BEST'S REVIEW
www.bestreview.com April 2016

Asset Management

THE ETF ALTERNATIVE

Insurers are increasing investments in exchange traded funds for both tactical and strategic purposes, but just how long will this growth last?

by Angelo John Lewis

Now that exchange traded funds enjoy a significant presence in the variable annuity industry—where Prudential, MetLife and others are using them as subaccount options—they're being eyed by insurance companies as potential components of general account portfolios, alongside conventional investments such as bonds, stocks and real estate.

Opinions are mixed as to whether ETFs—funds that hold a bucket of assets such as stocks, commodities or bonds and frequently track an index—will remain niche market access vehicles, or if they will grow to significantly influence standard industry investment practices.

> **Key Points**
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> **Current Landscape:** Exchange traded funds comprise a small portion of insurers' investment portfolios.
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> **Regulatory Issues:** The NAIC decision to change ratings of some ETFs from equities to bonds has increased insurer incentives to invest in them.
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> **The Future:** Although ETF usage will likely grow, few observers expect these market access instruments to significantly disrupt traditional insurer investment practices.

"The insurance market is seen by some as potentially one of the biggest untapped opportunities for ETFs," acknowledged PricewaterhouseCoopers in a recent report of the $2.6 trillion industry. "ETFs have not yet penetrated very deeply into this massive pool of assets, but opportunities abound for their use, not only as building blocks in packaged products, but also as assets on insurers' balance sheets."

Still, there are significant obstacles for expansion, such as the relative newness of the sector and the higher capital charges for the majority of funds. For now, experts say, ETFs remain a very small part of insurers' investments.

"Insurers … are more likely to use passive

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investment for traditional asset classes or core allocations," said Doug Earney, director of fixed income for Miles Capital, a Midwest-based insurance asset management firm. "We do see usage picking up for insurance companies, but we see it more often as an ancillary allocation as opposed to a primary allocation for most insurers."

One often-cited reason for the lack of enthusiasm within the insurance industry is the high risk-based capital charges.

"The problem is that the ETF structure has the same issues as when an insurance company buys a mutual fund," said John Simone, senior vice president and head of insurance investment management sales and solutions, institutional, of Voya Investment Management. "It's treated like an equity. The folks who have been successful have been those who have gotten some kind of bond-like rating for their ETF."

NAIC Response

The National Association of Insurance Commissioners addressed this very issue in 2012, when it changed the risk-based capital designation of some ETFs from stocks to bonds. The change meant a substantial reduction in the amount of reserves insurers needed to cover asset risks, thereby increasing insurers' incentives to invest in the sector.

This sparked a substantial uptick in insurer ETF investments. Sensing a marketing opportunity, some of the major ETF providers—BlackRock (iShares), State Street Global Advisors, Pimco—applied and received NAIC eligibility for their funds to be registered as Schedule D bonds. As of December 2015, approximately 150 ETFs had received this designation, though that is still a small fraction of the more than 5,600 ETFs currently in existence.

"When you suddenly are able to put an NAIC designation 1-through-6 on the fixed income ETF, just as they would a single J.P. Morgan bond, that is very beneficial to the way insurers use them accounting-wise within their general account portfolios," said Steve Mickle, director of ETF trading solutions for the New York-based WallachBeth Capital.

For example, a life insurer would need 30 cents of capital to back the risk of owning a dollar of an ETF categorized as common stock, but only 0.4 cents to back one dollar of an ETF rated as NAIC 1.

"When you purchase an ETF, you get the market exposure as defined by that fund's parameter or index, whether or not that's a particularly good fit for the insurance company's needs."

Doug Earney
Miles Capital

But ETFs are advantageous for insurers for reasons that go beyond their regulatory designation, according to Raman Suri, managing director and head of iShares Insurance for BlackRock. "The structure of an ETF and its exchange-traded nature combine to provide investors with lower risk and costs, and higher liquidity and investment strategy flexibility," Suri said. "And while catering to large companies seeking diversified, cost-efficient exposure, the industry continues to develop more focused ETFs that help smaller-to medium-sized insurers without separate account managers or the required in-house expertise to allocate toward a more specific asset class or switch easily to meet revised investment objectives."

The Other Side

Earney, of Miles Capital, is less bullish about these instruments and believes there are several disadvantages to investing in them.

"The primary one is really the lack of ability to customize," Earney said. "When you purchase an ETF, you get the market exposure as defined by that fund's parameter or index, whether or not that's a particularly good fit for the insurance company's needs. Another component is that you lose the ability to manage gains and losses or duration or asset liability positioning as effectively as individual securities. Insurers trade a significant amount of flexibility in order to access convenience."

The vehicles are attractive, however, to small insurers looking for diversification in strategic investments, Earney said. "For example, it might be more difficult or costly for an insurance company with a $250 million general account to allocate 3% to 5% to a high yield or global equity strategy and achieve the right diversification or liquidity profile through individual securities," Earney said. "So they often utilize ETFs in those instances."

Leena Shah, principal at global consulting firm Mercer, agreed.

"For smaller insurance companies that either do not have in-house investment capabilities or that do not have significant assets to access institutional share classes of pooled funds, it makes a lot of sense to invest in active or passive ETFs," Shah explained. "One reason is that it's cheaper for these smaller investors to access ETFs due to the lower expense ratios. A second reason is favorable risk based capital treatment: Given

the low yield environment, a lot of insurers are adding more non-traditional fixed income assets to their portfolio, such as high yield bonds and emerging market debt, but the investment is often not substantial and may not qualify for separate account management. The NAIC capital charge for pooled fund investments can be quite significant, but with many of the fixed income ETFs in the market having NAIC designations, it can lead to more favorable capital treatment."

Long-term strategic investments are less common, Shah said.

"On a strategic basis we have not seen extensive use of ETFs by insurance companies," Shah said. "For large insurance companies, we don't think it even makes sense for longer-term exposure, because they can get more favorable pricing or better institutional quality vehicles to implement their strategic asset allocations."

Insurers primarily use ETFs for tactical purposes, she explained, such as temporary investments to take advantage of market dislocations; to help maintain market exposure while longer-term investments are sourced; to invest incoming cash; or to shift allocations from one type of investment to another.

"We have seen insurance companies use ETFs on a tactical basis, especially within fixed income, as ETFs can have good liquidity and low bid/ask spreads compared to individual bonds," Shah said. "As market liquidity has diminished in the last few years and transaction costs have gone up, specifically for individual corporate bonds, it just makes sense to maintain exposure with ETFs while you're waiting for better price levels to buy individual bonds or more desirable bonds to build your portfolio thoughtfully. You get the beta exposure immediately through an ETF, giving you time to build the exposure you want in a cost-efficient manner."

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Raman Suri
BlackRock

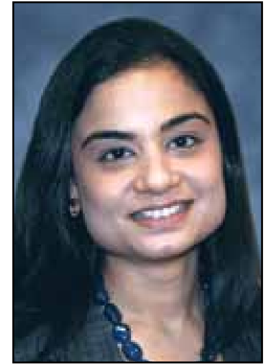
The Great Unknown

It's difficult to get a precise fix on how widespread ETF use is among insurers, or the percentage of general account assets these investments represent. However, there is some educated speculation.

According to State Street Global Advisors, more than 500 insurance companies currently hold ETFs. Cerulli Associates, a market research firm, estimated that insurer assets in all funds (not just ETFs) total about $185 billion, or just 3% of total insurer investments, with ETFs comprising a smaller fraction of that number. Suri estimates ETFs represent 0.5% to 1% of insurance portfolios.

Whatever the degree of ETF popularity, there is some evidence that insurers are expanding their use of ETFs in both volume and manner.

A 2016 Greenwich Associates report found a remarkable increase—in just two years—in the number of insurers using ETFs to invest in surplus assets. In 2013, 30% of the admittedly small sample of 24 insurers surveyed said they used ETFs for those investments; that number nearly doubled to 59% in 2015. During the same period, the proportion investing in ETFs as reserve assets mushroomed from 6% to 71%.



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"Back in the day, when I first started covering insurance companies, in the first half of '09, it wasn't primarily the general accounts at insurers that were using the assets; it was the actual asset management subsidiaries of big insurers doing things like '40 Act, separately managed accounts and, to a degree, variable annuities," said Mickle, of WallachBeth Capital. A '40 Act fund is a pooled investment vehicle offered by a registered investment company as defined in the 1940 Investment Company Act, according to Citigroup.

"At the time it was mainly equity ETFs that served as a sort of a placeholder for things like emerging market exposure, where insurers didn't have analysts to pick individual stocks," he added. "Now I think the sales to insurance companies primarily revolve around the fixed income side of ETFs."

Indeed, although bond ETF investments are increasing, equities still form the majority of

these passive investment holdings, according to Rob Trumbull, vice president of State Street Global Advisors and head of institutional ETF sales for the SPDR business.

"Historically, prior to NAIC designations for bond ETFs, almost all of the ETF AUM [assets under management] was in equity ETFs. If you look at the overall assets of insurance companies, roughly 80% of assets are invested in fixed income across all lines of insurance, and the rest are in equities and other assets; it's been the reverse in ETFs," Trumbull said. "However, the mix is shifting. And over the next maybe five to 10 years, the ETF AUM profile will actually look more similar to the overall asset profile of insurance companies because fixed income ETFs are being more heavily adopted in the reserve portfolio."

Much of the ETF usage has been by property/casualty companies and others who have higher allocations to equities than life insurers, said BlackRock's Suri.

"Even in those places, the investment team's underlying expertise is typically much stronger in fixed income," Suri said. "What they've realized over time is that short of building up an equity team, buying ETFs to run that equity strategy is much less risky and gives them the flexibility they need to put a much more diversified portfolio together and at a very low cost."

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State Street Global Advisors

Changes Afoot?

Trumbull believes insurers are transitioning from tactical to strategic ETF investments.

"Generally what will happen is that an insurance company will use an ETF to solve a very particular challenge they may have, such as managing cash flows or gaining exposure to a non-traditional asset class," Trumbull said. "From there they realize the operational efficiencies of the ETF structure and they start to find other uses for ETFs within their portfolio." He cited, for example, a Midwestern insurer that first used an ETF to gain exposure to the high-yield bond sector, and later expanded its holdings to include short-, medium- and long-duration corporate bonds and a dividend-paying equity ETF.

"That's an increasingly common example of an insurance company starting with one ETF and then finding other places within the portfolio where they help to add value," Trumbull said.

Suri, whose company, BlackRock, has an asset base of more than $1 trillion and 40% market share, said the insurance industry's adoption of ETFs is accelerating.

"Even as insurers are accepting ETFs and seeing the value, there is still a lot of work that remains to be done in designing products that are more specific to the insurance industry, for example," Suri said. "But the opportunity is huge because ETFs provide many benefits to insurers around lowering risk, lowering cost and having more liquid portfolios." BR

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