



BLACKROCK®

GLOBAL INSURANCE
INVESTMENT
STRATEGY AT AN
INFLECTION POINT?

WRITTEN BY

The
Economist

Intelligence
Unit

Global Insurance: Investment strategy at an inflection point?

FOREWORD



In January, we outlined four key themes that would dominate the global insurance industry in 2013: income, profitability, capital and regulation. The findings of our latest research, conducted in partnership with the Economist Research Unit, suggest that these themes remain centre stage.

Insurers are struggling to mitigate the implications of low yields in an environment where there is a constrained supply of higher quality, high-yielding assets, due in part to central bank policies in operation around the globe. In addition, the imminent tapering of QE and the volatility that this is likely to bring, combined with regulatory uncertainty across the financial services industry, is causing many to re-consider their investment strategies.

But to quote one industry leader, “coping with change is in the industry’s DNA”. Our research, which surveyed more than 200 insurers globally, indicates that the industry is keenly aware of the need to adapt.

Many insurers have already increased allocations to investment grade and high yield debt. Many more say they are exploring non-traditional asset classes to source additional income, generate diversification and deliver improved correlation benefits. Our research points to ETFs and derivatives becoming essential tools in achieving those goals. As the end of QE approaches, we also see a growing focus on reducing interest rate risk exposure by loosening benchmark constraints and diversifying into non-core fixed income assets and more absolute return strategies.

However, much remains to be done. Insurers will need to enhance their risk management capabilities to match the evolution of their investment portfolios. Derivatives and non-traditional asset classes bring a host of new challenges; a clear plan for how to manage risk exposures and better deploy capital in light of regulatory charges and the need for higher risk-adjusted returns on capital is paramount.

Perhaps the most important finding is that many insurers recognise the need for greater support to carry these changes forward. I firmly believe that closer, more effective partnerships with fewer, specialist insurance asset managers are the key to success. This puts the onus on managers such as BlackRock to deliver a flexible partnership model with the required insurance investment expertise. Our research includes real world examples of how this approach can improve the likelihood for better outcomes.

As the industry embraces the need for deeper partnerships with asset managers, I am confident that the insurance industry will emerge better equipped to meet the needs of insurance end-users. I hope that you find the research informative and useful as you navigate a course through this challenging environment.

Sincerely,

David Lomas, ACII

Head of Global Financial Institutions Group, BlackRock

financialinstitutions@blackrock.com

CONTENTS

Executive summary	3
Key findings	4
About this report	6
Introduction	7
Drivers of change	8
Evolving investment strategies and risk assessment	13
Adapting products and strategies for future growth	33
Conclusion	41
About BlackRock	43
Appendix	44

Executive summary

“THERE HAS ALWAYS BEEN SUBSTANTIAL CHANGE IN INSURANCE, SO COPING WITH THAT CHANGE IS IN THE INDUSTRY’S DNA.”

Otto Thoresen

Director-general, Association of British Insurers

As insurers battle challenging economic conditions and a barrage of financial regulation, identifying the likely drivers of change and responding effectively will be critical to success. Investment strategies, risk management, product lines and operational processes are all targets for a whole new way of thinking across the industry.

Insurers must respond to shorter-term factors such as continued market volatility and the ending of quantitative easing (QE) by central banks, in addition to long-term drivers such as stricter regulation and the corresponding increase in focus on risk management.

In this climate, The Economist Intelligence Unit, on behalf of BlackRock, surveyed over 200 insurers worldwide in April and May 2013 to find out how they were adapting to change. Respondents gave insights into attitudes towards risk, likely investments, their readiness for further market volatility and the likely sources of future profitability.

An additional survey of half of the original respondents, conducted in July after the announcement that the Federal Reserve, the US central bank, would begin tapering QE in the near future, further explored insurers’ reactions to the variable investment environment created by changing monetary policy. It found a shift in strategy as insurers diversify their portfolios in anticipation of higher rates, more volatility and less liquidity, particularly in the fixed-income space.

Key findings

KEY FINDINGS INCLUDE:

- ▶ **Four-fifths of insurers say that their businesses will have to change to produce adequate shareholder returns over the next three years.** Insurers are revisiting investment strategies, product lines and operational processes to improve efficiency and maintain profitability. Almost one-third (30%) of respondents predict large-scale change for the insurance industry over the next three years, driven by the low-yield environment and restrictive regulation.
- ▶ **The low-yield environment created by QE has led insurers to diversify across asset classes and implement tactical strategies.** More than half (52%) of respondents say that they have diversified into new fixed-income asset classes, while 48% have diversified across all asset classes, exploring new asset classes such as derivatives and alternatives. Nearly half (47%) have implemented a tactical asset allocation framework.
- ▶ **Changing central bank policy is now forcing insurers to reconsider their fixed-income strategies.** Differing views on issues such as the expiration date for US QE are reflected in respondents' preparations. Asian respondents are more likely than their European or North American counterparts to increase credit exposure and shorten duration in order to prepare for the unwinding of QE. Insurers also plan to increase exposure to risk assets and move away from traditional benchmarks to adopt more absolute return strategies.
- ▶ **Some 90% of insurers have increased investment in risk management.** The growing demands of prudential financial regulation and a tougher economic environment have forced insurers to improve their understanding of risk. However, insurers are still limiting their investments where they feel they do not properly understand the risks of different asset classes.
- ▶ **Insurers will develop closer working relationships with third parties to improve risk management and product design/development.** Existing working relationships with third parties will expand as insurers call on additional external resources to support their core competencies.
- ▶ **Regulatory change will stop nearly two-thirds of insurers writing certain lines of business.** Guaranteed products are becoming increasingly expensive, with insurers favouring unit-linked alternatives. However, not all insurers have abandoned guaranteed products and companies continue to innovate to find new ways of meeting customer demand.
- ▶ **One-quarter of insurers will grow their businesses via acquisitions, with their home regions the key target areas for future organic and acquisitive growth.** Insurers remain focused on expanding operations irrespective of the challenging environment but will tend to favour domestic and developed markets for future growth.

About this report

Introduction

In April and May 2013 The Economist Intelligence Unit surveyed 206 insurers worldwide.

- ▶ 102 had assets under management (AUM) of more than US\$25bn, 20 of US\$11bn-25bn, 22 of US\$6bn-10bn, 24 of US\$2bn-5bn, 11 of US\$500m-1bn and 27 of US\$100m-500m.
- ▶ Life companies accounted for 53 responses, non-life for 61 and composites for 75 respondents. 17 were reinsurers.
- ▶ Regionally, respondents were split as follows: 103 from Europe, Africa and the Middle East; 63 from North America; and 40 from Asia-Pacific.
- ▶ An additional survey was conducted in July 2013, of 100 respondents with a similar demographic to the main survey.
- ▶ In addition, in-depth interviews were conducted with 17 experts from insurance companies, regulators and trade bodies.

Our thanks are due to the following for their time and insight (listed alphabetically):

- Patrick Bowes**
Director of Old Mutual
- Michael Burns**
European, Latin America and China PR director at Genworth Financial
- Steven Cameron**
Head of regulatory strategy at Aegon
- Tim Corbett**
Chief investment officer at MassMutual
- W. Preston Hutchings**
President of Arch Investment Management Ltd. and senior vice president and chief investment officer of ACGL
- Japan's Financial Services Agency**
- Steve Lewis**
Chief executive officer, UK general insurance, Zurich
- Alfred Lerman**
Managing director, Prudential Financial
- Bronek Masojada**
Chief executive officer at Hiscox

- Craig Meller**
Managing director at AMP
- Carlos Montalvo**
Executive director at the European Insurance and Occupational Pensions Authority
- Nicolas Moreau**
Chief executive officer of AXA France
- The National Association of Insurance Commissioners**
- Hiroshi Ono**
General manager in the equity investment department at Sumitomo Life
- Sarah Street**
Chief investment officer at XL Group
- Otto Thoresen**
Director-general of the Association of British Insurers
- Maximilian Zimmerer**
Member of the board of Allianz SE in charge of the investment portfolio

The report was written by **Gill Wadsworth** and edited by **Monica Woodley**.

Global insurers are operating in an increasingly complicated world. The continued fallout from the global financial crisis and recession – central bank policies resulting in record low yields, more stringent regulations and continued market volatility – is leading insurers to rethink their investment portfolio risks and opportunities.

In light of these factors, insurers have shifted towards more tactical strategies that diversify across asset classes to generate returns and protect against specific market risks. As such, insurers are prioritising their investment risk management functions to improve their understanding of the challenges and identify appropriate solutions.

Flexible investment strategies that allow for change within a risk-managed framework will be the key to ensuring that portfolios meet the demands of both today's and tomorrow's challenging environments. For example, in response to stringent regulation and low interest rates, insurers have increased their allocations to new sectors of higher-yielding, fixed-income instruments such as bank loans.

However, the gradual withdrawal of quantitative easing (QE) is creating further complications. Both the Federal Reserve (the Fed) and the Bank of Japan acted this summer, but the US has signalled that it will not continue to do so indefinitely.

Insurers reacted by moving out of some of the more esoteric parts of the fixed-income universe and shortening durations while increasing credit exposure. When they reduced their risk exposure, it was into a market with less liquidity – creating an increasingly volatile trading environment.

And with repeated delays to the implementation of regulations such as Solvency II, insurers continue to worry about the potential impact of capital charges and other details yet to be clarified.

Although there may be much to cause concern to the boards of global insurers, there is also much to be optimistic about. The industry is expanding, embracing new markets and targeting yet untapped sources of organic growth. The retraction of certain product ranges means an opportunity to innovate and develop new lines.

Those organisations that have survived some of the toughest conditions in living memory believe the end is in sight and their operations are leaner, more efficient and better equipped to cope with market risk and unexpected shocks than ever before.

Drivers of change

As market volatility persists alongside economic and political uncertainty, insurers have been forced to rethink accepted investment wisdom, while regulations are forcing a greater appreciation of risk. These two inextricably linked forces – regulatory change and economic uncertainty – are behind some of the biggest challenges the insurance industry has ever encountered.

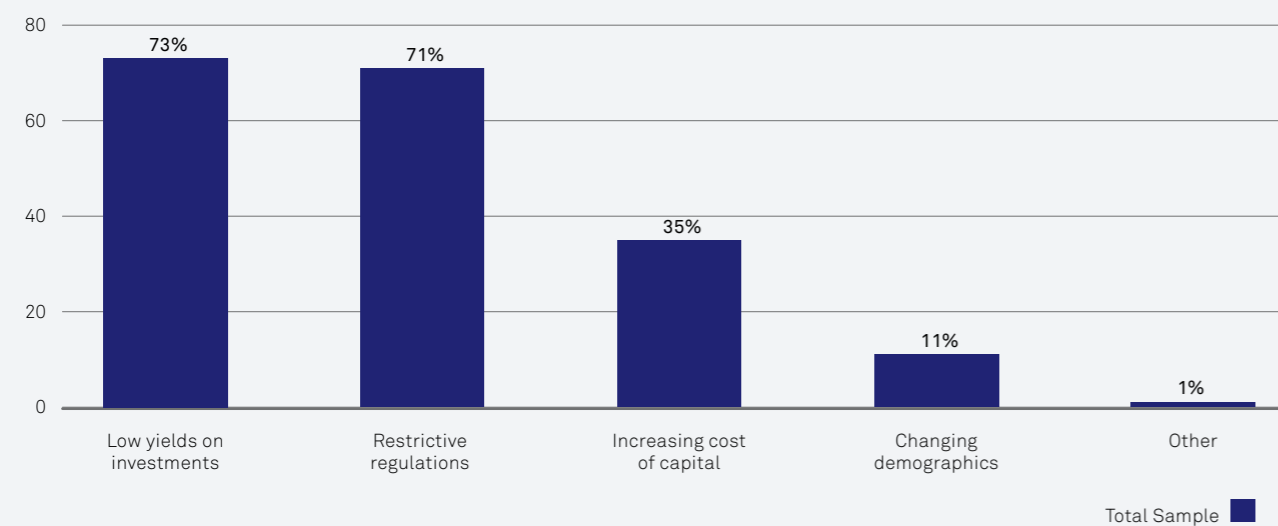
Recent concerns centre on the low-yield environment created by QE. Central banks across the globe have pumped money into the economy through bond-buying programmes since the financial crisis took hold, in order to support liquidity and encourage investment. However, this has kept interest rates artificially low and depressed yields. As higher-yielding bonds mature and are replaced with lower-yielding issues, the problem has grown.

Sarah Street, chief investment officer at XL Group, says: “One of the big challenges we face is the low yields we are earning on our investment portfolios. As time goes by, that bleeds more into our book yields as higher coupon bonds are maturing.”

QE has also reduced the supply of fixed income available to investors like insurers, which concerns **Tim Corbett**, the chief investment officer at MassMutual. “Pre-2008 crisis, the market had mortgage backed securities and corporate credit structures using credit default swaps that were a large part of the supply, and that’s no longer there” he says. “In the corporate bond market, we see record amounts of supply, but what you don’t see is that much of this is refinancing of existing debt, so the net supply of total investment grade fixed income is minimal whereas the demand is greater than ever on the part of institutional investors.”

WHAT DO YOU BELIEVE ARE THE MOST CRITICAL DRIVERS OF THE CHANGE AFFECTING THE INSURANCE INDUSTRY?

Choose up to two.

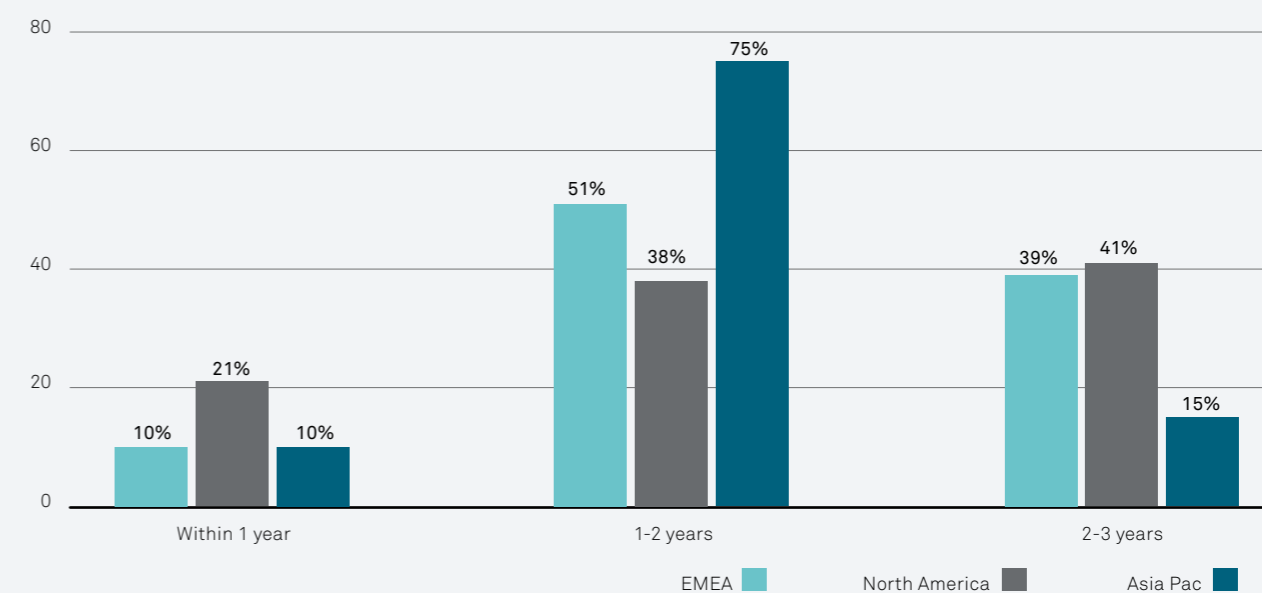


Maximilian Zimmerer, a member of the board of Allianz SE, in charge of the investment portfolio, is less worried about the overall supply of fixed income, but is more concerned with finding the diversity of investments he needs.

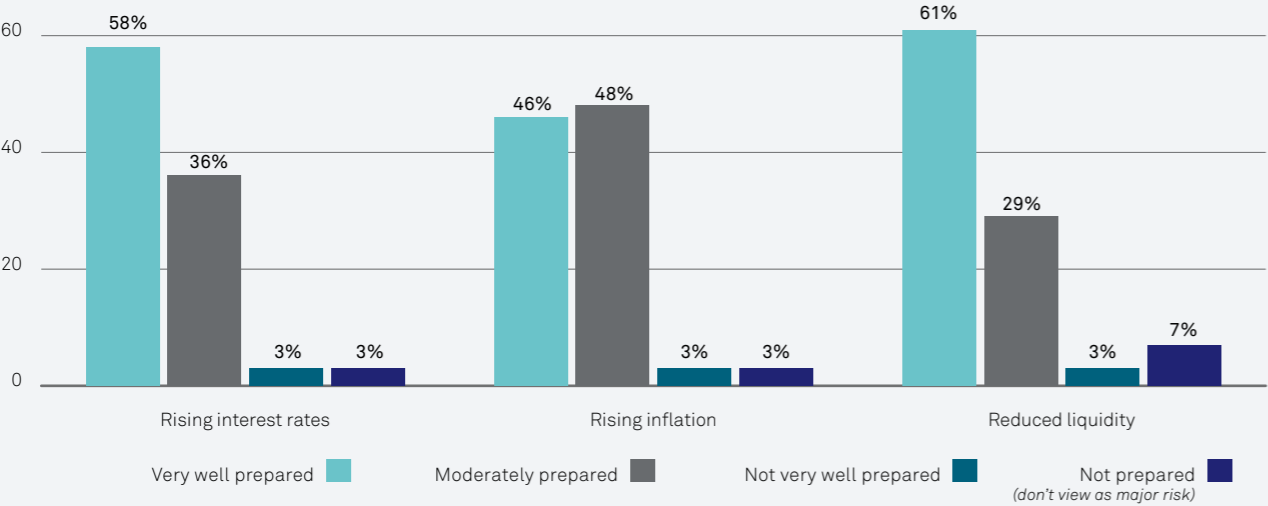
“Given the current government debt levels, it appears unlikely that there will be a sustained shortage in investment-grade opportunities in general,” he says. “However, there are certain regional sub-segments, such as covered bonds, of which we would like to see more.”

As economic conditions improve, the US central bank has signalled that this monetary stimulus will gradually come to an end. Insurers – surveyed after the chairman of the Federal Reserve, Ben Bernanke, announced in July that the Fed may begin drawing down its asset purchases later this year – seem to believe that tapering will be gradual, but they are ready to respond. Nearly all insurers (94%) say they will take some action to prepare for the unwinding of QE, and their plans give insight into their concerns around tapering such as rising interest rates (see Section Two).

WHEN DO YOU BELIEVE QE WILL END?



HOW PREPARED IS YOUR ORGANISATION FOR THE FOLLOWING POTENTIAL MARKET CHANGES OVER THE NEXT THREE YEARS?



Base: Total (n=206)
Source: Economist Intelligence Unit, May 2013

As QE ends, insurers are expecting rising interest rates, rising inflation and reduced liquidity, but survey respondents feel, overall, prepared for these challenges.

BlackRock view

After an extended period of accommodative policy by central banks globally, all eyes are on the Federal Reserve and the timing of their next policy move.

Since the end of May, the Fed’s verbiage surrounding potential tapering had a notable impact on fixed-income markets in the form of a 100+ basis point rise in ten-year US Treasury notes and an increase in volatility across markets. In concert with increased regulatory burdens on market participants, it also had a negative impact on liquidity in most markets. Although we believe these shifts could reverse in the short term as the Fed postponed reducing asset purchases at its September, 2013 meeting, we expect higher rates, higher volatility and decreased liquidity to be hallmarks of the fixed-income marketplace for several years at least.

This should serve to increase focus on the front end of the yield curve, as insurers attempt to create laddered portfolios that will allow for maturing shorter bonds to be reinvested at higher interest rates over time. In addition, we would expect that floating-rate products would receive renewed attention for their attractiveness in rising-rate environments, and that as rates rise, the marginal dollars flowing into more esoteric/lower-quality sectors would diminish over time, as acceptable yields will be available in higher-quality sectors.

Jeff Jacobs
Global Head, Financial Institutions Group, Fixed Income Alpha Strategies



REGULATORY CONCERNS CONTINUE

Insurers also feel relatively well prepared for the onslaught of regulation hitting the industry, even though many disagree with the rules being pushed through and worry about the consequences, on their own businesses and the wider economy.

Nicolas Moreau, the chief executive of AXA France, says: “On the regulatory front, there is an accumulation of regulation coming through. In France, it is not always consistent and, on average, it is unwelcome. But we are hoping that these reforms will encourage insurers to play their natural role as long-term investors.”

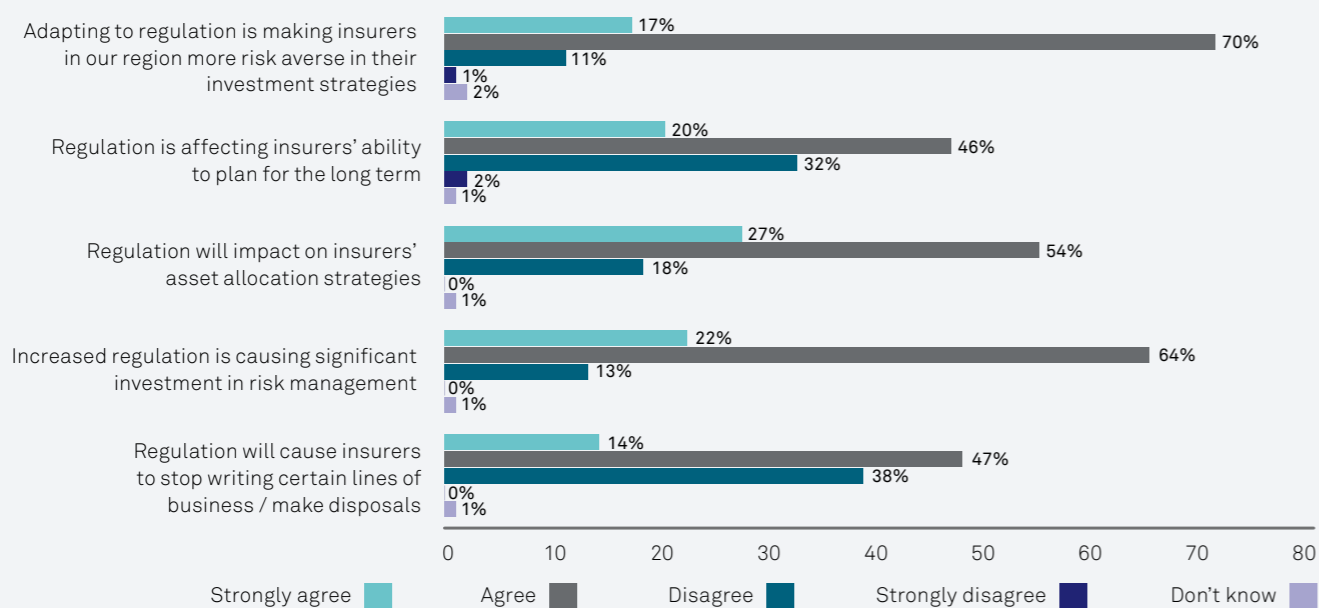
Preston Hutchings, the chief investment officer at Arch Capital, adds: “The action of regulators, principally in Europe, has been to reduce the supply of capital available to provide ready markets to legitimate investors such as ourselves. The ultimate consequence is to drive up the cost of debt and equity for those companies and countries that need it. In my mind, much of what is being done is short sighted in the extreme.”

HOW PREPARED IS YOUR ORGANISATION FOR CHANGING REGULATORY REQUIREMENTS IN YOUR REGION?

	Very well prepared	Moderately prepared
Solvency II	55%	37%
Derivative Central Clearing reforms	19%	53%
Alternative Investment Fund Managers Directive (AIFMD)	9%	36%
Markets in Financial Instruments Directive II (MiFID)	17%	42%
Dodd Frank	6%	28%
Solvency Modernisation Initiative (SMI)	13%	39%
Own Risk Solvency Assessment (ORSA)	39%	47%

Base: Total (n=206)
Source: Economist Intelligence Unit, May 2013

DO YOU AGREE OR DISAGREE WITH THE FOLLOWING STATEMENTS ON THE CURRENT REGULATORY ENVIRONMENT?



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013
Figures do not add to 100% due to rounding

With so many external pressures on their businesses, insurers are making substantial alterations to their systems and processes. Almost all (98%) of respondents to the survey predict at least some change in regulation, investments and operational functions in the next three years, with 30% expecting large-scale change.

Changes to investment strategy and risk management are detailed in the next section, while operational and product changes are covered in Section Three.

IN SUMMARY

- ▶ Challenging investment conditions and regulatory uncertainty have prompted the industry to diversify allocations and renew their focus on risk. Broadly speaking, insurers are confident that they can meet these challenges.
- ▶ However, the industry braces itself for new challenges in the wake of upcoming central bank action, which could require further alterations to systems and processes.

Evolving investment strategies and risk assessment

Insurers' concerns about the unwinding of QE and the continuing market volatility that QE is at least partly responsible for – as well as regulatory changes – are affecting their investment strategies. More than four-fifths (81%) of survey respondents say that regulation is affecting their asset allocation decisions.

Insurers' fears that they will not make the returns to maintain investment contribution to return on equity (ROE) also are driving them to diversify their asset allocations and implement more tactical investment strategies, as well as increase their focus on risk assessment.

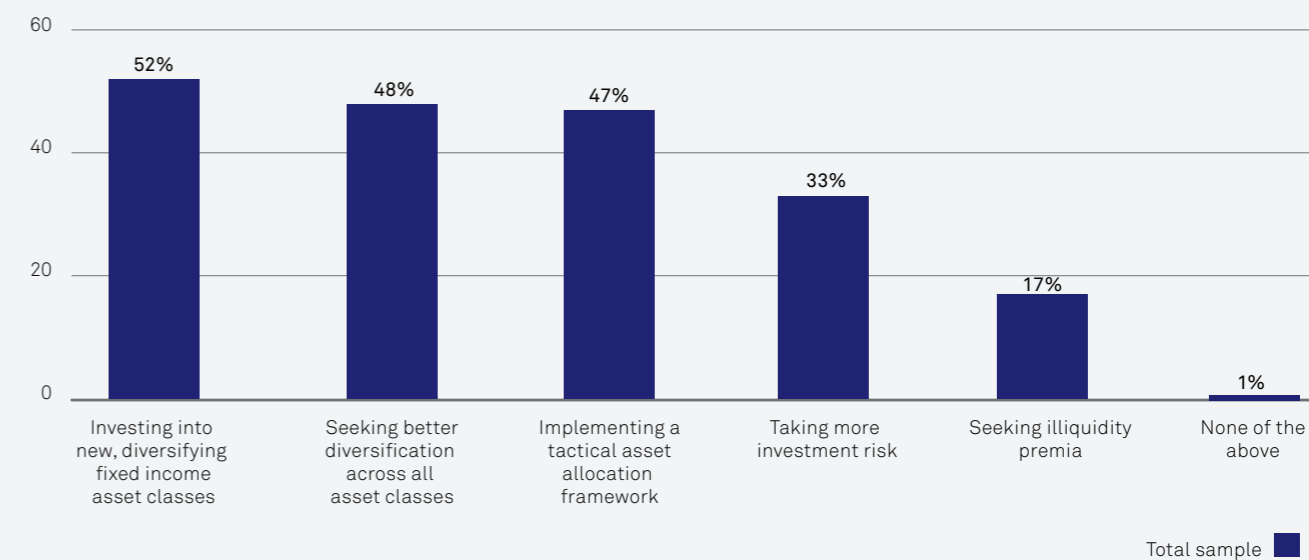
More than half (52%) of respondents say that they are diversifying into new fixed-income asset classes, with insurers clearly expecting innovation in this area to deal with supply issues.

Investment-grade fixed income – always a core investment for insurers – will still remain a critical component of insurers' portfolios in the years to come, as increased yields and slightly wider spreads boost their attractiveness. Nearly half (48%) of insurers are very likely and 40% are moderately likely to increase allocations to this tried and tested asset class, which provides a good match to liability cash flows.

However, although 80% of UK insurers say that they are increasing allocations to high-yielding fixed income, **Bronek Masojada**, the chief executive at Hiscox, says that his firm will not be following suit. "If when [high-yielding bonds] were yielding 8% we didn't think they were a good buy, why should we think they are a good buy when they are yielding 5%?" he says. "It might be that 8% was a spread of 3% or 4% over Treasuries and now at 5% it is 4% over Treasuries but if we didn't think 8% was a good number, then why should we think 5% is a good number?"

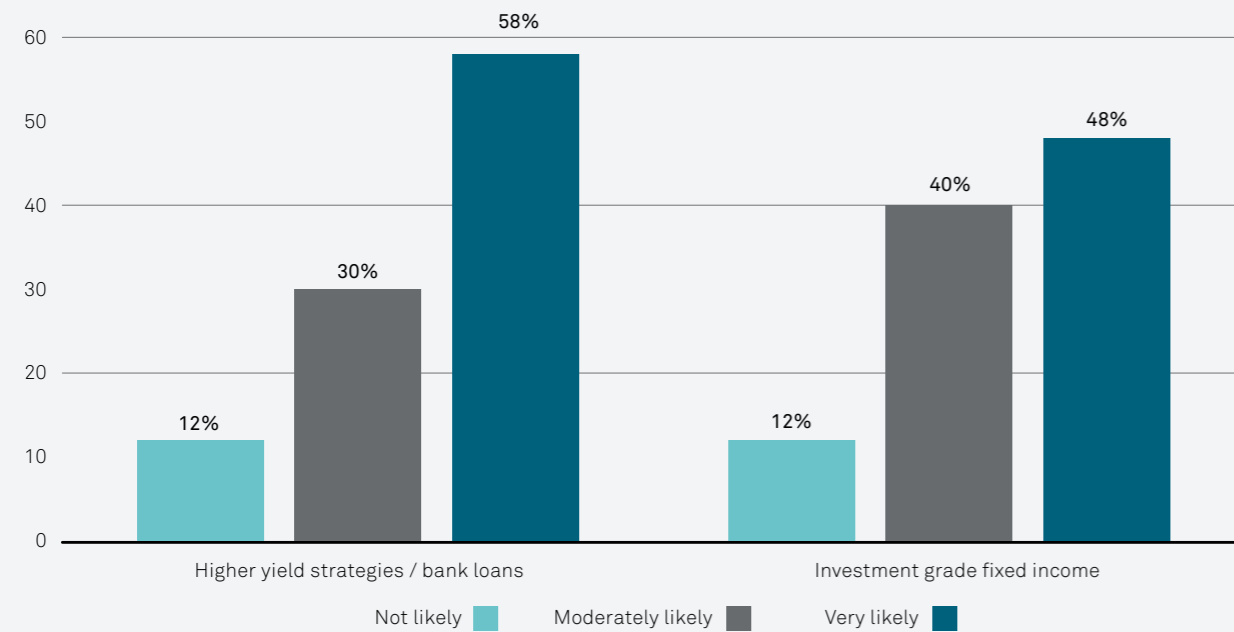
IN THE MAY 2013 SURVEY, 80% OF RESPONDENTS AGREED THAT CHANGE WITHIN THEIR BUSINESSES IS NEEDED TO PRODUCE ADEQUATE RETURNS OVER THE NEXT THREE YEARS. WHAT ARE THE KEY INVESTMENT CHANGES YOU ARE WORKING ON, IF ANY?

Choose up to two.



Base: Total (n=100)
Source: The Economist Intelligence Unit, July 2013

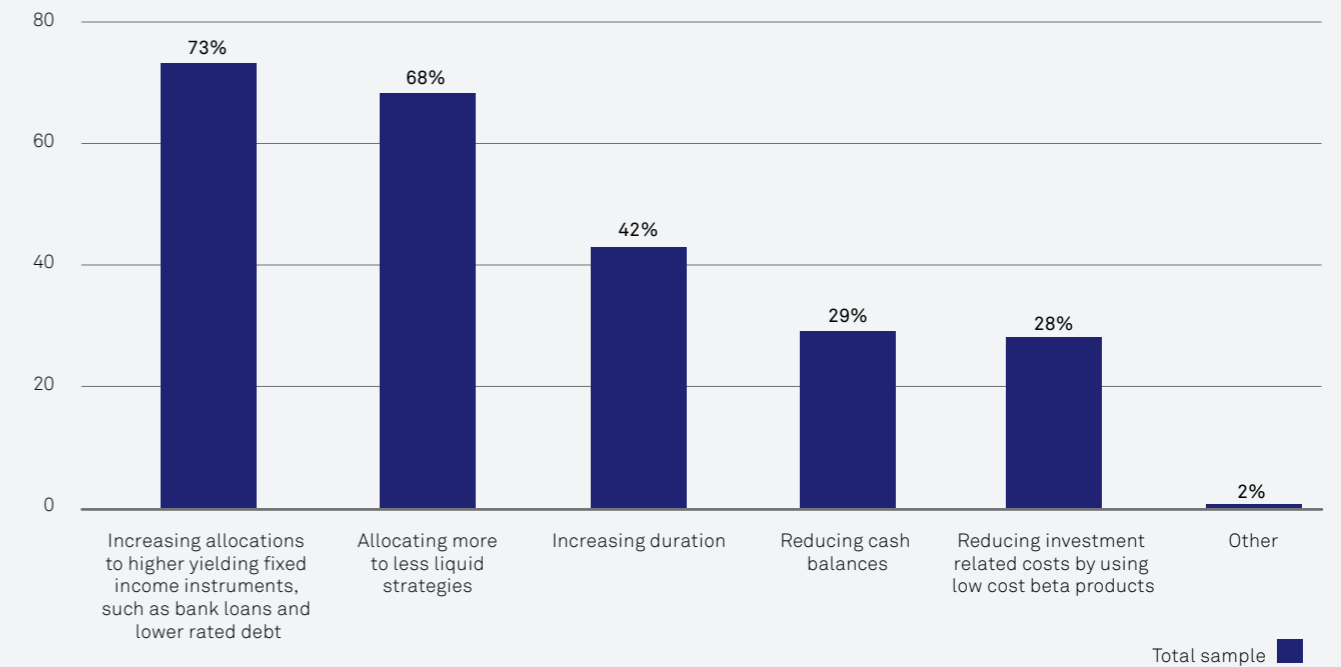
HOW LIKELY ARE YOU TO INCREASE ALLOCATIONS TO EACH OF THE FOLLOWING ASSET CLASSES?



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

HOW ARE YOU ADAPTING YOUR INVESTMENT STRATEGIES TO LOW INTEREST RATES? (ASKED OF SURVEY RESPONDENTS IN MAY 2013, BEFORE THE US QE ANNOUNCEMENT)

Select all that apply.



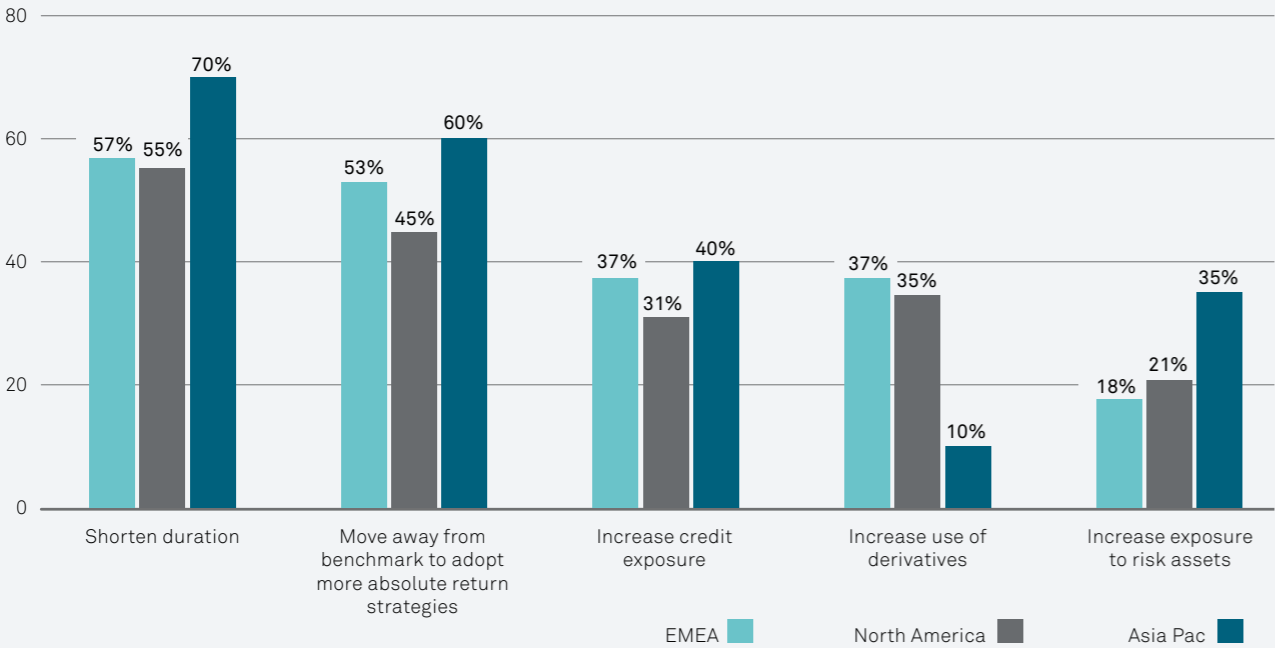
Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

Although planning for the medium and long term, insurers have also adapted their strategies for the current low interest-rate environment created by QE. The focus on fixed income, particularly higher-yielding instruments, continues, with nearly three-quarters (73%) of survey respondents saying that they have increased allocations to higher-yielding fixed income. Insurers have also increased allocations to less liquid instruments (68%) and increased duration (42%).

However, with the news that QE in the US will be coming to an end in the near future, insurers know that they must adapt some of their strategies as the conditions created by QE – low interest rates, low yields and less fixed-income supply – change. The most notable shift in strategy observed between the May 2013 survey and the follow-up survey in July 2013 (after the US QE announcement) is in duration management. Whereas insurers increased duration in the low-rate environment created by QE, in preparation for the unwinding of QE they plan to shorten duration. Asian insurers in particular say that they will shorten duration.

WHICH OF THE FOLLOWING IS YOUR ORGANISATION DOING TO PREPARE FOR THE UNWINDING OF QE BY CENTRAL BANKS?
(ASKED OF SURVEY RESPONDENTS IN JULY 2013, AFTER THE US QE ANNOUNCEMENT)

Select all that apply.



Base: EMEA (n=51), North America (n=29), AsiaPac (n=20)
Source: The Economist Intelligence Unit, July 2013

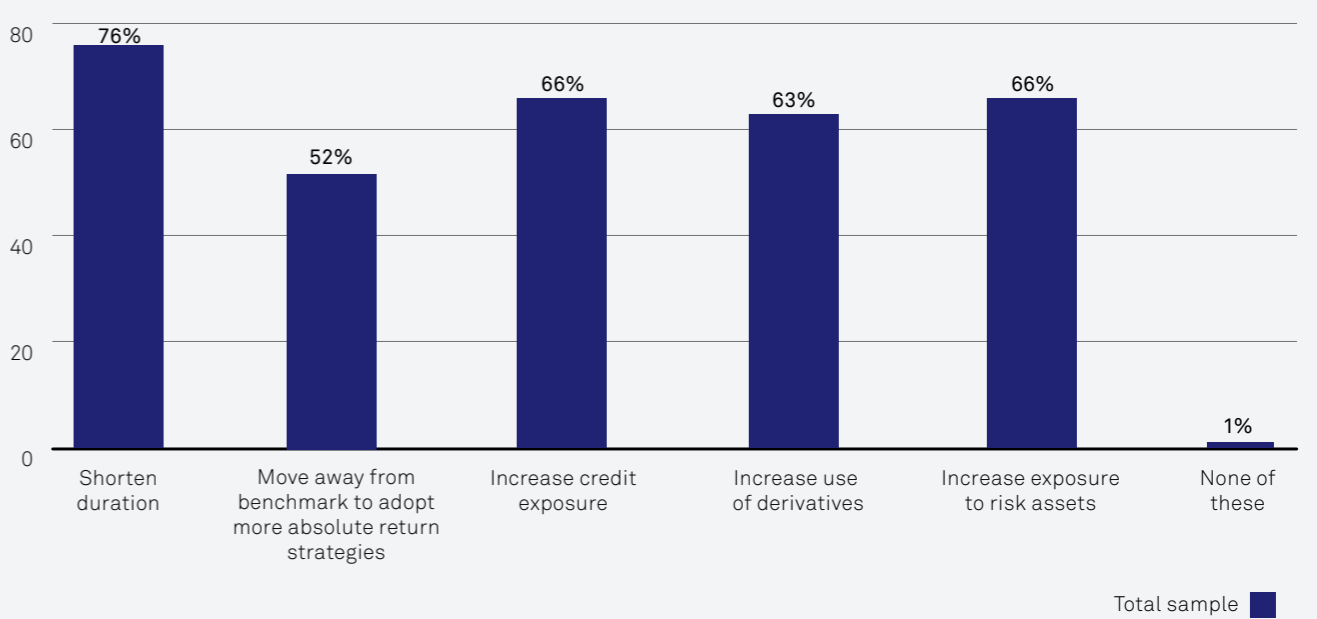
Alfred Lerman, the managing director of Prudential Financial in the US, says: “While we manage duration of our assets consistent with that of our liabilities, greater likelihood of interest rates increasing over a short term is a consideration in how we position our portfolio at the margin over this time period. We also recognise the fact that much of that expectation may have already been priced into the market.”

The prospect of QE tapering has taken much of the blame for recent market volatility, but survey respondents seem more focused on the result rather than the cause.

A majority of survey respondents say that they plan to take action to prepare their portfolios to deal with ongoing market volatility, rather than to prepare for the unwinding of QE – perhaps anticipating that market volatility will continue long after the effects of QE have dissipated. Again, however, shortening duration is the most popular course of action, but insurers are more likely to increase exposure to risk assets as a strategy for dealing with volatility than for preparing for QE tapering.

WHICH OF THE FOLLOWING IS YOUR ORGANISATION DOING TO PREPARE FOR THE CONTINUED MARKET VOLATILITY? (ASKED OF SURVEY RESPONDENTS IN JULY 2013, AFTER THE US QE ANNOUNCEMENT)

Select all that apply.



Base: Total (n=100)
Source: The Economist Intelligence Unit, July 2013

EMERGING MARKETS

Insurers are also increasing their exposure to emerging markets, both for yield and for diversification benefits. Two-thirds of respondents say that they are likely to increase investment in emerging markets in the next 12 months. Insurers in Asia-Pacific are most likely to increase allocations to emerging markets (82%), followed by EMEA (75%) and North America (60%). It is important to note that these survey responses were given in April and May – before emerging-market currencies were hit hard by the news that the US plans to taper QE in the near future. However, as insurers typically have low allocations to emerging markets, the short-term impact of QE tapering on emerging-market currencies may have little effect on insurers’ decisions to increase holdings longer term.

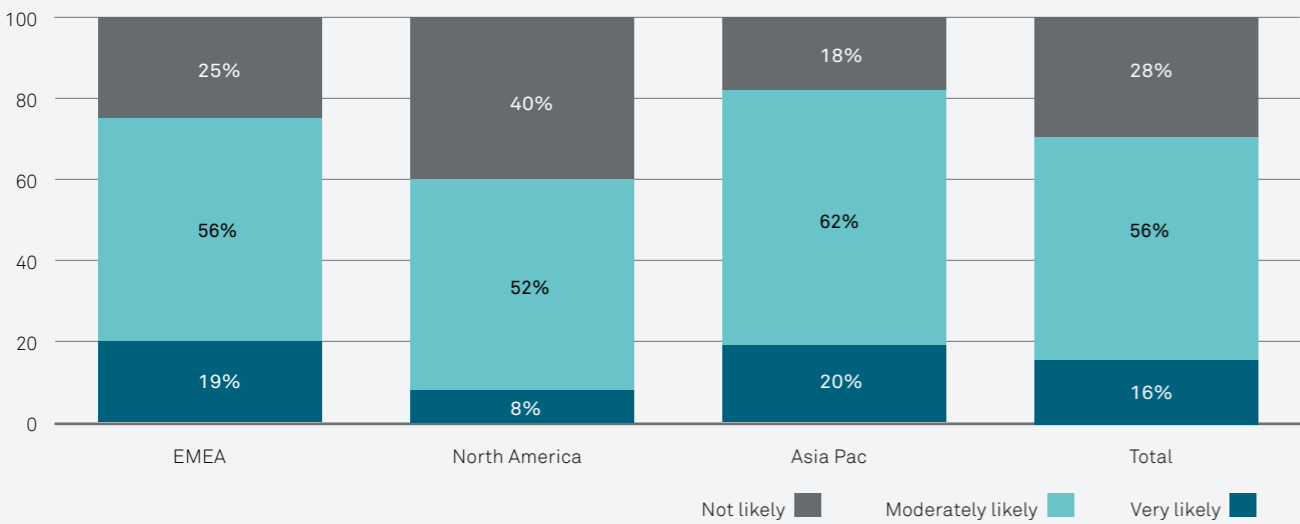
Axa’s **Mr Moreau** says: “We are looking at emerging markets for both fixed income and equities, but we look at it as we do any asset class, whether government, bond or equity. We have a big portfolio, so tactical moves are more at the margin. However, the allocation has increased.”

At XL Group, the allocation to emerging markets is about diversification not yield. **Ms Street** says: “We took the baby steps three years ago and allocated to external dollar-denominated investment-grade emerging-market debt. We did it not for the yield but as a diversification strategy on the basis that owning bonds in growing, booming economies felt better than loading up on developed markets with huge deficits and with fiscal challenges. However, it’s a small allocation of 3-4%.”

Not all insurers are keen to expand into markets they considered to be on the way down thanks to slower than expected growth in China and a strengthening dollar. More than one-quarter (28%) of respondents say that they are not likely to invest in the emerging regions in the next 12 months.

Craig Meller, the managing director at AMP in Australia, says that his company will not invest more heavily in emerging markets under present economic conditions. “The combination of an improving outlook in developed countries at the margin, a stronger US dollar and slower growth in China, which is putting downwards pressure on commodity prices, along with the deterioration in the growth/inflation trade-off, are all working against emerging markets,” he says.

HOW LIKELY IS YOUR COMPANY TO MAKE HIGHER ALLOCATIONS TO EMERGING MARKET INVESTMENTS IN THE NEXT 12 MONTHS?



Base: Total (n=206), EMEA (n=103), North America (n=63), Asia Pac (n=40)
Source: The Economist Intelligence Unit, May 2013

ILLIQUID ASSETS

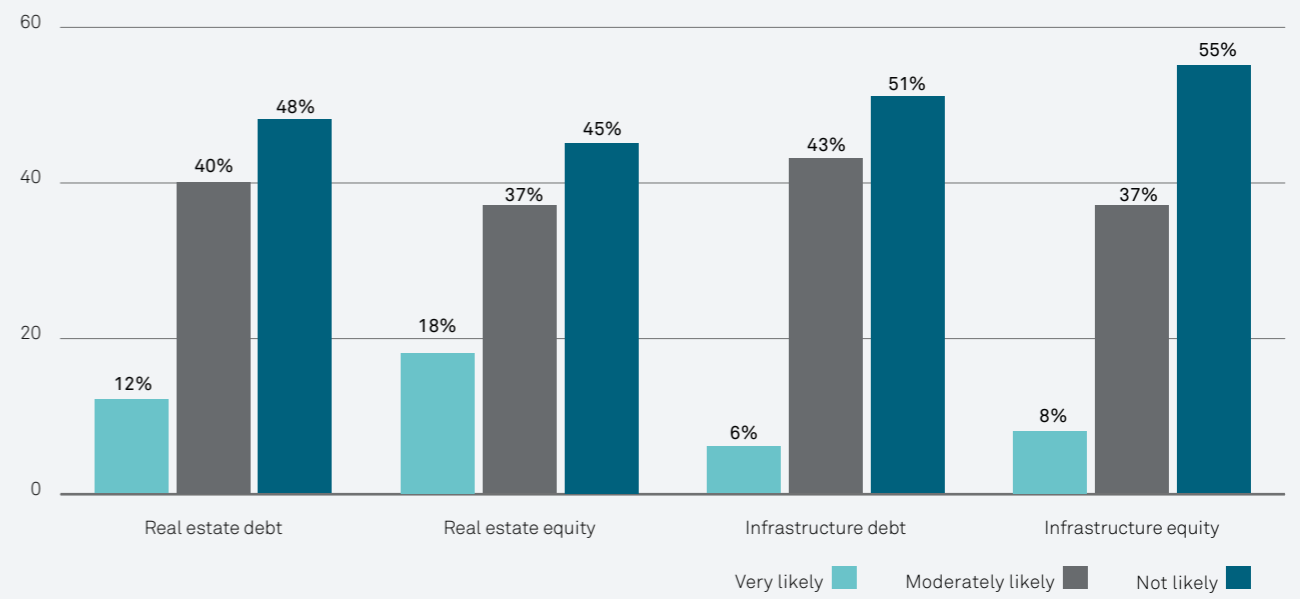
Insurers have always been able to take on some illiquid assets as many of them, particularly life companies, often have longer-dated liability profiles. However, insurers are showing a greater willingness to look beyond traditional long-duration bonds – perhaps in order to capture the illiquidity premium – with more than two-thirds (68%) of insurers planning to allocate more to less liquid strategies.

Mr Moreau says: “We are looking at infrastructure and real estate, and investing in loans which are not very liquid. We are trying to find an alternative to government bonds, which are often the only long-duration bonds available. Infrastructure offers an alternative on the long part of the curve, enabling us to also keep the liquidity we need to face uncertain perspectives”.

The introduction of regulation such as Basel III has made direct lending, which tends to be illiquid, more expensive and less attractive to the banks. As a result, these kinds of illiquid assets become more attractive to insurers who are able to fill the lending gap.

XL Group’s **Ms Street** says: “We are in the process of adding more illiquid assets to our allocation. In the direct lending space there is disruption still taking place among the traditional providers, such as the banks. From a relative value perspective there is a very attractive risk/return there. As an insurance company, we can afford some illiquid assets on our balance sheet and we are taking advantage of that because we get well paid.”

HOW LIKELY ARE YOU TO INCREASE ALLOCATIONS TO EACH OF THE FOLLOWING ASSET CLASSES?



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

BlackRock view

Infrastructure debt will become an increasingly important source of long-term income given the benefits it can bring to insurers’ portfolios: capital preservation, stable cash flows, inflation protection and diversification. We expect to see significant insurer inflows into this asset class in the mid term.

Currently, infrastructure debt offers both higher spreads and diversification benefits over sovereign and mainstream corporate debt with comparable credit ratings. Private infrastructure debt can also offer an illiquidity (or complexity) premium over comparably rated debt issued in the public bond markets.

Infrastructure debt is inherently stable because the underlying businesses have limited exposure to commercial demand risk. Much of the debt is also secured with comprehensive covenants which make it a suitable investment as part of a medium- or long-term buy-and-hold strategy for liability matching purposes.

There is now a strong pipeline of investment opportunities for institutional investors. This is because traditional bank capacity for long-term loans has reduced significantly. Investing in essential public infrastructure businesses is also good for the economy and job creation.

Regarding regulatory treatment, there is strong political and governmental support for insurers and pension funds to hold infrastructure debt. We believe this should help to ensure that appropriate regulatory capital requirements are set. This support is important because of the long-term nature of infrastructure debt and the fact that much of the debt is rated in the BBB or single A category.

Chris Wrenn
Co-head, Infrastructure Debt Group



The potential for higher returns may help insurers overlook the illiquid nature of some investments. **Mr Lerman** of Prudential Financial says that there are a number of benefits to investing outside of non-traditional asset classes. “We have made a strategic decision over the last few years to allocate a limited portion of our assets into a well diversified mix of alternatives including private equity, hedge funds and real estate. These asset classes exhibit unique risk-return characteristics and provide the portfolio with enhanced long-term return and diversification with traditional credit risk,” he says.

However, regulation remains a sticking point in their willingness to invest in these assets. Although illiquidity does not directly affect capital charges, the charges applied to asset classes such as real estate debt remain unclear and, until these are clarified, many insurers will be unwilling to commit.

Mr Masojada says: “Solvency II makes it difficult for a firm like us to invest in things like infrastructure, which gets so thumped by capital rules – and are less attractive because of their illiquidity – that you conclude that it is not going to work.”

Carlos Montalvo of the European Insurance and Occupational Pensions Authority (EIOPA) says that the Solvency II system of capital charges aims to be neutral and not favour any particular assets nor drive insurers’ investment decisions. “Capital charges cannot be the same because risks are not the same, but if there were incentives to allocate assets in a given way, it would not be right,” he says. “If I invest in venture capital instead of corporate bonds it should be because it is my decision and not because regulation artificially incentivises me to.”

However, he recognises that continued regulatory uncertainty is taking a toll and adds: “I am convinced that by Autumn this year we will have an agreement and the framework will be stable”. (A key European parliamentary session to approve proposed amendments to Solvency II, scheduled for the Autumn, has now been put back until next year.)

But these alternative investments are not for everyone.

Hiroshi Ono, general manager in the equity investment department at Sumitomo Life in Japan, says that the insurer has pulled back from its peak investment of ¥400bn (US\$4bn) in hedge funds. “Hedge funds lack transparency in the investment allocations and these funds run liquidity risk, which is a lesson we have learnt from the Lehman [Brothers] shock,” he says. “We have been withdrawing from this type of fund. Today, the level of investment in hedge funds in the overall portfolio is almost nothing.”

Non-life insurers are far more likely than life insurers to reject hedge funds (64% compared with 47% are unlikely to consider hedge-fund investment). Chinese respondents are most in favour of hedge-fund investment.

THE RISE OF ETFs

While looking to illiquid assets for higher returns, insurers are also using exchange traded funds (ETFs) to diversify out of cash and access certain asset classes, while remaining liquid. ETFs also help insurers deal with supply issues, allowing them to invest in asset classes through ETFs that may be difficult to access directly. ETFs have the added bonus of generally being a more cost-effective way to invest.

More than four-fifths (83%) of survey respondents agree or strongly agree that more insurers will use ETFs over the next three years. Some 70% agree that these vehicles are suitable as a long-term strategic holding for both core and satellite holdings.

BlackRock view

Most insurers have used ETFs before, but the ways they are using ETFs are changing and adoption is accelerating. Historically, insurers used ETFs primarily in equities to efficiently invest surplus assets. However, in 2012 over 85%¹ of insurer ETF flows were in fixed income for GA use. Constructing diversified bond portfolios is time-consuming and costly given low inventory and liquidity levels, and this is prompting insurers to seek new solutions.

Insurers increasingly find the ability to gain instant exposure through ETFs extremely valuable for both short-term strategies and longer-term core exposure. However, other factors are also driving adoption. The barriers historically preventing insurers from using ETFs broadly, such as regulatory/accounting treatment and lack of integration with risk analytics, are being dismantled. For instance, National Association of Insurance Commissioners (NAIC)-designated ETFs receive favourable financial statement and risk-based capital treatment in the US, allowing for increased GA usage. Product innovation is another major adoption driver. For example, innovative bullet-maturity ETFs, such as iSharesBonds, are gaining in popularity in part because of their bond-like qualities, which are particularly useful for insurers using asset and liability management (ALM) strategies.

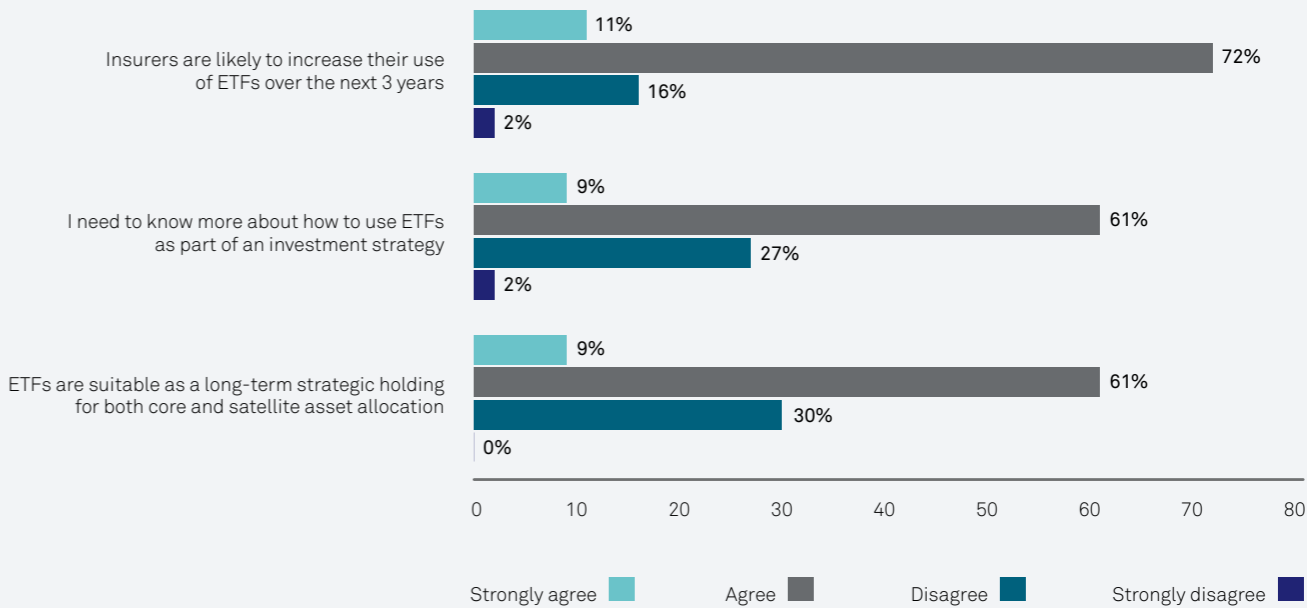
As the results of the survey suggest, we expect the current market environment and continued innovation across the ETF industry to drive increasing use of ETFs by insurers.

Raman Suri
Head, iShares Insurance



¹ Source: SNL; US domiciled insurers

IN LIGHT OF CHANGING MARKETS AND REGULATIONS, INSURERS ARE USING NEW VEHICLES SUCH AS ETFs TO ACCESS CERTAIN ASSET CLASSES. DO YOU AGREE OR DISAGREE WITH THESE STATEMENTS ABOUT ETFs?



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013
Figures do not add to 100% due to rounding

Mr Ono says:

“Given that there are ETFs that are traded in high volume, we are interested in ETFs. Even if we’ve wanted to capture the high growth in Asia, it’s not quite easy to be sure about individual companies or the regulatory details of individual markets. We are particularly interested in the ETFs that invest in Asian companies, listed in the US.”

However, 70% said that they needed to know more about these ETFs before making an investment.

Mr Masojada says:

“At Hiscox we do have index funds, some of which are ETFs. It’s just a different way of buying an asset. If you look at ETFs you have some very complicated ones which are too clever for us but the simple ETFs do have an attraction.”



BLACKROCK CASE STUDY 1
FIXED INCOME ETFs FOR FLEXIBILITY

OBJECTIVES

- ▶ To develop a more flexible, dynamic and efficient approach to fixed-income beta investing.
- ▶ To find a more suitable vehicle for tactical fixed income investing than cash bonds which can present significant obstacles to more dynamic approaches to investing due to limited liquidity, low inventory levels and fragmentation.

BLACKROCK ACTIONS

Blackrock implemented iShares’ range of fixed income ETFs to meet a variety of different needs, including:

- ▶ **Transition management** – ETFs were used as a solution for the client to seek interim exposures, minimising execution risk in the face of declining bond liquidity.
- ▶ **Liquidity** – ETFs continue to be used to reflect market views with greater speed and efficiency than cash bonds.
- ▶ **Granular exposures** – iShares’s broad range of fixed income ETFs are leveraged to gain more targeted exposures to sub-sectors and markets. ETFs allow for large scale investment while niche institutional fund counterparts may be too small for the client to invest.
- ▶ **Low cost** – The client continues to benefit from significant transaction cost savings that on-exchange bond ETFs can provide versus cash bonds.

CLIENT RESULT

- ▶ The depth and breadth of iShares fixed income ETF offering provides the client with the flexibility and efficiency necessary to make short term, tactical allocations.

APPRECIATING RISK

Just as some insurers are still hesitant to use ETFs without understanding more about them, survey respondents show a clear correlation between the asset classes that they are willing to include in their portfolios and their ability to assess the associated risks.

Sumitomo Life’s **Mr Ono** knows that risk assessment is crucial – and an ongoing activity as the risk environment shifts. “The assessment of risk assets is a critical and difficult one; we are yet to see the fuller development of Abenomics [a suite of measures introduced this year by the Japanese prime minister, Shinzo Abe] and its impact on the economy and interest rates. Accumulating internal reserves to strengthen our capacity to embrace risk is increasingly an important issue.”

MassMutual’s **Mr Corbett** is shifting back to more traditional assets as a result of his risk assessment. “On the equity side, we are looking to diversify our strategy, in addition to our core of US real estate and middle market buyout funds,” he says. “So we are looking to allocate more to global growth strategies, for instance emerging-market equities.

That includes infrastructure and global natural resource strategies, both public and private.”

Regulation is clearly a major factor here as well, as it forces greater focus on risk assessment and management. Some 87% of survey respondents say that adapting to regulation is making them more risk averse, while nine out of ten say that regulation has significantly increased investment in risk management.

One potential stumbling block for risk assessment is achieving look-through to underlying holdings – which is demanded by Solvency II. This is a problem for two-fifths of respondents and is much more of a problem for life (57%) than non-life (27%) companies.

Just over half (51%) of respondents say that access to the factors needed to be able to model risk makes assessing risk a challenge. This was marginally less of a challenge for life (47%) than for non-life (51%), and less of a problem for North American and Asian insurers who are more likely (48%) than those from other regions to cite a lack of data as the key challenge.

HOW LIKELY ARE YOU TO INCREASE ALLOCATIONS TO EACH ASSET CLASS?
HOW CONFIDENT ARE YOU THAT YOUR ORGANISATION IS CAPABLE OF ASSESSING THE RISKS PROPERLY WITHIN EACH OF THE ASSET CLASSES?

	Very likely to invest	Moderately likely to invest	Very confident in assessing risk	Moderately confident in assessing risk
Investment-grade fixed income	48%	40%	71%	28%
Higher-yield strategies/bank loans	58%	30%	68%	26%
Hedge funds	9%	41%	18%	45%
Real estate debt	12%	40%	25%	45%
Real estate equity	18%	37%	26%	44%
Infrastructure debt	6%	43%	10%	56%
Infrastructure equity	8%	37%	9%	49%
Private equity	8%	46%	17%	53%

Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

BlackRock view

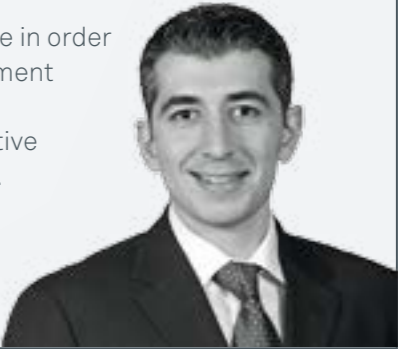
Clearly, no investor should invest in an asset where the risks are not understood. But those investors that have the support and resources, whether internal or external, to understand the risks of a broader investment universe are able to capture greater optionality from a rich opportunity set, and an information advantage in less crowded markets.

As a result, we see insurers wrestling with the intersection between:

- a) the increasing use of risk factor-based asset allocation, and
- b) increasing allocations to alternatives.

The asset-allocation models used by most of the industry need to advance in order to absorb and translate the risk factors of alternatives. Alternative investment management is evolving to deliver greater risk transparency to meet this need. The upshot: closer partnership between risk allocators and alternative managers will become a hallmark for the future of alternative investment.

Nugi Jakobishvili
Managing Director, BlackRock Alternative Investors



But rather than feeling a sense of frustration at the lack of transparency or clarity in any given asset class, some insurers take a pragmatic approach and prefer to avoid anything they do not understand. Allianz’s **Mr Zimmerer** says: “We like to keep it simple; if there is something we don’t understand, we walk away.”

Arch Capital’s **Mr Hutchings** shares Mr Zimmerer’s view and adds that no particular asset class is on the blacklist; rather it will be instruments within particular classes that are discarded because of opacity. “It is not so much any specific asset class [that lacks transparency], it’s more that a certain bond has a structure that is too complicated,” Mr Hutchings says.

In spite of most insurers becoming more risk averse, one-third say that they will take more investment risk. Axa’s **Mr Moreau** does not believe that this is contradictory. “Are we more risk averse?” he asks.

“*I don’t think so. We are risk conscious, but that doesn’t mean we don’t take any risks. No risk means no progress, no innovation, no value-creation for either our customers or AXA. We are more careful in the dispersion of certain risks and we are better at analysing the ones we take: measuring them, reducing them, dialing them down.*”

MANAGING DERIVATIVE RISK

Much of the recent global and regional regulation has focused on improving transparency and trading in derivatives. The Derivative Central Clearing Reforms, Dodd Frank and the European Market Infrastructure Regulation (EMIR) all contain elements designed to tackle areas of concern in this sector of the market.

Respondents to the survey show a low level of preparedness for Dodd Frank – one-third admitted they were not ready for the legislation – and insurers with significant investment in derivatives see this piece of regulation as a threat.

MassMutual’s **Mr Corbett** says: “In terms of regulation [affecting us], it is primarily Dodd Frank because we use derivatives to hedge our asset liability model and our enterprise risk management programs. The implications of Dodd Frank and how it will play out remains uncertain, but it is important we are able to continue to carry out our hedging and investment programmes.”

However, the survey shows high levels of preparedness for the Derivative Central Clearing Reforms, with just one in ten respondents to whom the regulation applies admitting that they are not ready for the regulation. Further, the survey shows high levels of confidence in assessing derivative risk, with more than four-fifths (82%) of insurers saying that they are able to assess this risk.

However, the NAIC says that organisations should not invest in derivatives if they do not fully understand them. “Insurers are limited by state investment laws that require a conservative approach to managing their assets.

Investment in mortgage-backed securities, other asset-backed securities, credit default swaps and other types of derivative instruments should only be done by those who understand the potential downside risks.”

The survey found a strong appetite for using these instruments as part of risk or investment management strategies within the next three years. Only 12% of respondents say that they have no intention of using any of the derivatives listed.

BlackRock view

The findings suggest a heightened interest in pursuing derivative-based solutions to meet the challenges faced by insurers. Nearly 50% of respondents are seeking greater diversification, and are exploring new instruments and asset classes in order to achieve this, with a similar proportion seeking to implement tactical asset allocation (TAA). It is difficult to imagine meeting either aim without increased derivative usage and, in the case of TAA, almost unthinkable that derivatives will not play a central role on cost and speed of implementation grounds.

With significant risk arising from rising interest rates it was perhaps unsurprising to find that interest-rate options were regarded as the most likely derivative instruments to be used. However, to find nearly 70% of respondents actively considering using a type of option that most had previously used infrequently if at all is remarkable.

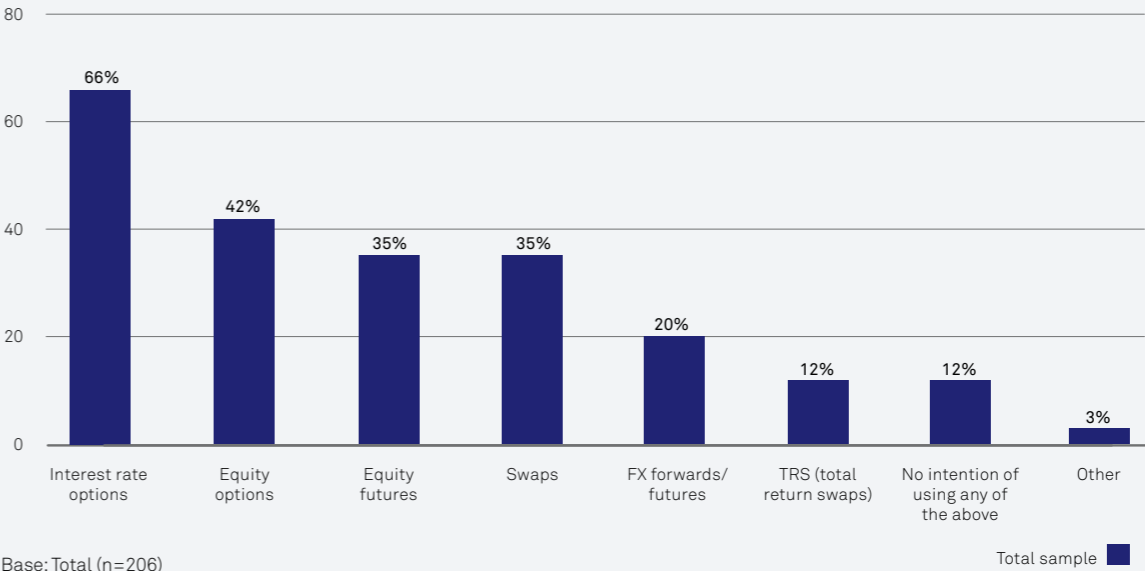
The survey also highlighted some of the difficulties insurers are experiencing as a result of the coming into being of a new derivative market infrastructure. The new over-the-counter (OTC) derivative clearing platforms and the associated US and European regulations are still evolving and bring new complexity and cost to participation in these markets. Navigating this changing infrastructure to ensure that portfolio positions in derivatives are effective, efficient and secure is of critical importance at this juncture.

Nigel Foster
Head, Trading and Liquidity Strategies Group, EMEA



WHICH OF THE FOLLOWING INSTRUMENTS, IF ANY, ARE YOU LIKELY TO USE FOR RISK OR INVESTMENT MANAGEMENT PURPOSES OVER NEXT THREE YEARS?

Select all that apply.



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013



BLACKROCK CASE STUDY 2 DERIVATIVES HEDGING OF INSURANCE LIABILITIES

OBJECTIVES

- ▶ To assist the client in using interest rate swaptions to hedge policyholder deferral risk.
- ▶ Provide full execution and on-going portfolio reporting services.
- ▶ Provide in-house training.

BLACKROCK ACTIONS

BlackRock provided analysis of the client's swaption portfolio

- ▶ Assisted the client in modeling new and existing portfolios across a range of market shocks.
- ▶ Supported the client with analysis to allow them to explore a range of solutions.

BlackRock assisted the client in transitioning into the new swaption portfolio

- ▶ Reviewed all CSAs with the client's bank counterparties.
- ▶ Execute required trades to restructure the portfolio, including careful planning to achieve best execution.

CLIENT RESULT

- ▶ The client restructured their swaption portfolio, reducing their exposure to changes in interest rates.

Japanese insurers are the most likely to reject derivatives, with more than one-quarter (28%) saying that they will not consider the instruments listed for risk or investment management purposes over the next three years.

A spokesperson for the Financial Services Agency, the Japanese financial sector regulator, says: “Japanese insurers have been enhancing their risk management but, in light of frequent natural disasters and enlargement of overseas operations, there is room for improvement of their management.”

He adds: “As the supervisory authority, we are focusing our attention on ensuring that insurance companies give due consideration to risk when deciding on investment policies and that there are no concerns in assessing forward-looking solvency by themselves.”

Interest-rate options are the most popular instrument, with two-thirds of respondents expecting to use them. Equity options are the next most popular with just over two-fifths (42%) of insurers expecting to use them, followed by equity futures and swaps (both 35%).

Arch Capital's **Mr Hutchings** sees derivatives as a useful means of hedging risk, while Axa's **Mr Moreau** adds: “We use derivatives to hedge our portfolio, access asset classes or as a tactical way to exit asset classes when we can't sell the assets. We are quite active on this and always have been, but we don't use them in a speculative way.”



BLACKROCK CASE STUDY 3 MANAGING RISK FOR RETURN

OBJECTIVES

- ▶ To increase total return and dampen volatility through a more efficient allocation of surplus capital to risk assets.
- ▶ Before the assessment, the client portfolio's primary risk exposure was to interest rates while returns were driven by book yield, which was expected to continue to decline with maturities.
- ▶ The portfolio held equity exposure through passive ETFs. This allocation was expected to contribute positively to portfolio return relative to fixed income, but it lowered the overall portfolio book yield and increased volatility.

BLACKROCK ACTIONS

- ▶ Diversified and increased surplus allocation to risk assets to reduce portfolio interest-rate exposure, increase portfolio book yield and achieve equivalent equity returns on risk assets with less equity volatility.
- ▶ Diversification into income-focused equities, real return and absolute return strategies materially reduces the impact of equity and interest-rate risk factors while increasing yield.
- ▶ It also introduces an illiquidity premium in select exposures without compromising overall liquidity.
- ▶ The new allocation mix allocates 70% to liquid strategies and 80% to yield-generating asset classes.

CLIENT RESULT

- ▶ The modified portfolio potentially increases portfolio return and yield while reducing interest-rate and equity exposure in favour of greater spread exposure.
- ▶ Increase in expected net return of 30bps and book yield of 30bps, decrease in total portfolio risk of 13bps and improvement of portfolio performance in stress situations including S&P, high yield and investment grade shock scenarios.

GETTING EXTERNAL HELP

More than one-quarter (29%) of respondents to the survey say that a lack of internal expertise is hindering them in their efforts to switch asset classes and alter investment strategies. Where insurers have internal risk assessment expertise the appetite for investing outside of traditional asset classes is greater. Prudential Financial, for example, has an internal group dedicated to assessing investment risk from alternative asset classes.

Mr Lerman says: “It takes specialised knowledge and skill to identify opportunities and assess investment risk within this space. We analyse these assets as part of our strategic asset allocation framework and having an internal team dedicated to this effort supports our long-term investment strategy.”

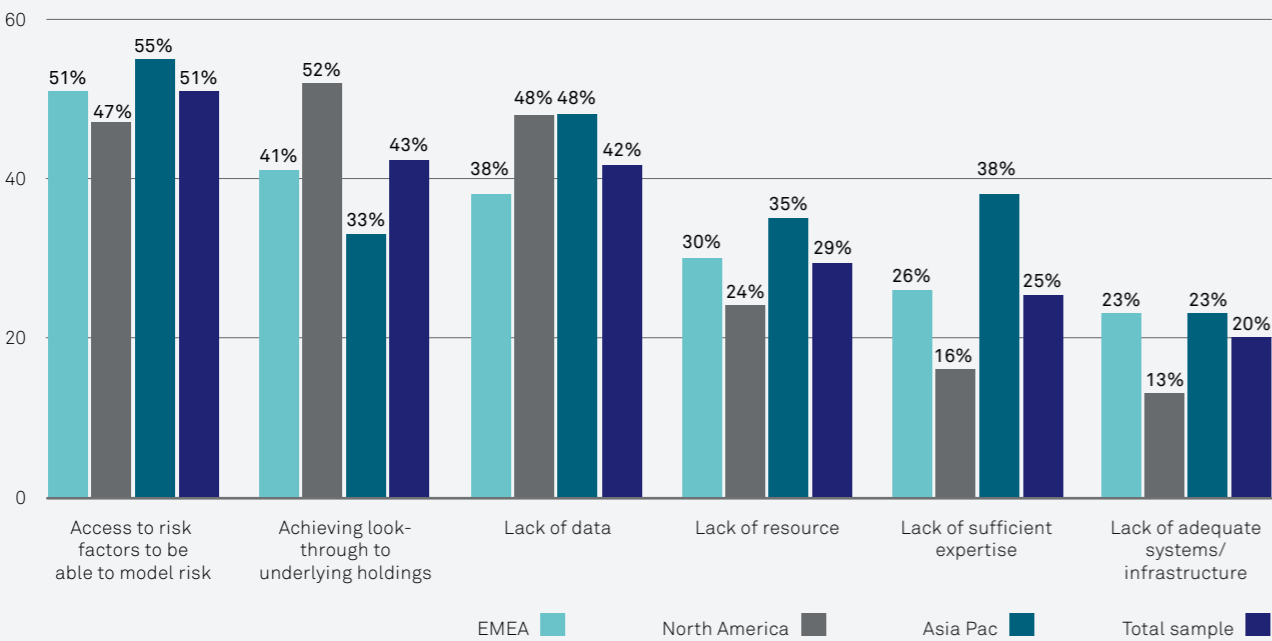
However, insurers also favour calling on third parties for supplementary support with risk analysis. Over two-thirds (69%) say that they will work more closely with their fund managers on risk management and governance and 28% say that they will use this resource to provide data and look-through support.

Mr Lerman says: “It's always beneficial to get external perspectives as it helps us stay informed of industry's best practices and market views.”

Insurers in Asia-Pacific are more likely to cite a lack of internal expertise as a hindrance than their North American and EMEA counterparts.

WHAT ARE YOUR MAIN CHALLENGES WHEN ASSESSING WHERE RISKS LIE ACROSS ALL ASSET CLASSES IN YOUR ORGANISATION’S INVESTMENT PORTFOLIO?

Select all that apply.



Base: Total (n=206), EMEA (n=103), North America (n=63), Asia Pac (n=40)
Source: The Economist Intelligence Unit, May 2013

In order to build up their internal expertise, 90% of insurers responding to the survey say that they have invested significantly more in risk management as a result of regulation. Instances of additional risk management spend are highest in China (including Hong Kong) and EMEA, although North America and Asia-Pacific are not far behind.

Asian insurers need to be prepared for the possibility that their own regulators will follow the US and European lead in tightening legislation. **Michael Burns**, the European, Latin America and China PR director at Genworth Financial, says: “In order to manage the fast growth of Asian markets, industry players must be able to take advantage of the lessons learned from other legal systems and markets, and adapt quickly and be highly flexible and responsive to regulatory developments.”

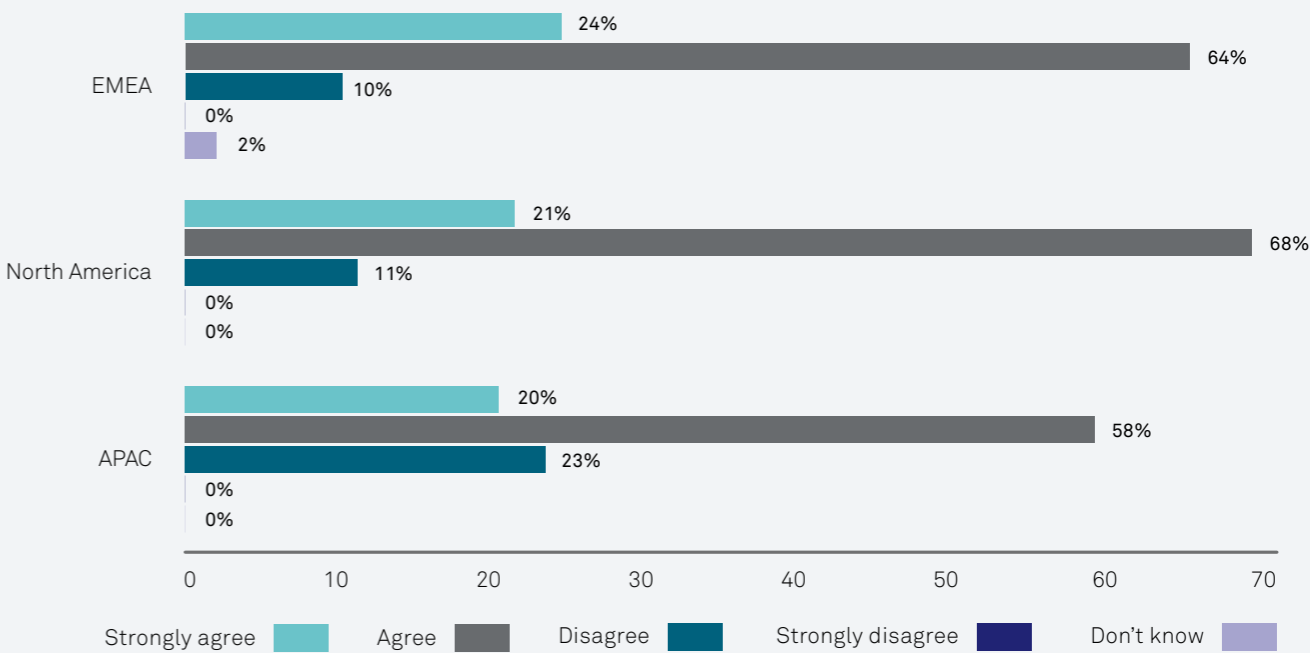
Where prudential regulation is well established, such as in the UK, **Otto Thoresen** of the Association of British Insurers (ABI) says that insurers are taking the risk management requirements seriously. Yet he adds that insurers still need more clarity on what is expected of them from regulators.

“The industry has been engineering stronger risk management into its model in the last three or four years and very successfully. It has the resource but it needs consistent and clear signalling from the partner with whom they are trying to work [the regulators],” he says.

Meanwhile, the regional financial regulators are pleased with insurers’ additional risk management spend and see this as a triumph for the prudential legislation created since the 2008 crisis.

DO YOU AGREE OR DISAGREE WITH THE FOLLOWING STATEMENTS ON THE CURRENT REGULATORY ENVIRONMENT?

Increased regulation is causing significant investment in risk management.



Base: Total (n=206), EMEA (n=103), North America (n=63), Asia Pac (n=40)
Source: The Economist Intelligence Unit, May 2013
Figures do not add to 100% due to rounding

Mr Montalvo of EIOPA says:

“I am convinced that better risk management is good not only for the company and for shareholders, but also for the consumers. Better risk management is about having the right toolkit to make better business decisions, to be able to identify opportunities and risks and to find the right balance between them.”

The view from the US insurance supervisor is similar, noting the potential cost benefits for consumers. The NAIC says: “The cost of insurance is based on the future expected loss costs, future estimated operational expenses, an allowance for profit and a measure of uncertainty in the estimated future loss costs. When uncertainty is reduced, this reduction affects prices charged in the marketplace.”

INVESTMENT RETURNS VERSUS OPERATIONAL CHANGES

For some insurers, in a low-yield and more risk-averse environment, the focus has switched to making money from the organisation's core competence – underwriting – rather than attempting to chase additional yield from complex investment strategies.

Zurich Insurance Group is wary of chasing investment returns. **Steve Lewis**, the chief executive of UK general insurance, says: “In 2002 the group focused on de-risking its portfolio and repositioning its investment strategy in

the context of ‘we are an insurer, not an investment house’. If you want to invest in us, we’re an insurer, if you want investment risk, invest somewhere else. The work we did to de-risk our portfolios to bring more centralist control and realign our investment strategy to being an insurer paid dividends in the context of the crisis.”

Hiscox’s **Mr Masojada** says: “Instead of going to more complicated and esoteric areas in order to maintain investment yield, we’d rather accept the fact that investment markets will give less return and make more money on underwriting to offset that.”

Adapting products and strategies for future growth

Growing regulatory pressures and evolving investment strategies have inevitably led to changes in product offerings.

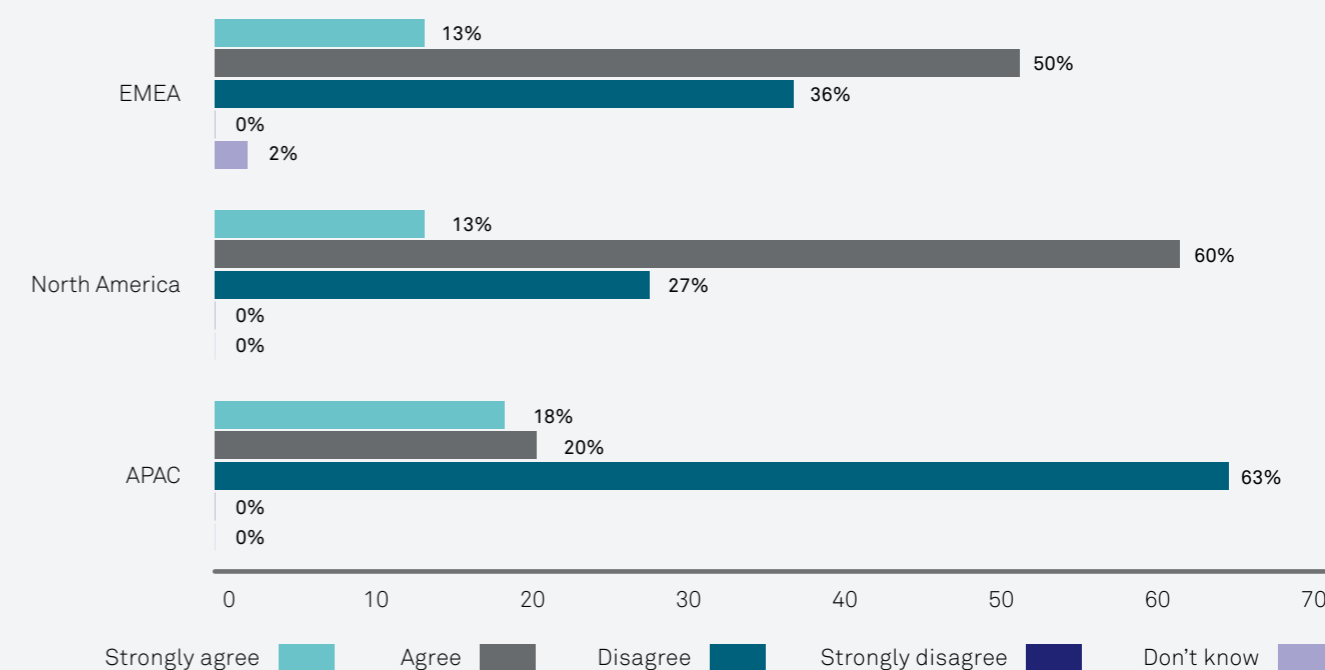
Some 61% of insurers say that regulatory change will stop them writing certain lines of business in the future. North American insurers are more likely to agree (73%) than EMEA (63%) or Asia-Pacific (38%) respondents.

Steven Cameron, the head of regulatory strategy at Aegon in the UK, says: “If we were anticipating a big regulatory change that would have an impact on the way products are sold, or how we would need to describe the product in our literature, that could put some products on hold.”

For insurers holding a with-profits book of business, the regulatory impact of Solvency II is already clear. The directive demands that insurers hold additional capital to cover these policies, making them more expensive and, in some cases prohibitively so, for organisations to run. One-fifth of survey respondents say that replacing with-profits with alternative guaranteed savings products is either very important or moderately important, with unit-linked and guarantee products the most popular replacement.

DO YOU AGREE OR DISAGREE WITH THE FOLLOWING STATEMENTS ON THE CURRENT REGULATORY ENVIRONMENT?

Regulation will cause insurers to stop writing certain lines of business/make disposals



Base: Total (n=206), EMEA (n=103), North America (n=63), Asia Pac (n=40)
Source: The Economist Intelligence Unit, May 2013

IN SUMMARY

- ▶ Insurers are broadening their investment horizons in response to yield compression, the need to diversify and fixed income supply constraints. Survey results highlight increased take up in:
 - Investment-grade fixed income and higher-yielding strategies, such as bank loans for increased yield;
 - Emerging markets for diversification purposes as well as yield pick-up;
 - Illiquid assets such as infrastructure for increased yield and diversification; and
 - ETFs for flexibility and tactical response.
- ▶ While many insurers have looked to longer duration assets for higher yields, the spectre of a rise in rates is leading many to reconsider their duration position.
- ▶ Portfolio revision and regulatory requirements bring significant risk management implications. Many insurers feel that they lack sufficient expertise to make the changes necessary to succeed in the current environment.
- ▶ Survey results suggest that many are considering seeking help from third parties to help them better manage these risks and to design and innovate new products

BlackRock view

Legacy savings products are generally acknowledged to be unsustainable because of a combination of complexity, opacity and cost of delivery. In addition, the primary way in which insurance companies differentiate themselves in the savings business is through the provision of guarantees. This remains challenging in the context of a low interest-rate environment and increasingly stringent regulation.

Insurers can benefit from partnering with their asset managers when designing new savings products. This allows them to access input on the specification and pricing of guarantees, the formulation of appropriate investment strategies and advice on the construction of a risk management and hedging programme. Asset managers can also help with the design of appropriate investment vehicles and efficient liaison with regulators.

The design of effective and efficient new products increasingly requires marketing, investment, risk and profitability considerations to be ‘designed-in’ from the start. A partnership approach allows insurers to seek help where they need it most and to access a valuable sounding board throughout the process.

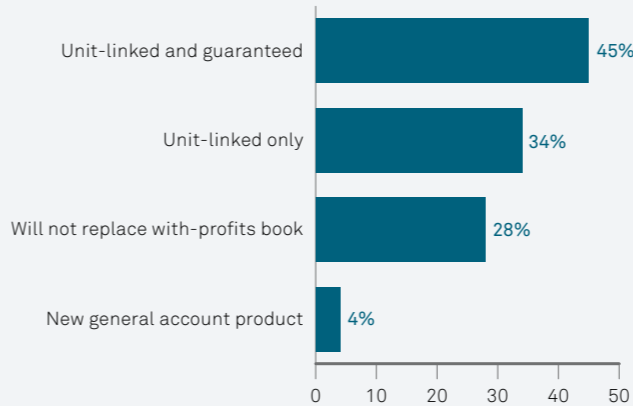
Mark Azzopardi

Head, Insurance Client Strategy



HOW WILL YOU REPLACE YOUR WITH-PROFITS BOOK?

Select all that apply



Base: All EMEA insurers saying with-profits products with alternative guaranteed savings products is important (n=47).
Source: The Economist Intelligence Unit, May 2013.

Axa's **Mr Moreau** says:

“The main [business] activity to be impacted will be the long-term savings and pensions business, as that’s where regulation is hurting most. Giving guarantees on our balance sheet on long-term business to customers is more and more difficult because the cost [of providing guarantees] is very high and so we are increasingly moving to unit-linked contracts. This is the big evolution we see in the French market.”

DRIVING INNOVATION

Although it may be that some insurers are forced to scale back their product suites as a result of regulatory and economic pressures, other organisations believe this environment creates opportunities to innovate and get rid of ‘dead wood’.

If the existing product range is not up to scratch, insurers are willing to cut what does not work and put in place lines that will drive growth. Nearly two-thirds (63%) of respondents expect to achieve growth in the next three years through product innovation.

Patrick Bowes of Old Mutual Global says: “Change is always a threat and an opportunity, and innovation can be triggered by regulatory change. For example, why have an annuity when you can have an income drawdown product? If you have got the philosophy of capital-light products, you can innovate to provide customer products that you think actually fit with the new regulatory regime.”

At Aegon, **Mr Cameron** says that the insurer is rethinking its approach to product development, putting the needs of the consumer at the centre of the process.

“Product development as a concept has changed dramatically. Twenty years ago, a provider would develop a product, take it out to market and then hope that people would buy it or advisers would recommend it,” he says. “Now you start by looking at the needs of your customers, then consider a product solution and design value-added features, often involving technology elements such as digital communications and online access for the customer. Finally, you’ll decide how the product can be distributed appropriately. That’s all at the heart of product development.”

In terms of improving product design and creating a range to work better with today’s consumer needs, while remaining affordable, two-fifths of insurers say that they will work more closely with asset managers on product design.



BLACKROCK CASE STUDY 4 PARTNERING TO MANAGE GUARANTEES

OBJECTIVES

- ▶ To develop new volatility managed funds for the UK and euro variable annuity markets.
- ▶ The funds were required to be compatible with effective insurance guarantee hedging and to remain within specific risk boundaries while minimising transaction costs from risk management.

BLACKROCK ACTIONS

- ▶ Recommended a framework that systematically adjusts the allocation between multiple asset classes with varying risk characteristics to maintain a specified target volatility. This allowed the client to differentiate from existing products in the market which control volatility by only varying the equity and cash allocations.
- ▶ In addition to equity futures, which are used in most volatility control funds, BlackRock's solution uses sovereign bond futures to cost-efficiently rebalance the fixed-income allocation.
- ▶ BlackRock focused on developing a transparent solution that was straightforward for the client to incorporate into their actuarial models.

CLIENT RESULT

- ▶ The client is able to offer guarantees on a range of multi-asset funds with the comfort of knowing that these guarantees are capable of being priced and risk-managed effectively.

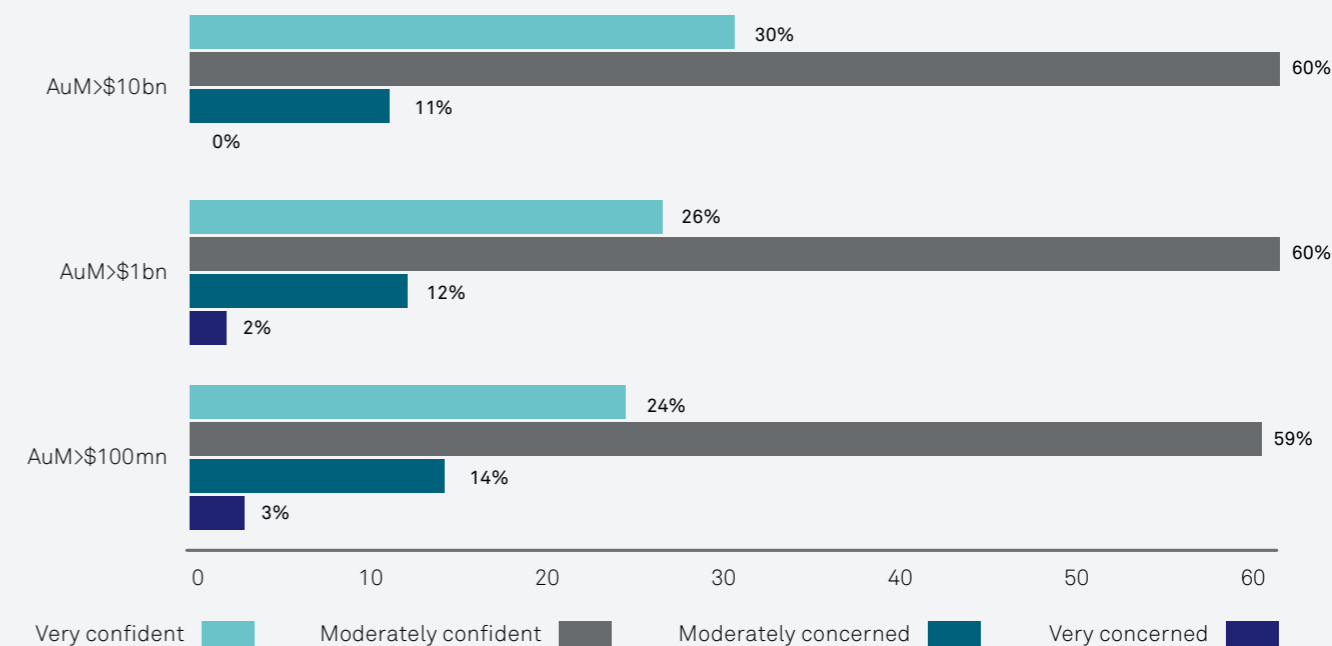
FUTURE PROFITABILITY

Operating within the financial services sector has been a challenge since 2008 and insurance companies are no exception to that rule. Low investment returns, regulatory demands and the ensuing changes to operations have all threatened insurers' profitability. In fact, 80% of respondents say that their businesses will have to undergo at least some change if they are to produce adequate shareholder returns over the next three years.

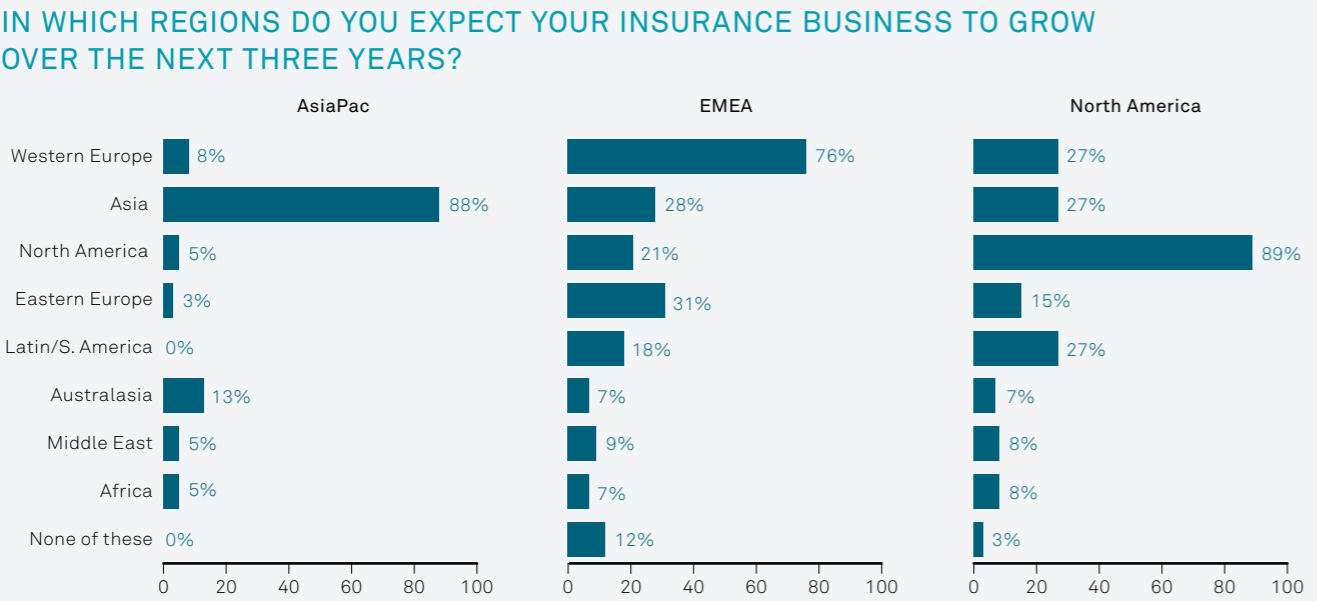
The ABI's **Mr Thoresen** says: "There has always been substantial change in insurance, so coping with that change is in the industry's DNA."

However, with their investment strategies and product lines revamped to reflect the new reality, insurers are feeling fairly confident about their performance. Nearly one-quarter (24%) of respondents are very confident and another 60% are moderately confident that they will be able to earn sufficient returns on investments to maintain return on equity (ROE) to shareholders over the next three years, with Asian insurers and the largest insurers the most confident.

HOW CONFIDENT ARE YOU THAT YOU WILL EARN SUFFICIENT INVESTMENT RETURNS TO MAINTAIN YOUR INVESTMENT CONTRIBUTION TO ROE OVER THE NEXT THREE YEARS?



Base: Total (n=206), AUM > \$10bn (n=122), AUM > \$1bn (n=168), AUM > \$100mn (n=206)
Source: The Economist Intelligence Unit, May 2013
Figures do not add to 100% due to rounding



Base: Total (n=206), EMEA (n=103), North America (n=63), Asia Pac (n=40)
Source: The Economist Intelligence Unit, May 2013

Such confidence may be a result of revisiting previous ROE expectations and reducing them in line with the lower-return environment. **Ms Street** says: “Many in the insurance sector including us have said the 15% long-term ROE targets are unrealistic at this stage in the cycle. I don’t think our investors are expecting that level with the lower interest-rate environment. With risk-free [assets] where they are, everyone’s expectations have moved down.”

In terms of attractive geographies for targeting growth, the countries in which respondents are domiciled correlate to the areas they see as important to future profitability.

MassMutual’s **Mr Corbett** says: “From a business perspective, we are very focused on the US. I know other insurers are expanding globally and while we do have insurance businesses in Asia, we think of them more as strategic investments that ultimately benefit our policyowners.”

Mr Bowes, the director of African-based Old Mutual, says: “We have substantial assets under management both in the US and Europe, but the likely demographics will mean that the expansion of our customer numbers in Africa will substantially exceed that of the Northern hemisphere. The growth of the emerging middle class in Africa will be the most profound change to our businesses in Africa.”

Old Mutual may be looking to its own backyard for growth, but overall, Africa proves the least popular region to target for future growth, with just 7% choosing this continent.

Hiscox’s **Mr Masojada** says that although emerging nations may be attractive, regulatory hurdles make it difficult for foreign companies to enter some of these markets. “Some countries make it incredibly difficult for foreigners to enter their market so even though in theory they might be attractive, market access is a big challenge,” he says.

In spite of potential barriers, 40% of UK insurers saw Latin America as a region to target in the next three years, while 30% of US insurers see Asia as a source of future revenue.

Zurich Insurance Group is one that is looking to Latin America. **Mr Lewis** says: “I don’t think our strategy is dissimilar to any group. As an organisation, clearly we are looking to rebalance our business portfolios towards more growth markets, which tend to be the developing markets – Latin America, Asia, Middle East and Africa. The Zurich group has made a fairly substantive move in terms of a joint venture with Santander in Latin America 18 months ago. It is about over time, repositioning the portfolio to have a greater weight to developing markets.”

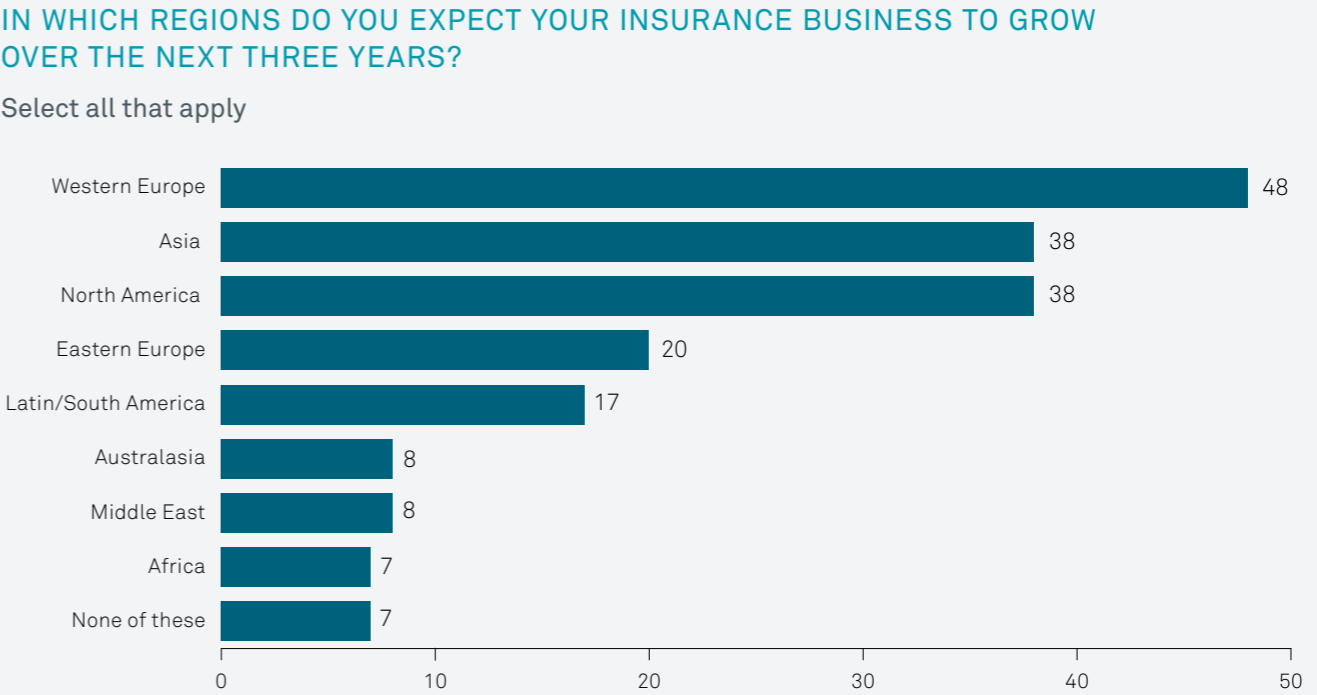
Half of French insurers are targeting Asia as a key future market, which is demonstrated by Axa’s recent expansion in China. **Mr Moreau** says: “In Asia we just completed a big investment in China for Chong Ping, providing us with a huge opportunity to provide motor insurance direct across the whole of China. We also completed a large deal with HSBC, where we bought its P&C [property and casualty] subsidiaries in Hong Kong, Mexico, China. In addition, we are looking at South America and Central America.”

Similarly, Sumitomo is expanding its operations outside of Japan and into other Asian markets, particularly China. **Mr Ono** says: “We are interested in the rest of Asia. In fact, we already established a joint venture with a Chinese insurance company back in 2005 and in 2012 we became a strategic partner to a Vietnamese insurance and financial company.”

Mr Burns at Genworth Financial says: “Genworth’s Lifestyle Protection is focused on navigating the tough economic climate in its core business in Europe and is selectively expanding in new markets outside of Europe. The business is making progress on its plans to grow in new markets in reinsurance, such as through our relationship with MAPFRE in Latin America and PICC in China.”

ORGANIC AND ACQUISITIVE GROWTH

As well as venturing into new markets, insurers are also focusing on merger and acquisition activity to help grow their businesses. Nearly one-quarter (22%) of respondents plan to make acquisitions, while 19% foresee mergers with equals as a means of growing their operations.



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

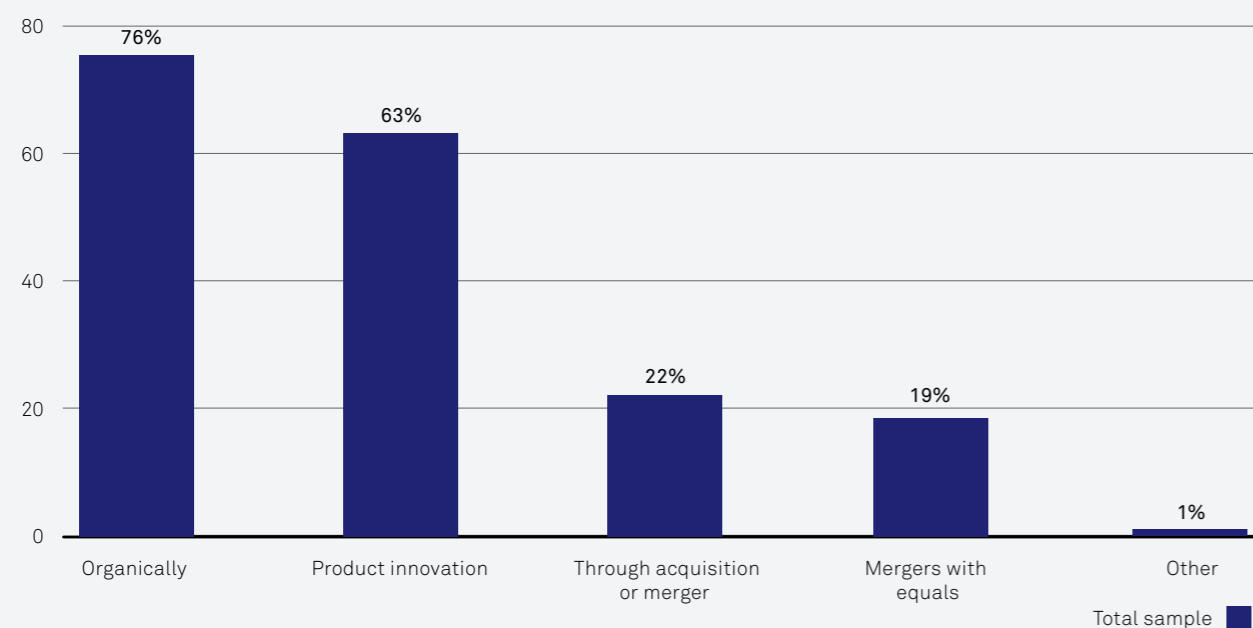
Mr Corbett says that MassMutual purchased The Hartford's Retirement Plans business last year to double the size of its retirement services business in the US. "[With] all the regulatory changes and current economic environment we are seeing in the US and Europe, we are seeking ways to capitalise on opportunities we see in the marketplace," he says. "We see ourselves as better buyers than sellers, so we are looking for opportunities to position ourselves for future growth."

However, insurers are most likely to grow organically, with three-quarters of respondents saying that they will expand this way.

Old Mutual's **Mr Bowes** says: "In the last few months we've been active ... buying a licence to operate in some of the smaller African countries. That's part one of the operation. Part two is actually building operational businesses in these markets, building distribution, educating the population on the financial services market and the products that are available."

HOW DO YOU EXPECT TO ACHIEVE THAT GROWTH FROM A BUSINESS/ UNDERWRITING PERSPECTIVE?

Select all that apply



Base: Total (n=206)
Source: The Economist Intelligence Unit, May 2013

IN SUMMARY

External pressures are prompting insurers to revise business priorities and strategies:

- ▶ Regulation is forcing insurers to re-evaluate certain lines of business, particularly with-profit products, and to drive growth through product innovation.
- ▶ Insurers regard domestic markets as the main focus for growth.
- ▶ Most insurers aim to expand organically.

Conclusion

Global insurers are acutely aware that they must adapt to survive in today's challenging markets. Although much of the regulatory change is out of their hands, organisations recognise that they must work with supervisors to ensure that their businesses can thrive within a stricter, more risk-aware framework.

Similarly, trying economic conditions – as well as central banks' efforts to improve these conditions, and the implications of these efforts – are outside insurers' control. Yet they are willing and able to adapt their operations and investment strategies to remain profitable.

The main challenge now is adapting investment strategies in light of the changing environment created by central bank action. Insurers have increased allocations to higher-yielding fixed-income instruments to handle low interest rates, and say that they will increase credit exposure to prepare for the unwinding of QE. However, they will have to shift from their current strategy of increasing duration to shortening duration as interest rates rise following the end of QE.

More broadly, diversification across all asset classes, and particularly within fixed income, will be the focus for insurers over the next three years. They are also adopting more tactical asset allocation strategies in order to produce the returns they need.

Risk assessment, particularly in light of regulatory requirements, remains key. How well insurers understand the risks associated with different assets classes is driving their investment decisions. In order to assess those risks better, insurers are both beefing up their internal expertise by investing in risk management and turning to third parties for help in understanding the risks and regulatory requirements, such as achieving look-through to underlying holdings.

Global insurers are, as far as they can be, prepared for external risks, including continued market volatility and the implications of the tapering of QE. Flexible investment strategies that allow for change within a tightly risk-managed framework will be the key to ensuring portfolios meet the demands of both today's and tomorrow's challenging environments.

BlackRock commentators



David Lomas, Global Head, Financial Institutions Group, Institutional Client Business
David A. Lomas, ACII, Managing Director, is Head of BlackRock's Global Financial Institutions Group within the Institutional client business. This global business is focused on managing balance sheet and subadvisory assets, and providing risk management services to financial institutions. Mr. Lomas is responsible for BlackRock's strategy, service offering, client strategy and client proposition. He sits on BlackRock's Global Operating Committee.



Jeff Jacobs, Global Head, Financial Institutions Group, Fixed Income Alpha Strategies
Jeff Jacobs, Managing Director and portfolio manager, is Global Head of the Financial Institutions Group within the Multi-Sector Institutional division of Americas Fixed Income Alpha Strategies. Mr. Jacobs has been a member of the Financial Institutions Group at BlackRock since its inception, holding a variety of positions, including Co-Head of FIG Portfolios, and Senior Portfolio Manager.



Chris Wrenn, Co-Head, Infrastructure Debt Group
Chris Wrenn, Managing Director, is Co-Head of the Infrastructure Debt Group, within BlackRock Alternative Investors (BAI). He is responsible for establishing the platform, originating investment opportunities, leading the investment process, establishing industry partnerships, and maintaining relationships with key sponsors.



Raman Suri, Head, iShares Insurance and New Markets Distribution
Raman Suri, Managing Director, is Head of iShares Insurance and New Markets Distribution. Before this Mr. Suri was the US Chief Operating Officer of the US iShares business at BlackRock. He has also served as Head of Distribution for the Institutional-RIA segments. Mr. Suri ran the Product and Capital Markets Group for iShares prior to that and has been in the iShares business since 2003.



Nugi Jakobishvili, Managing Director, member of the Executive team for BlackRock Alternative Investors (BAI)
Mr. Jakobishvili is responsible for developing and managing investment solutions across Alternatives. Mr. Jakobishvili's service with the firm dates back to 2006. He was previously a member of BlackRock's Financial Markets Advisory (FMA) Group, where he advised clients on valuation, structuring and governance solutions for over \$600 billion in whole loan, securities and derivative exposures as part of complex, time-sensitive transactions.



Nigel Foster, Head, Trading and Liquidity Strategies Group, EMEA
Nigel Foster, Managing Director, is Head of BlackRock's Trading & Liquidity Strategies Group for the EMEA region. He is responsible for overseeing the firm's trading functions and the Cash and Securities Lending business. In addition, Mr. Foster chairs the Derivatives Oversight Committee (DOC), is a member of the Counterparty Oversight Committee (CPOC) and the EMEA Operating Committee (EOC).



Mark Azzopardi, Head, Insurance Client Strategy
Mark Azzopardi, Managing Director, is a member of the Client Strategy team within BlackRock Solutions. BlackRock Solutions is responsible for developing, assembling and managing investment solutions involving multiple strategies and asset classes. Within Client Strategy, Mr. Azzopardi has a specific focus on Insurance Solutions.

About BlackRock

Why BlackRock

As the world's largest investment manager, we believe it's our responsibility to help investors of all sizes succeed in the New World of Investing. We were built to provide the global market insight, breadth of capabilities and deep risk management expertise these times require.

The resources you need for a new world of investing

Investing with BlackRock gives you access to almost every asset class, geography and investment style, as well as extensive market intelligence and risk analysis, to help build the dynamic, diverse portfolios we believe these times require.

The best thinking you need to uncover opportunity

With deep roots in all corners of the globe, our 100 investment teams in 30 countries share their best thinking to translate local insight into actionable ideas that strive to deliver better, more consistent returns over time.

The risk management you need to invest with clarity

With more than 1,000 risk professionals and premier risk management technology, BlackRock digs deep into the data to understand the risk that has to be managed for the returns our clients need and bring clarity to the most daunting financial situations.

BlackRock. Investing for a new world.

Source: BlackRock, data as at 30 June 2013.

About BlackRock's Financial Institutions Group

We partner with insurers to go beyond traditional asset management offering strategic advice, liability assessment and as part of BlackRock Solutions, investment accounting and risk management services to help our clients navigate increasingly complex financial, accounting, and regulatory environments.

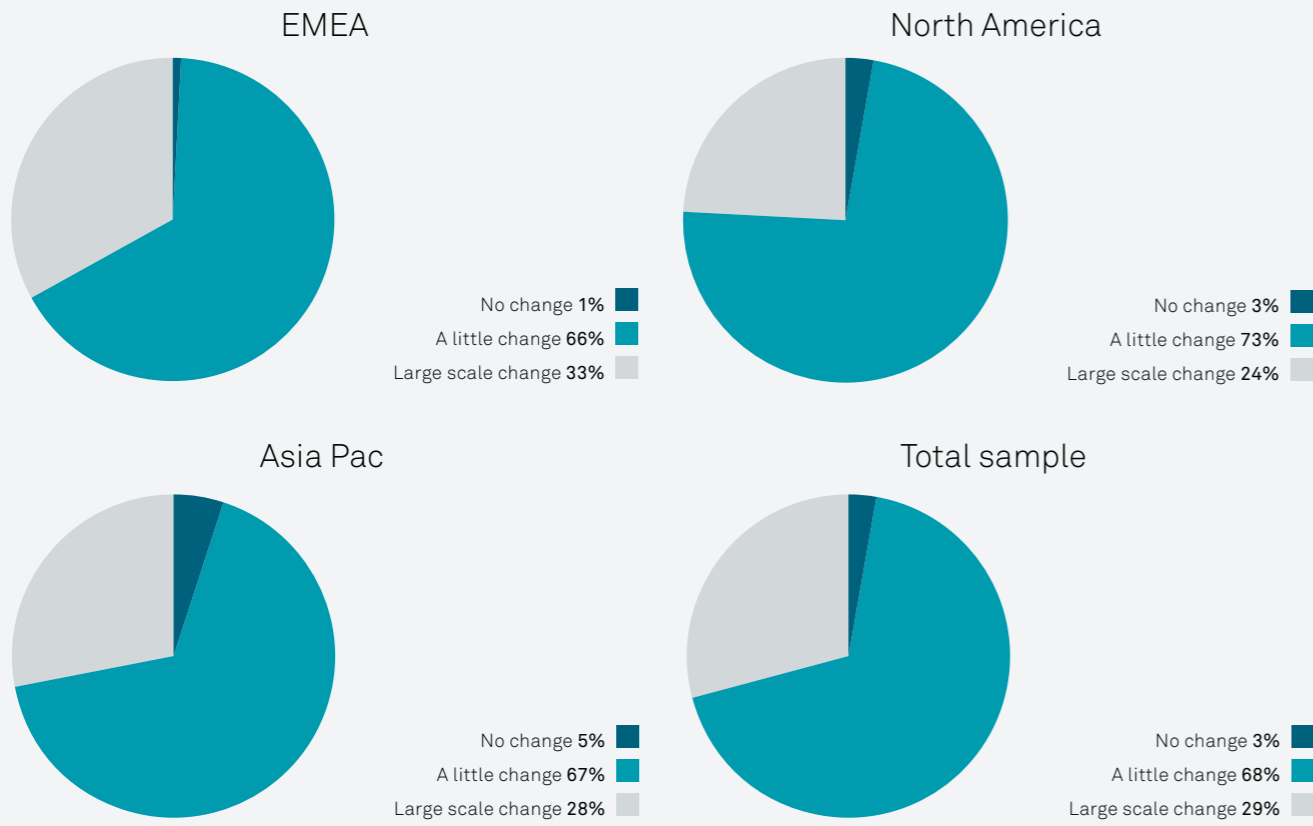
- ▶ Team of 75+ client service professionals located in New York, San Francisco, Chicago, Princeton, London, Munich, Copenhagen, and Milan
- ▶ Manage \$306 billion in unaffiliated general account and subadvisory assets for 151 insurers in 20 countries
- ▶ Provide risk management and investment accounting services to 56 insurers through BlackRock Solutions®.

As of 30 June 2013: AUM does not include iShares® or other pooled vehicles. Includes Settlement Trusts and Financial Guaranty.

**FOR MORE INFORMATION
PLEASE CONTACT US:**
financialinstitutions@blackrock.com
blackrock.com

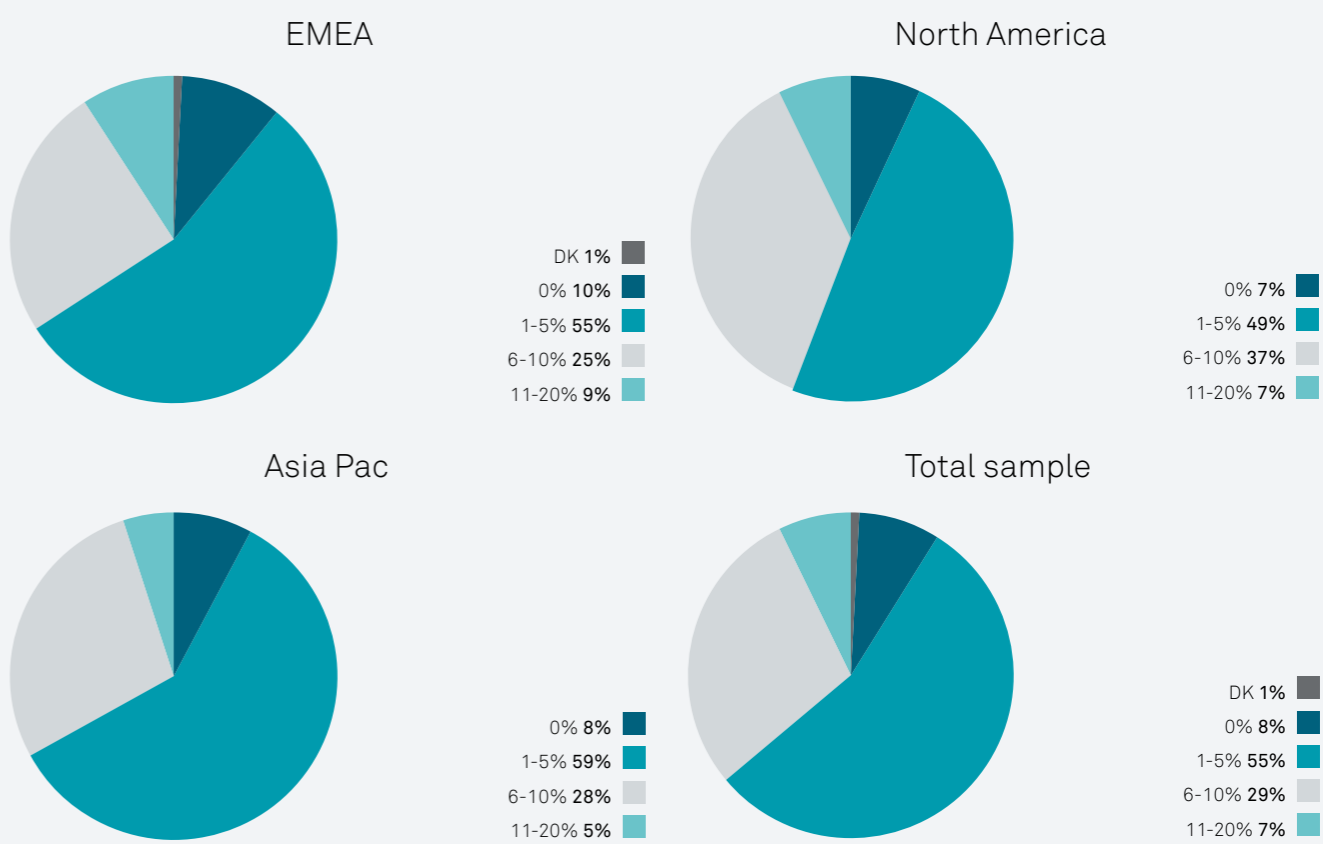
Appendix

THE INSURANCE INDUSTRY IS SEEING CHANGE ACROSS REGULATION, INVESTMENT AND OPERATIONAL FUNCTIONS. WHAT LEVEL OF FURTHER CHANGE DO YOU EXPECT THERE TO BE OVER THE NEXT THREE YEARS IN YOUR MARKET?



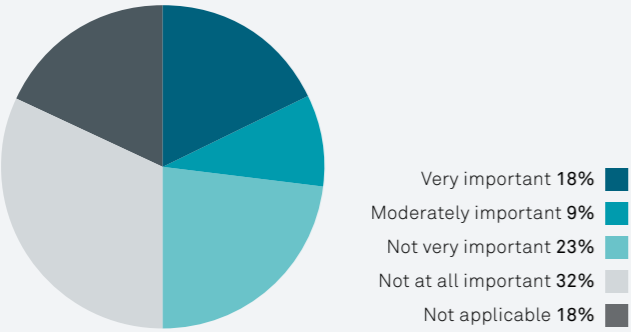
Base: Total (n=206), AsiaPac (n=40), EMEA (n=103), North America (n=63)
Source: The Economist Intelligence Unit, May 2013

THINKING ABOUT ILLIQUID ASSETS, APPROXIMATELY WHAT PROPORTION OF YOUR PORTFOLIO WOULD YOU EXPECT TO ALLOCATE TO THESE LESS LIQUID INVESTMENTS OVER THE NEXT THREE YEARS?



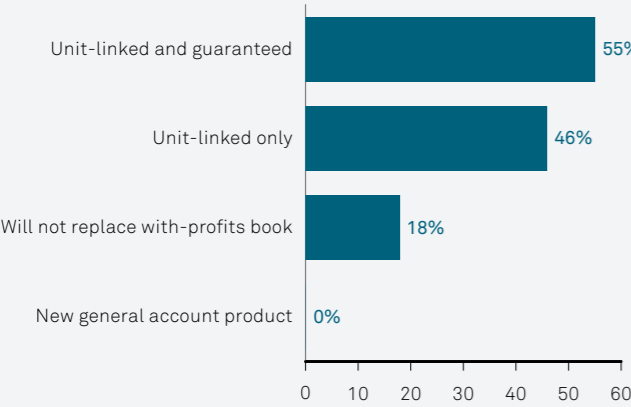
Base: Total (n=206), AsiaPac (n=40), EMEA (n=103), North America (n=63)
Source: The Economist Intelligence Unit, May 2013

HOW IMPORTANT IS IT TO THE SUCCESS OF YOUR BUSINESS TO REPLACE YOUR EXISTING WITH-PROFITS PRODUCTS WITH ALTERNATIVE GUARANTEED SAVINGS PRODUCTS?



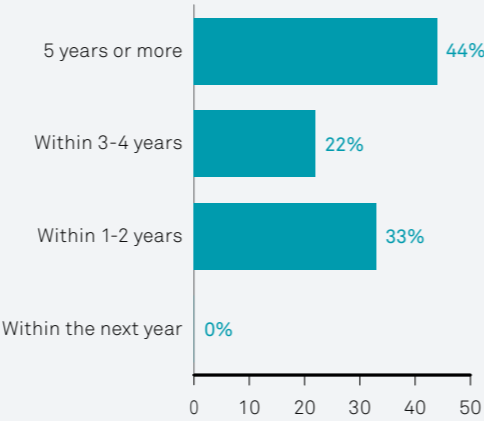
HOW WILL YOU REPLACE YOUR WITH-PROFITS BOOK?

Select all that apply



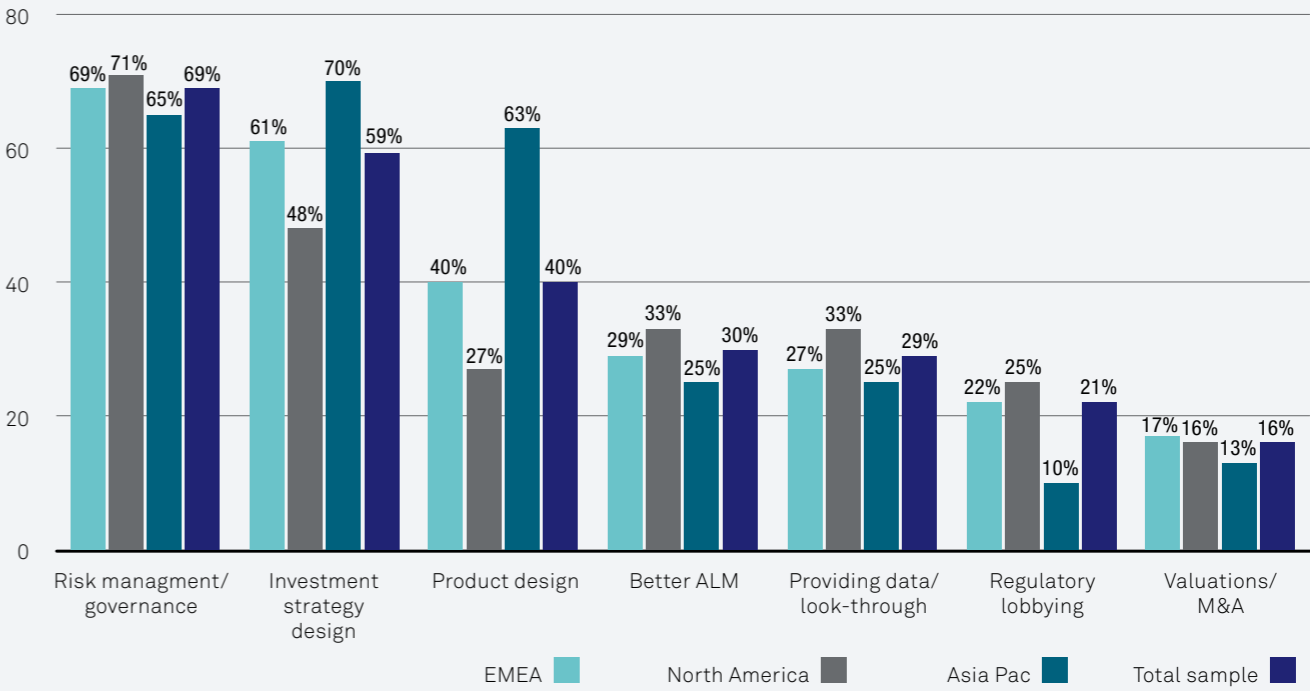
Base: EMEA Life companies only (n=21)
Source: The Economist Intelligence Unit, May 2013
Figures do not add to 100% due to rounding

WHEN ARE YOU LIKELY TO REPLACE YOUR WITH-PROFITS BOOK?



IN WHICH AREAS WILL INSURERS NEED TO WORK MORE CLOSELY WITH THIRD PARTIES SUCH AS ASSET MANAGERS TO EVOLVE THEIR BUSINESSES?

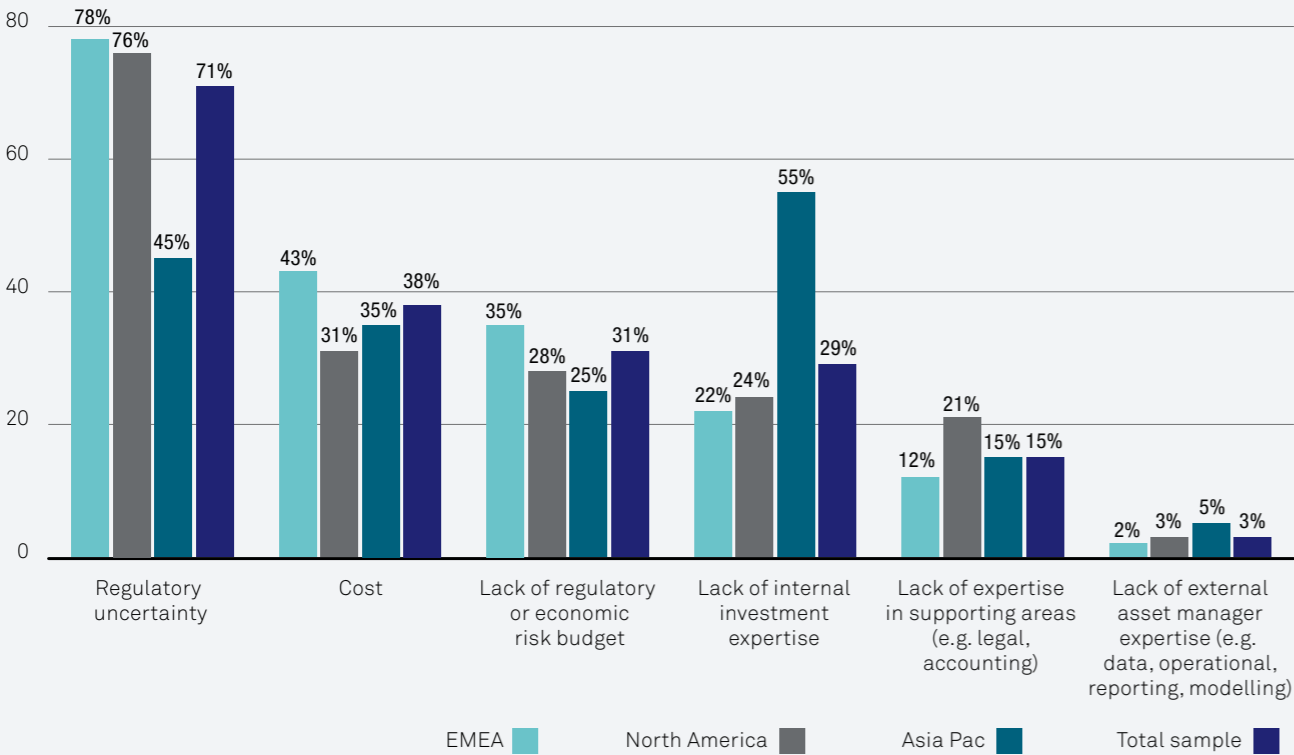
Select up to three.



Base: Total (n=206), EMEA (n=103), North America (n=63), AsiaPac (n=40)
Source: The Economist Intelligence Unit, May 2013

WHAT ARE THE MAIN BARRIERS PREVENTING YOU FROM MOVING INTO NEW ASSET CLASSES?

Choose up to two.



Base: Total (n=206), EMEA (n=103), North America (n=63), AsiaPac (n=40)
Source: The Economist Intelligence Unit, May 2013

Important information

This material is for distribution to Professional Clients (as defined by the FCA Rules) and should not be relied upon by any other persons. Circulation must be restricted accordingly.

The opinions expressed are as of 25.09.2013 and may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and non-proprietary sources deemed by BlackRock to be reliable, are not necessarily all inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will come to pass. Any investments named within this material may not necessarily be held in any accounts managed by BlackRock. Reliance upon information in this material is at the sole discretion of the reader. Past performance is no guarantee of future results.

Any research in this document has been procured and may have been acted on by BlackRock for its own purpose. The results of such research are being made available only incidentally. The views expressed do not constitute investment or any other advice and are subject to change. They do not necessarily reflect the views of any company in the BlackRock Group or any part thereof and no assurances are made as to their accuracy.

In the EU issued by BlackRock Investment Management (UK) Limited (authorised and regulated by the Financial Conduct Authority). Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Registered in England No. 2020394. Tel: 020 7743 3000. For your protection, telephone calls are usually recorded. BlackRock is a trading name of BlackRock Investment Management (UK) Limited. In Hong Kong, the information provided is issued by BlackRock (Hong Kong) Limited and is only for distribution to "professional investors" (as defined in the Securities and Futures Ordinances (Cap. 571 of the laws of Hong Kong)) and should not be relied upon by any other persons. In Singapore, this is issued by BlackRock (Singapore) Limited (company registration number: 200010143N) for institutional investors only. For distribution in Korea for Professional Investors only (or "professional clients", as such term may apply in local jurisdictions). For distribution in EMEA and Korea, for Professional Investors only (or "professional clients", as such term may apply in relevant jurisdictions). This material has not been approved for distribution in Taiwan. In Japan, not for use with individual investors. In Canada, this material is intended for accredited investors only. This material is being distributed/issued in Australia and New Zealand by BlackRock Financial Management, Inc. ("BFM"), which is a United States domiciled entity and is exempted under ASIC CO 03/1100 from the requirement to hold an Australian Financial Services License and is regulated by the Securities and Exchange Commission under US laws which differ from Australian laws. In Australia this document is only distributed to "wholesale" and "professional" investors within the meaning of the Corporations Act 2001. In New Zealand, this document is not to be distributed to retail clients. BFM believes that the information in this document is correct at the time of compilation, but no warranty of accuracy or reliability is given and no responsibility arising in any other way for errors and omissions (including responsibility to any person by reason of negligence) is accepted by BFM, its officers, employees or agents.


In Latin America, for Institutional and Professional Investors only. This material is solely for educational purposes and does not constitute investment advice, or an offer or a solicitation to sell or a solicitation of an offer to buy any shares of any funds (nor shall any such shares be offered or sold to any person) in any jurisdiction within Latin America in which such an offer, solicitation, purchase or sale would be unlawful under the securities laws of that jurisdiction. If any funds are mentioned or inferred to in this material, it is possible that some or all of the funds have not been registered with the securities regulator of Brazil, Chile, Colombia, Mexico, Peru or any other securities regulator in any Latin American country, and thus, might not be publicly offered within any such country. The securities regulators of such countries have not confirmed the accuracy of any information contained herein. No information discussed herein can be provided to the general public in Latin America.

© 2013 BlackRock, Inc. All Rights reserved. BLACKROCK, BLACKROCK SOLUTIONS, iSHARES, SO WHAT DO I DO WITH MY MONEY, INVESTING FOR A NEW WORLD and BUILT FOR THESE TIMES are registered and unregistered trademarks of BlackRock, Inc. or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners. (007066-13 Sep)

FOR MORE INFORMATION

+44(0)20 7743 3000
financialinstitutions@blackrock.com
blackrock.com

BLACKROCK®

 **iShares®** **BLACKROCK SOLUTIONS®**