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THE RETURN OF INFLATION:
What it means for insurance

Research summary
January 2023

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The resurgence of inflation in late 2021 came as a surprise, if not a shock. It arose from the continued aftermath of the COVID-19 pandemic, which saw pent-up demand, government stimulus packages and supply chain bottlenecks, and was followed by sharp energy and food price increases as a result of Russia's invasion of Ukraine in late February 2022.

Three other, more structural forces could make inflation 'stick', even if central banks succeed in taming the current episode during the course of 2023. First, decarbonisation and the need for massive capital expenditure on green energy as well as higher carbon prices; second, deglobalisation and the trend towards supply chain reshoring and increasing protectionism; and third, demographic changes, as ageing populations will require more public expenditure on health and elderly care and may cause shortages in labour supply.

The immediate impact of inflation on non-life (property & casualty and health) insurers' earnings is negative, primarily through rising future claims costs on current insurance policies, the need to bolster loss reserves and, in case of stagflation, reduced demand. The effect on life insurers' earnings is more neutral. As opposed to non-life insurance, most life insurance products, e.g. mortality, wealth accumulation and longevity protection, offer benefits that are nominally fixed. Having said this, inflation tends to erode the value proposition of life insurance with fixed benefit payouts, weighing on new business and leading to higher lapses.

Lower equity markets, rising interest rates and widening credit spreads adversely affect insurers' balance sheets through mark-to-market valuation losses. On the other hand, higher interest rates, i.e. discount rates, have a favourable effect on the net present value of future liabilities.

There is a wide range of management actions insurers can take to respond to the new macroeconomic environment (see Table 1). In terms of product design, with customers typically suffering a reduction in real income, insurers could offer more affordable, low-cost products with an increased focus on risk and loss prevention.

With tight labour markets and increasing wage pressure, insurers will also maintain their drive to improve operational cost efficiency and overall productivity, i.e. output per employee. Digitalisation is one obvious route to achieve this objective in areas such as distribution (the biggest non-claims cost block), marketing and customer service.

The main underwriting response is to reprice insurance risks that exhibit elevated claims costs. The need and scope for doing so depend on the competitive environment in the relevant insurance markets, insurers' assumptions concerning central banks' ability to tame inflation within a reasonable period of time and the degree of public policy and regulatory constraints and interventions.

To counter rising claims costs, insurers may further accelerate claims automation and straight-through processing as well as expand (or build) partner and supplier networks in order to negotiate fixed prices for a longer period of time.

In investment management, there is some scope for inflation protection on the back of tactical asset allocation, for example by tilting the investment portfolio away from bonds towards commodities, equities and real estate. For insurers, however, such benefits remain elusive in light of very high solvency capital requirements for those asset classes.

TABLE 1: HOW INSURERS RESPOND TO INFLATION ACROSS THE VALUE CHAIN

Product design	Marketing	Underwriting/ pricing/ reserving	Distribution	Claims	Customer service	Investments
Shorten durations in long-tail business Design more affordable, lower-risk, 'essential value-based' products	Invest in online marketing to counter wage inflation and improve customer targeting	Reprice insurance risks Write more new business in lower-risk segments Review and adjust reserves more regularly	Invest in online sales and policy binding to counter wage inflation	Monitor claims inflation above and beyond general inflation Invest in claims automation and partner networks	Invest in digital self-service to counter wage inflation	Consider inflation-linked bonds and 'inflation-proof' equities and real estate

Source: The Geneva Association

Inflationary episodes typically entail lower economic growth or even recessions, which hurt demand for insurance, especially in areas where customers consider insurance a discretionary (non-essential) expense item. However, we argue that for customers and society at large, the value of insurance increases in times of inflation, for the following reasons (see Table 2):

- Customers' reduced financial flexibility during an inflationary shock adds to the relevance of financial protection and stability afforded by insurance coverage; especially in periods of inflationary recession, insurance customers are likely to attach a particular value to the 'peace of mind' derived from insurance. Customers feel more reassured about their ability to absorb (inflated) financial shocks from major unexpected events, replace lost assets and cover more costly routine expenses such as annual medical checkups and dental visits. The financial value of non-life insurance in particular increases in times of inflation as its key benefits, such as cost savings and cash-flow smoothing in the event of major losses, gain in importance, especially for lower-income earners.

- The role of insurance in loss prevention and reduction is especially relevant as individuals, households and businesses would face a higher financial burden from any uninsured losses and a lower inflation-adjusted value of fixed payouts. Based on their risk data and expertise, insurers have a competitive edge in prevention-oriented risk assessment and control.

- In the absence of price stability, insurers' traditional role in financial intermediation further gains in importance. Life insurers in particular can help transform individuals' and households' short-term (cash) deposits into longer-term, higher-yielding savings, which are less prone to value erosion than deposits.

- By stabilising the financial situation of individuals and households, insurance also contributes to mitigating social inequality: as long as insurance is in place and affordable, vulnerable people are less exposed to falling (back) into poverty following a financial shock exacerbated by a sudden surge in inflation. This role of insurance matters greatly in times of inflation, when low-income earners' income and wealth tend to suffer disproportionately.

TABLE 2: THE VALUE OF INSURANCE IN TIMES OF INFLATION

Financial flexibility	Loss prevention and reduction	Financial intermediation	Mitigation of social inequality
Absorbs financial shocks, replaces lost assets and covers routine expenses Enables cost savings and cash-flow smoothing	Mitigates financial burdens from uninsured losses and lower value of inflation-adjusted fixed payouts	Transforms cash deposits into longer-term, higher-yielding savings less prone to value erosion Mobilises savings for 'real' investments	Protects low-income earners from income and wealth erosion

Source: The Geneva Association

Going forward, demand for insurance could benefit from the shock experience of resurging inflation. Such shocks – similar to what we witnessed as a result of COVID-19 – typically affect risk perception and sharpen risk awareness.

Demand for non-life insurance could also benefit from portfolio shifts from financial to real assets. Furthermore, increasing prices of real assets such as cars and property translate into higher demand for insurance as asset owners seek to expand policy limits.

For life insurance, inflation presents particular challenges as it erodes the value of future fixed payouts, making in-force life insurance products less attractive, adversely impacting sales and increasing lapses and surrenders. However, the effects of inflation on interest rates are widely considered more relevant. Customers might have more appetite for savings-oriented life insurance products that come with higher yields and inflation-protection features.

More generally, as professional absorbers and managers of risk, macroeconomic shocks such as unexpected inflation challenge insurers' role in society, but they also offer opportunities. With that in mind, we offer the following conclusions and recommendations for insurers, policy-makers and regulators.

Demonstrate the value of insurance in times of shock

The COVID-19 pandemic has significantly strengthened the risk awareness of individuals, households and businesses. Despite contractual ambiguities and fundamental insurability issues in the area of business continuity risk, insurers have proven their mettle during the pandemic and continued to pay legitimate claims in a 'business-as-usual' manner. Life and health insurers in particular have proven their worth by meeting their obligations in the face of increasing mortality and hospitalisation rates. Demand for such insurance products has surged as a consequence and remains structurally above pre-pandemic levels, especially in emerging.

The inflationary shock offers similar opportunities for insurers that help customers remain resilient in times of increasing financial stress when the value of protection becomes much more apparent. At the same time, insurers need to respond to the profitability and solvency challenges presented by inflation. Adjusting prices and risk appetite are among the inevitable responses but further improved cost efficiency could help insurers soften the potentially negative impacts on their customers.

Protect profitability and solvency

For non-life insurers in particular, inflation and subsequent increases in interest rates generate adverse impacts on earnings and net-asset value. Remedial action, ranging from product redesign, repricing and cost management to changes to the asset allocation, is inevitable in order to be able to offer lasting and reliable risk protection in the long run.

Respond to changing customer needs in light of inflation

Customers have woken up to the risk of unexpected rampant inflation. Insurers' perceived value going forward may therefore also depend on their ability to manage inflation risk on behalf of their customers. Evolving customer expectations may give rise to changes to product design. In addition, normalising interest rates revive customer appetite for life insurance products, which combine yield guarantees with profit-sharing features. However, painful lessons from the past suggest caution when re-entering the financial guarantee business.

Adjust solvency regimes to reflect the new macroeconomic realities

With normalising interest rates, there is now a clear customer appetite for the protection offered by financial guarantees. Prohibitive risk capital charges for such guarantees, set during an extended period of interest rate declines, ultimately hinder the insurance industry from tackling the pension savings gap.