REPRESENTING ALTERNATIVE INVESTMENTS

German Alternative Investor Landscape **Insurance companies**

Focus on Interest rate turnaround, inflation and ESG

März 2023

Executive Summary:

Insurance companies, like all institutional investors, are facing the challenges of a complex macroeconomic environment with high inflation and rising interest rates. However, despite the challenging market phase, our data show that **Alternative Investments (AI) remain attractive for insurance companies and continue to grow in importance in Strategic Asset Allocation (SAA).**

While illiquid AI asset classes served as a substitute for fixed income in the past phase of low interest rates, they are now again facing increasing competition from rising bond yields. Moreover, our data indicate that relatively more insurance companies than other investors expect the interest rate turnaround and inflation to increase the importance of traditional assets, especially for building up additional allocations. This fact could be explained by their greater focus on **nominal return targets** and the **denominator effect** and could also impact insurance companies‘ risk situation and risk management.

However, the overall importance of AI in insurance companies’ portfolios continues to show a clear positive trend. **Across all illiquid asset classes, more insurance companies plan to increase the allocation than to reduce it.** Therefore, other drivers for AI investments are coming increasingly into focus for insurance companies. Due to their long investment horizon, illiquid assets fit very well with insurance companies’ long-term business models and offer attractive alternative risk premia and opportunities for diversification.

In addition to interest rates and inflation, ESG is a crucial topic for the entire industry. Our data suggest that integrating ESG strategies is increasingly important for insurance companies. Furthermore, **insurance companies are ahead of their peers of institutional investors and allocate significantly more resources to ESG implementation.** This seems to be caused by a more pronounced awareness of environmental issues and a focus on overall socio-economic risks since ecological catastrophes significantly impact insurance companies’ business.

However, despite the greater resource availability at insurance companies, due to factors such as a lack of clarity regarding regulatory requirements and uncertainties regarding data availability and quality, **significantly more insurance companies also rely on outside expertise for ESG integration.**

1. Structure and representation of the participating insurance companies in the BAI Investor Survey 2022

The 9th BAI Investor Survey 2022 had a record number of participants, with 106 participating German institutional investors (LPs) with more than € 2.1 trillion assets under management (AuM) in total. Insurance companies are once again the largest group of participating LPs, making up 45% of the participants. Furthermore, 33.9% of the total surveyed LPs are bigger insurance companies regulated under Solvency 2, and 11% are comparatively smaller insurance companies under AnIV regulation (Figure 1).

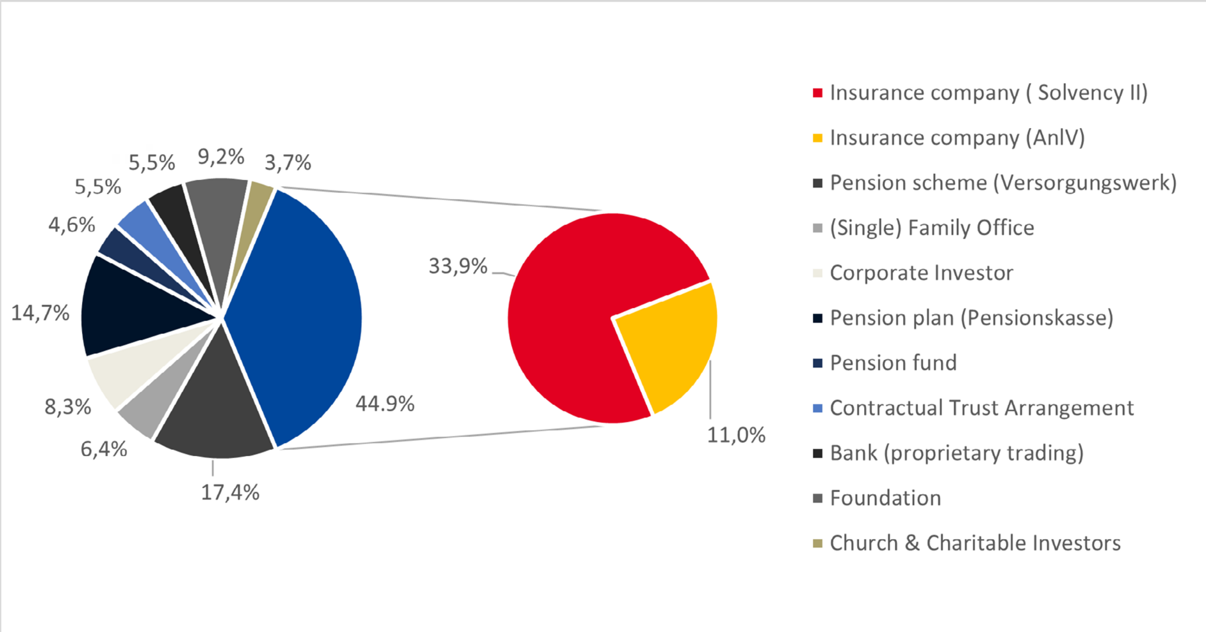

Figure 1: Investor types participating in the BAI Investor Survey 2022.

Their average size is around € 34 bn AuM. Therefore, on average, insurance companies are significantly bigger than other investor types, with an estimated average of approximately € 20 bn. With an estimated AuM of € 1400bn, our sample is representative for the industry.

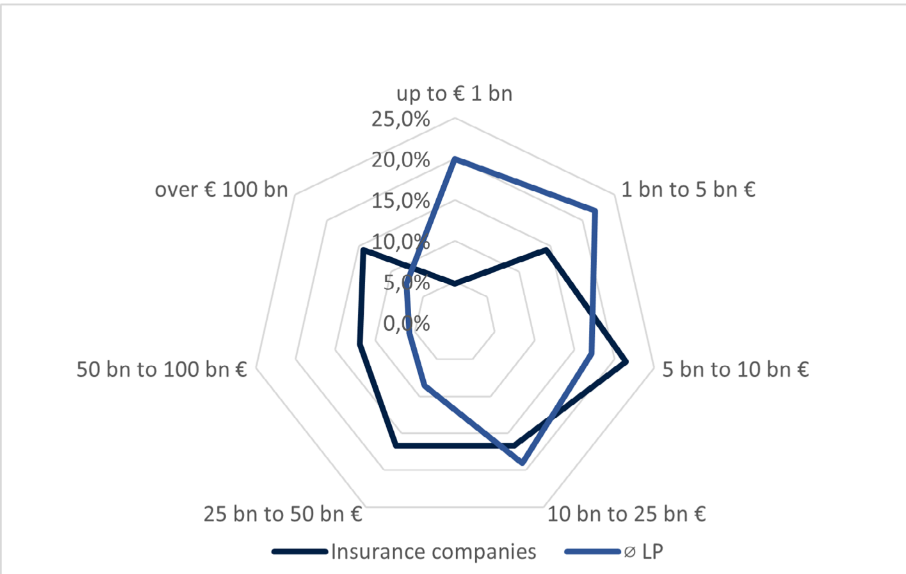

Figure 2: Distribution of insurance companies and other LPs according to their assets under management. Source: BAI Investor Survey 2022.

The highest share of insurance companies is invested in Real Estate Equity (83.3%), followed by Infrastructure Equity (81%) and Corporate Private Equity (70.6%). We can see that participation rates* are significantly higher in Real Estate (Equity and Debt), and Infrastructure Equity compared to the average of all LPs, which might be the case due to their stable long-term investment profiles with comparatively low risk- and return structures. Insurance companies still have to catch up in Hedge Funds and Liquid Alternatives.

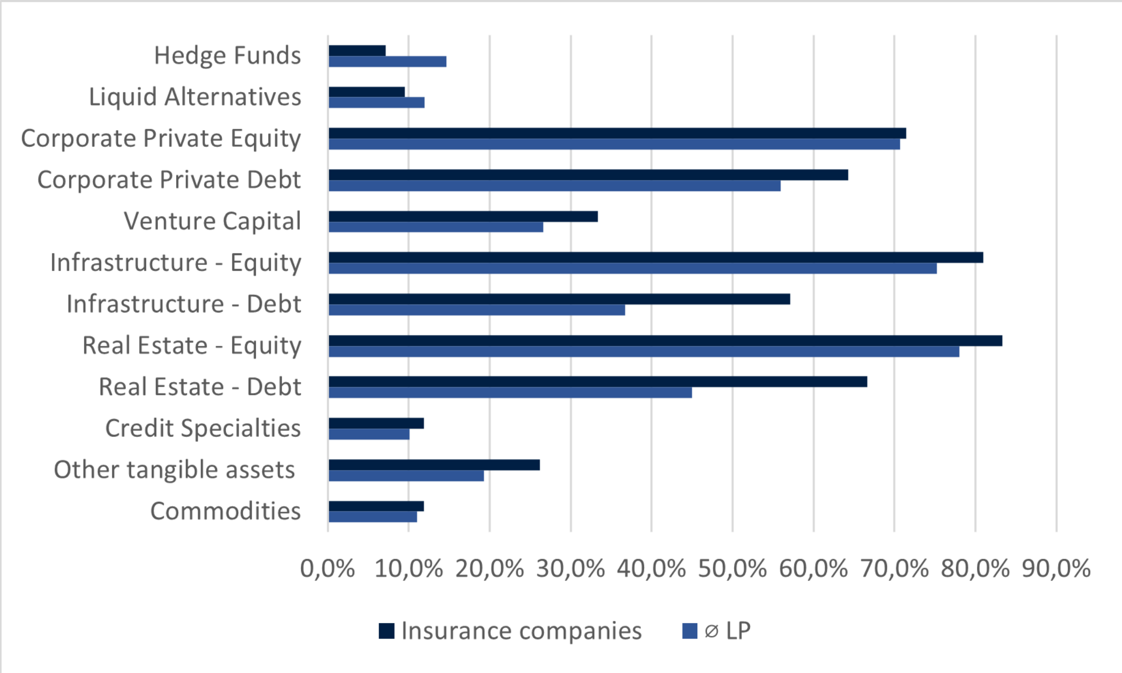

Figure 3: Participation rates. Source: BAI Investor Survey 2022.

2. The impact of the interest rate turnaround and inflation and portfolio allocation adjustments at insurance companies

In the BAI Investor Survey 2021, the low interest rate environment was still named a primary reason to invest in AI for 46.9% of the insurance companies surveyed, and 34.4% answered that AI's feature as an attractive substitute for bonds would be a crucial driver. However, the macroeconomic environment has shifted dramatically by now. While portfolio diversification (95.2%), a good risk-return ratio (83.3%), and illiquidity premiums (71.4%) are in line with the most important drivers for insurance companies' AI investment from the previous year, only 31,0% of the investors in insurance companies named the interest rate environment as a reason to invest in AI in the BAI Investor Survey 2022.

* Share of all investors invested in the respective asset classes

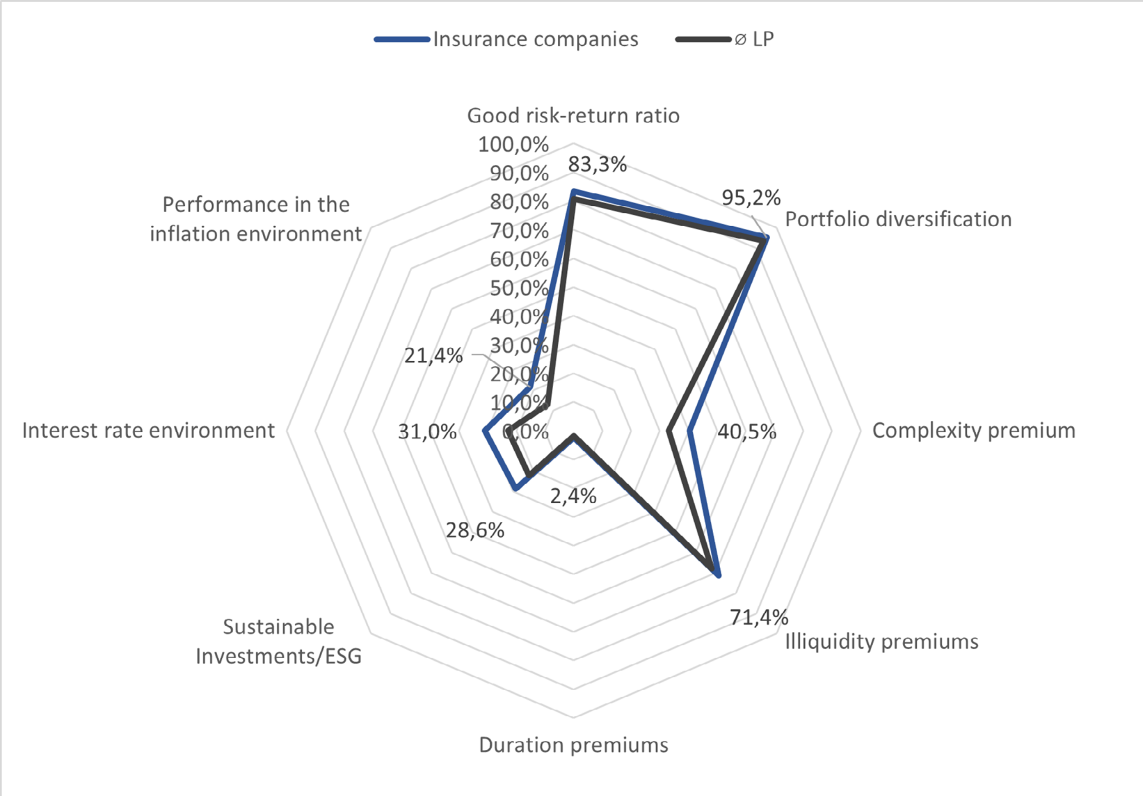

Figure 4: Main reasons for insurance companies to invest in AI. Source: BAI Investor Survey 2022.

Rising bond yields and the denominator effect as potential frictions to continue allocating further to AI

As we already discussed in our recent publication* AI is defying the current market turmoil, and various drivers guarantee their persistent significance in institutional investors' SAA. However, we also outlined that AI's role as a substitute for bonds has lost significance to a certain extent due to rising bond yields.

Our data suggest that the expected impact of interest rate turnaround and inflation on strategic asset allocation (SAA) varies significantly across different investor types. For instance, more than 30% of foundations, churches & charitable investors expect increasing importance for AI in their SAA, and 37% of the surveyed pension schemes expect AI to increase in significance, with 12% expecting decreases compared to traditional assets. However, 32% of the insurance companies (Solvency and AnIV) see a potential increase in the importance of traditional assets, 66.7% see no impact, and under 3% expect an increase in AI in SAA due to interest rate turnaround and inflation. The varying return targets, actuarial interest rates, and current allocations of different investors determine the extent to which rising interest rates and traditional fixed income compete with AI. Since the focus for insurance companies lies more on nominal return targets, traditional assets could play an increasing role in building up additional allocations.

Moreover, the „denominator effect" affects SAA. Since insurance companies are subject to strict investment quotas or capital requirements, they are fractioned to continue allocating further to AI from a pure return and diversification perspective. Due to the decline in the market value of traditional investments such as equities and bonds this year, illiquid assets have automatically gained importance in insurance companies' asset allocations without active adjustments.

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* 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.

Though long-term reasons for AI continue to exist. Insurance companies, therefore, indicated that the long-term build-up plan towards more diversification might have to be interrupted in the short term due to the denominator effect. This fact may lead to significant deviations in the actual asset allocation of insurance companies from their initially planned strategic asset allocation. As a result, as BaFin states, the diversification of insurance companies' portfolios could be impacted, requiring adjustments to risk management due to the changed risk situation.*

AI continues to grow in importance for insurance companies

The expectation of 32% of insurance companies that traditional assets could become relatively more important again due to the interest rate turnaround and inflation seems to be more relevant for building up additional allocations. However, it contrasts with their concrete plans regarding adjustments to existing AI allocations. Insurance companies' AI quota continues to rise slightly. From an estimated average of 17.9% in the previous year, it rose to 18.6% and is expected to rise another percentage point in the SAA.

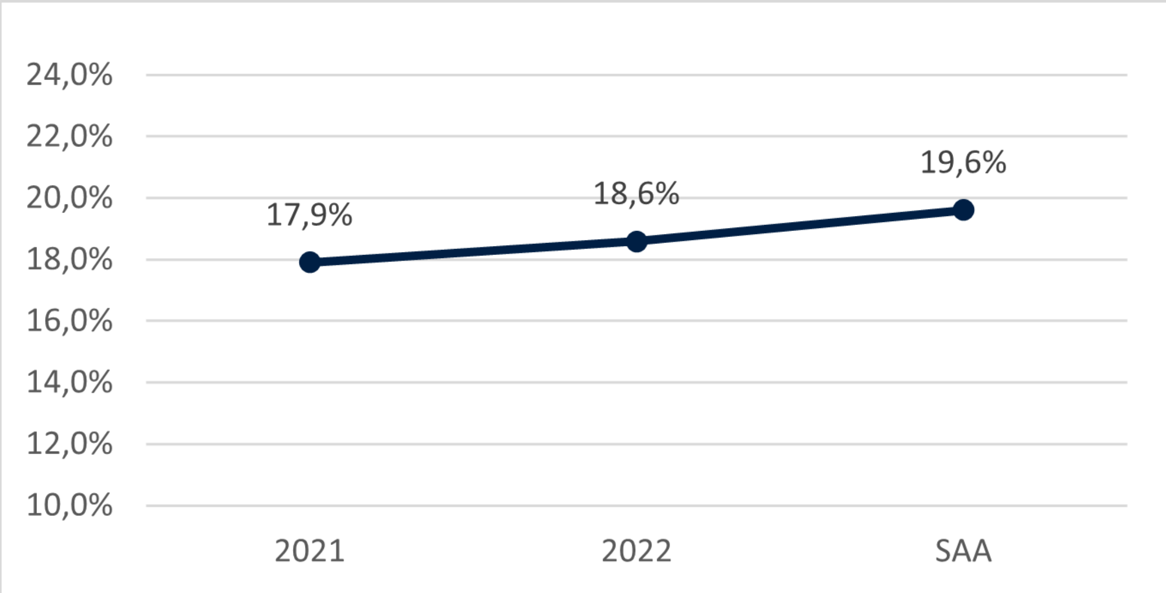

Figure 5: Estimated AI quotas for insurance companies. Source: BAI Investor Survey 2021 and 2022.

How insurance companies in Germany plan to adjust their existing allocations

Looking at the planned adjustments of insurance companies in the allocations of individual alternative asset classes, it becomes apparent that across all illiquid asset classes, more insurance companies expect an expansion of the allocation than a reduction. The overall pattern is very similar to the average of all institutional investors surveyed. About 2/3 of the insurance companies surveyed said they plan to increase their allocation to Infrastructure Equity, which is slightly above the average for all investors.

Overall, our data from the BAI Investor Survey shows that Infrastructure, especially Infrastructure Equity, can be seen as a winner from the interest rate turnaround and inflation, which is the case also for insurance companies. Factors relevant in this context are the low demand elasticity of regulated tariffs; for instance, ferry services or private rail providers can raise prices with inflation. Also, high barriers to market entry result in infrastructure providers' high pricing power, and higher costs can be passed on.

* Cf. https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Fachartikel/2023/fa_bj_2212_illiquide_Anlagen.html.

Also, a positive trend is evident in Infrastructure Debt, where a majority is planning an increase in allocation. However, also 6% plan to decrease the allocation, which could be due to rising bond yields, determining a new benchmark for those asset classes with profiles of comparatively low risk and return. This potential competition from rising (investment-grade) bond yields is even more the case for Real Estate Equity and Real Estate Debt, with 11% and 9% of insurance companies planning to reduce their allocation*. In addition, real estate investments suffer from rising interest rates while they benefit from inflation to a certain extent**.

Furthermore, Corporate Private Debt enjoys disproportionate popularity among insurance companies. More insurance companies plan to increase their allocation to Corporate Private Debt (61%) than the average of the LPs surveyed, with 48%. This can be explained by the fact that due to the inverse yield curve, investors not only have to accept significantly higher interest rate risks with longer durations but also pay for them. Despite the increased focus of insurance companies on nominal values, this is a clear obstacle to investing heavily in bonds. Bonds are, therefore, not directly competing with Corporate Private Debt but have a complementary function.

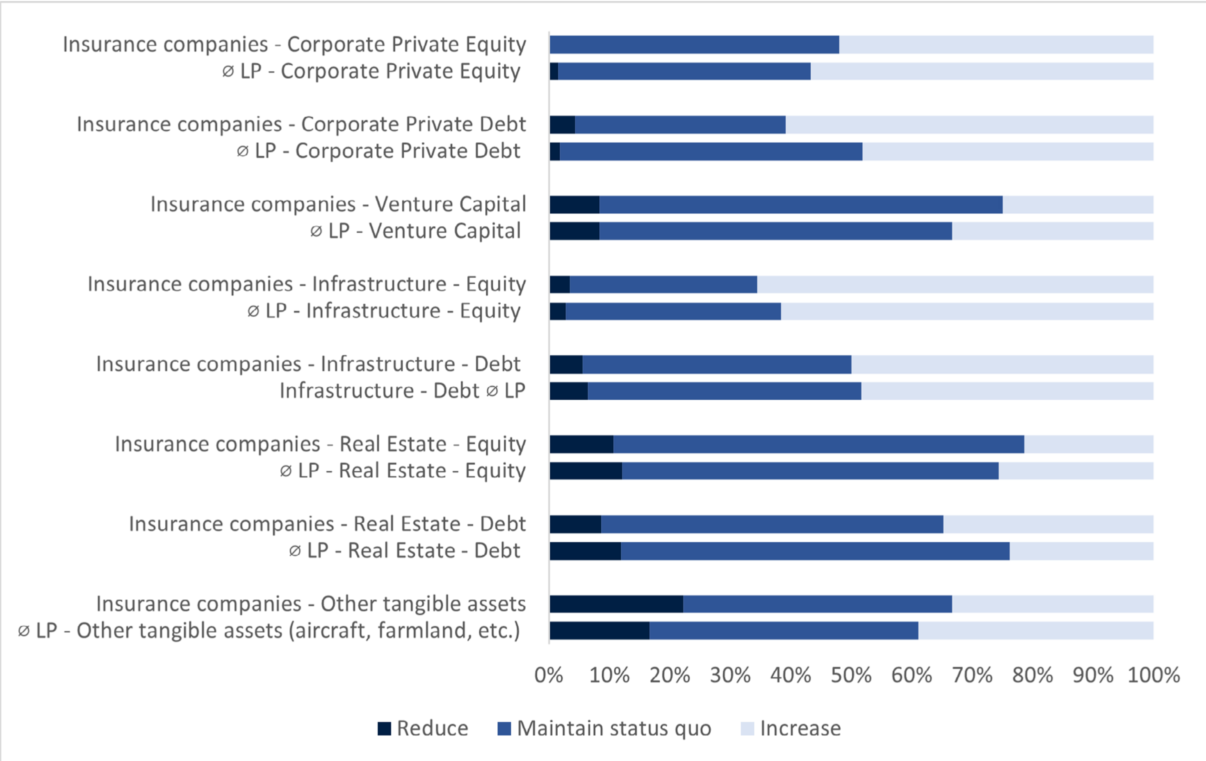

Figure 6: Shares of insurance companies and average investors who plan to adjust the allocation in a certain asset class. Source: BAI Investor Survey 2022.

Drivers for AI investments for insurance companies

While illiquid assets partly lost their role as a substitute for bonds to cover the liabilities side in case nominal income is required, the overall importance of AI in portfolios continues to show a clear positive trend. Therefore, other drivers for AI investments are coming increasingly into focus for insurance companies. We, therefore, asked insurance companies about their reasons for entering alternative asset classes. The reasons given are manifold and depend strongly on the respective asset class in which the new investment is made, the respective insurance company, and its individual requirements.

* Cf. https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/Alternative_Investments_remain_robust_-_despite_competition_from_rising_bond_yields.pdf.

** https://www.bvr.de/p.nsf/0/B9EAF2392188C861C12588A70020F4B9/%24FILE/BVR_VolkswirtschaftKompakt_Ausgabe_8-2022.pdf.

It shows that illiquid assets fit very well with insurance companies' long-term business models since they have long investment horizons and offer attractive alternative risk premia and diversification opportunities. For instance, insurance companies stated that they plan to increase existing allocations in Corporate Private Equity due to the beneficial risk/return structure, diversification, illiquidity-, and complexity premia. In addition, the importance of tapping into further risk premia and further enhancing portfolio diversification was outlined, especially for difficult market phases. Also, investors from insurance companies stated that a potential recession and market downturns could trigger good opportunities for new market entries into Corporate Private Equity, for instance.

3. Insurance companies and ESG

In addition to interest rates and inflation, ESG plays a crucial role in the entire industry. Our data suggest that ESG integration is also becoming increasingly important for insurance companies[*]. Moreover, our recent data from the BAI Investor Survey 2022 shows that insurance companies continue to follow their path toward ESG integration, with 86.5% of those surveyed already having implemented an ESG strategy or planning to do so. As per our data, a similar share of insurance companies in Germany compared to other investor types plans the implementation of an ESG strategy.

Insurance companies are ahead of other investor types in their awareness of ESG

A recent global institutional investor study by Nuveen[**] suggests that insurance companies are ahead of other investor types, such as corporate and government pension funds, in their awareness of ESG topics. Globally, insurance companies are more likely (78% versus 71%) to see climate risk as investment risk and are ahead of their institutional counterparts in addressing concrete climate risk plans and net-zero carbon commitments. Furthermore, there is a stronger belief among insurance companies that they can influence social inequality through their investment decisions (61% versus 51%). As a result, more insurance companies globally are pursuing social investments with a focus on diversity, equity, and inclusion matters (DE&I) for their management decisions or plan to do so in the next two years.

This awareness among insurance companies regarding environmental issues can be attributed to the direct impact of ecological catastrophes on insured property and individuals since ecological issues also significantly impact insurance companies' business. Furthermore, their relatively more pronounced focus on social issues could also be related to the fact that insurance companies not only consider the indirect effects of environmental and social risks on financial markets, but due to their business, the focus within the companies is more on overall socio-economic risks. It is, therefore, also highly relevant for other institutional investors to analyze how insurance companies deal with ESG issues.

ESG strategies pursued by insurance companies

A closer look at the strategies used by insurance companies to implement ESG shows that the use of exclusion criteria has increased compared to the previous year. This trend is not surprising, as using exclusion criteria is the easiest way to incorporate ESG criteria by excluding assets that are considered harmful in some way. ESG integration, which attempts to consider ESG aspects in investment decisions using indicators, is the second most popular strategy, following the same trend as the previous year. Furthermore, impact investing has gained significant importance, rising from 34.8% to 44%.

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* https://www.bvai.de/fileadmin/Veroeffentlichungen/BAI_Publikationen/BAI_Investor_Survey/German_Alternative_Investor_Landscape_NEU_17_03_14_54.pdf.

** https://www.nuveen.com/global/insights/equilibrium/impact-investing-the-insurance-experience.

However, it is important to note that the term „impact investing“ needs to be clearly defined as it is sometimes interpreted broadly.

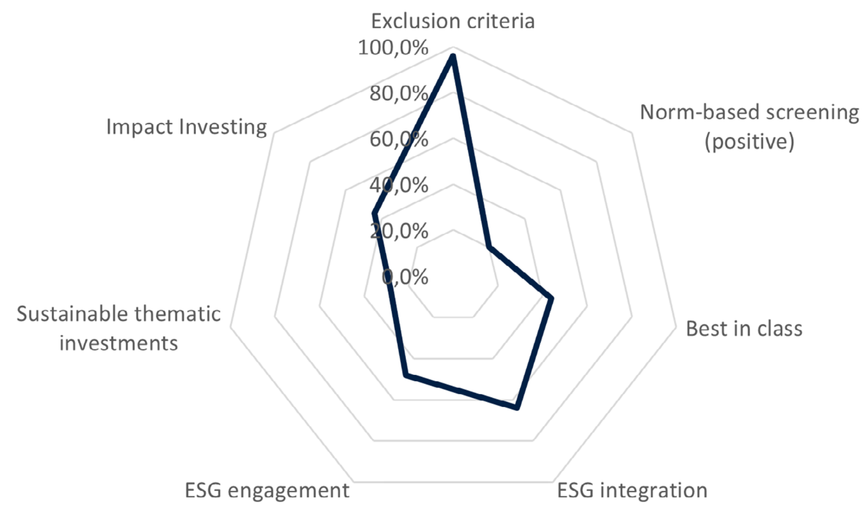

Figure 7: ESG strategies pursued by insurance companies. Source: BAI Investor Survey 2022.

The use of thematically sustainable investments was surveyed for the first time, and 28% of insurance companies reported using this strategy. This pattern could be attributed to the growing trend towards renewable energy and the need to ensure a secure energy supply. The survey also revealed that 92% of insurance companies investing in Infrastructure Equity or Debt specifically invest in renewable energy, with wind power being the most popular, followed by photovoltaics and hydropower. Infrastructure Equity investments are also seen as resistant to inflation (as outlined above), making them a favorable choice in the current macroeconomic environment.

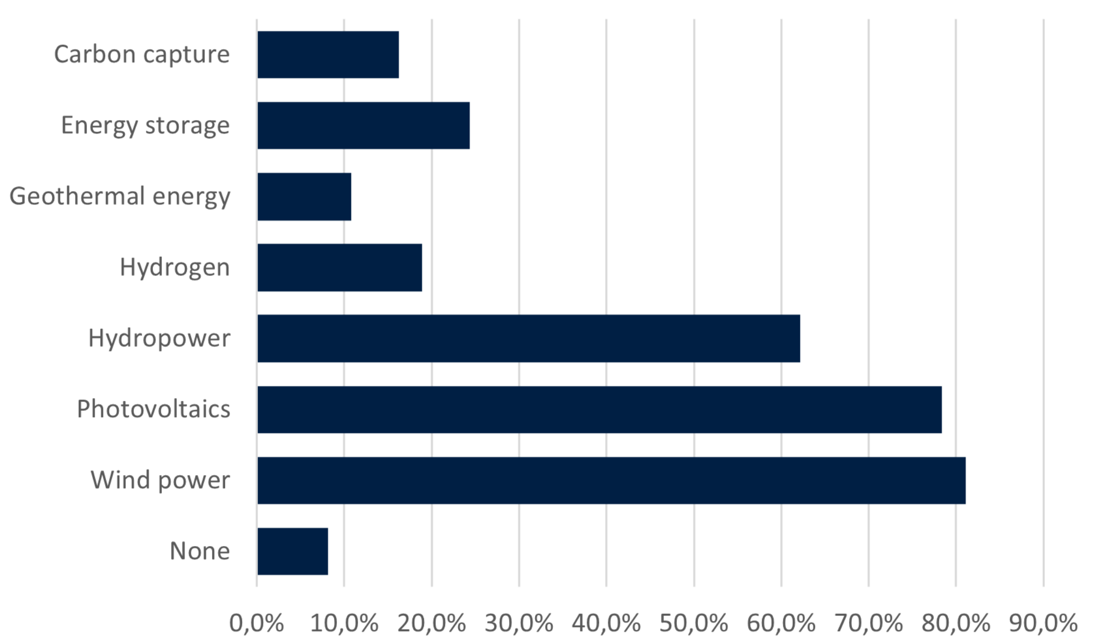

Figure 8: Infrastructure investments in renewable energies from insurance companies which are invested in Infrastructure Equity or Infrastructure Debt. Source: BAI Investor Survey 2022.

Concrete measures insurance companies take for ESG implementation

Awareness of environmental and social issues and theoretically implementing an ESG strategy are essential steps toward more ESG integration. However, practical actions an investor derives from an ESG strategy are crucial regarding the concrete impact. Therefore, in our BAI Investor Survey 2022, we asked for which measures and analyses institutional investors' companies used up resources in the last year during their sustainability strategy.

Data shows that insurance companies allocate significantly more resources to ESG implementation measures than companies of the average surveyed investor. Moreover, for all measures surveyed, the proportion of insurance companies that take one specific action for ESG implementation is considerably higher than the average. As outlined above, one reason for the higher shares of insurance companies taking concrete measures for ESG implementation compared to other investor types could be their more pronounced awareness of environmental issues. Therefore, 56% of insurance companies take steps for CO2 reduction, compared to 36.2% of the average for institutional investors.

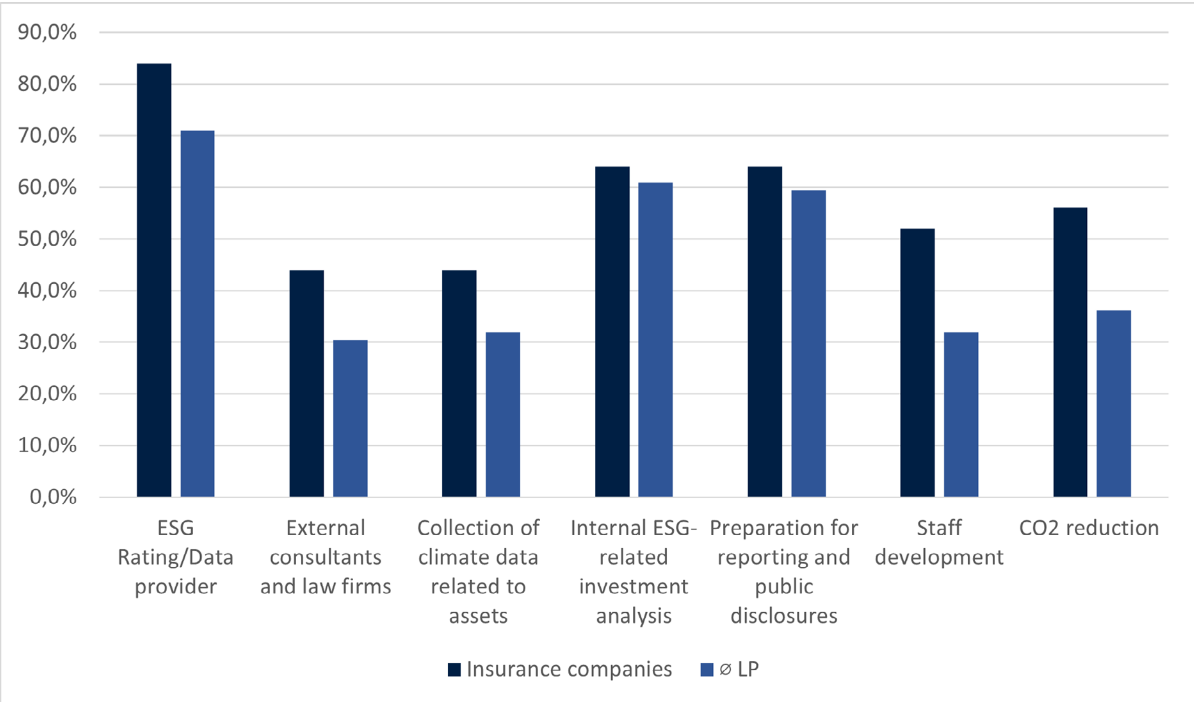

Figure 9: For which measures and analyses in the course of your sustainability strategy has your company used up resources in the last year? Source: BAI Investor Survey 2022.

Also, since insurance companies are significantly bigger than other institutional investors (cf. Figure 2), they may have more resources to allocate to ESG. Moreover, due to their larger structures, they may be able to operate more specialized units. For example, this might be why 52% of insurance companies allocate resources towards staff development, compared to 31.9% for the average institutional investor. Also, companies with more employees might have more resources for collecting climate data related to assets, a measure 44% of insurance companies take, compared to 31.9% of the average investor.

Significantly more insurance companies rely on outside expertise for ESG integration

However, despite the more significant resources available on average, 44% of insurance companies use outside expertise from consultants and law firms for ESG integration, compared to 30% on average among investors. A stronger focus on ESG issues also creates disproportionately additional challenges, especially in legal and regulatory terms, for which external support is needed. This aligns with the main obstacles when implementing their ESG strategies, insurance companies named in our survey. Therefore, data availability and quality were named most frequently. Furthermore, insurance companies see a lack of clarity regarding regulatory requirements, such as implementation dates, as major friction, where external service providers play an increasing role.

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