Addressing volatility in a heightened inflationary and interest rate environment

Guy Carpenter's Blake Dimitrijevic on the challenges posed by high inflation and interest rates

Insurers are facing unprecedented challenges as they navigate a volatile and ever-evolving (re)insurance landscape.

They are confronting heightened inflation, high interest rates over prolonged periods, claims volatility, geopolitical uncertainty and hardened reinsurance conditions. Equity markets have reacted to the riskier insurance landscape, as demonstrated by the rising cost of equity.

While the inflationary environment in the Asia Pacific region is lower than in the rest of the world, it continues to pressure insurers in multiple areas, including pricing, insured valuations, underwriting margins, reserves and asset values.

The higher yields on the asset side – sovereign bonds, investment-grade credit and cash deposits – are welcomed. Nevertheless, it is the rising claims cost in property and catastrophe lines that is driving volatility of profits.

Prudent asset and liability management will often mean a lag in higher book returns on investment as longer-dated fixed income investments amortise in line with claims' duration profiles. Therefore, yields on existing asset portfolios will rise only gradually. Aggressive attempts to chase higher yields in the short term will result in significant realised losses on fixed income portfolios.

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With monetary tightening, premium growth in both advanced and emerging markets will remain below the 2012 to 2021 average. This is another challenge for insurers, as new business premium is typically quickly invested at the more attractive yield levels, which helps to meet heightened investor return expectations.

So how to respond?

It is critical for companies to integrate macroeconomic and financial market forecasting into decision making. Based on robust data and modelling, they will need to adjust pricing for inflation.

Insurance reserving, critical to balance sheet management, requires analyses and scenario testing that lead to informed decisions in future underwriting and reinsurance buying.

Blake Dimitrijevic, head of capital advisory, Asia Pacific, Guy Carpenter

Insurers have moved to retain more risk on their own balance sheets as reinsurance pricing and retentions have increased. In addition, recent renewals saw particularly restrictive terms and conditions presented by reinsurers. Insurers can respond by mitigating the impact of the challenging risk-transfer market and the associated higher volatility with proactive management of insured valuations and adjusting pricing for inflation, and by rebalancing their underwriting portfolio away from tail risks and underperforming accounts.

Companies can enhance overall capital efficiency by reducing excess, trapped or underperforming capital through customised, structured reinsurance transactions that enable carriers to redeploy capital supporting prior years' underwriting. This becomes especially relevant when the cost of equity is rising.

Capacity is rebounding

Reinsurance capital exists to support insurers. By mid-year 2023, Guy Carpenter and AM Best estimated that $4bn of new reinsurance capital had been raised, largely from existing players. Incumbent reinsurers appear well-capitalised and capital deployment remains disciplined.

In addition to the new capital raised, future estimated returns on equity for reinsurers tracked in the Guy Carpenter Reinsurance Composite are expected to be materially above the current cost of equity. Therefore, we estimate that up to $50bn could be added to the composite's total equity by year end 2025 if these returns materialise.

Additionally, a record $9.3bn of risk capital was issued in 144A catastrophe bonds in the first half of 2023. The implication overall is for a sizeable amount of risk capital to be available for deployment to support insurers' growth and volatility management, and release some of the pricing pressures.

How Guy Carpenter can help

True insight is invaluable for effectively managing risk and seizing opportunities. By leveraging the power of the GC MetaRisk platform, a robust and comprehensive suite of capital modelling, stochastic risk analysis, catastrophe model aggregation and reinsurance optimisation tools, our clients can drive better and more informed reinsurance strategies.