Solving an intricate Norwegian puzzle

Nordic Fund Selection Journal talks to **Truls Tollefsen**, chief financial officer at **DNB Livsforsikring**, about the difficult juggling act around returns and regulation and why the Norwegian life and pension company is dumping real estate for loans.

Text: **Caroline Liinanki** Photo: **DNB**

Low interest rates mixed with regulation can be a lethal cocktail but few investors in the Nordics are in quite as challenging a position as the Norwegian life and pension companies, which are dealing with a triple whammy of forces pulling in different directions. While low interest rates mean that it is impossible to get high enough returns by investing too much in government bonds, the EU-wide Solvency II directive is making everything apart from government bonds costly from a financial reserves perspective.

On top of that comes the annual guarantees that Norwegian pension companies are forced to pay their defined benefit customers every year. This means targeting steady returns a little bit above the guarantee rates each year to keep the customers sweet but at all costs trying to avoid returns lower than the guarantees to prevent the pension company from having to chip in to cover the deficit.

At Norwegian life and pension company DNB Livsforsikring (DNB Liv), finding ways to optimise against all these different ends is an intricate puzzle and appears like an almost unsolvable equation. Truls Tollefsen, its chief financial officer and head of investments, admits that it is tricky.

"It's a bit like the Gordian knot – almost impossible to solve," he says. "We're trying to balance having an asset mix that gives acceptable capital requirements and at the same time enough returns to cover the annual guarantees as well as building some buffer capital. But such a model obviously gets put under a lot of pressure when interest rates are falling."

Despite being closed for new customers, more than two-thirds of DNB Liv's total assets are still in the "old" defined benefit portfolio and will continue to be so for the foreseeable future. Like elsewhere, the Norwegian pension

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CAREER:

2009	CFO, DNB Livsforsikring
2007	CEO Vital Eiendom
2005	Investment manager, Vital Forsikring
2003	Financial analyst, Vital Forsikring
2000	Investment manager, DNB NOR Kapitalforvaltning
1998	Equity sales, DNB Markets
1997	Equity sales, Bergen Fondsmeglerforretning
1994	Bond broker, DNB Fonds

providers are looking to shift their customers to defined contribution products but doing so takes time. DNB Liv's guarantee-rate portfolio has a life span of another 50 years or so, although assets are expected to begin to decline in a few years' time.

This part of the portfolio, which has about NOK 210 billion (EUR 23.3 billion) in total assets and organised in nine sub-portfolios, is also where Truls Tollefsen allocates most of his time. "We've spent a lot of time analysing alternative paths and have done a few major adjustments," he says. "We're not chasing double-digit yields but want stable returns that are a bit higher than the interest rate guarantees. That's our target." The average guarantees are just above 3 per cent, which means aiming for returns of around 4 per cent per year.

For the past few years, DNB Liv has embarked on a shift from more traditional investments like listed equities and investment-grade bonds to more illiquid assets, especially those that are favourably treated under Solvency II.

"We have a large comparative advantage in relation to many other investors: we don't need liquidity. We know exactly how much we will pay out every year going forward – we have full control over that – so it's been very favourable selling liquid assets to access illiquid assets," says Truls Tollefsen. "We've come far in building up an illiquid asset portfolio that suits our liabilities very well. I think of our strategy as liability driven investments with a yield enhancement – we're thinking 'liabilities' but all the time with a yield pick-up."

Most significantly, DNB Liv, which was called Vital until a rebranding in 2011, has gotten rid of half of its property holdings, which have been substituted with property loans. Last year, its 20 per cent exposure to real estate was cut to 10 per cent of assets, which instead was put into loans with property as the collateral. Some of these loans were in fact to the buyers of the buildings that were sold. In addition to providing good yield, the loans are also regulatory efficient. "Compared to real estate, Solvency II treats loans with collateral very favourably," Truls Tollefsen says.

Having gotten rid of NOK 20 billion worth of real estate, DNB Liv has obviously been offloading some very large assets. The life and pension company has in the past not just been a major direct owner of retail property in Norway but also in Sweden. At the end of last year, it sold the shopping centre Oslo City next to the central station in the largest property deal ever made in Norway. It also sold Stockholm Waterfront, the hotel and congress building next to the Stockholm central station, to Norwegian pension company KLP.

In addition, Truls Tollefsen points out that it also has sold

DNB LIVSFORSIKRING

LOCATION: Bergen

TOTAL ASSETS: NOK 295.5 billion

CUSTOMERS: More than 1 million

RETURNS Q1 TO Q3: 3.1 per cent

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> *– Truls Tollefsen, DNB Livsforsikring*

"this building", referring to the DNB group headquarters situated on the stretch of newly built high-rises in Bjørvika next to the Oslo Opera House. Rather curiously and somewhat unexpected, the DNB offices were picked up by a wealthy Norwegian businessman, Trond Mohn.

During a previous meeting with Truls Tollefsen in Stockholm some years ago, the extent of the life and pension company's investments in Swedish real estate became very evident as he could just point around in central Stockholm to show some examples of its holdings. Out of this portfolio, which primarily was made up of assets in Stockholm and Malmö, the only ones remaining are the buildings near Arlanda Express housing the hotels Nordic Light and Nordic C, Truls Tollefsen reveals.

However, whether this change in strategy will pay off over the long term remains to be seen, he notes. "We're aware that we've given up on the potential upside if the property market continues to rise. But the property market can also go down and we don't have that risk anymore. So we're pretty comfortable with that," he says.

While rising interest rates is another factor that would have a negative effect on real estate, it would be a blessing for DNB Liv's portfolio in general. "For us, that's the best thing that could happen," says Truls Tollefsen. "We could invest at a higher interest rate at the same time as our solvency requirements would be reduced."

The direction of interest rates is also currently receiving a lot of attention from Truls Tollefsen and his team. "We spend a lot time trying to understand what all these central banks are doing – the Bank of Japan, the ECB or the Swedish Riksbank – and the implications of central banks owning such a large share of the outstanding bonds in the world and what that will mean for interest rates," he says.

Asked how easy that really is to figure out, he responds: "It can make you completely philosophical and make you start questioning what money really is." He mentions a scenario for Japan recently painted by an industry analyst in which the Japanese central bank would own all government debt in Japan within five to six years if it continues buying with the same pace as today. When that happened, the analyst thought that the debt would be forgiven, which essentially would erase all government debt.

The point of that example, Truls Tollefsen says, is that there is a scenario out there with high inflation, which central banks may or may not be able to keep under control.

Although not very likely, this still deserves some attention, he notes. "We think that interest rates will be low for a longer period of time but that scenario of high inflation is increasing in probability and I don't think any asset owner or anyone managing money can ignore that," Truls Tollefsen says.

Truls Tollefsen has headed up DNB Liv's investments for more than seven years, having spent more or less his whole career within the DNB group. Asked about the best parts of his job, he mentions the academic aspects of investing combined with working with very professional colleagues. "It's very rewarding to have the responsibility for people's pensions and I'm humble about the trust they put in us," he says. He also mentions balancing investments with the effects on solvency capital and the company's P&L, which "gives the job a special dimension that's both challenging and exciting." Furthermore, the job also comes with the added benefit of allowing him to reside in his hometown Bergen, where DNB Liv's management and investment team is located.

Compared to its size, DNB Liv has a disproportionately small investment department. Only five people are working there, focusing primarily on asset allocation and risk management. This is made possible by its close cooperation with DNB Asset Management, which manages the lion's share of its assets. It also has external mandates outside of the group sphere but to a lesser extent than before.

As for changes to its investments, another new addition to its portfolio is a 10 per cent allocation to mortgage loans, an investment utilising the advantages of being part of a bank. Last year, it bought a fixed-rate NOK 20 billion portfolio from DNB bank, which Truls Tollefsen says offers a significant pick up in yield compared to liquid assets as well as having low capital requirements under Solvency II.

"We've taken on the investment and own the risk but we've also signed a management agreement with the bank to administer the loans," he says. "It's a portfolio of very good quality loans, which has been through DNB's credit process, with an average loan-to-value ratio of 40 per cent, so it suits us perfectly."

DNB Liv has also been looking at buying more loans from the bank within other sectors. At the end of November, it bought a NOK 5 billion loan portfolio with retail property as collateral from DNB Bank in a similar arrangement with the bank as for the mortgage loan portfolio.

The more traditional assets usually found in an institutional portfolio have at DNB Liv taken a hit. Listed equities only make up about 7 per cent of assets, a major difference compared to some 30 per cent invested in equities in the pre-financial crisis days. It has also discarded government bonds and found a substitute in hold-to-maturity bonds, which it mainly purchased in 2012 to 2013 in preparation for Solvency II. The hold-to-maturity bonds, which make up 42 per cent of assets, serve as the liability matching portfolio and are set up through private placements where sovereigns or companies have issued bonds denominated in Norwegian krona or done so via investments banks.

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up a large portfolio [of hold-to-maturity bonds]. It's typically investment grade bonds with an average rating of AA and an average yield of 4.6 per cent. Due to these bonds, we're managing fine but they're also maturing at some stage and we've done very little over the past few years due to low interest rates," he says.

Despite the challenges presented by Solvency II, Truls Tollefsen also sees some benefits. "I think it's good with risk-based capital requirements," he says. His comment should perhaps be seen in the light of the very stringent former Norwegian quantitative investment rules that Solvency II at the beginning of this year replaced. Asked whether it has been a relief to have gotten rid of these, he responds "yes".

He is, however, equally quick to point out some issues with Solvency II. "Solvency II is a joint European regulation that has different consequences in different countries. In Norway, we've got a product framework that was set up before Solvency II and certain products come out very unfortunate," he notes.

This is particularly the case for paid-up policies, a type of pension product that is a side-effect of the shift from defined benefit to defined contribution. When a company decides to move its employees to a defined contribution scheme, the defined benefit savings become paid-up policies. While the pension company takes the full downside risk for paid-up policies and have to make up the difference if returns are lower than the guarantees, it only gets 20 per cent of any extra returns above the guarantee level, making it a difficult business model.

The strains of managing these paid-up policies have recently been evident in the case of Silver, the Norwegian pension company specialising in paid-up policies, which was on the verge of going bankrupt due to the strains of Solvency II. In a creative move to escape the regulation, Silver has now struck a deal with LGT Capital Partners to transfer assets to a new company set up in Liechtenstein, an arrangement awaiting approval from Norwegian authorities.

DNB Liv has about NOK 110 billion in paid-up policies but this amount will increase in size as the shift from defined benefit to defined contribution continues, Truls Tollefsen points out.

Going forward, Truls Tollefsen's eyes are set on making further additions to its credit and bank loan investments. "We will in particular have a focus on increasing the loan book as well as private credit, which is an area we think have attractive characteristics that suits our liabilities extremely well," he says.