

# Insurance: Royal Wedding

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Solvency II and other projects that BRAVE Partners is engaged on reminds the firm of the need for long dated matching for life insurer annuity books.

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The wedding on 29 April, 2011 of Prince William to Miss Catherine Middleton was a global phenomenon. If only all long term matching were followed so closely around the world, then the long dated liabilities of the life insurers might not be such an issue. We are talking ALM – asset liability management – which is all about long term matching of assets and liabilities.

## That's life

Asset liability management – ALM – is the corner stone of much life insurance business. This business tends to be long dated, but stable liabilities. Often investment products have some kind of minimum return.

## The rise of the asset manager

As asset intensive products grew, life insurers set up specific teams to manage the assets. It was then a natural progression for these teams to take on asset management for other third parties. This meant that the asset management had to be split out from the life insurance business.

## Degrees of separation

Progressively, life insurers developed two sides to the business – the asset side and the liability side and never the twain shall meet. Progressively, the asset side talked about targets in terms of an industry benchmark – the Lehman Aggregate bond index, or the FTSE 100 for stocks, and the liability side projected out the liabilities and made vague assumptions about the long term asset returns.

## Nothing can go wrong ... go wrong ... go wrong ...

Googling the phrase “nothing can go wrong ... go wrong ... go wrong” brings up a story with the following content:

“But, like all things automated, sooner or later something goes haywire, and when it does it can be potentially very costly.

With the benefit of hindsight, the separation of asset management and liability management within life insurers is one of the worst decisions ever made within the industry.

Last week, a United Airlines B757 aircraft had a run-in -- literally -- with a DoubleDock jet bridge at Denver. United Flight 965 had just arrived from Boston on March 30, 2007 when, as the FAA's

preliminary report about the incident says, "while positioning at the gate, the rear part of the jetway collapsed onto the left wing." Oopsie.

The FAA report said that the extent of the damage to the aircraft (and presumably to the jet bridge) was "unknown." The aircraft did not continue on its next scheduled leg. Fortunately, no one was injured."

This "automated" ALM had a similar impact.

### Zombies v policyholders

Those readers with an iPad will almost certainly be familiar with Plants v Zombies. Those that have played the game will also know that the ambition of the zombies is to get into your house and eat your brains.

The early 2000s saw the emergence and growth of "zombie funds". These were life insurance "with profits" funds.

"Zombie funds" were big news in the personal finance pages of the Sunday Newspapers. The issue was a serious embarrassment to the Financial Services Authority and continues to be so.

### Without profits

Most "with profits" life insurance policies contain highly complex embedded guarantees that put a floor on the value of the investments. Analysing these products certainly does make one feel like something has been attacking your brain after a while – although that is not why they are called "zombie funds". The term "zombie fund" was derived because the returns on still active funds became so low, they might as well be dead. The policies were very much living dead.

Wherever the phrase "zombie fund" is derived from, the issue is clear. The "with-profits" policies contained highly complex financial options.

### Look back in anger

The technical jargon for the option embedded in the "with profits" policy is a look-back option. These are among the most complex that can be written because their value does not only depend on the value of the investments at expiry, but on the path that those values took over the lifetime of the investment. That is the reason for the "look back".

These options need to be backed by significant capital if there is any risk to the investments, making their path highly uncertain. Riskier investments should grow more over the long term. Zombie funds were funds that had run out of capital to support the guarantees if the fund were invested in riskier assets. The funds were therefore switched to invest in cash and government bonds, neither of which produce high returns – and in fact right now both of which give very low returns, so the zombie fund performance continues to decline.

## Solvency II

A cynic might suggest that the new regulation is called Solvency II – almost as a reference to second time lucky! The original solvency regime simply did not have the complexity needed to ensure that the complex “with profits” policies were backed by sufficient capital.

The UK regulator pre-empted Solvency II, partly in response to the zombie fund fiasco. The new rules, and Solvency II in particular, now require detailed modelling of assets and liabilities and are brutal on mismatches. If assets and liabilities are mismatched, then the capital requirements accelerate fast.

## A match made in Brussels

In the opinion of BRAVE Partners, the new rules are too strict on matching. The issue is that the liabilities are only an actuary's best estimate – they are not fixed in stone. Matching the assets to this estimate of the liabilities too rigorously is again a recipe for disaster if, as is highly likely, the liabilities prove to deviate from the assumptions – which they invariably will.

That said long term matching is definitely in for Solvency II.

## Long dated and stable – the perfect match

These Solvency II requirements have driven insurance companies to seek out assets bearing long dated, stable cashflows at good yields. Many such assets originate from project and energy finance. BRAVE Partners has strong access to these assets through their business in the energy sector.

## BRAVE Partners services

BRAVE Partners LLP is a boutique investment bank that specialises in (re)insurance, energy and pensions. The firm is ideally suited to understanding the investment needs of insurers and pension funds and to source high quality, long dated, stable cashflows to satisfy these needs.

## Interaction

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- The asset intensive life insurance business has traditionally not been strong at integrated asset-liability management.
- Whilst this situation is improving substantially, it has been formalised in Solvency II which is draconian on matching assets to liabilities.
- This has created strong demand for long dated, stable cashflow assets.
- The energy sector is currently a fertile source of long dated, stable cashflow assets.
  
- BRAVE Partners LLP can assist life insurers and pension funds in sourcing long dated, stable cashflow assets.

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