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Insurers must perform balancing act

There are testing times ahead for life insurers, with a host of regulatory changes about to come into force. Emir's central clearing and greater scrutiny on market-makers mean insurers will need to develop increasingly nimble investment strategies in order to reassure their investors as they adapt to Solvency II, say Andrew Kenyon, Keith Law and Robin Thompson of RBS Insurance Solutions

Insurance Risk: What are the implications of changes in the gilt-swap spread for insurers?
RBS: While some insurers have been active in quantifying and managing gilt-swap spread exposures in their books in the past, additional guidance from the Prudential Regulation Authority (PRA) and the European Insurance and Occupational Pensions Authority (EIOPA) in 2015 makes it clear that sovereign spread risk should be considered part of the Solvency II balance sheet. Holding capital against government bond risk levels the risk/return playing field between gilts, corporates bonds or other investments.

Firms most affected are those with future guarantees discounted using a swap-based discount curve but backed with gilts. The maturity guarantees within with-profit funds are a common example, with funds exposed to volatility in their working capital as a result of changes in the swap spread and, most likely, holding more capital as a consequence.

Reducing this risk by replacing gilts with swaps for duration management, then reinvesting the proceeds in Libor-linked assets (to fund the floating leg of the swaps) allows firms to remove this volatility and, depending on how the proceeds are reinvested, reduce capital consumed. Increased flexibility over the investment approach going forward may also be beneficial.

For with-profit funds, increasing the stability of working capital will become much more important in coming years, with funds running off and firms seeking to distribute estates.

Insurance Risk: Hedging the Solvency II risk margin looks to be a key theme going forward. What options do insurers have?
RBS: The inclusion of the risk margin is an obvious place to start when considering changes to the duration profile of the balance sheet pre- and post-January 1, 2016. But, in reality, the risk margin is only going to be one part of the overall duration management picture, and the objective of most firms is probably stabilisation of the overall balance sheet and Solvency Capital Requirement (SCR) ratio, rather than matching any single component.

Added to this, the risk margin arises from a complex, nested calculation and some firms will struggle to build the infrastructure required to model its interest rate sensitivity in a detailed manner. A simplified calculation might be acceptable (using appropriate risk drivers, for example), but the resulting hedge is also likely to be simpler. Given these challenges, a higher-level overlay that helps keep rates exposure within accepted bounds for the whole balance sheet may be preferred.

Insurance Risk: Do you see further opportunities for insurers to benefit from supply/demand imbalances in rates/inflation and, if so, where?
RBS: We often look at pension scheme activity when it comes to creating supply and demand imbalances that might present opportunities for insurers. Pension schemes make up a large proportion of the rates and inflation markets and often have similar investment strategies. For example, insurers can take advantage of this now by using a swaption collar to alter the profile of their interest rate exposure in the tails, reducing capital requirements where best-estimate liabilities have been overhedged to help manage balance-sheet stability.

Pension schemes have made the opposite transaction – selling payer swaptions at a strike at which they would consider increasing their quantum of interest rate hedging. This allows them to earn a premium and, if rates rise, the swaption will be exercised, forcing them into a receiver swap that they would have elected to transact at that level anyway, monetising their hedging 'trigger' level.

Insurance Risk: What do you see as the main asset/liability management (ALM) challenges facing insurers in 2016?
RBS: One of the main challenges for insurers will be demonstrating to investors their understanding of, and ability to manage, the new framework. Key measures of this will be stability of surplus and SCR ratios, leading to continued ability to generate cash. From the perspective of external stakeholders, capital management and ALM will be linked with cash generation and dividends in a more transparent way.

The need to demonstrate stable capital ratios and a balance sheet that evolves in a predictable manner will require ALM to move beyond simple SCR minimisation into a greater understanding of second – and third – order impacts and beyond.

But insurers, like other market participants, will need to achieve their objectives in markets made evermore challenging by regulatory developments. Central clearing from the European Market Infrastructure Regulation (Emir) comes into effect for most large insurers in 2016, requiring variation margin to be posted in cash only for eligible new derivative trades, starting with interest rate swaps. Additionally, concerns about Basel III's leverage ratio are increasing the cost of repo and pricing for derivatives collateralised by gilts – pushing insurers towards a cash-only model once again.

Firms will need a detailed understanding of the liquidity requirements across their business, particularly where external options – such as repo – are relied upon to provide liquidity in stressed situations. Will their assumptions still be valid, or do firms need to consider what other options might be available to them as they look to optimise their approach?