THREE OPTIONS FOR INSURERS WORKING THROUGH CURRENCY ASSET LIABILITY MATCHING (ALM): NON-GBP LIABILITIES

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Insurers underwriting risk in multiple currencies have, in the past, not needed to think twice about matching assets by currency. Historically, examining alternatives to the status quo hasn't been beneficial enough to pass even a simple cost-benefit review, particularly for insurers with relatively small foreign currency exposures. However, in the current environment of ultra-low and even negative bond yields, this is no longer a no-brainer for insurers and certainly worth a closer look.

Most insurers wouldn't consider holding unhedged foreign exchange ('FX') positions due to a combination of punitive Solvency II (SII) FX capital charges, and the economic risk that exchange rates move against the insurer as liabilities come due. However, each set of circumstances is unique and a one-size-fits-all approach simply doesn't work.

In this case study we briefly explore the implications for insurers considering holding GBP assets against non-GBP liabilities and what options are available for actively managing that risk. This case study is presented in the context of work we have done for an insurer exploring these very questions.

CASE STUDY

We've recently worked with a UK insurer holding short-dated liabilities across a range of currencies. The base currency was Sterling and that was reflected in their investment portfolio which was entirely allocated to Sterling assets. This mismatch was starting to have an impact on their SII capital position and creating internal problems around underwriting performance reporting.

Our team worked through a potential asset liability matching (ALM) exercise to find appropriate assets to match liability currency, duration and liquidity profile in line with the insurer's risk appetite. The insurer's risk appetite was translated into a set of investment guidelines and it was clear that for certain currencies most assets that met the investment guidelines as well as provided aggregated cashflows that matched the liabilities were negative yielding. Consequently, we set about exploring alternatives to these negative yielding assets .The alternatives suggested needed to meet certain criteria, namely:

1. Needed to maintain an average credit rating for the overall portfolio of greater than A+.

2. Limited to only fixed income assets.

The global fixed income market remains a market divided by currency. The largest universe of investment options is the one available to US Dollar investors with UK & European fixed income investors restricted to a much smaller set of options. What's more, with negative yields across much of the European fixed income market, investing in these smaller markets can be challenging for insurers.

For our insurer, the currencies in question were the Swiss Franc (CHF), the Danish Krone (DKK) and the Swedish Krona (SEK). As you might expect, the universe of eligible assets under the insurer's investment guidelines to match these liabilities was, on average, negative yielding (in the range of -0.5% p.a. to -0.8% p.a.). Having discussed the project in detail with the insurer, it was clear there were three options available:

- Option 1: GBP Buy & Maintain – Invest in GBP assets over the lifetime of the liabilities and manage the investment to identify opportunities to improve portfolio yield where possible.
- Option 2: GBP Buy & Switch – Invest in GBP assets for a period of 6 – 12 months and switch back to liability currency assets.
- Option 3: Pure matching – Leave the asset mix unchanged and actively manage the portfolio to minimise holdings in negative yielding debt.

OPTION 1: GBP BUY & MAINTAIN

Our objective in the 'GBP Buy & Maintain' strategy was to manage a portfolio of assets that provided enough of a yield pick-up to counter-act the 25% FX SII capital charge they were incurring for mis-matched assets and liabilities, while minimising investment and FX risk. Given the largely positive outlook for Sterling relative to CHF, DKK and SEK, and with careful management of liquidity risk relative to liabilities, there was some promise in this strategy.

BENEFIT

It's important to appreciate that the combined CHF, DKK & SEK exposures amounted to less than 7.5% of the insurer's total assets. Separately managing these assets can incur additional cost (i.e. custody fees for each separate currency account) and add complexity, particularly around financial reporting. Managing the assets in tandem with the Sterling assets, eliminates these additional costs and also avoids areas of the fixed income market where negative yielding bonds dominate. We estimated the insurer would benefit from a yield pick-up of c.0.6% - 1.0% by adopting this 'GBP Buy & Maintain' strategy.

CHALLENGE

However, the SII capital charges for taking on the additional FX risk involved in this strategy is a challenging one. At 25%, the capital charge can be punitive for large mismatches between assets and liabilities. We quantified the implication of this large charge and, taking into consideration the cost of capital (CoC) for the insurer, we estimated the yield pick-up, net of CoC, for this strategy to be c.-0.7% p.a. Naturally, the baseline for this type of strategy needs to be a positive yield pick-up net of CoC and so, on this basis, this strategy would likely fail. The insurer would likely incur higher capital costs than additional investment return.

OPTION 2: GBP BUY & SWITCH

The next step was to consider whether there was an intermediate option available which would allow the insurer to benefit from some additional yield without necessarily having to accept the extra capital charge on a long-term basis. In this 'GBP Buy & Switch' strategy, we reviewed whether we could hold assets that provided a short-term yield pick-up but switch back to the appropriate liability currency (CHF, DKK or SEK) at some point within a 6-12 month window (based on market conditions). The positive outlook for Sterling relative to CHF, DKK and SEK made this strategy attractive. Sterling should benefit from the positive economic backdrop and from the end of the Brexit uncertainty that has dogged the currency since 2016. In addition, the cashflow profile of the insurer meant there were no large liability payments expected over the next 12 months, with ordinary outflows being met without liquidating positions through our a liquidity management strategy.

BENEFIT

As with Option 1, this strategy also benefits from cost savings. Although these savings would only be temporary while the assets are invested in Sterling, the short-term simplicity allowed the insurer some time to prepare and gear up for the additional reporting processes. Our estimate of the potential yield pick-up from this 'GBP Buy & Switch' strategy was c.0.3% p.a - 0.75% p.a.

CHALLENGE

The major risk was the economic risk of currency volatility and necessity of fortuitous timing when switching the assets back from GBP to FX matched assets. We analysed the volatility and forward guidance for the currency pairs and, once we considered the expected asset returns, adjusted for expected currency volatility, the asset risk profiles looked more like high yield bonds than investment grade bonds.

Given the insurer's investment guidelines do not allow investment in high yield bonds for reason of their heightened volatility profile, this strategy is on the margin of accessibility from a risk appetite perspective and probably not one that could be achieved within their risk budget.

OPTION 3: PURE MATCHING

The implications of this ‘Pure matchingstrategy are relatively straightforward and self-explanatory. The strategy is focused on maintaining the ALM dynamic for each currency while also actively minimising the impact of negative yields. Although each separate currency portfolio is relatively small, they’re still able to be actively managed with distinct duration targets.

BENEFIT

The obvious benefit of this strategy is to reduce portfolio currency volatility, relative to liabilities, to zero. The insurer also saw regulatory capital savings from removing asset-liability currency mismatches.

CHALLENGE

Given the average negative yield profile of the available investment universe in each currency, achieving a positive investment return looks to be a difficult challenge to solve. However, there are a number of sub-asset classes within the fixed income space where positive yields, even in CHF, DKK & SEK can be found and so our team have prioritised creating an actively managed balanced, diversified portfolio for each currency that minimises negative yielding debt where possible.

OPTIONS FALLING OUTSIDE THE SCOPE

For this insurer, certain constraints around the use of derivatives and FX hedging strategies meant that some options available to most insurers fell outside the scope of available strategies.

One common strategy often employed by insurers is to make use of FX hedging to purchase bonds in one currency and hedge that exposure back into the liability currency, effectively removing the non-liability currency FX risk. These kind of strategies are most attractive when the cost of hedging is less than the yield pick-up from holding assets in the non-liability currency. This is a strategy we have employed with some success for some of our insurers and although conceptually simple, the practicalities around use of derivatives for hedging FX risk under SII does add some complexity. Working with an asset manager with experience in the insurance space is essential for deploying this strategy.

Another alternative strategy may have been to move down the credit quality spectrum to source higher yielding assets in the liability currencies. Again, this a strategy we have employed with some success for our insurers. Careful credit analysis is, of course, key but the insurer also needs to ensure they have sufficient regulatory capital available to support these higher risk assets.

SUMMARY & CONCLUSION

Although this case study is relatively specific, it does give a framework for the features of an insurance portfolio that should be considered when making asset allocation decisions, especially decisions involving FX exposure.

We work with our insurers to identify the pros and cons of investment strategies before implementation. A clear understanding of risk appetite can help insurers clearly evaluate investment strategies that may not have ordinarily been under consideration, provided your asset manager can also provide the necessary economic outlook and market data required to complete the picture.