Analysis

Insurance companies as major investors are a potential source of systemic risk

Financial stability | 09 June 2015 | Eero Savolainen

AUTHOR



Eero Savolainen

Insurance companies promote economic activity by offering savings products and protection against risks. At the same time, insurance companies themselves are also investors. The reliability of insurance business is important for the economy as a whole. The low level of interest rates weakens insurance companies' investment returns and increases the market value of liabilities in the sector; when protracted, this poses problems, particularly for life insurers. Systemic risks in the insurance business have begun to attract attention, especially in consideration of insurance companies' importance as significant institutional investors.



Insurance business promotes economic growth

The insurance business increases the efficiency of the economy and promotes economic growth. Because of insurance cover, customers can carry out business transactions without being exposed to incidental risks, the materialisation of which would cause substantial costs. For instance, fire insurance cover enables an enterprise to concentrate on the management of business risk, while the insurance company covers the fire risk. In addition to traditional life cover, life insurance companies offer pension and long-term savings products to their customers, and some of these products have tax benefits.

Insurance companies reinvest insurance premia collected in advance. They play a major role as institutional investors and are also an important source of finance for banks, especially as purchasers of long-term debt securities. Equally, Finnish insurance companies are also important investors, even though their total assets are less than the total assets of the banking sector.At the end of 2014, the aggregate balance sheet of Finnish insurance companies was 32% of GDP, as against 259% for the banking sector.[1] This is partly explained by the statutory employment pension scheme in Finland, on account of which voluntary pension saving has remained more modest in Finland than in several other countries.

Low interest rates a place strain on life insurers

An environment characterised by a low level of interest rates and slow economic growth poses challenges for insurance companies. When interest rates decline, insurance companies first profit from additional returns on valuation changes of their debt security holdings. However, as the period of low interest rates drags on, insurance companies begin to receive lower returns on reinvestment of matured fixed-income investments, which weakens their profitability.

Low returns on fixed-income investments brings challenges for life insurers, in particular, which have guaranteed to their customers benefits that markedly exceed the prevailing level of interest rates. If investment returns are repeatedly lower than the returns guaranteed to customers, this will weaken the insurance company's financial result and thereby also solvency. Finnish life insurance companies' average return on investment has so far been higher than the guaranteed return. This is partly explained by the fact that, in European comparison, equities account for a significant proportion of Finnish insurance companies' investment portfolios.

The negative impact of low interest rates on both investment returns and technical provisions can encourage insurance companies to increase the risk level of their investments. Such a search for yield can contribute to unhealthy developments in valuation levels on the investment markets, especially when considering insurance companies' importance as institutional investors. The search for yield is also reflected in customer behaviour, because customers have shifted funds from lower-yielding fixed-income agreements to insurance companies' unit-linked insurance products that carry higher expected returns and risks. This development has been positive for investment companies, since policyholders bear the investment risk associated with unit-linked insurance products to almost one hundred percent. In 2014, unit-linked policies accounted for 87% of life insurers' premium income in Finland.

Fire sales as a source of systemic risk

Insurance companies have typically not been regarded essential in terms of systemic risk. This is partly because they are less vulnerable to liquidity risk than banks. Insurance companies' liabilities consist mainly of technical provisions which are relatively constant in nature, and also the related cash flows are rather predictable. Hence, insurance companies are not exposed to situations such as deposit or wholesale flight.

Insurance companies have rarely caused problems that have spread from the financial sector to the real economy. In such cases, the problems have typically stemmed from insurance activities that are not typical to the traditional insurance business.[2] The most famous case is that of the

American insurance company AIG: credit default swaps sold by AIG's Financial Products division caused losses that ultimately led to a rescue package of USD 180 billion in 2008.

However, insurance companies' role as major investors can cause market disruptions, especially in situations in which companies have to resort to fire sales. For instance, life insurance companies can be faced with a situation where investment values plunge and the risk-free interest rate used in discounting technical provisions declines. The 2014 Insurance Stress Test of the European Insurance and Occupational Pensions Authority (EIOPA) showed that the insurance sector in the EU is vulnerable to such a 'double hit' scenario.

Risks stemming from investments should be monitored

The Solvency II regime entering into force at the beginning of 2016 includes some features that are similar to the Basel III frameworks for banks. Both are complex regimes aimed at calculating capital requirements by taking into account, as far as possible, the risk inherent in the business of an individual undertaking, and by using market consistent valuation methods. As in the banking sector, a significant proportion of insurance companies will use internal models in the calculation of capital requirements.

The primary purpose of Solvency II is to improve the cover of policyholders and beneficiaries. Therefore, Solvency II does not include provisions related directly to financial stability, nor can authorities require capital add-ons purely for macroprudential reasons. However, Solvency II includes certain features that dampen the business cycle, such as matching adjustments and volatility adjustments that will reduce the probability of forced sales, thereby minimising systemic risks stemming from insurance companies' large investments. Nevertheless, potential systemic risks arising from insurance companies' investments still need to be monitored closely.

Notes

1. At the end of 2014, the aggregate balance sheet of Finnish insurance companies was 32% of GDP, as against 259% for the banking sector. ↑
2. Non-traditional and non-insurance (NTNI) activities. ↑

Keywords

insurance companies, systemic risks