Safety first?

Traditional German life funds are dominated by fixed income, with a focus on credit and covered bonds. But will Solvency II models encourage more diverse portfolios?

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IN TERMS OF ASSET ALLOCATION, German life funds are traditionally very safety oriented. One reason for this conservative approach is the strict legal investment restrictions (see table 1, page 20). But traditionally, German life insurance companies do not even make full use of the possibilities they are given within the legislative framework. Table 2 shows the asset allocation of German life insurance companies as per June 30, 2008, as well as over the past three years, revealing that asset allocation, on a whole, has been quite stable.

The reason for this conservative approach is that German life insurance companies have to guarantee a certain minimum performance every year, for the whole length of the contract. "The quality of this guarantee is much tougher than the guarantees given, for example, by British life insurance companies. In traditional products, German life insurers guarantee not only a specific sum at maturity, but also a minimum increase of the surrender value every year," says Jan Wicke, CFO of Stuttgart based Wuestenrot & Wuerttembergische (W&W). The minimum performance is determined by the Federal ministry of finance in combination with BaFin. For newly issued contracts the guaranteed performance is currently 2.25%. Due to falling interest rates, this guarantee level has been gradually reduced from 3.5%. But the mix of older and newer policies means the average guaranteed minimum performance of the overall capital is higher than 2.25%.

Pension funds, for example, have to pay an annuity that is often pegged to wages – or, effectively, inflation. This is why they invest much more into instruments that provide inflation protection, such as equity or property. German life insurance companies, however, have to comply with a nominal guarantee. "Maybe we should stress this factor more in our marketing," says Uwe Siegmund, chief investment strategist at R+V

Uwe Siegmund

Versicherungen in Wiesbaden, which belongs to the network of German co-operative banks. "During these times of low interest rates, this guarantee is a very nice thing to have if you are saving for your old age."

The guarantees put pressure on German insurers. Ten-year government bonds or "Bunds" now only bear an interest of 3.6%, while it was well above 6% in the middle of the 1990s and as high as 9.2% in 1990. Reserves are being eroded, so either the risk budgets need to be reduced or money needs to be spent on hedging. But while large insurers such as Ergo or AMB Generali have hedged interest rate risk using derivatives, they remain in a minority.

Ralf Florian, board member at Debeka Versicherungen, typifies the majority view. "We do not see the need to hedge the risk of a change in interest rates, as our interest earnings are always well above the guaranteed minimum performance, and we expect this to remain the case in the future. Our past performance confirms our view in this."

But R+V's Siegmund is more open to the idea. "R+V does not employ a swaptions programme to hedge interest rate risks, be it to hedge against falling rates in order to deliver a nominal guarantee or be it to hedge against rising rates in order to be prepared for surrender shocks. R+V has a well-structured portfolio to withstand short-term shocks. Nevertheless, we are prepared to do so."

Challenge: decreasing marketing success

Life insurance companies in Germany are suffering a decline in new business, due to the changed taxation of life insurance products since 2005 and the relative strength of competitive retail products that offer a higher degree of flexibility, such as life cycle funds, guaranteed funds and certificates, with their often partially guaranteed payout structure.

Although these products do not cover any biometrical risk, investors consider them appropriate for old age provision and therefore, to a certain extent, exchangeable with life insurance products. On top of this, the new transparency

Table 1: Investment restrictions for the assets of German Insurance companies, according to the Anlageverordnung (AnlV):

Asset class	Maximum
Risk capital quota in total (equities, etc.)	35%
Property, REITs, property funds	25%
Accounts receivable from securities lending	5%
Asset-backed securities and credit linked notes	7.5%
Hedge funds (launched in Euroland)	5%
Other instruments ("trash clause")	5%
…with agreement of BaFin this can be increased to	10%

* In addition, there are restrictions per issuer and per debtor, and there are diversification rules.

Table 2: Investments of German life insurance companies (average)

	June 30, 2008	end 2007	end 2006	end 2005
Bonds	79.7%	78.8%	78.1%	78.1%
Equity	7.8%	8.7%	8.7%	8.6%
Property	3.4%	3.4%	3.9%	4.1%
Partnerships	2.3%	2.2%	2.3%	2.3%
Other	6.9%	6.8%	7.0%	7.0%
Total	100%*	100%*	100%	100%*

* including rounding differences

rules, as seen in the new VVG contract law, make the cost structure of life insurance products appear higher to clients than before. This, in combination with the given degree of inflexibility, has made made life products appear less attractive to clients.

This leaves German life insurance companies with two possibilities: the first is to increase the flexibility of their products, and to add bells and whistles that investors like; the second is to emphasise the safety and security of a life insurance contract, with all the guarantees it provides.

During crisis: more conservative asset allocation

German life insurance companies have learnt their lesson since the dot-com bubble, when some got caught with a relatively high equity quota of 15% to 20%. This made it difficult to provide the guaranteed annual minimum performance. In 2003, for example, the German life insurance guarantee organisation Protektor was forced to take over Mannheimer Leben and guarantee its life insurance contracts until surrender or maturity. However, Mannheimer's surplus funds were withheld from policyholders, resulting in a loss of bonus payments. German insurers point out that Protektor's guarantees are more robust than those available offshore.

Wicke explains that W&W has reacted to the current crisis by buying put options to hedge its existing equity positions. "On the bond side, we have reduced our exposure to US banks since September 2007 to reduce the credit risk," he says. W&W group, as a whole, has €35 billion of assets, meaning its losses related to Lehman Brothers (€3.3 million) and AIG (€3.6 million) are quite small. "We not only reduced our bond position with US banks, but our exposure to banks as a whole. Throughout 2008 we reduced our risk level, by reducing second-tier papers, and since spring 2008 we only buy covered bonds (Pfandbriefe)." Market values of the bond positions have fallen, "but in practice, this is not a critical issue as long as there are no issues that require an impairment, as we normally hold the bonds until maturity," says Wicke.

R+V Versicherung has also reduced its risk, as Siegmund explains. "We were more optimistic regarding equities at the beginning of the year than we are now. We think the negative effect of the crisis on the industrial companies is not fully priced in and the negative trend has further to run. So we have reduced our equity position from about 15% at the end of 2007 to about 5% right now." However, R+V is taking more risk now in credit: "About 50% of our bond portfolio consists of Pfandbriefe and individual mortgage-backed loans," says Siegmund.

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Uniquely, German life companies are allowed to offer retail mortgage loans directly to customers, with the rationale that they understand the collateral well, since they also provide the mortgage holder with a life insurance policy. Siegmund continues: "During the past months, we saw the attractive credit spreads that were building up again, so we took on more risk by increasing our position in bank and corporate bonds. On the other hand, we need to take out risk, which we did by reducing or hedging our equity position."

Meanwhile, Debeka, which is based in Koblenz, will be focusing on government bonds in the near future. Ranked sixth in terms of premium income, it is known as one of Germany's most conservative insurance companies – and Rolf Florian, director for finance, IT and organisation, and member of the Debeka Versicherungen board, says this conservatism has paid off: "Debeka-Group has less than 1% of its €50 billion assets invested in equities. Also, we did not turn towards absolute return mandates, structured notes or alternative assets during the years 2003 to 2008, when these instruments became popular elsewhere," he says. With only 1% equity exposure, Debeka is on the low end. Other German life insurance companies go as high as 15%, with the average equity exposure being roughly 8%.

When asked about the investments in problematic issuers, Florian insists he has no need to worry. "Our investments are well diversified.

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We hold securities of Hypo Real Estate and Lehman Brothers, but this is only a very small proportion of our portfolio," he says. "We are happy that we never offered unit-linked products, which are now seeing considerable losses on the side of the policyholders. Old age products must be solid, and so we are expecting German clients will turn back to classical life insurance products and private pensions. These products might have appeared boring in the past, but it is time for a conservative products revival."

A general problem facing every investor is that diversification only works in normal market conditions, where stable correlations exist. During a crisis, correlations tend to increase: "We have simultaneous problems in the equity, bond and liquidity markets, so diversification is not much of a defence," says Siegmund. "As insurance companies cannot go to the central banks, our only truly safe haven at the moment is government bonds. This crisis is quite severe – it is touching every region and almost all financial instruments. Therefore, we will be very careful in our strategic asset allocation decisions for next year," he adds.

Most experts believe German life insurance companies will be able to produce the guaranteed minimum performance during the crisis, and that the promised surplus performance ("Ueberschussbeteiligung") – the performance above the guaranteed minimum level – might be slightly reduced for the year 2009. As long as there are still reserves left, the industry will try to keep the surplus performance as stable as possible.

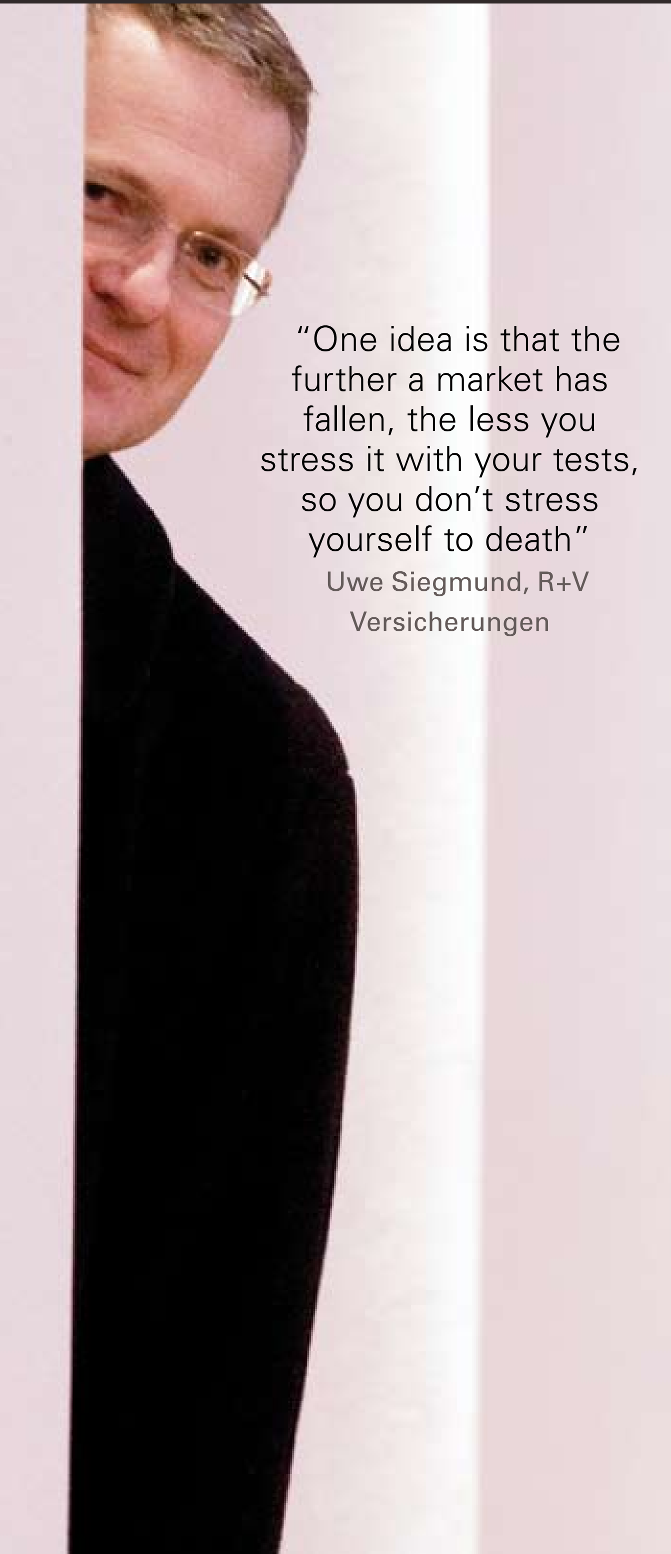
No increased surrender activity

German insurance companies do not face liquidity or refinance problems in the current financial crisis, as they can rely on their regular premium and interest income. "We do not see an increased level of surrender," says Siegmund. "However, we have a lot of policies at R+V reaching maturity now, as we have been writing many new policies in the 1980s and 1990s. But this is planned and, therefore, not a problem. We also do not anticipate surrenders in our unit-linked policies; it is only the new business that is likely to contract. Currently, savers do not like to invest in long-term products." The surrender rate of German life policies remains stable at about 5% of the contracts – in 2007 it was at 4.95% and in 2006 at 5.05%. (This figure includes contracts that were bought back, as well as contracts where only premium payments were stopped.) Although the industry association collects this data just once a year, there are no indicators of increased surrender activity during the current crisis.

MaRisk and QIS4 as preparation for Solvency II

While many German insurers espouse investment conservatism as a form of risk management, national supervisor BaFin also watches organisational risks. Recent changes in paragraph 64a of the insurance supervisory act (Versicherungsaufsichtsgesetz, VAG), require German insurance companies to apply qualitative rules about internal control and reporting systems. Under the so-called "MaRisk" rules, insurance supervisor BaFin has implemented stress tests that are applied to the asset side of insurer balance sheets. While most of the larger insurance companies in Germany insist they already have sufficient internal control and steering systems in place, some of the smaller companies will have to implement more systems to comply with MaRisk.

The QIS4 tests, as opposed to MaRisk, are quantitative impact studies in preparation for Solvency II, first pillar. These tests will calculate the combined effect of stresses on assets and liabilities on the solvency and the capital



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requirements of life insurance companies in Europe. According to BaFin, almost all German insurance companies will have no solvency problems with these scenarios. "We consider Solvency II a clear improvement on Solvency I. And I think we need Solvency II now, and should not further delay it," says Wicke. "The economic side of Solvency II would provide us with a wider range of investment opportunities. But it is the German rules in the 'Anlageverordnung' that are restricting us. These restrictions need to be widened when Solvency II is implemented," he adds.

Siegmund does not consider the economic side of Solvency II a restriction for his asset management; however he will use additional models. "Solvency II models reward you if you match your asset to the liability duration, both at market values. This typically means buying long bonds and/or heavy hedging in times of low risk-free interest rates. The model assumes that the interest rate downward shift will stay with you. Whether the latter is the best risk modelling and the former the best long-term risk strategy is questionable," he says. "Moreover, we have higher diversification effects with our different risks that we are covering on our asset and liability side. So we run our own models in addition to the QIS4 model. This should also be allowed in the Solvency II world. But of course, things must be comparable for supervisors. As a whole, we cannot say Solvency II is restrictive for R+V Versicherung in terms of our capital investments." He stresses that R+V by far over-fulfils the capital requirements when running QIS4.

Fine tuning on risk systems

Most German insurance companies run additional models and stress tests, in addition to the required risk models. "We now have to calculate with higher volatilities than in the past," says Wicke. "From my point of view, this crisis clearly shows that in the current Solvency II discussion about the treatment of equity risk, it is Germany, the UK and the rest of Europe's approach that is adequate – and not France's."

Wicke criticises the French wish to have more flexible rules regarding the equity proportion. "During this crisis we have learned that we need to give more emphasis to the issue of liquidity of assets. Although insurance companies are cash long, while the banks are currently cash short, we need to reflect liquidity issues in more detail in our risk models."

Frank Grund, chief executive of Hamburg-based Deutscher Ring, is also taking a closer look at the risk models: "The stress tests and other risk models at Deutscher Ring have worked well and we are still on the safe side. But in the future, we will focus even more on the counterparty and issuer risk." Of course, risk managers have always known that even the large banks could run into liquidity problems. But the current crisis has shown dramatically that this is more than a theoretical threat.

"2008 has provided some extreme scenarios, and at R+V we will probably do some fine tuning to our risk models," says Siegmund. "The problem is that most of the risk models used in the financial industry are procyclical: when valuations go down and volatility goes up, risk models reduce the risk budgets. One idea is that the further a market has fallen, the less you stress it with your tests, so you don't stress yourself to death. But we know we have to be very careful about removing procyclicality from the models. This year, for example, valuations went down in spring, and the situation became even worse in autumn," he says.

Asked if the improvement of risk models meant German life insurance companies might widen their risk budgets, Wicke was sceptical: "The conservative investment approach of German insurance companies is a result of the way risks are divided up between policyholders and insurance companies in Germany. As this will stay the same, so will our conservative investment approach." One should keep in mind the fact that the so-called free RFB surplus funds qualify as capital provided by policyholders, but can be withheld in adverse environments. Wicke makes it clear that the risk models exist in order to comply at any time with the given promises to policyholders, and not to increase performance by widening risk budgets. Siegmund agrees: "Our main goal is risk management and not maximising performance." L&P