**ATLANTIC**
FINANCIAL GROUP

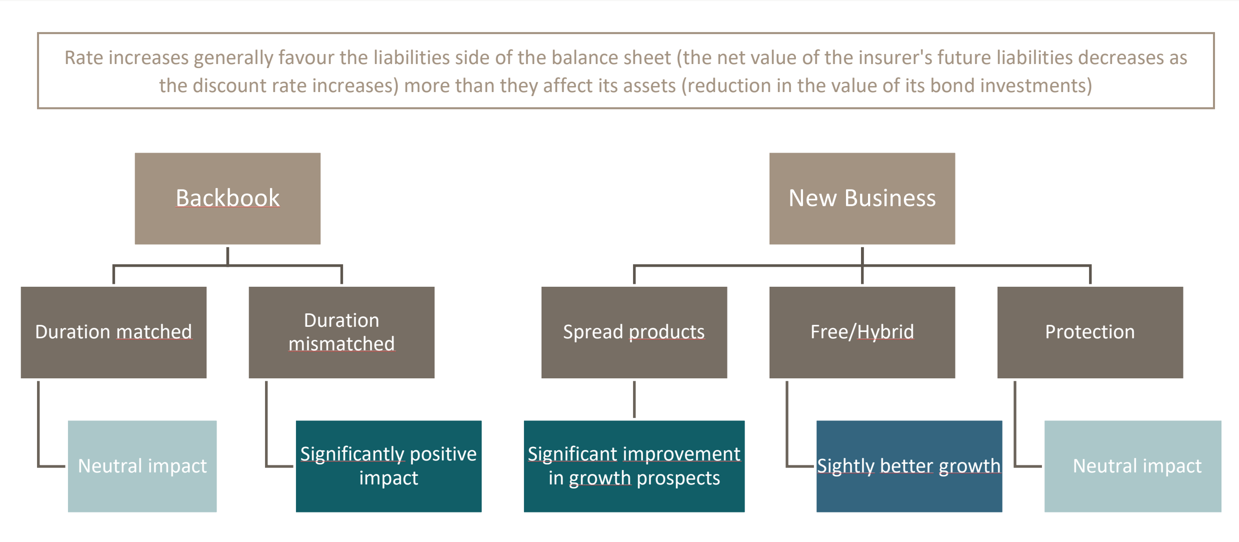
# Weekly Investment Focus

15 May 2023

## "HOW SAFE ARE INSURERS?"

- Insurers perform differently depending on their activities
- The rise in interest rates benefits more the liabilities side of life insurers' balance sheets...
- ...but it is the assets side of the balance sheet that worries investors.
- Could the problems of US regional banks affect insurers?

### Chart of the week: " Economics of rising interest rates for life insurers"




Source: Morgan Stanley Research, Atlantic Financial Group

## ANALYSIS OF FINANCIAL MARKETS

Despite outperforming the MSCI World over the last twelve months, the MSCI World Insurance has massively underperformed over these past three months. The failure of Silicon Valley Bank, due to the rapid rise in interest rates and poor asset-liability management, has made investors fear similar consequences for US life insurers. Life insurers have fallen the most and are now down around -17% year to date, while P&C insurers are down only -3%. The same thing has happened in Europe, but to a lesser extent. European life insurers are down -4%, P&C insurers are up 1% and European reinsurers are up 4%.

◆ The rise in interest rates benefits more the liabilities side of life insurers' balance sheets...

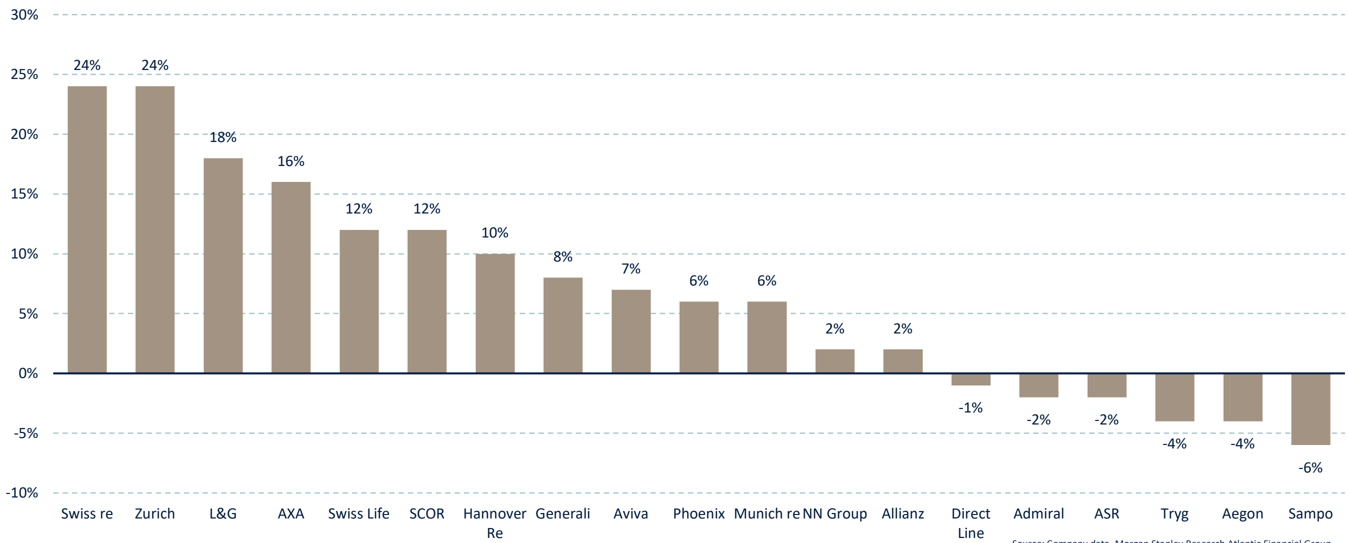
Insurance companies have complex business models based on actuarial or statistical calculations. **Life insurance companies, in particular, have to manage the time variable.** Their contracts sometimes run for several decades, which increases the risk of error.

A life insurance contract works as follows: the signatory undertakes to make periodic contributions to build up savings. The insurer, in return, must make these savings grow in order to pay a capital sum or an annuity to the beneficiary of the contract.

Movements in interest rates therefore not only play an important role in the calculation of the insurance premium, but also affect the performance needed to grow the savings to the final capital or the predefined or estimated annuity. **When interest rates rise, the expected return on the insurer's investments from the premiums paid by policyholders increases. This can lead to profits for the insurer, resulting in lower premiums or improved benefits for policyholders.** In addition, **if the insurer invests the premiums in bonds, higher interest rates lead to higher yields on these securities, which also benefits the policyholders.** (see Chart of the week).

To ensure that insurance companies will be able to pay their contractual commitments, the regulator has instituted a prudential regime called "Solvency II", in implementation since January 2016 and inspired by the "Bale III" regime put in place for banks. **The solvency ratio is determined according to insurance risks, market risks or operational risks.** Changes in interest rates can influence each of these risks and thus have a greater or lesser effect on the insurer's solvency ratio depending on its product mix, and also on its investment decisions (see Fig. 2).

Fig. 2 - Sensitivity of the solvency ratio to a 1% increase in interest rates in 2022




Source: Company data, Morgan Stanley Research Atlantic Financial Group

**Rising interest rates can have an impact on both the assets and liabilities of a life insurance company,** but generally have a greater impact on the liabilities side of the balance sheet for reasons of scale. This is because future benefits paid to policyholders are often long-term liabilities with fixed or guaranteed amounts. **When interest rates rise, the present value of these future payments falls, which means that the insurer's balance sheet liabilities also decrease.**

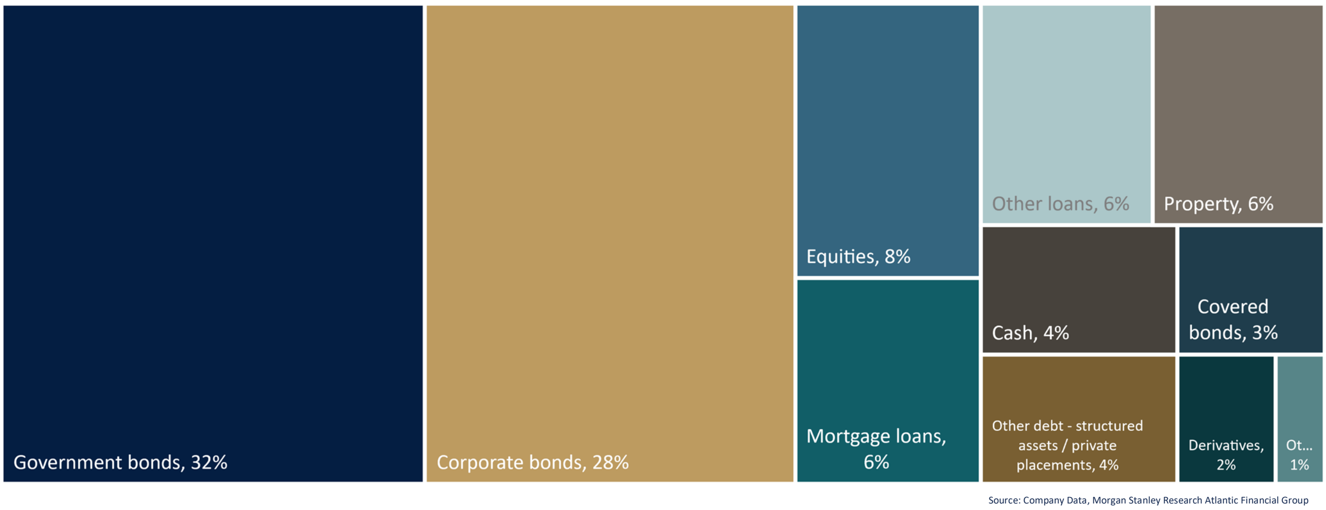
♦ ...but it is the assets side of the balance sheet that worries investors.

On the asset side of the balance sheet, life insurers typically invest in fixed income securities, such as bonds, which provide a steady stream of income. **When interest rates rise, the market value of these securities may decline, resulting in lower gains or even losses in the insurer's investment portfolio.** However, the losses are usually smaller than the beneficial effect on insurers' liabilities.

It is therefore important to study both the underwriting terms and conditions of new life insurance policies and the investment portfolios of insurers. **In recent years, insurers have diversified their investment portfolios into illiquid assets such as real estate or infrastructure in order to increase returns. Indeed,** in a regime of low or even negative interest rates, which has persisted since the great financial crisis, bond investments offered insufficient returns.

The concern about the asset side of the balance sheet is that insurance companies hold more cyclical and rate-sensitive positions in their portfolios. Indeed, **insurers have sometimes taken over from banks to lend on real estate**, especially in US commercial real estate such as office buildings. In Europe, insurance companies have also invested in commercial real estate and a little in the "Cocos" or AT1 of European banks to boost the yields of their bond portfolio. However, the allocation remains very defensive with over 30% in government bonds (see Fig. 3).

Fig. 3 - Sectoral distribution of investments on the assets side of European insurers' balance sheets in 2022




The most important thing is to look at the risk of each asset class, whether it is **the credit risk in the bond portfolio** (see Fig. 4) or **the sectoral exposure of the real estate portfolio** (see Fig. 5).

Fig. 4 - Corporate bond rating

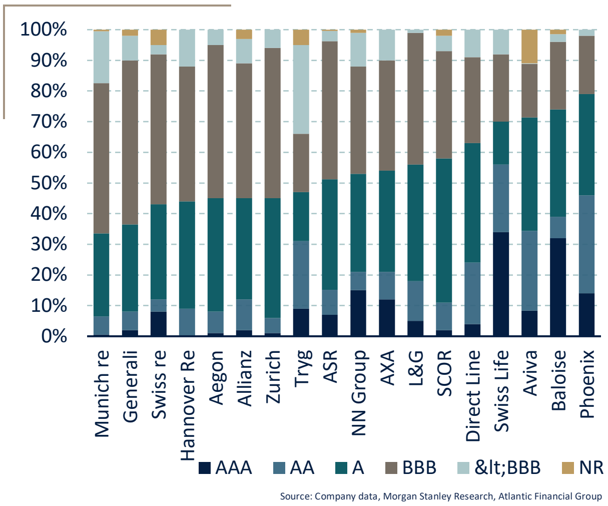
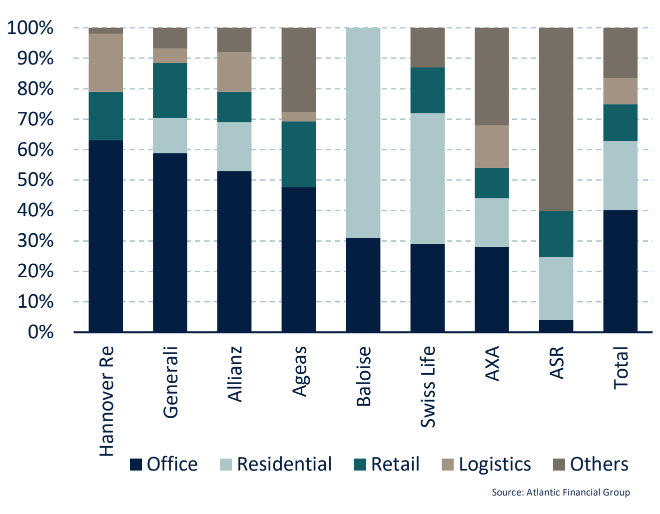



Fig. 5 - Real estate portfolio by sector




Insurers' portfolios are effectively exposed to assets whose fundamentals could deteriorate substantially in a period of economic crisis and whose liquidity is limited. The US commercial real estate situation remains a concern, especially if interest rates remain high. Among life insurers, Principal, MetLife and Brighthouse are the most exposed (see Fig. 7). In general, the quality of their loans is high, with loan-to-value ratios of around 50%, which cushions any defaults.

As for bond portfolios, investors' fears about insurers' exposure to European banks via AT1s should fade. The recent volatility was not due to a deterioration in the credit rating of European banks but to the specific situation of Credit Suisse.

The accounting of insurers has been further strengthened since January 2023 with **the implementation of new IFRS17 accounting standards which harmonise insurers' financial information and allow for better comparability**.

### ♦ Could the problems of US regional banks affect insurers?

The US regional banks lost the confidence of their clients and investors following the failure of Silicon Valley Bank. This loss of confidence was caused by poor asset-liability management, exacerbated by the rapid rise in interest rates.

Insurers should not experience the same setbacks:

1- **There can be no "bank run" among insurers.** Customers may look for higher yielding investments when interest rates rise, but they have no interest in closing existing life insurance policies. They would lose the tax benefits associated with these policies. Life insurance policies often have significant surrender charges or penalties that discourage policyholders from terminating their policies early. These penalties can be significant, particularly in the early years of a policy, and can effectively lock policyholders in for some time.

2- **Insurance companies are required by law to maintain reserves and meet solvency requirements** to ensure that they have the financial resources to pay claims as they fall due. The solvency of insurers has never been higher, which should reassure investors (see Fig. 6).

Fig. 6 – European Insurers' Solvency ratio

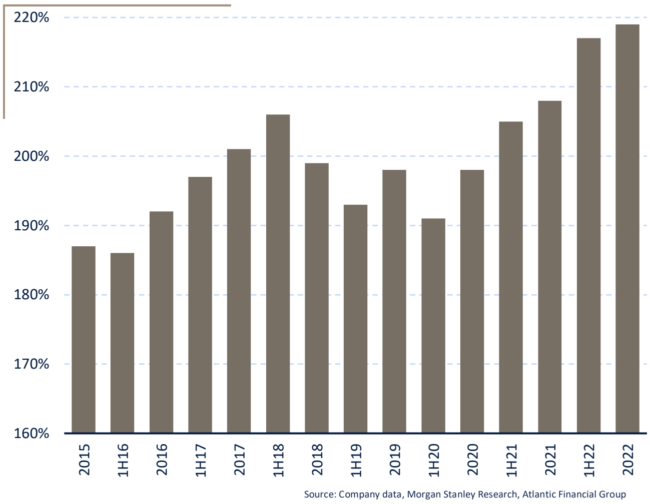
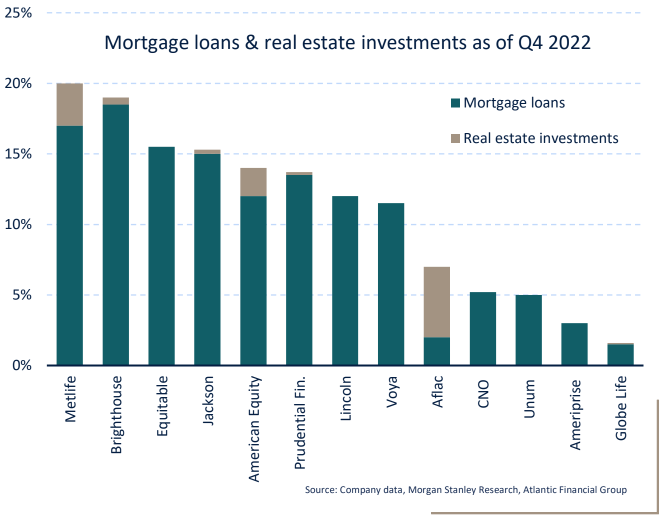



Fig. 7 - Exposure to US commercial real estate




The biggest job for insurers is to write policies at the right price to attract new customers while ensuring the profitability of the business. **Insurance companies are generally well covered against interest rate risks. They are less well covered against inflation risks.**

Inflation will mainly affect salaries and general management costs. For health, property and casualty insurance companies, premiums are revalued each year to include inflationary effects. For life insurance policies, investment returns must be sufficient to cover increases in management fees.

## Conclusion:

The sector is exposed to many risks, just like the banking sector, but its intrinsic business is to anticipate them and maintain a wide prudential margin. Insurance companies are not cyclical, even if they have experienced some difficult years following the bursting of the internet bubble (2003) and the financial crisis (2009). Over the long term they offer good earnings visibility, generate strong cash flows and deliver generous returns to their shareholders.

## RETURN ON FINANCIAL ASSETS

| Markets Performances (local currencies) | Last Price | Momentum Indicator (RSI) | 1-Week (%) | 1-Month (%) | 2023 Year-to-Date (%) | 2022 (%) | 2021 (%) |
|---|---|---|---|---|---|---|---|
| **Equities** | | | | | | | |
| World (MSCI) | 649.2 | 51.17 | -0.4% | 0.5% | 8.3% | -17.9% | 19.0% |
| USA (S&P 500) | 4 124 | 52.58 | -0.2% | 0.9% | 8.1% | -18.1% | 28.7% |
| USA (Dow Jones) | 33 301 | 45.99 | -1.0% | -0.9% | 1.2% | -6.9% | 20.9% |
| USA (Nasdaq) | 12 285 | 58.00 | 0.4% | 3.0% | 17.7% | -32.5% | 22.2% |
| Euro Area (DJ EuroStoxx) | 457.4 | 49.72 | 0.0% | 0.9% | 13.6% | -11.4% | 23.5% |
| UK (FTSE 100) | 7 755 | 47.93 | -0.2% | -0.5% | 5.7% | 4.6% | 18.4% |
| Switzerland (SMI) | 11 565 | 62.15 | 0.2% | 3.9% | 10.9% | -14.3% | 23.7% |
| Japan (Nikkei) | 29 626 | 68.46 | 0.8% | 4.6% | 13.8% | -7.3% | 6.7% |
| Emerging (MSCI) | 973 | 44.44 | -0.9% | -1.9% | 2.5% | -19.8% | -2.3% |
| Brasil (IBOVESPA) | 108 464 | 64.90 | 3.2% | 1.5% | -1.2% | 4.7% | -11.9% |
| Russia (MOEX) | 2 565 | 53.76 | 2.9% | 3.2% | 22.1% | -36.9% | 21.9% |
| India (SENSEX) | 62 396 | 68.78 | 1.6% | 2.7% | 2.2% | 5.8% | 23.2% |
| China (CSI) | 3 991 | 37.06 | -2.0% | -3.8% | 1.8% | -19.8% | -3.5% |
| Communication Serv. (MSCI Worl | 84.12 | 60.74 | 2.4% | 2.4% | 20.1% | -35.3% | 10.9% |
| Consumer Discret. (MSCI World) | 313.6 | 55.24 | 0.4% | 2.5% | 13.9% | -31.5% | 9.2% |
| Consumer Staples (MSCI World) | 282.0 | 57.11 | -0.8% | 2.0% | 6.7% | -6.0% | 11.7% |
| Energy (MSCI World) | 227.0 | 39.36 | -1.3% | -6.1% | -4.3% | 34.6% | 37.5% |
| Financials (MSCI World) | 129.6 | 42.74 | -0.8% | -0.6% | -0.4% | -9.2% | 25.1% |
| Health Care (MSCI World) | 344.7 | 50.71 | -0.9% | -0.4% | 1.5% | -5.7% | 18.0% |
| Industrials (MSCI World) | 300.8 | 49.72 | -0.6% | 0.7% | 7.1% | -12.6% | 16.6% |
| Info. Tech. (MSCI World) | 470.0 | 56.25 | -0.3% | 2.2% | 20.2% | -30.9% | 27.6% |
| Materials (MSCI World) | 316.7 | 38.04 | -2.2% | -3.6% | 2.9% | -11.0% | 15.4% |
| Real Estate (MSCI World) | 171.0 | 46.59 | -1.6% | -1.0% | 0.4% | -24.0% | 23.6% |
| Utilities (MSCI World) | 153.7 | 55.48 | -0.1% | 0.1% | 2.9% | -3.8% | 11.1% |
| **Bonds (FTSE)** | | | | | | | |
| USA (7-10 Yr) | 3.48% | 51.78 | -0.1% | -0.2% | 4.2% | -14.5% | -2.4% |
| Euro Area (7-10 Yr) | 2.97% | 55.05 | 0.2% | 0.9% | 3.7% | -19.4% | -2.9% |
| Germany (7-10 Yr) | 2.32% | 54.14 | 0.1% | 0.7% | 2.3% | -17.8% | -2.7% |
| UK (7-10 Yr) | 3.78% | 46.10 | 0.1% | -1.2% | 1.2% | -17.1% | -4.9% |
| Switzerland (7-10 Yr) | 0.99% | 61.60 | 0.9% | 1.2% | 4.3% | -12.5% | -2.3% |
| Japan (5-10 Yr) | 0.41% | 66.73 | 0.3% | 0.6% | 1.7% | -2.8% | 0.0% |
| Emerging (5-10 Yr) | 7.83% | 57.00 | 0.5% | 0.1% | 2.5% | -17.4% | -2.3% |
| USA (IG Corp.) | 5.19% | 49.49 | 0.4% | -0.1% | 3.5% | -15.8% | -1.0% |
| Euro Area (IG Corp.) | 4.12% | 57.19 | 0.2% | 0.9% | 2.7% | -13.6% | -1.0% |
| Emerging (IG Corp.) | 7.62% | 50.91 | 0.0% | -0.2% | 2.4% | -14.9% | -3.0% |
| USA (HY Corp.) | 8.61% | 53.45 | 0.0% | -0.3% | 4.2% | -11.2% | 5.3% |
| Euro Area (HY Corp.) | 8.04% | 65.27 | 0.2% | 0.4% | 3.5% | -10.6% | 3.4% |
| Emerging (HY Corp.) | 11.30% | 50.93 | 0.3% | -0.8% | 0.6% | -12.4% | -3.2% |
| World (Convertibles) | 371.6 | 46.90 | -0.1% | -0.8% | 3.6% | -18.2% | 2.4% |
| USA (Convertibles) | 490.9 | 51.00 | 0.5% | -0.6% | 3.6% | -20.1% | 3.1% |
| Euro Area (Convertibles) | 190 | 60.33 | 0.1% | 0.7% | 5.1% | -12.1% | 1.2% |
| Switzerland (Convertibles) | 175.8 | 68.49 | 0.4% | 1.3% | 2.2% | -7.5% | -0.5% |
| Japan (Convertibles) | 205.6 | 53.13 | 0.2% | 0.5% | 3.8% | -1.3% | 3.3% |
| **Hedge Funds (Crédit Suisse)** | | | | | | | |
| Hedge Funds Indus. | 738 | 58.07 | n.a. | 0.3% | 0.5% | 1.0% | 8.2% |
| Distressed | 935 | 54.64 | n.a. | 0.6% | 1.3% | -4.5% | 12.5% |
| Event Driven | 772 | 54.65 | n.a. | 0.7% | 2.0% | -6.8% | 12.9% |
| Fixed Income | 397 | 68.39 | n.a. | 0.2% | 2.0% | -1.0% | 5.2% |
| Global Macro | 1294 | 49.27 | n.a. | 0.0% | -7.3% | 15.9% | 9.6% |
| Long/Short | 913 | 46.74 | n.a. | 2.0% | 4.5% | -5.8% | 8.3% |
| CTA's | 387 | 52.62 | n.a. | 2.1% | -5.0% | 19.1% | 8.2% |
| Market Neutral | 302 | 67.30 | n.a. | 0.8% | 2.2% | 1.7% | 6.2% |
| Multi-Strategy | 713 | 65.16 | n.a. | -0.2% | 1.0% | 1.3% | 7.0% |
| **Volatility** | | | | | | | |
| VIX | 17.03 | 45.71 | -0.9% | -10.8% | -21.4% | 25.8% | -24.3% |
| VSTOXX | 17.01 | 42.81 | -7.0% | -8.7% | -18.6% | 8.4% | -17.6% |
| **Commodities** | | | | | | | |
| Commodities (CRB) | 542.4 | n.a. | -1.1% | -0.8% | -2.2% | -4.1% | 30.3% |
| Gold (Troy Ounce) | 2 016 | 53.71 | -0.3% | 0.6% | 10.5% | -0.3% | -3.6% |
| Oil (WTI, Barrel) | 70.04 | n.a. | -1.8% | -15.9% | -12.7% | 4.2% | 58.7% |
| Oil (Brent, Barrel) | 74.11 | n.a. | -3.4% | -15.5% | -12.8% | 9.7% | 51.4% |
| **Currencies (vs USD)** | | | | | | | |
| USD (Dollar Index) | 102.61 | 57.59 | 1.2% | 1.0% | -0.9% | 8.2% | 6.4% |
| EUR | 1.0863 | 42.33 | -1.3% | -0.6% | 1.5% | -5.8% | -7.5% |
| JPY | 136.11 | 41.17 | -0.7% | -1.2% | -3.7% | -12.2% | -10.2% |
| GBP | 1.2468 | 48.97 | -1.2% | 0.7% | 3.2% | -10.7% | -1.0% |
| AUD | 0.6681 | 48.13 | -1.5% | -0.3% | -1.9% | -6.2% | -5.6% |
| CAD | 1.3523 | 48.52 | -1.1% | -1.0% | 0.2% | -6.8% | 0.7% |
| CHF | 0.8974 | 48.76 | -0.9% | 0.1% | 3.0% | -1.3% | -3.0% |
| CNY | 6.9552 | 33.44 | -0.6% | -1.1% | -0.8% | -7.9% | 2.7% |
| MXN | 17.577 | 70.89 | 1.3% | 2.5% | 10.9% | 5.3% | -3.0% |
| EM (Emerging Index) | 1 687.5 | 46.98 | -0.4% | -0.2% | 1.6% | -4.3% | 0.9% |

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

DISCLAIMER