NATIXIS BEYOND BANKING

Flash Economics

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What problems for life insurers in the euro zone?

We see the following problems for euro-zone life insurers from a macro-financial viewpoint:

1- Interest rates may remain low for a long time in the euro zone; moreover, in a long-term perspective, it was logical for life insurers to invest in bonds in a period of disinflation and falling interest rates, but not in a period of stable, low interest rates or of a lasting rise in long-term interest rates;

2- It would be logical for insurers to switch from bonds to equities given the relative returns on the two asset classes; this is made difficult:

- By the capital risk linked to the holding of equities
- In the short term by the global cyclical risk;

3- Life insurance is caught in vicious circles:

- The fall in interest rates increases the present value of the liabilities and reduces the capital, hence the temptation to sell assets that consume capital (equities, corporate bonds), but which are those that provide return on the assets;
- The holding of risky assets is procyclical: a slowdown in growth leads to falling share prices and widening credit spreads, and gives an incentive to sell risky assets to reduce capital consumption when they are cheap;

4- The life insurance "of the future" should diversify into High Yield, private equity, real estate, infrastructure, etc. (illiquid, unlisted assets). If insurers' demand for these assets increased, the supply of these assets would also increase as a reaction.

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ECONOMIC RESEARCH

First question for life insurers in the zone euro: Long-term interest rates

As long as euro-zone inflation remains low **(Chart 1A)** as a result of employees' weak bargaining power and companies' weak pricing power and, in addition, as long as the ECB has an incentive to keep interest rates low due to the high debt level **(Charts 1B** and **C),** and demand for risk-free bonds is strong, **long-term interest rates will remain very low in the euro zone (Chart 1D).** What shock could drive up them up? A change to labour market rules; a loss of production in the oil market.

Chart 1A
Euro zone: Core inflation* (core CPI, Y/Y as %)

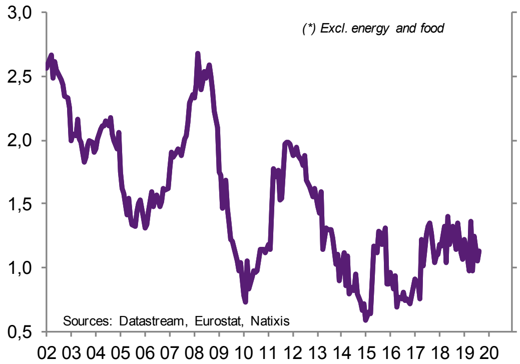


Chart 1B
Euro zone: Public and private-sector debt (as % of nominal GDP)

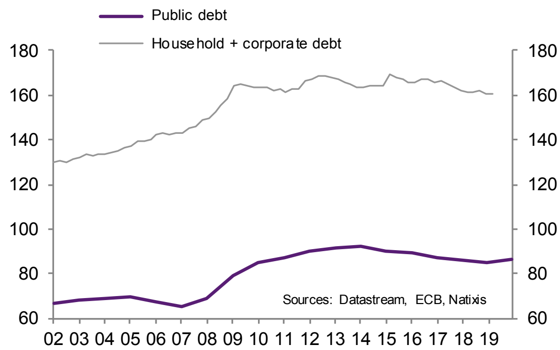


Chart 1C
Euro zone excl. Germany: Public and private-sector debt (as % of nominal GDP)

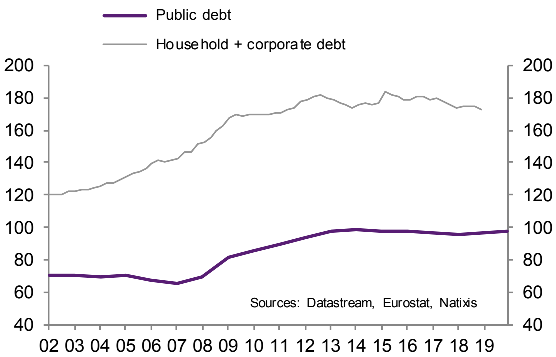
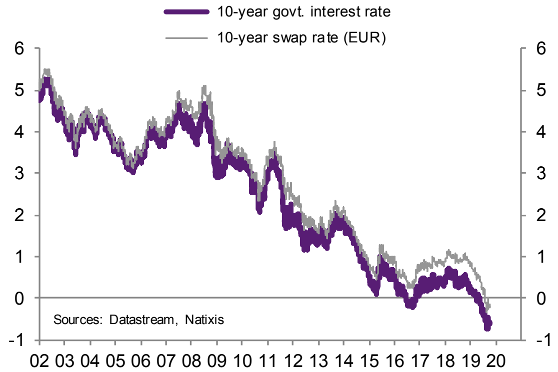
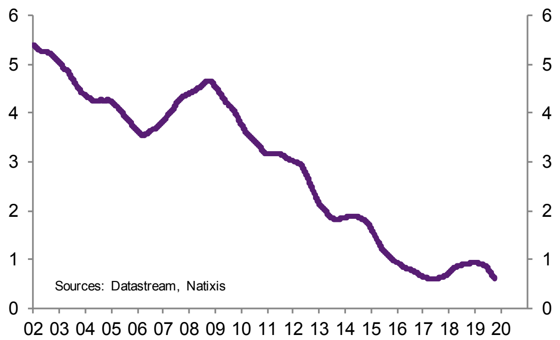


Chart 1D
10-year interest rates (as %)



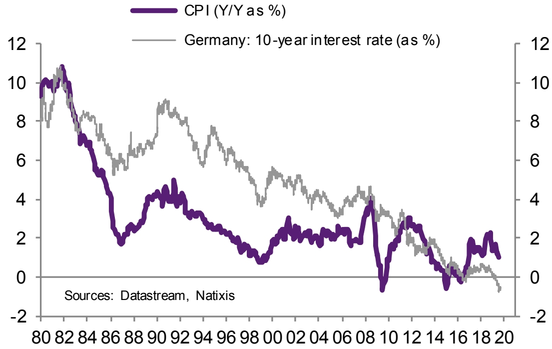
This is likely to **drive life insurers to pull out of low-risk bond investments** (governments, agencies, covered bonds, Investment Grade) before the return on its assets (which we can approximate by smoothing long-term interest rates, **Chart 1E**) becomes too low.

Chart 1E
Euro zone: 10-year inflation swaps smoothed over 5 years (as %)



Moreover, it **is logical for life insurers to invest in bonds in a long-term perspective of disinflation and falling interest rates (Chart 1F).**

Chart 1F
Euro zone: Inflation and interest rate on 10-year government bonds



It is not logical in a prospect of very low and stable interest rates or a lasting rise in interest rates generating capital losses.

Second question for insurers: Why not invest more in equities?

The fact that interest rates are lower than growth **(Chart 2A)** and the high level of corporate profitability **(Chart 2B) should lead life insurers to rotate from bonds to equities.**

Chart 2A
Euro zone: Nominal GDP and interest rate on 10-year government bonds

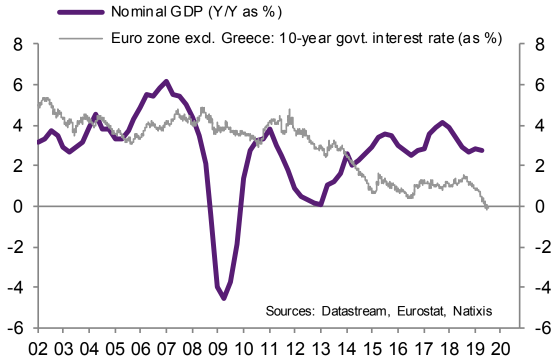
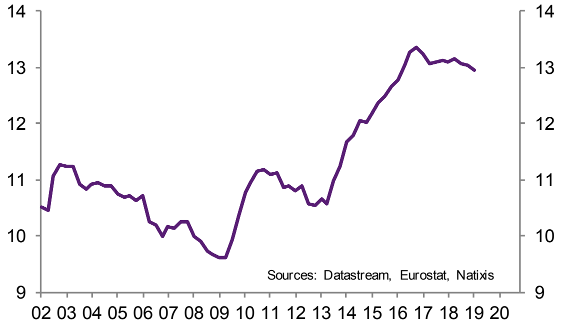


Chart 2B
Euro zone: Profits after tax, interest and dividends (as % of nominal GDP)



This rotation is not taking place (Chart 2C), which explains the low European equity valuation **(Chart 2D).**

Chart 2C
Euro zone: Net purchases by institutional investors
(as % of nominal GDP)

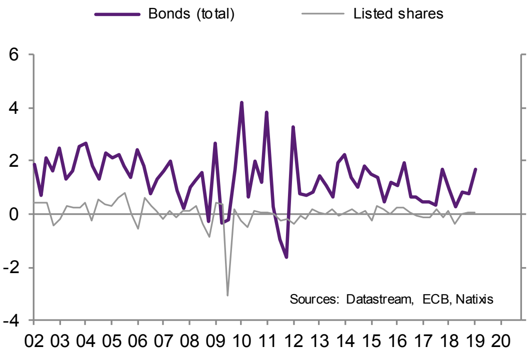
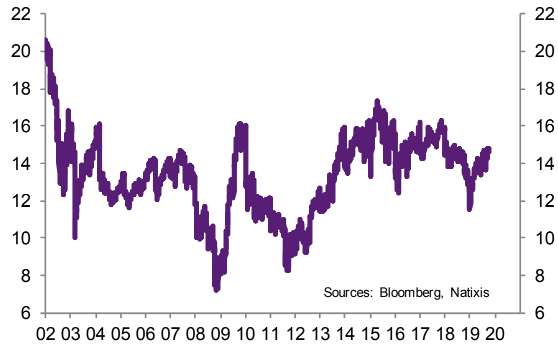


Chart 2D
Euro Stoxx: Forward PER



This lack of rotation to equities is explained:

- **By the capital risk** (equity risk) **linked to the holding of equities,** in a context of **recurrent high equity market variability (Chart 2E);**
- In the short term, by the **global cyclical risk (Chart 2F).**

Chart 2E
Euro Stoxx: Stock market index (2002:1 = 100)

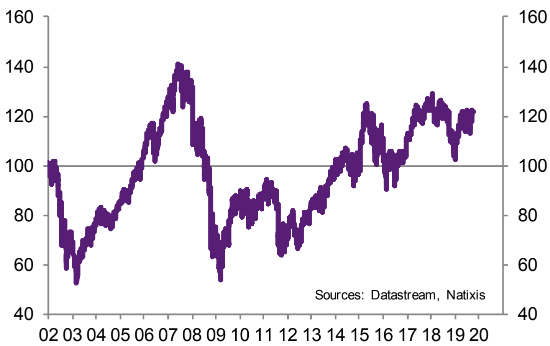
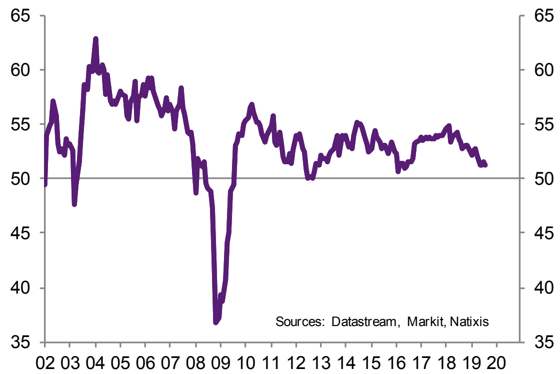


Chart 2F
World: Composite PMI



Third question for insurers: How to avoid vicious circles?

- **The first vicious circle is a decline in the return on assets.** The fall in interest rates increases the present value of the liabilities, leading to a fall in capital and **a need to sell risky assets that consume capital;** the asset portfolio then focuses on bonds with a very low yield;

- **The second vicious circle is procyclical investment;** when the value of risky assets (equities, corporate bonds) falls, insurers sell these assets, although their prices are low, to reduce their capital consumption.

Life insurance regulators should think about **ways to make insurers' behaviour countercyclical:** capital requirements adjusted according to the cycle?

Fourth question: The supply of alternative assets

If life insurers:

- Have to reduce their exposure to bonds;
- Cannot markedly increase their exposure to equities,

they should be able to diversify into illiquid or unlisted assets: High Yield, private equity, infrastructure, etc.

The problem is that the supply of these assets is insufficient **(Chart 3, Tables 1** and **2).**

Chart 3
Euro zone: Outstanding High Yield corporate bonds (USD bn)

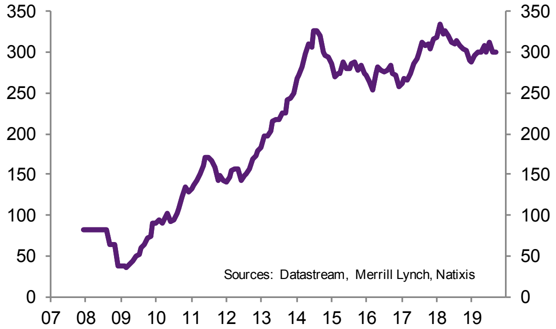


Table 1: Private Equity (funds raised in LBO, in EUR bn)

Years	Amount
2002	27.5
2003	27.0
2004	27.5
2005	71.8
2006	112.3
2007	82.3
2008	82.6
2009	20.4
2010	25.5
2011	42.4
2012	27.0
2013	59.1
2014	57.0
2015	54.7
2016	84.1
2017	96.6
2018	97.3

Sources: EVCA, NVCA, Natixis

Table 2: Europe: Investment in renewable energy (EUR bn)

Year	Amount
2004	24.9
2005	33.1
2006	46.8
2007	67.4
2008	81.3
2009	82.5
2010	113.9
2011	128.4
2012	88.9
2013	59.4
2014	67.9
2015	62.9
2016	64.1
2017	40.9

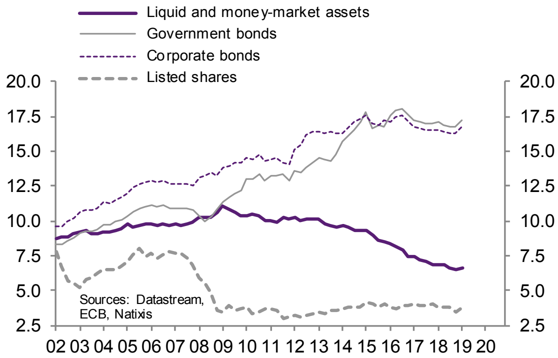
Sources: International Renewable Energy Agency (IRENA), Natixis

But we could expect that **if demand for these asset classes increased, supply would also increase.**

Conclusion: A very difficult situation if nothing changes

If the structure of life insurers' assets does not change **(Chart 4),** and if long-term interest rates remain more or less at the current level, the attractiveness of life insurance for savers will rapidly disappear.

Chart 4
Euro zone: Outstanding... in the assets of institutional investors (as % of nominal GDP)



A rotation of assets to equities and unlisted or illiquid financial assets is essential, and must be made possible by changes to the products and also to regulations.

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