

Macro forces and the new normal for insurance

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It's a time of change for insurers. Taken together, low interest rates, ageing populations and new regulations are ushering in a new normal. This new world requires insurers to revisit their business models and demands a fresh, dynamic approach to many areas of investing.

Looking first at interest rates, the global financial crisis (GFC) of 2008-2009 acted to accelerate even faster the era of lower rates that the pandemic appears to have prolonged. 12-month US Treasury yields have plummeted from double digits in the 80s and 90s and over 4% before the GFC to close to zero or even negative levels today.

Turning to demographics, ageing and increased longevity are putting retirement planning under the spotlight. In 2018, for the first time in history the number of people over the age of 65 outnumbered children under five, according to the United Nations¹. By 2050, they project that there will be twice as many over-65s as children under five.

Regulatory change

Equally important is the impact of regulatory change. 2023 will see the introduction of IFRS 17, the new accounting standard governing public reporting to shareholders of insurers' assets and liabilities. Meanwhile Risk Based Capital regulations are being implemented across the world. These solvency standards clearly impact the ways that insurance companies can deploy risk on their Balance Sheets.

So what does all this mean? For a start, low interest rates and the increasingly demanding regulatory regimes have made it more difficult to write guaranteed products, leading to a move to investment-linked products. Even so, there remains a need to find ways of delivering investment outcomes with a degree of confidence that policyholders continue to demand.

¹ United Nations. World Population Prospects 2019. https://population.un.org/wpp/Publications/Files/WPP2019_Highlights.pdf

Insurers need to replicate the experience delivered by guaranteed products but without the balance sheet burden of these guarantees. At the same time, policyholders want to buy products which are simple and effective in protecting them against capital erosion and which are also environmentally friendly, socially responsible and have sound governance credentials.

Everything suggests that insurers need to consider their strategies for capital, investments and products as they enter 2021. Which lines of business should they focus their capital on? What kind of investment strategies will deliver investor outcomes in ways that are capital-efficient and diversified? And, what products will meet investor demand? We highlight three approaches that illustrate how insurers are moving forward in their new normal.

Finding the right approach

Firstly, revisiting strategic asset allocation is key, partly in reaction to the difficulty of writing guarantees. It is rarely a good idea to think about return and capital on their own; insurers must also consider risk. In fact, when rethinking strategic asset allocation it is often possible to reduce capital with minimum impact on risk/return efficiency. Additionally, we see a move away from strategic asset allocation as a static 'set and forget' approach. A dynamic approach that is capital-aware is one way forward. We have developed our investment processes to incorporate "market states" – which determine whether risk is likely to be rewarded. This mechanism can be applied to diverse client portfolios and allows the Strategic Asset Allocation to be tilted to one which is better rewarded from a risk and capital perspective given the current market state.

Secondly, investment-linked products with risk ratings are becoming more popular. By designing products with approaches to strategic asset allocation that match five specific risk bands – from defensive to aggressive – we are able to meet the needs of a range of end investors. As with any SAA, we apply tactical asset allocation as an additional overlay to add value in these multi-asset portfolios.

Thirdly, customised fixed income portfolios have an important part to play. Applying advanced portfolio construction techniques ensures that insurers' portfolios are aligned with insurers' objectives across three dimensions – yield, risk and regulatory capital. Algorithms tune the portfolio to maximise or minimise specific metrics – for example, to minimise the regulatory capital charge, maximise yield, minimise cashflow mismatch or minimise duration mismatch.

What are the advantages of these advanced fixed income portfolio construction techniques? One obvious application is to traditional matching portfolios, where insurers seek to maximise yield while taking into account capital and/or matching adjustments in regulatory reporting. Recently, we see a great deal of interest from fixed maturity portfolios, or buy-and-hold type strategies, looking to minimise default risk while maximising yield and managing interest rate risk. In addition, in the retirement area insurers are using this portfolio construction approach to protect capital and provide a high level of income while also generating an elevated long-term return by combining them with higher-growth asset classes.

In 2021 and beyond, we believe that insurers will react to the macro forces they are facing by increasingly turning to these new approaches. This will allow them to balance the demands of capital protection and regulatory constraints in today's low-yield world.



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