

How insurers are adapting to the new paradigm

Reactivity and pro-activity both needed to meet the challenges of macro, regulatory and ESG shifts



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Highlights

- Since 2021, there has been a steady reversal in the direction of interest rates meaning insurers are confronted with an entirely new investment paradigm. Many insurers find themselves locked into yields which do not match market yields.
- Insurers are also contending with “Big Bang” regulatory changes in the form of IFRS 9 and IFRS 17, which significantly impact how portfolios are managed and structured. ESG constraints add a further layer of complexity to allocation decisions.
- The big challenge for insurers is to raise book yield while operating under new market, regulatory and ESG objectives. They require fund managers who have the dedicated resources and tools to adapt to both the changing operating environment and investment landscape.

“Change is the law of life. And those who look only to the past or present are certain to miss the future.”

That perspective, offered by John F. Kennedy back in 1963, will resonate with many investors today. The paradigm of the last 10 years – categorised by low interest rates and low yields – has melted away and investors must now adapt fast.

This is especially true of insurance companies, whose sizeable assets, complicated liability profiles and operating constraints are not well suited to sudden and sharp reversals in market dynamics.

As well as organic constraints imposed by size and complexity, they also operate under more external constraints than any other type of investor – in Europe at least. As a result of years of evolving regulation and ESG demands, they must make now judicious allocation decisions that hold the potential not only for higher yields, but to achieve higher yields while satisfying all external demands.

Lower for longer

After the Great Financial Crisis and more than 10 years of historically low rates, many investors were locked into a vision of a near-zero rate world. “Lower for longer” was heard in investment committees across the globe and portfolio decisions reflected this mantra.

Investing in cash or near-cash products was a losing strategy and only minimum levels of cash were held, principally to manage liquidity.

Insurers typically increased the duration of their bond holdings and their credit exposures in order to increase book yield. Many also turned to structured products, while portions of the portfolio with longer time horizons were invested in illiquid assets. Allocations to income-producing equities were increased to harvest dividends that were typically higher than yields from fixed income.

Since 2021, however, there has been a steady reversal in the direction of interest rates and insurers are still adapting to the new paradigm.

Higher for longer?

“Lower for longer” is now redundant, replaced with “higher for longer” – marking a period of higher inflation in the medium term and concurrently higher interest rates.

Although developed market policymakers have signalled their willingness to lower interest rates to stimulate weak economic growth, it would take some time for the impacts of these interest rates moves to materialise.

Many insurers have consequently found themselves locked into bond yields which do not match current market yields. Illiquid assets, once accretive to yields, are now often responsible for holding down book yields.

“In today’s environment you have to ask yourself if the illiquidity premium matches the higher rates available in markets,” says Xavier-André Audoli, Head of Multi Asset Expertise for Insurance at Ostrum Asset Management (Ostrum AM), an affiliate of Natixis Investment Managers.

Moreover, the value of core real estate, a staple of large financial institutions, has taken a hit following Covid and the ensuing trend of working from home. Once considered a rock-solid store of value, capital writedowns – the first in many decades – have forced a reappraisal of the asset class.

The Big Bang for rules

Market changes are material, but are just one consideration for insurers. They are also contending with “Big Bang” regulatory changes in the form of IFRS 9 and IFRS 17, which have finally entered into force and significantly impact how portfolios are managed and structured.

For insurers with publicly-listed shares and bonds, IFRS 9 demands a new way of classifying and measuring financial assets and may increase volatility in the P&L if the right investment choices are not made. Meanwhile, IFRS 17 imposes new ways to recognise, measure and disclose liabilities.

The major change brought about by these regulations is the requirement to measure assets at fair value rather than at cost and to provide market-consistent valuation of liabilities.

With both liabilities and assets marked to market, insurers are concerned about the volatility this might bring to their results and the possibility of accounting mismatches.

These risks emphasize more actively-managed portfolios. They also demand great care in how to apply fair value. For example, value can be applied to the balance sheet or through the P&L for equity.

“There is no single right way to make accounting policy choices, so accounting policies must be carefully weighted and should reflect each insurer’s objectives and circumstances,” says Rémi Lamaud, Insurance Solutions Expert at Ostrum AM.

ESG a major part of paradigm shift

The new paradigm for insurers includes an increasingly laser-like focus on climate and energy transition. ESG is far from new, but its tenets now permeate all institutional portfolio decisions.

“Nearly all investors have ESG objectives, be they ESG scoring and climate indicators, or carbon footprint reduction. That has a lot of impact on asset allocation, and on bond selection in particular,” says Audoli.

Ostrum AM’s three-step approach to ESG starts by working with insurers to define, understand and estimate the impact of an ESG policy on a portfolio. The second step is implementation, across fixed income, equities and illiquid assets. The third step is to provide accurate reporting to measure and monitor the impact of ESG assets.

Audoli says: “Many clients choose an alignment with the Paris Agreement or another major initiative, but increasingly they are asking for integration of less mainstream ESG themes such as biodiversity.”

Insurers have to be ready and a big part of readiness is harvesting and employing data. “To do ESG well requires a huge number of data points and not all insurers are equipped for that,” Audoli adds.

Consequences for allocation

The keyword for today’s insurance portfolios is “accretion”. That is, how to raise the book yield of the portfolio to that of the market, while operating under the many market, regulatory and ESG constraints.

“It’s not as simple as selling large parts of the portfolio and re-allocating to higher yielding instruments,” says Lamaud. “Insurance portfolios are like supertankers, they take time to turn round.”

Buying and holding bonds is not an optimal strategy, as the rising rates era has shown. Lamaud says: “As an investment house we believe in active management of bonds and across the portfolio. We don’t do buy and hold.”

Yield optimisation for many insurers is likely to mean a greater allocation to sovereign bonds and cash-linked securities. Money markets, in particular, offer a

very competitive return compared to bonds, and have become a strategic allocation rather than just a liquidity management tool.

To reduce volatility, allocations to equities may well decrease with insurers preferring low volatility or risk-managed equity strategies. For illiquid investments, widely used by insurers over the last decade, the question is now whether they provide better returns than cash.

In terms of instrument, directly-held assets may be preferable to those contained with fund structures.

Building in flexibility

Given the many challenges of re-orienting insurance portfolios to adapt to the new paradigm, it is essential that asset managers understand the operating environment as well as the investment landscape.

“We have resources to forecast ahead – it’s important to establish strong, long-term views if you want to add value through strategic advisory,” says Audoli.

Ostrum AM has a full-time macro economist and three market strategists in addition to its credit analysts and portfolio managers. Rare in the asset management space, it has a dedicated 27-strong insurance team, which operates as a standalone business function, but with access to all of Ostrum AM’s considerable resources.

Fixed income allocation and management for insurance, for example, is performed within the insurance team, rather than by the wider organisation as is mostly the case elsewhere in the industry.

Audoli says: “It’s a very large team focused solely on insurers. The experience and resources at our disposal mean we can be flexible both in terms of mindset and tools.”

The size and skillset of the dedicated insurance team means every portfolio decision can be made with reference to mark-to-market concepts, the financial fundamentals and the ESG impact of each issuer.

Change is a challenge to be met head-on

Change may be the law of life, but that doesn’t make it any easier.

Audoli says: “More than ever, insurers need to be both reactive and active to profit from market volatility. That requires expertise in investment, but much more than that.”

Additional notes

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