversified portfolio across private equity, real estate and infrastructure.

At the same time, there are barriers – real and perceived – to increasing allocations to external managers. At its heart, a potential problem is that it is as if asset managers and insurers speak different languages.

Asset managers with in-house insurance expertise of their own can effectively provide a translation capability, linking investors and actuaries, internally and externally.

External managers must take steps to acquire the requisite skills and capabilities to know the nuances that influence insurance solutions, offer expertise that can generate the best results and work with their clients to fully capitalise on the alternative investment opportunities.

As the old cliché goes, it takes two to tango.

A current state of affairs

The recent Asia Pacific Insurance Survey conducted by Standard Life Investments found that despite the current high allocations within alternatives, insurers were reticent about increasing the use of external asset managers over the next three to five years. The chart below shows the proportion of assets that the region's insurers currently place with external asset managers.

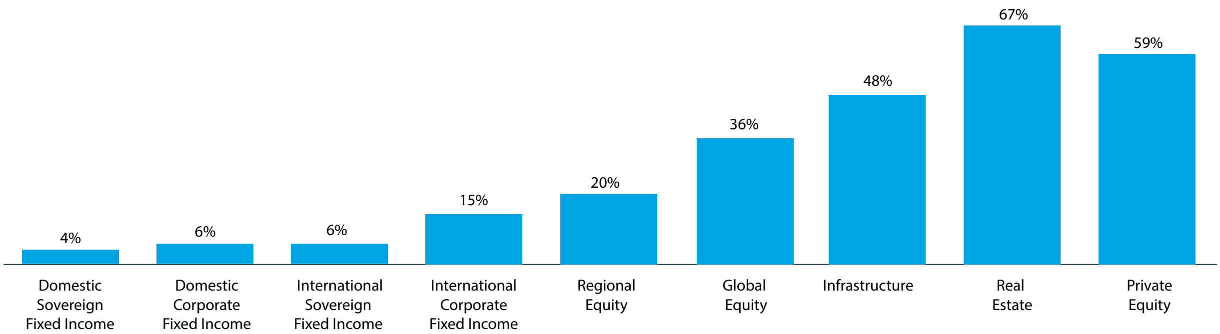
The survey found that only 10% of insurers surveyed expect to increase their use of external managers for infrastructure assets. In fact, 5% of respondents intend to reduce their use of external managers. These are particularly the larger insurers, who are looking to establish or expand their own in-house teams. This will allow them to source and manage more of their infrastructure investments internally.

However, building an in-house capability for investing in alternatives takes time and money. It also requires specialist skills even to access the investments, let alone to add value.

What are the barriers that Asia Pacific insurers say may stop them from using external managers? How can these managers adapt in response? What solutions and capabilities must they bring to add value to insurers' businesses?

Figure 1

Proportion of assets managed by external managers



Note: 43 out of 51 respondents answered this question.
Q22. Please indicate the proportion of each asset class held with external asset managers

Source: Standard Life Investments Asia Pacific Insurance Survey 2017

Reticence over external managers

The Asia Pacific insurance survey identified issues around performance and value for money were high on the list of what were termed 'perceived' barriers, as shown in the word cloud below.

Lack of asset class expertise and insurance regulatory knowledge were also seen as areas where asset managers' skills were not up to the mark.

An inability by asset managers to clearly communicate performance attribution confused matters. For example, external managers often focused exclusively on relative return benchmarks, with little regard to the absolute returns that are vital to the insurers.

Structural barriers were also identified. For example, if there is an asset manager within the insurance group, there is an obvious reluctance to place the assets outside the group. However, this can even be the case where an external manager is clearly better able to meet the needs of the insurer.

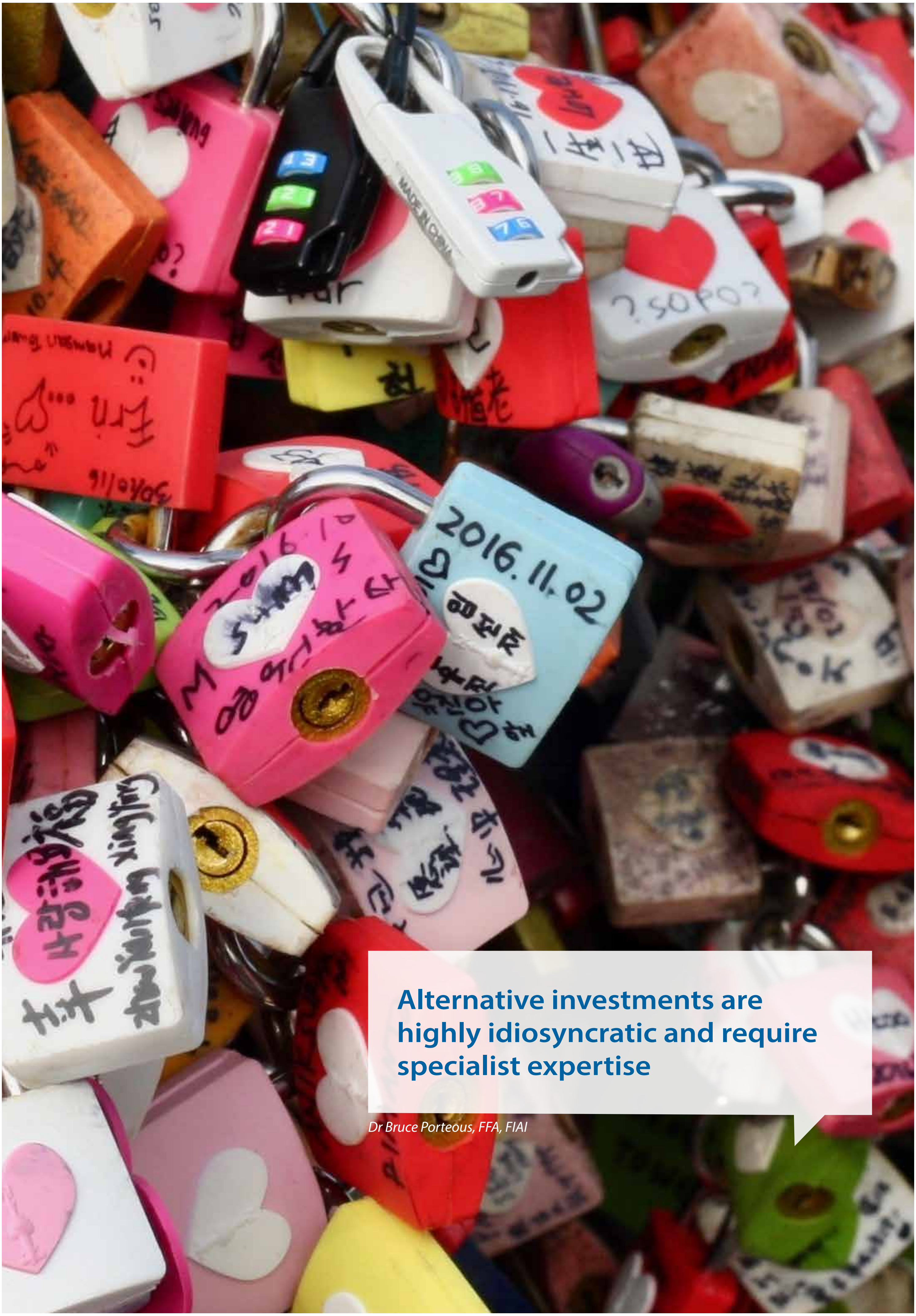
We believe the barriers are surmountable by those asset managers who develop the specific expertise needed to meet the requirements of insurer clients.

There are very real and significant opportunities for dedicated insurance asset managers with the right capabilities, experience and skill-sets to add significant value for their insurance clients.

Figure 2
Barriers to using external managers

Source: Q29. Where there is a desire to increase allocation to external managers, what are the main challenges that need to be overcome?

Standard Life Investments Asia Pacific Insurance Survey 2017



Alternative investments are highly idiosyncratic and require specialist expertise

Dr Bruce Porteous, FFA, FIAI

Insurance asset managers become de rigueur

It is widely acknowledged within investing that the requirements of insurer asset management are more specialised and demanding than for other institutional investors such as pension funds. This is mainly due to the complicated liabilities that insurers have on their balance sheets and the restrictive regulatory environments in which they operate.

Value-add in alternatives and global assets

We know that Asia Pacific insurers have a huge appetite to invest in alternatives, especially debt. Alternative debt markets include longer-term asset durations that can help insurers manage the asset-liability duration mismatch issues prevalent in the region.

Alternatives are seen as attractive because they can offer illiquidity premiums that help insurers combat the very low (or even negative) yields currently available on sovereign bonds and low-risk corporate bonds globally.

Alternative investments are highly idiosyncratic and require specialist expertise. Most asset managers and insurers have little or no practical experience managing the idiosyncrasies of alternative assets.

Take infrastructure debt as an example. This is a form of direct lending to finance a wide array of potential projects, including social housing, hospitals, student accommodation, roads, railways, bridges, renewable energy such as wind farms and solar power, agriculture and so on. The risks associated with each of these projects are vastly different.

Most asset managers and insurers have limited experience of even the more plain types of direct lending, such as retail mortgages, never mind more specialised asset classes. The real hands-on experience has traditionally resided in the banking sector and now banks are withdrawing from this type of lending as they de-risk their balance sheets.

Asset managers committed to alternative investing have, as a consequence, built teams of dedicated professionals recruited mainly from the banking sector. These personnel have thorough expertise of the sector and many years of experience, including an understanding of the mistakes of the past as well as deep knowledge of the many pitfalls involved.

When investing in alternatives, especially overseas, insurers have much to gain from using managers with genuine experience; both to help source assets with attractive illiquidity premiums and to minimise the risk when complications arise.

For all but the very largest insurers, the option of building an in-house team proved to be prohibitively expensive, especially as there is a shortage of banking professionals with the relevant expertise.

When investing globally, most insurers lack sufficient resources to have investment professionals on the ground in every market, and for every asset class of interest. Thus, they struggle to research and access attractive investment opportunities in these markets. Asset managers located in a particular market, or with a stronger global footprint, are better placed to support and add value.

> " The option of building an in-house team proved to be prohibitively expensive" *Dr Bruce Porteous, FFA, FIAI*

Value-add in risk management and operational support

Risk measurement

Insurers tend to measure risk by subjecting the market values of their assets and liabilities to a range of stresses, usually calibrated to a 0.5% probability level. Moreover, these market values are often estimated using bespoke actuarial models.

This type of approach usually has a regulatory driver and is consistent with insurers' own internal economic capital modelling methods. It is different from the way that asset managers and banks measure risk, which often use much simpler VaR-type modelling techniques.

Insurers look for external asset managers that have practical experience of estimating base market values for difficult-to-value illiquid assets, such as infrastructure debt, and are able to subject these base values to stress tests that are consistent with the methods used by insurers.

This is especially the case if asset managers have the ability to:

- carry out the calculations in a manner that is fit-for-purpose and acceptable to insurers and their supervisors
- have a good understanding of the rationale and technical language behind these insurance industry-specific approaches.

External managers that understand how insurance firms measure and manage risk, without the need to be 'educated' by their clients, can greatly assist insurers in designing and implementing risk-efficient solutions.

Credit ratings

Alternative debt is typically not publically credit-rated. Reliable private ratings are extremely useful to insurers, especially small- to mid-sized firms firms that may not have their own in-house credit-ratings capability and are dependent on such ratings to assess risk.

However, the internal credit-ratings processes used by asset managers need to be tailored specifically for the insurance industry, to satisfy the very demanding requirements of insurance supervisors. For example, the documentation and evidencing of the objectivity of the ratings process, and its repeatability, must be rigorous for insurers.

Asset managers that invest in building internal credit rating processes, designed specifically to meet the needs of insurers and their supervisors, will be very well placed to support insurance clients in their risk assessments of these more specialised asset classes.

Reporting

Insurers' detailed asset data and risk reporting requirements are also areas where asset managers have great opportunities to help and support their insurance clients.

In Europe, for example, it is now standard practice for asset managers to provide full look-through data to their insurance clients by 'Working Day 5' of each month. Otherwise, insurers are not able to complete their risk capital modelling and regulatory reporting on time. Moreover, the pace of this reporting is only going to increase as technological advances allow insurers to carry out real-time risk management of their balance sheets.

The ability to provide insurers with the asset data they need requires very significant investment in data management processes and capabilities. We believe it will yield really significant benefits for both managers and their insurance clients in the longer term. Faster and more granular data will help give insurers an edge in risk and capital management in an increasingly competitive environment.

Regulatory and accounting guidance

The survey identified regulatory change as a key issue affecting insurers' asset allocations and their investment decision-making processes. Risk-based solvency is being introduced in Asia Pacific and global accounting regimes are becoming more market-based.

In future, when insurers make investment decisions, they will need to be aware of the capital consequences of those decisions and how the investments will impact the volatility of the profits from their business. These are very complex calculations. Insurers can only make effective investment decisions by working with an asset manager that understands and is on top of these issues.

To satisfy insurance clients' regulatory needs, asset managers must have in place dedicated teams of insurance specialists and actuaries who understand and can provide direction on these complicated issues and stay abreast of regulatory change.

Insurers' investment teams will collaborate much more closely with their actuarial colleagues, both those within the insurer and those employed by asset managers. Such actuarial expertise is an extremely valuable add-on service that asset managers can provide to their insurer clients, as global regulatory change and complexity accelerates.

Effective solutions

Designing and implementing effective investment solutions for insurers is a challenging problem to solve, comprising the ability to source insurer-friendly asset classes, understand the regulatory constraints involved and requiring demanding operational capabilities to support the solution.

The provision of effective insurance solutions will usually involve an understanding of the full range of factors, including: asset eligibility assessment, market valuation, asset and liability matching, capital efficiency, regulatory guidance, performance and fees.

For asset managers without the skills and capabilities needed, or who are unable to make the investments required to build these capabilities, it is hardly possible that they will be able to adequately and appropriately support their current or prospective insurance clients, let alone provide them with innovative insurance solutions.

For asset managers that have invested to develop and acquire the requisite skills and capabilities, they are very well placed to help and support insurers in Asia Pacific and beyond.

This enables insurers to meet the needs of their own clients and stakeholders.

Dr Bruce Porteous, FFA, FIAI
Investment Director
Global Insurance Solutions

Bruce T. Porteous is an Investment Director, Global Insurance Solutions, at Aberdeen Standard Investments, and is responsible for developing insurance solutions propositions and business. Our dedicated insurance solutions team manages relationships with both internal and external insurance clients in order to develop innovative solutions that enhance their risk-return profile. The team comprises highly experienced insurance actuaries with detailed knowledge of regulation, as well as risk.

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