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Insurance Companies in Alternative Investments 2023

Macroeconomic Challenges and Their Impact on Asset Allocation

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Current macroeconomic conditions pose significant challenges for insurance companies in generating underwriting income. Considering these challenges, the role of investment income has become increasingly critical. In this analysis, we delve into the hurdles insurance companies face and how these factors influence their strategic asset allocation (SAA) and investments in alternative assets (AI).

*To shed light on this matter, we present **brand-new data from the BAI Investor Survey 2023** and place it in an international context. Globally, **inflation is currently the most frequently cited risk** by insurance companies, followed by **macroeconomic risk factors** and **geopolitical tensions**. Through the various services that insurance companies offer, they actively contribute to mitigating the negative impacts of various geopolitical, macroeconomic, and environmental risks on the economy and society.*

*The present global risks are also reflected in the challenges cited by German insurance companies. Insurance companies are **significantly more affected by the so-called denominator effect** than other institutional investors surveyed. Compared to their peers in the institutional investment sphere, insurance companies also demonstrate a more substantial and enduring commitment to alternative investments (AI). Therefore, they have more extensive expertise, which affords them more profound internal knowledge and a more robust understanding of private markets, **mitigating information deficits**.*

*However, in the context of a challenging underwriting income environment, issues related to the **illiquidity of alternative investments and prolonged capital lock-up periods** are perceived as significantly more challenging by insurance companies than by other institutional investors. Additionally, interest rate fluctuations and inflation have a pronounced impact on the strategic asset allocation strategies of insurance companies.*

*As a result of current macroeconomic challenges, as well as the increasing attractiveness of investment-grade liquid fixed-income investments, the **momentum of AI increases among German insurance companies has slowed down**. However, it's essential to emphasize that **the overall importance of AI within their portfolios continues to rise**. The enduring drivers for AI investments from the perspective of insurance companies remain intact, particularly for diversification and the preservation of real capital in the face of persistent inflation. This increasing significance is especially evident in the realms of Corporate Private Debt and Infrastructure investments. Notably, any adjustments made to asset allocations are primarily tactical in nature rather than signaling a fundamental shift in long-term strategic positioning.*

In sum, AI remains indispensable to insurance companies' portfolios as they navigate the complex currents of today's economic landscape.

1. Investment income as a central building block for insurance companies' business model

To gain insight into the impact of the current market conditions characterized by rising interest rates, elevated inflation, and persistent geopolitical tensions on insurance companies, we examine their revenue sources within their business model. Insurance companies primarily generate income from two sources: underwriting income and investment income. Underwriting income refers to the profit or loss an insurance company makes from its insurance activities, especially from transferring risk through insurance policies. Therefore, underwriting is the process of risk evaluation and deciding whether and on what terms an insurance policy is issued for those risks. Underwriting income results from the company's premiums from its policyholders minus payments and operating expenses.

Investment income, on the other hand, is derived from the investment of premium revenue generated by insurance companies.

The significance of the investment income component for insurance companies is underscored by historical data, which reveals that for over 25 years, spanning from 1979 to 2003, the property & casualty insurance industry consistently reported underwriting losses annually. Though in the 2000s and 2010s, significantly positive underwriting returns could be generated in the industry[1], forecasts assume another possible period of underwriting losses until at least 2025[2]. Consequently, investment income has served and will continue to be, a pivotal driver behind earnings in the insurance sector.

The ongoing shift in interest rates and the heightened levels of inflation have a direct impact on insurance companies' investment income and underwriting income. As interest rates rise, the borrowing costs for policyholders also increase. This could potentially reduce the demand for insurance policies, resulting in a decrease in premium income. Moreover, higher interest rates can impact overall economic activity, potentially leading to an uptick in claims due to financial stress, which could negatively affect underwriting income. Furthermore, elevated inflation also affects claims costs and policyholder behaviour. For instance, the increased prices of goods and services can raise the expenses incurred by insurance companies for replacements or repairs. Consequently, higher interest rates and inflation theoretically have the potential to contribute to a decline in underwriting income. Despite the global insurance industry proving robust in 2022 regarding nominal premiums, the collected premiums did not grow at the same pace as in the previous year. At 4.9%, they grew at about the average rate of the last ten years. However, premium growth has weakened significantly compared to the previous year's period (7.1% in 2021).

Additionally, considering the inflation rate outpaced nominal premium growth, real premium income has already experienced a decline. It's important to note, though, that there are notable disparities between different insurance subsectors, and the decrease in insurance penetration follows an underlying trend that is not solely attributed to rising interest rates.[3]

A more challenging environment for underwriting earnings thus means that - as in the past - investment income will become increasingly important for insurance companies to meet their obligations. We use our latest data from the BAI Investor Survey 2023 to shed light on the topic and set the results for the German market into a broader context by comparing it internationally.

1 https://www.slcmanagement.com/us/en/insights/all-insights/a-window-of-opportunity-in-fixed-income/.
2 https://www.iii.org/insuranceindustryblog/p-c-underwriting-losses-forecast-to-at-least-2025/.
3 Allianz Global Insurance Report 2023: Anchor in turbulent times, https://www.allianz.com/en/economic_research/publications/specials_fmo/global-insurance-report.html.

2. Structure and representation of the participating insurance companies in the BAI Investor Survey 2023

With 109 participating institutional investors with approximately 2,400 billion Euro assets under management, the BAI Investor Survey 2023 recorded another participation record. In the BAI Investor Survey 2023, insurance companies again make up the largest group of participating institutional investors.

38.0% of the investors surveyed stated they work for insurance companies subject to Solvency 2 or AnlV regulation.

With an estimated AuM of € 1,400bn, our sample is representative of the industry.

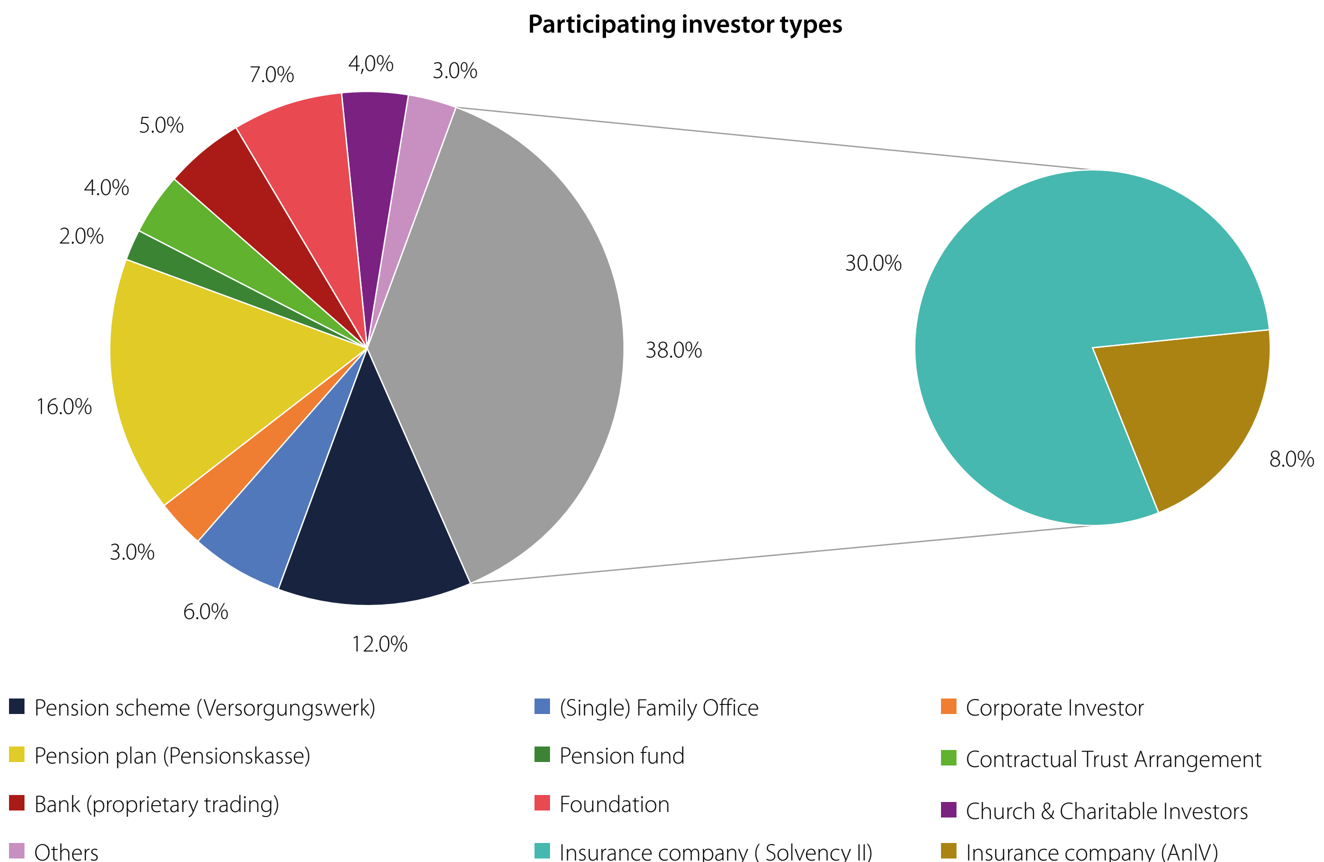

Figure 1: Investor types participating in the BAI Investor Survey 2023.

3. Risks and challenges for insurance companies in the current market environment

As previously highlighted in our prior study,[4] the interest rate dynamics and inflationary pressures influence the strategic asset allocations of insurance companies.

According to the Goldman Sachs Asset Management Insurance Survey 2023, a substantial majority of 55% of global insurance companies now rank inflation among their top three concerns. Notably, from a global insurance perspective, inflation precedes recessionary threats and other macroeconomic risk factors (*Figure 2*).

Closely related to inflation and recession risks are the immediate geopolitical risks. Of particular significance is the ongoing Russian aggression in Ukraine. The current geopolitical tensions and the difficult economic situation in China also play a role in this context.

From an economic perspective, insurance companies play a pivotal role amidst the complex macroeconomic landscape. Through the various services insurance companies offer, they actively contribute to mitigating adverse impacts on both the economy and society.[5]

Macroeconomic risks for global insurance companies

Risk	Share
Inflation	55%
Economic Slowdown/ Recession in the US	52%
Credit & Equity Market Volatility	46%
Political Events/ Geopolitical Tensions	45%
Monetary Tightening	38%
Economic Slowdown/ Recession in Europe	24%
Deteriorating Liquidity Condition	21%
Deflation	5%
Large Scale Cyber Event	5%
Economic Slowdown/Recession in China	5%
Resurgence of a COVID variant	4%

Figure 2: Macroeconomic global risks for insurance companies - top three issues, source: Goldman Sachs Asset Management Insurance Survey 2023: Executive Summary – Balancing with yield on the inflationary tightrope.

Insurance companies with more expertise and higher allocations to AI compared to other institutional investors

We asked for the most significant challenges German institutional investors face in AI (*Figure 4*). The survey reveals that the largest segment of institutional investors (comprising 44.9%) perceives the lack of transparency in private markets as a substantial hurdle. Conversely, this challenge is less pronounced among insurance companies, affecting only 27.9% of them. In this context, only 2.3% of the surveyed insurance companies see a lack of internal expertise as a challenge for AI. This can be attributed to the fact that, when compared to other institutional investors, insurance companies exhibit a disproportionate and enduring commitment to AI[6], have higher allocations, and have already built up more ex-

4 https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/German_Investor_Landscape_-_Insurance_Companies.pdf.
5 https://www.gdv.de/resource/blob/132874/dfee49064478c928cffbf908be92cdb7/download-publikation-insurance-perspectives-inflation-data.pdf
6 Also compare our previous publications on insurance companies: https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/German_Alternative_Investor_Landscape_NEU_17_03_14_54.pdf, https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/German_Investor_Landscape_-_Insurance_Companies.pdf.

pertise. Remarkably, beyond Hedge Funds and Real Estate Equity, a considerably higher proportion of insurance companies have ventured into all alternative asset classes when compared to their institutional counterparts (*Figure 3*).

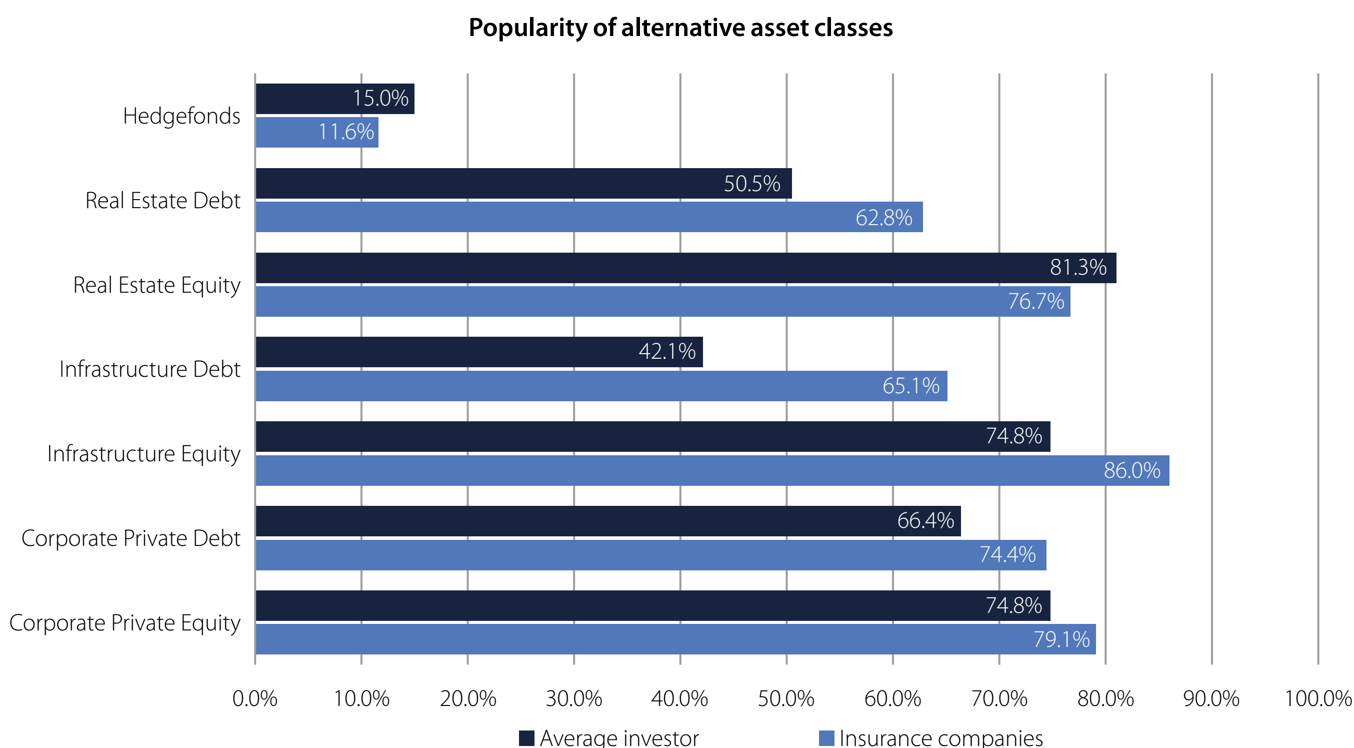

Figure 3: Participation rates in AI-asset classes, source: BAI Investor Survey 2023.

The denominator effect

The downside of these more pronounced AI allocations by insurance companies is that they are more affected by the denominator effect. As outlined in our previous publications[7], insurance companies must adhere to stringent investment quotas and capital requirements. When AI allocations are already substantial, these regulations can hinder additional allocations to AI purely from the perspective of returns and diversification. Due to the recent decline in the market value of traditional investments like stocks and bonds, illiquid assets have taken on greater significance in insurance company portfolios without active adjustments. However, it's worth noting that the denominator effect is expected to be a temporary phenomenon. Investors believe it may only briefly disrupt long-term plans to build up AI allocations in the short term. Specifically, this effect isn't perceived as a persistent threat to the appeal of illiquid assets, as underlying factors like enhanced diversification remain intact.

Nevertheless, a significant 37.2% of insurance companies have ranked the denominator effect as one of the foremost current challenges, surpassing the average among institutional investors (26.2%). Furthermore, the strong upswing in public equities during the first half of the year has already mitigated the impact of the denominator effect.

Liquidity

An issue closely linked to the denominator effect is the challenge of liquidity (long capital commitment period), which is presently the foremost concern for most insurance companies (51.2%). This concern is notably more prevalent among insurance companies than in the average among surveyed investors (36.4%). The more an investor is affected by the denominator effect, the more the illiquidity of alternative investments is a barrier to additional investment. In this context, the challenging environment for underwriting income described above also plays a central

7 Interest rate turnaround and inflation - Alternative Investments remain robust - despite competition from rising bond yields (December 2022). https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Alternative_Investments_remain_robust_-_despite_competition_from_rising_bond_yields.pdf.

role. It means that there are currently fewer inflows, and therefore less liquidity tends to be available.

The current macroeconomic environment, marked by recession and geopolitical uncertainties, has the potential to heighten market volatility. As explained above, insurance companies also play the role of a hedge for the national economy by enabling companies and individuals to mitigate risks. Within this context, it's worth noting the potential for an increase in extreme weather events due to climate change. Accordingly, it is currently particularly relevant for insurance companies to keep sufficient liquidity on hand for unforeseen events. Illiquid assets place special demands on the risk management of insurance companies, as BAFIN states[8].

On the other hand, asset managers currently contend that the market for liquid bonds lacks true liquidity, given the significant decline in new bond issuances. Furthermore, liquid bonds can only be sold at substantial losses now, diminishing the advantages typically associated with liquidity.[9]

High inflation and the interest rate turnaround

Inflation, as a key issue for insurance companies' global investment, aligns with the results from our BAI Investor Survey 2023 (*Figure 4*). With 34.9%, significantly more insurance companies than other institutional investors named the high inflation and rising interest rates as a key challenge. Insurance companies, particularly life insurers, are often perceived as beneficiaries of the interest rate shift.[10] This perception is also rooted in the attractiveness of fixed-income products, which become more appealing and facilitate attaining nominal return objectives. However, persistently high inflation can be challenging for insurance companies, primarily because they tend to bear very long-term liabilities. If these liabilities are in real terms and thus inflation-protected, insurance companies depend on assets that can outpace inflation. This situation can become notably challenging when confronted with unanticipated inflation-level fluctuations, mainly since insurance companies operate with models that incorporate inflation expectations.

To meet payout obligations, insurance companies face the challenge of correctly anticipating inflation and interest rates, reacting to permanently increased levels, and, if necessary, adjusting the endowment.

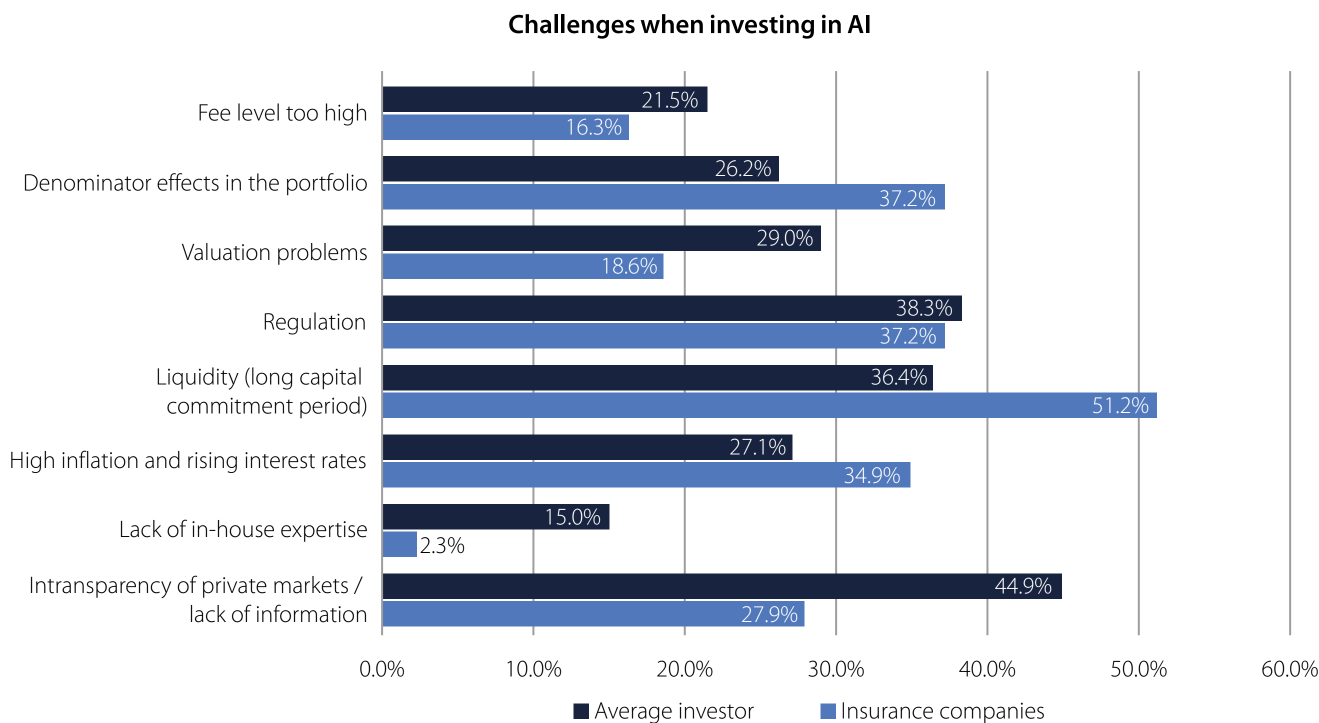

Figure 4: Biggest challenges for insurance companies and the average investor when investing in alternative investments, source: BAI Investor Survey 2023.

8 https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2023/fa_bj_2301_illiquide_Anlagen.html.
9 Chancen und Herausforderungen von Corporate Private Debt im aktuellen Marktumfeld, https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Private_Debt_Studie_geschuetzt.pdf.
10 https://www.boerse-online.de/nachrichten/aktien/zinswende-warum-lebensversicherungen-die-gewinner-sind-20311163.html.

4. Effects of the market environment on the asset allocation of insurance companies

In the following, we look at how current macroeconomic conditions and changes are impacting the strategic asset allocation of insurance companies. Global insurance data (*Figure 5*) shows that rising yields due to rising interest rates creating new investment opportunities are seen as the most important factor for asset allocation (68%). Following closely behind are considerations related to alterations or anticipated modifications in regulatory capital, accounting standards, or rating agency mandates, which resonate with 43% of respondents. These considerations may also relate to the shifts in asset-liability management prerequisites and the denominator effect, encompassing factors like liquidity management, which registers at 32% agreement among respondents.

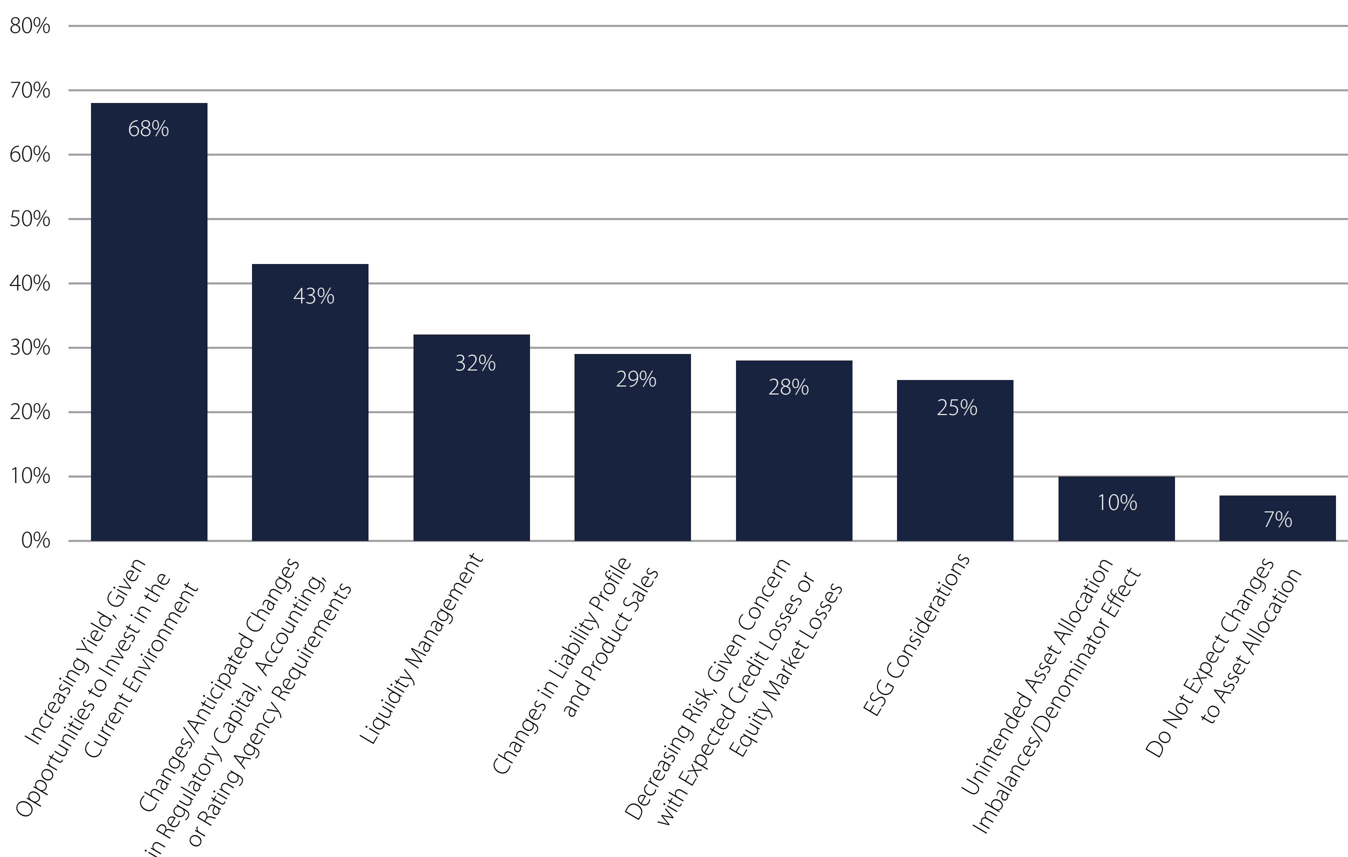

Figure 5: Which of the following factors do insurance companies expect to have an impact on their asset allocation decisions in the next few years (Global, %), source: Goldman Sachs Asset Management Insurance Survey 2023: Executive Summary – Balancing with yield on the inflationary tightrope.

As described in the publication "German Alternative Investor Landscape Insurance Companies - Focus on Interest Rate Turnaround, Inflation, and ESG", illiquid AI have served as a substitute for fixed-income investments during the low-interest rate phase since 2008. Rising bond yields for investment-grade bonds mean correspondingly rising opportunities for insurance companies.

Consequently, illiquid investments have, to some extent, diminished their role as a replacement for bonds from the standpoint of insurance companies. Thus, the primary rationale for insurance companies to engage in AI (*Figure 6*) is currently diversification (90.7%).

This is followed by a good risk-return ratio (74.4%) and illiquidity premiums (53.5%), characteristics of alternative investments that are responsible for outperforming liquid benchmarks. As interest rates are currently widely assumed to remain below inflation

levels from the perspective of asset managers, investors, and economists, these factors are crucial for insurance companies when targeting real returns for certain products.[11]

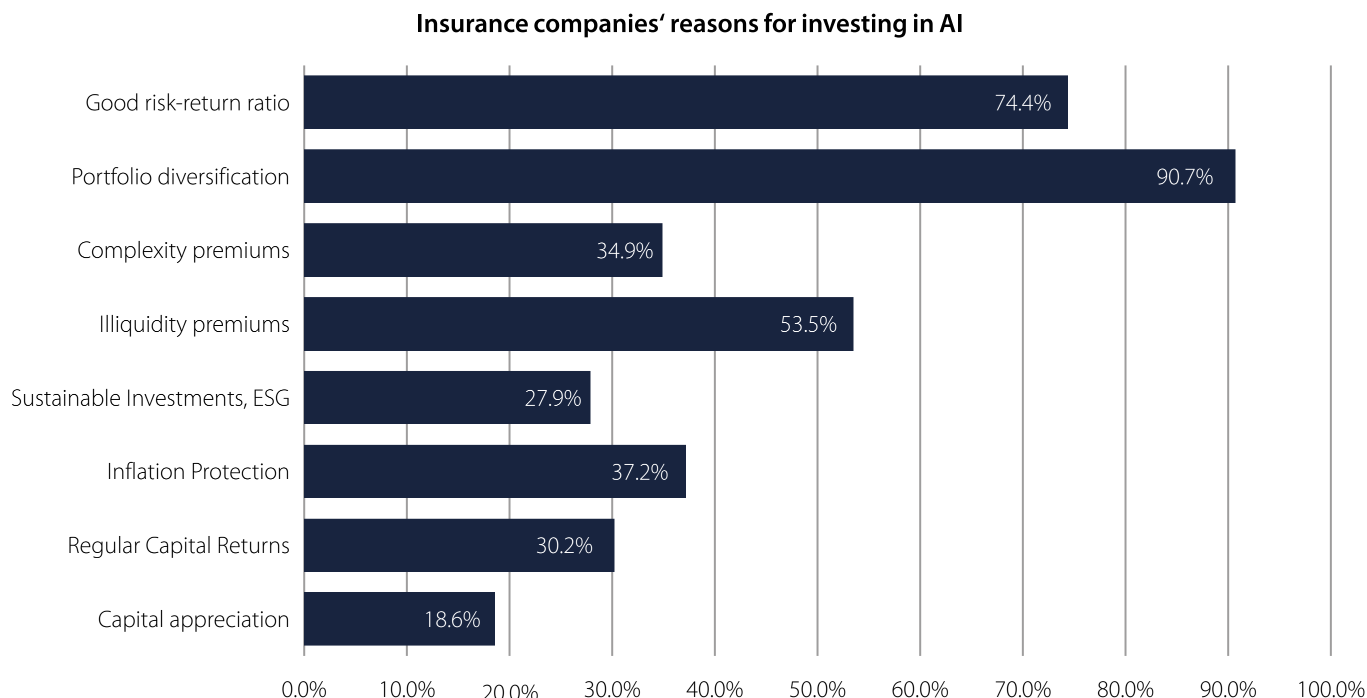

Figure 6: Main reasons for investing in alternative investments for insurance companies, source: BAI Investor Survey 2023.

Insurance companies place a greater emphasis on nominal returns rather than real returns when compared to other investor categories. In conjunction with their already substantial AI, this divergence could be one of the reasons why a higher proportion of insurance companies, precisely 13.5% as opposed to 8.8% among other investors, anticipate a reduction in their alternative investments' allocation (*Figure 7*, *Figure 8*). 40.5% (compared to 46.1% for the average investor) plan to further increase their AI allocation. As the latest figures show, the increasing attractiveness of liquid bonds does not mean that AI is becoming less critical for insurance companies. Various intact drivers, as well as the expertise already built up in the field of AI, mean that significantly more insurance companies want to expand their AI allocation than reduce it.

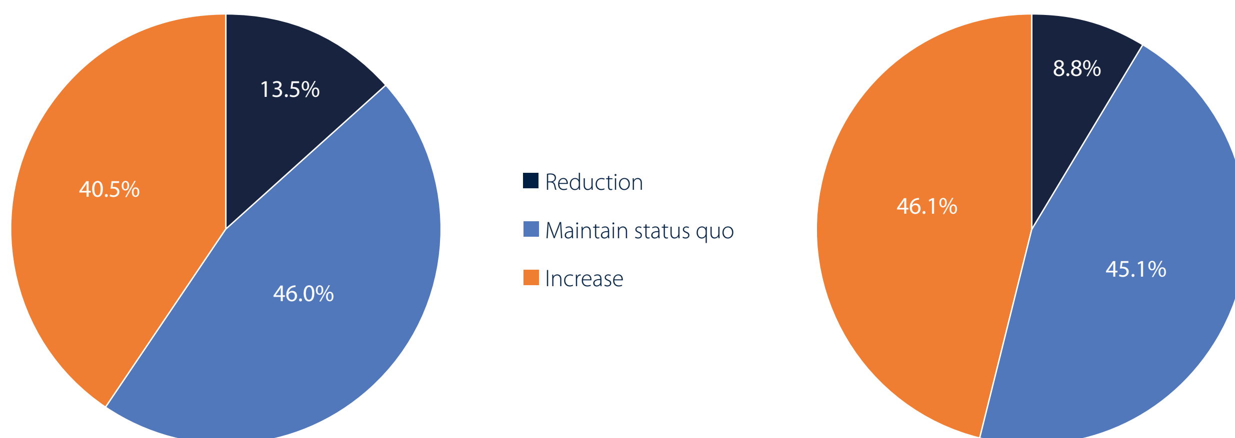

Figure 7: Planned adjustments to the allocations - shifts between AI and traditional assets- of insurance companies(left), and the average institutional investor, source: BAI Investor Survey 2023.

11 *For a discussion of real and nominal return targets and differences by product category from the perspective of insurance companies, cf. the publication Interest rate turnaround and inflation Alternative Investments remain robust - despite competition from rising bond yields (December 2022), https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Interest_rate_turnaround_and_inflation_2022_Teil_2.pdf.*

International data from the Goldman Sachs Asset Management Insurance Survey 2023 reveals that insurance companies in the EMEA region (Europe, Middle East, and Africa) share similar intentions with their German counterparts regarding adjusting their allocation between private assets and traditional investments. Over the next 12 months, 43% of surveyed insurance companies in this region aim to increase their allocation, while 47% plan to maintain their current allocation, and 10% intend to decrease their share of private assets.

Compared to the global average, the Americas region, and Asia, the EMEA region shows a significantly higher proportion of insurance companies intending to reduce their allocation to private assets. Especially in Asia, private assets are perceived as much more attractive from the insurance companies' perspective, and 61% intend to increase the allocation, while no insurers in their sample intend to reduce it. In North and South America, the ratio of planned increases to reductions is also significantly more positive. Reasons why the outlook for AI in Germany and the EMEA is less positive compared to other regions must be discussed.

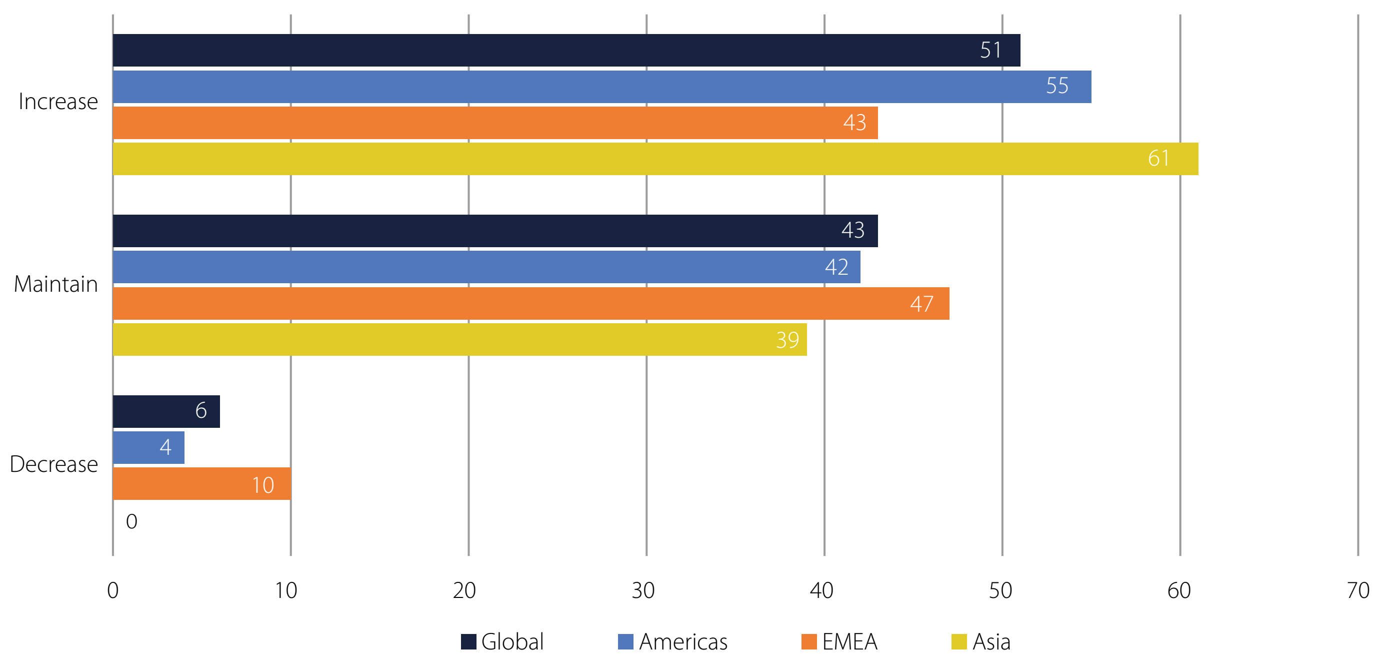

Figure 8: Over the next 12 months, are insurance companies planning to increase, maintain, or decrease their allocation to private assets, source: Goldman Sachs Asset Management Insurance Survey 2023: Executive Summary – Balancing with yield on the inflationary tightrope.

Although a higher proportion of insurance companies plan to reduce their AI allocation compared to other institutional investors, especially in Germany and the EMEA region, recent data suggests that the impact of rising bond yields on the attractiveness of AI investments for insurance companies is less pronounced than initially feared by many.

Furthermore, most insurance companies want to maintain or expand AI allocation overall. Especially, Corporate Private Debt, Infrastructure Equity, and Infrastructure Debt show the most apparent positive trend (*Figure 9*). Across all AI-asset classes, a significant majority still plans to either increase their allocation or maintain the current status quo.

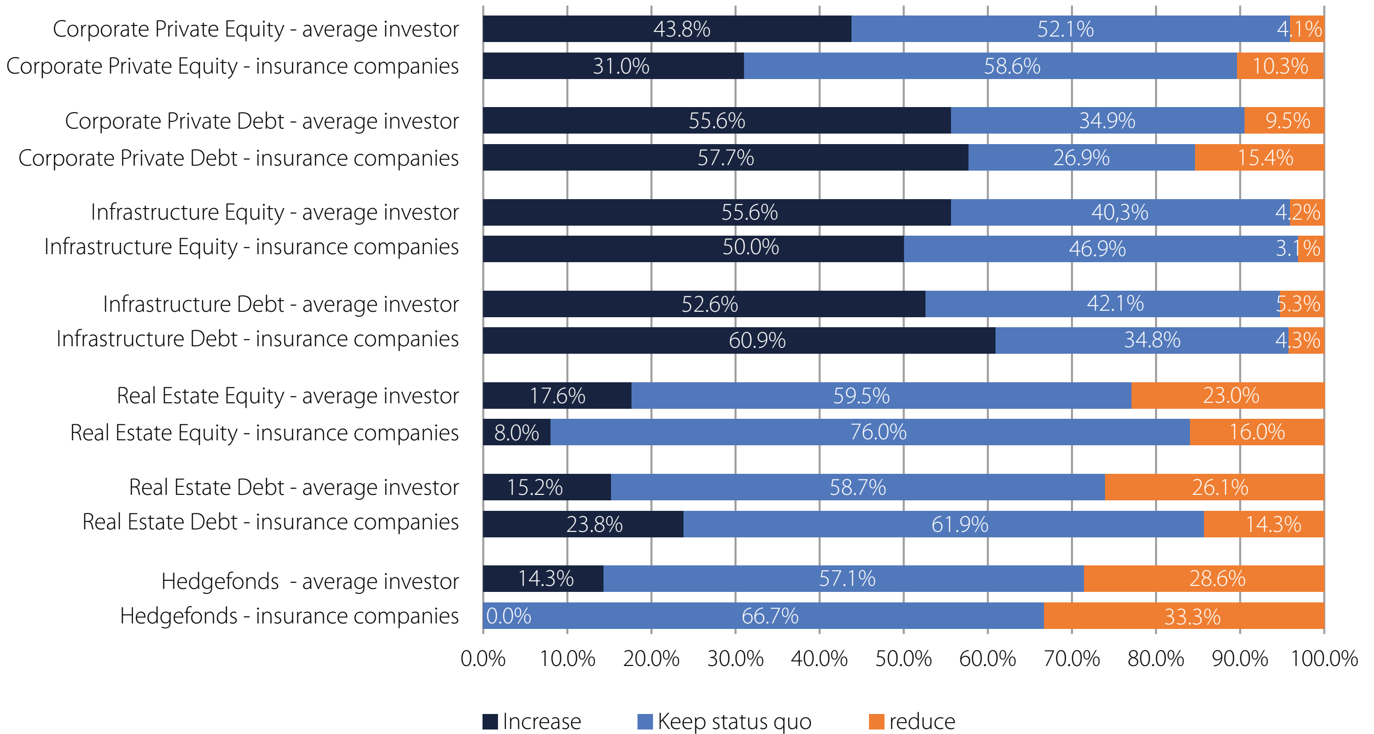

Figure 9: Planned adjustments to the allocations of insurance companies and the average investor in 2022 and 2023, source: BAI Investor Survey 2022 and BAI Investor Survey 2023.

As outlined, insurance companies have accumulated substantial expertise in the realm of alternative assets in recent years. Furthermore, the enduring drivers for AI, such as diversification and the pursuit of alternative risk premia, continue to remain important. These factors enable insurance companies to maintain their long-term trajectory of augmenting AI allocations, even if short-term interruptions occur due to market conditions or the denominator effect. The commitment of insurance companies to their long-term strategies is further evidenced by the fact that 25.7% of them are engaged in refining their tactical asset allocation, surpassing the proportion of those planning to adjust their strategic asset allocation (17.1%) (*Figure 10, Figure 11*).

Insurance companies' strategical and tactical asset allocation adjustments

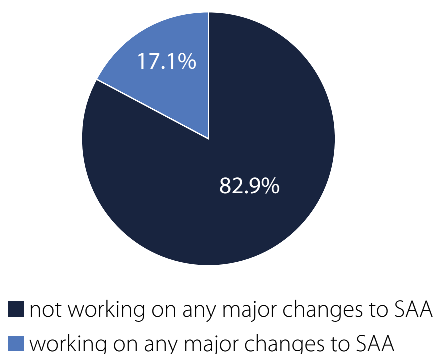

Figure 10: Insurance companies working on SAA adjustments, source: BAI Investor Survey 2023.

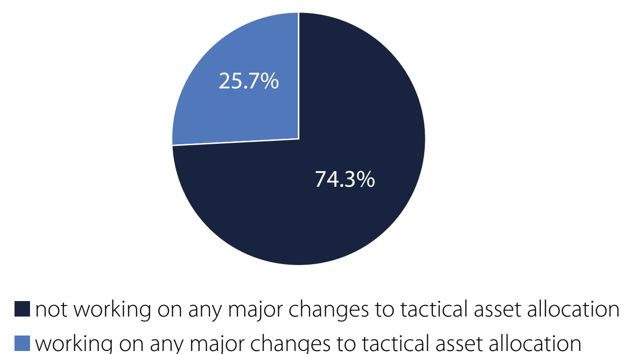

Figure 11: Insurance companies working on tactical asset allocation adjustments, source: BAI Investor Survey 2023.

The development of the attractiveness of individual alternative asset classes among insurance companies largely corresponds to that of other investor types. Investors and asset managers currently assume that the market conditions for Corporate Private Debt are very good, especially due to the increased interest rate level and the historically large yield pick-up from to investment grade bonds.[12] Infrastructure is currently seen as particularly attractive due to the large investments required in the energy sector and the stable cash flow generated.

Despite the overall still very positive environment for AI from the perspective of insurance companies, it's noticeable that the momentum concerning additional AI allocations has substantially diminished from 2022 to 2023 (*Figure 9*). Across all alternative asset classes, except for Infrastructure Equity and Infrastructure Debt, more insurance companies want to decrease their allocation than in the previous year. This trend is likely attributed to the factors outlined earlier, namely the denominator effect, existing high allocations that leave limited room for expansion, the complex market environment, liquidity concerns, and rising bond yields.

However, insurance companies that want to reduce their share of AI are still very much in the minority. Although their share has increased due to the current macroeconomic conditions, it is still small. The current difficult market conditions and the wait-and-see attitude of many investors are also reflected in the fact that insurance companies that have not yet allocated, tend to shy away from entering AI investment. Except for Infrastructure Debt, the percentage of insurance companies planning to enter newly into an AI asset class has decreased for all asset classes compared to the previous year (*Figure 12*). This is also since, as explained above, a very high proportion of insurance companies already have AI allocations. Therefore, there are fewer insurance companies left that still want to enter the market.

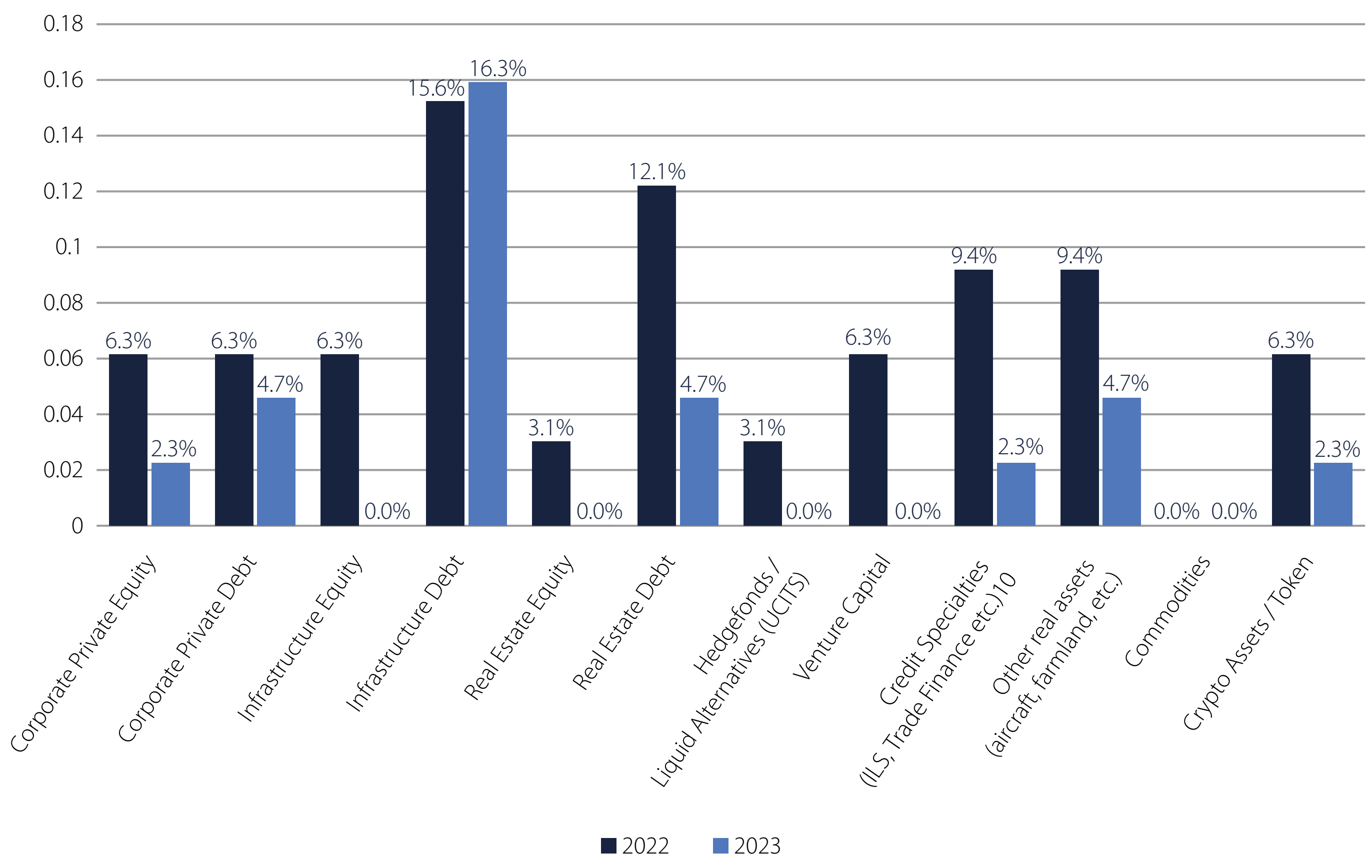

Figure 12: Insurance companies planning to enter new alternative asset classes for the first time in the next few years, source: BAI Investor Survey 2023.

12 *„Chancen und Herausforderungen von Corporate Private Debt im aktuellen Marktumfeld", https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Private_Debt_Studie_geschuetzt.pdf."*

5. Conclusion

Our data from the BAI Investor Survey 2023 demonstrates that, despite a challenging macroeconomic environment, the significance of AI in the portfolios of insurance companies is on a consistent upward trajectory. The long-term factors driving the appeal of AI remain robust. For the purposes of diversification and safeguarding real capital against the backdrop of sustained inflation, AI retains its vital role within the perspective of insurance companies. It's important to note that adjustments in allocation are primarily tactical in nature, rather than representing a shift in long-term strategic positioning.

Author:

Florian Bucher,
Consultant Alternative Markets, BAI e.V.
bucher@bvai.de

Imprint:

Responsible:
Bundesverband Alternative Investments e.V. (BAI)
Poppelsdorfer Allee 106 D-53115 Bonn
Telefon: +49(0)228-96987-0
Fax: +49(0)228-96987-90