Life-assurance companies and multi-employer occupational pension funds

Alternative investments

Alternative investments by life-assurance companies and multi-employer occupational pension funds

1 Conclusion

With the currently low interest rates in Denmark and the Eurozone, and the prospect that this may be long-term, Danish life-assurance companies and multi-employer occupational pension funds ("the companies") are increasingly facing challenges in ensuring good returns for their customers.

The Danish FSA has noted a trend where an increasing number of companies convert part of their investment portfolio from "traditional" investments to "alternative" investments.

Alternative investments are characterised by trading assets on markets which are not deep, liquid and transparent compared with markets for traditional investments. Another characteristic of alternative investments is that they are more often long-term. Finally, this type of investment is associated with risks which are not necessarily found in traditional investments.

Against this backdrop, in its "Christmas newsletter" in December 2012, the Danish FSA requested a statement from the board of directors of the companies. A total of 23 companies and groups of companies provided replies to the following questions:

- Which alternative investments does the company have?
- How and how often are alternative investments valued, and how does the board of directors respond in the event of low frequency of valuations?
- How is the valuation validated; which type of sensitivity analyses are carried out?
- How is the return/risk ratio evaluated; how is the liquidity risk premium for the low depth, liquidity and transparency measured?
- What type of other risks does the board of directors associate with these alternative investments and how are these risks measured?
- What are the board's expectations for the future with regard to alternative investments?
- How is the solvency requirement for the different alternative investments quantified, and what is the basis for the quantification applied?

Key for all types of investments, and thus also alternative investments, is that the companies must be in a position to identify, manage, monitor, control and report on the risks associated with the investments. Such conditions must be identified before making an investment, for example in the due diligence process. This will ensure that the asset is purchased at a value, which, as a minimum, counterbalances the risks assumed by the company, and it ensures there is clarity as to how the relevant asset is subsequently to be managed by the company. In the opinion of the Danish FSA, the competences required to be able to identify, manage, monitor, control and report the risks are higher for alternative investments than for traditional investments.

Particularly with regard to customised alternative investments, for which there is no clear practice for the design of the contract or the underlying asset is more unique, the Danish

FSA is of the opinion that special competences are required to be able to make the investment. At the same time this type of investment is primarily seen in high-value contracts, and therefore only the largest companies or affiliations of companies have the resources to make the investment.

On the basis of the statements from the companies, in general the Danish FSA is under the impression that:

- investments by the companies in alternative assets are concentrated in few companies (at the end of 2012).
- the companies should make more extensive assessments of the liquidity premium linked to alternative assets.
- the companies should generally focus more on the risks of alternative assets.
- in some cases the companies can be more critical in relation to their regular valuation of alternative investments.

Alternative investments are concentrated in few companies

The survey shows that 21 out of 23 companies had alternative investments worth DKK 152 bn. at the end of 2012. The companies' investments in properties are not included in the calculation of alternative investments, as these are treated differently in the statements from the companies and not all companies consider investments in properties to be alternative.

On average each company has invested 7% of total assets in alternative assets. The company with the largest percentage of alternative investments has placed almost 16% of total assets in alternatives. The five largest investors have together almost 60% of all the companies' alternative investments, while the ten largest have almost 90%.

Eleven companies, large and small, representing 70% of the alternative investments, expect to make further alternative-type investments. Nine companies state that they expect to reduce focus on alternative investments, of which some point out that this is not a good time to increase their risk in this category.

The Danish FSA expects that the companies will address their percentage of alternative investments and take a view on their concentration risk so that they do not become dependent upon a single asset or category of assets. Furthermore it is expected that, in selection and management of alternative assets, the companies will examine the underlying assets when making investments so that infrastructure funds, for example, are not treated as private equity. Among other things, this will ensure that the companies quantify their concentration risk as well as possible.

Five out of 21 companies specifically address the liquidity premium

The companies mention that the primary reason for investing in alternative assets is to obtain a higher return than with traditional investments, particularly in the form of a liquidity premium. Only five out of 21 companies, representing 39% of the alternative investments, state, however, that they specifically address the liquidity premium.

Of the remaining 16 companies which do not specifically address the liquidity premium, some state that the liquidity premium is regarded as part of the overall risk premium, and some state that it cannot be determined precisely.

The Danish FSA expects that the companies quantify and address the liquidity premium in the alternative investments. That the companies regard the liquidity premium as part of the overall risk premium, or believe that it cannot be determined precisely does not absolve them from addressing the liquidity premium, as they should ensure that a return is obtained that corresponds to the risk assumed.

Focus on risks in alternative investments
The companies should generally address the risks in alternative investments with a view to making an assessment of whether there is an appropriate relationship between return and risk. The overall impression of the Danish FSA is that, to a greater or lesser extent, the companies address the overall return-risk ratio, but they do not explicitly address the individual risks such as the liquidity premium.

Therefore, there is a significant variation across the companies in the number of risks mentioned in the context of alternative investments. Liquidity risk, political risk, management risk and legal risk are mentioned by most companies, while model risk, financing risk (gearing), natural disaster risk, technical risk and correlation risk are only mentioned by a few.

Several companies mention liquidity risk, but some companies also deem that they are not exposed to this risk because they follow a buy-and-hold strategy and therefore it is not relevant to assess the liquidity risk separately. Only four companies mention model risk in connection with valuations. Correspondingly, only a couple of companies mention correlation risk and that a lack of market data makes it difficult to observe whether correlation risk changes over time. This should be considered in the context that many companies mention that alternative investments contribute to diversification of their overall portfolio and therefore this is an important reason for investing in assets within the group of illiquid alternative assets.

Not all risks necessarily affect the value of the asset, e.g. operational risk, but all material risks should be included in an assessment of the attractiveness of the assets. The Danish FSA expects therefore that the companies quantify the expected returns and risks for a given alternative investment so that it is possible to assess the attractiveness of the investment. It is also expected that the companies address the individual risks, e.g. the risks that the companies cannot themselves influence, and the risks which may materialise during ownership of the alternative investments. This may be political risk following changes in subsidies, legal risk where either the contract does not cover the transaction or there is a change in legal practice during the term of the agreement, or the risk that there is a change in technological developments.

The companies should also address correlation risk when the contribution of investments to diversification is to be assessed, and they should regularly assess liquidity risk, even if there is a buy-and-hold strategy, as a change in credit rating of the assets may make the companies limit the credit risk by selling before expiry of the strategy period.

With regard to quantifying the market risk of alternative investments in connection with calculation of the individual solvency need, the Danish FSA has also ascertained that the companies have primarily applied a yellow light and the QIS5 method Therefore it seems that the companies have applied different stress levels for what are apparently the same types of asset. On 1 January 2014, a new Executive Order on solvency and operating plans entered into force, under which the companies should initially apply a standard model in calculating their individual solvency need. Therefore, the Danish FSA in the future expects more uniformity in the stress applied by the companies in relation to alternative investments.

The Danish FSA expects a critical approach to valuation

According to the accounting regulations, alternative investments should generally be valued at fair value. The fair value of alternative investments can only rarely be ascertained from the market and therefore appropriate valuation techniques have to be applied. The Danish FSA expects that the valuation technique is based on parameters which affect the value of the relevant asset and that the companies regularly address these critically.

No matter whether the companies make alternative investments directly or through funds etc., the companies are responsible for ensuring that the assets are regularly valued at fair value. The Danish FSA expects that the companies have ensured that the assets can be valued at fair value and that they have taken a position on how valuation is to take place, including the validation and sensitivity analyses that are to be made. The assets should be valued suitably frequently to ensure that the asset is regularly set at fair value on the basis of available information. It should be ensured that the companies can measure, manage, validate, control and report the risks the undertaking is or can be exposed to in connection with investments in alternative assets.

In this context, the statements give an impression that, in general, valuations by the companies seem to be carried out appropriately, although in some areas the companies could be more critical in their valuations. Among other things, in addition to the lack of focus on the liquidity premium, the Danish FSA notes that only half of the companies, representing 66% of the alternative investments, state that they conduct sensitivity analyses. The Danish FSA is of the opinion that sensitivity analyses provide the companies with the information necessary to address the uncertainty in valuations.

Examples of good approaches to alternative investments

To a greater or lesser extent the companies have described in their statements their specific approaches to alternative assets. Because of the large differences in the assets categorised as alternative assets, it is difficult to summarise the approaches use in one overall best practice. However, in its review of the statements, the Danish FSA has ascertained a number of examples of good approaches to various sub-areas:

- The required return is quantified on the basis of the long-term risk-free interest rate plus a relevant risk premium and a liquidity premium which are set on the basis of selected existing assets.
- For example, the liquidity premium is quantified by comparing illiquid listed bonds with liquid listed bonds.
- Validation of the valuation is through an independent function set up specifically for this purpose.
- Regular sensitivity analyses are made of the most important assumptions behind valuation.
- The due-diligence process is very thorough and important parameters, for example in a valuation model, and risks, for example legal, are analysed in detail. Depending on the complexity, external advisors may be used.

In future the Danish FSA will sharpen focus on alternative investments by the companies
The Danish FSA has assessed the statements in full knowledge that they are not exhaustive and therefore there can be areas which are less well covered by the statements and thus do not give an accurate and complete picture of how the companies manage alternative assets.

In future the Danish FSA will sharpen focus on the companies with regard to their alternative investments. Among other things, the Danish FSA will assess whether the companies have adequate focus on the returns-risk ratio, including whether the companies specifically address the liquidity premium and whether the companies are sufficiently critical in their valuation of alternative investments.

1.1 About the survey

This report is based on the companies' own data and this data has not been checked by the Danish FSA. The data is not submitted periodically to the Danish FSA.

When the companies have reported the percentage of alternative investments in total investment assets, this percentage has been adjusted in relation to total assets.

When processing some of the companies' replies, it has been necessary to make simplifying assumptions, for example in connection with companies' statements of how risks are quantified.

The conclusions of the survey are based on data for the investments the companies made in 2012 and pledges which have not been executed at the date of the survey have not been included.

1.2 Scope

The 2012 Christmas newsletter was sent to 19 market-oriented companies and 28 non-market-oriented companies. The replies from some companies have been grouped together so that some of this report comprises eight market-oriented companies/groups of companies, and 15 non-market-oriented companies/groups of companies. The deadline for replies to the survey was the end of June 2013 and all quantitative data was as at the end of 2012.

The companies themselves assessed which of their assets belonged to the group of alternative investments which formed the basis for their replies, and this has caused some differences in the data basis.

Property in particular has been treated differently. Some companies have omitted property completely, others have included untraditional property, and yet others have included property with alternative investments. This inconsistency means that property has not been included in the group of alternative investments in the conclusions on the survey.

Excluding property, the companies' alternative investments can be divided into five main categories: Private equity, alternative credit, infrastructure, agriculture and hedge funds. These main categories can be further divided into sub-categories.