How can financial risks on insurance company balance sheets be managed amid macroeconomic shocks?

By **Rémi Lamaud**, Insurance Solutions Expert, Ostrum Asset Management

What are today's financial risks and what consequences do they have for insurance company balance sheets?

Like many institutionals, insurers are exposed to multiple risk components, but the main component is interest rate risk. Interest rate risk stems from liabilities and it is necessary to have exposure in order to hedge this same risk carried under balance sheet liabilities. Fixed income instruments are thus a significant portion of the balance sheet and make the main contribution towards earnings on liabilities. This is a key factor of financial output for the euro-denominated fund. Given record low levels in previous years, bond strategies have led to a widespread search for yield and with interest rates on the rise, this risk has materialised in three forms. The uptrend in interest rates generated capital losses on the bond portfolio, which lost value. Because interest rates had previously been on the decline, this change was new, and both the magnitude and consistency of the increase were both surprising on the whole.

Furthermore, the average rate for the portfolio is not climbing as fast as rates on the market. There is a positive memory effect when interest rates drop, but one that is currently penalising the portfolio's average rate. This effect is all the slower to materialise given the portfolio's high duration. While the portfolio rate was diluted in past years, it is now subject to accretion. Lastly, the search for absolute return has uncovered biases in allocations relative to the investment universe. The corporate bond bucket was increased in a bid to capture the credit spread, while decreasing the portfolio's government bond allocation. We also made use of illiquid securities to take advantage of the illiquidity premium. Finally, structured products or bond repacks also drove the search for yield/diversification. To recap: in the wake of the rate hike phase, portfolios are recording capital losses, rates are climbing too slowly and allocation biases can be observed.

In light of this interest rate risk, how can insurers adapt? What instruments can be used? What allocation strategy?

This new environment offers an opportunity to review portfolio objectives, which need to be adapted. A more agile, dynamic strategy is needed, with the aim of accelerating portfolio accretion. This calls for allocation adjustments, i.e. selling generally short-dated securities with a low rate and reinvesting in longer-dated securities with a higher rate. The gain is the interest rate difference over the remaining term of the security sold and the new rate, through to the maturity of the security purchased. Of course, it is important to check the gain made from the allocation adjustment relative to the capital losses generated from selling the securities. Insurers that need to make these adjustments will only be able to do so if permitted by their endowment reserve, if the reserve was duly provisioned during an interest rate decline. Depending on the direction interest rates are going, it is a good idea to allocate funds to the endowment reserve on a preventative basis.

This would give greater flexibility to the portfolio by facilitating sales and accelerating the convergence of the portfolio rate with the market rate when interest rates are climbing.

These allocation adjustments provide an opportunity to rebalance the government bond bucket, which was reduced as interest rates were falling due to the lower return.

This agility in managing the bond bucket is also aligned with a more dynamic tactical strategy targeting other asset classes, to avoid income volatility from an IFRS standpoint, where the change in value directly impacts the income statement.

This reallocation also raises the question of adjusting duration, as the government bond and credit buckets do not have the same average durations.

For interest rate risk in the balance sheet, the duration gap is the most commonly accepted measurement.

Years of low interest rates led investors to take advantage of illiquidity premiums, but to the detriment of overall liquidity. Accordingly, the share of illiquid assets has grown continuously in recent years.

Determining the target gap gives a target duration for the asset. The tendency is to reduce the interest rate gap to guard against interest rate movements and thus reduce uncertainty on economic capital. This measurement is generally monitored on an annual basis and sets the roadmap for the year.

In a volatile interest rate period, it is a good idea to update this measurement more often so that portfolios can be adapted more directly. The duration gap is sensitive to interest rate levels and is not static. When it gets too low, it can change signs and upset the sensitivity of economic capital to interest rate movements.

In terms of instruments, in addition to fixed-rate bonds, derivatives are used either to protect the portfolio from interest rate hikes or to amplify the creation of capital gains in the event of a rate decline. In both cases, the accounting treatment can make using these instruments more complex, particularly with the two sets of standards employed (French GAAP and IFRS).

Have other risks been identified besides interest rate risk?

First, with interest rate risk comes credit spread risk, and potentially even default risk.

diversified and thus reduced, there is still directional exposure to the market, which is difficult to fully hedge under Solvency 2.

Equity risk is also a major source of risk, but one that can be managed dynamically.

Economic or regulatory hedges can be set up to facilitate rapid de-exposure before selling assets.

With the introduction of IFRS, equity buckets have been reduced in size and this risk has diminished. The ongoing shock on the real estate market also needs to be addressed.

Allocations often hold a stable portion of real estate assets, and the revision of appraisals also creates a risk of capital losses for the portfolio. Finally, asset liquidity risk must be considered in light of liability repayment requirements, particularly when building the maturity schedule of the portfolio.

It increases when there are tensions surrounding growth prospects. If, as is true for equity risk, a specific allocation can be years of low interest rates led investors to take advantage of illiquidity premiums, but to the detriment of overall liquidity. Accordingly, the share of illiquid assets has grown continuously in recent years.

So far we've talked about financial risks, but non-financial risks and ESG are gaining importance, fuelled by societal requirements and regulations. How can this be incorporated in the management process?

It is true that 2023 has marked a shift in how fast and how extensively non-financial risks are integrated in the management process. This was already the case beforehand, but policies have been refined and requirements or intentions clarified. We now have more data available and can gain a little more perspective on these figures.
Historically, these objectives were addressed upstream (when filtering the investment universe) or downstream (via stock/bond picking). Over time, the piling-on of multiple non-financial objectives introduced one after another can result in a significantly restricted investment universe, thus calling for a more general and extensive search for optimisation.

In our view, ESG targets are goals like any other and should be integrated the same way throughout the investment process in order to arrive at effective portfolio management decisions. An insurance strategy is essentially a multi-objective strategy and can incorporate non-financial indicators. However, they need to be addressed from a cross-disciplinary approach, across the entire value chain, to avoid making hasty adjustments, ensure the consistency of the whole and the effectiveness of investment decisions.

The same data should be consistent between the time the decision is made on the portfolio management side, and the reporting platform. Consistency and standardisation are key in this area. To that end, you need to use high-performance tools to aggregate masses of financial, non-financial, accounting and regulatory data. Portfolio deployment strategies are growing increasingly complex because these objectives can lead to gaps with investment universes not subject to ESG objectives.

For example, looking at the supply of sustainable securities, while they are on the rise, they do not yet cover the entire spectrum of a conventional bond universe. Investing in sustainable bonds can generate gaps in terms of sectors, duration, etc., relative to the investment universe. Furthermore, activity is focused on the primary market and it is more challenging to buy these securities over time on the secondary market.

In addition, sustainability must also be assessed independently, and we have a team of in-house analysts who assess whether or not the investments behind the bonds are sustainable or not.

The entire portfolio management process was revised to adapt to these new non-financial targets. Even if these criteria are "non-financial", they are embedded in the core of our process, on the same level as other financial criteria.

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Rémi Lamaud,
Insurance Solutions Expert, Ostrum Asset Management

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