Box 9
Insurers' investment in alternative assets

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In the current low interest rate environment, euro area insurers have been venturing into alternative asset classes such as alternative, infrastructure and private equity funds, loans and real estate holdings.[77] This move helps insurers diversify their portfolios. It may also boost their

[77] To capture most of the non-traditional and illiquid investments of insurers, this box considers a broad set of alternative assets including real estate holdings, even if they may not be considered as an "alternative" asset class in all euro area countries. For instance, in the Netherlands, insurers and pension funds have traditionally invested in real estate, mainly through the provision of mortgages.

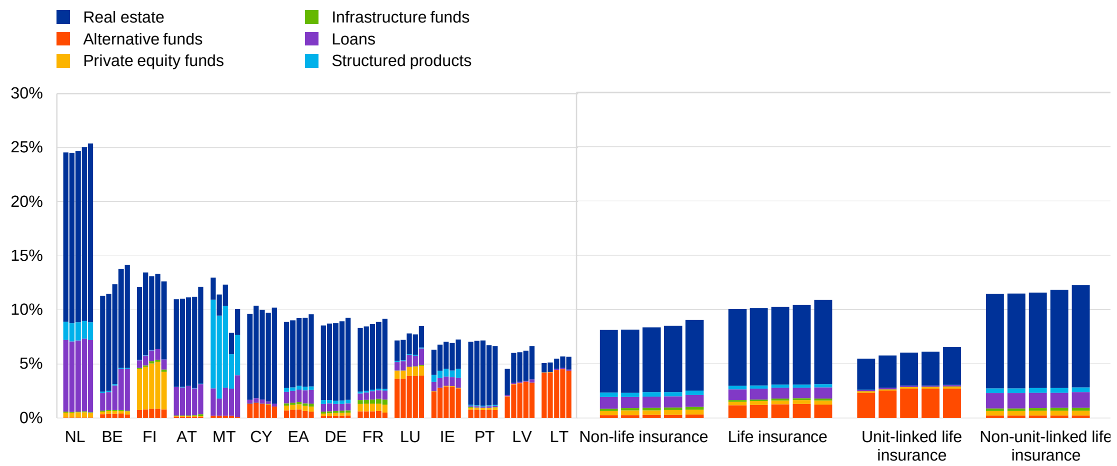
investment returns and limit the duration mismatch in their balance sheets. More broadly, it contributes to the diversification of the financing sources of the real economy (see **Chart 4.1**). But the portfolio shift towards alternative investments also raises financial stability concerns, which is the focus of this box. In particular, the shift may increase insurers' credit and liquidity risks and contribute to wider financial sector exuberance in some parts of the real economy as well as amplify market shocks in the event of (abrupt) price corrections.

Chart A

Exposures of euro area insurers to alternative assets have increased across all types of business and most euro area countries

Insurers' exposure to alternative asset classes: by country (left panel) and by type of business (right panel)

(Q4 2017-Q4 2018, percentage of total investment)



Sources: European Insurance and Occupational Pensions Authority (EIOPA) and ECB calculations.
Notes: Based on aggregate asset exposure statistics published by EIOPA (solo Solvency II reporting; template S.06.02). The "real estate" category includes exposures to residential and commercial properties (excluding the ones for own use), mortgages and equity of real estate-related corporations and real estate funds. "Alternative funds", "infrastructure funds" and "private equity funds" include exposures to the respective fund category. "Loans" include exposures to collateralised and securitised loans as well as loans without collateral (mortgages are included under "real estate"). "Structured products" include collateralised securities. Euro area countries with exposures below 5% at the end of 2018 (EE, ES, GR, IT, SI, SK) are not shown. Right panel: based on a limited set of 14 euro area countries, for which the split between exposures of life and non-life insurers is available.

On average, insurers' holdings of alternative assets increased from 8.9% to 9.6% of total investment assets over 2018 and are expected to rise further in the next years (see Chart A).[78,79] While the exposures grew across most euro area countries, there is a striking heterogeneity in their overall size (see **Chart A**, left panel). The largest exposures are currently in the Netherlands (25%), followed by Belgium (14%) and Finland (13%). There are also some differences across business types, with life insurers holding 10.9% of their assets in alternative investments at the end of 2018 (see **Chart A**, right panel).

While starting from low levels, infrastructure and alternative funds have been the fastest-growing among the alternative asset classes in insurers' portfolios. Traditional life insurers offering non-unit-linked policies were the most significant contributors to the fast growth in holdings of infrastructure funds, which may offer them a high-yield investment opportunity that matches the long-term duration of their liabilities. By contrast, the increase in exposures to alternative

[78] Based on the new quarterly exposure data published by EIOPA, which start only as of the end of 2017.

[79] According to the November 2017 EIOPA investment behaviour report and industry reports, although the level of alternative assets is currently low compared with the overall portfolio size, almost 75% of the European insurers surveyed responded positively about increasing their investments in asset classes such as infrastructure, mortgages, loans and real estate.

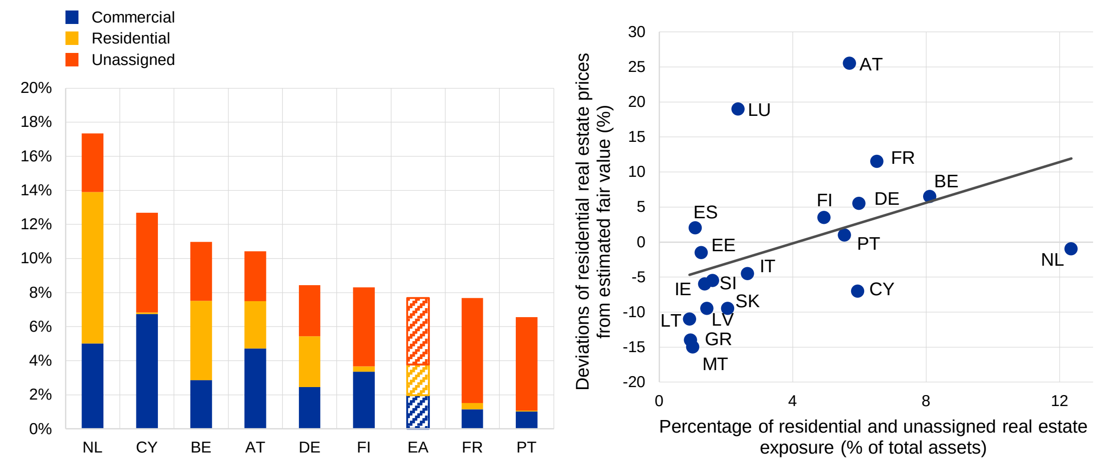
funds was mainly driven by unit-linked life insurers, which hold almost half of their alternative assets in such funds. Alternative funds are in turn subject to elevated liquidity risk, owing to the (possible) mismatch between daily or weekly redemption rights and their illiquid investments.[80] Moreover, these funds are often highly leveraged and exposed to credit risk, which can amplify the liquidity strains and expose insurers to large losses – even if the impact on the sector may be limited, owing to the design of unit-linked policies.

Chart B

Insurers' exposures to real estate tend to be high in countries with elevated property valuations

Euro area insurers' exposure to real estate as a percentage of total assets (left panel) and residential real estate prices (right panel)

(left panel: Q4 2018, percentage of total assets; right panel: Q4 2018; x-axis: percentage share of residential and unassigned real estate exposure in total assets; y-axis: percentage deviations of residential real estate prices from estimated fair value)



Sources: Solvency II data from EIOPA, ECB and ECB calculations.
Notes: Left panel: both direct exposure (through property, mortgages and real estate securities) and indirect exposure (through real estate funds) are included. The category "unassigned" consists of corporate bonds, equity, real estate funds and other real estate investments, for which the breakdown into commercial and residential real estate is not available. Right panel: for each country, the fair value estimations are calculated as an average of estimates obtained by two different methods: the price-to-income ratio and one model-based estimate (Bayesian vector autoregression or BVAR). For details of the methodology, see Box 3 in *Financial Stability Review*, ECB, June 2011, and Box 3 in *Financial Stability Review*, ECB, November 2015.

While less dynamic in terms of growth, real estate holdings represent by far the largest exposures to alternative assets in many euro area countries. Such exposures accounted for around 7.7% of insurers' investment portfolios at the end of 2018 and included exposures to both residential and commercial real estate markets (see **Chart B**, left panel). The exposures tend to be large in countries with elevated property valuations, which suggests that insurers may have contributed to exuberance in property markets (see **Chart B**, right panel). Also, potential property price corrections are more likely to occur in overvalued markets and could thus result in significant valuation losses in insurers' portfolios. In such a scenario, traditional life insurers would be the most exposed to the potential price drops as they hold more than 80% of the sector's exposures. But the growing investment of traditional life insurers in real estate and particularly in mortgages with long periods of fixed interest rates can also be seen as a positive development for financial stability, as it may help traditional life insurers to close the typically negative duration gaps on their balance sheets, while diversifying the financing sources of the economy.

80 See, for example, Annual Statistical Report on EU Alternative Investment Funds, ESMA, 2019.

There are several reasons why investment in alternative assets could also help insurers address the profitability challenges they face in the prevailing low-yield environment.[81] Alternative investments typically offer higher expected returns than bonds and stocks. This spread can be explained by the higher credit risk of the projects that corporations finance through these instruments and/or a higher illiquidity premium relative to publicly listed instruments. In particular, alternative asset classes are often difficult to price and imply high trading costs, owing to informational frictions and a limited set of potential buyers as well as legal impediments to trading. Furthermore, alternative asset classes are typically mildly correlated with traditional markets and result in a more diversified portfolio. All these characteristics make alternative asset classes attractive to institutional investors with a long-term investment horizon that usually "buy and hold", such as insurance corporations and pension funds.[82]

At the same time, a growing share of alternative investments in insurers' portfolios also raises financial stability concerns. First, the low credit quality and high leverage in some segments of the (private) corporate sector result in elevated exposures of insurers to risky assets. The returns on these investments may come under pressure should the weak growth outlook materialise or be worse than expected. Second, although insurers often engage in a "buy and hold" investment strategy, they may want to liquidate some of their alternative assets in a severe stress scenario, which may prove difficult due to their illiquid nature. Third, some of the alternative instruments – such as alternative and private equity funds as well as structured products – are highly complex and opaque, potentially making it difficult for insurers to manage these risks effectively. Finally, the exposure to higher-yielding and illiquid alternative assets is expected to rise over the coming years, which may further contribute to wider financial sector exuberance in some markets such as real estate and exacerbate financial cycles.

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81 The data available for a limited set of euro area countries suggests that low profitability of life insurers in 2017 (as measured by return on investment minus average guaranteed rates – see Chart 4.14) correlates with the size of their exposures to alternative assets at the end of 2018 (correlation coefficient of -44%).

82 According to Cummins, Cragg, Zhou and deFonsecka (2018), between 2010 and 2016, the allocation of US life insurers to privately placed bonds increased from 25% to 30% (see Cummins, D., Cragg, M., Zhou, B. and deFonseka, J., "The Social and Economic Contributions of the Life Insurance Industry", September 2018). At the same time, the share of illiquid asset classes held by pension funds rose globally from 4% in 1997 to 25% in 2017 (Willis Towers Watson's Global Pension Assets Study, 2018). See, for example, Ivashina, V. and Lerner, J., "Looking for Alternatives: Pension Investments Around the World, 2008 to 2017", 2018.