

# How policyholders and investors pay for the financial crisis

**Dr Kai-Uwe Schanz**, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, reviews the implications of the current ultra-low interest rate environment in mature markets.



In order to cushion the impact of the financial crisis and accelerate economic recovery, central banks in mature (and a number of emerging) economies have embarked on an ultra-loose monetary policy, pushing interest rates to rock-bottom levels. In addition, as interest rates can hardly drop any further, central banks pursue unprecedented policies of “quantitative easing”: they create (print) money in order to purchase government and corporate bonds from investors.

These policies have resulted in a positive yield curve, with a sizeable differential between short and long-term yields. Banks are greatly benefiting from this constellation. They borrow at basically zero cost and lend longer-term at attractive margins. On that basis, the restoration of their badly hammered balance-sheets has been progressing much faster than widely expected.

All is well that ends well? Not really, as one man’s meat is another man’s poison. Whereas low interest rates are a major boon for banks, insurers and pension funds suffer as they struggle to even achieve the minimal returns mandated by lawmakers. Their policyholders and shareholders have to face painful reductions in returns and are ultimately made to pay the price for recapitalising banks.

## The impact of low yields

This is not the place to discuss whether current monetary policies, ultimately a redistribution of income at the expense of savers, are “just” or not. What is more important is to develop a clear understanding of the actual and potential costs arising from this constellation of ultra-low investment returns. As experience from Japan demonstrates, insufficient yields (compared to contractual commitments vis-à-vis policyholders) can be a slow poison with the potential to cripple life insurance companies.

But one does not need to embrace such a gloomy scenario to be concerned about the cost of the current yield regime to insurance policyholders and investors alike: According to Swiss Re (*sigma* no. 5/2010), global insurance assets amount to US\$22.6 trillion which corresponds to 12% of total global financial assets. A yield reduction of as little as 100 basis points would result in a loss of investment income of a whopping \$226 billion per annum, a number comparable to the capital base of the entire global reinsurance industry! 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 who have entered 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, that 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.

## Further complications

The challenges ahead of insurers are compounded by impending regulatory changes. The global trend towards risk-based capital regimes – with Solvency II arguably being the most complex and sophisticated framework – reduces insurers’ degrees of freedom when investing their assets.

Going forward, market risk (ie, 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. Sovereign bonds carry the lowest risk charges, providing a strong incentive for insurers to invest more heavily in this asset class. Unfortunately, as a consequence of current monetary policies these fixed-income securities yield at record-low levels. In addition, sovereign bonds, well beyond the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) are no longer considered as “fail-proof”.

In sum, insurers are caught in an uncomfortable dilemma: Either they accept low-yielding investments in government bonds (which do not even offer “peace of mind” anymore) or they engage in higher-risk asset classes which carry significant or even prohibitive capital charges.

Against this backdrop, insurers are “allergic” to assertions that they constitute a systemic risk to financial stability and should be burdened with additional levies reflective of the wider financial sector’s potential cost to taxpayers and society at large.

As a matter of fact, the annual loss in income resulting from the current low-interest environment probably easily outweighs the total and effective cost of public bailouts and capital injections in favour of insurance companies during the financial crisis – the bulk of it was devoted to saving AIG, a company which stumbled over non-insurance types of business.

Lawmakers may want to acknowledge that insurance policyholders and investors 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. ■

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