European Insurance

Unprecedented pressure and change

Standard Life Investments

November 2015

2.4% expected annual return from guaranteed savings market

60% planning to increase allocations to real estate, alternatives

Executive summary

The European insurance industry is experiencing a period of unprecedented change as both regulatory and capital forces exert increasing pressure. Standard Life Investments seeks to provide insight to investors and frame the challenges that need to be addressed. Independent research was commissioned to assess the longer-term impact that low-return environment and Solvency II regulations might have on insurers' businesses and investment strategies.

This research specifically targeted Chief Investment Officers and Chief Risk Officers across Europe to provide an in-depth perspective not previously captured within the industry.

Research findings confirmed that the impact of low returns and regulatory change is not uniform, varying by region and insurer type. It also highlighted the differences between the strategies that insurers expect to adopt in response. This research also identified five themes that apply broadly across the European industry.

1. **Increasingly, European insurers can no longer generate sufficient returns to meet guaranteed rates to policyholders.**

- While current book returns remain healthy, the low-return environment has caused a future returns gap in the guaranteed savings market. The expected future annual return of 2.4% identified is below the 2.7% that respondents need to meet policyholder commitments.
- These economics are a long-term issue and pose business challenges for insurers.

2. **In response, many European insurers are undertaking significant strategic asset allocation (SAA) and tactical asset allocation (TAA) changes, expanding traditional investment horizons to maximise returns.**

- Risk appetite is rising. Half of respondents expect to reduce sovereign fixed income exposure while over 60% expect to increase allocations to real estate and/or alternatives.
- Southern European insurers differed, expressing fewer concerns about their sovereign and investment grade debt weightings, given the higher yields available. However, southern European equity and high-yield fixed income allocations are increasing gradually.

3. **Insurers' investment freedom is constrained by Solvency II. This affects asset allocation as insurers balance greater risk appetite with optimising capital charges and the diversification benefits of the new regulations.**

- 73% of insurers explained that the Directive is limiting the way they design investment portfolios.
- The principle-based approach also adds complexity to reporting requirements and will mean delays to SAA changes.
- Findings indicate that a significant proportion of insurers are not yet ready for Solvency II's requirements.

4. **Outsourcing asset management activity is increasingly attractive, but there are concerns about industry capacity and the number of asset managers able to meet complex insurer requirements.**

- The proportion of assets managed internally varies across Europe, with the UK & Ireland outsourcing more than other regions. However, 44% of insurers are looking to outsource management of one or more asset classes.
- There is an emphasis on specialist mandates, with management information and support around the regulatory treatment of assets being key considerations.

5. **Insurer business strategies and profitability are under pressure from a structural shift away from guaranteed savings to unit-linked structures.**

- 43% of insurers stated they were unable to price new guaranteed investment products at competitive rates.
- The direction of interest rates and regulatory developments are a concern.
- The Markets in Financial Instruments Directive II (MiFID II) could also affect the profitability of unit-linked products via the Insurance Mediation Directive (IMD). The research suggests that these factors are likely to lead insurers to increase product-line diversification and M&A activity.

Insurers face several long-term strategic challenges. Once Solvency II compliance has been achieved and asset allocation strategies are implemented, what will this environment mean for insurers' product mix? Can the European insurance industry rely on their asset managers to adequately deal with the growing complexity of their needs? What will that mean for management fees? This research points to several directions to address these challenges.

Methodology

Standard Life Investments commissioned research to ascertain the long-term impact of the confluence of a lower-for-longer interest rate and investment return environment as well as the new capital adequacy regulatory requirements may have on European insurers. In doing so, an independent global consultancy was engaged to conduct the fieldwork and analysis that forms the basis of this report.

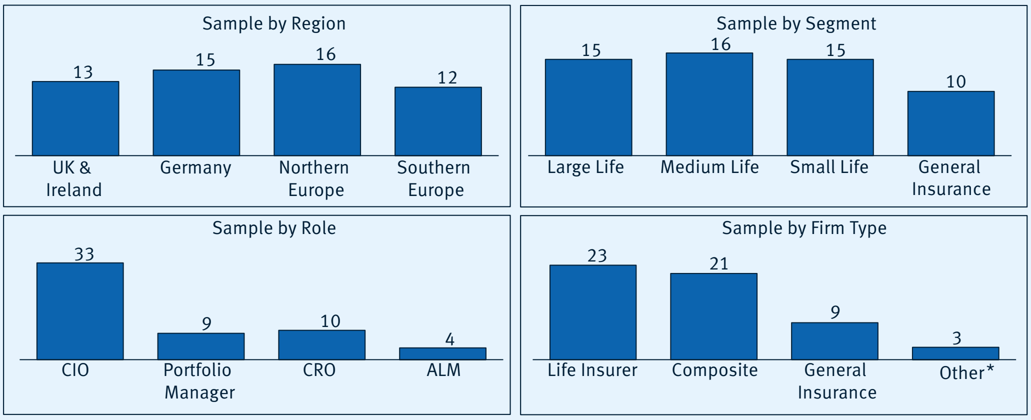
Report methodology

The research targeted a mix of markets and business models. The breakdown of the sample by job title, size of assets, region and business model is set out in Chart 1 below. Unit-linked life assets were also covered, although it is noted that policyholders, rather than insurers, bear the investment risk.

Population

The research focuses on European insurers defined as institutional investors managing balance sheet assets which back guaranteed savings, guaranteed income and other life and general insurance policies. Over 60% of executive interviews were undertaken with Chief Investment Officers across 56 different European insurers covering €2.4 trillion in assets, more than 30% of total insurer balance sheet assets across Europe. Face-to-face interviews were completed during the third quarter of 2015.

Chart 1 - Sample breakdown by region, segment, role and firm type



Q. Which of the following best describes your role?

Q. Which of the following best describes your firm? Total Sample = 56 for all graphs.

*Note: Other includes annuity and health insurers

Regions: United Kingdom and Ireland; Germany, Northern Europe (Finland, Sweden, Netherlands, Belgium, Liechtenstein, Switzerland), Southern Europe (Italy, France, Spain, Portugal) Segments: Large Life (L. Life), Medium Life (M. Life), Small Life (S. Life General Insurance Focused (GI) Bottom LHS

Source: Standard Life Investments European Insurer Study 2015

Key themes

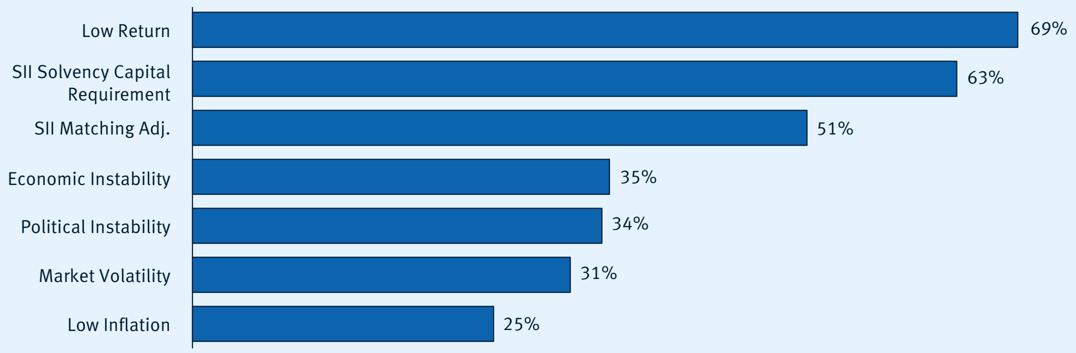
1 Increasingly, European insurers are no longer able to generate sufficient returns to meet guaranteed rates to policyholders.

- 44% of insurers are looking to outsource one or more asset classes, and
- 45% of European insurers suggest the low-return environment makes it more likely that they will outsource to external asset managers.

Pressure on guaranteed savings

The global financial crisis (GFC) and the related policy response have created a low-return investment environment. Current book returns are still healthy but the clear implication is lower expected future returns. Institutional investors have been grappling with this globally, and many have consequently increased risk-asset exposure to improve total asset return. European insurers face a version of this global challenge, with 69% rating the low-return environment quite high in terms of its influence on their investment objectives (see Chart 2).

Chart 2 - Impact of key change factors on European insurer investment strategy



Q. How are the following factors influencing your approach to managing your investments (rate on a scale of 1 to 10)?
Note: Percentage of respondents with an importance rating of 7 of greater; Total sample = 56.
Source: Standard Life Investments European Insurer Study 2015

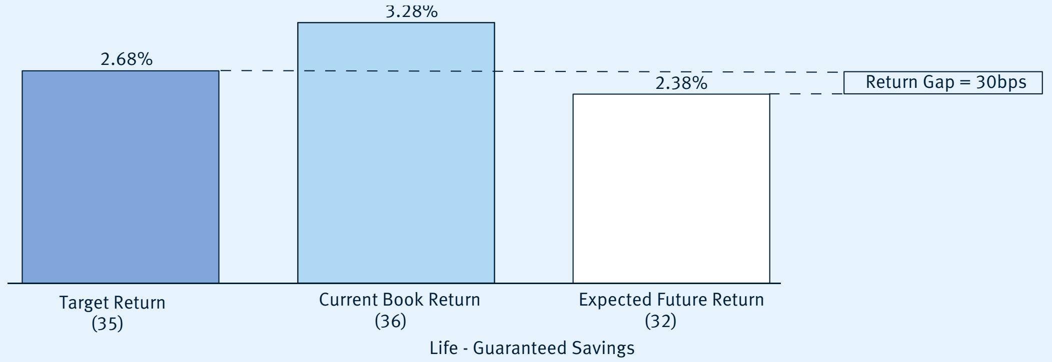
The research suggests that guaranteed savings books are under most pressure. Historically, insurers were able to buy long-duration bonds at higher yields than their guaranteed rates to policyholders. Even now in 2015, past purchases of long-duration fixed income mean that current book returns are higher than actuarial target returns based on insurers' liabilities. The issue is that, after the GFC, insurers have been buying long and short-duration bonds at yields lower than their required returns.

44%
seeking to
outsource one or
more asset classes

69%
low return
environment
most significant
investment factor

Chart 3 quantifies what is a multi-decade challenge for guaranteed savings books, i.e. current annual book returns are 3.3% versus target returns of 2.7%. However, expected future returns are forecast at 2.4%, well below target returns, and, in many markets, below the level which will interest customers in guaranteed savings products. Current book returns are above target returns but, in reality, insurers have been purchasing assets yielding less than their guarantees for a number of years. 'Current book return' indicates a historical portfolio-level view.

Chart 3 - Target, current and expected future returns for guaranteed savings



Q. For the above relevant product categories, what is a) your target return b) current portfolio returns (over the last 12 months) and c) your expected investment return in portfolio returns (over the last 12 months) and c) your expected investment return in the future (3 years)?

Source: Standard Life Investments European Insurer Study 2015

> "We've had a period of strong performance in investment grade credit since the financial crisis - this is unlikely to continue over the next 3-5 years. We need to look elsewhere for the same returns to help us."
>
> *UK life insurer*

> "We'll be looking to improve returns to help meet guarantees through diversifying credit exposure and adding infrastructure."
>
> *Medium-sized UK life insurer*

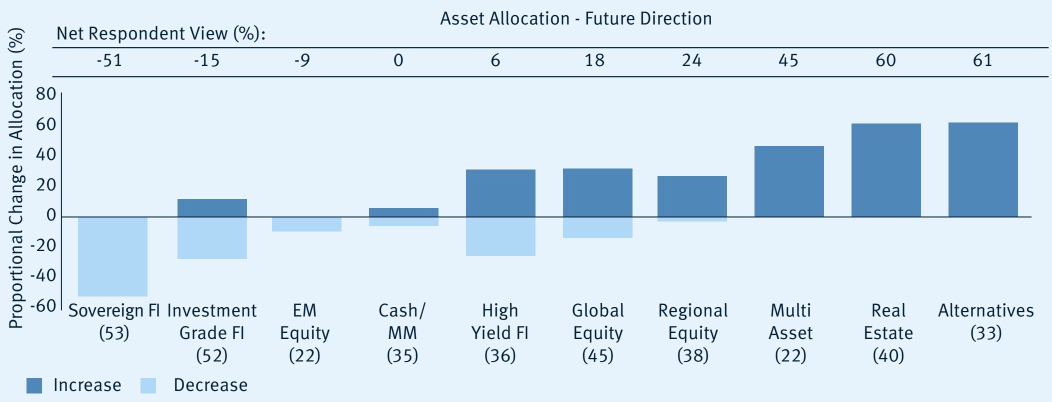
2 In response, many European insurers are undertaking significant strategic and tactical asset allocation changes, expanding their traditional investment horizons as they seek to maximise returns.

- 50% of insurers are expecting to decrease sovereign fixed income exposure
- 43% expect to increase their investment risk appetite, and
- Over 60% of insurers expect to increase allocations to real estate and/or alternatives.

Shifting allocations

In response to European insurers no longer able to generate sufficient returns to meet guaranteed rates to policyholders, most insurers express an aspiration to boost risk appetite and risk-asset exposure. At a high level, SAA to sovereign and investment-grade fixed income are expected to fall, with allocations to alternatives and equities expected to increase. Chart 4 shows that more than 50% of insurers expect to reduce sovereign fixed income exposure and a similar percentage expect to increase real estate and alternatives weightings. However, the research identified important variations in intended approach between regions.

Chart 4 - Expected future change in asset allocation over the next three years



Q. Do you expect your new allocations to each asset class to increase, stay the same or decrease over the next three years ?

Note: FI = Fixed Income. Sample shown in brackets. Net respondent view shows the net percentage of respondents looking to increase or decrease their allocation to each asset class. For example of the 53 respondents, no respondents indicated that they are looking to increase their allocation to Sovereign Fixed Income and 27 respondents confirmed their intention to reduce their exposure to this asset class, resulting in a net change of -51%.

Source: Standard Life Investments European Insurer Study 2015

UK & Ireland

In the UK and Ireland, there was a strong focus on exploiting illiquidity premia rather than credit risk. Infrastructure and real estate debt, or diversified fixed income, were cited as attractive sub asset classes for optimising return and capital efficiency. Respondents explained that, while taking on more credit risk (buying high-yield fixed income) improved yields, these investments attract higher capital charges and offer no diversification benefit.

> **"Long term, we are going to grow smart beta, illiquid credit, multi-asset and infrastructure. We have a negative view on securitised assets because of the reporting compliance burden."**
>
> *Large UK life insurer*

Germany

German respondents expressed the same preference for exploiting illiquidity premia over credit risk as UK & Ireland insurers. Furthermore, in addition to changes in SAA, TAA strategies are becoming more important to German insurers. They increasingly see TAA as a driver of return as market volatility is the new norm – a situation viewed as both an opportunity and a threat by investment divisions. A number of German insurers cited a 20 to 30 basis point uplift in annual return over the past few years from TAA activities. The fact that 60% of German insurers highlighted TAA as a key area for improvement supports these findings. Overall, TAA was ranked third behind SAA and investment reporting as a key area for improvement (see Chart 11 under Theme 4)

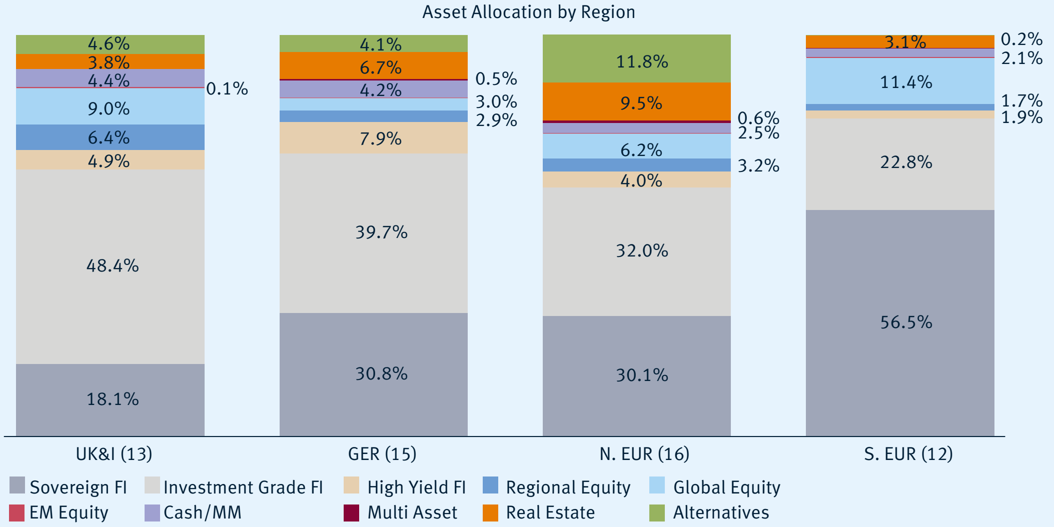
Southern Europe

Here, respondents expressed fewer concerns about SAA and more confidence in existing investment strategies. Southern European portfolios remain more weighted to sovereign fixed income and investment grade debt, where domestic yields are higher than in other parts of Europe (see Chart 5). There was more interest in building out equity exposure than alternatives in southern Europe (see Chart 6). In some cases, a stepping-stone approach was observed where equities or high-yield fixed income allocations are increasing in the short term. Ultimately, these investments will be moved into alternatives subject to internal capability and deal availability.

Northern Europe

This region expressed similar asset allocation preferences to the UK & Ireland, albeit with a still-high but less pronounced preference for alternatives. Of all four sub-regions, northern Europe displayed a greater interest in high-yield fixed income as an alternative asset class option. Equity was also identified as a destination, but to a lesser extent than other continental regions.

Chart 5 - Asset allocation by region



Key: Asset classes from bottom to top: Sovereign fixed income; Investment grade fixed income; High yield fixed income; Domestic or regional equity; Global equity; Emerging market equity; Cash & money markets funds; Absolute return / multi-asset; Real asset; Alternatives (commodities, hedge funds, infrastructure, private equity) Note: Sample shown in brackets

Q. How are your total assets split into the following asset classes?

Source: Standard Life Investments European Insurer Study 2015

Chart 6 - Net respondent view on future asset allocation over the next three years by region

Q. Do you expect your new allocations to each asset class to increase, stay the same or decrease over the next three years?

Note: Number in brackets references the total number of respondents which indicated they would increase, decrease or stay the same with their allocation over the next three years. The percentages shown represent the net increase or decrease in expected allocation. Results for Fixed Income and Equity are based on a weighted average using current levels of allocation to underlying asset classes. Fixed Income results combines Sovereign Fixed Income and Investment Grade Fixed Income. Equity results combine Regional Equity, Global Equity and Emerging Market Equity.

Number in brackets references total number of respondents within each region.

Source: Standard Life Investments European Insurer Study 2015

While insurers' use of long-term alternative debt asset classes continues to grow, some expressed wariness about the longevity of this trend. The withdrawal of banks from long-term funding over the last five years boosted the attractions of these assets. However, the insurers most active in this area highlighted a rapid increase in competitor activity. Pension and sovereign wealth funds in particular are more active and some respondents also expect banks to re-enter this market. This increase in interest has led to shrinking spreads and liquidity premia. Greater care will be required in the hunt for higher yields and low volatility, as supply here may be increasingly limited. This situation may limit the appeal and growth in use of these asset classes in future.

"We have moved to computer-driven market-timing models and use a lot of ETFs to trade in and out on a shorter time frame."

Medium-sized German life insurer

"As the volatility in the market has increased dramatically, even in bond markets, we can easily make some extra basis points over weeks or a couple of months which you cannot get with a buy-and-hold strategy."

Large German life Insurer

"We will have to look for an alternative to bonds and volatile stock markets, for example dividend strategies or alternatives like renewable energy or infrastructure."

Small German life insurer

3 European insurers' investment freedom is constrained by Solvency II. This affects asset allocation as they seek to take on more risk while also trying to optimise capital charges and the diversification benefits of the new regulatory regime.

- 89% confirmed that Solvency II is impacting asset allocation decisions, and
- 73% of insurers explained that Solvency II is limiting design of investment portfolios
- 38% suggest that Solvency II has made it harder to hedge their liabilities.

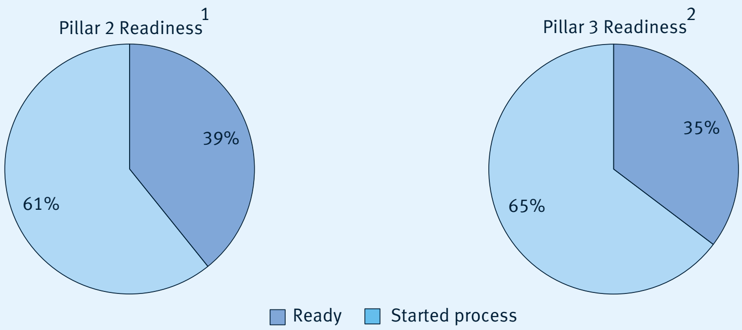
The importance and complexity of Solvency II

While the low-return environment is the key driver of the asset allocation changes described in Theme 1, Solvency II is the next most important factor in insurers' asset allocation considerations, influencing more than half of European insurers (see Chart 2). The Directive adds complexity to portfolio management, making the desired SAA changes expressed in Theme 1 more challenging to implement. The research indicates general unpreparedness and a last-minute rush to become compliant.

History and context are vitally important to understand the full impact of Solvency II. The Directive is principle-based rather than prescriptive, as was the case under Solvency I, and allows insurers to invest in a broader range of investments. However, this greater scope creates more complexity around investment portfolio design and reporting requirements, as risk has to be effectively communicated to the public, including shareholders.

The research revealed a sense of urgency among the majority of European insurers to meet Solvency II requirements, with a short term rush to sign-off internal models and meet investment reporting requirements. At the time of the research 61% of insurers stated they were not ready for Pillar 2 (related to risk and capital management) and 65% were not ready for Pillar 3 (related to Solvency II reporting, including investment reporting).

Chart 7 - European insurer readiness for Solvency II



Q. How ready is your firm for each of the three Solvency II Pillars in 2016? Total sample = 56

Note 1: Pillar 2 relates to risk and capital management which encompasses the supervisory review governance and Own Risk and Solvency Assessment (ORSA)

Note 2: Pillar 3 relates to Solvency II and risk reporting including public reporting to the market and private reporting to supervisors

Source: Standard Life Investments European Insurer Study 2015

Solvency II impact:

89%
say it impacts asset allocation

73%
believe it restricts portfolio design

38%
state it makes liability hedging more difficult

Diversification versus higher capital charges

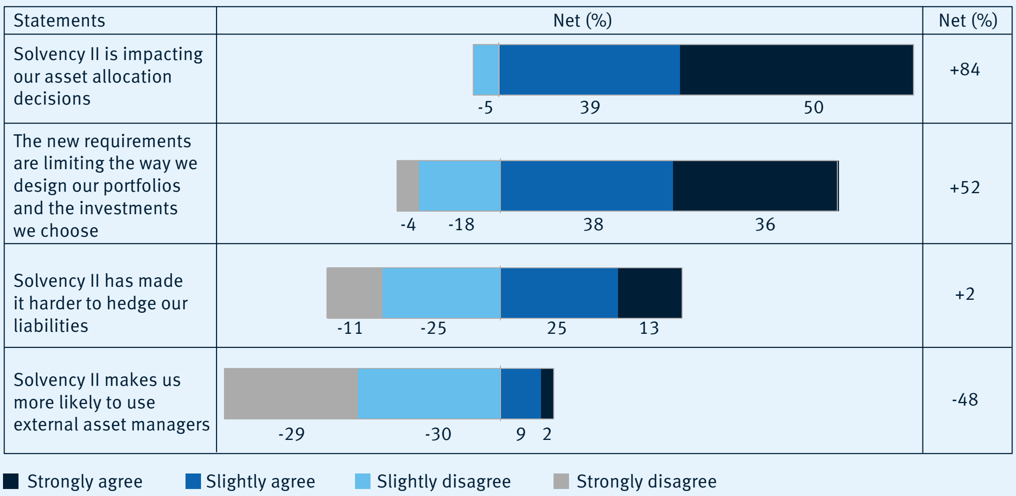
Many respondents explained that typical capital charges for more volatile equity investments and more illiquid real estate and infrastructure investments have related implementation challenges. While diversification benefits are recognised, respondents explained that, overall, Solvency II makes it harder to implement the SAA changes driven by a low-return environment. This is supported by Chart 8, which shows that 89% of insurers stated that Solvency II is impacting asset allocation decisions.

Heightened complexity

It was also evident that the development of a more complex internal model than the regulatory standard was helpful in achieving the appropriate classification and capital treatment for investments. This finding came despite common references to tougher model calibration than insurers had expected from the regulator.

There was also frustrations in terms of implementing asset management strategies with 38% of insurers explaining that Solvency II makes it harder to hedge liabilities. And while Solvency II itself is not a key driver behind the decision to outsource, there was a question about the asset management industry's capacity to respond and meet insurers requirements. The impact of the confluence of the low return environment and Solvency II on asset manager relationships is discussed in the next section.

Chart 8 - Impact of Solvency II on insurer investments



Note: Net = Agree less disagree; Total sample = 56
Q. To what extent do you agree with the following statements on Solvency II and investment reporting?
Source: Standard Life Investments European Insurer Study 2015

Delays to SAA changes

Finally, there was consensus that some important SAA changes will not be completed in advance of initial Solvency II implementation in January 2016. TAA activities are high on the agenda to deliver target returns, and investment reporting is consuming short-term resource capacity. Many insurers cited Solvency II reporting and model sign-off as a frustrating distraction to SAA initiatives. As a result, certain insurers recognised that their portfolios would include a percentage of assets with high capital charges under Solvency II and that the re-allocation process could take years to play out.

"We are not looking to take on more credit risk to enhance returns because Solvency II punishes us for that. Instead, illiquidity risk premiums will be our focus."
Large UK life insurer

"The next step for us is to develop a robust internal model for Solvency II and move away from the standard model."
Large south European life insurer

"For the next 18 months we will be focusing on regulatory compliance, then from 18 months to five years we will focus on maximising returns within that regulatory environment."
Medium-sized UK life insurer

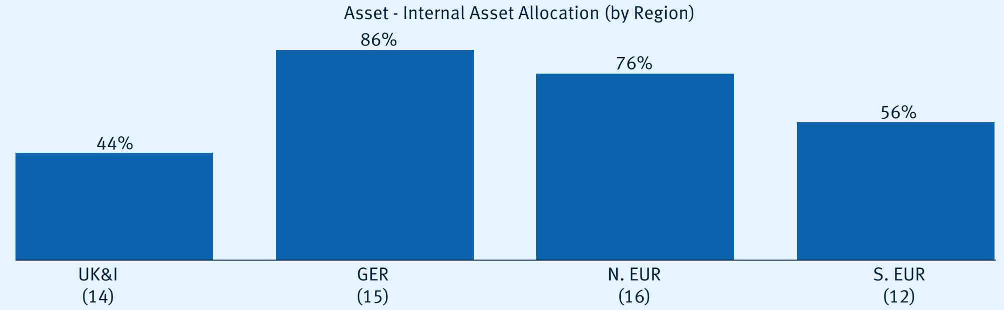
4 Outsourcing all or part of asset management activity is becoming increasingly attractive, but concerns exist around industry capacity as the number of asset managers able to meet complex insurer requirements is expected to decline.

- 44% of insurers are looking to outsource one or more asset classes
- 45% of European insurers suggest the low-return environment makes it more likely that they will outsource to external asset managers
- 43% of insurers are keen to access hedging services and 39% are keen to access greater SAA from asset managers, and
- 41% of European insurers identify investment reporting as a key area for improvement.

The shift from internal to external provision

This theme considers the level and nature of outsourcing from life insurers to the external asset management industry. Chart 9 shows that the percentage of assets managed internally in the life company or via captive asset managers varies by region, with the implication that outsourcing has some way to go in Germany and northern Europe should they converge with the levels reported in UK & Ireland. More importantly, insurers are planning to outsource asset management on a three-year view. Chart 10 shows that increases in outsourcing are most likely for high-yield fixed income, emerging market equities and multi-asset solutions, where insurers identify that their internal asset management capabilities are weakest.

Chart 9 - Overall percentage of assets that are internally managed

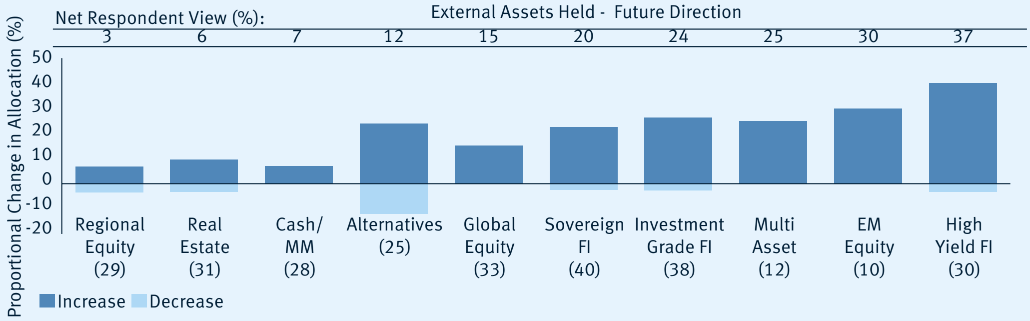


Note: Sample shown in brackets; Percentages based off weighted average by total assets held for each insurer

Q. Please indicate the proportion of each asset class held with external asset managers [percentage internally managed presented above]

Source: Standard Life Investments European Insurer Study 2015

Chart 10 - Direction of change in external asset management, three-year view



Note: FI = Fixed income; Sample shown in brackets

Q. Do you expect your allocations to external asset managers to increase, decrease or stay the same over the next three years by asset class?

Source: Standard Life Investments European Insurer Study 2015

Outsourcing driven by asset classes

From a regional perspective, there is a correlation between increased demand for asset classes and increased demand for outsourcing. For example, increased outsourcing for equities is expected in southern Europe while UK demand focuses more on alternatives and high-yield fixed income. More importantly, there was consensus that future outsourcing from larger insurers would be more selective while small insurers were more likely to take a broad-based approach.

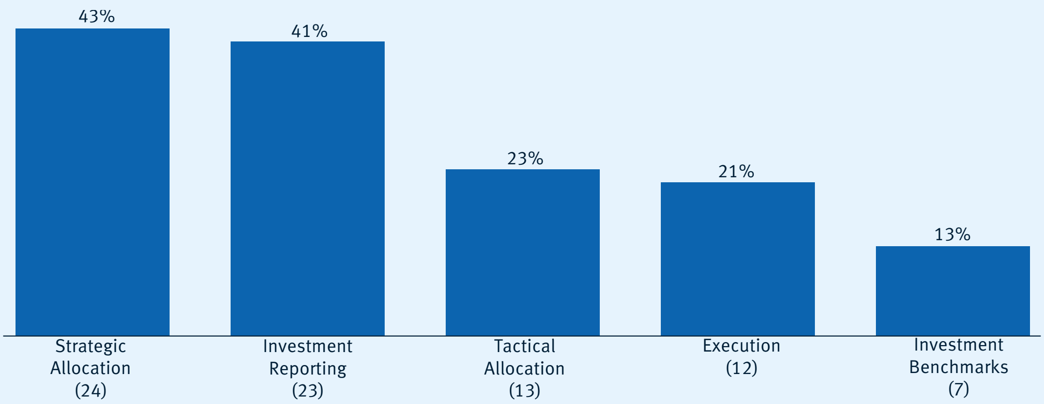
The research identified three themes which challenge some conventional wisdom on the use of outsourcing and the growth in indexing.

1. Large life insurers are increasingly willing to look beyond their internal asset manager divisions. In fact, many life insurers are increasing allocations to independent managers or building teams within the life insurer for TAA or direct investments into alternatives.
2. The growing demand for more complex alternative debt asset classes (identified in Theme 2) is not strongly correlated to outsourcing. Many insurers are building out their internal capability to realise these opportunities, notably in the UK and the Nordic region.
3. There are relatively small increases in internal or external indexing. Only 21% of insurers plan to increase indexing and, on average, more than 80% of total portfolio assets are allocated to active strategies with broadly consistent feedback across regions.

A dynamic trend

While outsourcing is a common driver, the findings indicate that the nature of active outsourcing is changing faster than the quantum of outsourcing. Nearly all insurers explained that they were issuing more specialist mandates with increased emphasis on management information about assets and portfolio re-balancing, and support for regulatory treatment of specific assets. Chart 11 validates this observation, with 41% of insurers citing investment reporting as a key area for improvement.

Chart 11 - Key areas for improvement



Q. What are the key areas you need to improve?

Note: Numbers in brackets references the number of respondents citing each factor. The percentages show those respondents as a proportion of the overall response base.

Source: Standard Life Investments European Insurer Study 2015

"We need asset managers to be much stronger on reporting and monitoring assets for Solvency II. Most managers don't understand the implications of their trades on our capital charge so we have to be very prescriptive in mandate design."

Medium-sized UK life insurer

"Larger managers tend to have dedicated Solvency II and insurance resources that are value adding and bring a consultative capability. We are looking at managers to partner with these managers."

Large south European life insurer

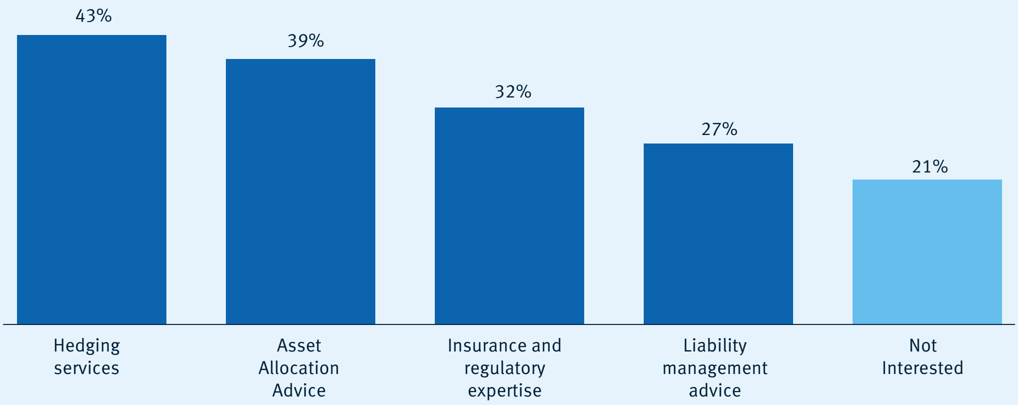
"Asset managers will increasingly need specialised skills to work with insurers, understanding how our liabilities and balance sheets work, which plays to larger managers and those owned by insurers. Having said that, there is some internal reluctance to work with asset managers owned by direct competitors."

Large UK life insurer

Increasingly, insurers are seeking more strategic partnerships with asset managers who understand their business. While asset managers are partnering with insurers to meet short-term deadlines, respondents explained that few managers really understand their liabilities and the capital implications on portfolios from Solvency II.

Over 30% of respondents were interested in insurance and regulatory expertise, and 27% cited liability management advice as key value-add services from asset managers (see Chart 12). Large fixed income managers and specialist (typically insurer-owned) managers were most frequently cited as partners. In fact, specialist equity managers were expected to de-prioritise the sector as the bespoke nature of insurer mandates is frustrating for managers who can reach capacity via other channels. In summary, insurers want to outsource more but recognise that the number of credible outsourcing partners is reducing.

Chart 12 - Insurer interest in asset manager value add services



Note: Percentage of total sample of 56. Q. Are you interested in (or do you use) any of the following services from asset managers?
Source: Standard Life Investments European Insurer Study 2015

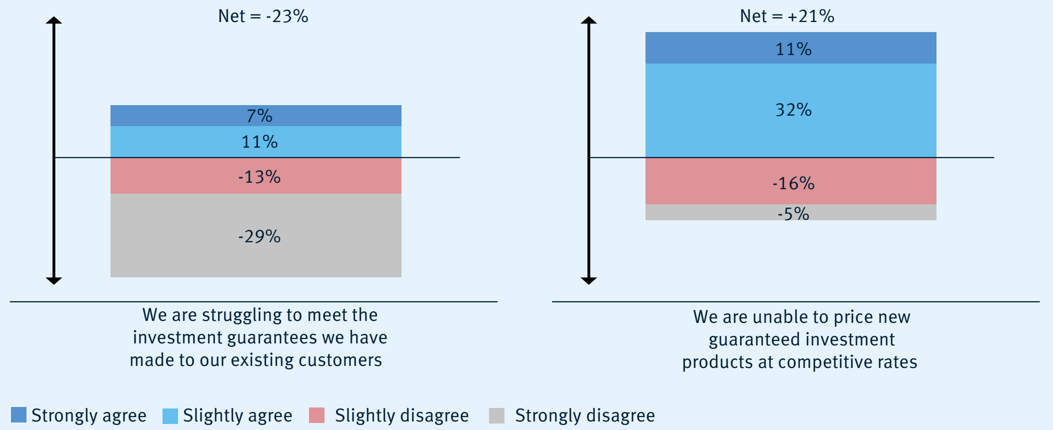
> "Fewer managers are going to be interested in dealing with insurers going forward. Servicing costs are now very high. I think larger and specialist insurance-focused asset managers are better placed to remain. Unless managers can get real scale, management fees will have to rise."
>
> *Small UK life insurer*

5 Broader insurer business strategies and profitability are under pressure from the structural shift away from guaranteed savings to unit-linked structures, creating new challenges.

- 43% of insurers explained that they were unable to price new guaranteed investment products at competitive rates.

We earlier identified the key challenge for European insurers: guaranteed savings returns are falling and expected future returns are below required actuarial returns. Not only does this force tough decisions on investment strategy for existing assets but it also challenges the broader business strategy for insurers. In most markets, the 2.4% expected future return is not sufficient to attract new customers to guaranteed savings. Respondents explained that the extent to which existing policyholders should fund new guaranteed savings rates was a key question. Chart 13 supports these findings: only 18% of insurers are struggling to meet existing guarantees, but 43% are struggling to price new products.

Chart 13 - European insurer responses to statements on guaranteed savings



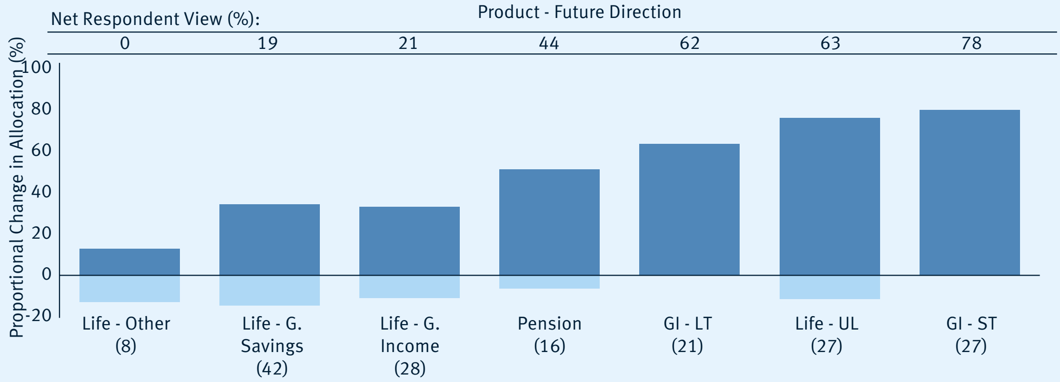
Q.To what extent do you agree with the following statements?
Note: Excludes insurers classified with a general insurance focus; Total sample = 56;
Source: Standard Life Investments European Insurer Study 2015

> "We are struggling to design attractive new guaranteed savings products due to the low interest rate environment."
> *Small German life insurer*

> "We do not develop new products with guarantees - we have a clear strategic focus to diversify from guarantees!"
> *Medium-sized German life insurer*

Chart 14 highlights industry responses to future asset growth in different product categories and confirms that guaranteed savings products are under pressure relative to unit-linked solutions. Some respondents were positive, explaining that existing policyholders benefit from scale and cost savings from new guaranteed savings policyholders and, assuming interest rates rise, the level of cross-subsidisation would be limited. However, on balance, there was strong evidence for a structural shift away from guaranteed savings across Europe.

Chart 14 - European insurer views on future asset growth by product line



Key: Products from left to right: Life – Other (Life Insurance or Long Term Care); Life – Guaranteed Savings; Life – Guaranteed Income; Insurer Staff Pension Fund; General – Long Tail Insurance; Insurer Staff Pension Fund; Life = Unit/ Investment Linked; General – Short Tail Insurance; Note: Sample shown in brackets

Q. Excluding asset class growth driven by performance, to what extent do you expect the assets you manage to increase (↑), decrease (↓) or stay the same (→) over the over the next three years?

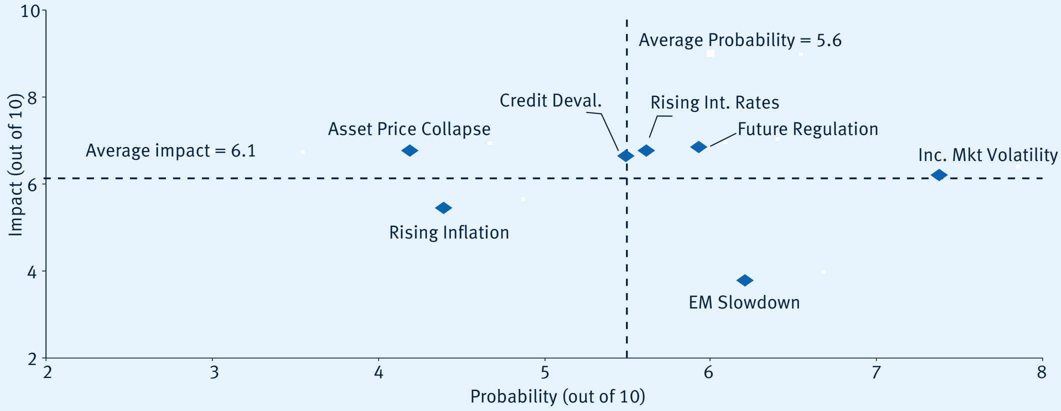
Source: Standard Life Investments European Insurer Study 2015

The drive to diversify

In the UK life market, the decline of guaranteed savings is well documented but optimising capital diversification benefits across product lines and the decline in guaranteed income following Pensions Freedom were also key themes. M&A and greater focus on bulk annuities were seen as key strategic responses. Overall, general insurers faced fewer investment or business model challenges and responses in Chart 14 present a more positive outlook than for life insurers.

Future regulatory change was deemed both a high-probability and a high-impact future change factor, as qualitative feedback focused heavily on MiFID II (see Chart 15). Respondents explained that margins from guaranteed savings funded commission to brokers and infrastructure to run their tied agency or direct sales forces. MiFID II provisions are expected to be reflected in the Insurance Mediation Directive (IMD) and, as a result, could transform the value chain. UK insurers operating in a fee-based environment since the Retail Distribution Review (RDR) in 2012 have observed falling total customer charges and an accelerated decline in unit-linked revenue margins. Many European insurers are concerned their markets may follow a similar path.

Chart 15 - Probability and impact of future change factors



Q. Please indicate the probability and impact of future scenarios over the next three years (please rate on a scale of 1 to 10 where 10 = high probability or high impact); Total Sample = 53
Source: Standard Life Investments European Insurer Study 2015

> **"MiFID II is of concern as the life and wealth management industry is still heavily dependent on commission."**
> *Large north European life insurer*

Twin challenges: interest rates and regulation

The future of the guaranteed savings industry in Europe remains dependent on interest rates, investment returns and MiFID II implementation. Future interest rates were a key topic for insurers. While rising rates support new product development, the change challenges existing portfolio returns. As rates rise, government bond prices fall and credit quality may devalue with negative implications for insurance asset portfolios. While the probability of these shocks appears relatively low, the association with rising rates makes insurers nervous about the future even under a positive macroeconomic scenario.

> **"Rising interest rates would have the strongest adverse impact given the nature of our existing portfolio."**
> *General insurer in Germany*

As an aside, the perceived low impact of an emerging market slowdown is notable. While these interviews took place before the stock market shock in China, qualitative feedback indicated limited concern given relatively low direct emerging market exposure in portfolios. However, there would clearly be severe second-order impacts if an emerging market slowdown transitioned into a full-blown economic crisis.

Unit-linked products have their own issues

Technically, MiFID II does not apply to unit-linked insurance products, as these were removed from the scope of the Directive and, instead, will fall under the purview of the IMD, which also seeks to enhance retail investor protection. MiFID II aims to create greater transparency and liquidity in the market places of numerous asset classes with the goal of bringing the investor protection changes made in the retail sphere to the professional investor. Importantly, it is expected that the IMD standards will be aligned with those of MiFID II and follow closely behind in terms of timeline, meaning the advent of MiFID II on 3 January 2017 presents another set of considerations for insurers. Like the RDR changes, there are potential ramifications for commissions and fees for independent advisers, with clear conditions likely to be set around those situations where fees are involved. This suggests potentially material change to insurance product charging structures and distribution models.

However, perhaps of greater interest is the real-life effect these regulatory changes could have on what remain fixed income-dominated products. MiFID II's primary focus is enhancing transparency. However, there are very real fears that the unintended consequence could be much-reduced liquidity in this important market. Whatever the eventual outcomes, clearly the flow of regulation does not end with Solvency II, and insurers need to be mindful of the other challenges looming on the horizon.

Conclusion

In undertaking this research, Standard Life Investments set out to both understand the impact of the confluence of leading investment and regulatory headwinds that currently face the European insurance industry and to assess what this means for their business models and execution of investment strategies. The findings reveal a number of issues that affect regions in a variety of ways.

Common among them is the shift away from guaranteed savings towards unit-linked products. The low-return investment environment is challenging guaranteed product economics, forcing insurers to reappraise asset allocation strategies in a bid to enhance returns. Intentions vary by region, but insurers generally plan to increase risk-asset exposure primarily through reductions in sovereign fixed income exposure in favour of equities. Real estate and alternatives are other favoured asset classes.

Solvency II is another important factor in this shift. The Directive's complex reporting requirements and a general lack of readiness are compromising insurers' ability to make SAA changes. For a time, this may mean higher capital charges while they adapt, making the desired SAA changes a medium-term ambition. For some, TAA will assume greater importance in the interim. The regulatory complications do not end there as looming MiFID II provisions, expected to be reflected in the IMD rules which govern insurance products, portend important changes to unit-linked economics.

Meanwhile, Solvency II's complexity is making outsourcing an attractive option, although this is very much asset class-dependent. Smaller insurers are also likely to outsource more across a broader range of asset classes than larger peers who expect to be more selective. The key driver is specialist mandates with a greater emphasis on investment reporting, but there are concerns about asset managers' ability to cope with insurers' increasingly complex needs.

Looking ahead, these long-term issues raise a number of strategic questions for insurers.

- Once they have addressed Solvency II compliance over the coming months and seek to execute their asset allocation strategies, what will this environment mean for product development, product offerings and fees further out?
- Can the asset management industry cope with the emerging demand from what is a non-traditional form of asset management?
- Can it adapt to provide the increasingly complex servicing requirements that the insurance industry will require and demands?

Despite these challenges, it is clear the insurance sector is simply at the start of a process of continual regulatory and industry change. This process may require insurers to consider unfamiliar approaches, perhaps embracing unconventional and innovative investment solutions. Importantly, these solutions will come from genuine partnerships with their asset managers. This report starkly highlights the key issues which currently need to be addressed – long term success for European insurers will depend on them being prepared to take a collaborative approach to finding appropriate solutions.

Standard Life Investments insurance solutions

The insurance sector is an important sector. Standard Life Investments manage insurance assets worth £137 billion, as at 30 June 2015, including £84 billion for our parent company Standard Life. We also manage £53 billion for a wide range of insurance clients across the UK, US, Europe and Asia.

Our dedicated insurance solutions team manages relationships with both internal and external insurance clients with a view to developing innovative solutions that enhance their risk-return profile. The team comprises highly experienced insurance actuaries with detailed knowledge of regulation, as well as risk.

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