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Beyond £ Credit & Equity Release Mortgages

Investment ideas for Matching Adjustment portfolios

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22nd November 2018

Investment strategy for annuities

Benefits

Pricing for Bulk
Purchase Annuities

Balance sheet
optimisation for annuity
back-books

Solvency II and Matching
Adjustment rules

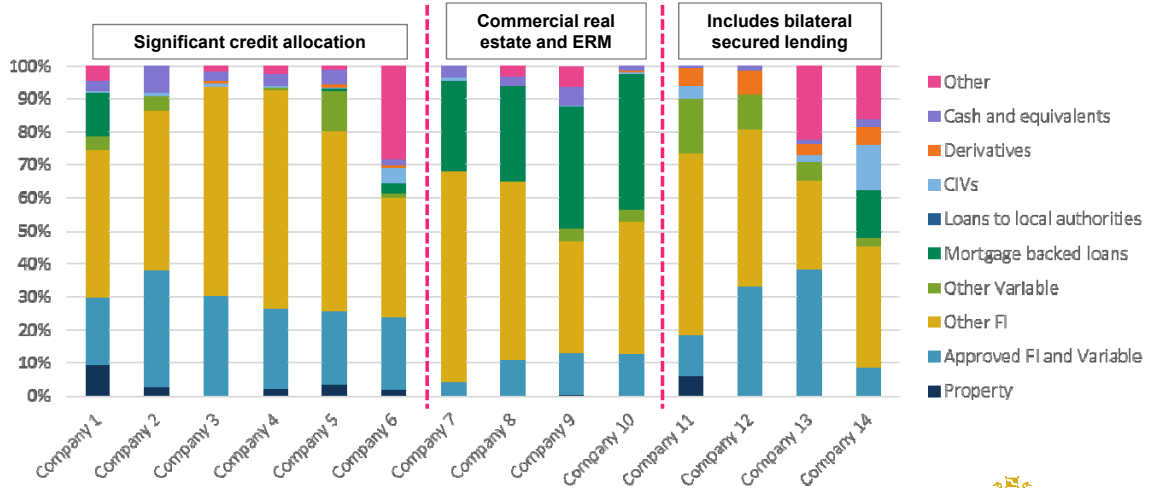
Increased pressure on £
corporate bonds

Challenges



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Annuity Investment Strategies – a 2015 snapshot



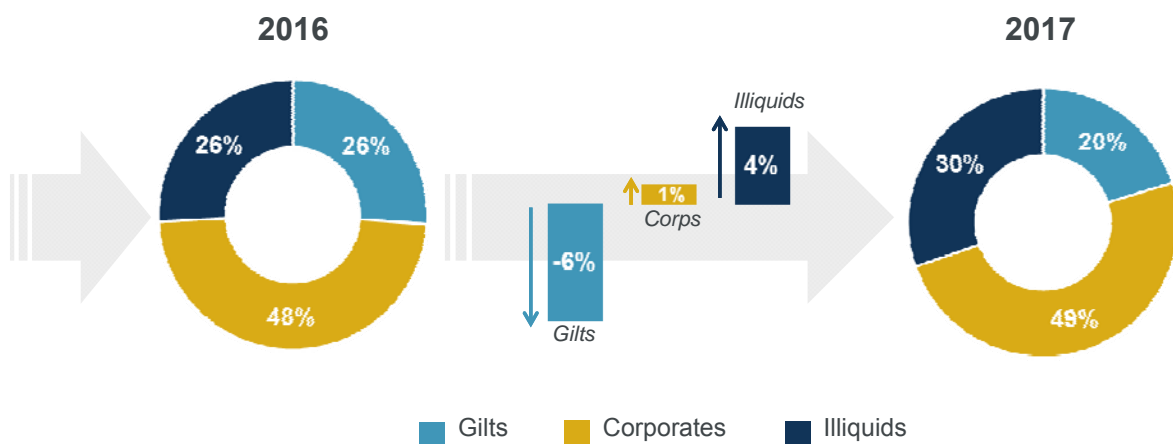
• Source: based on PRA Insurance Returns and Hymans Robertson research
 • For all firms, total assets in both Form 48 (non-linked) and Form 56 (index-linked) have been included.
 • For some companies (for the funds shown in the chart) there may be some assets backing non-annuity business



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3

Annuity Investment Strategies – recent trends



Source: Estimates, based on a selection of firms active in bulk annuities, and using information from SFCRs, annual reports and company presentations



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4

Annuity Investment Strategies – a continuing trend

“ 2018 marks a significant new era for the pension scheme risk transfer market, with bulk annuity transaction volumes set to exceed £20 billion, a 50% increase compared to the previous record of £13.2 billion set in 2014. ”

Hymans Robertson, 2018
Risk Transfer Report

“ These ‘illiquid assets’ ... currently make up more than 25% of the assets backing annuities across UK insurers. Insurers’ business plans suggest this proportion might increase to around 40% by 2020. ”

David Rule, Speech given
at Westminster and City
Bulk Annuities Conference,
April 2018

“ Shifting the portfolio towards illiquids is “a good opportunity to increase yield in back book” ... and will drive profit margins. ”

Insurer Chief Executive,
Quote included in
Insurance Asset Risk
article, July 2016



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5

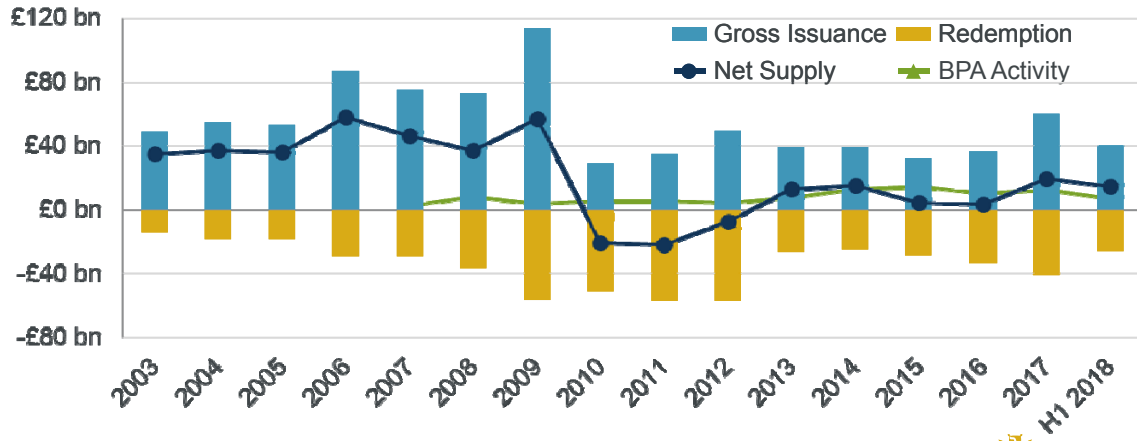


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Challenges for £ corporate bonds

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Scarcity of new £ bonds



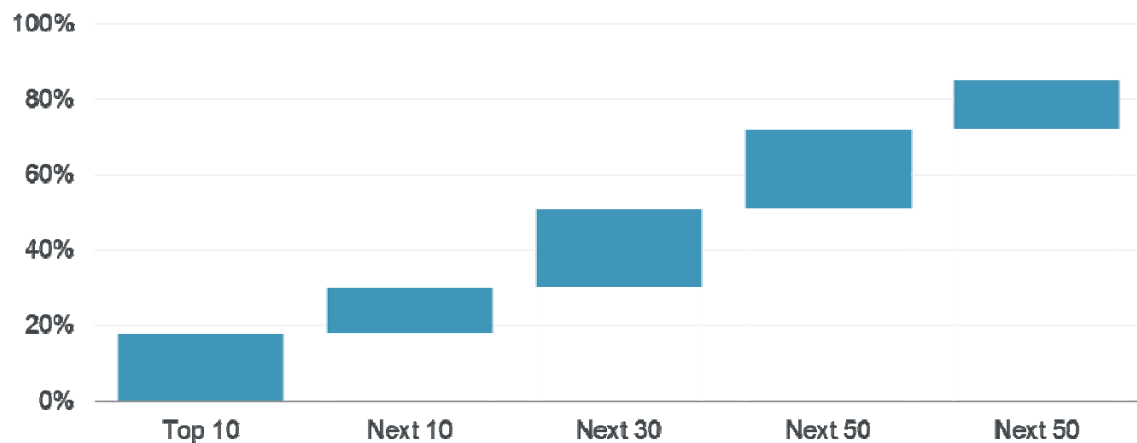
Source: GSAM, Bloomberg Barclays indices, as of October 2018, and Hymans Robertson Risk Transfer Report



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7

Relatively few issuers



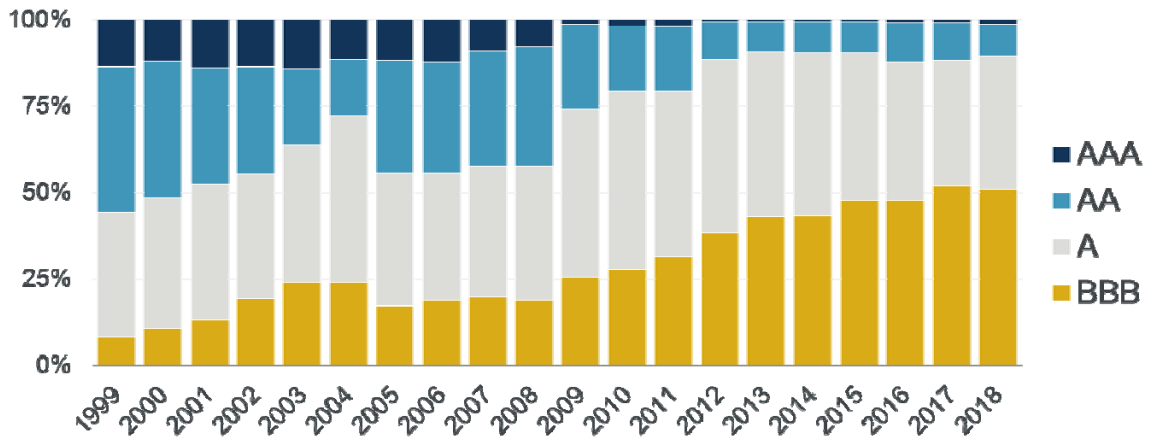
Source: GSAM, Bloomberg Barclays indices, as of September 2018



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8

Rise of the £ BBB



Source: GSAM, Bloomberg Barclays indices, as of September 2018



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9



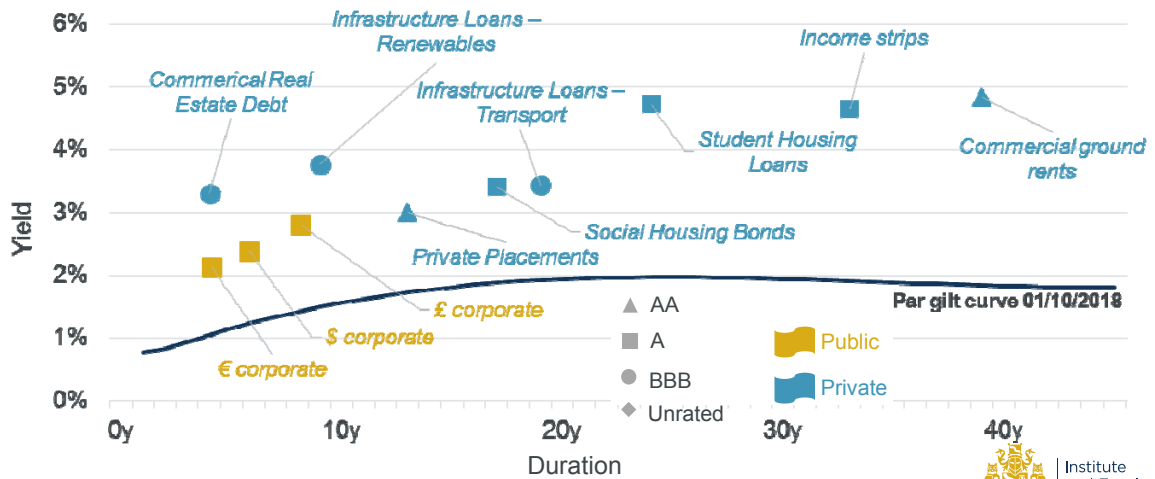
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What are the alternatives to £ corporate bonds?

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What are the alternatives?

Chart is for illustrative purposes only



Source: Hymans Robertson research, October 2018.

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11



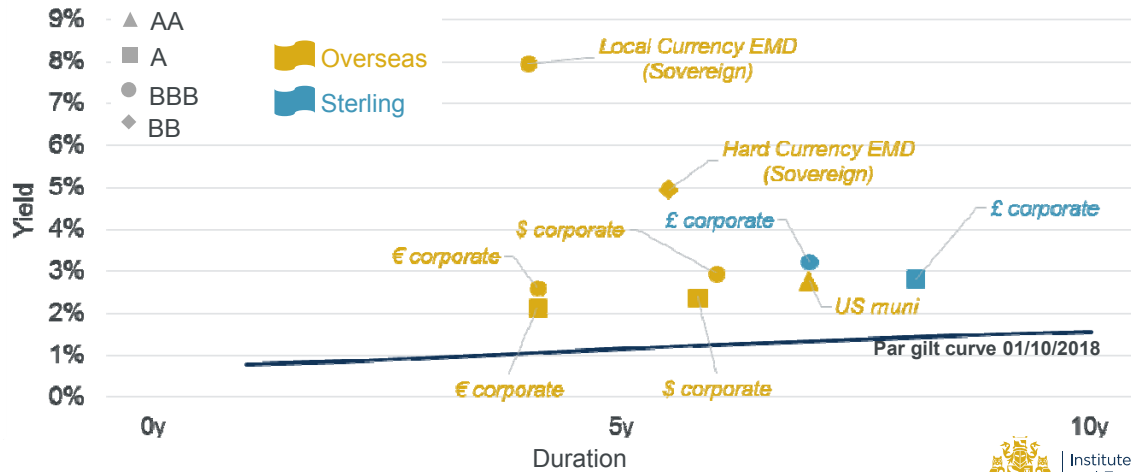
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Alternative 1: Non-£ Public Credit

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Overview of non-£ public credit

Chart is for illustrative purposes only



Source: Hymans Robertson research, October 2018.

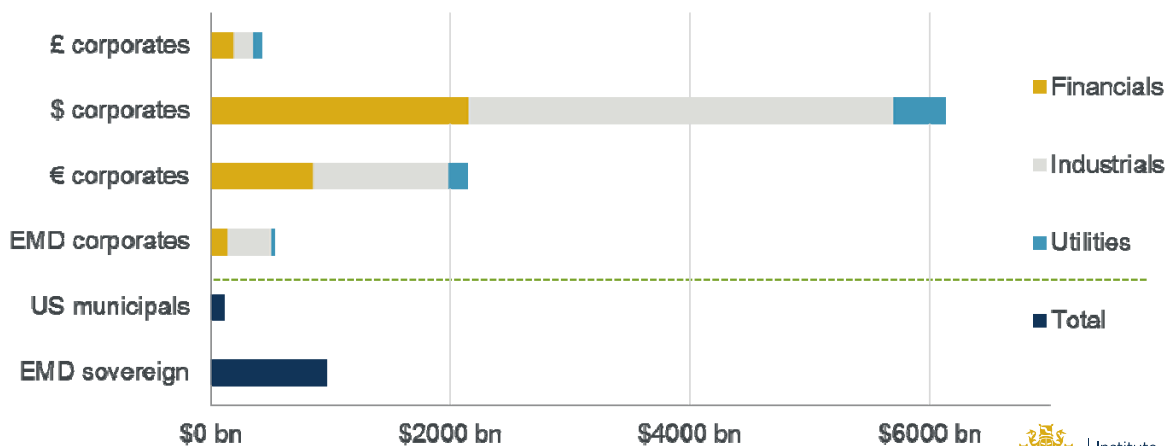


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13

Challenge #1

What volumes are available?



Source: GSAM, Bloomberg Barclays indices, as of October 2018. Note that EMD corporates refer to EMD corporates in hard currencies, US municipals refer to US taxable municipals.

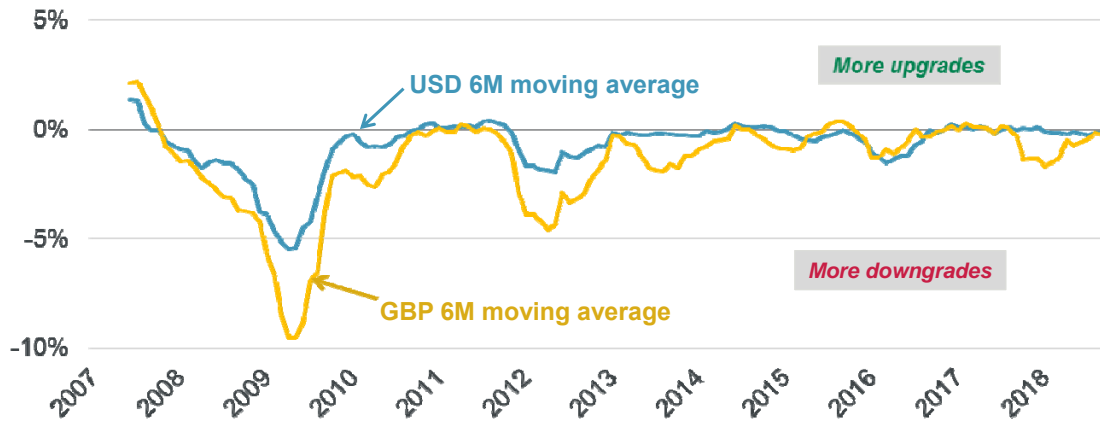


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14

Challenge #2

What diversification can be achieved vs. £ credit?



Source: GSAM, Bloomberg Barclays indices, as of October 2018. The Y-axis shows the percentage of bond upgrades relative to downgrades on a monthly basis within the Barclays Global Aggregate Corporate Index.

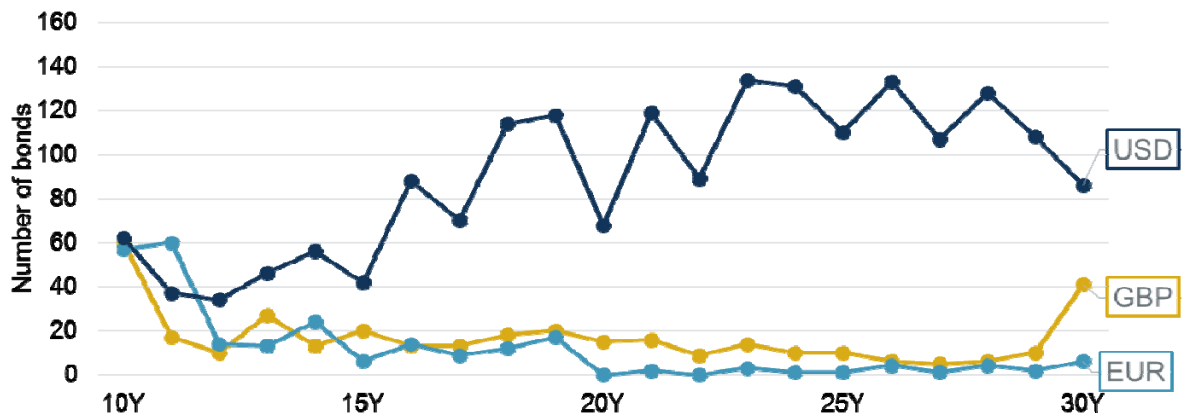


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15

Challenge #3

What maturities are available in the MA universe?



Source: GSAM, Bloomberg Barclays indices, as of October 2018

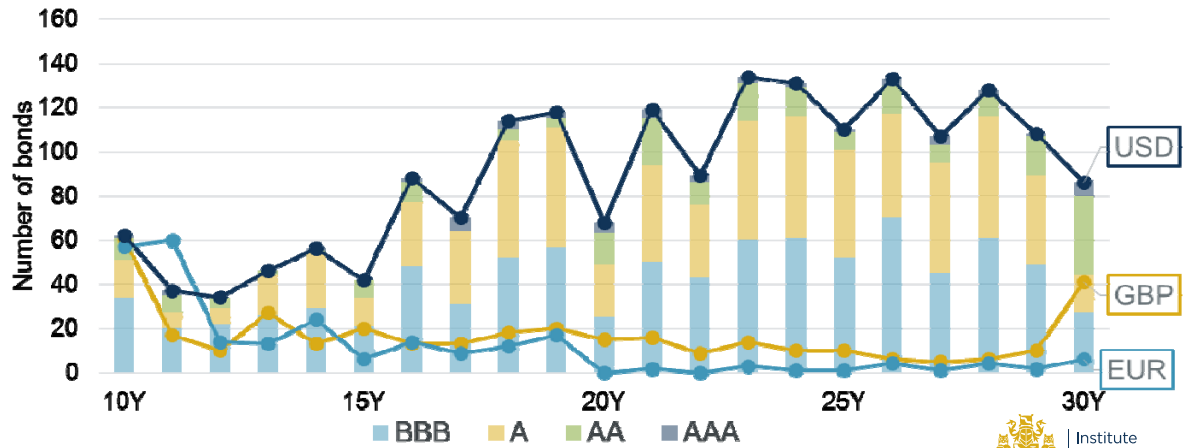


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16

Challenge #3

What maturities are available in the MA universe?



Source: GSAM, Bloomberg Barclays indices, as of October 2018. Note that the analysis is based on the MA-eligible universe.



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17

Challenge #4

Are the assets MA-eligible?

Make whole clauses

- Redemption before maturity at a price defined based on a reference government yield plus spread

Convenience calls

- Call option for issuer “convenience” shortly before legal maturity

Extraordinary redemptions

- Call option activated contingent on “extraordinary” trigger (e.g. change in tax regime; fundamental change to business model)

c.30% of \$ / c.15% of £ / c.10% of € corporates embed make-whole provisions

c.50% of \$ / c.20% of £ / c.40% of € corporates can be called within 6 months of final maturity

c.60% of \$ US municipal bonds have XO features

Source: GSAM and Barclays Bloomberg indices, as of October 2018.



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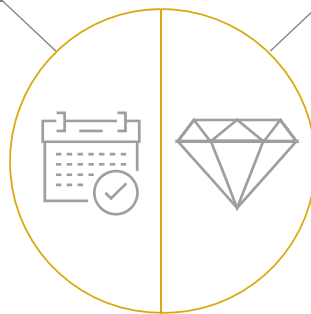
18

Challenge #5

How are cash flows hedged?

Hedging strategy

- Derivatives
- Macro vs. Micro
- Gross vs. Net



Collateral

- MA eligibility
- Liquidity planning

Source: Prudential Regulation Authority, Supervisory Statement | SS7/18, July 2018

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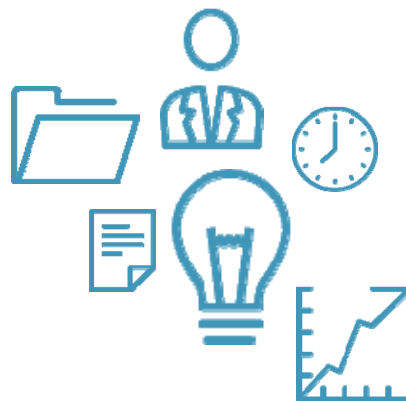


19

Challenge #6

Governance

- Reporting processes
- MA application
- External asset managers
- In-house expertise
- Legal
- Tax
- Capital methodology



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20

Key challenges to consider

Table is for illustrative purposes only

	£ corporates	\$ corporates	€ corporates	US municipal bonds	Emerging markets debt
Volume / market depth					
Diversification vs. £					
Variety of durations and credit qualities					
Potential for MA eligibility					
Hedging					
Governance					

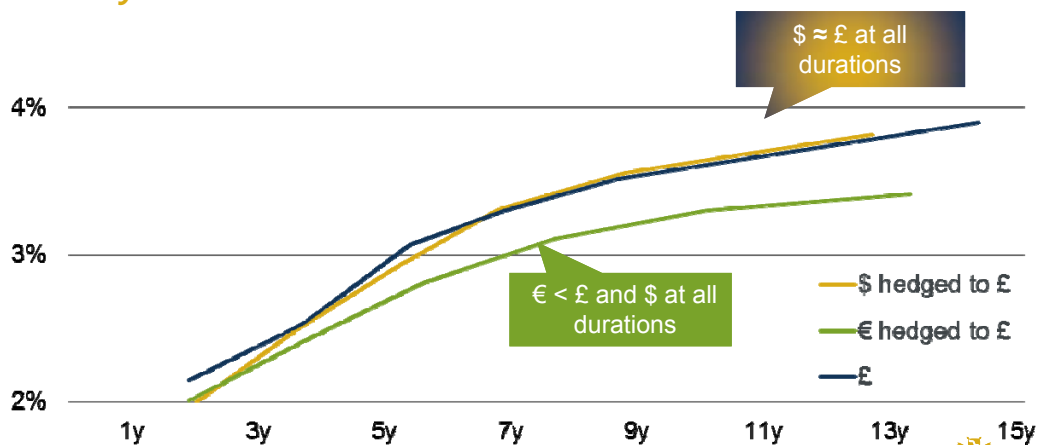
The scale used here is for illustrative purposes.



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21

Is it worth it? A index yields

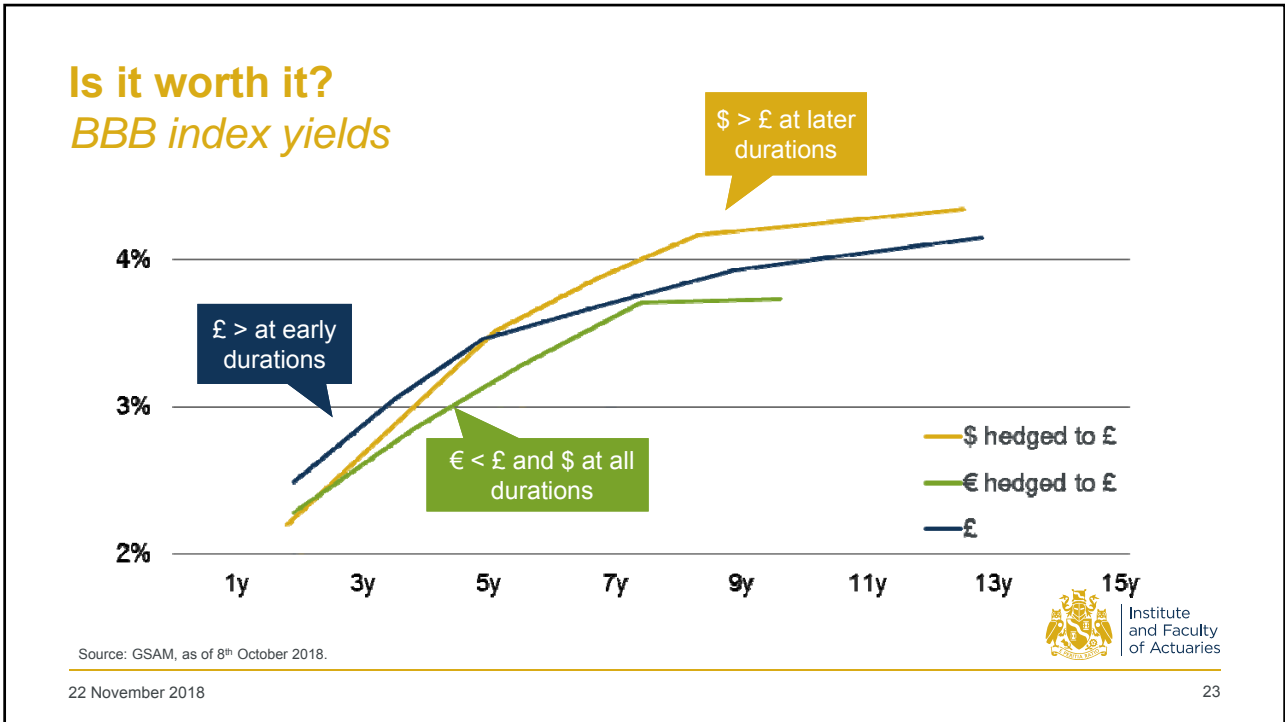


Source: GSAM, as of 8th October 2018.



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22



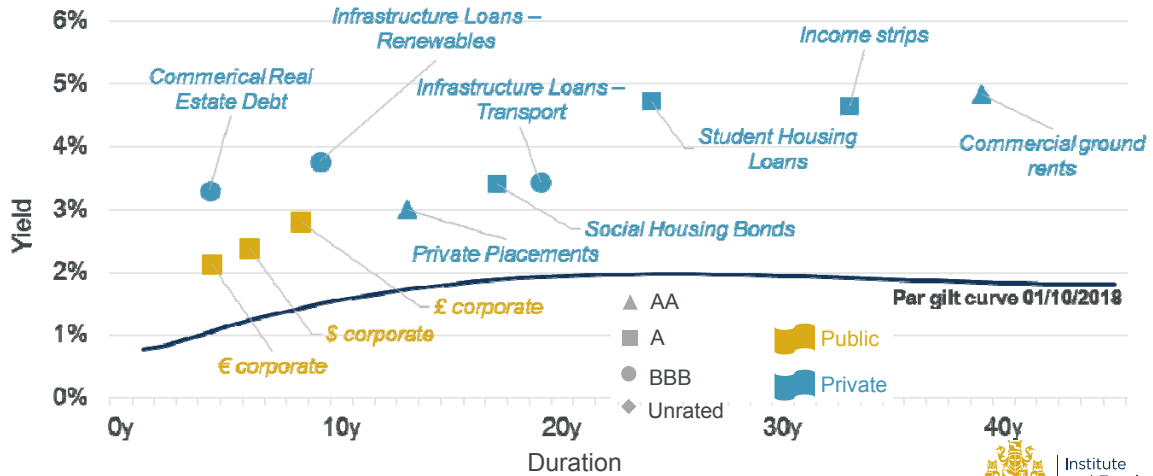
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Alternative 2: Private Credit

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Overview of (UK) private credit

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Source: Hymans Robertson research, October 2018.

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25

Trend to private credit



27 September 2018

Rothesay Life buys £860m of UK 'bad bank' mortgage loans

The portfolio was sold by UK Asset Resolution (Ukar), a holding company for the closed mortgage books of failed lenders Northern Rock, Bradford & Bingley and Mortgage Express.



14 June 2018

L&G strikes pensions and loan deal with Heathrow

Legal & General has signed a novel pensions deal with Heathrow airport, lending money to the company at the same time as taking on some of its pension promises.



04 July 2018

PIC secures £100m housing deal

Pension Insurance Corporation (PIC) has invested £100m (\$132m) into the Accord Housing Association in a "long dated senior secured" private placement deal.



16 October 2018

Aviva gets real on illiquid assets

At its annual results presentation in March, Aviva told its affiliate, Aviva Investors, to find more illiquid investments. The company said its general account was focused on a low liquidity risk profile, adding it wanted more illiquids in 2018.

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26

So what next?



Spread compression



Significant future growth
in annuity liabilities



Targeted growth in
illiquid %



Competition for assets

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27

What else is there?

- ➔ Private placements
- ➔ Swap repacks
- ➔ Fund financing
- ➔ Legacy portfolios on bank balance sheets
- ➔ SME lending



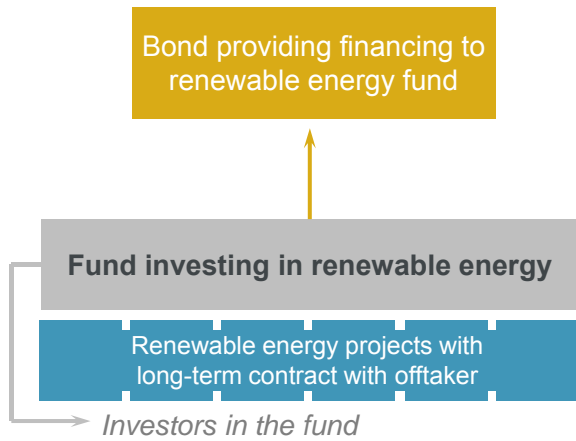
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28

Example #1

Financing of renewable energy contracts



Criteria	
Spread	175-250 bps
Term	20y Deterministically amortizing
Rating	Internal rating A - BBB
Structuring	Currency hedging

Source: GSAM, as of September 2018

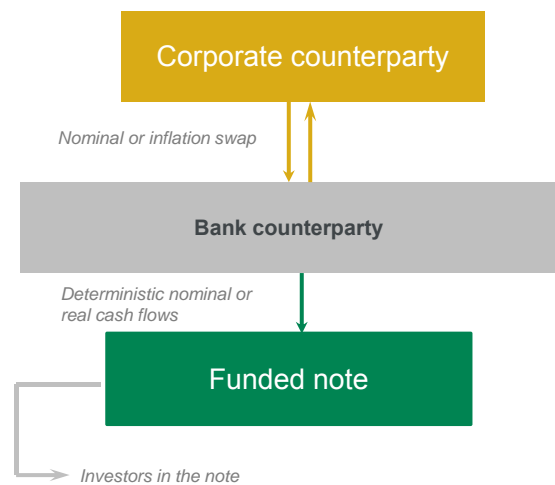


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29

Example #2

Swap Counterparty Transfer



Criteria	
Spread	100-250bps
Term	Deterministically amortizing
Credit quality	Rating improvement over senior unsecured debt
Structuring	Bespoke cash flow profile



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30

Is it worth it?



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31

Conclusions



Competitive BPA pricing opportunities are available



Illiquidity premia available can optimise back book balance sheets

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32

Questions

Comments

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33

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34