Rollercoaster ride

COVID-19 has made the job of insurance company CIOs exceptionally challenging as they navigate the current financial landscape.

By Marc Jones, Associate Editor

Describing the current state of the global stock markets as we enter May is, in a word, problematic. Over the past few months the impact of the COVID-19 coronavirus on the global economy has caused stock indices all over the world to swing wildly, although mostly downward.

A good example is the Dow Jones Industrial Average Index. At the start of the year it was hovering at around 30,000 points. Then in a matter of weeks it fell to 20,000 points, swept briefly up again and is at time of this writing swinging erratically – up and down.

To make matters worse, the lockdown has forced many companies into a form of stasis, unable to operate as normal. As a result, business confidence has fallen in many areas as companies able to operate try to adjust by having employees work from home.

As this issue of *Reactions* went to press it was becoming increasingly clear that the economic dislocation from the coronavirus crisis will have a lasting economic impact, tipping much of the global economy into the first recession since the great financial crisis of 2008-09.

The current environment presents a fresh set of challenges for Chief Investment Officers and other executives at insurance companies whose task it is to determine where to invest.

As Wojciech Herchel, ALM Director at Schroders, points out, insurers are "liability-driven" investors in the sense that they need to invest their money to meet their liabilities when they fall due, subject to capital and accounting considerations. In continental Europe, general account business dominates – and traditionally, it has come with investment guarantees for policyholders. One of the main considerations for an insurance company thus will be creating and maintaining a portfolio of assets that at least meets those guarantees.

Peter McGloughlin, Head of UK and Ireland Insurance at DWS, adds that strong, robust, and reliable investment returns can help drive shareholder value versus competitors. That said, above all else, insurance companies need investment portfolios to preserve capital, pay claims or annuitants, and meet regulatory solvency requirements.

"COVID-19 has certainly created mark to market volatility and potential capital strain," says McGloughlin. "However, in the longer term if credit defaults do not emerge in the way some market prices imply (particularly in high yield), then overall we see wider credit spreads as a good longer term opportunity to increase book yield and overall investment income for insurers."

He notes that some insurers, particularly in the P&C sector, "have been struggling with a soft market on underwriting combined with significant falls in investment income on the asset side over the last few years – all essentially due to excess liquidity in the financial system. Now, following the COVID-19 market correction, for the first time in 10 years we've seen real dispersion between asset prices again and exciting investment opportunities.

"Clearly there may be some short-term pain for insurers on existing portfolios," he adds. "However, for new business and/or reinvestment, the yield outlook is looking much more attractive for insurance investors."

The asset mix

When asked what assets insurance companies tend to invest in, Herchel explains that allocation varies between geographies and sectors (for example, life and non-life). However, at the high level, insurers tend to be predominantly fixed-income investors – again, driven by the features of their liabilities.

Thus a bulk of an average portfolio will be fixed-income, investment-grade assets, typically local currency government and credit (subject to market depth) with some allocation to overseas assets and more tactical allocations, which can be any of high-yield credit or emerging market debt. Insurers also became big investors in private credit, particularly in assets like real estate debt or infrastructure. Depending on capital position and risk appetite, equities and physical property also feature in their investment portfolios – although those allocations tend to be on a smaller scale (rarely above single digits).

According to McGloughlin, insurers are traditionally credit-spread investors. They match liabilities with the "risk-free" part of the portfolio and typically generate investment returns from the excess credit spread above a capital reserve for any expected loss given defaults. As such, the volatility in credit spreads that DWS has seen over the last month (mid-March to mid-April) has been a wild ride for insurance portfolios.

"Now at least with the unprecedented action by the Fed and central banks it gives everyone time to ensure portfolios are well-positioned for the various post-COVID scenarios," McGloughlin points out. "In bond markets we've seen record-breaking new issuance of investment-grade corporate bonds in the U.S. and Europe. Bonds have been printing with 50 to 100bps new issue premiums, offering very enticing levels to insurers who can increase allocation to corporate credit. It's been a super busy period, with over €50bn new issuance in Europe and $113bn in the U.S. in the first week of April alone."

In addition, McGloughlin says that insurers have also been increasingly investing in private market assets over the past few years. Here, given the mark to model/internal rating nature of these assets, DWS hasn't seen the same price volatility as in public markets – yet. However, he adds: "Given lower transparency it is crucial for insurers to be diligent on manager oversight and understand how asset managers are adapting to the COVID-19 impact in private markets. Some repositioning may be required and new opportunities may emerge, although the relative value will need to be reassessed given the repricing taking place in the public bond markets."

The coronavirus impact

What, therefore, has the impact of the COVID-19 crisis been on these assets so far? Herchel thinks that it's fair to say that the first reaction to the coronavirus for his clients has been a focus on risk management of the existing portfolios. He says that approval processes for new investments have been slowed until more clarity can be gained on what COVID-19 and the global lockdown means for the economy and different subsectors.

Herchel also claims that over the years, insurers' portfolios have become heavily geared toward BBB-rated assets and that with the approaching recession a large part of that universe could be downgraded to high yield, which will have important capital implications.

"Clients with tight capital position tend to spend a lot of time managing this risk and rotating out of certain positions at risk of a downgrade," says Herchel. "At the same time, those in a better capital position have headroom to re-risk and are actively looking to be opportunistically buying strong credits that perhaps oversold. There is a potential for re-risking to also extend to more esoteric assets for insurers, like securitised credit. A large part of this market has sold off and the sophisticated accounts identified this as an opportunity to earn a very attractive return over the medium term, effectively providing liquidity for distressed sellers."

Herchel feels that on the real estate front there is a lot of risk management going on as well, due to the fact that tenants will be struggling to pay rent. More generally on the private assets origination front, activity seems to be slowing down, he adds, due to practicalities of the requirements of social distancing: for example, valuers/surveyors cannot get to properties for inspections.

According to McGloughlin, the key moves are very much about security and issuer selection. He says that the actions of the rating agencies have been "crucial" and insurers need to assess the risk of being forced to act if bonds are downgraded below investment grade. In many cases this will very much depend on regulatory capital requirements, but managing the impact from "Fallen Angel" risk is a key focus for DWS' insurance clients.

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"In private market assets, anticipating any change to internal model ratings is also crucial," he says. "In real estate debt, for example, insurers need to start getting on top of any potential changes to ratings if underlying tenants have temporarily stopped paying rents due to COVID-19 disruption. Is this a short-term manageable risk, or a sign of a longer-term, more systemic impact on the portfolio? And what are the realistic workout scenarios if the manager is forced to take action?

"We've also seen increasing opportunities for Private Equity Solutions (PES)," McGloughlin adds. "Here, DWS provides additional capital to companies owned by private equity funds normally for growth or

continuation at the end of the fund life. COVID-19 has led to a 200%+ increase in our deal pipeline as PE funds look to shore up capital and/or take advantage of M&A opportunities."

According to Gareth Haslip, Managing Director and Global Head of Insurance Strategy and Analytics for JP Morgan, the main effect of the COVID -19 crisis has been a liquidity crunch. Haslip says that a lot of market participants saw redemption requests in a very illiquid market. As a result, spreads widened quickly in the absence of an immediate and massive buyer of last resort. On top of this, a lot of sellers have no other choice but to sell the better quality assets given the absence of bids for the riskier ones. "Therefore, we also saw a sell-off of core government bonds and high-quality short duration credit. Hopefully, Central Banks' actions should help normalise these markets," he adds.

"It is critical that insurers conduct careful stress testing around downgrades and plan accordingly to avoid crystallising capital losses."

Gareth Haslip, JP Morgan

"Equity markets have fallen by around 25% from mid-February to date," says Haslip. "This is comparable to the fall in equity markets seen over September to October 2008 at the start of the GFC (also around 25%). In Europe, a typical non-life insurer has around 7%-9% allocated to equity investments. As a high-level estimate, the immediate mark to market impact of the equity market falls would be around a 2% reduction in the value of a typical insurer's investment portfolio."

Haslip also points out that alternative portfolios tend to invest in private rather than public assets. This tends to provide an advantage for alternatives through dampened accounting volatility, since the underlying assets are marked to model rather than listed on public markets.

"As time progresses in the current crisis and lower earnings emerge, we can expect to see lower or negative returns experienced in the asset class," he adds. It should be noted that alternatives span a wide range of underlying investments, and performance will be driven by strength of covenants and collateral in private credit as well as the geographic and sector exposures of private equity and real estate. Also worth noting is that alternative investments are often made into smaller companies which could be more affected by the crisis.

The regulatory eye

Mention of downgraded investments became particularly pertinent as this article was being written, as on 23 April the Bank of England's Prudential Regulation Authority (PRA) issued a statement noting that on Thursday 26 March 2020, Sam Woods, Deputy Governor and CEO of the PRA, wrote to CEOs of UK Banks setting out the PRA's position regarding IFRS 9, capital requirements for their firms and loan covenants. According to the PRA, some insurance firms have sought clarification as to how the points in that letter should be read across to their internal assessments of loan creditworthiness and treatment of unrated assets.

According to the statement, "The PRA's expectations for the use by insurers of unrated assets are set out in Supervisory Statement (SS) 3/17 'Solvency II: Illiquid, unrated assets' (updated on Thursday 2 April 2020). Paragraphs 2.8A to 2.8L of the SS set out relevant expectations regarding risk identification and the application of judgements and methodologies. The accompanying Policy Statement (PS) 9/20 'Solvency II: Income producing real estate loans and internal credit assessments for illiquid, unrated assets' further refers to published measures to alleviate operational burdens arising due to the COVID-19 outbreak.

"In this context, while Sam Woods' letter itself does not address insurers' internal credit ratings, some points in the letter can be considered of wider applicability beyond those insurers using IFRS 9 to account for financial instruments.

"Insurers are advised to read the letter in its entirety. Of particular relevance to the judgements underlying internal ratings is the paragraph stating that firms should 'make well-balanced and consistent decisions that consider not just the potential impact of the virus, but also take full account of the unprecedented level of support provided by governments and central banks domestically and internationally to protect the economy. The need for well-balanced decisions also means that due weight will need to be given to established long-term economic trends, given the challenges of preparing detailed forecasts far into the future.' Paragraph 5 of the letter's Annex includes further examples of considerations that insurance firms may find helpful when forming their judgements on the impact of COVID-19 on their internal credit assessments."

Finally, Haslip stresses one very important point – that we are not at the end of the crisis, and there remains potential for further market volatility. He adds that from a credit perspective, the key risk for investment capital requirements is the potential for downgrades of A-rated bonds to BBB and BBB-rated bonds to high yield.

"As the current crisis progresses, a key risk for insurers is the potential for downgrades to reduce their Solvency II ratio through both increased capital requirements on a lower-average-rated portfolio alongside the reduction in own funds driven by spread widening," Haslip concludes. "This could trigger an insurer to become a forced seller of downgraded bonds in order to improve the capital ratio. It is critical that insurers conduct careful stress testing around downgrades and plan accordingly to avoid crystallising capital losses."