White Paper

Insurance investing in a low-forever world

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For professional clients only

HSBC
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Management

Insurance investing in a low-forever world

In brief

- One of the main questions for insurance investors is whether low-for-longer really is turning into low-forever, and if so, what are the implications for insurance investing and the wider business model for insurers.
- Part of the answer lies in the three broad dimensions along which insurers can make adjustments to continue to thrive in the future: business mix, asset allocation and investment philosophy.

- The variations around these three interrelated dimensions, combined with the impact of lower interest rates on asset class returns, produce a highly complex challenge for insurance investors.
- One potential option to explore is to move away from buy-and-maintain strategies in fixed income to integrate a more active asset allocation within the asset liability matching (ALM) process.

- There is a large body of academic research that supports the importance of asset allocation in driving long-term investment returns and we believe that active asset allocation should be the centrepiece of an investment strategy.
- In our opinion, an active ALM framework would allow insurers to invest in new strategies and risk premia whilst ensuring predictable and efficient use of regulatory and economic capital.

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Introduction

The low-for-longer interest rate environment has persisted for a number of years. Among the world's major developed economies, the USA has been the main country that has been flying the flag for rate hawks. Whilst the European and Japanese economies have not shown any significant signs of inflation risk, as recently as a year ago many US investors ranked inflation among the principal investment risks on their radar.

Over the past months, it has become clear that there is no inflation pressure on the American horizon either. Short-term drivers such as the fiscal stimulus and a solid labour market have not caused a significant shift in inflationary pressure in the US – in fact, the US Fed has shifted to an accommodative policy stance in the past months. One of the key questions for insurance investors is whether low-for-longer really is turning into low-forever, and if so, what the implications could be for insurance investing and the wider business model for insurers.

In this paper, we look into the possible drivers for a low-forever interest rate environment and the impact on the balance sheet and business model of insurers. We then discuss three investment related dimensions along which insurers can make adjustments in order to succeed in such an economic environment.

Will low-for-longer become low-forever?

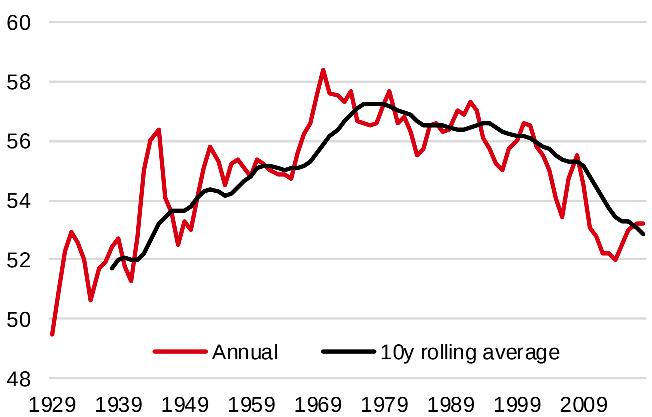
There has been an active debate around whether the weakening in recent years of the traditional Phillips curve relationship between employment rates, wage inflation and price inflation, is a temporary or a more permanent phenomenon.

Looking at the long-term history of US employee compensation as a percentage of GDP, this peaked in the early 1970s and held steady for nearly two decades, after which it started to decline.

Since the mid-2000s, this decline appears to have accelerated, suggesting that the pricing power of labour has been in decline for several decades.

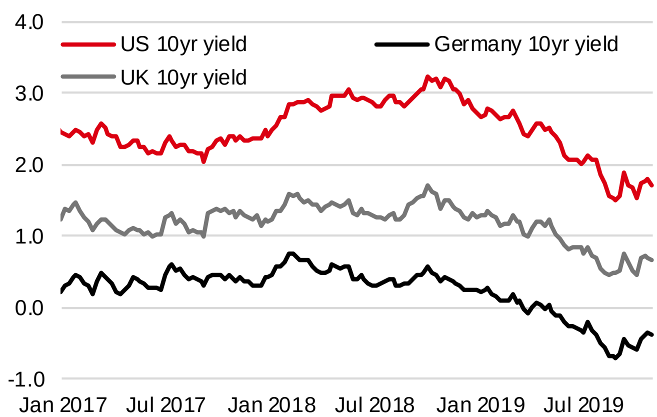
Changes in the structure of the economy and competitive pressures appear to be limiting the ability of companies to pass increased labour costs on to consumers through price rises. With these secular trends keeping a lid on inflation and with much of the developed world still working through the latter stages of quantitative easing, there are good reasons to assume rates will remain low for much longer in all of the major developed currencies – including the US dollar. Nevertheless, many investors were expecting or hoping for 2019 to be a year for interest rates to start the journey towards "normalisation". These hope were firmly crushed. More than 15 central banks cut rates in 2019 and many of the main government bond yields fell strongly.

Exhibit 1: US Employee compensation as % of GDP



Source: Federal Reserve Bank of St. Louis, 2019

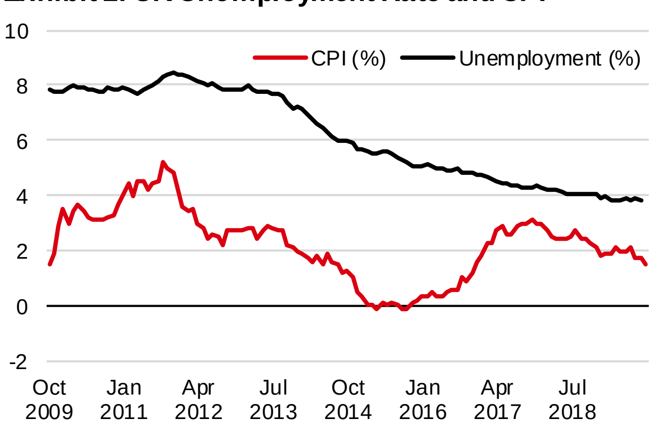
Exhibit 3: 10-year rates in Europe (%)



Source: HSBC Global Asset Management, Bloomberg, November 2019

In the UK, falling unemployment since the financial crisis has not to date produced an upward trend in price inflation. In fact, in the last two years UK price inflation has fallen even as unemployment continued to fall, which in itself did produce upward wage pressure with average weekly earnings up 3.6% year on year as per September 2019.

Exhibit 2: UK Unemployment Rate and CPI



Source: Office for National Statistics, UK, September 2019

Past performance is not a reliable indicator of future performance.

As a result, the question for insurance companies has become: what should they do if this is the new equilibrium and even solid economic growth can be accompanied by low inflation?

Generating returns within multiple dimensions of constraints

The investment challenge for insurance companies has traditionally been about finding the best returns within three broad constraints:

- Economic risk/capital;
- Regulatory capital;
- Accounting.

This multidimensional set of constraints is what sets insurance investing apart from investing for other categories of institutional investors. All three areas are interrelated and have seen significant change in recent years; this trend will continue in years to come. For example, many insurers have traditionally booked long-dated liabilities at historical discount rates in their accounts, which created a strong incentive to invest in long-dated fixed income assets that could be booked at amortised cost.

Changes in regulatory capital regimes such as the introduction of Solvency II have created explicit capital charges for mismatches in interest rate sensitivity between assets and liabilities, further pushing insurers towards more comprehensive liability matching.

On top of this, the introduction of IFRS 17 in 2022 may upend the accounting relationship between long-dated liabilities and assets by introducing interest rate sensitivity on the liability side that needs to be booked through OCI or P&L. Insurers may decide they want to change the accounting convention for the corresponding assets to create offsetting interest rate sensitivity on the asset side.

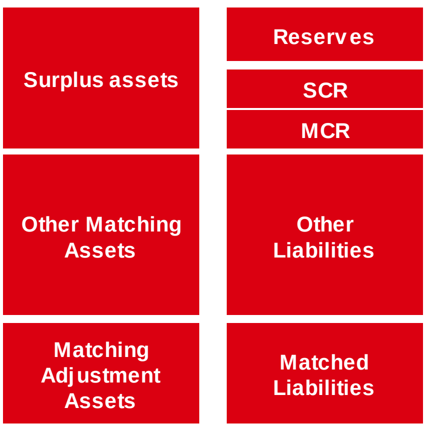
The movements along these three interrelated dimensions combined with changes in the relative ranking of expected returns for different asset classes driven by lower interest rates to produce a highly complex challenge for insurance investors.

Impact of low rates on insurance balance sheets

Low rates will have an impact on both sides of the balance sheet as well as on regulatory and economic capital ratios. The accounting choices an insurer has made for the different books of assets and liabilities also play an important role.

The diagram below shows a stylised insurance balance sheet. We have used the perspective of Solvency II to allow us to discuss a number of distinct components, but the points we will highlight would apply to other regulatory regimes as well.

Exhibit 4: stylised insurance balance sheet



Source: HSBC Global Asset Management, 2019

In broad terms, the diagram shows three components:

1. Matching Adjustment assets/cash flow matched liabilities
2. Other matching assets/broadly matched liabilities
3. Surplus assets

Matching Adjustment is the term Solvency II uses for the preferential capital treatment applied to asset portfolios that are designed to match liabilities on a cash flow basis.

The nature of cash flow matching and the requirements for Matching Adjustment treatment mean that the matching portfolios are dominated by fixed income assets without prepayment risk.

The assets are typically valued on an amortised cost basis in the financial accounts, partly driven by the fact that currently, the corresponding liabilities are often valued at historical discount rates under local accounting regimes[1]. Other Matching Assets are the investment portfolios that are designed to broadly cover the remaining insurance liabilities of the company. This broad matching could include a degree of duration matching at portfolio level.

Any remaining assets are surplus assets ("Own Funds" in Solvency II parlance). These can be invested with a higher amount of freedom since they are not linked to any particular set of liabilities. There will be some constraints on these assets around e.g. minimum holdings of cash and highly liquid assets, and possibly around duration if these assets are expected to provide a certain amount of duration as part of the ALM strategy.

The impact of falling rates will depend on the type of insurer and their business model. For example, the practice of cash flow matching is typically limited to life/annuity insurers, who will sell long-dated policies with the levels of any return guarantees closely related to the returns available in the long-dated fixed income markets at the time the policies are sold. Investment portfolios are designed and built as the long-dated products are sold. As long as the insurance products remain competitive and the returns that can be locked in on the investment portfolios remain the same or even improve, the insurer can continue to sell policies (assuming it has sufficient regulatory capital available). Falling interest rates will reduce available investment returns, and may lead insurers to slow down or stop sales of certain policies, or lower the guarantee levels. There may not be an immediate mark-to-market impact from falling rates, but profitability may be reduced over time if access to attractive fixed income assets is reduced and sales of long-dated products decline.

On the other hand, a non-life insurer may find it difficult to achieve satisfactory investment returns without having more interest rate risk in the investment portfolio than exists in the book of liabilities. This means that falling rates will produce profits if the insurer uses fair value accounting.

Below we will discuss three general approaches insurers could use to develop a strategy to flourish in a low-forever interest rate environment. The three are:

- Change product mix and design
- Change the asset allocation
- Change the investment philosophy/style

Insurers can use these three levers to define a comprehensive strategy that fits with their specific business model and provides the best opportunity to be successful in a low-forever environment.

[1]The introduction of IFRS17 will create a more consistent measurement of insurance liabilities across a large number of countries, with more dynamic valuations that move with changes in interest rates.

Change product mix and product design

The investment of premium inflows and surpluses is a key part of the business model of each insurer: investment returns help to lower premiums for policyholders and to provide economic returns for shareholders. Expected investment returns play a major part in the design and pricing of insurance products, so this an obvious avenue to explore, especially for insurers with large books of long-term business. A low-forever interest rate environment affects all competitors in the market, but insurers may be able to reduce the specific impact on their business by making judicious choices around product mix and product design.

With interest rates having fallen across the developed world for a significant period of time, insurers in many countries have been actively working to adjust their liability portfolios and product propositions, especially in long-dated insurance products. The impact of these activities has varied from country to country, providing an indication that local market dynamics can put constraints on the degree of adjustment that can be achieved using this lever without endangering an insurer's competitive position. For example, in the UK a full-fledged category of specialist consolidators has developed over a number of years that competes to acquire closed books of long-dated liabilities from insurers and pension schemes. In other European countries such as Germany, Italy and France, this development has only just started to emerge, even though all countries operate under the same Solvency II regulatory capital regime. Life insurers in these countries have started to focus on offering products with low or no embedded guarantees, but the vast majority of premium income is still received on legacy products with high embedded guarantees.

As interest rates remain very low for longer and regulatory capital pressures on the legacy books increase, closed book consolidation is expected to gather pace in these countries, with regulators offering qualified support and the resistance of policyholders, which has been significant in countries like Germany, lowering over time.

The benefits of such closed book transfers come in three areas: cost savings (avoiding legacy systems and marketing costs), regulatory capital savings, and customised investment strategies. Consolidators are often owned by private equity companies with a different and more integrated view of the investment risk inside the insurer as part of their overall private equity investment portfolio. This can create more freedom in terms of investment strategy as compared to public and mutual insurers. Similarly, regulatory capital savings (e.g. through Matching Adjustment treatment under Solvency II) may free up risk budget on the investment side.

Insurers looking at outsourcing closed books will be focused on two main objectives: retaining the connection to the policyholders, and replacing the revenue stream. The first is relatively easy to achieve through the design of the outsourcing solution. The second will be a function of the market dynamics in the markets where the insurers operate. This is outside the immediate control of the insurance company and means that changing the product mix alone may not be sufficient to achieve the required adjustments.

Change the asset allocation

The second broad avenue to maintain and improve financial performance in a low-forever world is to increase investment returns by changing the asset allocation. Some of the returns no longer available from risk-free interest rates may be recouped by judiciously taking investment risk. Many insurers have started investing in less liquid assets a number of years ago – or in some cases, decades ago. There are sound investment and risk management reasons for allocating a portion of the risk budget to liquidity risk premium, especially for life insurers. Traditional liquidity premium asset classes for insurers include real estate (debt and equity) and loans, often with a strong home bias (e.g. Schuldscheine in Germany).

But liquidity premium is just one of a number of risk premia that insurers have investigated and started to invest in. These include:

- Complexity risk premium
- Equity risk premium
- Factor risk premia
- Volatility risk premium
- Insurance risk premium.

Many types of investments can be said to carry a combination of risk premia. Complexity risk premium is often intertwined with liquidity risk premium. For example, insurers may invest in project finance loans where there is prepayment risk and the cash flows depend on the performance of the project's operator. Similarly, private equity investments carry a mix of equity risk premium, illiquidity premium and complexity risk premium.

Factor risk premia can be pursued in single-asset class strategies (typically equities and fixed income) and as multi-asset strategies, often with the objective of providing returns uncorrelated to other asset classes in strategies implemented with liquid instruments. Volatility risk premium strategies are less commonly visible on insurance general accounts, although they are regularly pursued through hedged fund investments and as part of systematic hedging strategies (typically in equities).

It is even less common to see insurance risk premium as part of the strategic asset allocation of an insurer – for most insurers, the business model is predicated on pursuing this risk premium through the sale of policies rather than through investments. But depending on the mix of insurance risk on the balance sheet and the regulatory capital regime, there may be very good reasons to invest in insurance risk that is not correlated to the core insurance business. For example, a European insurer operating under Solvency II or an Asian insurer under a similar capital regime may find that Florida hurricane risk or California earthquake risk could provide attractive risk-adjusted returns that consume very low marginal regulatory capital because of the diversification properties embedded in the solvency formula.

Insurers' traditional focus on fixed income investments accounted at amortised cost as the backbone of the asset allocation has meant that illiquid credit assets have had most of the attention in the search for new risk premia. The other risk premia mentioned very much remain available to be explored through careful asset allocation optimisation.

Change the investment philosophy

The third significant lever insurers can move in the quest to prosper in a low-forever environment is that of investment philosophy. As described above, insurance investment strategy has traditionally often been focused on building low-risk and low-turnover investment portfolios that support the insurance liabilities, and that do not demand ongoing active management. In recent years however, the relative importance of investment returns for insurance companies has been rising as the operating environment has become more competitive and insurance margins have shrunk.

Investment style or philosophy can play a major role in improving returns. Buy-and-hold and buy-and-maintain investment strategies have been very useful for insurers in the past, but they may preclude investors from benefiting from returns generated through active portfolio management. To illustrate the point, whilst a large proportion of Eurozone government bonds has negative yields, the Bloomberg Barclays Euro Aggregate Treasury Total Return Index returned over 9% during the 12 months from November 2018 to November 2019[2].

Many insurers have traditionally shied away from fair value accounting for fixed income portfolios – partly because of the accounting reasons described earlier. In Europe, the arrival of Solvency II has spurred an increase in the number of insurers that have moved to fair value accounting for most or all of their investment portfolios. This has aligned accounting and regulatory valuations much more closely, but it has also removed a constraint on the investment style for the dominant asset class in their investment portfolios. In turn, it has opened up active portfolio management as an avenue for return generation and risk management in fixed income.

With a consistent accounting basis for most (if not all) of the investments in place, it becomes possible to explore active asset allocation as a further driver of risk-adjusted returns. There is a large body of academic research that supports the importance of asset allocation in driving long-term investment returns and we believe that active asset allocation should be the centrepiece of investment strategy. As valuations change, relative attractiveness between asset classes will change over time, and portfolios should be adjusted regularly to these evolving market realities.

For insurance companies, running an active asset allocation strategy needs to be considered in the context of economic and regulatory capital constraints, which is complicated even if the accounting constraints have been mitigated by moving to fair value accounting. Certain portfolios may need to be excluded from the optimisations, for example matching adjustment portfolios. In addition, liquidity constraints may play a role in how an active asset allocation strategy can be implemented.

The need for concurrent optimisation of the investment portfolios for regulatory and economic capital and the fact that in many regulatory capital frameworks, investment risk, insurance risk and interest rate risk are combined into a single calculation, point the way towards active asset-liability management as a tool to support the implementation of an active asset allocation strategy. Insurers that have made a significant commitment to liquidity premium strategies may want to avoid regular rebalancing of large parts of such portfolios as relative values between asset classes move around. It makes sense in such cases to implement active asset allocation, at least in part, in the form of an overlay strategy and to integrate this within the ALM process. Decisions to implement specific trades in order to ensure ongoing compliance with economic and regulatory capital budgets would also take place within this process.

Another advantage of integrating active asset allocation within the ALM process can be that there remains more room within the physical portfolios to implement active strategies within single-asset class strategies that aim to harvest some of the risk premia listed earlier.

[2]Source: https://www.bloomberg.com/quote/LEATTREU:IND

Past performance is not a reliable indicator of future performance.

Conclusion

As the low-for-longer interest rate environment morphs into a low-forever environment, the need for insurance investors to transition to different sources of investment returns increases. The ever-increasing competitiveness of the insurance market means that investment returns are becoming more and more important for insurers.

There are three broad dimensions along which insurers can make adjustments to continue to thrive in the future:

- Business mix;
- Asset allocation;
- Investment philosophy.

On the investment side, there are numerous avenues to explore including different risk premia and more active asset allocation. To take full advantage of these opportunities, it makes sense for insurers to move away from buy-and-maintain strategies in fixed income and towards more actively managed strategies. Recent developments in regulatory capital regimes such as Solvency II in Europe and similar systems elsewhere, combined with accounting changes in the form of IFRS 9 and IFRS 17, provide incentives for insurers to apply fair value accounting much more broadly.

Interestingly, this makes it easier to implement more actively managed investment strategies. In order to ensure ongoing compliance with regulatory and economic capital budgets in a fair value world, more active ALM is required. And with an active ALM framework in place, insurers have the scope to invest in new risk premia and strategies whilst ensuring predictable and efficient use of regulatory and economic capital. For insurance asset managers, there is a challenge to help their clients with this transformation by assisting with the design of investment frameworks and fulfilment strategies.

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