THE DAMAGING TREND OF LOW INTEREST RATES

The continued policy of low interest rates in many parts of the world might have helped the banks regain financial strength but it has damaged insurers—and regulators must let their policies evolve to reflect the challenges they face, says Mike Morrissey.

Although interest rates have risen a bit from their historic lows of recent years, insurance company investment portfolio yields are still painfully low. Overall portfolio returns are 100 basis points or more under where they were a few years ago. More distressing, insurers now face the disheartening task of replacing maturing bonds that yielded 5 percent to 6 percent with newly issued securities yielding 2 percent to 3 percent. Declines of 300 basis points from old to new bonds are therefore not uncommon.

As a consequence, investment income has declined for most insurers. Considering that most insurers, both life and non-life, depend on investment income for the lion's share of overall profits, the urgency of improving investment returns is great.

Unfortunately, regulators in most jurisdictions around the world are using traditional concepts of riskiness and volatility in their assessment of insurers' investment risk, and in the process hampering the industry's ability to achieve much-needed performance.

Regulators overwhelmingly continue to assume that government bonds are the safest investments in assigning capital charges to different asset classes. While they tend to allow unlimited investment in government bonds, many of which (Italy, Spain, etc) are clearly understood to be volatile and risky, they punish companies who seek returns from other asset classes that history shows are no less—and are frequently more—safe.

For instance, bank loans, infrastructure debt and real estate debt are typically unrated, and are subject to severe capital charges out of line with their historical performance. Structured products are treated harshly by the regulators. Mortgage loans on residential property with low loan to value ratios have proved very safe, and over the long term equities have performed well, but all are discouraged.

Regulatory attitudes about insurer investment portfolio composition have not kept up with changes in the global economy and the capital markets. In the slow growing, low interest rate world we will occupy for the foreseeable future, relying on outdated, pre-financial crisis ideas about risk and volatility will limit insurers' flexibility and their ability to invest appropriately in the challenging markets of today. In doing so, regulators undermine the financial security of the very companies they are supposed to be protecting.

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Traditional investment policies will not produce adequate overall financial results for insurers in the current environment. Keeping interest rates so low for an extended period of time has helped banks regain financial strength, but the collateral damage to the insurance industry has been severe. Insurance regulators must let their policies evolve to permit their companies to invest in a way that recognises the risks and opportunities that exist in the capital markets of the post-financial crisis world. □

Mike Morrissey has been president and chief executive of the International Insurance Society since 2009. Prior to this, he was chief executive of Firemark Investments. He is the global insurance industry representative on the G20 Private Sector Taskforce of Regulated Professions and Industries, a member of the American Risk & Insurance Association, the Asia Pacific Risk & Insurance Association, the European Group of Risk & Insurance Economists, and the Center for Strategic and International Studies. He is a past president of the Association of Insurance and Financial Analysts.