Facing up to renewed global economic uncertainty

Europe is sliding into a new recession, and other regions may follow suit. **Dr Kai-Uwe Schanz**, Principal Partner, **Dr Schanz, Alms & Co AG**, Zurich discusses some key resultant challenges insurers are facing: slowing premium growth, dwindling investment returns and threats to monetary stability.

Macroeconomic indicators such as GDP growth, the rate of inflation and interest rates determine the fortunes of the insurance industry. Therefore, the roller coaster of the past three years (a major global recession in 2009, a sharp rebound in 2010 and renewed economic uncertainty in 2011) present extraordinary challenges to insurance management teams.

How insurance demand is affected by slowing GDP growth

Economic growth is the single biggest determinant of insurance demand. Subdued investment and consumption, driven by the continuing need to deleverage corporate and household balance-sheets, will, therefore, take its toll on insurance demand. Encouragingly though, during recessions and downturns, the income elasticity of non-life insurance demand tends to be below one, or, simply, speaking: insurance demand falls by less than overall GDP, cushioning the impact of slowing economies on the insurance sector. For example, in 2009, when the world saw a 2% decline in real GDP, non-life premiums were basically flat.

Life insurance, however, exhibits a completely different pattern: demand is extremely sensitive to financial market volatility and the prospect of a sharp economic slowdown. Let us remember the year 2008 when the world was facing up to a major credit crisis, with a recession widely anticipated for the following year. Whereas global GDP growth remained positive at less than 2%, life insurance premiums dropped by more than 3%, driven by double-digit percentage declines in demand for unit-linked products in major advanced countries.

Against this backdrop, insurers are highly concerned about the spectre of a renewed prolonged recession which could, for example, be triggered by another banking crisis in the wake of an uncontrolled escalation of the European sovereign debt crisis.

Asset management: Record-low yields and looming impairments

Since 2007, the US Federal Reserve has pursued an aggressively loose monetary policy. By the end of 2008, the US federal funds rate was pushed down to close to zero and has remained there since. Most other advanced countries' central banks followed suit as the US subprime crisis morphed into a global financial crisis, resulting in a severe economic downturn.

For the insurance industry, record-low interest rates entail formidable challenges. The sector counts on investment income as a major pillar of its business model ("collect and invest premiums now, pay claims later"). Globally, insurers and reinsurers invest more than US$20 trillion to back up future policyholder claims. A reduction in the available yield of as little as 100 basis points translates into an annual loss of income in the amount of $200 billion – three times the insured industry loss resulting from Hurricane Katrina in 2005 – the biggest insured natural disaster to date. For non-life insurers, this "state of emergency" (as described by Munich Re CEO Dr Nikolaus von Bomhard) is a challenge. For life insurers, it could even develop into an existential threat as a negative spread between market interest rates and contractually agreed minimum policyholder yields erodes companies' capital base and solvency.

At the same time, insurers face the prospect of another round of asset impairments as a direct result of the European sovereign debt saga. The Greek calamities are manageable, provided that the contagion does not spread to Spain or worse, Italy, and cause a serious banking crisis (as some insurers have invested more than 50% of their total assets in bank securities and loans). In general, widening spreads on certain government bonds, in conjunction with massive setbacks on stock markets since July, have adversely affected insurers' asset portfolios.

Inflation or deflation: The choice between Scylla and Charybdis

In addition, there is tremendous uncertainty over future monetary stability. On the one hand, the massive post-crisis degradation of fiscal positions in many developed countries, combined with ultra-loose monetary policies suggests that a surge in inflation is a scenario to be seriously reckoned with, as consumers and investors are revising upwards their inflation expectations and governments may feel tempted to inflate their debt burden away. From an insurer's perspective, three key variables would be affected: investment returns, asset valuations and future insurance liabilities. As far as the latter is concerned: inflation pushes claims costs up, eating into insurers' profitability, especially in long-tail non-life business.

On the other hand, the opposite scenario of deflation cannot be ruled out either. Developed economies have to digest the legacy of the pre-2007 boom years. Both the private and corporate sectors face the need to deleverage their balance sheets. Finally, austerity is the name of the game for fiscal policies in many advanced countries. Against this backdrop, the prospects for a strong and sustainable economic recovery remain dimmed. From an insurance perspective, deflation implies lower interest rates and a continuation of meager investment yields – a major threat in particular to life insurers with long-term contractual minimum yield obligations.

This triple challenge of anaemic top line growth, depressed investment returns and threats to monetary stability will keep insurance executives on their toes for the foreseeable future. M

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