The “great acceleration” intensifies pressure on insurers

While the world is recovering from 2020’s massive shock, it accentuated the challenges facing insurers. There is now greater urgency to adapt business models and portfolios while looking afresh at asset-liability management.

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When the global pandemic triggered a tailspin in financial markets in March 2020, it intensified the complex set of challenges faced by insurance companies. As the world’s central banks launched a massive intervention in bond markets, they sent already low interest rates to zero or below in some countries, undermining insurers’ profits, capital positions and solvency ratios.

At the same time, the pandemic led to more expensive equity valuations and soaring levels of global debt, including corporate debt[1], all of which raises the risk of financial market volatility and credit defaults to come.

As the pandemic swept through the economy, it widened the gap between corporate winners and losers, hastening existing trends in what has been termed the “great acceleration”[2]. Within the insurance industry it dramatically deepened the difficulties that were already building. The result is a growing risk that current business models, asset-liability management and asset allocation are no longer fit for purpose, especially at a time of mounting regulatory change and a need to fight climate change.

Financial markets in 2021 have responded to optimism around vaccine rollouts and signs of recovery in major economies, leading to a revival in inflationary pressure. Yield curves have reacted to this, especially in the US where the curve has significantly steepened since 2020’s lows. But all-in-all insurers are still living in a low rates environment (fig 1).

That means it is increasingly urgent for insurers to protect and prepare their businesses – there is no longer room for a wait-and-see approach. Learning partly from Japan’s insurers – living in a low interest rate world for decades – they have clear options which should make them more suited to today’s changed environment.

Figure 1: G7 government bond yield to maturity (%)

Source: ICE BofA ML G7 Government Index W0G7, data as of April 30 2021

[1] Global debt soared to a new record high of $281 trillion in 2020 Institute of International Finance Global Debt Monitor. Feb 2021

[2] McKinsey & Company – The great acceleration – July 14, 2020.

Quartet of strategic challenges

Insurers are complex organisations, which compounds the difficulty of the strategic challenges they face. They protect policyholders through the pooling, diversification and management of risks, providing life insurance, savings, property and casualty products. In doing so, they must balance economic, regulatory, accounting and, increasingly, sustainability considerations.

That has led many insurers to build investment portfolios comprised mainly of bonds for investment returns, backed by other asset classes for diversification and yield enhancement. To give a sense of the dependence on fixed income, European life insurers in 2019 held 32% of their portfolios in government bonds on average and 34% in corporates[3]. Many also deploy derivatives and repos for managing assets and liabilities, as well as tactical asset allocation purposes.

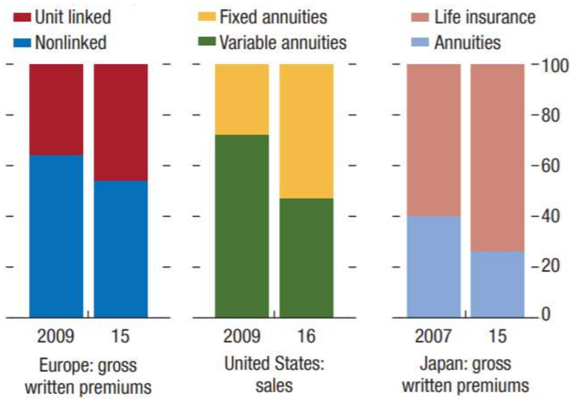
For the past 10 years, the pressures have been building as bond yields have fallen along with other developments such as new regulations. We believe 2020's "great acceleration" has intensified the pressure around four key challenges for insurers.

1. *Low interest rates*

Insurers have endured a multi-decade decline in interest rates which deepened in 2020 when a number of European countries' rates turned negative. This has had a major impact on insurers' balance sheets and profitability. Profit margins arise from the spread between investment returns and policyholders' benefits, so negative rates can push some life insurers into loss.

To adapt, many insurers have already been slowly revising their asset-liability management and investment strategies. European and US insurers have lengthened asset duration[4] which increases income yield and contributes to reduce duration gaps. They have also diversified portfolios into alternatives such as private equity, hedge funds and real estate in the US[5], as well as private equity and loans in Europe[6]. Some large insurers have increased their use of interest rate derivatives to manage the duration gap [7]. Turning to business models, many insurers are offering fewer guaranteed products and making policyholders bear more market risk (fig 2). For instance, European insurers are selling more unit-linked products, which do not provide market guarantees.

Figure 2: Changes in insurance product mix (%)

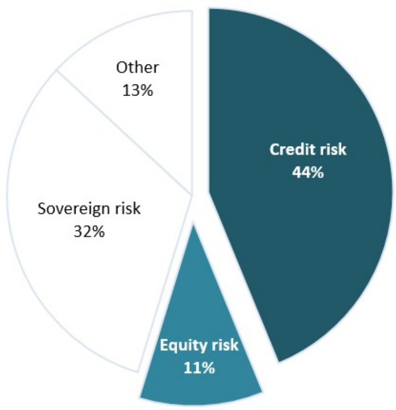


Source: IMF, Global Financial Stability Report, October 2017

2. *Financial market risks*

Related to low interest rates is the challenge of financial market volatility. Insurers are exposed to financial market and credit risks (fig 3). As governments and corporates have become more indebted, especially as borrowing increased in the pandemic, so the credit risks have arguably become greater.

Figure 3: European life insurers exposure to credit and equity assets (2019)



Source: EIOPA Financial Stability Report 2020[8]

[3] EIOPA Financial Stability Report 2020.
[4] Eg US portfolio durations have increased from five to eight years since 2012. IAIS Global Insurance Market Report.
[5] NAIC US Insurer Exposure to Schedule BA: Focus on Private Equity, Hedge Funds and Real Estate, March 2016.
[6] EIOPA Investment Behaviour Report, November 2017.
[7] Derivatives use doubled in the US between 2010 and 2014. NAIC, Update on the Insurance Industry's Use of Derivatives and Exposure Trends, February 2016.
[8] Credit exposure comprises corporate bonds (34.3%), collateralised securities (0.9%) as well as mortgages and loans (8.6%) – Equity exposure comprises both listed (7%) and unlisted equity (3.9%)

Insurers' balance sheets may be better at matching long-term assets and liabilities than banks', but short-term credit and equity volatility can harm insurers' capital positions and solvency. New accounting frameworks capture these market movements, heightening the sensitivity of insurers' stock prices to financial market volatility. So, insurers have a strong incentive to manage volatility risk.

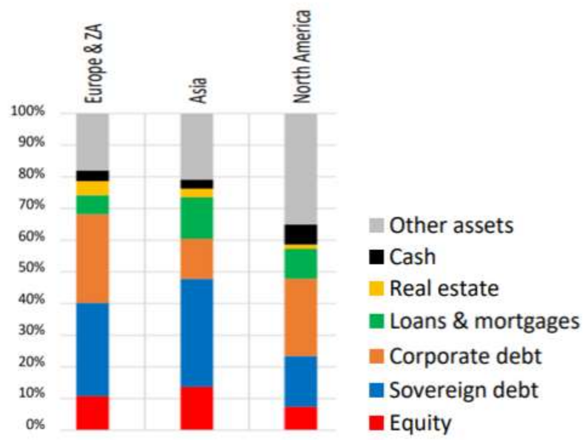
3. Regulatory risk and solvency

Just as interest rate and financial market risks have intensified, so regulations are progressively making insurers' balance sheets more sensitive to market movements. Regulatory regimes governing insurers in the EU, US and Japan are converging towards a more "market-consistent" approach, with individual nuances that influence asset allocations (fig 4).

Most recently, a 2020 review of the EU Solvency II regime by the European Insurance and Occupational Pensions Authority (EIOPA), the EU supervisory authority, proposed changes to the way that insurers measure liabilities that would be more sensitive and would, effectively, increase the size of liabilities in the current low-interest rate environment, so worsening capital positions.

Additionally, the new accounting regimes of IFRS 9 relating to financial instruments and IFRS 17 covering insurance contracts, due to be introduced in 2023, will make insurance companies' accounts still more sensitive, potentially reducing the apparent stability of profits and balance sheets. This will have a major impact on the way that insurance companies structure and manage their portfolios.

Figure 4: Asset allocation of insurers in %, Q2 2020



Source: IAIS, Global Insurance Market Report 2020

4. ESG, sustainability and climate

Environmental, social and governance (ESG) factors represent the final challenge in the quartet. They have been steadily growing in importance for several years, and are now a significant part of business and investment decision making. Climate change, in particular, is now recognised as a global crisis, with regulatory and policy momentum to match (fig 5).

As major players in the economy, insurers are expected to play their part in the transition to zero-carbon by 2050 that is regarded as necessary in order to meet the goal of limiting warming to the target of 1.5-2°C approved at the 2015 COP21 Paris agreement. AXA is a member of the Net-Zero Asset Owner Alliance, committing it to ambitious interim targets on the road to a 2050 net-zero target. This is leading to adjustments on both the liability side of the business and within the investment portfolio, illustrating the potential for other insurers to do the same.

Figure 5: The importance of climate change for investors

Source: AXA IM, March 2021. [1] Climate Bonds Initiative, Jan 2021

A growing urgency for change

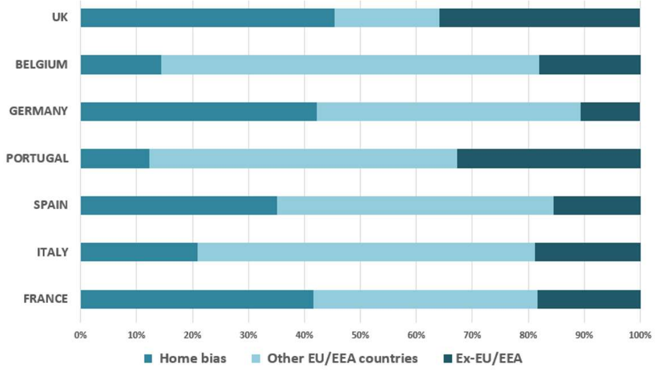
While it is true that insurers were already adapting to these challenges, the forces unleashed by the pandemic have made doing so an urgent matter. A failure could undermine solvency and profitability while leaving companies exposed to any further market storms, especially a rise in credit defaults arising from today's high levels of corporate indebtedness. At the same time, hesitation around climate risk could leave insurers behind the curve as major economic actors move to reduce their carbon footprint. Efforts to address these challenges have been made, but the industry has had to overcome some inertia, and progress has been uneven.

In recent years, insurers have been addressing these challenges but there has been considerable inertia, although some have moved faster than others. For instance, European insurers have been increasing allocations to new asset classes such as unlisted equity, mortgages and loans, and property – but only slowly.

One survey showed that European insurers have invested in bonds with lower credit ratings or longer maturities and bought more illiquid assets such as private equity, real estate and corporate loans, as well as tip-toeing into new asset classes such as mortgages and infrastructure debt[9]. Acting in this way is logical: it increases yields, reduces the duration gap (for mortgages and infrastructure debt) and improves portfolio diversification. These changes, however, have been tentative[10]. What is more, insurers must go beyond monetising their liquidity.

They also have to diversify their core portfolios, especially the bond portfolios backing their liabilities. But while diversifying overseas could provide a cushion against further crises, European insurers retain a strong home bias (fig 6).

Figure 6: Home biased behaviour for insurers' holdings of corporate bonds



Source: EIOPA Financial Stability Report 2020

French insurers invest more than 60% of their government bond allocations and 40% of corporate bond allocations domestically. Even when they do diversify it is chiefly into other EU countries. By contrast, Japan's insurers, which have been living with low interest rates for 30 years, have learned to diversify their portfolios geographically to a far greater degree[11]. We are convinced that diversifying further across the global public fixed income markets should be, for the years to come, a key investment theme for insurers.

Finally, expanding the investment universe of insurers' portfolios should be carried out in conjunction with their specific constraints. Bearing in mind the regulatory constraints, portfolios can be diversified, hedged and structured in ways that ensure the best capital and accounting treatment, while incorporating a thorough analysis of ESG risks.

The "great acceleration" of 2020 has delivered a pressing need for insurers to adapt quickly to a world marked by ongoing low interest rates, heightened market and credit risks, and the drive to decarbonise portfolios. Fortunately, we believe the tools exist that can allow them to do so successfully.

[9] EIOPA investment survey behaviour report 2017.
[10] EIOPA 2020 Financial Stability Report.
[11] IMF, Global Financial Stability Report, October 2017