Australian unregulated insurers: The state of play: FY23

February 2024

Frontier Advisors

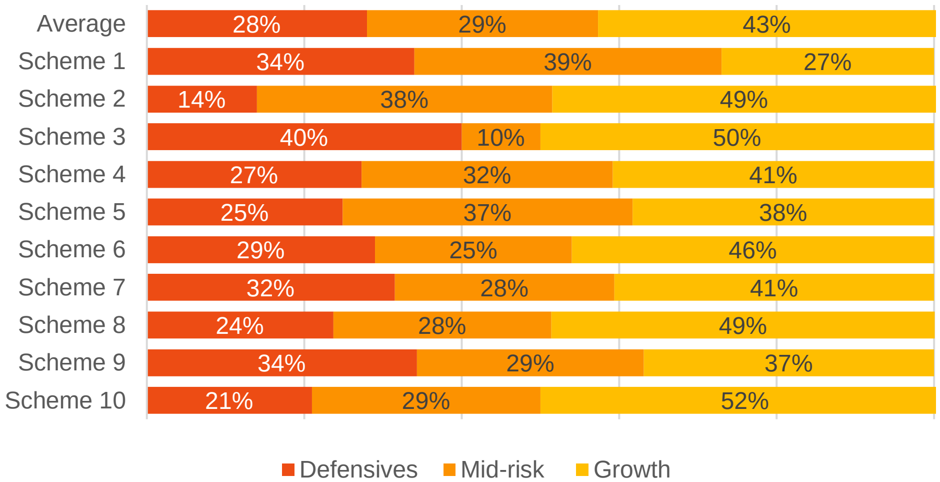
Introduction

- This report has been produced using the respective annual reports of Australian unregulated liability driven investors for the 2023 financial year.
- While Frontier maintains a database of the industry, which includes a range of unregulated entities (e.g. CTP schemes, long service leave schemes, workers compensation schemes and redundancy trusts), this report focuses on long-tail insurers. Due to the similarity of their liability profiles, CTP and workers compensation schemes are the focus of this report. We also include the Future Fund in some parts of this report because it is a large government institution and other schemes and institutions show interest in its asset allocation and performance.
- We utilise various data series to compare the performance of each insurer, identify the nature of their investments, assess their risk appetite, and comment on any investment trends that offer forward-looking insights.
- These long-tail schemes have some common characteristics including:
  - Longer-term investment horizon, in part because of the long duration of their liabilities and their sensitivity to changes in inflation and superimposed inflation.
  - Additional flexibility in investible asset classes that may be prohibitive under APRA's Life and General Insurance Capital Standards (LAGIC), such as equities, real assets and alternatives. Schemes may include a broad range of asset classes within alternatives. For instance, alternatives may include hedge funds, multi-asset class strategies and in some instances, infrastructure.
  - A greater willingness to invest in markets overseas due to their zero-tax status, positive cash flow profile with no regulatory limits imposed.
- Unregulated schemes are generally willing and able to take higher risks to achieve higher returns (compared to regulated insurers) and therefore typically hold more growth assets than defensive assets.
- Mid-risk assets such as unlisted property, unlisted infrastructure and private credit are attractive to long tail schemes because they can reduce return volatility, provide diversification to equities and bonds and offer relatively consistent returns.

Growth/defensive assets

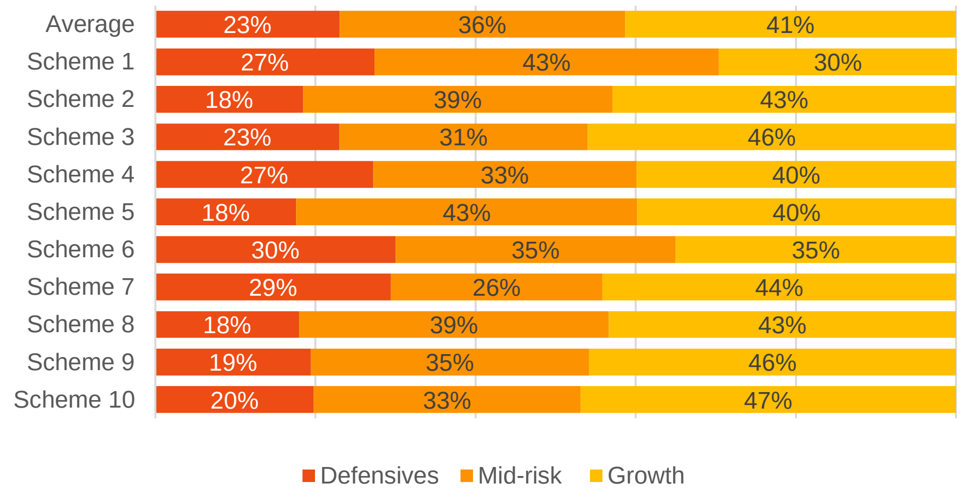
Comparison between 2019 and 2023

Chart 1: 2019 asset allocation by asset grouping



Source: Annual Reports. May not sum due to rounding. Scheme 10 is the Future Fund

Chart 2: 2023 asset allocation by asset grouping



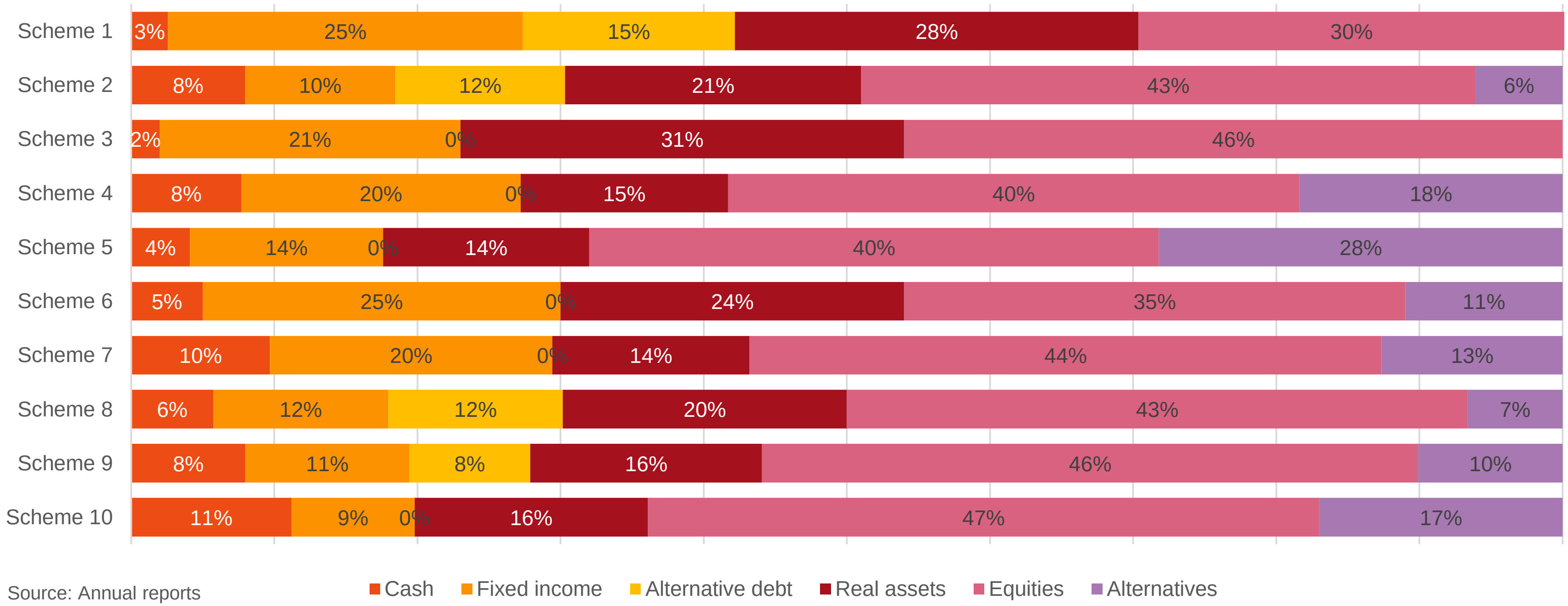
Source: Annual Reports. May not sum due to rounding. Scheme 10 is the Future Fund

- These unregulated schemes' main objectives are to maintain a funding ratio within their target bands and exceed investment return objectives. Considering the objectives, the charts show insurers are more likely to invest in higher risk and higher return investments over defensive investments.
- The high allocation to equities allows government insurers to ensure their assets can grow over time to cover liabilities which typically grow faster than CPI or wage inflation.
- **In 2023, on average, portfolios held over 35% in mid risk assets. This is a 7% increase from 2019. Government insurers, like other investors, find the diversification benefits of private credit, unlisted property and unlisted infrastructure attractive. Mid risk assets reduce volatility in a portfolio and offer consistent returns, largely generated from income.**
- Since 2019, mid-risk assets have been a significant part of the portfolios of these schemes except for scheme 3 with only 10% allocated to this asset class. However, in 2023, a significant shift to mid-risk assets for scheme 3 is observed and as the market normalises, Frontier believes investments in mid-risk assets is likely to continue for all schemes.
- The average allocation for defensive assets shifted to 23% from 30% and to 36% from 29% for mid-risk assets, essentially representing a switch between bonds and unlisted assets during a period when bond yields were expected to rise from historical lows.

Asset allocations

- At the asset class level, we observe a few major trends to the end of FY23. These include:
  - Cash allocations continue to fall, perhaps partly due to the typically net positive cashflow nature of schemes and because deposit rates remained benign for the majority of the last five years. We question if cash allocations will begin to increase with more attractive yields being offered in late 2023 and early 2024.
  - Fixed income allocations vary widely across the cohort and may incorporate significant allocations to inflation-linked as well as nominal bonds. The data tells us that traditional fixed income and real asset allocations are close to equal weight.
  - For those schemes with lower allocations to real assets, there's evidence to show they have chosen to add alternatives to portfolios for the diversification benefit. Alternatives can include a range of investment strategies including hedge funds, global macro and other liquid alternatives strategies.

Chart 3: 2023 asset allocations



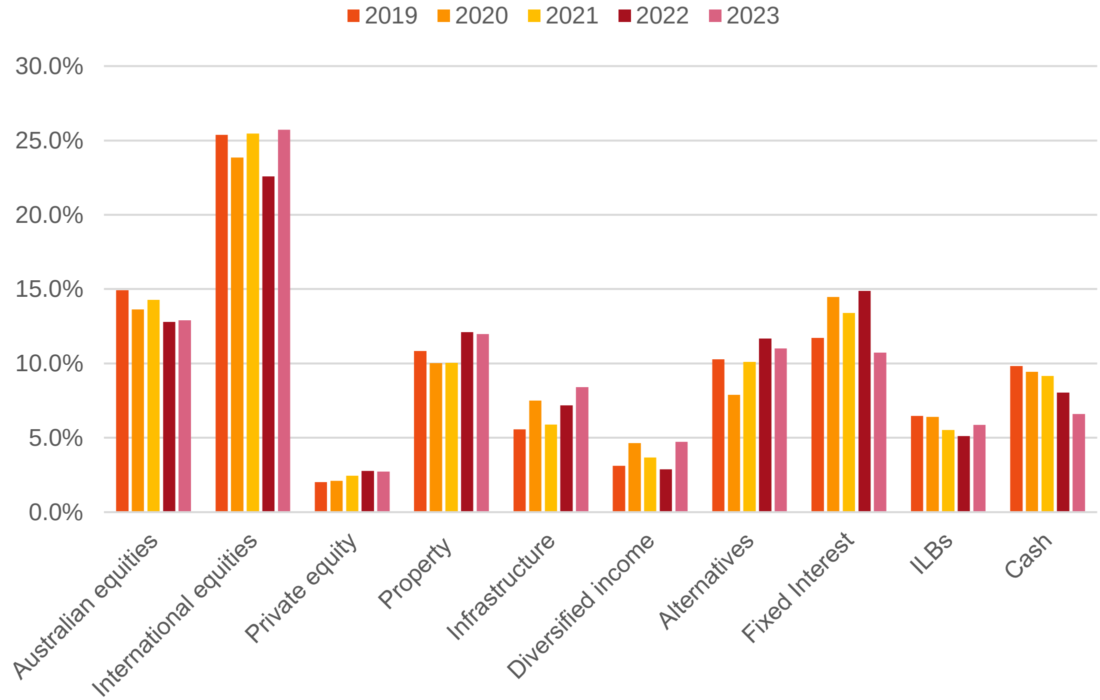
Source: Annual reports

Asset allocations

Change in asset allocation over time

- **Broadly, we observe a trend of decreasing allocations to defensive assets in favour of mid risk assets. However, there will be underlying trends within each asset grouping only visible from asset class data.**
- For example, allocations to Australian equities have been falling over time as insurers have favoured global equities, likely for the increased diversification benefits and prospects of higher returns from the US technology sector.
- Further, we anticipate allocations to Australian equities will continue to drift lower over time given that long-tail government insurers do not benefit from franking credits generated by the Australian company dividends.
- Schemes may include a broad range of asset classes within alternatives depending on how they have chosen to group investments. For instance, alternatives may include infrastructure, hedge funds and multi-asset class strategies.
- Within defensives, allocations to cash and inflation-linked bonds have also exhibited a clear downward trend as insurers shifted portfolios to alternative (non-fixed income) sources of income, that also demonstrate long-term inflationary protection.
- Interestingly, in 2022 portfolios bucked the trend observed from 2019. Many insurers moved to a risk-off position, as evidenced by lower global and Australian equities allocations and a higher allocation to fixed interest. De-risking of portfolios was a prudent decision as equity market lost 12% in the 12 months to June 2022, but since then, equity markets have seen a strong rebound.

Chart 4: Change in asset allocations



Source: Annual reports

Infrastructure, inflation and net zero

Over the years infrastructure experienced an upward trend

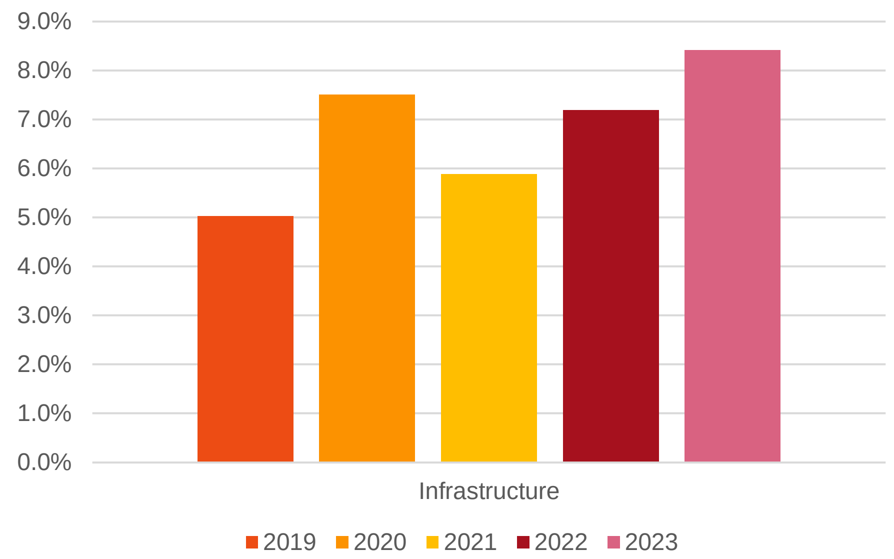
Inflation benefits

- Monopolistic or essential service infrastructure provides defensiveness through highly regulated or long-term-contracted cash flow streams.
- Revenues can be indexed to inflation and thus provide an inflationary hedge.
- Infrastructure assets linked to economic activity (seaports, communications) provide attractive growth options and returns. Capital inflows and returns of the asset class remain attractive.

ESG credentials

- Not only has infrastructure been a strong performing asset class, but the asset class can play a role in decarbonisation of portfolios.
- With insurers focusing more on sustainability this asset class can play a critical role to achieve these goals.
- Renewable energy and social infrastructure assets can help create positive climate change and social outcomes.
- Depending on the net zero objectives of government insurers, investments in infrastructure can help reduce the carbon intensity of portfolios and support government policy goals.

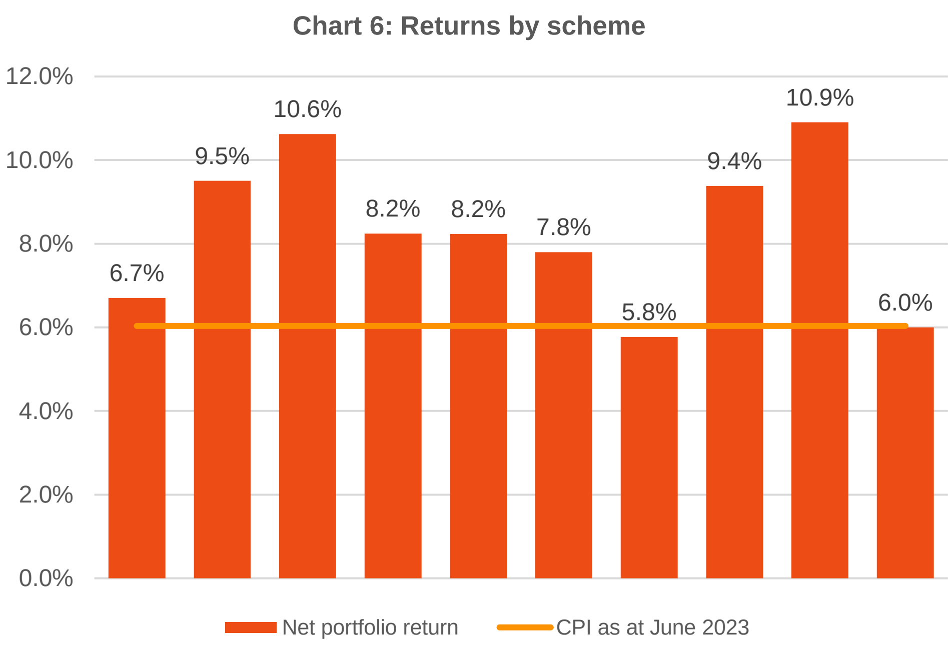
Chart 5: Average infrastructure allocations over time



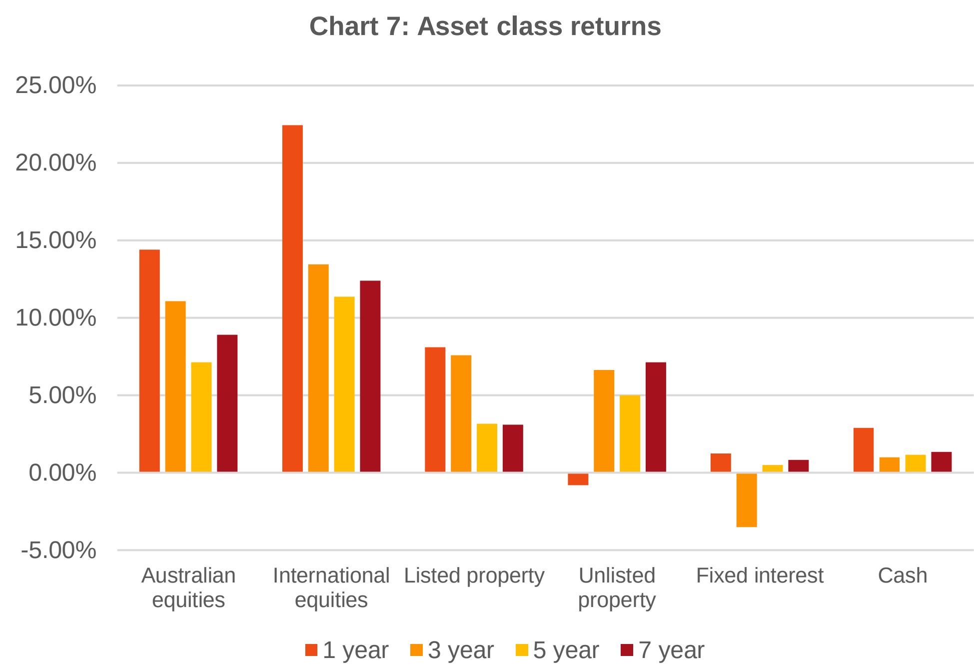
Source: Annual reports

Performance

Returns



Source: Annual reports



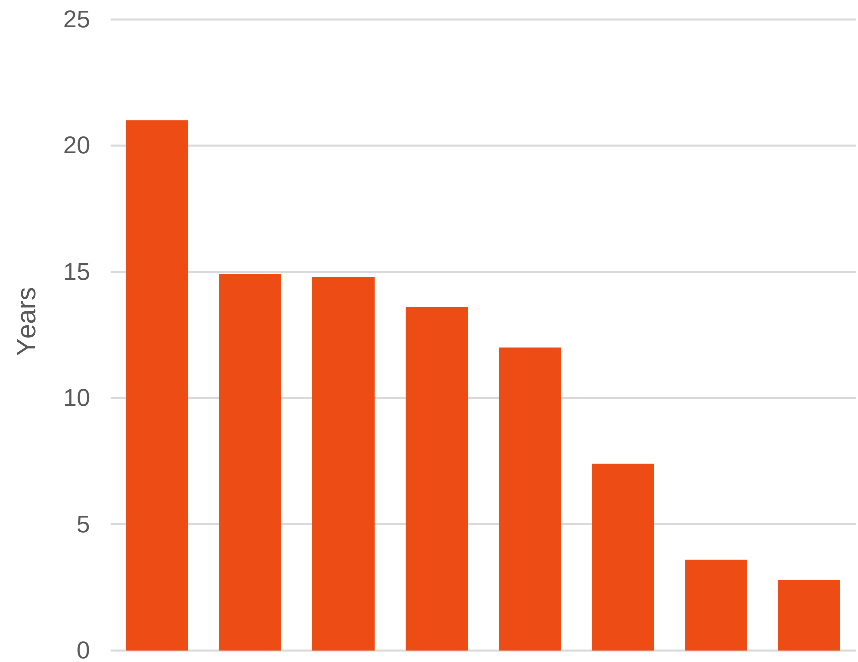
Source: Frontier Advisors

- Unregulated schemes performed strongly in the 2023 financial year despite higher interest rates and an uncertain macroeconomic environment. Chart 7 shows healthy returns were driven by international equities (largely US equities) which generated returns above 20%.
- On average the government insurers returned 8.3% for the year, ranging from the highest at 10.9% and lowest at 5.8%.
- On average, these schemes target a CPI +3.5% investment return objective. However, despite strong returns, most portfolios would have failed to meet their investment return objectives with inflation at a 30-year high.

Duration

- Chart 8 presents, where data is publicly available, information on the duration of each insurer's liability cash flows.
- On average, CTP claims have a duration of 13.6 years while worker's compensation schemes have a liability duration of 7.4 years. CTP schemes may have a higher duration due to more complex and catastrophic injuries resulting in lifetime payments compared to accidents in the workplace which are less likely to result in longer term, complex care.
- Schemes with longer duration liabilities have a longer time frame and therefore the flexibility to invest more in growth assets as they are able to withstand short-term volatility. We also note that longer-duration schemes have greater exposure to healthcare cost inflation rather than shorter-term wage inflation.

Chart 8: Scheme duration

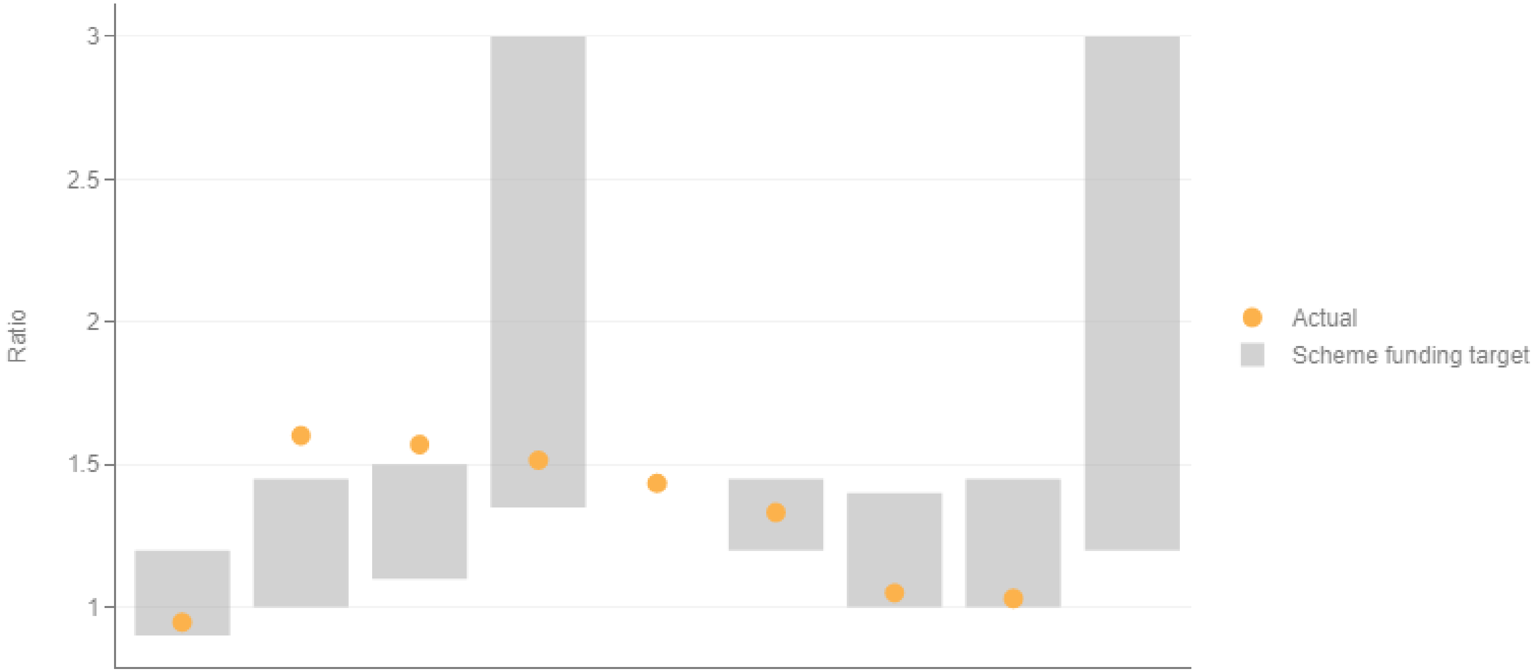


Source: Annual reports

Solvency

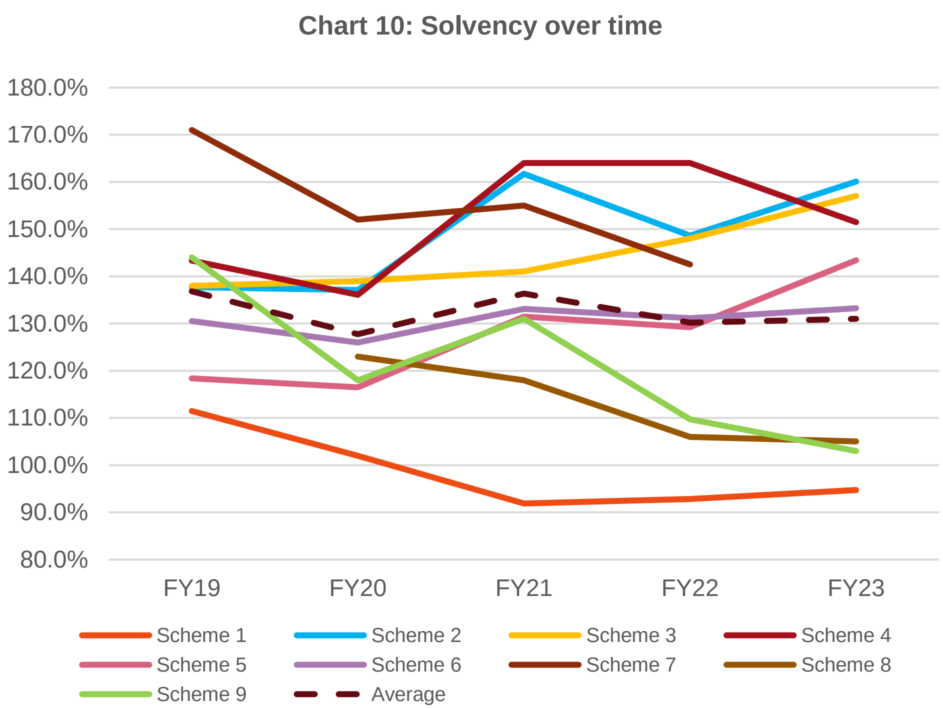
- One of the main financial goals of government insurers is to maintain a sufficient level of solvency. Chart 9 shows most schemes lie within their funding targets and maintain a reasonable level of solvency.
- In general, CTP schemes have improved their solvency levels over time while worker's compensation schemes have experienced a deterioration in their solvency position. Improvements in CTP scheme solvencies may be driven by more favourable outcomes with fewer drivers on the roads through the COVID-19 period. On the other hand, worker's compensation schemes have been challenged by rising claims costs, particularly around mental health injuries, which may negatively impact funding ratios, especially in some major states.

Chart 9: Scheme solvency

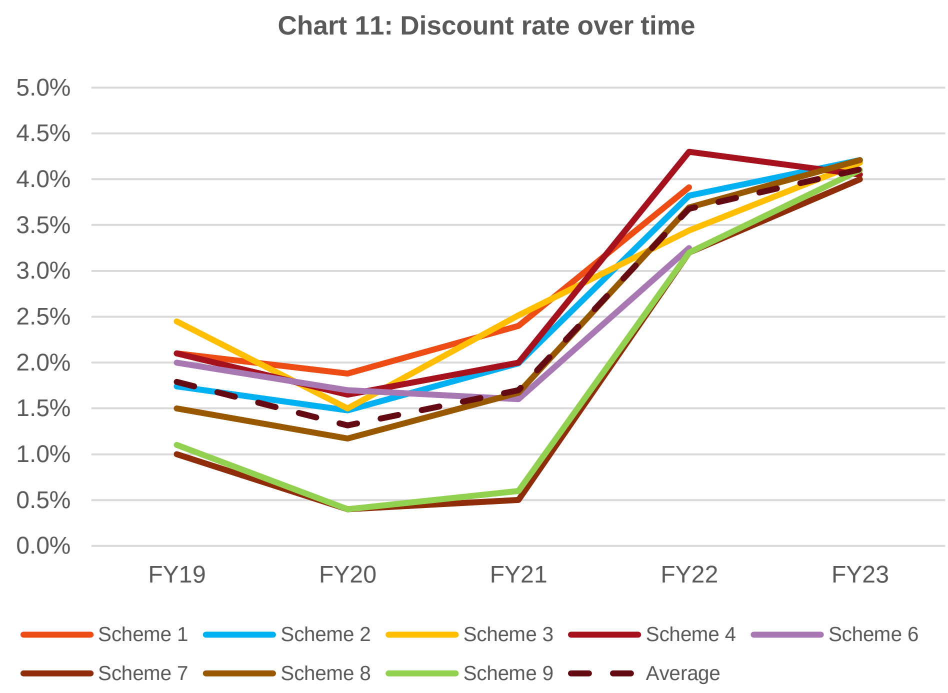


Source: Annual reports

Solvency and discount rates



Source: Annual reports



Source: Annual reports
Note: Discount rate for 2023 were unavailable for two schemes

- As discount rates increase, the present value of liabilities will decrease, all else being equal. As liabilities decrease, solvency levels should increase for all insurers dependent on investment returns. We observe some schemes have recently received contributions from their respective governments (treated as income in the financial statements), whereas historically schemes were a source of dividend back to their state governments.
- Discount rates are typically based on the risk-free rate and as government bond yields increase, we expect discount rates to also increase, putting downward pressure on the present value of liabilities. Solvency of insurers should improve over time as we enter a more normalised interest rate environment. This should help partially offset rising claims costs.

The final word

- While most schemes de-risked their investment portfolios in 2022, this was against the longer-term trend of adding growth and mid-risk assets which continued in 2023. In FY23, strong equity markets boosted portfolio values more than offsetting losses in bond portfolios as yields rose. Unlisted infrastructure performed well and continues to experience inflows at the expense of other asset classes (property and equities). During the year, infrastructure valuations stabilised despite rising discount rates and schemes continued to shift their focus towards renewable assets to move towards net zero ambitions.
- With inflation moderating and interest rates likely to ease soon, we anticipate a more normalised environment for insurers with higher passive returns from higher bond yields, lower liability valuations (due to higher discount rates) all based on the premise of a soft landing for the Australian economy. This should result in higher and more stable solvency levels. Frontier believes long-tail insurers will continue to seek out investments across the growth and mid-risk asset groupings for diversification, better long-term solvency and to earn returns above their liability inflation profile.

Learn more

Frontier Advisors has experience working with a range of government insurers across a number of states and territories helping create diversified portfolios, fit for both the current and future investment environment. Please contact our dedicated LDI & Government Team if you would like more information on how we can help you customise your portfolio.

Level 17, 130 Lonsdale Street
Melbourne, Victoria 3000
Tel: +61 3 8648 4300

frontieradvisors.com.au
@frontier_adv

Disclaimer: