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WHY LIFE INSURERS AND ASSET MANAGERS MUST JOIN FORCES TO WIN

By Walter Reinl, Andrea Giudici, and Ofir Eyal

LIFE INSURERS ARE FEELING the squeeze. The industry's overall business growth has stalled, and investment income has become a critical mainstay. Yet that income stream is weakening, as low-risk investment yields dip toward 0% and central banks continue to drain the bond markets.

In their efforts to adapt to this upside-down world, life insurers are focusing on optimizing their investment strategies and operations. And they are asking challenging questions: How can we shift investments to compensate for the evaporation of low-risk returns? Can we cut costs to boost overall profit? How do we manage capital consumption and the volatility of our assets?

Many internal asset managers have become caught in the headlights of this rising scrutiny. Increasingly, managers find themselves in sometimes heated debate, pitted against their companies' actuaries, product managers, risk and finance executives, and boards of directors.

As each side of the business jockeys to promote its own agenda, a life insurer can quickly lose sight of its long-term goals. The result: investments are managed opportunistically as each faction seeks to optimize its own favored KPI quarter by quarter—whether it is cash flow, earnings, solvency, market risk exposure, rating requirements, or investment performance. Corporate life becomes a series of zero-sum battles in a war with no winners.

A Structured Process and Radical Cooperation

To escape this trap and prevail in today's environment, life insurers and asset managers must close ranks. In our experience, a structured process is necessary to bridge divisions and map a collaborative path forward. This will require greater transparency on both sides and a shared understanding on a number of issues—including how the asset manager creates value, relative to costs, for shareholders and policyholders alike. Cooperation and even radical reteaming across siloed interests will be needed to create powerful, integrated management of both sides of the balance sheet.

Asset management has become a crucial activity for life insurers. It offers a steady flow of customers' captive assets and—for the best insurers—significant revenues from managing the assets of third parties. Moreover, as return on equity becomes an increasingly critical performance benchmark for insurers, asset management has the advantage of consuming negligible amounts of risk capital.

Yet with ultra-low yields beginning to sting, life insurers and asset managers fight to overcome formidable challenges that can drive a wedge between them, such as the following:

- Ensuring predictable absolute returns that match the cash flow from liabilities
- Managing solvency levels as asset risk and capital market volatility rise
- Justifying fees for managing captive assets, as life funds and policyholders watch their customers' returns drop year after year

As yields fall across fixed-income maturities and ratings, there is less room for error in the cash flow generated by asset managers. It is therefore crucial to fine-tune the strategic asset allocation (SAA) of investments to prevent wrong bets that can't be corrected or offset through tactical moves. Both insurers and asset managers need to revisit questions regarding SAA, especially those related to participating business that is written on the general account:

- As market volatility rises, will the existing SAA still make sense for shareholders—especially if the upside is shared with policyholders while the downside risk remains with the company? How does your SAA link to your new business strategy?
- Do you focus on realizing your return targets by asset class or do you concentrate on outperforming benchmarks? We recommend choosing the right benchmark—whether open market or synthetic—and delivering against it rather than concentrating on alpha generation. The concept here is "smart beta," which can also be executed in combination with passive instruments.
- How adept is your assessment and management of low-correlation, alternative assets—particularly those that are illiquid, including infrastructure, venture capital, private equity, and non-capital-market correlated classes, such as insurance-linked, parametric securities? Is your team skilled in managing overlays and efficiently making controlled SAA or market-driven bets? We expect insurers with significant third-party business to retain an advantage in alternative assets over peers that manage only captive assets. But to do so, they will need to develop asset management capabilities that are more specialized than ever.

Adapting to an Era of Increased Capital Constraints

Many insurers entered the European Union's Solvency II era with significant excess capital on their books. That surplus will be short-lived. Capital will increasingly constrain asset strategies as back-book reserve requirements rise, capital gains are realized, investors hunger for cash, and new money is encumbered by low yields. In this environment, diligent life insurers are tightening the management of their balance sheets. They are bringing together actuaries and internal model experts, as well as capital-steering and investment strategists, to form more integrated, strategically focused teams that oversee their asset and liability management (ALM).

Simulating the likely outcomes of liabilities against current assets reveals management questions and options, such as the following, that can transform an insurer's fortunes:

- Is your asset strategy truly driven by your ALM model? Or is it actually shaped by the need to produce quarterly earnings reports? How tight is the link between your risk capital model and your SAA? Do you know precisely—on a day-by-day, operational basis—the efficient frontier of all your assets? (By "efficient frontier" we mean the set of investment positions that provide the highest return for the lowest level of capital consumption at an acceptable degree of expected volatility.)

- Do the findings of your ALM simulations inform product development, to ensure that new business has a positive impact on the balance sheet and does not exacerbate existing mismatches or one-sided bets?

- Is increasing investment allocations to higher-return assets your only option? Or could you switch to a more conservative asset strategy if required? Life insurers have been acting as a group in a cyclical fashion, switching in and out of risky assets during various peaks and crises over the past 20 years. We believe it is important to assess alternative ways to manage assets more actively.

- Are you able to identify and act on opportunities to reduce capital market risk through open-market instruments or over-the-counter transactions? How much could you enhance your SAA if you sold off some of your liability risk or if you managed your liabilities—especially the back book—more actively?

- Have you calculated the potential benefits of restructuring your liabilities, possibly even removing some from your balance sheet altogether?

Justifying Management Fees and Reducing Costs

Asset management costs are increasingly important—and a source of growing disagreement between insurers and asset managers. Historically, when portfolio yields exceeded 6%, those costs had negligible commercial impact. That is no longer the case. Under Solvency II, and with new-money yields dipping below 3% in the UK and below 2% in Germany and Switzerland, many insurers are still saddled with sales and administrative costs exceeding 100 basis points. Meanwhile, capital charges can easily add another 100 basis points, as new money is invested in ever-riskier assets. Suddenly, a cost differential of 20 to 40 basis points is no longer academic. This is especially pertinent for asset managers that have built a significant third-party business and now face increasing scrutiny from regulators and nonexecutive directors alike.

Simply arguing over fee levels, however, adds little shareholder value and is unlikely to lead to a resolution or to change the underlying economics. Instead, insurers and their in-house asset managers should cooperate closely to identify the solutions that will allow them to prosper jointly. They should consider, for example, the following questions:

- **Where can the asset manager add value that would exceed any provided by a third-party manager or by employing a passive strategy?** This overarching question must be addressed rigorously, so that the insurer and the manager can reach an explicit, shared view.

- **How can the asset manager help differentiate the life insurer's products?** As insurers focus on the next generation of products, internal asset managers can help build a differentiated customer proposition—for example, by supporting "segment of one" products, transparency on fees, robo-advice, or client access to differentiated investment strategies.

- **How should insurers prioritize their asset classes?** In which asset classes does the insurer already have a clear edge or have the ability to develop one? In which is the manager certain to be able to perform at least at market level in terms of costs and returns over the next ten years?

- **Should operations be in-house or outsourced?** Which parts of the insurer's asset management value chain should be kept in-house, and which (such as commodity operations) should be outsourced? Which activities could be discontinued as a result of digitization? It is worth noting that the highest-margin asset management businesses are often the most selective about which functions they retain in-house.

- **How can insurers optimize and align asset managers' incentives?** What are the right performance incentives for an asset manager? Do those incentives align with the respective insurer's strategy and business model? For example, is the manager truly motivated to control costs if it is compensated on a cost-plus basis? Asset managers' costs are a key underlying value driver for policyholders and shareholders alike. Insurers and managers should therefore approach the topic strategically and jointly.

Captive asset management can be rewarding for all parties. Benefits for the insurer include the ability to define and execute long-term strategies, to create business transparency at the base fund level, and to build its retail business on in-house capabilities. Benefits for the asset manager include access to attractive funds—such as those of endowments, pension funds, and smaller insurers—and investment opportunities, all under the brand of the life insurer. Captive management also allows the insurer to commit funds to long-term investments (such as in private equity, senior debt, and private placements) and to bring scale to product innovation.

Breaking Down the Silos

To prosper together, both insurers and asset managers must review options jointly, transparently, and in a spirit of cooperation—an approach that differs radically from that of traditional, siloed interactions:

- The life insurer should be transparent about the level of funding it can commit over the long term so that the asset manager can invest in building capabilities and developing the right talent.

- The asset manager should provide an accurate account of its performance through, for example, indexed strategies and robust, timely reporting.

- The insurer should avoid any shifts in its internal model and risk management practices that could undercut the asset manager's operations, efficiency, and fund structures. The manager must be able to commit assets to virtual pools and adhere to defined rules and restrictions.

- The asset manager must diligently measure and track the resources expended for the captive business. Ideally, the manager will designate key teams that serve only the internal client to ensure responsiveness, accountability, and cost transparency.

The life insurance industry's evolution over the coming decade is not yet charted. Global markets, central banks, regulators, technological innovation, and the needs of customers will all play roles in creating the opportunities and challenges ahead. But insurers and their asset managers don't have the luxury of waiting to see what the future holds. They must make decisions now that will either improve their institutions or leave them weaker in the years to come.

Assessing these choices in a spirit of radical cooperation, and capturing the new opportunities collectively, can make the task a lot more agreeable and, ultimately, more profitable.

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