Quarterly insurance update

Q3 2023

Summary

Welcome to the Quarter 3 2023 investment update designed for insurers and produced by Royal London Asset Management. Central bank interest rate rises were the story of the second quarter. For the major central banks, after more than 12 months of tightening monetary policy, market attention has turned towards expectations of when and at what level rates will peak. In contrast to 2022, when all three major central banks were expected to continue hiking, the changing growth and inflation picture in the US, euro zone and UK means that expectations have become more differentiated. The inflationary pressure and central bank policies remain key concerns prompting cautious investor sentiment.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress.

In the UK, the Prudential Regulation Authority (PRA) published a consultation paper which outlined a major set of reforms to the existing Solvency II regime with the aim of establishing the Solvency UK (SUK) regime, tailored to the UK insurance market. The reforms can be viewed under three thematic areas: simplifications, improved flexibility and encouraging entry.

In wider Europe, the European Commission adopted a Retail Investment Package, placing consumer interests at the centre of retail investing, although there was significant negative feedback from industry bodies around the detailed implementation. Additionally, the European Supervisory Authorities (ESA) published their Progress Reports on Greenwashing within the financial sector including banking, insurance and pensions and financial markets.

From a broader international perspective, the International Sustainability Standards Board (ISSB) issued its inaugural standards on sustainability related disclosures for corporate reporting, IFRS S1 and IFRS S2.

Within this quarterly update, we cover developments to the two main areas most prevalent to the asset side of insurers' balance sheets - investment markets and regulations. In addition, we highlight two investment themes we believe should be considered by many insurers at the present time.

Market update:

- Government bond markets faced further upward pressure on yields as investors faced fears of additional rising inflation. With inflation remaining persistently high, and labour market data stronger than expected once again, markets re-appraised their outlook for both peak and neutral rates, which in turn saw bond yields rise dramatically.
- US corporate bond markets performed relatively well against equivalent duration Treasuries, while in the eurozone corporate bond markets were broadly flat overall. In both markets, modest spread tightening and the additional carry in these markets offset most or all of the rise in underlying yields (depending on market).
- Equity markets held onto gains made earlier this year, with uncertainty around US debt ceiling issues failing to lead to any particular weakness in stock markets. The performance of 'growth' over 'value' stocks continued into the second quarter with the MSCI World Growth Index outperforming the MSCI World Value Index.

Regulatory update:

The regulatory environment for insurers continued to develop rapidly. Over the quarter:

Europe

- EIOPA (European Insurance and Occupational Pensions Authority) published its Risk Dashboard based on Q4 2022 Solvency II data. The analysis shows that insurers' exposures to macro and market risks are currently the main concern for EIOPA within the insurance sector.
- The European Commission adopted a Retail Investment Package, placing consumer interests at the centre of retail investing. Various measures are being introduced to achieve this around improved disclosures and reporting, a focus on value for money, improving financial literacy and protection from misleading marketing.
- The ESA proposed new ESG disclosures for Simple, Transparent and Standardised (STS) securitisations. The aim is to ensure consistency with the SFDR (Sustainable Finance Disclosure Regulation) regime for securities where the underlying exposures are residential loans, auto loans and leases.
- The ESAs (including EIOPA) published their Progress Reports on Greenwashing within the financial sector including banking, insurance and pensions and financial markets.
- EIOPA published its June 2023 Financial Stability Report which notes key developments and risks in the European insurance (and pension) sectors. It noted that the European economy is currently experiencing a new period of high uncertainty and elevated financial stability risk.

UK

- The PRA published a consultation paper on the proposed SUK regime. Overall, the proposed reforms in the paper are intended to result in a less cumbersome regime by streamlining existing processes, regulation and reporting.
- The ABI (Association of British Insurers) published a report on how the UK Government can increase investments into the UK economy through pension scheme savings, focusing on long term assets as well as reforms to existing fee regulations.
- ABI published a guide to help insurers assess the risk and opportunities to aid in creating a strategy for action concerning the decline in nature in the UK.
- The Bank of England launched its first System-Wide Exploratory Scenario exercise (SWES) to improve understanding of the possible actions of banks and non-bank financial institutions (NBFIs – including insurance companies) during stressed financial market conditions, and how those behaviours might interact to amplify shocks in UK financial markets that are core to UK financial stability.

International

- Finally, the International Sustainability Standards Board (ISSB) issued its inaugural standards on sustainability related disclosures for corporate reporting, IFRS S1 and IFRS S2. The Standards are intended to assist in improving trust and confidence in company disclosures around sustainability and help inform investment decisions.

We explore these areas in more detail, also highlighting what these could mean for insurers going forwards.

Insurance investment themes:

We set out two investment ideas and themes for insurers that we believe are well placed and relevant relative to the future economic and regulatory environment. For this quarter's publication we include:

- **Unconstrained Bonds:** Most fixed income strategies have struggled materially over 2022 with the significant increase in interest rates, government bond yields and credit spreads associated with the higher inflation position. We consider how unconstrained bond strategies can provide opportunities for investors wanting to manage their duration profile as well as take advantage of fixed income assets with fewer constraints around credit rating, maturity, geography and type.
- **Secured Credit**: Secured bonds are backed by collateral or specific assets providing an added layer of security for investors and provide a welcome diverse set of economic exposures with one critical commonality – a charge over assets. We discuss the benefits of secured credit and how this can be implemented in an insurance-aware manner.

Market update

	Yield (%)*		Total 3 month return*
	31 March 2023	30 June 2023	
Euro Treasuries†	3.00	3.21	0.39% (GBP) 0.05% (EUR)
UK Gilts†	3.70	4.46	-5.42% (GBP)
US Treasuries†	3.83	4.37	-1.58% (GBP) -1.94% (EUR)

	Spread (bps)*		Total 3 month return*
	31 March 2023	30 June 2023	
Global IG Corporates†	153	138	-0.22% (GBP) -0.59% (EUR)
Euro IG Corporates†	161	163	0.42% (EUR)
UK IG Corporates†	167	153	-3.39% (GBP)
Emerging Market Debt†	484	432	1.15% (GBP) 0.79% (EUR)
Global High Yield†	414	377	1.01% (GBP) 0.67% (EUR)

	Price index*		Total 3 month return*
	31 March 2023	30 June 2023	
Global Equities†	405.45	431.34	3.90% (GBP) 6.39% (EUR)
Euro Equities†	4315.05	4399.09	1.95% (EUR)
UK Equities†	4157.88	4096.26	-0.46% (GBP)
Emerging Market Equities†	436.64	438.72	-1.87% (GBP) 0.48% (EUR)

	Index*	
	31 March 2023	30 June 2023
Volatility†	18.70	13.59

*Source: Bloomberg, IHS Markit.

†See appendix for details on index used and returns quoted.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Overview

Central bank interest rate rises have been the story of the second quarter. For the major central banks of the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), after more than 12 months of tightening monetary policy, market attention has turned towards expectations of when and at what level rates will peak. In contrast to 2022, when all three were expected to continue hiking, the changing growth and inflation picture in the US, euro zone and UK means that expectations have become more differentiated.

Despite the emerging divergent paths of the major central banks, they continued their rate hiking route with the Fed, ECB and BoE all pushing rates higher in the quarter. The BoE increased rates the most, with increases of 0.25% and 0.50% in May and June respectively, while the ECB hiked 0.25% at its two meetings and continued to talk future rate rises. In contrast, after increasing rates by 0.25% in May, the Fed left rates unchanged in June. Despite market hopes that this may be the end of the tightening cycle, Fed officials pencilled in a further two interest rate increases over the coming quarters as well as revising up their expectations for inflation, citing a strong labour market and persistent ‘stickier’ core inflation.

Since the start of the current cycle the Fed has increased rates by 5% over the course of ten rises since March 2022. The BoE started the cycle at 0.1% but has moved rates higher 13 times since the end of 2021, now sitting at 5%, while the ECB on the other hand has only increased its main refinancing operation rate by eight times to 4%. The ECB also hiked rates in July and said that “inflation has been coming down but is projected to remain too high for too long”. For the BoE, inflation also means more increases are likely, with the market now pricing in a peak of 6-6.25%.

Government bonds

In the second quarter, macroeconomic data was the key driving force behind any shift in government bond markets. With inflation remaining persistently high, and labour market data stronger than expected once again, markets re-appraised their outlook for both peak and neutral rates, which in turn saw bond yields rise dramatically.

In the US, 10-year treasury yields rose to 3.84% from 3.47%, while in Germany the 10-year bund yield increased to 2.39% from 2.29%. Gilts delivered a -5.42% return (FTSE Actuaries) over the second quarter with the benchmark 10-year gilt yield rising 90 basis points to 4.39%.

Credit

US corporate bond markets performed relatively well against this backdrop, the ICE BofAML US Corporate Index returning -0.21%, while in the eurozone, the ICE BofAML Euro Corporate & Pfandbrief Index returned 0.42%. In both markets, modest spread tightening and the additional carry in these markets was sufficient to offset all or most of the rise in underlying risk-free yields. However, in the UK, the much larger jump in government yields meant that the sterling investment grade credit market (non-Gilt) returned -3.39% over the quarter.

Equities

Equity markets held onto gains made earlier on this year, with uncertainty around US debt ceiling issues failing to lead to any particular weakness in stock markets. Technology stocks have been particularly strong this year, with excitement around AI bringing a boost to sentiment. Japanese stocks have also been strong outperformers with better-than-expected growth data, solid domestic earnings and inflows from foreign investors helping the region.

In local currency terms, all major stock markets rose. For the second quarter, MSCI World and MSCI All Countries World Index (ACWI) produced positive returns for the quarter in US dollar, euro and sterling terms. Looking at national MSCI indices, the strongest market was Greece, while the weakest was China.

Within equity markets, the performance of 'growth' over 'value' stocks continued with the MSCI World Growth Index producing stronger returns than the MSCI World Value Index. This contrasts with the position in 2022 and at the start of 2023 when rising interest rates led to a significant rotation out of growth stocks and into value stocks.

Regulatory updates

1. Risk Dashboard shows macro and market risks as top concern for insurers

- EIOPA published its Risk Dashboard based on Q4 2022 Solvency II data. The analysis shows that insurers' exposures to macro and market risks are currently the main concern for EIOPA within the insurance sector.

On 15 May 2023, EIOPA published its Risk Dashboard based on Q4 2022 Solvency II data. The analysis shows that insurers' exposures to macro and market risks are currently the main concern for EIOPA within the insurance sector.

Key observations:

- Market risks remained high amid increased volatility in bond and equity markets. Insurers' relative exposure to bonds, equity and property nevertheless remains largely unchanged.
- Liquidity and funding risks increased. Insurers' cash and liquid asset holdings dropped in the last quarter of 2022.
- Profitability and solvency risks remain at medium level. Life insurers reported an increase in their SCR (Solvency Capital Requirement) ratio, while the same measure for non-life insurers experienced a slight decrease.
- ESG related risks remain at medium level. The median exposure toward climate relevant assets slightly increased to around 3% of total assets. The share of insurers' investment in green bonds relative to other total green bonds outstanding in the market decreased slightly compared to the previous quarter.

What does it mean for insurers?

EIOPA's analysis revealed that market risks remained the most significant risk for the overall insurance industry, likely driven by heightened market volatility, the inflationary and higher interest rate situation, and ongoing geopolitical risks. Insurers should ensure that their risk management frameworks and investment strategies are appropriately robust recognising this increased risk environment.

2. European Commission adopts Retail Investment Package

- The European Commission adopted a Retail Investment Package, placing consumer interests at the centre of retail investing. Various measures are being introduced to achieve this around improved disclosures and reporting, a focus on value for money, improving financial literacy and protection from misleading marketing.

On 24 May, the European Commission adopted a Retail Investment Package that looks to place the consumer interests at the centre of retail investing. The aim is to empower retail investors to make investment decisions that are aligned with their needs and preferences, ensuring that they are treated fairly and duly protected and enhance retail investors' trust and confidence around investments. Various measures are being introduced to achieve this around improved disclosures and reporting, a focus on value for money, improving financial literacy and protection from misleading marketing.

The package also looks to encourage participation in EU capital markets, which has traditionally been lower than in other jurisdictions, such as the United States – even though Europeans have very high savings rates.

The changes are wide-ranging and detailed, and are being implemented via an amending Directive, which revises the existing rules set out in various pieces of existing legislation including MiFID II, the Insurance Distribution Directive (IDD), the UCITS Directive, the Alternative Investment Fund Managers Directive (AIFMD), Solvency II, and the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation.

The European insurance industry was quick to provide feedback on the package – whilst bodies were generally supportive of the European Commission's stated high level goal of increasing consumers' trust in financial services and encouraging their participation in capital markets, material concerns were registered around the detail. On 25 May, Insurance Europe raised its concerns that the overall impact of the many new requirements will make consumers' investment journey longer, more complicated and more intimidating than before. This was followed up on 7 June by a combined statement from Insurance Europe and seven associations representing the financial services industry registering further concerns.

What does this mean for insurers?

Whilst there is general support for the overall objectives of the European Commission in this area from industry, there was significant criticism around the detail. Insurers who are providing investment products impacted by the package will need to continue paying close attention to the detail of this as it further emerges, and it will be interesting to see how the Commission recognises and reflects the feedback received.

This process is expected to take at least a year and could be impacted by the European Parliament elections due in June 2024. The package also includes provisions for the ESAs to produce delegated acts setting out further detail which will also need to be reviewed in due course.

3. ESAs propose ESG disclosures for STS securitisations

- The ESA proposed new ESG disclosures for Simple, Transparent and Standardised (STS) securitisations. The aim is to ensure consistency with the SFDR regime for securities where the underlying exposures are residential loans, auto loans and leases.

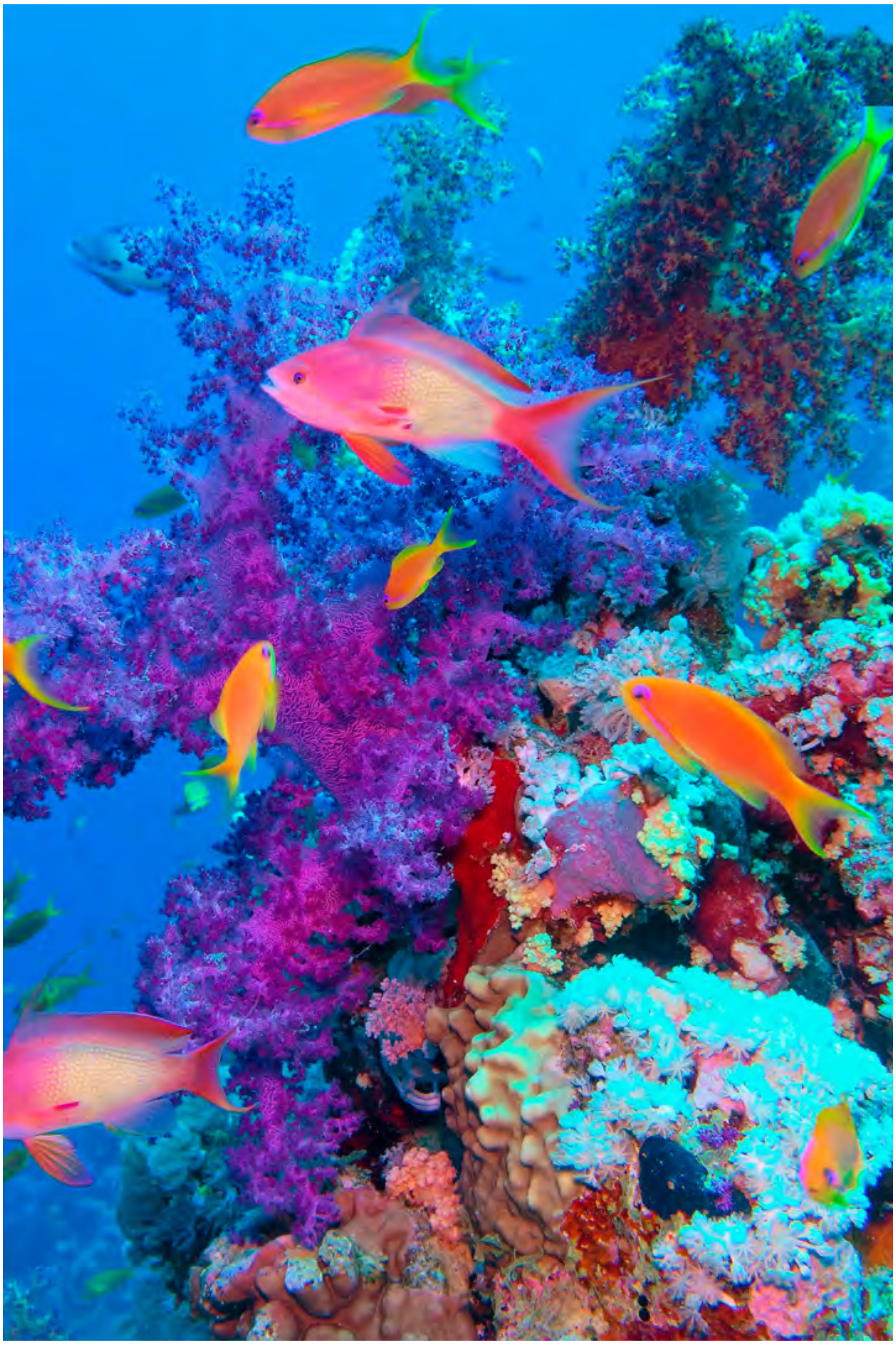
On 25 May 2023 the European Supervisory Authorities (EBA, EIOPA and ESMA – ESAs) jointly submitted to the European Commission Draft Regulatory Technical Standards (RTS) on the ESG impact disclosure for Simple, Transparent and Standardised (STS) securitisations under the Securitisation Regulation. This followed on from a May 2022 consultation paper from the ESAs regarding the content, methodologies, and presentation of disclosures for STS securitisations. The final draft standards aim to help market participants make informed decisions about the sustainability impact of their investments.

The key proposals included within the standards specify ESG disclosures which would apply to STS securitisations where the underlying exposures are residential loans, auto loans and leases. The aim is to ensure consistency with those developed under the Sustainable Finance Disclosure Regulation (SFDR) which distinguish between the publication of available information on mandatory indicators (e.g. energy efficiency) and on additional indicators (e.g. emissions).

Following the submission of these RTS, the European Commission is expected to endorse the RTS within three months of their publication

What does this mean for insurers?

The European insurance sector has a low proportionate allocation to securitisations within investment portfolios – even to STS securitisations that are treated relatively more favourably under the Solvency II Standard Formula than other securitisations. Given the direction of travel for insurers to focus more on ESG criteria within their investments and being able to report robustly on this, a further impediment to investing in securitisations has been the increased difficulty of reporting on ESG risks. The RTS should be useful to improve the disclosure framework, although this only applies for a subset of overall securitisations. Consistency with the SFDR disclosure framework is also likely to be viewed favourably given the increasing disclosure requirements applying to insurers' assets.



4. ESAs put forward common understanding of greenwashing and warn on risks

- The ESAs (including EIOPA) published their Progress Reports on Greenwashing within the financial sector including banking, insurance and pensions and financial markets.

On 1 June 2023, the ESAs (including EIOPA) published their Progress Reports on Greenwashing within the financial sector including banking, insurance and pensions and financial markets, as requested by the European Commission.

Within EIOPA's Progress Report, it noted that greenwashing can occur, to varying extents, as part of the broader set of conduct risks at all stages of the insurance lifecyle (e.g. entity level, product manufacturing, delivery and management).

The report presented concrete examples to show how greenwashing manifests itself in practice.

EIOPA has started to integrate greenwashing into its supervisory activities. However, it (and other European associations impacted by the package) clearly have concerns around the more detailed implementation. EIOPA will further refine its view on the definition of greenwashing, its impacts and risks (particularly on potential financial stability risk implications), as well as on how greenwashing can occur in the insurance lifecycle.

The ESAs will publish final greenwashing reports in May 2024 and will consider final recommendations, including on possible changes to the EU regulatory framework.

What does this mean for insurers?

The risks of greenwashing can manifest itself in two ways for insurers – as consumers of products potentially subject to greenwashing such as the investment funds and underlying assets it invests in, and also potentially in the products it produces for its clients (e.g. a life insurer providing an investment-related insurance policy).

If greenwashing isn't effectively mitigated it can have a substantial impact on both providers of insurance and their end consumers. Given the prominence of greenwashing as a key risk and the wider public prominence that this has, insurers should ensure that they remain on top of the requirements if both writing products potentially subject to this as well as ensuring that the assets they are investing in are not subject to greenwashing, by appropriately challenging their underlying managers.

5. European insurers and pension funds hold up well despite elevated financial stability risk

- EIOPA published its June 2023 Financial Stability Report which notes key developments and risks in the European insurance (and pension) sectors. It noted that the European economy is currently experiencing a new period of high uncertainty and elevated financial stability risk.

On 22 June 2023 EIOPA published its June 2023 Financial Stability Report which notes key developments and risks in the European insurance (and pension) sectors. It noted that the European economy is currently experiencing a new period of high uncertainty and elevated financial stability risk. Despite this challenging environment, insurers and pension funds have remained resilient.

Some of the key conclusions from the Report included:

- European insurers entered 2023 with robust solvency positions even in the face of various headwinds including sizeable natural catastrophe losses, weaker investment returns and higher-than-expected inflation.
- The switch from a low yield environment to an inflationary regime with higher interest rates has brought various new challenges and opportunities for insurers.
- Fixed income assets remain the dominant category for insurers, although the share of government and corporate bonds in their investment portfolios declined through market movements and insurers being net sellers of corporate bonds and government bonds to reduce interest rate sensitivities.
- The allocation to alternative assets has grown in the past years, with alternative-like funds having represented 5.6% of total investments in 2022 compared to 3.3% five years ago.
- The insurance sector was connected to the banking sector through investment exposures which represented 13% of total investments at the end of 2022.
- The Gilt crisis in the UK last year illustrated the risks associated with more liability-driven investment strategies.

What does this mean for insurers?

The report was mainly positive in concluding that, despite the various challenges that emerged over 2022, the insurance sector remained resilient. Some of the key themes emerging from an investment perspective included the higher interest rate and inflation environment, the ongoing issues around the banking sector and the continuing trend to more alternative assets. Insurers should continue to ensure that their investment approach and wider business model is able to react to these developments accordingly.

1. PRA Consultation Paper on Solvency UK (SUK) Framework

- The PRA published a consultation paper on the proposed SUK regime. Overall, the proposed reforms in the paper are intended to result in a less cumbersome regime by streamlining existing processes, regulation and reporting.

On 29 June 2023, the Prudential Regulation Authority (PRA) published a consultation paper which outlined a major set of reforms to the existing Solvency II regime with the aim of establishing the Solvency UK (SUK) regime, tailored to the UK insurance market. The objectives of the proposed reforms are to foster:

- a competitive insurance sector.
- investment to support growth.
- policy holder protection.

The proposals target a material reduction in the administrative and reporting requirements, decreasing costs and complexity whilst also maintaining strong prudential standards.

The proposed reforms in the consultation paper are as follows:

Simplifications

Transitional Measure on Technical Provisions (TMTP) reforms – simplifications to the calculation of the TMTP. Reducing costs (inclusive of costs pertaining to the retention of legacy Solvency I models) and complexity for firms.

Streamlining reporting requirements – by increasing proportionality and reducing complexity, these proposals are expected to reduce costs in the medium term, also having accounted for implementation costs and minimal newly proposed reporting.

Improved flexibility

Streamlined rules for Internal Models (IM) – a shift in focus from the current extensive prescriptive requirements to a smaller number of principle-based requirements. This is expected to lead to greater flexibility and a more dynamic approach to model approval. Under the new regime, instead of rejecting IMs that have residual limitations the PRA proposes two new safeguards which will facilitate the granting of model permissions: a residual capital add on tool, and model-use requirements.

Increased flexibility in the calculation of group solvency requirements – providing more flexibility in the development of group IMs, facilitating a better reflection of the groups underlying risks.

Increased proportionality – increasing the size threshold at which small insurers are required to enter the Solvency UK regime. This will benefit smaller insurers that are close to the existing current threshold, presently or in the future. The primary beneficiaries are expected to be mutual insurers who currently make up more than half of the firms near the threshold.

Encouraging entry

International competition – removing some requirements (e.g. around branch capital requirements and the risk margin) for branches of international insurers operating within the UK, encouraging entry and/or expansion into the UK, all while increasing the competitiveness of the UK market.

Mobilisation regime – the PRA would offer new insurers an additional period of time where they can build up their systems and recourses, under business restrictions and proportionate regulations. This would enable the PRA to reduce the minimum capital requirements applied during this period.

The PRA will consult on the new SUK reforms in two tranches:

1). In the current consultation paper, and

2). In a second consultation paper intended for September 2023, focusing on reform proposals for the life insurance industry covering: investment flexibility, matching adjustments, new attestation requirements and changes to calculations and reporting.

For the first paper, there is a two month consultation period for the majority of the proposals; however the final chapter (covering "administrative amendments to PRA rules") has only a one month consultation period.

What does it mean for insurers?

This is a significant overhaul of the regulatory regime governing the UK insurance industry and has wide reaching impacts across the industry. Overall, the proposed reforms are expected to result in a less cumbersome regime by streamlining existing processes, regulation and reporting. Whilst there will be some implementation compliance costs, there should be significant operational savings for insurers in the medium and long term with the streamlining of various regulation and reporting requirements.

Insurers should pay close attention to the consultation to understand how the proposed changes might impact them specifically (e.g. around reporting requirements or the regulatory threshold for smaller insurers).

The main body of reforms expected to have the most impact on the investment approach (particularly for life insurers) is still to come in September 2023 through revisions to the Matching Adjustment, Risk Margin and wider investment flexibility.

2. Increasing investment and protecting savers

- The ABI published a report on how the UK Government can increase investments into the UK economy through pension scheme savings, focusing on long term assets as well as reforms to existing fee regulations.

The Association of British Insurers (ABI) in July 2023 published the report 'Investing in our Future: Delivering for Savers and the Economy'. This report outlined how the ABI anticipates the government can increase investments into the UK economy, particularly in assets aligning with its broader policy objectives – namely long-term and less liquid assets such as private equity and infrastructure, all while maintaining high levels of protection for savers.

Key proposals include:

- Building on the Long-Term Investment for Technology and Science (LIFTS) initiative to support the growth and ambitions of the UK's most innovative science and technology companies.
- Shifting the focus from fees to value for money, enabling DC schemes to invest across a broader range of assets, supporting government policy to increase investment in UK infrastructure.
- Encourage investments through incentives and regulation – revising existing regulation to remove barriers to investing in illiquid assets including through long-term asset funds.

In general, there is support for further pooling of assets, be that through consolidation of pension fund assets or other pooling initiatives between the government and pension schemes.

What does it mean for insurers?

A subset of the UK insurance market has a direct interest in this initiative, being life insurers offering pension products or products that support pension scheme investments. As such, these insurers should pay close attention to developments in this area as this may present both risks to existing business and opportunities.

More broadly, the UK government has a stated intention to facilitate increased investment in UK assets and companies from individual and institutional investors and is looking to amend various pieces of legislation to achieve this in the post-Brexit environment. In addition to the pension scheme initiative detailed here, we await further clarification from the UK government around how the UK insurance industry should support this, and insurers more generally should monitor developments in this area.

3. ABI guide to aid insurers tackling the decline in nature

- ABI published a guide to help insurers assess the risk and opportunities to aid in creating a strategy for action concerning the decline in nature in the UK.

It is well understood within the insurance industry the risks that climate change and the reduction in biodiversity entail. Nature loss exposes homes and businesses to a range of physical risks. Additionally, there are well established links between physical and mental health with healthy ecosystems potentially impacting the well-being of life and health insurance policy holders. The guide noted the direct links between net zero and nature, but also recognised that protecting nature was different, being more location-specific, more complex to measure and involving a range of sometimes competing interests.

Recognising the risks and impacts on the insurance industry, the ABI published a guide to help insurers assess the risk and opportunities to aid in developing strategies to mitigate a decline in nature. This included:

1. Identifying external organisations, tools and best practices
2. Developing a heatmap to estimate impacts and identify key focus areas
3. Lessons learned from early movers
4. Setting up internal working groups

From an investment perspective, some of the key risks stated included the potential for stranded assets, increased investment return volatility, credit rating downgrades, a reduced pool of investment grade assets and reduced business investment appetites.

The ABI also provided an update to their Climate Change Roadmap, where 84% of participating insurers have already set targets and begun to develop transition plans.

What does it mean for insurers?

The insurance industry has a proportionately high exposure to the various risks associated with climate change and biodiversity loss. As such, there is a direct incentive for insurers to do what they can to mitigate the associated risks. The ABI guide noted various actions insurers could take around their investments, including scaling up investment in nature-positive businesses or projects alongside targets to reduce nature-damaging activities, investing in sustainable or green bonds, and reviewing net zero targets and transition plans for biodiversity impact. Insurers should review the appropriateness of these areas in line with their broader sustainability policies.

4. BoE System-Wide Exploratory Scenario Exercise

- The BoE launched its first System-Wide Exploratory Scenario exercise (SWES). The purpose of the SWES is to improve understanding of the possible actions of banks and non-bank financial institutions (NBFIs – including insurance companies) during stressed financial market conditions, and how those behaviours might interact to amplify shocks in UK financial markets that are core to UK financial stability.

On 19 June the Bank of England (BoE) launched its first System-Wide Exploratory Scenario exercise (SWES). Participating firms include larger banks, insurers, central counterparties and a variety of investment funds.

The purpose of the SWES is twofold:

1. Enhance understanding of risks to and from non-bank financial institutions (NBFI), as well as the behaviour of NBFIs and banks during stress, including the driving factors for said behaviours.
2. Investigate how behaviour and market dynamics can amplify shocks in markets, posing a risk to UK financial stability.

The exercise focuses on how the actions of individual firms can correlate and interact to exacerbate shocks, and the impact this has on specific markets of focus including markets in gilts, gilt repos, sterling corporate bonds and associated derivatives. The exercise has a system-wide focus and as such is not testing the resilience of individual firms.

The scope of the exercise will focus on the actions of individual firms. For example, if a common action in response to the scenario is to sell off the same asset, then a fire-sale dynamic occurs, which can only be understood from considering a system-wide perspective. Additionally, the BoE also has an interest in how firms may act to stabilise markets.

The SWES exercise has been designed with two rounds. In the first round, participants will model the impact and intended subsequent actions to a shock. The BoE will then consider how these actions may interact with the shock. In the second round, the BoE proposes an updated scenario accounting for potential amplification effects and how they might cause institutions to act differently.

The BoE is expected to publish its results from the SWES exercise in 2024. This will include system-wide (including sectoral) aggregate findings, implications for the markets of focus, and an assessment of risks to broader UK financial stability.

What does it mean for insurers?

The larger insurers ‘in scope’ for the SWES should prepare to engage robustly in the exercise including through data, modelling and BoE feedback. For the wider insurance industry in the UK, the calibration of the stresses may provide useful inputs to existing stress testing frameworks.

There may be direct implications from the exercise for the regulation of insurers’ assets going forwards, if the exercise reveals excessive risks attached to certain types of asset. For example, the PRA has previously communicated systemic risks around insurers investing in less liquid assets allowing for management actions taken in a stress situation.

International

1. ISSB issues first sustainability disclosure standards

- The International Sustainability Standards Board (ISSB) issued its inaugural standards on sustainability related disclosures for corporate reporting, IFRS S1 and IFRS S2. The Standards are intended to assist in improving trust and confidence in company disclosures around sustainability and help inform investment decisions.

On 26 June 2023, the International Sustainability Standards Board (ISSB) issued its inaugural standards on sustainability related disclosures for corporate reporting, IFRS S1 and IFRS S2. The Standards are intended to assist in improving trust and confidence in company disclosures around sustainability and help inform investment decisions. Both standards incorporate the recommendations of the Task Force on Climate-Related Financial Disclosures.

IFRS S1: General requirements for disclosure of sustainability-related financial information which sets out the general reporting requirements for sustainability-related financial information.

It requires an entity to disclose material information about the sustainability-related risks and opportunities to which it is exposed, including information about the entity's:

- Governance
- Strategy
- Risk management, and
- Metrics and targets.

IFRS S2: Climate-related disclosures, designed to be used alongside IFRS S1 and requires an entity to disclose certain information about its governance, strategy, risk management, and metrics and targets in respect of climate-related risks and opportunities. This includes information about physical risks, such as extreme weather events, as well as transition risks, for example changes in customer behaviour.

The ISSB Standards are designed to ensure that companies provide sustainability-related information alongside financial statements—in the same reporting package. The Standards have been developed to be used in conjunction with any accounting requirements.

On a related point, it has been confirmed that the IFRS Foundation, which oversees the International Sustainability Standards Board (ISSB), will take over the monitoring of companies' progress on climate-related disclosures from the TCFD going forwards.

What does this mean for insurers?

The ISSB standards are a welcome development to improve the detail, coverage, and quality of sustainability-related disclosures – particularly around climate change. Many insurers are likely to be subject to the standards as corporate entities (although the applicability and timescales for this will vary between geographies) and should prepare to provide the required information.

From an asset perspective, the disclosures will improve the quality of sustainability information for insurers for their underlying investments and hence improve transparency, understanding, reporting and generally facilitate more robust investment decision-making around sustainability objectives. The ISSB taking on the monitoring responsibilities of the TCFD is also a logical next step.

Insurance investment themes

1. Adopting a more unconstrained bond strategy

Many insurers effectively adopt a 'barbell' approach to investments, investing in government bonds and high-quality corporate bonds at one end of the spectrum, but balanced by some allocation to riskier assets such as equities and property at the other. This approach can miss opportunities with a risk profile in-between, such as more unconstrained fixed income strategies, that can enhance the overall risk-adjusted return potential of the overall investments and capital efficiency, through:

- Improving diversification of sources of return, asset classes, geographies, credit exposures and counterparties
- Accessing more niche investment opportunities that may not be part of the universe associated with current investments
- Dynamically managing credit (and other) risks through a more involved active management framework

In addition to the strategic case for using such a bond strategy, there are shorter term, more tactical reasons for considering this. The path of future interest rate rises is still highly uncertain, as is the extent to which higher interest rates will tip various economies into recession (increasing overall credit risks). In addition, various wider risks persist such as further escalation of the Ukraine conflict. A more nimble and less constrained approach has intuitive appeal under such an environment, if implemented efficiently.

Due to these factors, we believe unconstrained bond strategies may have merits for many insurers.

Designing a robust unconstrained approach

There is no one single definition of what an 'unconstrained bond strategy' looks like. However, there are several common themes:

The implementation of such strategies tends to still involve investing at the more liquid end of the credit markets, as compared with private credit where the focus is more on illiquidity premia to generate outperformance.

Benchmark agnostic

- Less anchoring to specific benchmark or indicies
- Allows managers to take advantage of various market opportunities
- Adapts to changing eceonomic conditions

Credit rating flexibility

- More flexibility to invest across the credit spectrum
- ...including investment grade, high yeld and unrated bonds...
- .. whilst still focusing on managing underlying credit risks and generating superior returns

Wide investment universe

- Lower need to align to particular sectors, geographies, issuers, etc.
- Provides access to wider pool of issuers to facilitate diversification and wider opportunities

Active managemnt

- Tend to be managed highly actively given the reduced constraints applying
- Enables nimbler reaction to opportunities emerging...
- ...and also in managing downside risks

How might this look in practice?

Within Royal London Asset Management, we have been successfully running an unconstrained bond strategy - the Global Bond Opportunities strategy since 2015. This strategy aims to achieve a high level of income with the opportunity for capital growth by seeking attractive investments that span a broad range of fixed income opportunities.

The key features of the Global Bond Opportunities strategy are:

- **Diversified exposure:** invests across a broad range of fixed interest securities across the credit spectrum and global universe, with typically around 180 holdings.
- **Strong income generation:** targets bonds which offer an attractive yield with the aim of maximising income, without taking on the degree of risk associated with high yield bond funds.
- **Shorter duration:** The average duration of the strategy is relatively short to mitigate material changes in interest rate expectations, and the duration is managed on a regular basis using interest rate and bond futures.
- **Unconstrained approach:** seeks attractive investments across a broad spectrum of fixed income opportunities and currencies. Aims is to exploit credit market inefficiencies and seek bonds that offer the best returns on a risk adjusted basis whilst mitigating stock specific risk.
- **Integrated credit and ESG framework:** security selection considers credit analysis, bond documentation, capital structure analysis and ESG assessment holistically.
- **Focus on security:** Targeted analysis of structure and covenants to provide enhanced downside protection.

This results in the more detailed strategy profile summarised in figure 1:

Figure 1: Strategy profile

Stratagy facts	
Yield to maturity	7.81%
No. of holdings	169
Duration (years)	3.9%

Credit rating positioning	(%)
AAA/A/BBB	37.6
BB and below	39.8
Unrated	23.6

Maturity profile	(%)
0-5 years	58.16
5-10 years	18.88
10-15 years	3.21
15+ years	19.75

Sector positioning	(%)
General Industrials	24.1
Banks & Financial Services	23.6
Insurance	21.2
Utility	9.2
Telecommunications	5.7
Structured	4.2
Real Estate	3.9
Consumer Goods	3.6
Consumer Services	2.5%
Sovereigns	1.9

Currency profile	(%)
USD	52.6
EUR	22.5
GBP	21.7
NOK	3.2
SEK	0.0

Past performance is not a guide to future performance. Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation. For information purposes only. Gross redemption yield is the rate of discount at which a bond's future obligations of interest and capital payments equates to its current price. The gross redemption yield shown for the strategy is the average for its individual holdings, weighted by their currecnt value, net of relevant strategy management costs and gross of tax.

Source: RLAM as at 30 June 2023. exchange rate US$1.2707 - £1 as at 30 June 2023. Subject to rounding.

Delivering benefits from a more unconstrained approach

Whilst the drivers for a less constrained approach sounds attractive in principle, it is useful to see whether such strategies have been successful in practice. To review this, we compare in the chart (figure 2) the historical performance of our Global Bond Opportunities strategy against different fixed income benchmark indices and over assorted time periods. As can be seen, the Global Bond Opportunities strategy has outperformed all of these benchmarks over the longer term, and also produced overall positive returns over these periods in an environment where fixed income investing over recent years has been highly challenging.

Figure 2: RL Global Bond opportunities (GLOBO) vs market indices - to 30 June 2023

Source: RLAM and Barclays Bloomberg as at 30 June 2023.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

For many insurers we believe that there is merit in exploring more unconstrained fixed income strategies as a complement to existing assets to improve overall financial and capital efficiency.

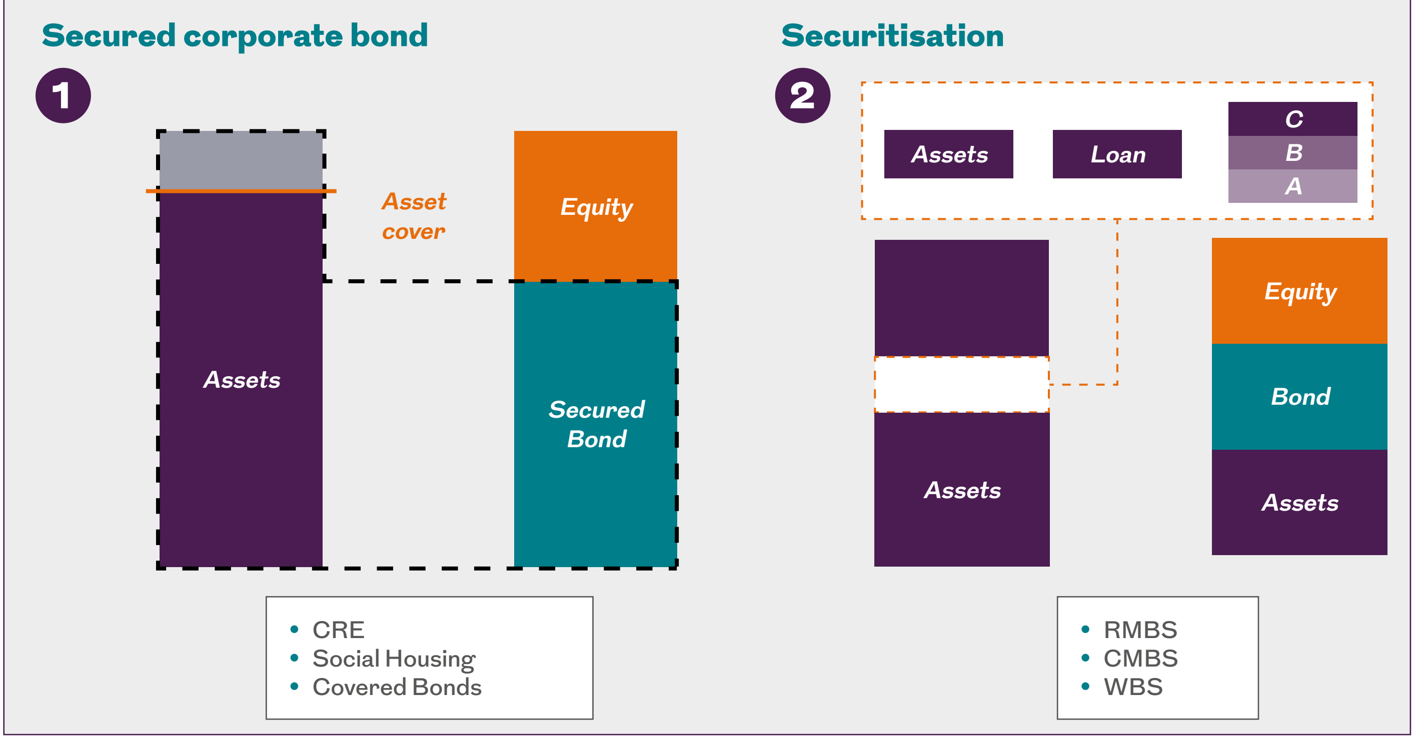
2. Secured Credit – remaining underappreciated and undervalued?

Insurance companies globally remain significant investors in credit bonds to match liabilities and provide for superior returns from the credit spreads available above government bonds. In general, these portfolios tend to focus more on mainstream corporate bonds to simplify governance and credit research needs. However, in many cases this means insurers are missing out on the full potential of investing in secured bonds, which still represent a small proportion of the overall credit universe.

Secured bonds are those backed by collateral or specific assets providing an added layer of security for investors. These represent a welcome diverse set of economic exposures with one critical commonality – a charge over assets.

We have been investing in secured corporate bonds (1 in figure 3) for over thirty years across a wide range of asset-rich sectors including infrastructure, social housing, investment trusts and commercial real estate (CRE) and an extremely granular range of issuers. From this heritage, post the Global Financial Crisis, we extended our reach into the securitisation market (2 in figure 3) by investing selectively across Residential Mortgage-Backed Securities (RMBS), Commercial Mortgage-Backed Securities (CMBS) and other Asset Backed Securities (ABS).

Figure 3: An evolution of lending structure.



Source: RLAM, for illustrative purposes only.
Whilst the origin of secured lending was initially in the unrated market, at a time when investors favoured security over credit ratings, there has been a big shift. Now, most secured bonds are publicly listed and rated by one of the major agencies (S&P, Moody's, and Fitch).

Secured credit – initial and ongoing benefits

Security is a key credit enhancement, providing tangible backing to enhance bond recovery should a company default. However, its true value is more nuanced. By investing in bonds with the right type of security, both in terms of legal enforceability and appropriateness of collateral, dovetailing with protective covenants such as early triggers that require issuers to supplement collateral pools as values fall, more dynamic protection can be injected into credit portfolios. In an increasingly uncertain world, in an asset class with asymmetric risk and return profiles, the enhanced control from secured lending is hugely beneficial.

In addition to lending well at the outset of an investment, the ability to have increased control on an ongoing basis with more pre-emptive control is also beneficial. This can help to dampen the impact of unforeseen risks (e.g. ESG risks such as poor governance, latent environmental liabilities). In addition, borrowers are required to negotiate early if performance deteriorates, or they require amendments to restrictive bond terms. Therefore, on an ad hoc but not infrequent basis, bonds are redeemed early at prices above market levels to remove these borrowing restrictions. Most typically this is due to the borrower believing they can finance more efficiently in unsecured form or post M&A, where covenants prevent the new owners of the borrower executing a leveraging strategy. Another underappreciated characteristic.

Buying secured bonds is not a free ride. The analysis cannot be delegated and gaps in third party ESG data must be plugged. Each bond is unique, whether due to the underlying assets or cashflows or different covenant packages and issuing structures. Accordingly, secured bond documentation is more complex and comprehensive than that for unsecured bonds; this is a good thing for investors or managers where capabilities exist. What is more, as security and covenants are permanent over the life of the bond, the extra effort required to fully understand the investment is efficient.

In addition, from an insurance company perspective, for insurers using the Standard Formula under either SUK or Solvency II the Solvency Capital Requirement can vary materially depending on the exact type of secured credit (e.g. non-STS securitisations are treated very penally). The secured credit that we typically use within our strategies is generally SCR-efficient viewed through this lens, but care needs to be taken around security selection if the SCR position is a big constraint.

The ultimate attraction of secured bonds is that enhancements remain under-appreciated and undervalued in a market that primarily focuses on unsecured finance. Rating agency methodologies perpetuate this inefficiency by concentrating on probability of default. Effectively, rating agencies, as the largest arbiters of credit risk in the economy and embedded in control and regulatory frameworks across the globe, are telling investors that bond recovery post default is an incidental issue, so it is no wonder fundamental protections, such as security and covenants, are often overlooked.

Exploiting market efficiencies

We think it can seem remarkable that name recognition can count for more than a tangible claim on assets. How else can we explain a market that accepts a lower credit spread for unsecured lending to the UK retailer, Next plc, than it does for secured lending to Sainsbury's. Issued as Longstone Finance, rather than Sainsbury's and lacking name familiarity, we feel the belt and braces protection of Sainsbury's cash flow generation, full amortisation of the bond removing bullet refinancing risk and ring-fenced collateral worth over ten times the value of the money we have lent is under appreciated – even before the added attraction of a higher credit spread than Next. See figure 4:

Figure 4: Market inefficiencies – name recognition

	Next **Next plc** **£250m 3.5% 2026**	Sainsbury's **Longstone Finance** **£542.5m 4.791% 2030**
Rating	BBB	AAA
Benchmark	Yes	Yes
Security	Unsecured	First fixed charge on property
Asset cover	n/a	>10x
Refinance	Bullet risk	Fully amortising
Spread	**1.0%**	**1.4%**

Portfolio characteristics and holdings are subject to change without notice. This does not constitute an investment recommendation
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Source: RLAM, Bloomberg as at 31 May 2023.

Lending with control in an uncertain world

With money increasingly diverted to more mainstream (and typically unsecured) investment grade corporate bonds as a standardised building block for portfolios, the opportunity to create better credit portfolios by embracing the idiosyncrasy of bonds will persist. Efficiently structured secured lending has always been a feature of a differentiated credit approach and the more the wider market commoditises, the more opportunities this provides for skilled asset managers to unearth quirks and the nuances of corporate bonds that can make a fundamental difference to portfolio risk and return.

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both strategy losses and gains. The impact to the strategy can be greater where they are used in an extensive or complex manner, where the strategy could lose significantly more than the amount invested in derivatives.

EPM techniques: The strategy may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the strategy to increased price volatility.

Exchange rate risk: Changes in currency exchange rates may affect the value of investments.

Interest rate risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity risk: In difficult market conditions the value of certain strategy investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the fund to financial loss.

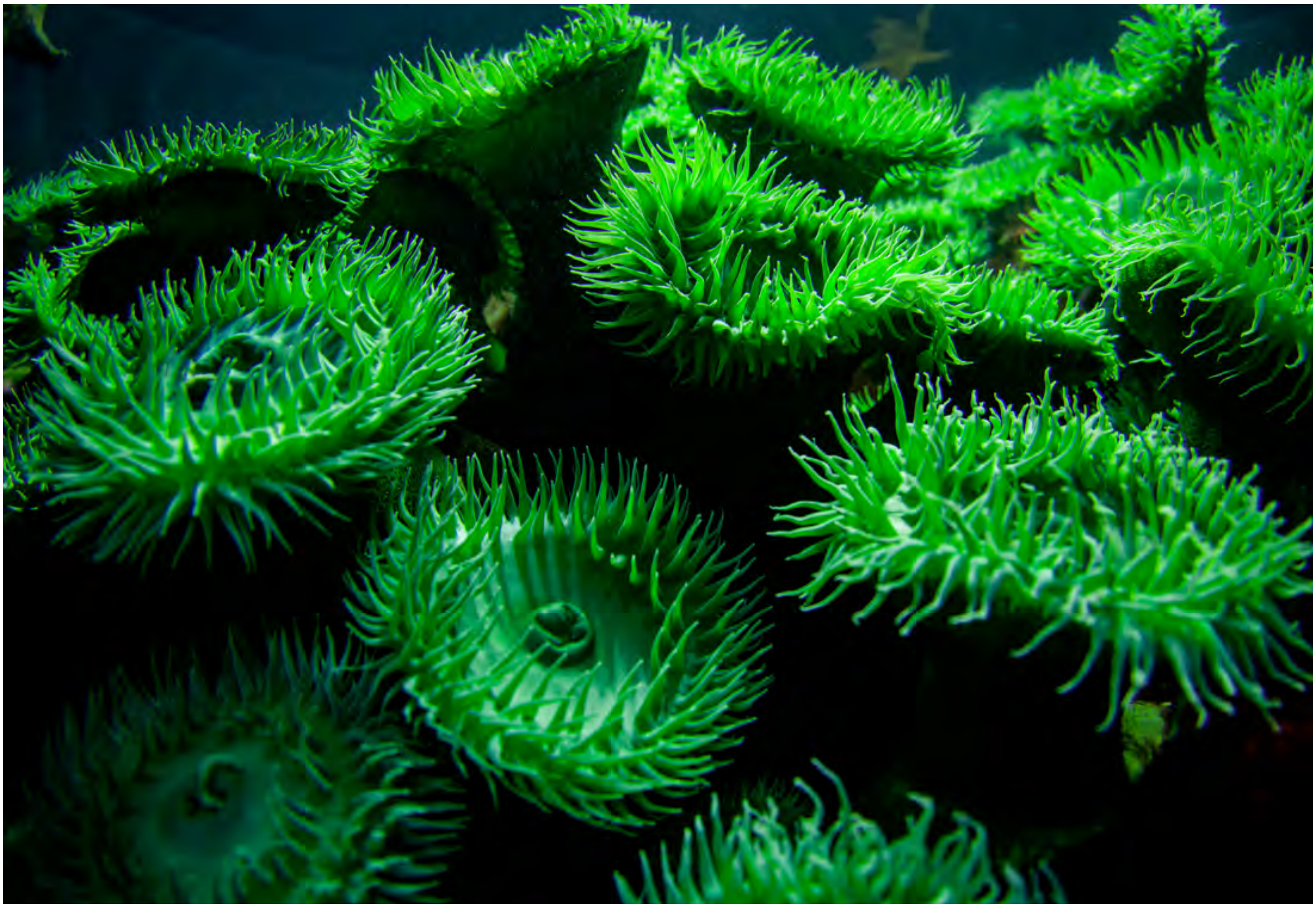
Appendix

Fixed income	Index used	Returns quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged

Equities	Index used	Returns quoted
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged

Volatility	Index used
Volatility	Cboe Volatility Index (VIX)

Source: Bloomberg, HIS Markit



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114943 08 2023