

Bearing the brunt

The sector is paying a high price for the financial services failures of others



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In autumn 2008, in order to fend off the most serious threat to the global economy since the Great Depression of the 1930s, governments deployed a wide spectrum of different tools.

Financial institutions deemed systemically crucial were bailed out. Others benefited from significant capital injections and debt guarantees from national treasuries. In addition, central banks took decisive and unconventional measures to secure sufficient liquidity in the financial system and its key players. To cushion the effect 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, printing money by purchasing government and corporate bonds from investors. As a result of these measures, financial markets were flooded with liquidity and the financial crisis' effect on the real economy was successfully cushioned.

In addition, a collapse of the global financial system as such was prevented. And there is no change to these policies in sight as the European sovereign debt crisis has highlighted the fragility of economic recovery.

When examining the consequences of the financial crisis and related policy responses on the insurance industry, it is important to differentiate between direct and indirect

effects on the one hand and the short- and medium-term ramifications on the other.

Insurers were directly affected by writedowns 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 writedowns, according to the Organisation of Economic Co-operation and Development, amounted to more than \$250bn. The subsequent economic slowdown had a further adverse impact on equity markets and credit quality, impairing the insurance industry's massive corporate bond portfolios.

Economic slowdown

Indirectly, insurers were hit by the economic slowdown which followed the turmoil in financial markets. In 2009, developed countries experienced the worst recession in 80 years. The ongoing sovereign debt crisis in Europe – which has been accelerated by the financial crisis – conjures up the spectre of a double-dip recession.

In response, households and firms alike cut their insurance budgets and premium volumes contracted sharply.

Life insurers in particular continue to feel the pinch as interest rates head for record low levels, making companies struggle to meet guaranteed policyholder returns. 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 greatly benefited from this situation. Generally, banks 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. Leveraging the present shape of the yield curve, the banks borrow at, basically, zero cost

and lend longer term at attractive margins. On that basis, the restoration of their balance sheets has been progressing much faster than widely expected.

The flip side of this is 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.

These policies should be clearly identified as resulting 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 kind of brinkmanship because their long-term effect on inflation expectations is highly uncertain.

It is important to develop a clear understanding of the actual and potential costs arising from ultra-low investment returns. As Japan has demonstrated, insufficient yields (compared to contractual commitments vis-à-vis policyholders) can slowly immobilise life insurance companies.

But one does not need to embrace such a gloomy scenario to be concerned about the cost of the yield regime to insurance policyholders and investors alike: global insurance assets amount to close to \$24trn, which corresponds to more than 10% of total global financial assets.

A yield reduction of as little as 100 basis points would result in a loss of investment income of close to \$240bn per annum, more than three times the total costs for hurricane Katrina every year.

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 that have entered into contractual minimum yield obligations.

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.

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. Looking ahead, 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. This reduces the capacity of insurers to act in a counter-cyclical manner, in particular in the very long-term lines of business. Regulators, therefore, run the risk of weaken-

ing the stabilising role insurers traditionally play within the financial markets.

Unfortunately, the upcoming insurance-related changes to International Financial Reporting Standards 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.

Sovereign bonds carry the lowest risk charges under Solvency II, providing a strong incentive for insurers to invest more heavily in this asset class. However, as a consequence of present monetary policies top-rated fixed-income securities yield at record low levels. In addition, sovereign bonds, well beyond the so-called PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) are no longer considered "fail-proof".

Insurers, then, are caught in an uncomfortable dilemma: to either accept low-yielding investments in government bonds (which do not even offer "peace of mind" anymore) or engage in higher-risk asset classes which carry significant – even prohibitive – capital charges and imply a much higher volatility of results.

Lawmakers may want to acknowledge insurance policyholders are 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 – higher premium rates primarily in non-life business and lower guarantees and profit participation on the life side. ■

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\$24trn
Total global insurance assets, which account for...

10%
Of total global financial assets

\$250bn
Total insurer writedowns due to the crisis



Greek police officers, firefighters and coastguard officers, joined an anti-austerity protest outside the marble Panathenaean Stadium on Oct 17

AP Photo/Petros Giannakouris