

Welcome to LCP's review of the latest investment trends across the UK non-life insurance market

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Executive summary

Investing effectively is high on the agenda of non-life insurers, leading to lots of activity across the market.

We conducted in-depth interviews with key decision-makers at 22 non-life insurers, covering over £110bn of assets and a wide spectrum of non-life insurance classes.

Our key findings are

- The large majority of insurers now hold investments outside of the 'traditional' allocations to short-dated developed government bonds, investment grade corporate bonds and cash. The average allocation outside of these traditional areas is around 25%.
- On average, non-life insurers are targeting around 1% pa above their risk free rate (ie above the return of high quality government bonds or cash matching the currency of the claims).
- There is a much larger spread of investment risk appetite across the smaller insurers compared to larger ones.
- Some of the most popular investment ideas that have been implemented to date are absolute return bond funds, illiquic assets and equity downside protection strategies. Direct lending to small and medium enterprises and commercial mortgage loans are the most frequently held illiquid assets.
- Many insurers have been reducing the number of 'traditional' investment managers, typically looking to bring down fees and simplify governance. Where new managers are being introduced, it is often to bring specialist expertise in areas such as illiquid assets.
- Environmental, Social and Governance (ESG) issues are high on the 'to-do' list, with many insurers currently reviewing their ESG policy. Insurers are finding it difficult to determine what best practice looks like in this fast-evolving area.

Please contact us if you would like to discuss how our findings may apply to your investment strategy.

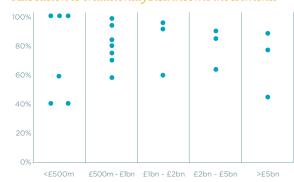


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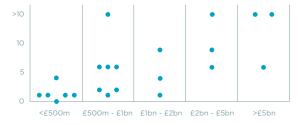
At a glance

Achieving a good level of diversification with manageable governance

Allocation to traditional fixed income investments



Number of investment managers



The top chart shows each insurer's total allocation to 'traditional' investments, taken as being short-dated developed government bonds, investment grade corporate bonds and cash. We have split this out by the total size of each insurer's invested assets.

Most insurers now have significant allocations to investments outside of these traditional areas, with only four insurers having more than 95% in the traditional assets.

The average allocation to these less traditional areas is around 25%, although many insurers have a much higher allocation (eg 40% or more).

Of the other investments held, some of the most prevalent are absolute return bond funds, illiquid assets and equities.

The bottom chart shows the number of investment managers appointed by each insurer. Overall, the median number is five. Smaller insurers (<£1bn) have around four investment managers on average, whereas larger insurers (£1bn+) have around nine.

For insurers of all sizes, there are two clear themes affecting how the overall number of investment managers is changing over time:

- Consolidating the number of traditional bond portfolio managers, to achieve better value for money, as well as simplifying governance and the overall quality of reporting; and
- Introducing new managers for specialist asset classes (eg illiquid assets), where existing managers may not be best-of-breed.

Our viewpoint

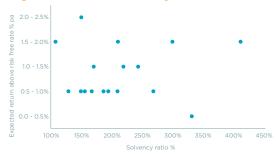
Reviewing your investment management arrangements can be a straightforward way of achieving material fee savings and can ensure you are getting a high level of investment expertise and service. Many insurers have already done this very successfully.

Understanding the investment risk appetite across the market

Expected returns vs invested assets



Expected returns vs solvency ratio²



On average, given the asset mix held, insurers may expect to deliver investment returns of broadly 1% pa above their risk free rate¹ (ie the return of high quality developed government bonds or cash matching the currency of their claims).

Strikingly, as shown in the top chart, there is a much larger spread across the returns being targeted by smaller insurers (less than £1bn) compared to larger ones. In other words, the investment risk appetite across larger insurers appears to be relatively consistent.

This ties up with comments made by many large insurers in our interviews. Many have teams of investment specialists that are up-to-speed with overall trends; and may be keen to not be 'too far out of line with the market'.

Perhaps surprisingly, an insurer's solvency position did not appear to have a very strong influence on the overall level of investment return being targeted. This is illustrated in the bottom chart, where there is no clear line of best fit. Our interviews revealed that an insurer's culture, ownership structure (eg a private equity parent) and the level of internal resource were the key drivers of the level of investment return being targeted.

Where insurers do have lower solvency ratios, rather than reducing the overall level of expected investment return, we instead saw a trend for taking steps to optimise the investments to reduce capital charges (for example by reducing any allocations to assets with relatively high capital charges, such as securitised investments).

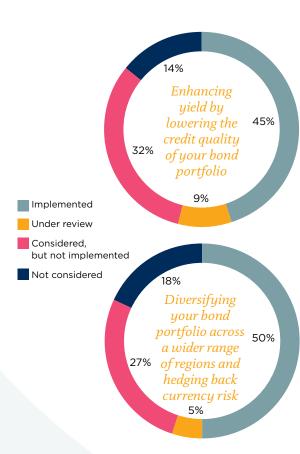
In order to provide a consistent comparison across different regions, we have assumed that high quality developed government bonds and 'plain vanilla' cash deliver the risk free rate; and we have used LCP's best estimate expected return assumptions for each asset class, rather than each insurer's own assumptions.

Our viewpoint

Insurers of all sizes recognise that delivering good investment returns is an essential part of their business. A key concern for many was to have better visibility of how they compared to the wider market, to ensure they didn't face a long-term headwind of lower investment returns than their competitors.

^{&#}x27;Solvency ratio' was taken from each insurer's latest Solvency and Financial Condition Report at the time of the interview, where available.

Taking steps to enhance the return of your bond portfolio



One of the key themes raised by insurers was acting to increase the yield of their traditional bond portfolios, in an environment where market yields are low by historical standards.

A particular issue where insurers had strong views was on the appropriateness of lowering the credit quality of corporate bond portfolios in order to enhance yield, for example by increasing the allocation to BBB-rated bonds:

- This idea jarred with many insurers, due to concerns that we are late in the credit cycle and lower-rated bonds may be vulnerable to economic shocks.
- Around one-third of insurers had considered but rejected lowering the quality of their traditional bond portfolios, typically due to these concerns.
- Around 45% had gone ahead with this idea, but often to a relatively modest extent due to concerns about market timing.

Another idea used to enhance the yield of bond portfolios was to invest globally and hedge out currency risk:

- Around half of insurers have already implemented this idea to some extent.
- Many noted that they increased the allocation to US bonds some years ago to take advantage of higher yields, but the cost of currency hedging has made this trade more or less attractive at different times.
- More recently, some were considering increasing their allocation to European bonds, to increase their overall yield after currency hedging effects are taken into account.

Our viewpoint

With a traditional bond portfolio typically representing the majority of an insurer's invested assets, taking steps to even modestly boost returns in % terms can make a big difference in real money terms. Many insurers are already doing this successfully.

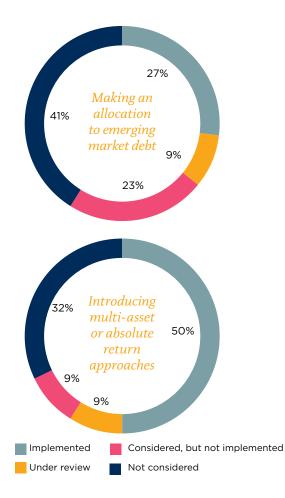
Emerging market debt has been a hot topic across the industry, as an asset class that may offer good potential returns with relatively attractive capital treatment.

- Around one-quarter of insurers have made a stand-alone allocation to emerging market debt.
- Whilst this is a meaningful proportion, it is lower than many other asset classes; and is perhaps lower than the 'hype' surrounding this asset class would suggest.
- Investment risk is the key reason given by insurers for not making a stand-alone allocation. Many felt more comfortable gaining some emerging market exposure in a risk-controlled way through an allocation to absolute return bond funds.

Half of insurers have already implemented an allocation to either an 'absolute return' or a multi-asset approach.

Most insurers have limited their absolute return mandates to cover bonds only, rather than a broader range of asset classes (eg equity assets).

- An absolute return bond approach is diversified globally across a wide range of different types of bonds, with an investment manager having flexibility to act quickly to capture tactical opportunities and manage downside risk.
- For those insurers who hold absolute return bond funds, the average allocation size is around 20%, with some having a much higher allocation (eg up to 40%).
- Many insurers commented that complexity and a lack of transparency were the key challenges with absolute return bonds. However, these challenges were generally surmountable, with fewer than 10% of insurers considering and then dismissing an absolute return bond approach.

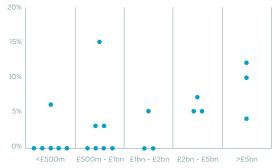


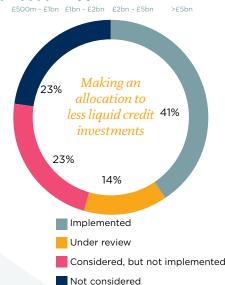
Our viewpoint

Absolute return bond funds are commonly used by insurers as a way of looking to deliver good returns in a risk-controlled way. A key theme from our interviews was the high importance of finding a manager suited to the insurer's specific needs, given the wide range of different approaches available.

Implementing an allocation to illiquid investments

Allocation to illiquid investments





The chart on the left shows each insurer's allocation to illiquid investments, which we have defined as including private equity, private credit (including direct lending and commercial mortgage loans), infrastructure, property and hedge funds.

Overall, about half of the insurers have already made some allocation to illiquid assets. For those insurers that have made an illiquid allocation, the average size of the total allocation is around 7% of the invested assets. If only allocating to a single illiquid asset class, the typical allocation is around 4%.

The insurers investing in illiquid assets tend to be larger, with all of the insurers we interviewed with assets of more than £2bn having already made an allocation. Typical reasons for implementing an allocation were attractive yields and relatively favourable capital treatment, as well as diversification.

Insurers who have not implemented an allocation cited portfolio liquidity requirements and governance as the key barriers.

Within illiquid allocations, the most commonly held investments are in the credit space (such as direct lending to small and medium enterprises and commercial mortgage loans). Over 40% of insurers overall have implemented an allocation to illiquid credit investments. This means that the majority of those that have gone ahead with implementing an illiquid allocation have invested in credit assets.

Our viewpoint

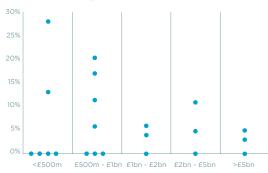
An illiquid allocation can be very attractive, particularly in an environment where the yields offered by many of the more liquid asset classes are relatively low. There are pooled fund structures available that mean illiquid assets can be accessed with a manageable governance framework, which is more practical for smaller insurers. However, any illiquid allocation should be implemented with care, as some areas of the market currently look quite crowded.

Holding equities and downside protection

The chart below shows that more than half of insurers hold an allocation to equities. For insurers who hold equities, the average allocation is around 10% of invested assets.

Large insurers (£1bn+) tend to have lower equity allocations. Across smaller insurers, the equity allocation varies widely.

Allocation to equities



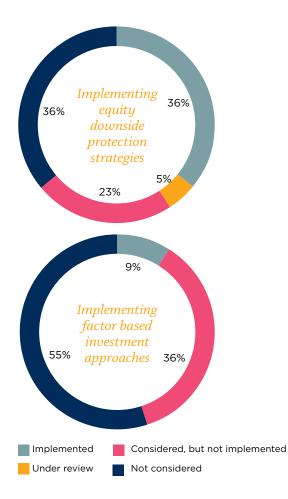
36% of insurers overall have already implemented equity downside protection strategies. In other words, the majority of insurers who invest in equities do so in conjunction with some downside protection (eg put options).

The key reasons given for insurers implementing equity downside protection related to concerns about real-world economic conditions. Most were not looking to structure the downside protection to realise lower capital charges.

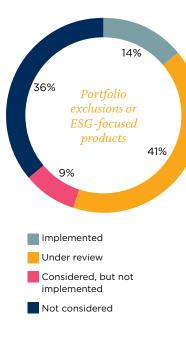
We also asked insurers about quantitative 'factor-based' (or 'risk-premia') investment approaches, which have been seeing significant press across the investment industry. Perhaps surprisingly, fewer than 10% have made an allocation to these approaches and there is not a strong pipeline of interest. Complexity and disappointing performance are the key barriers.

Our viewpoint

Given the volatility of markets, even a relatively modest allocation to equities can consume most of your investment risk budget. Whilst it may not be sensible to use equity downside protection in all market conditions, it can be useful to think in advance about when it may be attractive for you to take some risk off the table. Downside protection strategies can be an efficient way to do that, without compromising too much of your upside.



Reviewing your ESG investment policy



Environmental, Social and Governance (ESG) issues are high on the investment 'to-do list' of many insurers, with over 40% currently in the process of reviewing their ESG policy. This is a fast-evolving area in the fixed income space in particular.

Insurers are particularly interested in climate-related risks, reinforced by the recent publication of the PRA's supervisory statement¹. The PRA encourages a strategic approach, with climate change embedded in risk management processes and overseen by the Board. Insurers are expected to monitor climate risk exposures in their investment portfolios and address any concentrations of risk. As part of this, we believe they should also consider potential correlations with their underwriting risks.

The main reasons for considering ESG factors are to understand risk exposures, reduce investment risks and potentially increase returns. Other reasons may include protecting you from reputational risk (by avoiding certain controversial investments), enhancing your brand (by investing in sustainable assets such as green bonds) and supporting your corporate responsibility activities.

From our review of the market, the most common approaches to allow for ESG factors are:

- integrating them into investment analysis;
- engaging with debt and equity issuers on ESG topics; and
- including ESG in due diligence when appointing and monitoring third party investment managers.

In addition, insurers can implement ESG exclusions or invest in ESG focused products. We have seen around 14% of insurers do one or both of these actions already.

"Non-life insurers have been at the forefront of considering climate-related risks because of the obvious effects of changing weather patterns on their underwriting risks. Now their attention is turning to the other side of the balance sheet, and how climate change and other ESG risks can affect their investments. ESG factors have tended to be seen as primarily relevant to long-term equity investors, but it is now clear that they can have short-term impacts across all asset classes, including fixed income."

Claire Jones, Head of Responsible Investment at LCP & Research Lead of the IFoA Resource and Environment Board

 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisorystatement/2019/ss319.pdf?la=en&hash=7BA9824BAC5FB313F42C00889D4E3A6104881C44

Managing ESG reporting requirements

Disclosure requirements are likely to increase as ESG considerations are incorporated into regulations; and regulators encourage greater transparency.

Many insurers are already expanding their ESG disclosures and others have committed to do so by supporting the recommendations of the TCFD (Taskforce on Climate-related Financial Disclosures). Over a quarter of the insurers we surveyed have already taken steps to enhance their reporting; and a further third are reviewing or considering enhancements.

A typical first step is to ask your investment managers to provide information on the ESG risks of the securities they are holding on your behalf. However, a key challenge for insurers is knowing what to do with the large amounts of ESG information received. This is not helped by managers each having their own interpretation of what ESG actually means in practice; and providing information in different formats.

More wide-reaching changes in ESG practices are likely over the coming years as the European Commission's Sustainable Finance Action Plan is implemented, with potential changes to regulatory capital requirements and clarification of asset owners' fiduciary duties in relation to ESG factors.

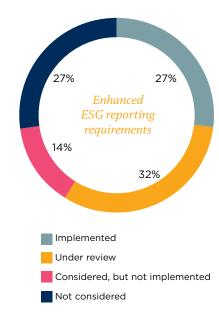
Even if the European changes are not implemented directly in the UK due to Brexit, they will no doubt influence UK practices. Policymakers may strive to maintain the UK's position as a world leader in green finance; and global insurers may look to adopt consistent practices across their business.



The bar has risen significantly on ESG requirements over the last few years; and is likely to keep rising for the foreseeable future.

ESG is a fast-evolving area and many investment managers are upping their game. That's good - but the key challenge for insurers is pulling this all together and understanding what good practice looks like.

We've seen a range of approaches across the market and have lots of useful examples that we would be very happy to discuss with you.



A simple checklist to ensure your investment strategy is ahead of the curve

- Do you understand the key investment themes that could help you?
- Are you comfortable that your overall level of target return and investment risk appetite is appropriate?
- Are you sure that you are getting really good value for money and a high level of service from your investment managers?
- Do you have a robust and defendable ESG policy?

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