SDM-101-13 Managing the Hidden Hedge Funds Within Life Insurers
Oliver Wyman

Key Points:

- Insurer balance sheets resemble that of hedge funds - hidden hedge funds
- Insurers have complex bets on various market variables (interest rates, equities, etc.)
- Currently little understanding of these risks, this is improving, Europe has responded, North America still has work to do

Executive Summary

- Insurer's balance sheets contain hedge funds – funds that have complex bets on interest rates, equities and other market risks
- Little oversight and occasional disastrous consequences
- Leaders are striving to better understand the bets, set themselves apart, create value for shareholders
- Need to educate parties (managers, investors, regulators, etc.) on the trade-off between GAAP earnings and economic value with the presence of these hidden hedge funds
- Accounting regulation changes will make the education task more difficult
- Leading executives should push for greater balance sheet/risk/economic P&L transparency
- Investors will soon demand how companies deploy capital and generate returns

Introduction

- The hedge fund market has grown substantially in the past decade – now a major market player
- Hedge fund control large amounts of assets – opaque in nature (don't know exactly what they are holding)
- Few hedge funds actually participate in hedging – instead they take highly leveraged/calculated bets in financial markets
- Hedge fund exposure is a major concern for credits – due to the large bets that they make
- Hedge funds are also a concern to financial regulators
- Hedge funds have a potential to cause catastrophic risks
- The world's largest and most complex hedge funds are actually hidden within the balance sheets of companies that are traditionally seen as conservative life insurers
- Life insurers usually are conservative with their investments and don't usually invest in hedge funds
- This is due to a hedge funds opaqueness, lack of accountability
- Life insurers have huge positions that are just as risky as hedge funds

3 Differences between Real Hedge Funds and Hidden Hedge Funds:

- Hidden hedge funds consist within relatively diverse portfolios of business – profit depends on several components – underwriting gains, persistency, behaviour of markets – reduces the risk of exposure to just one factor

- Senior managers have less awareness of the embedded positions than managers of hedge funds – hedge fund managers can see all investments/bets whereas insurer managers often only see simple summaries such as accounting changes to changes in interest rates
- Few hidden hedge funds achieve the same level of returns as a real hedge fund –
  - Regulatory/accounting rules that the insurers are forced to abide by
  - Insurers do not learn from past mistakes, have taken little action to reduce risk
- Exhibit 2 covers various activities that insurers participated in that went bad:
  - Defined benefit pension plan bet on interest rate levels, minimum guaranteed interest rates, duration mismatches, spread based products, equity backed policies

The Origin of Hidden Hedge Funds

- Insurers take these bets because customers require them - retail/corporate clients want more complex products (guarantees, optionality, negative convexity, etc.)
- Insurers are exposed to large interest rate risks - some are unhedgeable
- Insurers provide long-dated liabilities - hard to neutralize the asset-liability positions
- Insurers have also stacked the asset side with investments in mortgage backed securities and other assets - some that have the opposite convexity of their liabilities (such as pre-payment features)
- Accounting/measurement regimes have not kept pace with the market - accounting/regulator standards do not align - do not reflect volatility insurers are exposed to
- Insurers that manage their risk are punished on a GAAP basis - also exposed to confusing hybrid standards - results in inconsistent/ineffective management
- Insurers are forced to take these products on by competitive markets - creates a hidden hedge fund
- Hedge funds are managed ineffectively - little understanding of their effect on economic value
- Accounting standards correlate poorly with economic reality

Exhibit 3: Is it better to manage Economics or Earnings?

- Insurers that hedge their economic bets are often penalized on a GAAP basis
- This misalignment forces CFOs to consider whether they should hedge or not
- If they do hedge, this creates a GAAP/Economic basis misalignment - also creates communication problems for CFOs

Exhibit 4: Equity Exposures fall through the Accounting Net

- Hedging programs for variable annuities are now commonplace
- Operate a mixture of dynamic and static hedging programs
- Mark-to-market requirements (FAS 133) has driven some of this
- There are 2 significant anomalies:
  - Hedging of living benefits focuses on the products that fall under mark-to-market accounting - leaves out others that create different changes under economic vs. accounting exposures basis
  - Life insurers typically have larger economic exposure to equity markets on the balance sheet than captured by GAAP - insurers exposed to equity risk from more than just living benefits products

Spurred into Action

- Insurers are slow to adopt new ways of thinking about balance sheets - not recognizing hidden hedge funds
- This is changing - Solvency 2 is one thing that has changed
- Solvency 2 requires insurers to provide an economic view of their balance sheet
- Analysts in Europe are also demanding more transparency from insurers
- North American insurers cannot ignore that European insurers are subject to different rules
- Many North American executives appreciate the shortcomings of existing earnings and capital metrics
- Now seeking better ways to understand the value chain and optimize risk-return objectives
- It will take time to go from today's accounting regimes to a more economic based regime

The Strategic Agenda

- The transition to measurement/management on an economic basis is complex - firms need to start taking initiatives in this area
- Basic elements of an economic basis program:
  - (1) Identify hidden bets: need to quantify magnitude/direction of current bets, economic balance sheets need to reflect the mark-to-market impact of changes in market variables
  - (2) Articulate risk-return strategy: management needs to articulate its core strategy, should the company take economic bets
    - Reasons to take the Bet:
      - Lack of cost effective hedging tools
      - Temporary use of excess capital
      - Core competency or structural advantage
      - Stability of accounting earnings
    - Reasons not to take the bet:
      - Low multiples
      - Opaqueness discount
      - Inefficient deployment of capital
    - Insurers need to move away from strategies that result in large unstructured bets, move towards liabilities that generate profit
  - (3) Align the organization with the articulated strategy: management needs to establish a new "rules of the game", identify the tradeoffs between accounting and economics, need to back this up with clear mandates around managing economic P&L, need to educate external stakeholders

Conclusion

- Insurers are now aware that their balance sheets contain hidden hedge funds - complex best on various market variables
- Little oversight and understanding - could lead to disastrous consequences
- Leaders are striving to better understand these bets - take time for all stakeholders to get up to speed on economic measures vs. traditional accounting measures