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Viewpoint

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ASSET MANAGEMENT | WHITE PAPER

Seeing the Big Picture: Managing Total Investment Risk in the General Account and DB Pension Plan

By Sean Kurian, Managing Director, Head of Institutional Solutions

In an era when enterprise risk management and holistic balance sheets are table stakes for sophisticated insurance companies, many insurers have a blind spot: understanding the full investment risk of their general account and defined benefit (DB) pension plan separate account.

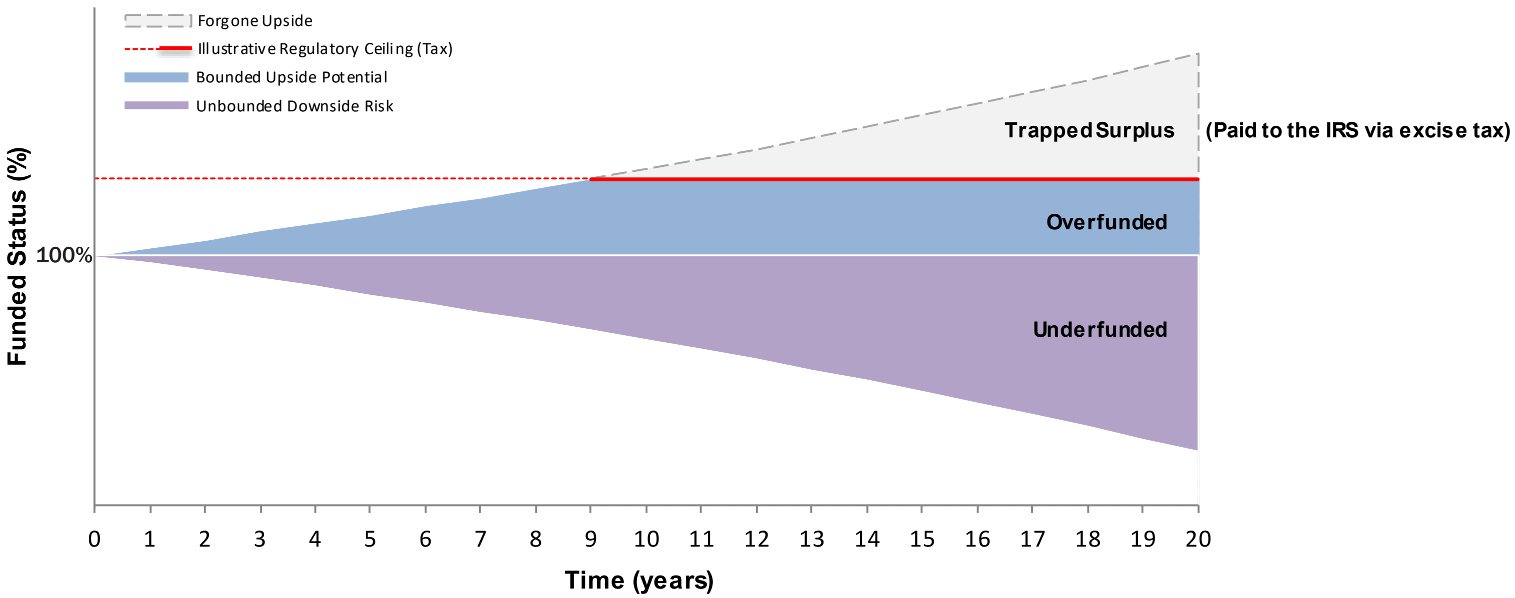
We have seen insurers with sizeable annuity businesses (pensions are most similar to annuity products) position their DB asset portfolios inconsistently – even counter-productively – with their general account assets, even when allowing for the differences in their respective investing approaches.

Too many insurers have not taken the opportunity to see the big picture of their enterprise-wide investment risk profile. That often leads to them developing inefficient investment strategies, resulting in missed opportunities to improve net income, pension plan funding and their bottom lines, harming potential surplus growth.

We think the problem lies with insurers not demanding a comprehensive, apples-to-apples view of general account and DB assets. In response, Conning has developed a proprietary solution to address this problem, based on our deep understanding of insurance and pension asset management.

Like a pair of prescription glasses, Conning can help insurers capture a clear and complete view of their general account and pension assets, an important step in developing the holistic, customized investment strategies that can better serve their needs.

Figure 1 - DB Investment Risk: Limited Upside, A Whole Lot of Downside



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The Advantage of the General Account Platform

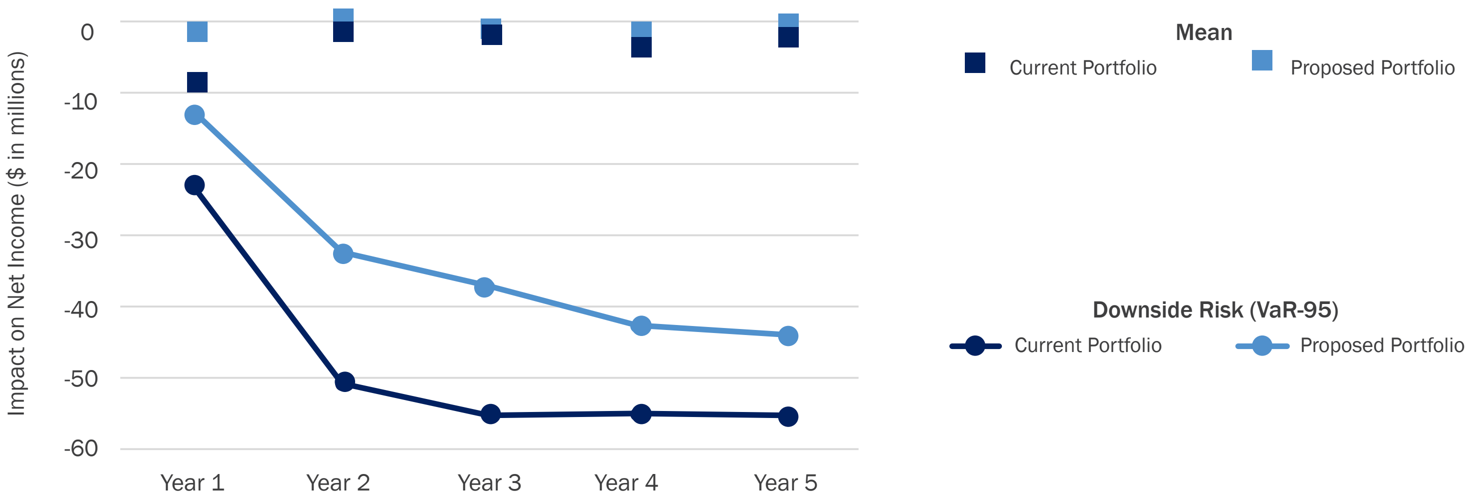
For insurance companies, the general account and DB pension plan are both investment platforms, but their differing tax treatment makes the former more desirable from a return-generation/shareholders' perspective. Fully understanding and appreciating this is a first step to building a more efficient overall investment strategy.

Following the 2017 tax law changes, investment returns for a general account are subject to a corporate tax rate of 21%. This means returns passed as profit to shareholders via net income only have a 21% tax rate applied. However, investment returns for a DB pension plan separate account are subject to an excise tax – usually far higher than the 21% corporate tax rate – if they were to be taken out of the plan and returned to the insurer's general account. That's one benefit of having returns come through the general account versus the pension plan from the shareholders' perspective.

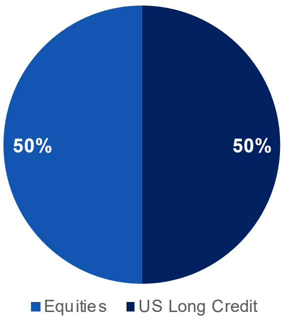
Per Figure 1 on the previous page, the DB plan also appears to be the weaker choice for adding investment risk as it is often poorly rewarded (on either an absolute or cost-of-capital basis). DB plans have limited upside, as beyond certain funding thresholds plan assets are subject to additional taxation. This effectively caps the incentive to pursue greater risk for greater potential return. The plans have asymmetric downside exposure, however, and if investments underperform sponsors remain on the hook for their full pension obligations.

Even when an insurer's DB plan is underfunded, it could be more efficient to make additional contributions from outperformance in the general account than to take on more risk in the pension plan's investment strategy. As noted, companies have greater flexibility over assets within the general account.

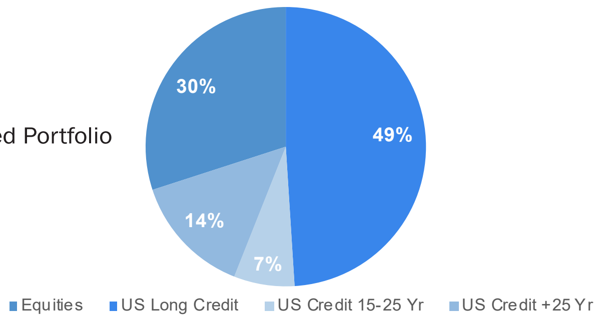
Figure 2 - Projected Impact on Company Net Income*



Current Portfolio



Proposed Portfolio



*Prepared by Conning, Inc. The data presented in Figure 2 is hypothetical, is based on 2019 sample client pension data, and is simulated for years 2020-2025 using GEMS© Economic Scenario Generator for illustrative purpose only. The modeled strategy shown carries a risk of loss and prospective investors should carefully read the methodology, assumptions, and other important information of the hypothetical model results presented herein and refer to the Hypothetical Model Disclosures (page 4). Source: Bloomberg Index Services Limited. Used with permission. Sources: Bloomberg is a trademark of Bloomberg Finance L.P. and its affiliates (collectively "Bloomberg"). Barclays is a trademark of Barclays Bank Plc (collectively with its affiliates, "Barclays"), used under license. Neither Bloomberg nor Barclays approves this material, guarantees the accuracy of any information herein, or makes any warranty as to the results to be obtained therefrom, and neither shall have any liability for injury or damages arising in connection therewith and ©2020 Analytics provided by "The Yield Book"® Software and Services/London Stock Exchange Group plc.

Creating a Common View of General Account and DB Pension Plan Assets

To identify potential opportunities for efficiently increasing investment risk in the general account versus the DB plan, insurers should compare their cost of capital with potential after-tax return on capital from investments on a risk-adjusted basis. Conning recommends doing this through projections of the general account and the DB pension plan separate account.

Easier said than done, however. The majority of general account assets under statutory accounting are treated at amortized cost, while the assets in the DB pension plan separate account are evaluated on a total-return basis (with volatility smoothing through amounts in unassigned funds (surplus) that have not yet been recognized as components of net periodic cost).

Figure 2 on the previous page illustrates the comparison of left-tail impact on statutory net income from a de-risked investment strategy within the DB pension plan separate account. Through our analysis, an insurer can assess the cumulative impact on net income and risk-adjusted return on capital by changing the investment strategy within the general account versus changing it within the DB pension plan separate account. This approach helps ensure that the two investment strategies are not inconsistent. For the situation illustrated in Figure 2, we see that the revised (de-risked) investment strategy-within the pension plan improves the downside risk for net income over the next five years. We can also demonstrate that it does so without materially changing the expected level of net income itself.*

The results of this analysis are unique for each insurer but, as demonstrated, Conning has developed the technology to compare investment policies between accounts on an "apples-to-apples" basis. We believe this capability is unique in the U.S. insurance industry today and a testament to our deep institutional investment expertise in both the insurance and corporate pensions arenas.

Sean Kurian, FSA, CAIA, FIA, FRM, is a Managing Director and Head of Institutional Solutions at Conning, responsible for a team providing strategic investment advice and broader investment solutions across the main institutional investor types. Mr. Kurian serves on the FTSE Bond Index Committee, responsible for the FTSE/Citi bond index range, and has been a frequent media commentator on financial risk management and institutional investment issues. He has over 20 years of industry experience, working on both sides of the Atlantic in portfolio management and consulting roles. Prior to joining Conning in 2016, Mr. Kurian was a lead structuring specialist and derivatives portfolio manager at J.P. Morgan Asset Management, and previously led Towers Watson's Structured Solutions group. Mr. Kurian earned a master's degree from the University of Oxford.

About Conning

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