Inside insurance

Global Insurance Solutions

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DE-RISKING AND THE CONTINUED SEARCH FOR YIELD

2019 was a difficult balancing act for many life insurers. As concerns about the end of the credit cycle rose, so did the pressure to raise the quality of credit holdings by reinvesting maturing BBB bonds into A rated or higher securities, or into government bonds. This de-risking accelerated in the second half of the year as interest rates fell 100 basis points (bps). Furthermore, when the next crisis hits, we estimate that 15%-20% of the BBB bonds could downgrade to high yield.

The result of this move up in quality was that some insurers suffered a substantial drop in their solvency ratios—at the low point for government rates in August, ratios for some French insurers fell close to 100%. On average, the drop in solvency ratios was estimated to be around 60 - 70% across European life insurers between Q4 2018 and Q3 2019.[1]

Stash the cash

The deterioration in solvency ratios is not only linked to the short duration positioning of insurers' asset portfolios compared to their liabilities, but also to the convexity of liabilities. The "moneyness" of the guarantee they offer further causes the duration of life insurance liabilities to lengthen (lower lapse risk).

How did insurers react to the deterioration in solvency ratios? Many reduced their equity exposure, while we also saw a broad increase in long government bond allocations to match duration (at a mouthwatering yield of 50bps). Anecdotally, a few insurers mentioned the difficulty of buying credit in the primary market, being forced instead to hold large cash positions.

Use more derivatives

In an environment of falling solvency ratios, insurers are also looking to use derivatives to mitigate their equity, rates and credit risk:

- **Equity**—Equity portfolios are often protected directly with options overlays or by investing in funds that systematically protect on the downside, with the aim to reduce the capital charge.
- **Rates**—In life insurance markets where lapse features are commonplace, insurers used to buy protection against rates rising (caplets, CMS caps). A slow rise in interest rates, spread over multiple years, would be the ideal scenario, allowing portfolios to be rebalanced and reinvested at higher levels. However, a sharp rise (+200bps) in a short timeframe could lead to mass lapse and liquidity issues. Given the negative rate environment, a few insurers have started buying protection against further drops in yields (-30bps to -70bps strikes on 10-year government bonds).

[1] Source: EIOPA as of January 2020.

INSIDE INSURANCE

Inside Insurance provides a regular round up of the key trends in the insurance market, as observed by the J.P. Morgan Asset Management Global Insurance Solutions Strategy & Analytics team. The aim is to provide insurers with all the information they need to stay up-to-date with breaking industry news, product developments and regulatory changes. Our experienced "actuarial influencers" spend time talking to a broad range of insurance clients to gather the latest news, taking the time to read research papers and regulatory reports so that you don't have to.

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- **Credit**—Until now, hedging credit exposures to reduce the Solvency II capital charge has not been viable, as it is difficult to get recognition for risk mitigation measures under Solvency II. However, the recent deterioration in solvency ratios has sparked increasing interest in credit hedging, line by line solvency capital ratio (SCR) optimisation.

A cap on illiquidity?

The search for yield has pushed insurers towards alternative assets (private credit, infrastructure equity), as they look to benefit from the illiquidity premium available from these investments without incurring an additional capital charge. From our discussions with insurers, a target exposure of about 25% to real assets, including real estate, is becoming fairly common.

Recently, however, several European regulators have started to scrutinise the liquidity of insurance balance sheets. The French regulator was asked to look at illiquidity levels of French insurers given their liability profile with buy-back features. The UK regulator has also published guidance on the prudent person principle and suggested measures of illiquidity risk. And the Dutch regulator is now looking into the Dutch mortgage asset class, which represents 30% of investment portfolios in the Netherlands. We are currently working on a framework to estimate adequate illiquid allocations and look forward to sharing it with you.

Regulatory developments

We very much enjoyed reading the 878-page Solvency II consultation paper over the Christmas break! A further in-depth review will be published separately. However, there are a few things that stand out:

1. **Long term equity**—Insurers will be allowed to hold European equity investments at 22% capital charge if they hold them for over five years and demonstrate they can hold them for the long term. The look-through to the security level will no longer be required and a fund investment held for five years becomes eligible. This has generated a lot of debates and some insurers have already used this classification as part of their year-end submission.

2. **Discount curve extension**—The European Insurance and Occupational Pensions Authority (EIOPA) proposes to extend the European "last liquid point" from 20 years to 50 years. This proposal is very worrying and would lead to a drop in ratios of roughly 50% across Europe! The insurance industry is firmly against this change.

3. **Interest rate shocks**—The Solvency II framework doesn't currently apply interest rate shocks to negative yields - a combination of relative and parallel shocks is considered instead. Applying interest rate shocks will put additional strain on market risk capital.

4. **Volatility adjustment**—EIOPA identified multiple shortcomings in the volatility adjustment and suggests various improvements.

The latest product trends

Several new product trends can be observed among insurers. Perhaps most notable, as already mentioned, is the move towards USD fixed income and corporates, and hard currency emerging market debt. Some areas of the US fixed income market that have not traditionally been accessed by European investors, such as taxable municipal bonds, are now being explored by some insurers in search for yield and long-dated assets.

Meanwhile, hard currency emerging market debt, hedged to euros, has become a core part of many insurance portfolios (buy and maintain or income focused), with the aim of optimising SCRs in the current low interest rate environment.

Another strategy that may see increased demand is high dividend equity, to help neutralise beta exposure to equity markets—particularly as the strategy incurs a low SII capital charge in an IFRS 9 friendly way. Mortgages are also gaining traction, not just among Dutch insurers.

Finally, given the level of interest rates for short dated maturities, we have seen examples of property and casualty (P&C) insurers moving away from traditional "available for sale"/buy and maintain fixed income portfolio management towards total return strategies.

Some thoughts on unit linked

Some insurers are incentivising customers to move their holdings towards unit-linked products (for example, by offering to pay higher rates on general account business if policyholders hold at least 30%-50% in unit-linked products, or by imposing a maximum general account allocation).

This trend towards unit linked is spurring the creation of unit-linked products that look like the general account. Some regulators are blocking this initiative while others are encouraging it through an accommodative regulatory environment. The increased focus on illiquid units (infrastructure equity, real estate) means that insurers need to hold these assets on their balance sheet in case of lapses.

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