KEY INVESTMENT THEMES FOR INSURERS

No immediate storm ahead but insurers should use the lull to build portfolio resilience

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Key points

- Our central scenario remains positive for 2022
- The hunt for yield is still top of insurers' agendas
- Inflation and interest rate uncertainty remains centre stage
- Insurers should consider enhancing diversification and risk management
- For many, 2022 will be a transition year from a regulatory perspective
- Sustainable investing should expand across all portfolios

Lingering COVID-19-related supply-side disruptions, alongside a significant rebound in consumer demand, are producing supply bottlenecks and an inflation rate not seen for decades. We expect 2022 to be a year of gradual absorption of the pandemic shock, with robust but less spectacular growth, while pressures on global supply gradually decline, contributing to a slowdown in inflation. A gradual convergence of 'transitory' inflation rates towards their target would allow central banks to remain prudent with the pace of monetary policy normalisation, making it digestible for investors as currently priced in to bond and equity markets.

This baseline outlook for 2022 is valid on the assumption that most economies continue to supress COVID-19 flare-ups and manage to remain open. It also presupposes a normalisation of the US employment participation rate in easing pressure on wages. There is still uncertainty on the impact of the pandemic on global economic trends, inflation dynamics, suggesting that investors should also plan for more adverse trajectories.

A worse outcome would be even higher inflation and a more aggressive than expected tightening of monetary policy. Additionally, a sharp rise in real yields would derail growth and earnings momentum and deliver a shock to bond and equity markets.

Transitory or not, inflation is back. Monetary policy is being adjusted while quantitative easing support is easing. In our central scenario, a modest increase in interest rates should allow investors to still enjoy decent returns, especially as they catch investment opportunities and follow capital flows allocated to the climate transition.

But market history shows that bouts of volatility are never far away. This has multiple implications for insurance companies, especially when considering the structure of their balance sheets and current developments in regulatory capital and accounting standards.

Hunting for yield remains high on the agenda

The normalisation of monetary policy in advanced economies should lead to higher interest rates and yields. This move would start from very low levels and should still force insurance companies to pursue their efforts to limit the dilution of average investment book yield to meet their insurance commitments, protect their capital and solvency positions and deliver earnings and returns on equity.

This is particularly true in the Eurozone where inflation is more contained, and the European Central Bank (ECB) is not expected to hike interest rates before 2023. For years insurance companies have been managing their in-force book of business to reduce the burden of guarantees and have also made good progress in their strategic shift toward less capital-intensive life and savings insurance products.

But the cost of guarantees remains elevated and thus the hunt for yield should persist. The burden of guarantees is particularly persistent in Germany where the average duration of life books is above 19 years compared to about 12 years in Europe[1]. This should continue to benefit real and private assets which exhibit significant illiquidity and sophistication premia and can provide a clear contribution to a zero-carbon future (e.g. renewables infrastructure).

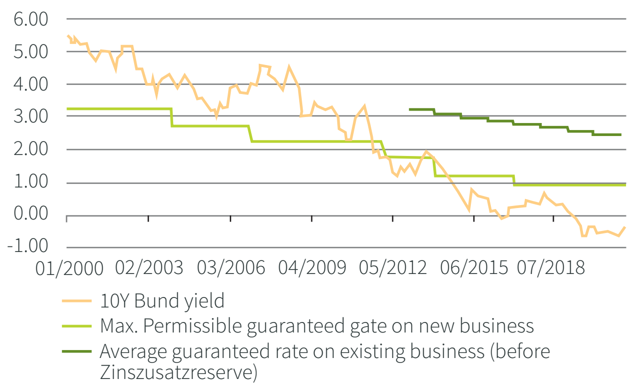
Low yields and downside risks call for thoughtful diversification

The hunt for yield cannot only rely on private markets where deploying capital through well-balanced portfolios can take time – but consideration should be given to the growing need for more risk diversification and agility in insurance portfolios. Credit markets have been relatively steady in the face of exogenous market jolts over the last few months. Our constructive view for spreads in 2022 incorporates expectations of elevated inflation pricing for at least part of the year, as economic activity – and thus earning growth – should continue to underpin credit fundamentals and keep the default outlook benign.

But the stock of debt has grown significantly since the end of 2019 (+18% for the global investment grade index and +31% for the global high yield index) – only made affordable by the global policy response which suppressed interest rates and so contained the rise in the cost of servicing the higher stock of debt[2]. In the medium term, tighter financial conditions and potential changes in the volatility regime could hurt corporates with a less sustainable debt burden, which advocates for more agility and more diversification in insurance credit portfolios which have a very strong domestic bias.

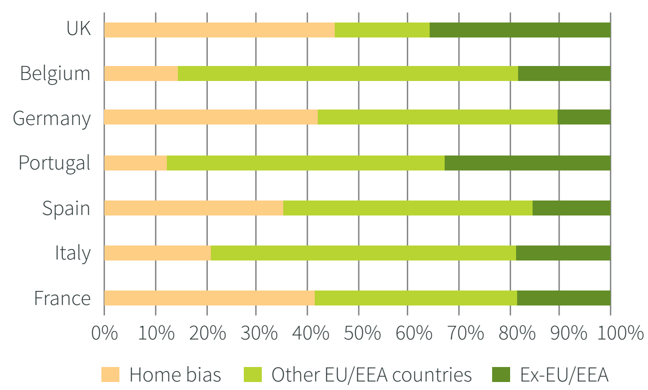
Expanding the investment universe not only reduces risk by diminishing the sensitivity to one single economic region and by selecting best-in-class companies across markets – it also enhances book yields while reducing a portfolio's carbon footprint as the set of sustainable opportunities becomes wider.

Yields have fallen faster than German new business guarantees rates



Source: Oliver Wyman/JP Morgan - Under Water: Withstanding Low Yields in Traditional Life – 2021

Home biased behaviour for insurer' holdings of corporate bonds



Source: EIOPA 2020 Financial Stability Report

[1] Source: Oliver Wyman/EIOPA/Morgan Stanley Research, 2021

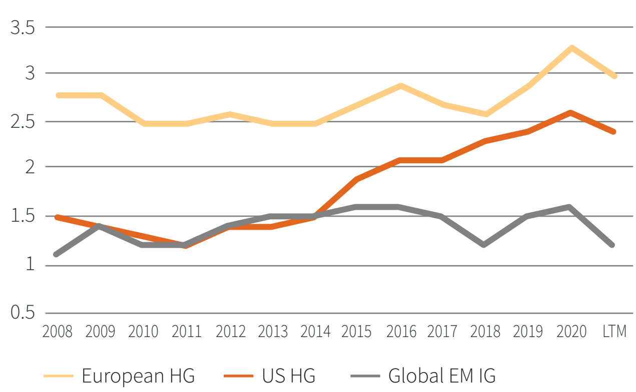
"The diversification of liabilities and the diversification of assets can help mitigate the impact of inflation risk"

Diversifying core fixed income matching (Buy and Maintain) portfolios into foreign credit markets requires that investments be structured in a way that is compliant with Asset Liability Matching (ALM), regulatory capital and accounting frameworks, but this is the price to pay for a true risk diversification and to harvest a sophistication premium.

After a contraction of 'just' 2% in 2020, growth in emerging markets is expected to rebound to 6.2% in 2021 and to continue to recover into 2022 with 4.4% growth. Growth rates should normalise into 2023, to an average of 4.3% against 2.4% for advanced economies[3]. Public fixed income markets have significantly developed and are instrumental in supporting the still structurally higher growth in developing countries. They now represent a large and diverse opportunity set, allowing the opportunity to enhance return and optimise portfolio construction, in our view. Interestingly, while emerging markets are characterized by periods of high volatility, they have been offering a steady spread advantage for a lower net leverage compared to developed corporate credit markets.

Still, allocation to emerging markets corporate bonds remains marginal in insurers' asset portfolios.

EM versus DM IG Net Leverage



Source: JP Morgan, Bloomberg Finance LP, CapitalIQ. 2021

[2] Inter Continental Exchange and AXA IM Research November 2021
[3] AXA IM forecasts December 2021

Inflation risk can be a threat for insurers

Transitory or not, inflation is centre stage and can hurt property and casualty (P&C) and health insurance companies particularly, as it can impact both assets and liabilities and ultimately the profitability and solvency of insurers. Regulatory capital regimes such as Solvency II do not explicitly require this risk to be quantified and so some insurers may not have paid it the attention it deserves.

For P&C and health insurers, inflation can translate into higher costs of claims despite the former market being in a hardening rate cycle and hedging this risk can prove to be challenging, subject to the types of insurance risks that are underwritten. P&C insurers tend to have positive duration gap and inflation can also hurt via the impact of higher interest rates on a net positive duration exposure. Depending on its magnitude and persistence, exposure to inflation risk should be factored into the asset and liability management framework and can call for potential adjustments of strategic and/or tactical asset allocations.

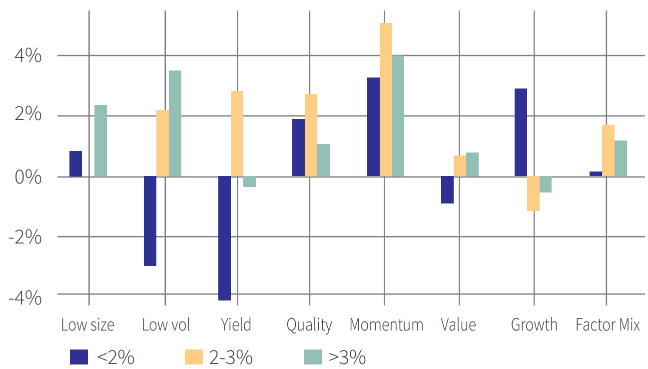
The diversification of liabilities and the diversification of assets can both contribute to mitigate the impact of inflation risk, as not all regions are expected to be impacted equally.

Inflation-linked bonds are natural candidates to hedge against inflation risk. They have outpaced actual inflation in this cycle and should continue to do so in 2022. But derivatives-based hedging techniques can also be useful as they allow the design of more tailored hedging strategies potentially better aligned with risks borne in liabilities.

Outside of inflation-linked instruments that are contractually indexed to inflation, all assets do not react to inflation risk in tandem. For example, some equity factors or sectors may be less impacted than others in an inflationary scenario and this can also be factored into asset allocation. History shows that growth delivered positive active returns in low-inflation environments, and negative active returns in moderate-to high-inflation environments and that quality and momentum were less sensitive to inflation and outperformed in all scenarios.

The energy industry is one of the sectors that have historically shown a higher correlation to inflation and so a compromise may have to be found between portfolio indexation to inflation and portfolio decarbonisation.

Inflation vs. Mean Annual Active returns



Source: MSCI - Impact of Inflation on Style Factors, 2021

A key component of an efficient asset and liability management is duration matching and insurers invest a significant portion of their asset portfolio into fixed income assets in an attempt to manage their duration gap. But some insurers could be tempted to slightly widen their duration gap (i.e. reduce the duration of their asset portfolio) to benefit from higher inflation through higher interest rates. This strategy is not without consequences. Going shorter can also mean lower investment book yields and a duration gap brings a capital charge under solvency regimes such as Solvency II.

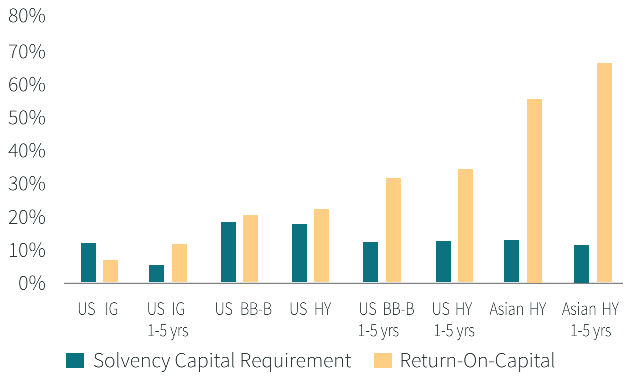
> **"The normalisation of monetary policy in advanced economies should lead to higher interest rates and yields"**

More insurance and agility are required in asset portfolios

As discussed earlier, diversifying fixed income matching (Buy and Maintain) portfolios into foreign credit markets reduces risks and can enhance book yields in a way that is consistent with ALM, accounting and regulatory capital constraints. But beyond investment-grade debt securities, the long-lasting low rates environment calls for diversifying further into higher yielding asset classes. Diversification is a basic concept to mitigate risks and enhance portfolio returns, but the selection of relevant building blocks and investment strategies can also make a huge difference. The current environment can also call for a reshaping of existing exposures.

In the fixed income space, a natural way to increase investment income is to go down the credit spectrum. Even though economic activity and earnings growth should continue to underpin credit fundamentals and extend the rangebound spread regime into 2022, high-yield investing can be a bumpy journey. Short duration high-yield strategies can potentially have advantages as they have historically provided a higher Sharpe ratio compared to broader indices with lower volatility and drawdown risks. High-yield short duration bond strategies could therefore be able to contribute to the central objectives of better protecting capital and stabilizing own funds in an insurance asset portfolio. They can also tend to exhibit a higher return on regulatory capital compared to broader indices.

Current S2 Return-on-Capital for HY investment (spread only)



Source: US HY average return decomposition: AXA IM, Inc., ICE BofA Merrill Lynch data from 12/31/1987 to 12/31/2020. *ICE BofA Merrill Lynch US High Yield Index, incepted 8/31/1986. For illustrative purposes only. Past performance is not indicative of future results.

Rising rates are a risk for all bonds that have interest rate exposure, but high-yield corporate bonds have much lower interest rate risk than investment grade. This is naturally truer for short-dated high-yield bonds which have historically outperformed broader indices in past rising rates periods.

Another interesting approach to high-yield investing that can contribute to enhance investment income and return with lower risks (and a lower capital charge) – compared to standard high-yield strategies – focuses on rising stars or the so called '5Bs segment'. The crossover between the lower end of investment grade and the upper end of high yield corporate bonds could provide strong investment opportunities.

2020 saw new record volume in fallen angels – debt that moves from investment grade to high yield. The stellar economic rebound in 2021 supported a strong improvement in fundamentals which in turn led rating agencies to upgrade a significant number of high-yield credits. Some investors have already taken advantage of mis-pricings, buying high quality companies at a discount, and subsequently benefiting from a significant spread tightening.

The high-yield default outlook appears very benign, historically speaking, and in our baseline scenario we expect to see more rising stars in the coming months as economic activity and thus earning growth should continue to underpin credit fundamentals and keep the default outlook relatively positive.

Identifying future rising stars relies on sound credit analysis as improvement in fundamentals and most of the spread tightening usually precede upgrades by agencies. BBs are usually underrepresented in standard high-yield strategies, leaving some room for investors seeking to exploit these opportunities.

In more adverse scenarios, which we cannot exclude in the current fluid context, a 5Bs portfolio should in our view exhibit lower volatility and drawdown risks especially if the portfolio manager is given some leeway to dynamically rebalance between BB and BBBs.

Still in the high-yield fixed income space, in the emerging market universe in particular, the financial industry has also proved to be innovative recently with new investment strategies embedding financial guarantee agreements. These agreements are notably provided by state-backed agencies engaged in the financing of the transition toward a low-carbon economy.

Such guarantees offer an absorption of first credit losses in a predefined bond portfolio, which significantly reduces volatility and drawdown risks. This approach is different to the well-known securitization techniques used in the structured finance world and strategies embedding such guarantees should also exhibit a relatively interesting return on capital under Solvency II. Such investment solutions should enable institutional investors and thus insurance companies to grow their allocation to emerging fixed income markets.

In the equity space, performance in 2021 was largely driven by earnings growth and it seems that corporates were able to pass on rising input costs, consistent with the notion that equities can help to mitigate inflation risk as outlined earlier. The threat for 2022 comes from the outlook for real rates. With valuation levels already stretched and interest rates expected to rise, the upside potential for multiples is limited. In 2022, the performance of equities should continue to be dependent on earnings. The concerns over inflation and interest rates almost make us forget the importance of economic growth for equities. Historically, equities have performed above their annual average when economic output rises above its potential. Our team forecasts US GDP to grow above potential at 3.5% for 2022, which should help to mitigate any headwinds in terms of earnings revisions and valuation considerations for the equity asset class.[4]

But, equities can be volatile and drawdowns significant, so this should push insurance companies to consider asymmetric or risk-managed equity strategies which allow the capture of the higher return and performance potential of equities while mitigating volatility and drawdown risks. This can be achieved through derivatives-based overlays in a Solvency II-friendly format. Convertible bonds also offer an asymmetric risk return profile and are also relatively well treated under solvency capital regimes.

The risk return profile of an insurance asset portfolio mostly relies on strategic asset allocation and its ability to cover the insurer's liabilities. The selection of relevant building blocks is also instrumental in delivering strong investment outcomes while managing risks.
But investment returns can be further enhanced, and risks even better managed by implementing tactical views in a strategic insurance asset portfolio.

> **“Identifying future rising stars relies on sound credit analysis as improvement in fundamentals, and most of the spread-tightening, usually precede upgrades by agencies”**

Sophisticated investment processes combining fundamental research, macroeconomic and market signals analysis and advanced risk management techniques can deliver extra returns while mitigating volatility and draw down risks. The extent to which an insurance portfolio can be actively managed mostly depends on the impact of turnover on capital requirements and on the income statement, but these parameters can be budgeted and factored in a multi-asset insurance investment solution.

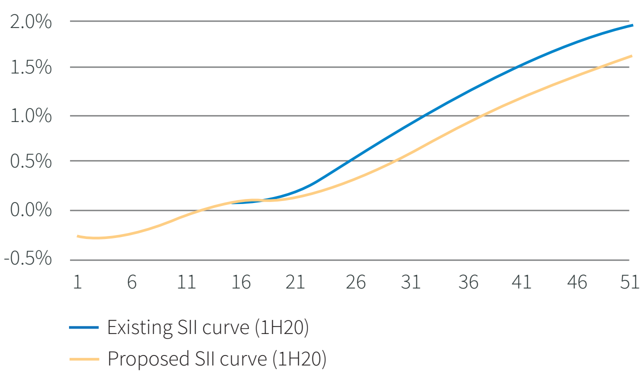
[4] Due to the subjective nature of these opinions and analysis, this forecast is not necessarily used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

A transition year from a regulatory standpoint

Insurance companies are facing a heavy regulatory agenda. In Europe, while Solvency II entered into force back in 2016, the European Insurance and Occupational Pensions Authority (EIOPA) proposed some adjustments to the formula at the end of 2020. If adopted by the European Parliament, presumably in 2023/2024, and even though the review embeds a transition period, these changes will have material implications for insurers.

The most impacting proposed changes are related to the way liabilities should be valued. EIOPA proposes changes in the extrapolation method to determine the liability discount curve beyond the 20 years last liquid point (LLP). The current method assumes an Ultimate Forward Rate (UFR) to extrapolate discount rates. For the euro, the applicable UFR as of 1 January 2022 is 3.45%. The new proposed methodology will result in more gradual convergence of interest rates to the assumed UFR which means lower discount rates and an increase in the liabilities' value beyond 20 years. This will hurt insurance companies with very long-dated liabilities and require that they adapt their duration management even if interest rate curves modestly steepen. Ability to properly measure and hedge duration risk as well as to source very long duration exposure will be key.

Proposed changes to the Solvency II discount would result in a materially lower curve at longer tenors



Source: EIOPA, Morgan Stanley Research, 2021

EIOPA also proposes to adjust the calculation methodology for interest rate risk capital requirements and to better consider the low rates environment. This will add to the burden and especially hurt insurance companies with long-dated liabilities and significant duration gaps.

EIOPA's review also contains positive developments. For instance, insurance companies should be authorised to consider Matching Adjustment portfolios when determining the diversification benefits as part of their overall solvency capital requirements calculation. This should push insurers will eligible liabilities to apply this mechanism and to optimize their cash-flow matching portfolios.

There are also positive recommendations for equity investments. The symmetric adjustment should be widened by seven percentage points [-17%; +17%] which would dampen further the volatility of insurers' own funds in case of changes in equity prices and would more easily allow them to maintain their equity exposure in case of market jitters or drawdowns.

EIOPA also proposes to ease the current requirements for Long Term Equity (LTE) investments which benefit from a much lower capital charge of 22%. The current requirement that an insurer cannot sell any stock with an average holding period below five years should be removed, and the five years minimum holding period should be appreciated at the LTE portfolio level.

The current rule requires that the LTE portfolio be included within a portfolio of assets which is assigned to cover insurance obligations corresponding to clearly identified businesses over the lifetime of the obligations.
EIOPA proposes to remove the requirement of an assignment over the life of the obligations which means that an LTE portfolio could back shorter/renewed or non-life liabilities. In its opinion, EIOPA also advises to ease the 'ring-fencing light' requirements which means that the LTE portfolio and the related liabilities would not have to be identified, managed and organized separately from other activities. So only the LTE portfolio would have to be

identified and managed separately and thus a dedicated fund wrapping LTE investments should be sufficient.

EIOPA also stipulates the liquidity conditions that insurers would have to meet to hold an LTE portfolio. For life insurers the LTE portfolio should back liabilities with a duration beyond 10 years while non-life insurers would have to demonstrate that they have a sufficient liquidity buffer to maintain the portfolio. There are other requirements that insurers would have to meet but all-in-all that is a positive change that could allow insurance companies to maintain or grow their long-term exposure to European equities at a lower capital cost. By definition, long-term horizon/low turnover and high Sharpe equity strategies look better suited. Insurers may want to explore this route especially as long-term investing is consistent with engagement and impact investing.

The European Commission adopted a comprehensive review of European Union (EU) insurance rules on September, 2021, including a legislative proposal to amend the Solvency II Directive (Directive 2009/138/EC) based on the technical advice provided by EIOPA in December 2020. The legislative package will now be discussed by the European Parliament and Council.

IFRS 9 and IFRS 17 starting from 2023

The upcoming IFRS 9 and IFRS 17 standards will enter into force in 2023 and will have significant impact on insurers. Not only will these standards have an impact on how assets for IFRS 9 and liabilities/insurance contracts for IFRS 17 are classified and measured, with direct implications on the net income's composition and volatility, but they may also require adapting the way assets portfolios are organised and structured.[5]

One aspect which is of particular importance for insurers is the classification and measurement of fixed income securities under IFRS 9 and the conditions to be fulfilled to classify bonds as amortised cost or Fair Value through Other Comprehensive Income (FVOCI) in order to mitigate their net income volatility (SPPI - Solely Payment of Principal and Interests - and business models tests have to be passed or bonds are classified as Fair Value through P&L - FVPL). In addition, open-ended funds cannot be looked through under IFRS 9 and do not pass the SPPI test. This has consequences on how insurers willing to mitigate their net income volatility should structure their fixed income portfolio.

Insurance fixed income strategies implemented in a dedicated format (be it a separate account of a dedicated fund) should be favoured. For fixed income made through open-ended funds, strategies exhibiting lower volatility, such as short duration high yield strategies, may be preferred. Under IFRS 9 equity investments are classified as fair value through P&L by default, and so here again insurers may prefer low volatility or risk-managed equity strategies to mitigate their net income volatility. An option to classify equities as FVOCI is offered but in this case only dividends can be recycled into the earnings, which prevents from recognizing the full equity performance potential in the bottom line.

The impairment module under IFRS 9 is based on an expected credit loss approach as opposed to an incurred credit loss approach under IAS 39. This means that credit risk deterioration will be more systematically recognized in the P&L and this certainly advocates for further diversification in corporate bond portfolios.

The Hedge Accounting module under IFRS 9 is also of key interest as on this module will depend the insurer's ability to use derivatives-based hedging strategies while mitigating net income volatility. Hedge accounting can be useful in multiple circumstances. For instance, a fair value hedge accounting (FVHA) can be considered when using payer interest rate swaps to shorten the asset portfolio duration and thus the positive duration gap of a P&C insurer. This can neutralise the net income volatility of interest rate swaps which are otherwise classified as fair value through P&L (FVTPL) by default.

Another example is when hedging foreign corporate bonds with cross-currency fix-fix swaps. In this case a cash-flow hedge accounting (CFHA) could also be considered to neutralise net income volatility otherwise produced by the swaps. These hedge accounting schemes are already permissible under IAS 39 and will remain permissible under IFRS 9 which is more flexible and better aligned with risk management practices.

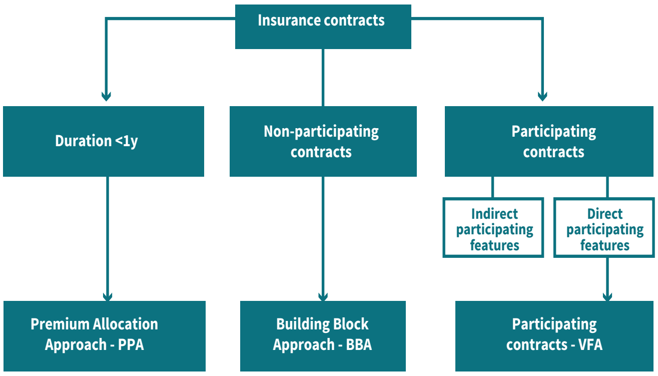
IFRS 9 standards have material investment implications, but choices made under IFRS 9 should also factor in the types of liabilities and their classification under IFRS 17. Indeed, the valuation method for liabilities will depend on their nature and length and different interactions between IFRS 9 and IFRS 17 must then be considered. For instance, for participating contracts with direct participating features and which comply with certain requirements, liabilities

[5] The International Financial Reporting Standards (IFRS) is a set of consistent guidelines for how businesses report their accounts. IFRS 9 relates to financial instruments while IFRS 17 relates to insurance contracts.

can be classified and valued based on the Variable Fee Approach (VFA) and the volatility of asset portfolios backing VFA liabilities can be absorbed by a liability component (the Contractual Service Margin – CSM) and do not impact the P&L directly.

IFRS 9 choices, investment strategies and formats can therefore differ depending on the liabilities' classification under IFRS 17. For those for which this is still a work-in-progress, 2022 will be the year to finalize their financial impacts assessment and adjust their portfolio when necessary.

Liability classification and measurement models under IFRS 17



Source: AXA IM

Sustainable investing and decarbonation is the new norm

The COP26 Glasgow Climate Pact may appear insufficient in multiple regards but it reconfirms the urgency to act and calls for public powers as well as private investors to accelerate on their commitments in developed and developing economies. Decarbonizing economies is a key objective of the Net Zero by 2050 roadmap and institutional investors are playing a key role in supporting de-carbonisation through asset allocation decisions. Physical risks are already more frequent and transition risks will materialize, especially if carbon pricing is sooner or later factored into the equation. In the end the climate transition represents investment risks that must be managed as well as investment opportunities that investors can profit from. Insurers are instrumental in the fight against climate change. Because climate physical risks translate into claims and directly impact insurers' profitability but also because of the strike force that they can use.

Regulatory pressure also requires the integration of sustainability risks into insurers' risk management under Solvency II. Climate risks are significant in insurers' balance sheets and policy makers are expecting these risks to be integrated in risk management frameworks. Insurers are clearly centre stage in ensuring the stability and effectiveness of the financial systems in the long term. With this objective in mind, EIOPA has already engaged in the process of integrating climate but more broadly ESG risks in the Solvency II framework.

An opinion on Sustainability within Solvency II was published in 2019 and EIOPA launched a consultation on climate scenarios in ORSA (Own Risk and Solvency Assessment) in 2020. There are still challenging methodological questions around climate risk quantification and stress testing, but discussions on the definition of climate risk scenarios and their impact on capital positions are moving forward. Insurers have already been asked to perform climate stress tests in certain countries, notably in the UK with the Climate Biennial Exploratory Scenario (CBES) exercise launched by the Bank of England in June 2021.

During its 5th Sustainable Finance Roundtable which took place on 7 December, 2021, EIOPA announced its sustainable finance agenda for the next three years and it is ambitious. EIOPA notably reaffirmed its objective to ensure the integration of sustainability in all pillars of the prudential frameworks.

In this context, insurance companies should certainly consider accelerating their sustainability plan.

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