REDUCING P&L VOLATILITY AND PROTECTING CAPITAL – AN INTEGRATED APPROACH TO HEDGING VARIABLE AND FIXED INDEX ANNUITIES

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Introduction – A modern age of annuities

The US annuity market is at an inflection point. In theory, demographic changes should be driving demand for annuities, with 10,000 baby boomers entering retirement every day and requiring products to provide financial security. In reality, regulatory, economic and geopolitical uncertainty have cast a shadow across the annuity business. Sales of annuities have faltered and their suitability as retirement vehicles is in question.

However, all is far from lost. We believe that annuity providers can still thrive – by bringing to market innovative new products and supporting their design and implementation with superior risk management capabilities. And critically, to deliver the capital growth potential and guarantees that the market demands of annuities, providers must implement sophisticated hedging strategies.

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The changing market

In 2016 sales of variable annuities in the U.S. fell for the fifth year in a row. With sales of fixed index annuities hitting record levels in the same year, what is driving this reversal of fortunes?  

1 The ongoing uncertainty

In a low interest rate environment, insurers can no longer offer the guarantees they used to. However, in March 2017 the U.S. Federal Reserve raised its base interest rate for the second time in three months, from 0.75 percent to one percent, taking the U.S. base rate to its highest level since 2008. But is this a true sign of an about-turn in economic policy, or will interest rates generally stay lower for longer? Whatever the outcome, many potential policyholders are putting off committing to an annuity until they can be more certain how rates will play out.

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Figure 1. U.S. interest rates have risen to their highest level since November 2008

Monthly federal funds effective rate %

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1 THINKADVISOR, FIXED ANNUITY SALES HIT RECORD $117.4 BILLION IN 2016, FEBRUARY, 2017
2 U.S. FEDERAL RESERVE, MARCH, 2017
The regulatory question
The uncertainty regards the Department of Labor (DOL) Fiduciary Rule continues to hang over the industry. Under the proposed legislation, brokers and registered investment advisors must now both show that the retirement plans they recommend are in the “best interest” of plan sponsors and participants rather than meeting the previous “suitability” standard. This burden of compliance, not to mention the risk of litigation, may prevent many brokers from recommending variable or fixed index annuities at all. Under the new U.S. administration, the Rule’s future is unclear. Since being proposed, however, it has certainly driven insurers to rethink the type of products they can bring to market.

Market volatility
Recently, market volatility has been very low indeed. But a spate of government election campaigns in Europe have followed hot on the heels of the new U.S. presidency – continuing a lengthy spell of geopolitical uncertainty. With strained relations between the U.S. and North Korea, we can now expect periods of sustained volatility, increasing the likelihood of un-hedged losses on the insurance book of business.

A focus on fees
The growth of passive investment products and exchange traded funds (ETFs) has led many investors to question whether the benefits of actively managed funds justify the investment fees that are charged as part of a variable product. At the same time, annuity providers are restricting the range of funds that are available to policyholders to limit the cost and capital associated with their guarantees. These “volatility controlled” funds limit the upside return for policyholders and in turn the growth potential of their benefit base.

The response of annuity providers
Faced with so many new trends and modern challenges, the annuity market is combating change with change. Specifically, providers are responding to the market’s evolution by delivering increasingly against five key objectives – each with its own implications for hedging strategies and operations.

Support product innovation
As a result of uncertain interest rates, regulatory changes like the DOL Fiduciary Rule and changing demographics, insurers are taking innovative approaches to bringing new products to market.

Innovations include developing more fee-based products that don’t rely on commission, designing products that are less sensitive to interest rates, creating new methods for crediting accumulations to indexed products and offering product hybrids such as buffered annuities.

The success of all of these products depends on hedging and modeling platforms that are flexible enough to support new ideas without their vendor having to update the software.

Improve operational efficiency through consolidation
Every insurer has unique aspects to its business, whether an innovative new product design or a cutting-edge dynamic actuarial algorithm. As a result, they have often developed their own internal platforms or adopted multiple vendor systems for specific purposes, leading to a fragmented, inefficient and costly operational environment.

In a challenging market, insurance companies are looking to reduce costs and risk, and increase efficiency, by consolidating the different platforms they may use for hedging and actuarial modeling.

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Focus on risk management
With market volatility expected to increase, today’s annuity providers can ill afford to generate losses through market risk exposures that are unintended – and above all, un-hedged. They are therefore developing robust, more sophisticated risk management platforms that support scenario analysis, stress testing and real-time decision-making – all critical for optimal hedging in volatile markets. By optimizing their risk management strategies in this way, providers are helping reduce volatility in their profit and loss (P&L) and in turn the amount of capital they need to set against their products for regulatory compliance.

As part of an overall risk management strategy, a focus on liquidity risk will also be increasingly important for annuity providers that hedge with derivatives. Currently, low interest rates make insurers the net beneficiaries of the collateral and margin that must be posted with derivative trades. But when, sooner or later, interest rates do start rising in earnest, this situation will reverse – and insurers will be subject to collateral and margin calls, requiring greater visibility and tighter management of liquidity.

Deliver flexibility and control
Today’s insurance companies are highly regulated entities that must demonstrate they have the proper controls in place to reduce operational risk. Consequently, their risk management, hedging and modeling platforms need full audit capabilities, secure, authorized access to data, controlled production environments – and the ability to define dynamic and static compliance rules for market exposures and trading activities.

At the same time, insurers need the flexibility of an “open” platform to meet the diverse needs of their businesses. This includes the ability to extend and customize their solutions to meet their specific needs.

The clashing requirement for both “open” and “closed” systems is further encouragement for insurers to consolidate hedging and modeling platforms – for maximum flexibility and minimal operational exposure.

Ensure connectivity across the organization
Many insurance companies are looking to break down the barriers and silos that exist within their organization to drive collaboration and connectivity – and ultimately deliver a coherent view of risk across their balance sheet. The traditionally separate actuarial and investment/hedging teams provide a case in point, with technology seen as an important means to connect them.
The modern hedging solution

To meet their modern objectives, annuity providers need a modern hedging environment to match – a comprehensive technology platform that can support their strategies efficiently from end to end. For optimal hedging in today’s market, an enterprise ecosystem of this kind should seamlessly integrate and consolidate insurers’ actuarial modeling and trading environment, driving collaboration between traditionally siloed business units and providing a single view of risk across the balance sheet.

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When considering a solution, make sure that it offers:

- The flexibility and transparency of an “open” platform and the governance and control of the “closed” platform – helping meet the diverse requirements of your risk management processes, manage operational complexity and risk, and deliver a complete audit trail of decision-making processes
- Scalability to keep pace with your business – reducing dependency on your technology vendor for new product development or support of new hedging strategies
- Capacity to handle the sophistication of your business – models that reflect the dynamic nature of your hedging strategy and provide core support for the complexity of your hedging instruments
- Support for key regulatory requirements such as Actuarial Guideline (AG) 43 for variable annuities
- A single, consistent set of market data and assumptions – delivering a coherent view of risk across assets and liabilities, driven by models that use a common source of current and historic market data
- High-speed calculations of liability portfolios – giving your hedge implementation team the most up-to-date view of the liability profile and so improving the effectiveness of your hedge strategy
- Minimal integration issues and potential points of process failure – reducing operational complexity and costs
- Real-time capabilities – supporting rapid, real-time decision-making, critical in managing your hedging strategy during periods of high market volatility
- P&L attribution – helping inform and improve your hedging strategy by identifying “leakages” in your P&L due to un-hedged exposures
- Dashboards – delivering a single view of risk across the balance sheet for senior stakeholders, helping drive connectivity throughout the organization
- Focus on managing liquidity – supporting collateral and cash management in uncertain market conditions
- Strategic partnership with your technology vendor – solving your business problems together

Conclusion – A single platform for all your hedging decisions

In a challenging regulatory and market environment, annuity providers need to continually develop innovative products while keeping down their operational costs. But to manage risk and volatility, they must support the sophistication of their retirement solutions with equally sophisticated hedging strategies.

An integrated platform for actuarial modeling, risk management and derivatives trade processing will be key to getting the best from those strategies in today’s market. With actuarial data directly feeding a single, real-time view of risk across the balance sheet, insurers will be in a stronger position to make effective hedging decisions.

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At the same time, the consolidation of disparate systems will help reduce operational costs and risk. And for compliance and audit, the management of the entire derivatives life cycle from a single platform will increase both transparency and control.

Once, a fragmented landscape of disparate solutions would have been necessary for managing products as complex as variable and fixed index annuities. Today, a single, consolidated, modern platform is by far the best option for meeting modern hedging demands.
**FIS’ Insurance**

FIS’ Insurance solution suite provides a complete ecosystem to support the implementation of hedging strategies, allowing you to consolidate platforms, deliver operational efficiencies and drive collaboration across the enterprise.

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