

The “new normal” – implications for the insurance industry

Financial markets have recovered forcefully from their March 2009 lows. In parallel, virtually all economies have emerged from recession. Having said this, it would be naïve to believe that corporate and public decision-makers will simply return to pre-crisis ways of doing business. **Dr Kai-Uwe Schanz**, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, examines some insurance-specific implications of the “new normal”, a term coined by Mr Mohamed El-Erian, CEO of fixed-income manager Pimco.



Even though the world economy has stabilised and financial markets have rebounded sharply, closer inspection suggests caution. Most sources of the current recovery seem to be of a temporary nature: the rebuilding of inventories, massive fiscal stimulus packages and ultra-loose monetary policies. The fundamental problems remain: in the US and other developed countries, households are strangled by huge levels of debts. Banks remain under pressure to bolster their capital. Both observations bode ill for the future economic landscape as consumer spending and bank lending are bound to fall short of their pre-crisis levels for an extended period of time.

In the longer term, the world economy's prospects will largely depend on a major global rebalancing: indebted (American) consumers must tighten their belts, whereas thrifty countries such as China, Japan and Germany should spend more and save less. In summary, the world economy is not likely to return to normal as we know it but to a “new normal” characterised by moderate growth and higher unemployment.

Coping with subdued premium growth

So far, most insurers have successfully weathered the financial crisis. Even though affected by massive asset write-downs, liquidity risk surprises and inadequate hedging strategies, the industry stayed afloat. The recovery of equity and debt markets has strengthened insurers' balance sheets and replenished risk capital and underwriting capacity.

In 2010, however, the sector will have to contend with the challenge of stagnating or even contracting business volumes as the economic slowdown of 2008 and 2009 is expected to filter through to private and commercial policyholders. The temptation to defend market share in such an environment is set to put pressure on margins. Utmost discipline and agility will be required from corporate decision-makers. Depending on how the “new normal” plays out, insurers might have to prepare for a longer period of subdued growth, necessitating adjustments to corporate structures, the product and distribution mix and other strategic parameters.

Managing interest rate risk

Economists are divided as to whether the world is facing an extended period of low inflationary pressure and interest rates. The

camp in favour of this hypothesis points to the dampening effects of anemic consumer demand as suggested by the “new normal”. Those who believe that interest rates are set to increase soon believe that economic growth will return to its pre-crisis path and also cite the spiralling of public debt and the build up of inflationary expectations among investors.

Both scenarios present the insurance industry with formidable challenges: Low interest rates will ultimately create a dangerous gap between life insurers' investment returns on the one hand and minimum returns guaranteed to policyholders on the other. This mismatch could have crippling effects on a life insurer's solvency as experienced in Japan over the past two decades.

On the other hand, a surge in interest rates arising from a faster than expected recovery of the global economy, and potentially fuelled by policy mistakes such as an ill-timed reversal of expansionary monetary policies, would blow major holes in insurers' US-GAAP or IFRS balance sheets, even though a rise in interest rates is neutral from an economic net worth perspective. Surging rates would also erode excess capital under the current capital regime of Solvency I and have a negative impact on the capital adequacy as measured by certain rating agencies.

Bracing for a new regulatory landscape

A third major challenge ahead is regulation: There is a general consensus that post-crisis the hand of governments will be more visible. Regulations are expected to tighten financial services, with a limited willingness among lawmakers to distinguish between the many different sectors of the financial services space.

The main area of concern for insurers is solvency regulation. In light of the recent financial crisis and severe flaws exposed by risk management in banking, faith in risk-based capital regimes and underlying internal risk models has taken a battering. Capital requirements for banks are set to be hiked. The risk-based approach underlying Basel II is expected to be complemented by rather crude leverage ratios, ie minimum equity to assets ratios, irrespective of any risk weights.

It remains to be seen to which extent these developments will spill over to solvency regulation in insurance. In any case, the benefits expected from Solvency II such as a more efficient allocation of capital based on a careful distinction between insurance, market, credit and operational risks must not be compromised. Otherwise, the “new normal” in insurance might spell lower returns for investors and higher costs for policyholders.■

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