The Geneva Association:

The costs of the financial crisis for insurance policyholders

Mr Daniel Haefeli

Dr Kai-Uwe Schanz

In this extract taken from The Geneva Association's Insurance and Finance newsletter, **Mr Daniel Haefeli** from **The Geneva Association** and **Dr Kai-Uwe Schanz** from **Dr Schanz, Alms & Co** discuss the impact of the "ultra-loose" monetary policies on insurers. Adopted by many central banks and governments to cushion the impact of the financial crisis and accelerate economic recovery, these policies resulted in low-interest environments which are seriously detrimental to many insurers and ultimately their policyholders.

In the autumn of 2008, governments across the world, especially in industrialised countries, took swift and radical measures to prevent the global financial system from melting down. Their primary objective was to avoid a disastrous impact on the real economy from such a meltdown. Saving financial intermediaries was just a means to this end – rather than an objective per se.

In order to fend off the most serious threat to the global economy since the Great Depression of the early 1930s, governments deployed a wide spectrum of different tools.

Rock-bottom short-term interest rates

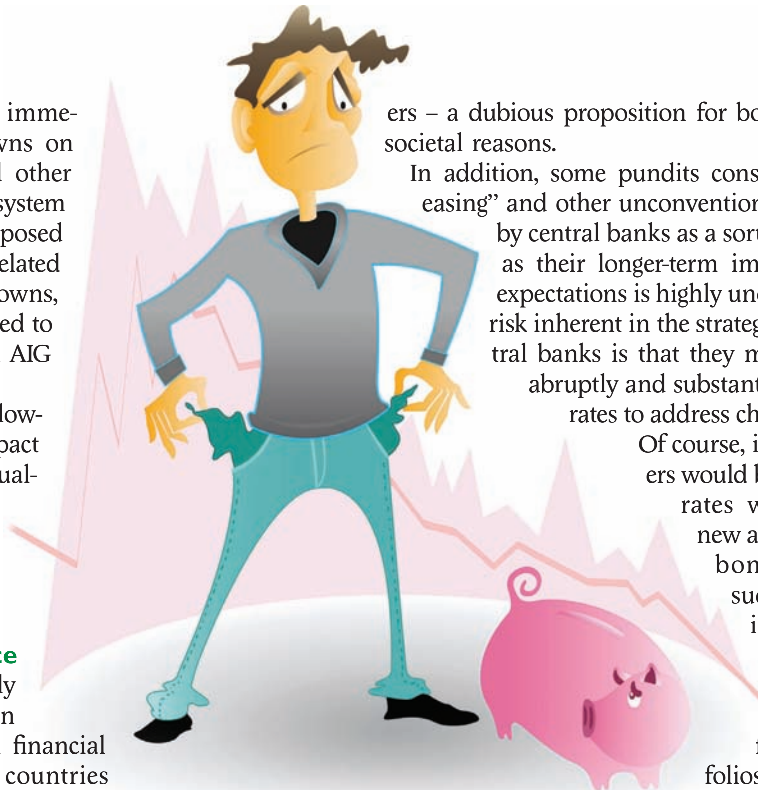
Financial institutions which were deemed systemically crucial were bailed-out, with AIG the most prominent example of a company that was virtually nationalised. Others benefitted from significant capital injections and debt guarantees from national treasuries. In addition, central banks took decisive and unconventional measures to secure a minimum liquidity of the financial system and its key players.

In order to cushion the impact of the financial crisis and accelerate economic recovery, they embarked on an ultra-loose monetary policy, pushing short-term interest rates to rock-bottom levels. When rates approached zero, central banks started to pursue additional unprecedented policies of "quantitative easing". They created (or "printed") money in order to purchase government and corporate bonds from investors. These purchases included 'toxic' securities such as mortgage-backed structured securities.

On top of all these measures, central banks eased the collateral requirements of commercial banks for access to short-term funds. As a result, financial markets were "flooded" with liquidity and the impact of the financial crisis on the real economy was successfully cushioned. In addition, a collapse of the global financial system as such was prevented. It goes without saying that these policies have had a significant impact on the insurance industry which we would like to highlight in this article.

Direct impact on equity and other asset portfolios

When examining the consequences of the financial crisis on the insurance industry, it is important to differentiate between direct and indirect effects on the one hand and short- and medium-term ramifications on the other.



Insurers were directly and immediately impacted by write-downs on their equity, fixed-income and other asset portfolios as the financial system began to crumble. On assets exposed to sub-prime mortgages and related credit losses alone, total write-downs, according to the OECD, amounted to more than US$250 billion, with AIG accounting for around 40%.

The subsequent economic slowdown had a further adverse impact on equity markets and credit quality, impairing the insurance industry's massive corporate bond portfolios.

Indirect impact through lower demand for insurance

Indirectly, insurers were heavily hit by the economic slowdown which followed the turmoil in financial markets. In 2009, developed countries experienced the worst recession in 80 years.

Households and firms alike cut their insurance budgets and premium volumes contracted sharply. Life insurers, in particular, felt the pinch as interest rates headed for record-low levels, making companies struggle to meet guaranteed policyholder returns. In addition, the need for, and the cost of, financial hedging strategies went up significantly in an environment characterised by high volatility and uncertainty.

Lower interest rates: Good for banks but detrimental to insurers

The ultra-loose monetary policies of central banks have resulted in a positive yield curve, with a sizeable differential between short- and long-term yields. Banks are greatly benefiting from this environment. In general, they tend to prefer low interest rates to reduce their funding costs whereas insurers benefit from higher rates as their inverse business cycle (collect premiums first, pay claims later) makes interest income a key pillar of their business model and a vital contributor to overall profitability. In addition, higher interest rates allow insurers to more heavily discount their future payment obligations. This discounting effect strengthens their balance sheets.

Leveraging the current shape of the yield curve, banks borrow at basically zero cost and lend longer-term at attractive margins. On that basis, the restoration of their badly affected balance-sheets has been progressing much faster than widely expected. The flip-side of this is that insurers and pension funds suffer and are forced to impose painful reductions in returns on their policyholders and shareholders. Ultimately, they are made to pay the price for recapitalising banks.

Longer-term impact on inflation uncertain

This is not the place to discuss whether current monetary policies which benefit banks and harm insurers are 'just" or not but there should be no doubt that these policies result in a redistribution of income at the expense of savers – a dubious proposition for both economic and societal reasons.

In addition, some pundits consider "quantitative easing" and other unconventional tools deployed by central banks as a sort of brinkmanship as their longer-term impact on inflation expectations is highly uncertain. The policy risk inherent in the strategy pursued by central banks is that they might be forced to abruptly and substantially raise interest rates to address changes in inflation.

Of course, in principle, insurers would benefit from rising rates when purchasing new and higher-yielding bonds. However, a sudden increase in interest rates would significantly impair the value of their existing fixed-income portfolios and, potentially, jeopardise solvency levels. Furthermore, if rising interest rates go hand in hand with increasing inflation, insurers would have to strengthen their claims reserves.

Cost of low-yield regime to policyholders and investors

It is important to develop a clear understanding of the actual and potential costs arising from ultra-low investment returns.

As experience from Japan demonstrates, insufficient yields (compared to contractual commitments vis-à-vis policyholders) can be a slow poison with the potential to cripple life insurance companies. But one does not need to embrace such a gloomy scenario to be concerned about the cost of the current yield regime to insurance policyholders and investors alike.

According to Swiss Re (*sigma* no – 5/2010), global insurance assets amount to $22.6 trillion which corresponds to 12% of total global financial assets. A yield reduction of as little as 100 basis points would result in a loss of investment income of around $226 billion p.a., more than the combined shareholders' funds of the world's top five insurance companies. A lasting negative impact on investment income would be a particular challenge for non-life insurers with low or volatile underwriting results and life insurers who have entered into contractual minimum yield obligations.

Lower yields result in higher insurance prices

Investment returns are a key input to pricing insurance contracts. Therefore, to make up for lower returns, insurers would have to raise premium rates for non-life and life insurance policies as well as reduce the returns they can offer to their life insurance policyholders. As a consequence, some clients would opt for less coverage or try to manage their (pension) assets on their own.

From a public policy perspective, this is not necessarily a desirable outcome as individuals would forego the expertise of one of the world's leading institutional asset managers – the insurance industry.

Regulatory challenges

The challenges ahead of insurers are compounded by impending regulatory changes. The global trend towards risk-based capital regimes – with Solvency II arguable being the most complex and sophisticated framework – reduces insurers' degrees of freedom when investing their assets.

Going forward, market risk (eg the risk of changing interest and foreign exchange rates) has to be underpinned by considerably more risk capital, making investments in higher-yielding asset classes potentially uneconomical. For example, under current draft rules, each euro invested in equities would have to be underpinned by more than 40 cents of equity.

Ultimately, higher capital charges for higher yield investments reduce the capacity of insurers to act in a counter-cyclical way, in particular in the very long-term lines of business.

Regulators, therefore, run the risk of weakening the stabilising role insurers traditionally play within the financial markets.

Accounting reforms add to insurers' challenges

Unfortunately, the upcoming insurance-related changes to International Financial Reporting Standards (IFRS) compound this undesirable effect as the mark-to-market principle fails to properly reflect the long-term character of insurance liabilities and corresponding assets, especially in times of stress and illiquid markets.

Under the new draft rules, temporary declines in the value of long-term investments will have to be accounted for as charges to equity with a direct adverse impact on the profit and loss statement – even if these investments are held to maturity.

The treacherous safety of sovereign bonds

Sovereign bonds carry the lowest risk charges, providing a strong incentive for insurers to invest more heavily in this asset class. However, as a consequence of current monetary policies these fixed-income securities yield at record-low levels.

In addition, sovereign bonds, well beyond the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) are no longer considered as "fail-proof". Insurers, therefore, are caught in an uncomfortable dilemma: either they accept low-yielding investments in government bonds (which don't even offer 'peace of mind' anymore) or they engage in higher-risk asset classes which carry significant or even prohibitive capital charges and imply a much higher volatility of results.

Policyholders paying the price for the global financial crisis

As a matter of fact the annual loss in income resulting from the current low-interest environment probably easily outweighs the total and effective cost of the limited public bail-outs and capital injections in favour of insurance companies during the financial crisis – the bulk of it was devoted to saving AIG, a financial services conglomerate which stumbled over non-insurance types of business.

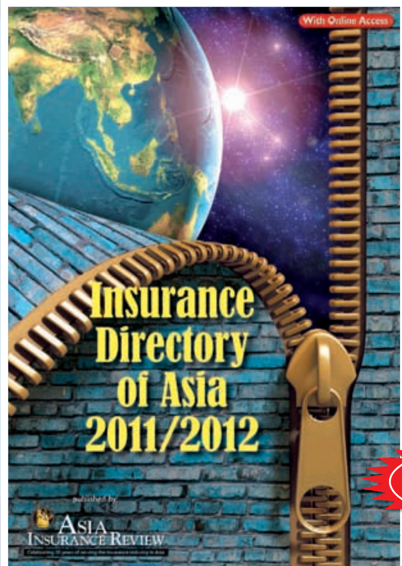
With higher premium rates primarily in non-life business and lower guarantees and profit participation on the life side, lawmakers should acknowledge that insurance policyholders are already paying a high price for restoring the balance-sheets of those financial services players who were instrumental in causing the financial crisis in the first place...

Mr Daniel Haefeli is Head of Insurance and Finance, The Geneva Association and Dr Kai-Uwe Schanz is Special Advisor Strategic Research, The Geneva Association.

This column is sponsored by

The Geneva Association
www.genevaassociation.org

Latest Edition
Insurance Directory of Asia



This latest update of the Insurance Directory of Asia includes detailed inputs and updates of about 240 insurers and reinsurers in the region, plus basic data for another 1,100 companies.

Place your order now!

Singapore / Malaysia* SG$480
Others* US$480

* All rates inclusive of handling and mailing charges

With Online Access

To order, please visit
www.asiainsurancereview.com