2.2 INTERVIEW

What asset allocation governance trends must insurers heed?

Interviewer

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Interviewee

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Noel Hillmann: What key trends are unfolding across the global investment world?

Ian Castledine: There are a number of sustained trends affecting the insurance market.

The first is the ongoing onslaught of regulatory changes that insurers are facing. The impact of these changes is far-reaching, especially with regards to transparency and disclosure requirements. Increasingly, data and technology issues are big concerns for insurers, particularly those who are utilizing self-solutioned legacy platforms that cannot accommodate growing investment complexity and greater regulatory rigor. As a result, we see a lot of insurers thinking about investing in new systems and solutions to find scale and efficiency, including solutions from the asset servicing industry to address the likes of Solvency II in Europe and NAIC-proposed changes in the U.S. alongside other regulatory changes which are increasing reporting and operational requirements.

Secondly we've seen a series of capital management challenges due to sustained low interest rates and lower investment returns as well as geo-political and economic uncertainty The result is a rethinking of insurers' asset allocations and increased investment, or planned increased investment, in alternatives including real estate, private equity and infrastructure. This is in addition to revisiting the platforms and infrastructure needed to support more illiquid investments and the natural operational and governance considerations associated with such asset allocation shifts.

Finally, both from a European and North American perspective, we're seeing a lot of activity with the run-off of defined benefit (DB) pension plans and the pressure there to de-risk is having two very real impacts on the insurance market.

The first impact is the shift of pensions into liability matching assets. This continues to impact on the fixed income market with regard to longer dated instruments. The second is the increase of full de-risking which is stimulating the insurance industry to develop solutions in the buy-in and buy-out space as we see pension schemes continuing the risk transfer trend to specialist insurance providers.

In the UK, the pace of pension risk transfer continues to push the capacity of insurers to support it. Some of that capacity may increase next year due to changes to personal pension redemptions whereby the historical prescriptive requirements for annuities will be lifted. This will reduce the market for traditional personal pension annuities and allow insurers to take on additional DB pension risk transfers.

The risk transfer market is a big focus for us presently and the subsequent need for a holistic risk monitoring platform between the sponsor, pension scheme managers and the new insurance partner. We are continuing to support pension schemes as they position themselves to enter into risk transfer arrangements through monitoring coverage ratios and satisfying their analytical requirements as they progress along their funding flight paths to achieve mandatory funding ratio requirements.

Noel: Are you in a very much responsive mode to insurers' present needs or are you proactively looking at what their next need will be?

Ian: We are in the fortunate position to be able to do a bit of both.

A large number of insurers' present needs are well supported by existing capabilities that we have had for many years at Northern Trust. A number of the regulatory requirements proposed by Solvency II and NAIC fit with our existing capabilities around stress testing and data transparency and we are able to support our clients with risk management analytics and disclosure reporting.

Our development focus has now become a balance between solving the components of insurers' present needs that we need to expand upon while continuing to strategically enhance our infrastructure to support our clients' future requirements. For example, we've continued to expand our capabilities in the regulatory reporting space to develop solutions to simplify Solvency II's Pillar 3 reporting requirements, leveraging our position as the custody and asset servicer to populate the Quantitative Reporting Templates and relieve our clients of much of the reporting burden.

Likewise, we continue to enhance our infrastructure to facilitate the increasing monitoring frequency required by our clients, especially in relation to the DB buy-in and buy-out and risk transfer space. This includes not only asset side monitoring but increasing our capabilities to support daily liability valuations. Frequent valuation and funding ratio monitoring is a primary focus as our pension clients work towards achieving the requirements set by insurers to enter risk transfer agreements. As such, they look to us to support them in this from a monitoring and servicing perspective while continuing to provide risk management and performance analytics, consistent with their increasingly robust governance process.

Enhancing our analytics and monitoring capabilities to get pension schemes to the level of being able to engage in risk transfers and then being able to support risk transfer instruments such as longevity swaps from an asset servicing perspective. This leverages our capabilities and position in providing complete solutions on both sides of the risk transfer arrangements for both our insurance clients and the pension schemes they are insuring.

As mentioned earlier, we see the evolution of asset allocations and the trend towards increased investment in alternative asset classes and higher yield instruments such as emerging market debt. Consequently we've been looking at liquidity solutions as insurers have gone into less liquid instruments like infrastructure and real estate but still express concerns with regard to the unintended consequences of diversifying into these asset classes. They are increasingly asking us to help them properly model liquidity at a total level and tie together all of these underlying instruments. We need to consider shock testing of liquidity in order to establish exactly how instruments would react at the most illiquid times. This then in turn needs to be fed back into the investment governance and oversight process and that liquidity sample is one of several areas where we've seen a spike in demand.

In relation to asset allocation, insurers increasingly need more frequent reporting of forward looking or implied correlations between asset classes to ensure that diversification holds throughout different economic lifecycles.

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One more area that I'll highlight is our multi-year compliance engine redevelopment. Our legacy platform was very much focused on per mandate guideline monitoring. We have redesigned and rebuilt the platform to reflect how we think about compliance and analytical solutioning now and for the future. The platform has undergone a fundamental redevelopment to serve as a holistic investment governance monitoring platform. The platform is capable of monitoring across managers to enable insurers to better understand their exposures, for example, their total credit exposures to collateral, and access better shock testing and scenario analysis as they move away from traditional vanilla instruments. By bringing in multiple analytical data sets across custody, performance and risk, we provide a flexible monitoring platform to support the current needs. It is a scalable and flexible platform from which to quickly build solutions for future use.

Noel: Are there any specific solutions that insurers can seek or strategies they should deploy to minimize those challenges and maximize on returns?

Ian: The trends we're seeing now are a good indication of the solutions that the insurance space has already taken in response to the changing environment. In large part, a number of these trends and solutions are shared across our institutional investor base, albeit with slight variations in approach for the specific investment goals. The themes are similar though. We spoke about the increasing diversification within the asset allocation and the expansion of alternatives including private market investments but also new public market opportunities around alternative returns seeking strategies like smart beta or low volatility funds. We also talked about the increased focus on asset liability management, managing surplus risk and ultimately minimizing balance sheet volatility, whether for insurers or for corporate plan sponsors.

One result of that is the increase in structured hedging strategies as a potential solution. In Europe, we see this as a direct result of regulatory risk-based capital requirement rules proposed in Solvency II and the benefit from hedging risk exposure. While the U.S. doesn't have the same granular level of regulatory structure in place yet, I think we continue to look at Europe as an indicator of potential regulatory change in the U.S.; possibly never reaching that same level of detail but nevertheless, following similar trends towards risk and disclosure requirements. The expansion of investment strategies and the tightening of regulatory requirements poses a challenge for insurers to find solutions to achieve their investment goals while controlling and minimizing the costs associated with regulatory compliance, whether that's solvency and liquidity requirements or efficient collateral management.

The amalgamation of all of these trends results in an increased appetite amongst insurers to leverage their relationships with their service partners and utilize their expertise or increase the efficiency of addressing these challenges. One component of this is a potential increase in outsourcing investments to specialist managers as they expand their asset allocation opportunities. The other is to outsource their asset servicing partners to find ways to satisfy their growing data, reporting and disclosure needs and the infrastructure required. It's in this area that we continue to leverage our core competencies and to focus our development roadmap to help support and provide solutions for the challenges ahead.

Finally I would say that the key trends discussed here all have a fundamental need for transparency at their heart. Insurers will find it increasingly difficult to respond to greater regulatory demands and investment complexity, revised asset allocations and increased allocations to illiquid assets, or successfully engage in the risk transfer market without strong governance and risk management frameworks in place. We firmly believe that effective governance and oversight is the most fundamental and critical strategy with which to minimize these challenges and maximize returns and this is exactly what we have been working on with many of our clients to date.

Noel: Thank you very much Ian.

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