Inside insurance

Assessing the investment options for insurers

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Introduction

We find ourselves in a very different regime since the beginning of the year. Higher and persistent inflation, rising interest rates, banking crisis and recession risk due to central bank tightening. This has been a tough environment for insurers to manage portfolios. Since the beginning of the year, we have been meeting insurance clients from across Europe and the UK to discuss the challenges they face and asset allocation solutions in today's market. In this paper, we share with you the key themes that emerged and help paint a more detailed picture of the current insurance investment landscape.

Solvency positions

Starting with the positive news; while faced with several market risks, insurers have generally reported improvements in Solvency II positions at the end of 2022. This improvement was largely due to their short duration positioning against liabilities which helped increase their own funds in the rising interest rate environment. On the other hand, those insurers who maintained a matched duration position, specifically the insurers under an internal model saw little movement in solvency ratios.

Non-life insurers suffered from a tough underwriting environment in 2022, particularly among personal lines insurers, where higher claims and the costs of reinsurance caused difficulties. While solvency ratios are expected to remain stable for these companies, their investment portfolios now largely bear unrealised losses, which significantly hampers profitability as non-life insurers do not discount liabilities (except for those that adopted IFRS 17).

Duration gap analysis

On the back of a general improvement in solvency ratios, the question now is whether insurers should close their duration gap? The answer, of course, is dependent on their views on interest rates, particularly at the long end of the curve.

In developed markets, central banks are reaching the end of their hiking cycles and market pricing is for interest rate cuts later in the year. The inverted yield curve in Europe has made insurers reluctant to invest in the long end of the market; however, the cost of hedging from the US dollar to the euro is relatively low for long maturities (assuming hedging to maturity) and definitely supports the investment case for US investment grade corporate and taxable municipal bonds.

Assuming we are close to a peak in interest rates, closing the duration gap would help protect against a large decrease in solvency ratios if rates were to drop from here. However, the liquidity constraints (discussed further below) are affecting the ability to rebalance into higher durations.

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Focus on liquidity

The biggest constraint that insurers we've spoken to have observed is liquidity. The situation is not dramatic ; however, it is a concern across Europe and is impacting asset allocation decisions.

The number one liquidity constraint is the low growth in new business written, which has been witnessed across in Europe and limits the cash available to be deployed. This low growth in premiums has often been accompanied by lapses on traditional policies. The solvency capital requirement for lapses has obviously increased significantly as interest rates have risen, which impacts Solvency ratios negatively.

Beyond SCR considerations, actual lapses have also been observed in Italy, France and Luxembourg where limited penalties are in place to prevent policy lapses. In France, the lapse rate has been as high as 6%-8%, compared to the historical rate of 4%, forcing some insurers to realise losses to face redemptions. Nevertheless, the high quality and liquid portfolios of insurers clearly allows them to face off these lapses – unlike what has been observed in the US banking crisis.

It is worth noting that, in the past few years, private banks have been offering levered exposure to insurance companies' general account to their clients. High net worth clients were able to borrow at a floating European Central Bank rate (posting their existing general account investment as collateral) to invest further in the general account and therefore doubling up their exposure. When traditional life policies were still paying roughly 1%-1.5% vs. close to zero borrowing costs, the trade made sense. Now that loan rates have gone up, these policies are lapsing. Large lapses are observed in the high-net-worth channels, where there is greater awareness of the alternatives available to put money to work. In this environment, insurance companies are conducting more granular analysis of their policy books to assess the likelihood of lapses based on the financial awareness of policyholders.

The alternatives available to policyholders include government bonds, which have provided strong competition to insurers, particularly in the Italian and Portuguese markets where these bonds are accessible through retail channels and pay 3-3.5% fixed rates. As an example, the lock-up period in Portugal is only three months and there is no redemption penalty. Insurers are obviously struggling to compete with these products given their cost structure.

In other markets, liabilities tend to be longer duration. Limited lapses are being observed and those policies that could be subject to lapses still benefit from high guaranteed rates and are unlikely to be redeemed.

However, the use of interest rate swaps to match long-dated liabilities is common, and these positions were subject to significant margin calls in 2022, forcing affected insurers to look closely at liquidity.

In the UK, liquidity issues have been more muted, since more of the life market is unit linked, while with profits policies have surrender penalties. One insurer commented that UK with profits clients tend not to be so financially astute and would not be comparing their guaranteed rates to deposit rates in most cases.

New business environment

Closely related to liquidity is the topic of new business. In the past couple of years, the low-rate environment had led insurers to shift their business towards unit-linked plans, which offered higher margins. This shift was sometimes enforced by barriers to entry into the general account, such as prohibitive fees, along with minimum investments needed into unit link accounts to be able to invest in the general account, as well as an attractive additional return on general account investments if a minimum amount was invested in units.

Given the liquidity pressures, some companies – particularly in France and Italy where lapse risks are the highest – are now rethinking this approach and sometimes lifting the barriers to general account entry. In the new higher rate environment, traditional life savings products are profitable again and margins are now closer to the ones obtained in the unit-linked market. Some Italian insurers have started writing guarantees again, either through term guarantees (for example, providing a guarantee if you stay invested for eight years) but also sometimes outright guarantees for three years. Players who have been proactive in new business generation have also seen net positive inflows across their general account.

The direction of the market from here largely depends on the evolution of interest rates, the appetite for writing traditional life liabilities and the ongoing liquidity constraints caused by lapses. Stable and higher rates would clearly benefit general account and favour the reintroduction of guarantees, while a return to lower rates would comfort insurers in their existing strategy to focus on unit linked.

The UK life market is focused on the pension risk transfer opportunity alongside the unit-linked business. The expected growth in bulk annuities is the main area of focus. For non-life insurers, the underwriting losses experienced in the UK motor market in 2022 is driving some insurers to exit the UK personal lines motor segment of the market.

Investment portfolio allocations

The various topics we discussed so far have downstream implications for portfolio investments. The peak in interest rates that is expected this year is a key driver of insurers' asset allocation decisions, with those who benefited from short duration positions over the last year likely to be looking to rebalance to matching duration positions.

We've broken down the most significant asset allocation trends shared by the insurers we spoke to by asset class:

Fixed income

The year has clearly been dominated by fixed income whose yields are attractive again for insurance investors. Over the course of 2022, most insurers lengthened the duration of their portfolio by buying long-dated government bonds as well as enhancing the credit quality of their corporate portfolio.

One of the key challenges faced by insurers in their fixed income portfolio is to increase book yield. Indeed, relying solely on cash flow reinvestments would allow increases of the order of only 20bps per year (for a life portfolio). The liquidity pressures slow down the speed at which book yield could be increased. We have seen numerous insurers who are rebalancing their portfolio proactively; realising some losses and deploying into higher yielding bonds. It is possible to achieve an increase in book yield that is compensating the loss realised; the accounting return for the year is therefore similar to previous years but will increase in subsequent years thanks to a higher book yield locked in.

In the UK, meanwhile, the liquidity issues raised by the 2022 Gilts crisis has seen UK life companies focused on global diversification of public fixed income.

Insurers are also seeing opportunities in the high yield space but are waiting for an attractive entry point, with spreads considered too narrow at this stage given the likelihood of recession. However, the attractive carry in the short duration high yield space could still support the investment case.

Outside European fixed income, there are opportunities for diversification. Most notably, US taxable municipal bonds which are long duration high quality assets that offer a pick up in yield vs. comparable European fixed income assets while also being diversifying from a risk point of view.

Equity

The activity in the equity space has been more muted. Overall, equity exposure has been reduced over 2022 as some insurers locked in gains to offset losses on their fixed income portfolios. Furthermore, equity hedges were often put in place towards the end of 2021 and were maintained throughout the year.

Real estate

The case for core real estate investment is double edged – on the one hand it should provide some inflation protection but the rapid rise in rates also give rise to concerns. Many insurers have been reducing their real estate exposure and selling funds as well as direct exposure. However, the liquidity in the space is relatively tight.

Private assets

In the private asset space, the denominator effect has prevented further investments as many insurers have reached their maximum capacity levels across alternative assets. In some cases, insurers are even looking to exit their private market strategies. At this stage, given the liquidity pressures, most insurers are not willing to increase their alternatives exposure but are only honouring their existing commitments. Regular reinvestments are nonetheless required to maintain the overall exposure and compensate for maturing vintages.

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