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# Policymakers Prolong Pain for Developed Markets' Insurers

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In key developed insurance markets, insurers are feeling the downside of policymakers' ongoing efforts to repair the global economy. The dominant risk is that interest rates will remain "lower for even longer," continuing the overall low-yield scenario, together with the spluttering global economy. Developing market insurers continue to grow strongly, but face a range of different challenges. Compounding the uncertainty for all insurers is policymakers' simultaneous pursuit of improved solvency standards, the systemic importance designation, recovery and resolution plans, a global capital standard, and new product and conduct regulations.

### Western European life insurance has joined global reinsurance with a more negative sector outlook

The Western European life insurance sector outlook was recently revised to stable-to-negative from stable. The global reinsurance sector outlook already moved in this direction in January 2014. Other sector outlooks are mainly stable (see table). The overall global impact is that near-term negative rating actions on individual insurers will likely outweigh positive rating actions.

| | Current business conditions | Business conditions outlook | Sector outlook |
|---|---|---|---|
| **North America** | | | |
| Life insurers | Satisfactory | No change | Stable |
| Property/casualty insurers | Satisfactory | No change | Stable |
| **Western Europe** | | | |
| Life insurers | Weak | No change | Stable-to-negative |
| Property/casualty insurers | Satisfactory | No change | Stable |
| CEEMEA * | Satisfactory | No change | Stable-to-negative |
| Asia Pacific | Satisfactory | No change | Stable |
| Latin America | Satisfactory | No change | Stable |
| Global reinsurance | Weak | Somewhat weaker | Stable-to-negative |

* CEEMEA = Central and Eastern Europe, the Middle East, and Africa.

This is partly reflected in the current outlooks on individual insurers, which have a negative bias. Ten percent of insurance ratings globally carry negative outlooks or credit watches, vs 8 per cent positive.

### "Lower for even longer" interest-rate scenario prolongs insurers' pain in developed markets

As policymakers continue their repair work on the global economy, the prospect of interest rates remaining at their unusually low current levels for a further extended period is a daunting one for insurers. The moderate increase in long-term interest rates we expected a year ago did not materialise. Instead, new lows have been reached. In Germany and Japan, 10-year government bond yields are currently under 0.5 per cent and 0.3 per cent, respectively. U.S. government bond yields have again fallen below 2 per cent. The People's Bank of China has also cut interest

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rates for the first time since 2012 in response to slowing growth. Exacerbating the problem is the narrowing of credit spreads (U.S. investment-grade corporate bonds currently yield only 3.0 per cent, according to Bloomberg.)

In response, global insurers continue to reallocate capital to higher-growth regions. U.K.-based Prudential plc has transformed its profile since the financial crisis, with Asian profits moving from 1 per cent of its global total in 2008 to 30 per cent in 2013. U.S.-based Prudential Financial Inc. and MetLife are also stepping up their focus on Latin America, most recently in Chile. Japanese life insurers continue to diversify offshore, most recently with Dai-Ichi's acquisition of Protective Life in the U.S. Large reinsurers such as Swiss Re and SCOR are deepening their focus on developing markets. Berkshire Hathaway is increasingly targeting Asia-Pacific. Lloyd's also is looking to expand in, and increase its understanding of, developing markets.

Insurers generally have repriced their products upwards, partly to reflect lower expected investment returns, while life players have increased their focus on less interest-sensitive products (unit-linked, variable annuity, variable life, pure protection, health insurance and asset management) and have lowered new business guarantees. However, life policyholders generally place a high value on guaranteed investment returns, even at today's lower levels, and insurers' success in quickly changing the balance of new business towards products with no/low guarantees has been mixed. The profiles of life insurers' back books (where the greater risks lie) take many years to reshape, and the lack of long-dated fixed-income instruments in many major markets gives rise to significant reinvestment risk.

In Europe, Germany—where regulators are reinforcing insurers' own actions—remains in the spotlight. The maximum guarantee allowed by regulators on new business was reduced to 1.25 per cent from 1.75 per cent on 1 January 2015. Furthermore, proposed new profit-sharing rules will restrict the distribution of unrealised investment gains to surrendering policyholders. These supplement the additional reserves (*Zinszusatzreserve* or ZZR) that had to be built for the first time in 2011. Although German life insurers continue to benefit from some flexibility in their crediting rates (the total investment return including the guaranteed portion) and a very stable flow of non-investment-related margins, their business model faces huge challenges. If these companies can't steer customer preferences away from traditional products, a continuation of low interest rates would likely reduce the sector's growth prospects, while the proposed reforms could reduce earnings prospects and financial flexibility.

The reinsurance sector is suffering from low investment yields on two fronts. The direct impact on their income is self-evident, but more importantly, the sector's overall returns in recent years have attracted new investors to catastrophe bonds and other nontraditional vehicles. This is increasingly commoditising the property catastrophe business. Pension funds have made large commitments, but have thus far deployed only a very small allocation of their total funds in the sector. As a result, reinsurers now face their greatest challenge of the past decade. Demand is static, and the soft market (marked by lowering premiums) is spreading to most lines of business. Scale is key for reinsurers to remain relevant, as is reducing dependence on commoditised business. In response, a new round of consolidation appears to be underway.

Insurers continue to search for investment yield. They are generally taking greater, albeit measured, credit and equity risk. Investment portfolios have not radically altered over the past five years, and are still dominated by high-quality, investment-grade, fixed-income, corporate and government securities. We do not expect radical change over the next five years, either. Policymakers have a particularly strong focus on infrastructure projects that have large global finance needs. We estimate that the gap between available public funds and actual global infrastructure spending will be about USD 500bn per year through 2030. Insurers are naturally attracted to this long-term asset class, and policymakers are attempting to facilitate their greater participation. Insurers are also steadily expanding their participation in private placements, mortgage loans, and lending to small and medium-sized enterprises (SMEs). To a modest extent, they are filling the financing void banks have left.

**Growth is slowing in developing markets, but insurers face different challenges**

Risks are more idiosyncratic in developing markets, although most face slower growth than in the recent past. Slower growth is easing capital pressures, but it remains a rating weakness relative to developed markets. Sector outlooks remain mainly stable, except for some CEEMEA (Central and Eastern Europe, the Middle East, and Africa) markets, which are negative. Growth levels that are still the envy of developed markets' insurers is the primary reason many global insurers continue to shift their regional emphasis here.

China leads the way among the larger economies in terms of premium growth. Its State Council recently announced an insurance penetration target of 5 per cent of GDP by 2020, from just over 3 per cent in 2013. This will require about 15 per cent annual growth in the sector, which we believe is feasible for the next two or three years at least, as the country's emerging middle class lifts demand. However, capital adequacy will still struggle to keep pace, based on our own analysis, and insurers will have to improve products and consumer awareness of risk protection. The finalisation of the China Risk-Oriented Solvency System (C-ROSS) is likely to make the market more sophisticated in its risk assessment and regulatory oversight over the coming few years. We expect it to be beneficial to the industry in the long run.

The Russian economy is operating amid extensive international sanctions that manifest in restricted access to Western capital markets, reduced foreign investment and uncertain business conditions. The drop in economic growth is causing premium volumes to fall.

The decline in oil prices and its potential effect on the growth of Russia, Kazakhstan, Azerbaijan and the Gulf Cooperation Council (GCC) countries are emerging risks for insurers. However, we haven't yet seen any significant reduction in government-sponsored infrastructure projects in these countries. The dominant risk in the GCC remains insurers' exposure to local equity and property markets, although this is mitigated by generally very high levels of capital.

The decline of local currencies against the euro and the U.S. dollar, particularly for Russian and South African insurers, is inflating claims costs because of the reliance on imported goods to service those claims. In response, auto and health insurers have increased premiums.

Economic slowdowns in Mexico and Brazil have hurt insurers' premiums. In Brazil, this is compounded by sluggish credit (and associated insurance product) growth because of its sizable bancassurance distribution channel.

**Policymakers' risk aversion compounds the challenges for all insurers**

The financial crisis has clearly led to risk aversion among policymakers, primarily in banking and then in the financial sector more broadly. Insurance has seen policymakers pursue improved solvency standards, the systemic importance designation, recovery and resolution planning, the development of a global capital standard, and new regulations for products and conduct. The upheaval in the way insurers are regulated and supervised does not pose near-term threats to ratings, but it looks set to continue for the rest of the decade and creates a backdrop of uncertainty for insurers, for their investors, and for their ratings.

Policymakers are pursuing improved solvency standards around the world. This was already under way before the crisis in many markets, partly because of the developing International Association of Insurance Supervisors' (IAIS) Insurance Core Principles (ICPs). Post-crisis, the International Monetary Fund's financial sector assessments gave the ICPs even greater influence. We believe the ICPs are positive for the global industry, but we expect a significant increase in aggregate capital requirements as a result, which may force smaller insurers to consolidate. This may not be the case in some markets, such as Hong Kong, where the current requirements lack risk-sensitivity but are very conservative.

The early solvency modernisers in the 2000s were Australia, Canada, the U.K., and Switzerland. Hong Kong, China, and Mexico are among the more recent. Solvency II in Europe is nearing implementation in 2016 after more than a decade of development, albeit with a transition period stretching to 2032 that will soften its initial impact. The Solvency Modernization Initiative continues in the U.S., with particular focus on holding companies and own risk and solvency assessments (ORSAs). However, U.S. state-based regulators remain wary of market-consistent balance sheets and internal models, which are included in the plans of many other regimes. State regulators now have to contend with growing influences from the Federal Reserve, the Financial Stability Oversight Council, and the Federal Insurance Office. The regulatory equivalence feature built into Solvency II in Europe is influencing the new solvency regimes in markets like Singapore, Hong Kong, and China.

While insurers' systemic importance is clear, in our view, their systemic risk is less clear. The nine global systemically important insurers (G-SIIs) face potential capital loadings on their nontraditional noninsurance activities, with a methodology to be designed by the IAIS in 2015. They also face a new global recovery and

resolution regime. While this is initially directed at G-SIIs, local regimes are likely to emerge as well. The G-SIIs and 40 or so other internationally active insurance groups (IAIGs) face a new global insurance capital standard (ICS), to be developed by the IAIS by 2016. Most insurers regard this timetable as aggressive, and one prominent regulator called it "reckless". It is not clear at this stage whether and how this will co-exist with local solvency regimes. The G-SII regime, associated policy measures, and ICS are partly transposed from banking regulation and are being orchestrated by the Financial Stability Board, rather than the regulatory community. Most insurers and many regulators question these measures' merits.

The impact on the competitive playing field is mixed. We believe most G-SIIs (and insurers designated as systemic under national regimes) would rather have avoided the designation because of the additional regulatory (and possibly capital) burden. However, it remains to be seen whether systemic insurers can market their unwanted "too big to fail" status as a positive factor in the eyes of their customers and investors. If they can, it could be positive for their ratings.

Most of the regulatory focus globally has been on solvency for the past decade. We believe that the emphasis will swing towards product and conduct regulation over the next decade. EU authorities have reforms in process that include the Packaged Retail Investment Products initiative and the new Insurance Mediation Directive (IMD), which could radically alter product design and distribution. The U.K. has already banned commissions payable to independent intermediaries on retail investment products because of concerns over conflicts of interest, and this is being considered in other European countries. The U.S. Department of Labor is proposing a less radical, but still controversial, move to expand fiduciary standards to those who render investment advice to retirement plans and individual retirement accounts (IRAs). Meanwhile, as consumerism and compensation laws spread around the world, the potential for more instances of damaging product mis-selling grows.

The insurance industry is also prone to direct political risk. This has most recently been demonstrated in the U.K., where the government removed the long-standing requirement to purchase an annuity on the grounds of freedom of choice. Conversely, in Australia the government is considering introducing such a requirement so that retirement funds are not squandered early in retirement, which would place a greater burden on society in the future, but will require reform to influence product design, tax policy, and consumer sentiment.

**Global megatrends have a mixed impact, but will take a long time to crystallise**

Global megatrends do not present immediate risk to ratings but could influence their direction in the long term. Ageing, climate change and technology fall into this emerging risk category.

Ageing populations should be a net benefit to the industry in the long term. The growth of ageing populations in most developed markets creates problems regarding pension affordability for governments and corporations. Individuals are increasingly responsible for providing their own pensions, and insurers are among the potential beneficiaries.

The frequency of extreme weather events, whether or not a direct result of climate change, is on the rise, and so are losses for insurers. The ratings impact of weather-related natural catastrophes so far has been limited because insurers have comfortably absorbed the losses. We take a favourable view of insurers that are considering the additional challenge that climate change poses in modelling extreme weather events and its implications for exposure management. An increase in the severity and number of extreme weather events could trigger negative rating changes, especially if they severely weaken capital. Over time, insurers should benefit in terms of demand as governments, corporations, and individuals buy more protection.

The rapid pace of technological change is both a threat and an opportunity. To take one "big data" example, car insurers around the world are increasingly using telematics, which monitors driver behaviour using a combination of GPS, sensors and mobile communications. As that practice becomes more widespread, it will begin to challenge the fundamental principle of pooling of risk on which the industry was built, because each policyholder will be charged based on their unique risk. The customary pricing of products based on actuarial analysis of many years of historical data will also likely be less important in the future as insurers will need to supplement such analysis with new disciplines and skill sets. Insurers will need to seize these opportunities while managing a range of threats to survive in the long run.