The risk of chasing yields

David Priebe explains that it's not just sliding premiums that should have (re)insurers worried — the global credit crunch has revealed an investment world fraught with risks of a different kind

Pricing and underwriting discipline dominate soft market conversations. We have the same discussions every time the industry reaches the soft phase of the insurance cycle. This time, though, conditions are different. Doubtless, the competing pressures to ease underwriting standards and write as much business as possible persist but there is another factor to watch. Weak investment returns may be more important to industry profitability than underwriting results this year.

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In the past year, short-term interest rates around the world have declined. Central Banks have taken expansionary postures to counter the negative impact of the sub-prime and related credit crises. In the UK, for example, the three-month LIBOR rate dropped from 5.4% in March 2007 to 3.1% in February 2008).

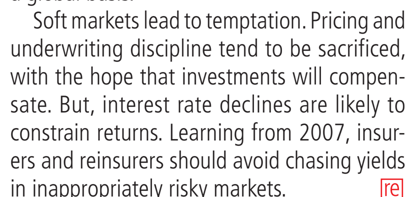
Loose monetary policies around the world could destroy the underwriting profits of risk bearers who rely on short-term assets. Consider an insurer or reinsurer that holds only short-term investments in its portfolio, with the assets paying the three-month LIBOR rate. Further, let's assume that the Net Earned Premium of this hypothetical risk bearer is £100m with an underwriting profit rate of 5%. The result is an underwriting profit of £5m. Using industry averages to calculate the investable assets of this company, we find that the decline in interest rates would cut investment income by £6 million, wiping out the underwriting gain of £5 million annually. The implication is clear: cheap money puts insurer and reinsurer profits at risk.

Of course, this example goes to the extreme. No firm holds all its assets in short-term notes. However, insurers and reinsurers have been shortening their bond portfolios, as the marketplace is fraught with uncertainty as to the ultimate direction of long-term interest rates. With long-term rates declining over the past year, the investment income derived from these instruments has dropped. Further, the economic slowdown in developed economies has put equity prices under strain, and realised capital losses from this source will cut into investment income. Taking these factors into account, the decrease in expected investment income shifts the entire net income distribution downward. This means increasing probabilities of both negative income and material loss of capital.

The most obvious implication of this analysis — and market conditions in general — is that (re)insurers need to pay at least as much attention to the investment side of the income statement as they do to the underwriting side. We are not suggesting that they allow themselves to be seduced by high-yield and inappropriately risky securities. After all, hardly a week goes by now without another revelation on how seemingly secure financial instruments, such as credit default swaps and auction rate securities, have soured. Instead, a careful analysis of investment allocations is necessary, putting insurers and reinsurers on the efficient frontier of the trade-off of risk and return.

A renewed focus on investment income also will help direct management's attention to an area where one of the industry's major debates of the next decade can be expected to develop, namely changes in international accounting standards toward market-driven valuations, including an increased emphasis on discounting reserves. With declining interest rates, the difference between reserves at current full values and on a discounted basis will shrink. Ultimately, this may accelerate the changes in the industry accounting model on a global basis.

Soft markets lead to temptation. Pricing and underwriting discipline tend to be sacrificed, with the hope that investments will compensate. But, interest rate declines are likely to constrain returns. Learning from 2007, insurers and reinsurers should avoid chasing yields in inappropriately risky markets. re



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