One of the conclusions that can be drawn from the Rendez-vous de Septembre held in Monte Carlo, that brought together insurers and reinsurers from across the globe, is the new attention paid to companies’ assets and, in particular, to investment performance. In general, the insurance sector pays little or no heed to central bank policies. Up to now the discussions in Monaco focused on insurance risk issues such as terrorism, liability and natural disasters, and on reinsurance developments in terms of proposed tariffs and capacity. The question of the reinsurance cycle, a constant in discussions, has almost disappeared, making room for talks on the consequences of the current financial cycle on the profitability and solvency of insurance and reinsurance companies.

The rates of return on assets have hit an all-time low. While the downward trend began before the financial crisis, it has since intensified significantly across the world. A recent study by Conning on the USA provides some very interesting statistics that are a prime example of the repercussions of the change in the financial climate for American Life and Non-Life insurers. For P&C insurers, the return on assets has dropped 200 basis points, falling from 5.7% in 1997 to 3.7% at the end of 2011. For Life insurers, the rate of return has dropped 230 basis points, hitting 5% at the end of 2011. The respective investment structures of P&C and Life companies naturally differ, as the duration of liabilities is longer in Life insurance than in P&C insurance. In Europe, the drop in returns is also very pronounced; the return on the ten-year Bund bond has fallen 225 basis points since 1 January 2011.

The main explanation for this drop in return is the monetary policy implemented since September 2008 by central banks, whose interventions aimed to strongly influence yield curves in order to help governments and banks refinance themselves. All quantitative easing measures have resulted in an exceptionally low level of government bond rates, naturally with the exception of Euro-zone countries significantly struggling with the crisis. The balance sheets of central banks have at least tripled in the space of four years. Yet insurance and reinsurance companies favour state securities in their asset portfolios on prudential grounds and for rating requirements.

The repercussions of this fall in the return on assets are already serious and will get worse as the bonds subscribed to at a time when rates were higher reach maturity. The average return on current investment flows is significantly lower than the average return on outstanding investments. The main impact will naturally affect insurance companies’ profitability as the contribution of their investments to their profits will dry up. Some claim that companies can offset this negative effect on their profitability by improving the margins of their insurance operations. It would “suffice” to increase the technical margin in Life insurance and lower the combined ratio in P&C insurance. In fact most companies have started to do this, but we must be realistic. Offsetting the loss of return via technical margins can, at best, only have a very partial effect. The state of the current insurance
markets, against the backdrop of a worsening economic climate, does not allow for much optimism with regard to a strong upturn in technical profitability. In Life insurance, specifically, the low profitability of new policies due to the current yield curve is not conducive to increased collection or cash flows.

While the current monetary policy is favourable for governments and banks, it is quite the opposite for insurance companies and their clients. There is definitely a transfer of wealth between debtors and creditors, and between those in debt and those who invest, which benefits the former and penalises the latter. The downward influence on rates is one of the tools of the current policy of financial repression, which eases problems for some and creates more for others.

The story does not end here. The current monetary policy is not sustainable. Some worry, quite rightly, about the excessive dilation of central bank balance sheets. They believe that this could create a risk of renewed inflation in the medium-term. Others claim that monetary policy is increasingly ineffective in that massive injections of liquidity into the system seem to have ever decreasing effects on the real economy. It is also true that all economies are slowing or stagnating despite the very accommodating attitude of central banks. In reality, there is only a transfer of wealth from sector to sector: from the private economy to governments that reduce their interest burden, and within the financial sector of insurers and other savings administrators such as pension funds to credit institutions that increase their interest margins, enabling them to manage their debt-clearing process and adapt to the new prudential rules. The European Banking Authority has just confirmed the spectacular method they used to rebuild their equity capital, in the space of a mere few months.

Sooner or later, interest rates will rise, when the pernicious effects of quantitative easing will become clear. What we do not yet know is how this increase will take place. Will long-term interest rates suddenly rise, with investors requesting a risk premium and an inflation premium? Will the entire yield curve move upwards homothetically? Will short-term rates be the only ones to rise? There are many scenarios for what will happen at the end of the current monetary injections. In any case, the increase in interest rates will affect the insurance industry. It will entail latent capital loss on their bond portfolios - the longer the duration the higher the loss - and the increase in return will take some time to improve profitability. And in the event of a bond market crash with an interest rate shock, the insured could be inclined to terminate their policies. This could result in liquidity problems in countries that have not implemented the necessary measures to limit early redemption (fiscal disincentives), or even to control it at the regulator’s initiative in the event of a crisis.