Capital Management through a Covid-19 lens

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Today’s agenda

1. The observed resilience
2. Capital Planning and Management Actions
3. Example: Australia
4. Opportunities and challenges
5. Closing remarks and Q&A

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The observed resilience
Year-end 2019 ratios

Image 1: Average Year-end Solvency Coverage Ratios

- Q4 2019 Solvency Coverage
  - Europe 232%
  - UK 157%

Image 2: Average Market Risk Proportion of Solvency Capital Requirement

- UK 49%
- Europe 60%

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Possible reasons:
- The relationship between Own Funds and Solvency Capital Requirement
- Built-in mechanisms to limit pro-cyclicality, including Solvency II transition arrangements, the matching adjustment and long-term guarantees
- Regulatory actions taken
- Capital planning and management actions taken before and during the crisis
Capital planning and management actions
A look at the solvency ratios...

Source: Company year-end reports and accounts

Note that shareholder ratios are used, where disclosed

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Steps taken during the pandemic

Step 1: Identify where the issues are
• Additional stress and scenario testing
• Revised business plans
• Increased solvency monitoring
• Credit portfolio management
• Claims analysis
• Interim ORSAs

Step 2: Consider impact of existing actions
• Significant interest rate hedging
• Significant equity hedging
• Significant mortality and longevity reinsurance
• Long Term Guarantee measures
• Lower new business volumes

Step 3: Identify additional actions required
• Additional rates hedging
• Property risk hedging
• Revised credit portfolio
• Additional longevity reinsurance
• Raising capital

Step 4: Identify future actions
• Credit downgrade protection
• Lapse reinsurance
• Revised credit portfolio
• Changes to risk capital calibrations
• Divestment of non-core business

Update capital management framework
Example: Australia
Opportunities and challenges
Immediate impact

- The management actions taken during the crisis were predominantly operational
- Also increased solvency monitoring
- And focus on cashflow management
- But hedging strategies mitigated risk for some insurers
- And active management of asset allocation
- Impact on solvency also mitigated by technical measures
  - Matching and volatility adjustments
  - Transitional provisions
  - Smoothing
- Rapid recovery in equities and corporate bonds helped

*Image: How prepared do you feel insurers’ investment functions were to weather the kind of turbulence we witnessed in Q1 of 2020?*
Longer term impact

• Longer term investment impact partly depends on how quickly economies recover
  ➢ Further waves, vaccine roll outs etc?

• Bond defaults peak later than spreads

• But largest impact is that interest rates are probably even lower for even longer than expected
Impact of low rates

Interest hedging can mitigate the impact on existing guaranteed liabilities

But lower rates impact the guarantees that can be offered on new business

And maybe the discretionary uplifts on existing business

Regulatory smoothing and transitional provisions can delay the problem but not solve it if low rates persist

This may change the type of business written in future
Yield curves 2020 vs 2019

Source: Moody’s Analytics

Maturity (years)
Investment strategies in a low rates environment

Investment strategy should look to boost the return on assets without taking more ‘risk’

» ‘Risk’ and permissible strategies partly defined by local regulatory regime

» Any internal model recalibrations following Covid are likely to raise rather than lower risk estimates of a given exposure

Approach taken should not depend on outsmarting financial markets

» Strategy not tactics
Credit spreads 2020 vs 2019

GBR - End Dec 2020 AAA, End Dec 2020 A, End Dec 2020 BBB
USD - End Dec 2019 AAA, End Dec 2019 A, End Dec 2019 BBB
EUR - End Dec 2019 AAA, End Dec 2019 A, End Dec 2019 BBB
Equity valuations

Cyclically adjusted earnings yields
Jan 1980 to Jan 2021

Source: Refinitiv (MSCI)

Source: Datastream (MSCI), Moody’s Analytics
Opportunities by asset class

Interest rate and FX exposure
» Would not expect to be rewarded for taking these risks

Standard corporate credit
» Credit risk should be a rewarded source of risk
» But spreads may not be particularly attractive

Quoted Equities
» May be difficult to justify in a cashflow matching portfolio
» Valuations stretched?

Illiquid assets
» May offer an illiquidity premium over quoted alternatives
» A ‘free lunch’ for investors who do not need liquidity?
Challenges of illiquid assets

Sourcing adequate volumes
Requires specialist expertise to select and manage
High fees
Can we quantify the liquidity premium?
  ➢ Maybe easier for debt than equity
How do we know we won’t need liquidity?
Regulatory constraints
Conclusion

Insurers typically weathered the initial crisis well

The biggest longer term investment impact is probably even lower rates for even longer

This will encourage insurers to hunt for return without taking more risk
Thank you
Appendix: Output from the IFoA Covid-19 Action Taskforce (ICAT) Capital Management Workstream

Capital and management actions taken by life insurers, both prior to and during the crisis, as well as those planned for the future:
http://blog.actuaries.org.uk/blog/using-hindsight-gain-foresight

The countercyclical measures in Solvency II and how well they worked in practice:

How insurers’ solvency ratios, under Solvency II, actually performed:
https://www.actuaries.org.uk/system/files/field/document/How%20Solvency%20ratios%20performed_v4_withGraphALT.pdf

Actions actually taken by international regulators in response to the crisis:

Solvency II – countercyclical capital requirements and regulatory flexibility: