COVID-19 impact on individual assets and balance sheet for Insurers

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5 May 2020

*Gareth Mee, Deputy Chair of the IFoA's Finance and Investment Board, blogs on volatility in the insurance market.*

With financial markets suddenly more volatile than they have been for more than ten years, insurers need to consider their role at a time when a public interest purpose is vital for the long term of the economy, particularly when governments are releasing extreme amounts of sovereign finance to address short term issues.

Can insurers see today's change in asset re-allocation as an opportunity to be more responsible investors? Are there opportunities to lend to the government, providing finance in a way that insurers can use their balance sheet to generate a return but provide liquidity and loan capacity to the market?

Here are three key thoughts for investors in the current market:

1. **Interest rates are at all-time lows** – Insurers' balance sheets have now been weakened and to protect themselves further may look expensive compared to historic norms. Insurers must understand the resilience of their balance sheet if interest rates fall further or stay low. The decision to extend your hedging programme is hard when rates are already so low. This decision may need to be taken though if your balance sheet's resilience is low, given most insurers consider interest rate risk to be an unrewarded risk. It will be important to manage all of your metrics, including best estimate views, Solvency and accounting balance sheets.

2. **Insurers dominate the European corporate bond market** - Some have offsetting assets on the balance sheet to help mitigate some of the downturn in the shape of the volatility adjustment, matching adjustment or the transitional measures. But is the spread widening going to continue to 2008 levels? Can insurers diversify now to ensure that they have some security across geographies or with real assets? And can they build a more diversified asset allocation to protect against the next phase of this crisis? It is important to consider how the portfolio and balance sheet might look in risk-on or risk-off scenarios.

3. **Private credit could be diversifying but needs careful management** - There are some sector specific issues right now, e.g., technical defaults on commercial real estate debt and strain on demand-based infrastructure. Generally, private credit can be less susceptible to volatility than other credit markets but this depends on sector outlook and asset valuations. Expertise could be needed in a variety of areas: re-assessment of single-name credit risk, covenant tests, asset valuation and borrower work-out. Insurers should consider whether they have sufficient in-house skill and expertise in the relevant

area to manage through the downturn or if they need to turn to credit insurers, managers, banks or consultants to support.

Interest rates

- Downward pressure on rates is likely to be net negative across Europe given most have shorter asset duration than liability duration. As solvency ratios weaken, there will be pressure to hedge further downward movements.
- Across Europe, much of the interest rate movement will be offset by the Ultimate Forward Rate (UFR) and the transitional measures.
- Swaptions are a possible hedging alternative to swaps but are likely to be expensive at this point.

Short term action - it is critical to understand how to manage accounting, regulation and solvency balance sheet during periods of high volatility.

Credit spreads

- Credit spread widening will systematically reduce the value of the asset side of the balance sheet. The extent to which it results in a fall in solvency ratio will depend on:
  - Matching adjustment: which should dampen the movement entirely for UK annuity writers.
  - Volatility adjustment: this should dampen only 65% of the movement for European insurers. The rest will hit own funds and increase transitional measures.
- The balance sheet will weaken (both due to the reduced matching adjustment (where applicable) and increased credit SCR) as downgrades occur, potentially causing procyclical behaviour. The actual balance sheet impact will be quite idiosyncratic for those with internal models.
- There is very limited (in some cases no) liquidity in the corporate bond market outside of central bank trading activity. As such, the true market view of spreads is difficult to determine and insurers should avoid becoming forced sellers in the secondary market.
- Single name and index CDS can be used for default protection if spreads widen further — however these are likely to seem expensive compared to recent times. In volatile times the basis risk with the physical market increases when the banks' trading desks are using these to take risk off.

Short term action - enhance credit-screening on portfolios for all sectors. Regular monitoring of spreads vs expectation of rating/duration to eliminate risky credits before downgrades.
Consider your plan of action in respect of assets that cease to meet your investment criteria e.g. cease to be investment grade.
Compare the capital implications of holding the name under different scenarios and then deciding what you can afford to do. In some cases, selling (after allowing for bid-offer spreads) may often not be as attractive as holding through the downturn but this needs proper consideration of your ability to hold the position. This analysis may, in turn, lead to the conclusion that a prudent course of action is to preserve capital by recalibrating the amount of new business that can be written in order to reduce new business (capital) strain.

Currency

- Currency volatility is high and Sterling is at all time lows vs the dollar. This won't have systematic impacts but there are some firms with large currency exposures and, for these firms, there are challenges on margin calls which impact liquidity.
- For those investing in corporate bonds overseas, the currency hedging programme will need to be adjusted due to changes in expectations of interest rates, currency (spot and basis) and credit spreads.

Short term action - to mitigate future FX risks, review existing hedging positions (both exchange-traded and over the counter programmes).

Equity investments

- Reduction in AMCs for UL firms which have not unit matched or got shareholder hedges.
- Additionally there is an impact from the European Central Bank requesting firms not to pay dividends and freeze share buy backs.
- Likely reduction in EBRs for many others that have an otherwise strained SCR ratio.

Short term action – assess the use of derivatives, e.g., put options or futures, can be used to reduce exposure to sectors with further downside potential.

Direct property

- Values are likely to fall and liquidity completely dry up. There are also the issues you have been facing in placing a value on these assets. This is likely to be an issue for:
  - Insurers with large exposures (e.g., Switzerland).
  - Potential for some guarantees to bite in WP funds with large property allocations.
  - For UL funds with property exposure, sufficient gating ability and market value reductions to protect against lapsing.

Short term action - balance sheets should be stress tested to ensure that insurers aren't forced to sell. There are practical issues for landlords e.g. management of a safe reopening and operation post lockdown. These should be considered with your advisors and experts.

Infrastructure debt

- Prices are increasingly stale, liquidity non-existent and spreads likely to have widened, potentially by more than corporate credit markets. Sectoral considerations:
  - Transport — likely to be heavily hit.
  - Renewable energy — usage likely to be reduced.
  - Hospitals — potential challenge for some operational covenants.
  - Defence — no obvious impact.
  - Infrastructure that is socially critical may imply government support leading to future price entry opportunities, assuming that spreads remain attractive.

Short term action - insurers should be trying to reach out to individual borrowers for solutions on restructuring of existing credit, noting that credit risk may significantly differ by sector.

Commercial real estate (CRE) lending

- Anecdotal evidence that tenants are not paying rent (and therefore borrowers not servicing their loans) in the short term which could move CRE loans into technical default, subject to possible payment holidays.

- Hits to property values may also move projects into technical default.
- Could bring about new opportunities if some withdraw from the market and spreads stay wide. Otherwise, insurers may have to work out some of these loans.

Short term action - credit risk will likely differ by sector and region and it may be beneficial to work with certain borrowers to restructure.

Social housing

- Main risks are linked to spreads widening with downgrades of sovereign debt being a large concern for insurers.
- Loss of rental income is likely given the macroeconomic outlook.
- Strong social purpose may imply government support leading to future price entry opportunities.

Short term action - hedging methods such as use of broad credit default swaps (noting the likely basis risk between the specific bonds/loans and the available credit protection) maybe available and restructuring of existing debt could also be an option.