LDI: Insurance: The third dimension

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Insurers challenged by rising rates

Insurers are exploring new investment strategies and greater diversification to generate sustainable real returns in a rising interest rate environment.

The challenge is relevant to an APRA-regulated insurer's liability profile, which ranges from very short (private health insurers), relatively short (general insurers that cover car and home), and long (life insurers).

General insurance portfolios have been dominated by fixed income while private health insurance portfolios have been dominated by fixed income and cash, although Frontier Advisors Principal Consultant, Cecily Williams, said there had been some recent diversification within portfolios.

"The sorts of fixed interest that general insurers have moved into would perhaps shock themselves if they look back 10 years, with loans – some predominantly investment grade credit, largely floating rate, even venturing into private debt," she said.

Life insurers materially de-risked their equity portfolios during the March 2020 COVID-19 downturn from about 50 per cent to 20 per cent of portfolios.

"Life companies are really challenged in terms of asset allocation in a low return environment and potentially in a higher inflationary environment. High inflation sounds great for a life company's net present value of liabilities – the unfortunate thing is people then don't want that insurance anymore."

Given a significant gap between low cash rates and surging inflation, assets beyond inflation-linked bonds were being considered.

"People talk about the inflation-protecting assets like commodities and infrastructure. Infrastructure's attractive to an insurer – it's returned a bit short of equities; capital asset charges are clearly a whole lot less... the returns are likely to have some inflation protection – maybe regular income."

Frontier Advisors, Principal Consultant, Elie Saikaly, also recommended assets such as niche real estate beyond traditional retail and office, such as offshore healthcare, as another option.

"Other ideas which Frontier has talked to its clients about include private debt or floating rate exposure in a fixed income portfolio in a world where you'd expect that traditional bond portfolios might experience further drawdowns."

However, diversification remains important as these assets are illiquid, which can create issues around cashflows. Saikaly said those large insurers who can take on more investment risk typically have well-resourced teams and savvy boards and investment committees to successfully diversify their investment strategies.

A key question for investors is what a traditional fixed income portfolio looks like when yields reach more normal levels, which will depend on where inflation settles. If inflation normalises at around 3 per cent and cash rates are 4-5 per cent, insurers' liability matching position will be easier to balance.

"But in the meantime, the more sophisticated strategies that we've discussed are the sorts of things that you're going to have to do to maintain the profitability," Williams said.

Frontier's three dimensional risk surface tool helps show potential efficient strategic asset allocations for insurers.

General insurers also have more ability to reprice premiums compared to government schemes such as workers compensation which are politically sensitive.