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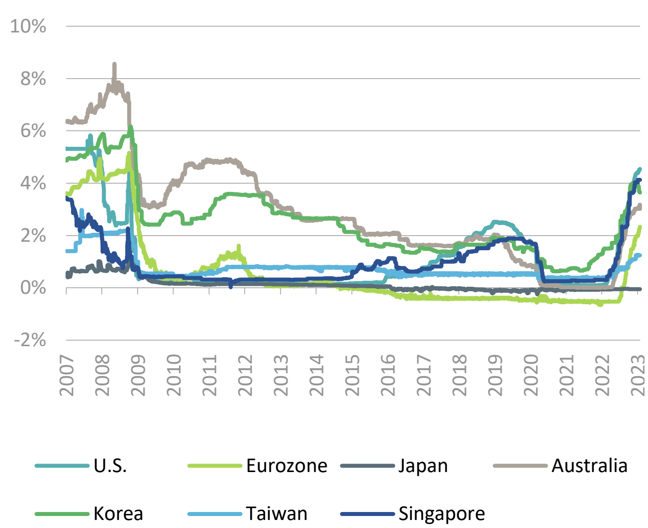
Back to normal? How Asian insurers are responding to rising interest rates

Rising interest rates have resulted in significant losses on the existing portfolios of Asian insurers while the overall impact on their solvency position has been positive. Starving for yield for more than a decade, Asian insurers can now again get a decent return from core fixed income investments.

Rising interest rates, but not everywhere in Asia

After more than a decade of ultra-low interest rates, most central banks globally have started to tighten their monetary policy to fight high levels of inflation. Even though not all central banks in Asia-Pacific have started to aggressively hike interest rates, many insurers in the region are still affected by the sharp rise in interest rates in the U.S. given their significant exposure to the U.S. fixed income market.

Figure-1: Money market interest rates in major economies



Source: Bloomberg, as of 27 January 2023. Past performance is not an indicator of future results.

For the U.S., DWS's CIO Office still expect additional 25 basis point hikes to bring the Fed Funds rate to a restrictive area, while policy rate cuts might be possible in 2024. Similarly, we expect the European Central Bank (ECB) to further take up deposit rates as the current inflation level is still far above the ECB's target.

On the contrary, the Bank of Japan (BoJ) remains largely dovish, but changes to the ultra-expansive monetary policy stance might come with the appointment of a new governor and deputy governs in Spring, largely depending on dynamics in prices and wages. A pivot toward more flexibility for long-term yields and a smaller policy rate hike could also be possible. In mainland China, DWS does not expect any changes in policy rates in the near-term; Hong Kong largely mirrors the policy of the U.S. Federal Reserve given the peg of the Hong Kong Dollar to the U.S. Dollar. The Reserve Bank of Australia (RBA) currently keeps a neutral rate (i.e. a rate that neither stimulates nor restricts growth) but further rate hikes are possible. However, their size and timing will depend on incoming data. In both South Korea and Taiwan, the economy has started to slow after some rounds of rate hikes, and we expect no further hikes, or even some initial rate cuts, this year.

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Negative impact on existing portfolios but overall improvement of solvency position

As liability-driven investors, insurance companies invest most of their assets in fixed income instruments. Hence, rising interest rates have resulted in significant losses on their existing portfolios, especially for life insurance companies that typically invest in longer-duration bonds. However, insurers tend to hold most of their fixed income investments until maturity and hence will likely not realize any of these non-default-related losses.

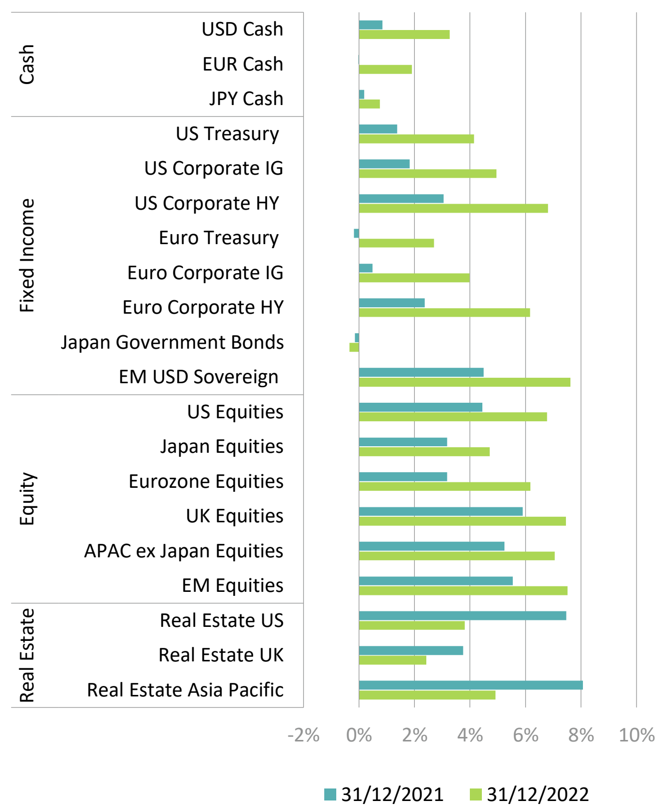
In addition, for insurance companies that have a sound asset-liability management (i.e. where the interest rate sensitivity of assets matches the one of the liabilities) in place, both the value of assets and liabilities should move in parallel if interest rates change so that the value of net assets will not be affected. In some jurisdictions this economic asset-liability match may not be fully reflected in the insurers' (solvency) balance sheet as insurance liabilities are not measured at fair value and hence their accounting value does not respond to changes in market rates. For example, such an accounting mismatch can be observed in Taiwan where investments may be measured at fair value while the discount rate used in the calculation of the accounting value of insurance liabilities is locked-in at the date the insurance policy was sold. In addition, most Taiwanese insurers are significantly invested in U.S. dollar-denominated bonds, where interest rates have risen sharply, while interest rates in Taiwan have remained fairly stable. As a result, the reported net assets of many Taiwanese insurers have dropped significantly. In order to mitigate the effects of this accounting mismatch, Taiwan's Financial Supervisory Commission (FSC) now allows insurance companies to change the accounting treatment of their fixed income assets to match the one of their liabilities.

However, in practice most insurance companies do not have a perfect match of assets and liabilities. Life insurance companies with long-dated policies often run a material duration gap with the duration of their assets being shorter than the duration of their liabilities. Rising rates had a positive impact on the net assets of these insurance companies as the value of their liabilities dropped more than the value of their fixed income investments. Therefore, the overall solvency position of many Asian life insurers has actually improved, which may allow them to either take more risks (both in investments and underwriting) or to reduce their capital (e.g. by reducing tier-2 debt or even by share buy-backs).

The renaissance of core fixed income but demand for alternative assets remains stable

For new investments, rising interest rates have improved the attractiveness of most liquid asset classes (see figure 2) amid the significant re-pricing that took place in 2022. During the low interest rate environment of the past several years, insurance companies had to significantly increase their investment risk in order to get a decent yield; they can now again get an attractive return from high-quality core fixed income instruments.

Figure-2: Expected returns (p.a., in local currency, next 10 years) of major asset classes – Q4/2021 vs. Q4/2022



Source: DWS, as of January 2023. Expected annual return over the next 10 years based on DWS's Long-term Capital Market Assumptions (LTCMA) methodology. Forecasts are based on assumptions, estimates, opinions, and hypothetical models that may prove to be incorrect.

In their search for yield, insurance companies not only took on more credit risk in fixed income investments but also significantly increased their allocation to alternative assets such as real estate, infrastructure or direct lending. While we see insurers now focusing again on high-quality fixed income instruments, such as government bonds and investment-grade corporate bonds, DWS does not yet see significantly less interest in alternative assets. The reason for this might be that alternative assets can still provide other advantages than just an illiquidity or complexity premium over comparable liquid assets. To name a few, alternative assets can typically also provide diversification benefits, better structural protection, some degree of inflation hedging as well as a high capital efficiency under most risk-based capital (RBC) regimes that have been introduced (or are currently in the process of being introduced) in many jurisdictions across Asia-Pacific.

However, given their illiquid nature, the prices of alternative assets typically only respond slowly to changes in the macroeconomic environment. Hence, we see insurance companies putting new investments in alternatives on hold until some expected re-pricing in these assets has taken place. This is likely true for the real estate sector where liquid instruments – i.e. Real Estate Investment Trusts (REITs) – have already seen a significant drop in market prices while the (typically appraisal-based) book values of the underlying real estate have remained fairly stable so far. Also, given that the value of liquid investments has dropped significantly in 2022 while the value of alternative investments has yet remained stable, some insurers now face an artificial overweight in alternative assets (also known as the denominator effect) which may force them to hold some new investments in alternatives to stay in line with their strategic asset allocation.

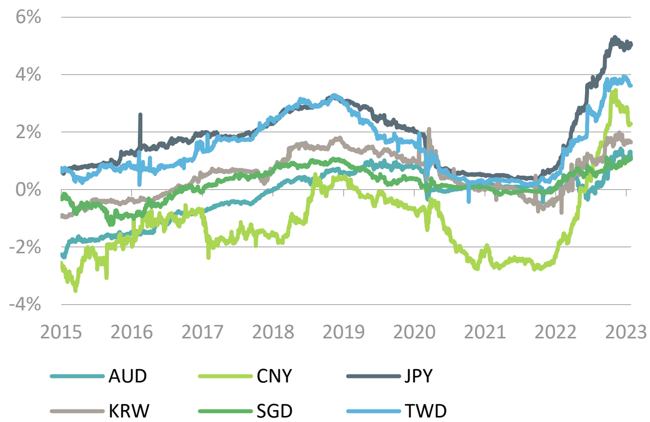
One alternative asset class that has almost immediately responded to rising interest rates is private debt, given that most loans are floating rate and higher rates are directly (or with a short time lag) passed on to investors. DWS is forecasting to see continued demand in this alternative asset class, which is also driven by other structural advantages such as typically lower expected credit losses than for comparable investments in bonds. However, at the same time, some insurers are also worried that rising rates could have a negative impact on the borrowers' capacity to service their debt payments. Therefore, the current market environment may serve as a "first stress test" for private debt investments of insurers as this asset class has basically emerged as a new one for them since the Great Financial Crisis (GFC) of 2007/2008.

Rising interest rates have also resulted in a significant re-pricing in equities, especially in growth sectors such as the IT sector. Insurance companies typically prefer investments in fixed income instruments owing to their liability-matching characteristics. This is especially true now as core fixed income instruments can again offer attractive yield and RBC regimes encourage stricter asset-liability management. In fact, DWS's long-term capital market assumptions suggest that some riskier segments of the fixed income market can even provide equity-like expected returns (see figure 2) but with less volatility, higher income generation and typically significantly lower capital charges. To this end we would likely observe insurance companies to consider taking risks outside equities and in the areas of credit or alternatives.

Higher FX hedging costs may weigh on the attractiveness of U.S. fixed income assets

Rising interest rates also had an impact on the currency hedging costs for overseas investments of Asian insurers and the potential attractiveness of these investments. Given that domestic fixed income markets in Asia are usually not very broad and deep, many Asian insurers tap into overseas bonds in particular the U.S. While interest rates have risen sharply in the U.S., they have remained at lower levels in some Asian markets, resulting in higher currency hedging costs for insurers in these markets. This is especially true for Japanese insurers where the demand for U.S. dollar-denominated fixed income investments has dropped significantly on the back of significantly higher FX hedging costs. This may also affect the attractiveness of existing overseas investments as FX hedges are typically implemented by using rolling short-dated forwards as opposed to using cross-currency swaps to fully hedge the FX risk over the lifetime of an investment.

Figure-3: Hedging costs of U.S. dollar back to major Asia-Pacific currencies (02-Jan-2015 to 27-Jan-2023)



Source: DWS, Bloomberg, as of 27 January 2023. Past performance is not an indicator of future results. Negative hedging costs represent a hedging gain.

The comeback of traditional life insurance policies?

To cope with the low interest rate environment of the last decade, many insurance companies have not only adopted their asset allocation but also the type of insurance policies they sold. Life insurers in many countries have shifted away from interest rate sensitive saving policies with guaranteed rates to investment-linked policies (ILPs) in which the investment risk is largely transferred to the policyholders. While the marketing of ILPs is typically challenging in volatile markets, and rising rates may have improved the attractiveness of traditional guaranteed life insurance products, we currently do not see the long-term trend toward ILPs to reverse. This is also because the development of these products has been encouraged by the introduction of RBC regimes. Under these regimes the insurance company has to hold almost no capital for the investment risks in ILPs given that they are largely borne by the policyholders.

DWS does, however, see some changing demand with to the types of funds in which these policies are linked due to the rising rate environment. While equity funds were especially in high demand over the past several years, we now see more interest in multi-asset products that also have an allocation to fixed income investments. This also includes solutions with capital protection features such as products based on the Constant Proportion Portfolio Insurance (CPPI) mechanism that dynamically shifts between a risky portfolio of assets (usually consisting of equities) and a less risky portfolio of assets (usually consisting of cash or high-quality bonds) to achieve a certain degree of capital protection. The construction of these products had been challenged during the low interest rate environment.

Another impact of rising interest rates on life insurance policies could be higher surrender rates in traditional savings policies that were written during the low interest rate environment of the last years and hence only provide low credited rates. Given that the premiums of these policies have typically been invested in long-dated fixed income instruments, there can be a significant time lag until insurers can reinvest the money in now higher-yielding bonds and pass on higher rates to policyholders. Policyholders may choose to surrender their in-force policies and either get a new policy or invest their money into short-term banking products.

In summary

Overall, rising interest rates had a positive impact on most insurance companies. Despite significant (unrealized) losses on existing investments, the overall solvency position of most insurers has remained stable or has even improved given the value of their liabilities has come down. Insurance companies that had been starving for yield on traditional fixed income investments for more than a decade now have the opportunity to again lock-in attractive yields on high-quality core fixed income instruments. However, at the same time we do not see that higher interest rates will result in the reversion of some long-term trends observed in the insurance industry, such as higher allocations to alternative assets as well as the shift from traditional life insurance policies to investment-linked policies as these structural trends have also been driven by other factors such as the introduction of risk-based capital regimes in most Asian countries.

Important risk information

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