Swiss Re

Challenges and Opportunities in the Financial Sector

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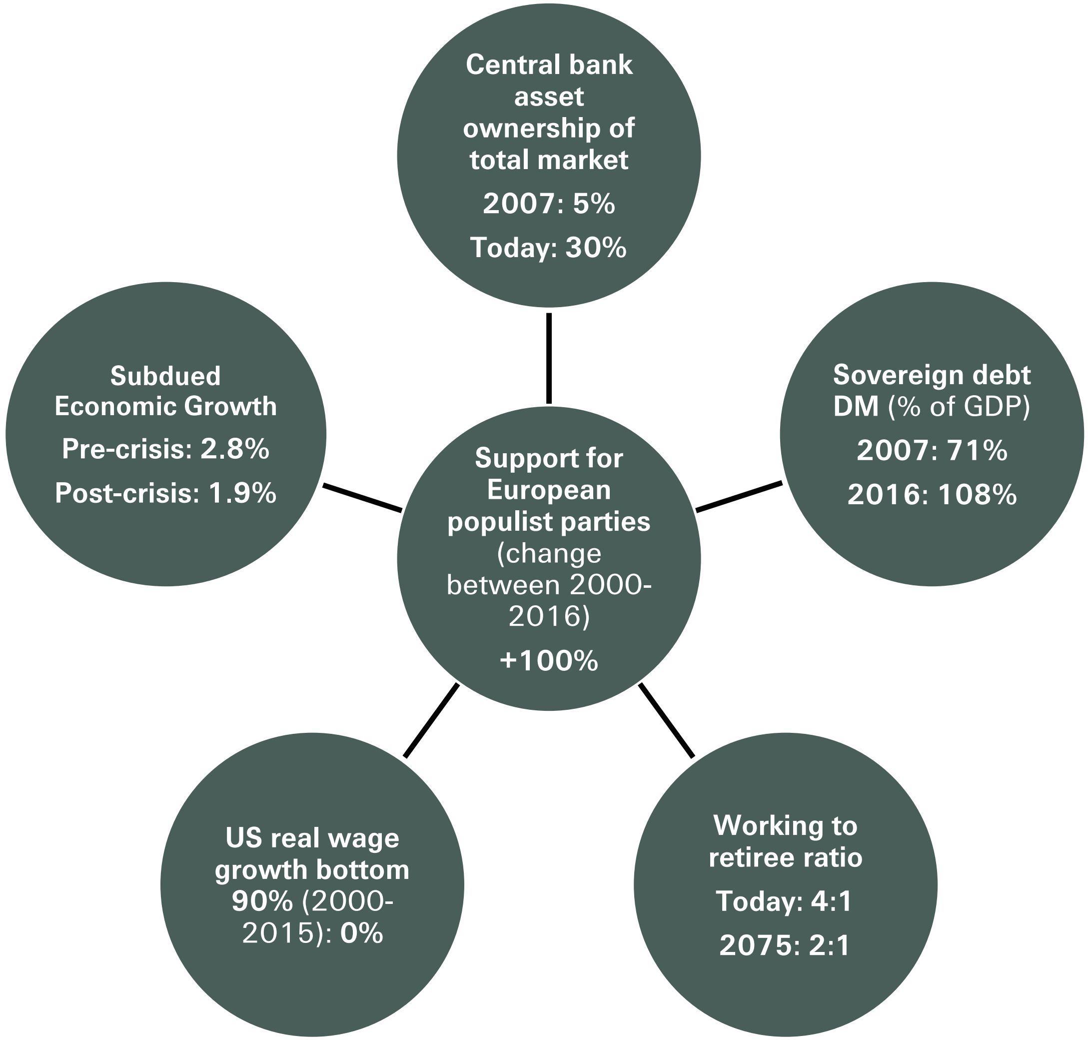
Key topics

- The macroeconomic and policy landscape
- What this means for the insurance industry
- How re/insurers are responding
- Concluding remarks

The macro and policy landscape

Macro and financial market imbalances reflect a changing global political climate

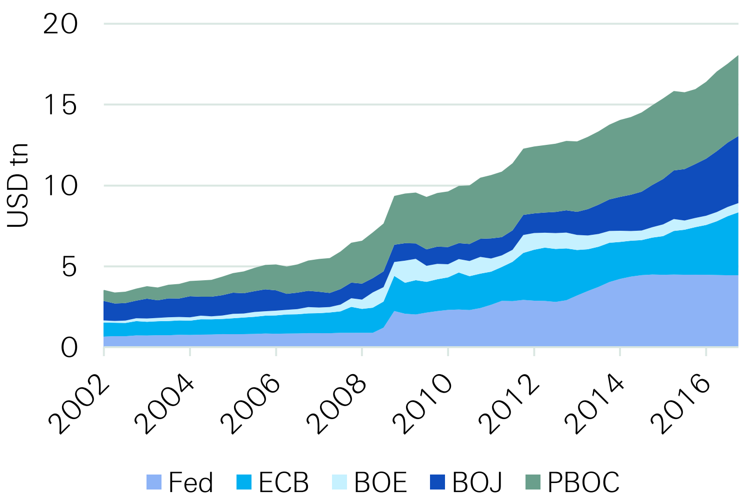


Monetary and fiscal policy responses are uncoordinated

While central banks have entered unchartered territory ...

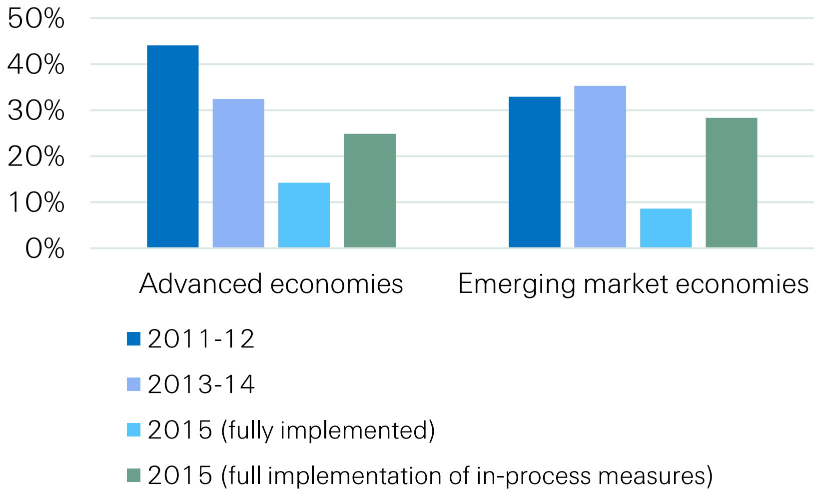
... the pace of structural reform implementation has slowed

Figure 1: Central bank assets



Source: Swiss Re

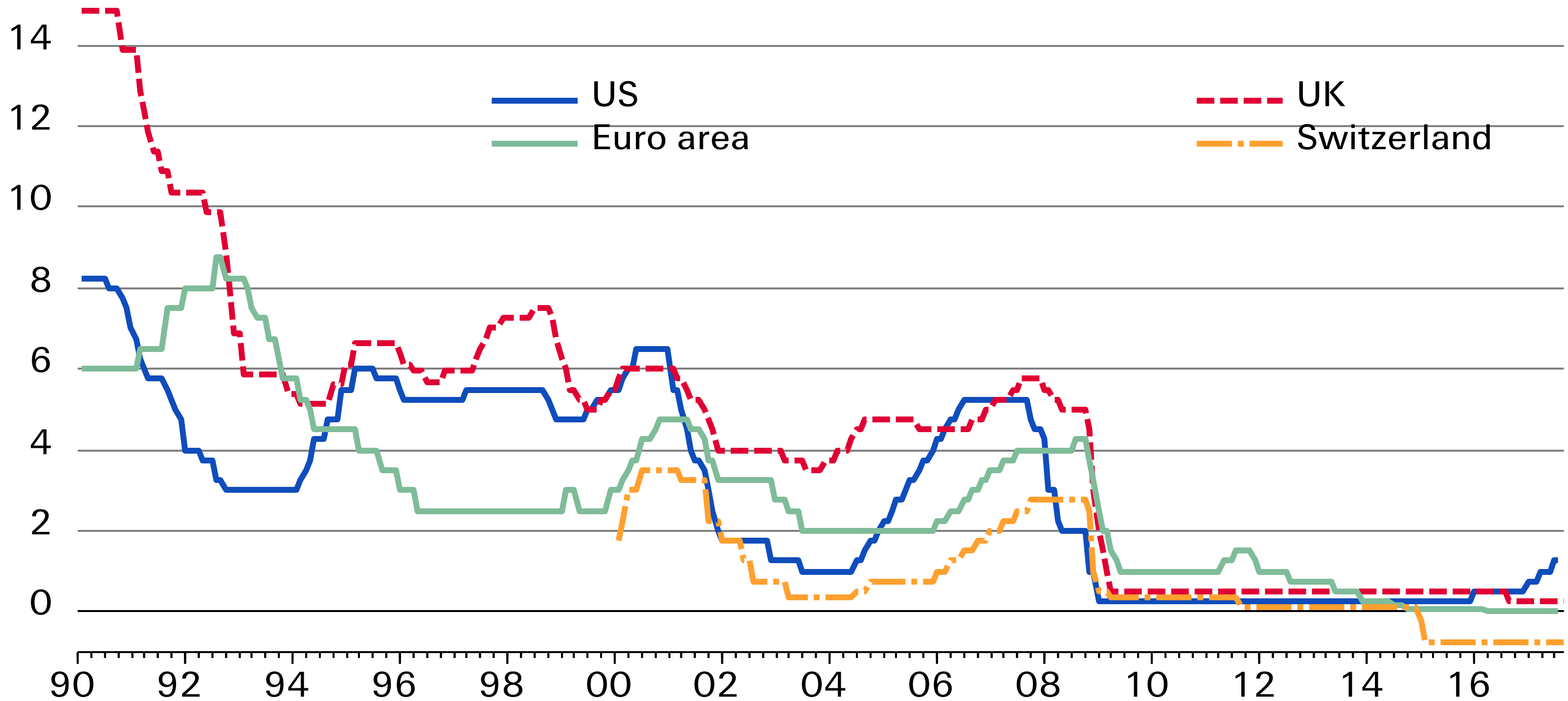
Figure 2: Share of implemented reform recommendations



Source: OECD

Central bank interest rates remain close to zero in most major advanced economies

Central bank policy rates of selected advanced economies (%)

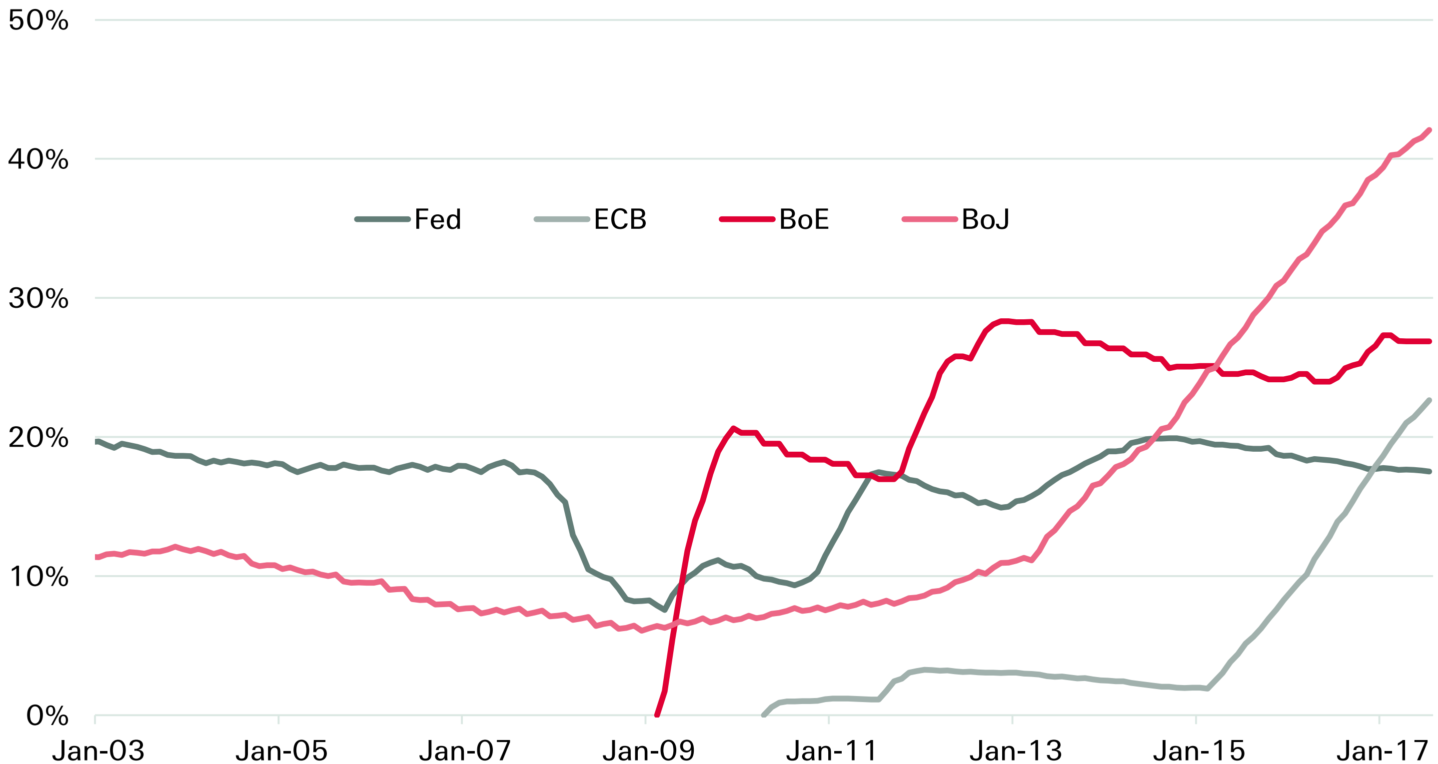


Source: Datastream

Central banks are buying "safe assets"

What is the fair "risk free" rate?

Central banks ownership share of sovereign bonds (% of total amount outstanding)

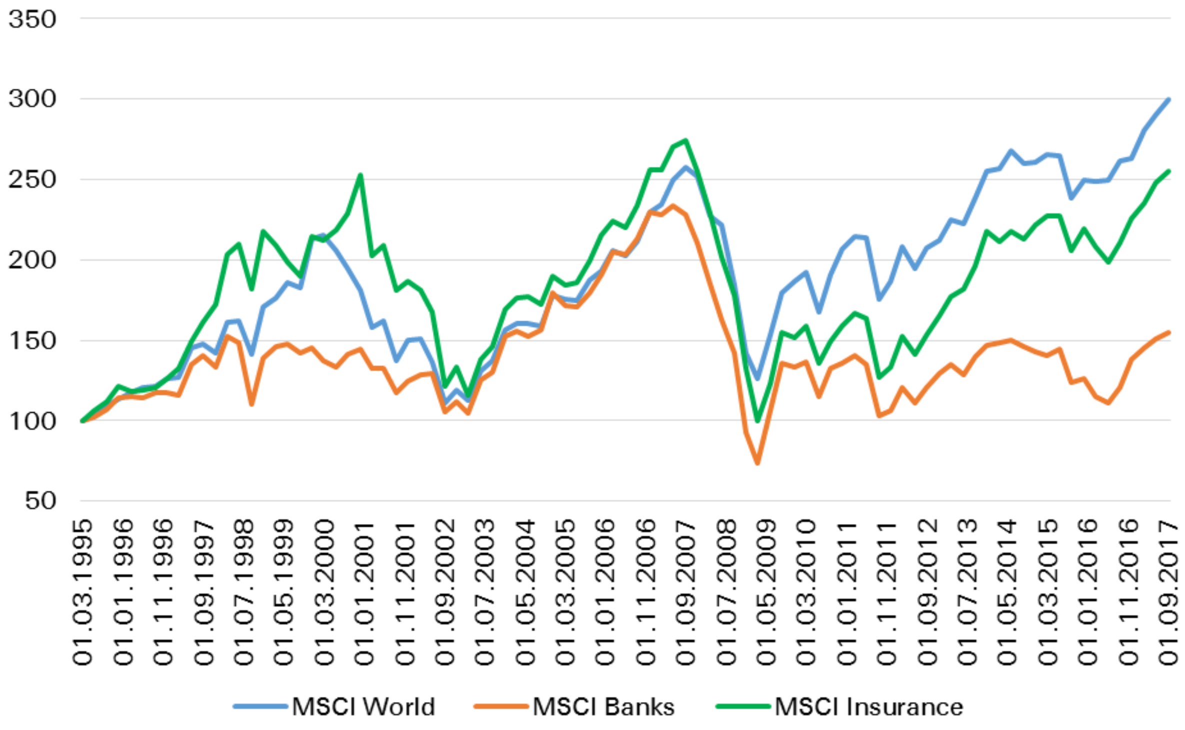


Source: Swiss Re

Equity market performance has helped pension funds, but mid-term equity outlook may be challenging

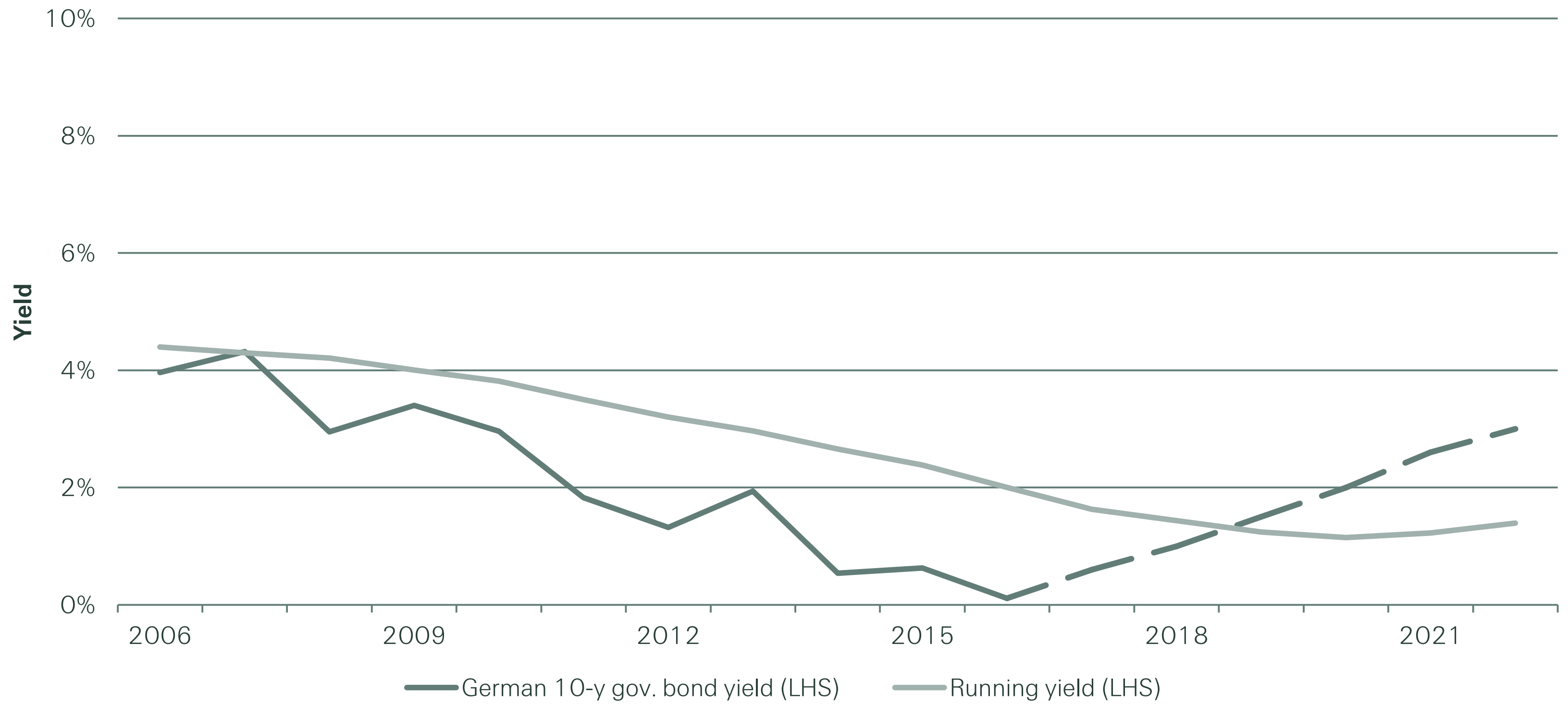
Pension funds tend to hold more investment in equity than re/insurers

MSCI Index since 1995, indexed to 100



Source: Bloomberg. Quarterly data

Even when interest rates rise, portfolio yields will only increase gradually as bonds mature



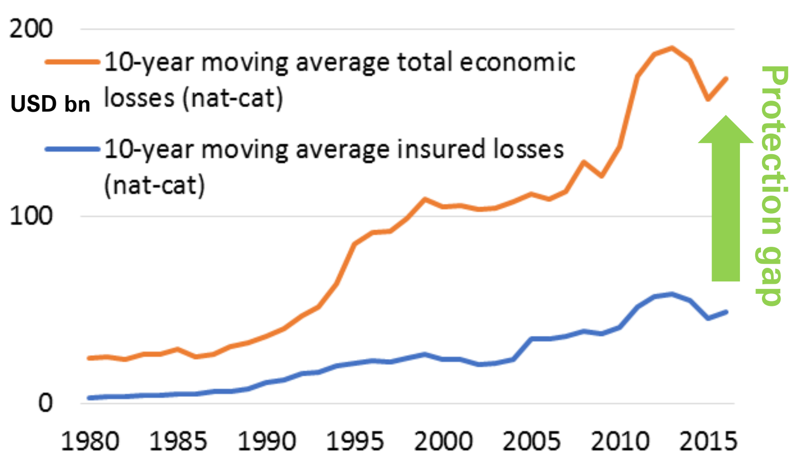
Running yields will remain low over the next few years.
Declining portfolio values will have a negative impact on accounting balance sheets.

Source: Swiss Re Institute

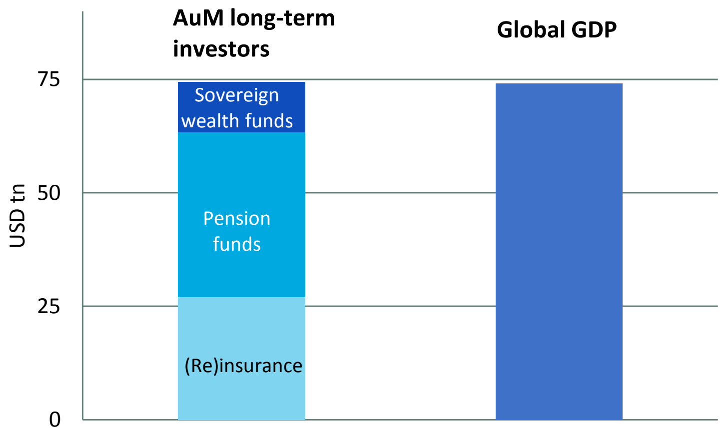
What this means for the insurance industry

The role of the insurance sector

Insuring underlying risk ...



... and matching long-term liabilities with long-term assets



Source: Swiss Re, PWC, Willis Towers Watson, UN, World Bank

Key drivers of the current competitive market

	Pricing drivers	Impact on Prices	Comments
	Low interest rates	↗	Pressure to improve underwriting discipline
	Regulatory changes	↗	Greater recognition of risk mitigating tools under risk-based and economic solvency frameworks
	Low inflation	↘	Recent low claims growth supported softening market and created reserve releases
	Industry capitalisation	↘	Low interest rates drive excess capacity and alternative capital; increase price pressure

What makes insurance business interest rate sensitive?

1. Importance of investment income as source of profit
   - differs by line of business: less important for short-tail P&C and life protection products, significant for long-tail P&C and life savings and pension products
   - in life insurance: asymmetric profit sharing rules exacerbate interest rate sensitivity because upside is shared with policyholders, but all the downside is borne by shareholders
2. Ability to hedge interest rate risks
   - limited availability of long-term securities in combination with long-term interest rate guarantees and pricing assumptions
   - policyholder behaviour complicates cash flow predictions and hence ALM and hedging strategies

In-force savings business is most exposed to interest rates.

Pension and life risk products are less impacted by low interest rates

Summary of upcoming accounting changes

Standard	**Effective**	**Comments**	**Impact on insurance sector (subjective)**
Solvency II	1 Jan 2016	Limited experience so far	Significant
IFRS 9	1 Jan 2018 (deferral possible)	Accounting for **financial instruments.** Main changes: **classification**, **measurement** and **impairment model**.	Higher **P&L volatility** (increased recognition of movements in the FV of assets through P&L and earlier credit loss recognition)
IFRS 17	1 Jan 2021	Accounting for **insurance liabilities**: moves to a **mark-to-market valuation** and introduces several new concepts.	**Massive impact** . Might trigger needs for more capital for some. Increased **complexity** is not helpful for non-specialists.
IFRS 15	1 Jan 2018	**Revenue recognition.** Aim: disaggregate the "milestones" within a contract and recognise revenue as each milestone is achieved.	Diffuse view of the magnitude of these impacts, but **likely limited for insurers**. IFRS 15 is similar to US GAAP Topic 606.
IFRS 16	1 Jan 2019	**Leasing**. Eliminates off-balance sheet accounting for lessees	Likely **very limited for insurers**
US GAAP 2016-01	1 Jan 2018	**Recognition and measurement** standard primarily for **equities** that are not consolidated or accounted for under equity method; will be carried at FV through P&L; AFS classification and cost method no longer allowed	Depends on equity exposure (average for US P&C players about 12% versus 4% for life companies with significant differences among companies; Source A.M. Best and Morgan Stanley)
Topic US GAAP 944	1 Jan 2020?	**Targeted changes** for **long duration contracts**. Improve timeliness of recognising changes in assumptions; modify cash flow discount rate; simplify amortisation of DAC; better disclosure	Unclear, details to be determined

IFRS 9: Deferral for qualifying insurers only, or accounting mis-match
IFRS 17 early adoption permitted, but must apply IFRS 9 and IFRS 15

How the Re/insurance Industry is Responding

Re/insurers are changing business models in response to lower interest rates

- Adjustment of **asset mix**
- Innovation in **product mix**
- Strategic **restructuring and M&A activity**

Insurance investment portfolios have shifted toward higher-risk, less liquid assets and longer maturities

Planned increases in asset allocations - all insurers

American top 5

- Commercial Mortgage Loans
- Private Equity
- Real Estate Equity
- Collateralized Loan Obligations
- Middle Market Corporate Loans

EMEA top 5

- European Investment Grade Corporates
- US Investment Grade Corporates
- Infrastructure Debt
- Middle Market Corporate Loans
- Real Estate Equity

Asia Pacific top 5

- US Investment Grade Corporates
- Infrastructure Debt
- Private Equity
- European Investment Grade Corporates
- Hedge Funds

Source: Goldman Sachs Asset Management – 2016 Insurance Survey

Stricter Solvency II capital requirements are pushing European investors away from equities and non-investment grade debt

Re/insurers are creating new product designs, distribution channels, and customized structures

- Adjustment of **product mix**
  - De-risking of inforce portfolios: hedging programs, risk transfer (cat mortality, longevity), disposals of portfolios, exchanges of existing policies
  - New business product design: products with shorter and more flexible guarantees, focus on protection business

The re/insurance industry is restructuring in response to market conditions

UK – sell the back book

- Swiss Re – Guardian
- Phoenix – AXA UK /Abbey Life
- Aviva – Friends Life
- Just Retirement – Partnership (merger)
- Longevity swaps or reinsurance (eg, Prudential (US) for BT Pension Scheme)

US – divest traditional business

- ING
- MetLife
- AXA

EU – playing at the margins

- Consolidation / IPO in The Netherlands (NN – Delta Lloyd; asr)
- Anbang – Vivat
- Fosun – BCP

Conclusions

Outlook

- Growth will require a different policy mix of less dominant central bank forces, active fiscal policies and structural reforms
- Failure to tackle the macro and associated financial market imbalances can cause political instability
- Continuing low interest rate environment and pricing pressures will lead re/insurers to develop new asset management strategies, business models, and product mixes
- Fundamental drivers for M&A activity persist
- The role of long-term investors and stable financial sector supports economic resilience

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