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WHAT IF... ECONOMIC VOLATILITY OVERWHELMS INSURERS?

Insurers know all about risk. Insurers know all about regulation. But do insurance company boardrooms spend enough time looking at political issues and their economic impact?

By David Worsfold

Insurers and reinsurers deploy a vast number of expert resources trying to understand the rapidly changing nature of the risks they underwrite, whether those be the erosion of asset returns caused by monetary policy, liability books struggling to cope with the extension of liability through new legal rights or technology, or long-term insurers juggling with greater longevity and once attractive but now unsustainable promises.

Regulation also depletes resources at the board level as politicians and society demand tighter control of the financial sector, a process that was set in motion long before the crises of the last decade.

Politics takes centre stage, too, with political factors now posing as big a threat to the future prosperity of the industry as the riskier world it insures, along with the regulatory burden imposed upon it.

"While all of these challenges have been thrown into sharper focus by the regulatory pressures flowing from the implementation of Solvency II, they exist independently of this," says Tigran Kalberer, principal and consulting actuary at Milliman. "The transparency of Solvency II has only exposed the already existing volatility of insurers' balance sheets. There is a need for more sophisticated and rigorous management of assets and liabilities. Evaluating the impact of different economic scenarios on that delicate balance of assets and liabilities in a world of low returns and tight margins is required."

Michael Culligan, also a principal and consulting actuary at Milliman, agrees: "Set alongside that the inevitable influence of politics on economic decisions, and it becomes essential for boards to adopt a broad, multi-faceted approach to planning their responses to a range of overlapping, often inter-related, political and economic scenarios."

Here, we examine a number of the possible scenarios and their potential impact.

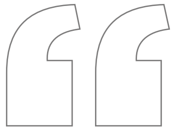
WHAT IF...

• Spreads go up and interest rates stay low?

This is one of the worst scenarios from a risk perspective as liabilities do not change but assets fall in value, making it a serious threat to solvency. Regulatory and political interests will clash because regulators will want risk-reduction while governments will not want insurers to bail out of their sovereign debt, which is subject to substantial spread risk. Quantitative easing (QE) programmes can release some of the pressure but these require a political will to deliver, and do not address the lack of trust in the sustainability of government debt, which is the root cause of rising spreads on government bonds. For many insurers the key will be how they manage their volatility adjuster if spreads widen.

Insurers review their resilience to developing economic trends on the understanding that political pressures are often national and narrow, and that decisions are taken on a supranational level. This can greatly increase the risk, for example in Italy where the government expects Italian insurers to support its own bonds, and can leave insurers very exposed if spreads on those bonds widen – a persistent threat while the Eurozone remains unstable.

One of the biggest challenges facing insurers is that even while the current regulatory models derived from Solvency II are being formed, the world is not standing



New, alternative asset classes have often been excluded from insurers' portfolios for good reasons, so caution must be applied. There may be big gains for those that get it right when adopting a riskier profile but there is a major downside for those who are reckless and get it wrong.

Michael Culligan, principal and consulting actuary, Milliman

still. Economic and market volatility persists across the world and the regulators' ability to act in the face of fast-moving political and economic challenges is untested and uncertain.

"This throws the spotlight onto policies with long-term guarantees, which feature prominently in the back-books of the insurers of many central European markets, especially Germany," says Kalberer. "New products have been designed to address the need for some kind of guarantee, mitigating a large part of the asset risk, but it will take time for these to have an impact on balance sheets."

• Interest rates jump up suddenly, maybe not evenly, in the Eurozone, UK and US?

The crucial focus for most insurers will be interest rates, which are influenced by so many factors that they are rarely out of the news. Central banks are keenly aware of the consequences of the years of historically low interest rates, and are showing increasing impatience at the conditions not emerging to start lifting them.

Insurers – especially those with long-term guarantees to policyholders – must be prepared for short-term shock if central banks get impatient and start pushing rates up quickly. This has the potential to wipe the unrealised gains that insurers have been sitting on. In the longer term a sustained upward movement of interest rates should be good news because it will enable insurers to reinvest at the new rates, making it easier to match the guarantees. Yet those who have been hedging an interest rate rise could struggle to find collateral, thus exerting pressure on liquidity. It could also open up market opportunities for new insurers who wouldn't have to reposition investment portfolios but could take advantage of the higher rates immediately.

Alongside the key question of when – not if – rates will start to rise is, where will it end? The current US Federal Reserve (Fed) projections take us to 3.5% by the end of 2018 but that seems too long, and too far. Many commentators are now focusing on a peak of between 2.5% and 3% being reached sometime in 2017. That would satisfy most insurers, giving them a chance to gradually re-shape more robust portfolios capable of withstanding other economic shocks. But portfolios will still need to be managed creatively, with value sought wherever it can be found.

Philippe Ithurbide, global head of research, strategy and analysis at Amundi, stresses the importance of factoring in the Fed's strategy as it will have a major influence on many financial institutions: "The US economy can probably withstand some interest rate increases. The global economy a bit less. And the financial markets, especially emerging ones, less still. This means the Fed's message is now absolutely crucial. Misinterpretation of the Fed's decisions remains a significant risk factor."

• Status quo – global interest rates stay as they are for a prolonged period of time?

This is where the main economies have been for several years, so some portfolios may be running out of time thanks to unrealised gains being used up at an unsustainable rate. Companies must seek value and higher returns elsewhere if they are to avoid exposing themselves to creeping insolvency.

Yet insurers seeking higher returns by turning to other assets must be wary of exposing themselves to new risks. There is a trade-off between being clever and finding new, sustainable value and being reckless by buying assets of a poor quality. So much will depend on the attitude of regulators charged with implementing Solvency II, and that may not be even across Europe.

This is a major cause of concern to insurers, says Culligan: “The fear in boardrooms of losing market share and of retrenching in a world that measures success in terms of growth is palpable but fraught with major traps. New, alternative asset classes have often been excluded from insurers’ portfolios for good reasons, so caution must be applied. There may be big gains for those that get it right when adopting a riskier profile but there is a major downside for those who are reckless and get it wrong.”

This propensity of the largest insurers and reinsurers to move into alternative asset classes is still apparent today, according to the global ratings Agency AM Best. It says the highest rated European insurance groups have a buffer of 20-30% in their investment portfolios to withstand market value fluctuations and in some instances, they could endure even greater asset depreciations. The vast majority of assets are in high-quality fixed income instruments, but AM Best notes that the low interest rate environment has prompted many (re)insurers to allocate more money to real assets, including infrastructure projects, equities and real estate.

These assets undoubtedly come with greater risk, but part of that risk is due to short-term market movements not explainable by the underlying economics. Insurers, however, are long-term-oriented so are not affected by these short-term movements, which regulation over-emphasises. Yet questions remain: should insurers pocket the reward for being long term? Or are they being tricked by bankers simply overselling the value of these assets?

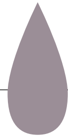
• The Eurozone fragments as the Greek debt crisis remains unresolved

This is as much a political as an economic battleground and is by no means resolved despite the last-ditch agreements to avert the mid-summer crisis. Other, more recent crises may add to this danger.

Economists and the International Monetary Fund have warned about the unsustainability of the debts Greece is carrying, even if the unstable Greek government is able to implement most of the reforms demanded.

But for as long as Greece stays in the Eurozone it will be legally impossible to write off any of the debt. Breaking laws so blatantly would be the death-blow for the EU, so there are only two viable solutions: bet on time, or Greece leaving the Eurozone. Even if the Eurozone remains intact insurers will still be exposed to a period of interest rate volatility.

While insurers work to understand the implications of economic instability in a world of virgin regulation,



understanding the importance of politics in shaping government, central bank and regulatory responses to economic pressures has also become an essential element of economic modelling. This became apparent when, at the height of the Greek crisis, the European Central Bank stepped outside its own rules to keep Greece afloat and in the Euro while negotiations continued.

That politics and economics are of equal importance is a fact fully appreciated by the big insurers and reinsurers says Michel Dacorogna, scientific adviser at Scor. "Greek debt is not sustainable. They will not put in place and see through the measures necessary to deal with it. Most people think of this as just an economic problem but it is a political one, too. The key point is that having Greece outside of the Euro is politically unacceptable. With instability across the Middle East spreading, having Greece nailed into the EU is essential. I am much less pessimistic than many analysts on the future of the Euro. Not only is it very convenient for people, a factor not to be overlooked, it is much more resilient than people think."

Insurers also need to be aware of the broader issues, says Bob Swarup, principal at Camdor Global Advisors: "Almost everyone agrees that the debt is unsustainable. Give it six months, a year and the crisis will be back again. The danger for insurers is that if that wider contagion happens you are talking about not just economic turmoil but also economic and regulatory turmoil. Then you have to ask 'What does Solvency II even mean in that context?'"

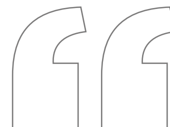
- **An inflation shock or creeping inflation hits major economies?**

An upwards thrust to inflation should be good news for insurers as central banks would most likely respond quickly with interest rate rises. But for some policyholders these circumstances will erode the value of the guarantees which – over the last six or seven years of low inflation – have maintained their value.

The danger for insurers is that if they respond to consumer demand and political pressure with increased guarantees, will they be exposing themselves to the same problems we see today? There will certainly be market pressure. The predictions of some economists that QE would spark consumer price inflation proved unfounded, but it has played a part in fuelling asset price inflation. Central banks are still working their way through the implications of QE but, far from fearing an inflationary push, they are now hoping that is precisely what more QE might do, as the UK and Europe look over the abyss of deflation. Indeed, the European Central Bank is eyeing a second round of QE because it fears the consequences of sustained low or negative inflation.

Assessing the risks of inflation to an insurance company balance sheet now means an analysis of the impact of zero inflation measured against the danger that providing an inflationary stimulus to economies might run out of control.

Dacorogna says there can be big rewards for insurers who make bold decisions when faced with this scenario: "Any inflation shock can be very damaging for insurers but you can insulate yourself. We saw this in Germany



China acted as a shock absorber for the global economy, a punch bag seemingly able to soak up the recessionary blows that would otherwise have totally derailed global growth. China's stabilizing actions have led to an overheated property market, a build-up in debt and a roller-coaster ride for the stock market.

Stephen King, economic adviser to HSBC

in the 1920s and again in the 1940s when Munich Re sold all its assets and put everything into real estate – it owned most of Munich and Cologne – and was not harmed by the hyperinflation."

- **The current equity market/real estate bubble bursts?**

The bubble, such as it is, is by no means uniform across different asset classes and in different regions. Recent events in China have served as a sharp reminder that bubbles burst, and that the consequences reach far beyond the asset or market concerned. With the heavy reliance on the expectation of significant Chinese investment, especially in infrastructure, many countries will be exposed to the collapse in Chinese equity values and the devaluation of the Yuan. Insurers will quickly feel the pressures from collapses in values in equities and property because of the new regulatory insistence on using market values. The blow would be two-fold because values would decline as volatility increased, requiring the commitment of more risk capital.

The response from financial markets to crises is often panic, especially when they are nervous about the underlying causes, or feel there are too many economic or political factors outside of their control. Never is this more so than when the prevailing conventional wisdom is challenged. This is one of the key characteristics of the most recent instability around China, says Christian Gattiker, chief strategist and head of research at Julius Baer: "Crises are testing times, often testing character both on an individual and at a collective level. The latest financial crisis seems the test for China and its authorities. The global perception of Chinese policymakers has changed drastically. The latest shift in currency regime plus a stretch of weakish macro data make China look like an economy that has gotten out of control – and its policymakers as having lost grip of the steering wheel.

"Whether this is a misunderstanding remains to be seen. The alternative reading is that this is a concerted, but ill-communicated plan with stakeholders such as the International Monetary Fund and the US Federal Reserve, given that the Chinese currency is likely to become a global reserve currency. And the collateral benefit (or damage) is that the Chinese economy is allowed some relief after a real appreciation bonanza."

China also underlines the need for boardrooms to be sensitive to the broader political dimension because much of what is happening there is government driven, says Stephen King, economic adviser to HSBC. "China acted as a shock absorber for the global economy, a punch bag seemingly able to soak up the recessionary blows that would otherwise have totally derailed global growth. China's stabilizing actions have led to an overheated property market, a build-up in debt and a roller-coaster ride for the stock market."

Each of the scenarios outlined above is complex and throws out myriad challenges to management boards, but insurers must recognise that they are not mutually exclusive. It is not impossible to imagine a scenario where – to take but one potential combination of circumstances – one central bank's response to any Eurozone fragmentation could be to hold interest rates down. "It is vital for boards to think through possible scenarios and formulate contingency plans. Many firms have struggled to recover from the financial crash of 2008-09 precisely because they were unprepared and had failed to answer the most extreme problems posed by asking, 'What If...?'," cautions Kalberer.

Find out more

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