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2023, a year of changes for insurers

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The rate movement since mid-2022, both highly anticipated and surprising in its magnitude, has changed some investment paradigms anchored for several decades. The new IFRS accounting rules also change the classification of assets for a large number of insurers. 2023 therefore offers the opportunity to review portfolios' structure and to implement a more active management, in order to take full advantage of the new market conditions, while integrating accounting concerns, explains Rémi Lamaud, Solution Expert, Insurance Management and ALM Solutions at Ostrum Asset Management.

WHAT ARE THE MAIN EFFECTS OF RISING RATES ON INSURERS?

The first impact is generally the materialization of unrealized losses on the bond portfolio, which reduces regulatory capital. However, depending on the difference in the sensitivity of assets/liabilities to interest rate movements, solvency can still improve. For life insurance, this has also led some holders to question the level of rates served on the contract in euros against other products, such as the Livret A. Its rate increases steadily and may exceed that of the insurance contract. To avoid redemptions, arbitrage strategies have emerged to boost portfolio management and interest rates. This dynamic in portfolio rotation is also a good opportunity to accelerate the integration of ESG approaches and temperature trajectories.

WHAT ARE THE IMPLICATIONS FOR ASSET MANAGEMENT AND ASSET ALLOCATION?

Higher rates lead to an increase in the proportion of liquid bond portfolios, particularly by integrating sustainable bonds. For equities, historical higher dividend rates than bond rates now look less attractive compared to government bonds or credit. In addition, their volatility leads a certain number of players to reduce the share of equities or to favor efficient but less volatile vehicles. Money market instruments are also back in allocations: their competitive rate allows for more flexibility while waiting for opportunities.

AND WHAT ABOUT THE BOND PORTFOLIO?

A market with higher rates leads to more active management to increase the rate served by portfolios. In addition to matured bonds, a rotation is possible by making arbitrages compliant with accounting constraints.

In terms of allocation, after several years of seeking returns through credit or increasing duration, it is time to rebalance portfolios towards government bonds, ensuring portfolios' quality and liquidity, or towards shorter bonds. Dynamic bond management is now required to reposition the portfolio. It aims to limit the impact of capital losses and actively take advantage of the capitalization reserve (for life insurance).

WHAT SPECIFIC SOLUTIONS IN THIS CONTEXT?

To accelerate bond portfolio movements, some financial techniques are possible, such as forward bond purchases. They make it possible to capture current interest rate levels by delaying the need for cash over time.

To hedge against a future rise in interest rates from an asset/liability perspective, swaps reduce the duration of the portfolio, but deprive the investor of the benefit of a fall in interest rates. Swaptions can be interesting as they hedge only the rise in rates, but with the payment of a premium.

Structured products also benefit from this context: The price of a zero-coupon bond, providing the guarantee of the future capital, automatically falls and thus leaves more room for equity indexations, for example.

IS THE NEW ACCOUNTING FRAMEWORK FAVOURABLE TO THIS CONTEXT?

'New' accounting standards have also come into force this year for insurers, leading them to review the nature of the bonds in the main portfolio and the types of investment vehicles.

Only conventional fixed income securities deviate from market value if they check the SPPI[1] test derived from IFRS 9. This capacity allows accounting to be consistent with liabilities, which are themselves subject to a new standard (IFRS 17). On the equity side, investments through funds weigh on the volatility of the income statement and some funds have been transformed into direct securities management, thus transferring movements only to the liabilities.

[1] *SPPI : Solely Payment of Principal and Interests. The cash flows of the asset correspond solely to the repayment of principal and interest on the principal amount outstanding (examples: Trade receivables, loans, etc.).*

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