Insurance investment outlook 2025: Navigating evolving markets and regulations

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Key points

- Favourable market conditions and higher yields have helped insurance companies strengthen their balance sheets, boost earnings and restore liquidity buffers over the past few years
- However, a combination of complex market conditions and risks to manage mean insurers have been faced with a difficult environment to navigate in recent years
- They must remain agile to optimise balance sheets and asset portfolios, against a backdrop of easing interest rates, geopolitical uncertainty and evolving regulations

A strong US economy and market, alongside benign economic conditions in Europe and other developed markets have helped insurers strengthen their balance sheets and boost their investment earnings while restoring liquidity buffers. However, looking towards 2025, there is no shortage of political, geopolitical and economic uncertainty.

Donald Trump's re-election as US President could be a gamechanger for financial markets. While there is uncertainty around the new administration's ability to execute its campaign promises in full, these promises are viewed as inflationary - and being priced in as such by the market.

Supply shocks from a potential labour shortage and tariffs, combined with sustained fiscal stimulus, might put pressure on prices and force the Federal Reserve to maintain a certain level of financial restriction. This in turn could dampen the US growth outlook, although from an above trend level, and have repercussions for Europe, China, and the broader emerging market world.

Meanwhile Europe is now facing gloomier economic conditions, marked by concerns over France's public deficit and fiscal tightening and energy costs and broader business model issues for Germany. This should convince the European Central Bank to significantly ease monetary conditions, which could support the region's 2025 growth outlook – albeit with potentially significant downward risks on the radar.

Changing navigation rules

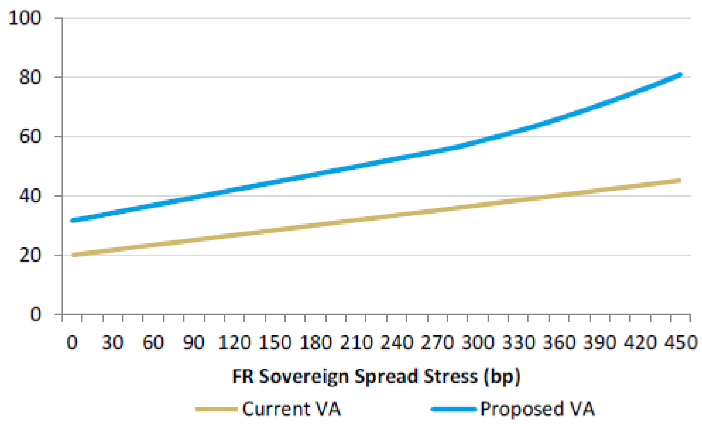
Against this backdrop, a key theme for insurers in 2025 is likely to be volatile interest rates and risk premia amid an uncertain environment. Insurers will need to be agile to optimise balance sheet and asset portfolio management, in terms of both generating investment earnings and risk management.

They will also have to contend with evolving regulatory capital and accounting frameworks, towards more market-consistent regimes – meaning assets and liabilities being valued closer to their market value. Indeed, certain regulatory capital regimes in jurisdictions like Hong Kong or Japan will become more market-consistent than before, capturing market changes and volatility further. The Solvency II[1] review – which sets out regulatory requirements for insurers in the European Union (EU) - is also expected to have an impact in the coming years. Meanwhile, the new International Financial Reporting Standards (IFRS), which entered into force in 2023, should experience their first significant change in macro and market conditions.

Solvency II review

Overall, the insurance industry welcomed many of the changes of Solvency II, notably the reduction of the risk margin, the widening of the symmetric adjustment for equity investments and the enhanced volatility adjustment mechanism. Regarding the latter, the higher application ratio, the duration correction and the smoother activation of the country adjustment will make this counter-cyclical measure more effective.

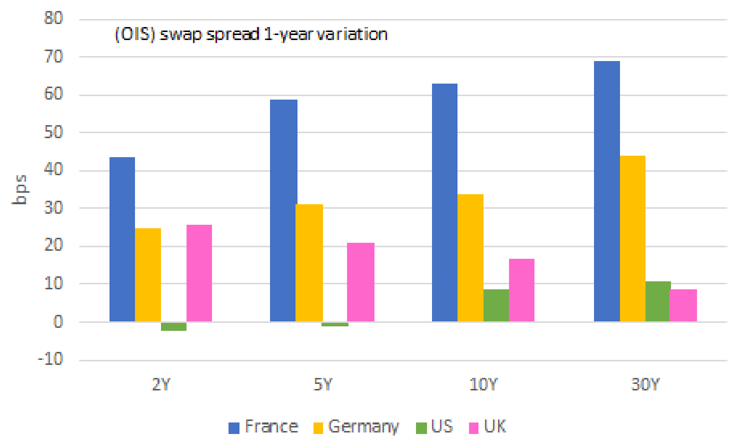
Figure 1: Volatility Adjustment (Total)



Source: Morgan Stanley; Solvency II Directive: Potential Impacts on Sovereign Spread Hedges - Q4 2024 - Current versus proposed VA - The case of France. Market data as of 30 September 2024

But the current volatility adjustment rules will continue to apply in the short-to-medium term and have shown their limited absorption capacity. Indeed, the recent significant widening of swap[2] spreads on euro-denominated government bonds, provoked by both technical and fundamental dynamics (quantitative tightening, structural budget deficits, debt supply and sustainability) has hit fixed income portfolios more strongly than the best estimate liabilities' value and thus negatively impacted insurers' capital positions. The current context of uncertainty calls for a close monitoring and management of this swap spread risk in balance sheets.

Figure 2: Cheapening government bonds is a global phenomenon



Source : BarclaysLive – 28 November 2024

Another noticeable change in the standard formula is the new method to extrapolate the discount curve used to value liabilities, which will increase the sensitivity of liabilities to changes in market interest rates. More precisely, the significant sensitivity at the 20-year point resulting from the current method is reduced with the new approach, while longer dated liabilities will be more sensitive to market movements.

This reinforces the need to manage duration gaps closely, especially for life insurers with long-dated liabilities and when considering worst case scenarios where 'risk-free' rates would be significantly pushed downward. In addition, the change in the calculation of the interest rate risk solvency capital requirement under the new formula, with more severe interest rate shocks compared to the current method, will make asset liability mismatches even more punitive.

The amended Solvency II directive will be published by the end of 2024. While the European Insurance and Occupational

Pensions Authority is providing draft technical standards, EU member states will then focus on implementing the legislation into their national frameworks. The new rules will start applying two years after the directive comes into force, and there will be transition periods before a full implementation of the new rules - but insurance companies will have to get prepared for the adjustments.

IFRS 9 and 17

Another significant change in the framework of insurance companies is due to the new international accounting standards IFRS 9 and IFRS 17 which came into force in 2023.

In brief, IFRS 9 impacts the classification and measurement of financial assets while IFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance liabilities. On its own, IFRS 9 cannot be classed as a gamechanger relative to the previous IAS 39 standard,[3] although it may bring more volatility to profit and loss (P&L) statements depending on the investment choices made.
IFRS 17, which replaces IFRS 4, has far more structural consequences. In fact, it represents the most significant change to insurance accounting requirements in 20 years and requires insurers to entirely overhaul the way they steer their financial statements.

The purpose of IFRS 17 is to better reflect economic reality and to improve comparability. IFRS 17 does not change the economics, cash or capital aspects of an insurance product. It does, however, require the measurement of insurance contracts at their current value – changing the composition and valuation of the balance sheet components.

In addition, profits will now be recognised as the insurer delivers insurance or investment services, rather than when it receives premiums, as could be the case under the previous regime which deferred to local rules. This will alter the amount of profits recognised in each reporting period and their presentation. What are the likely outcomes? We expect financial results to be more stable for life with-profit business lines but more sensitive to changes in interest rates and more volatile for property and casualty and other protection business lines.[4]

The combined effect of these standards, depending on the type of insurance contracts involved, may also have notable implications for how insurance companies can structure and manage their asset portfolio. This makes it paramount to understand how these new regimes interact.

Extra flexibility

One important observation is that insurers who run life with-profit books of business can benefit from much more flexibility to structure and manage asset portfolios, where they are not constrained by local (i.e. different) accounting rules. This is because returns from portfolios backing certain contracts with direct-participating features (those which are valued using the so-called Variable Fee Approach model - VFA) do not directly hit the P&L statement.

The performance effect impacts the P&L only progressively through the 'Contractual Service Margin' which amortises returns in the P&L over the life of an insurance contract. In practical terms, we think this can translate into more actively managed portfolios. In an expected scenario of lower (or still low) interest rates in certain economies (Europe and Japan in particular) in which investment earnings would be dampened by lower reinvestment yields and diluting book yields, this increased flexibility can become an opportunity to generate higher total returns and to maintain investment earnings.

This can be done by exploiting a wide range of investment tools and formats such as derivatives-based strategies[5] or open-ended funds, including exchange-traded funds (ETFs).

For other asset portfolios backing non-participating life or property and casualty contracts (under measurement models known as the Building Block Approach and Premium Allocation Approach),[6] IFRS 9 constraints apply fully. This means insurance companies who want to minimise P&L volatility have strategic choices to make. For accounting purposes, insurers must classify the assets in these investment portfolios in one of several ways – the most pertinent in this discussion being 'fair value through P&L' (FVTPL) or 'other comprehensive income' (OCI).

- Insurers who have most of their assets classified as FVTPL under IFRS 9 will see their P&L volatility partially compensated. This is because liabilities (the value of claims) are now discounted based on market-consistent interest rates. This effect is recognised in the P&L by default under IFRS 17. In this case, we think a proper asset liability duration matching should allow clients to maximise this compensation, which advocates for well-designed and liability-aware fixed income portfolios

- Insurers who have most of their assets classified as OCI are highly likely to have elected the OCI option under IFRS 17. This has the effect that the impact of interest rate changes on their liabilities' value is recognised in the OCI and not in the P&L. In this case, we think that maximising the portion of assets that can be classified as OCI is key to mitigate P&L volatility

We believe that insurers managing asset portfolios backing non-participating life or P&C contracts with most assets classified as OCI should consider favouring dedicated fixed income solutions and assets compliant with the 'SPPI' test rather over open-ended funds, which are classified as FVTPL by default under IFRS 9.[7]

This suggests the application of a more traditional 'buy and maintain' fixed income management approach which, in a scenario of lowering interest rates, will likely suffer from lower reinvestment yields and diluting book yields. There are other concerns for insurance companies managing P&C portfolios.

Indeed, for P&C contracts under the IFRS 17 'premium allocation approach' model, current year claims – which may not be paid out for several years – are accounted for using current year interest rates. This can have the effect of boosting results as a nominal claim amount can be discounted, thereby lowering the combined ratio (claims set against earned premiums).

However, as time goes by the discounting of prior years' claims reserves is unwound at locked-in rates, which may negatively impact the P&L. This makes technical results of P&C insurers even more sensitive to changes in interest rates and thus more volatile under IFRS 17. In other words, a significant decrease in interest rates following a period of high interest rates would hit the P&L of the current year (increase in the combined ratio).

Insurers have always sought to manage their reinvestment risk, but this should now become even more important considering the possible scenarios of lower interest rates ahead. Specific hedging techniques can be more easily implemented in custom fixed-income solutions combining bond and derivatives investing.

But more importantly, enhanced buy and maintain fixed income strategies can be implemented to aim to mitigate the dilution of book yields and maximise investment earnings. We think insurers should also increase diversification to reduce their impairment risk, which is based on an expected credit loss model under IFRS 9.

Implications for insurers' portfolios

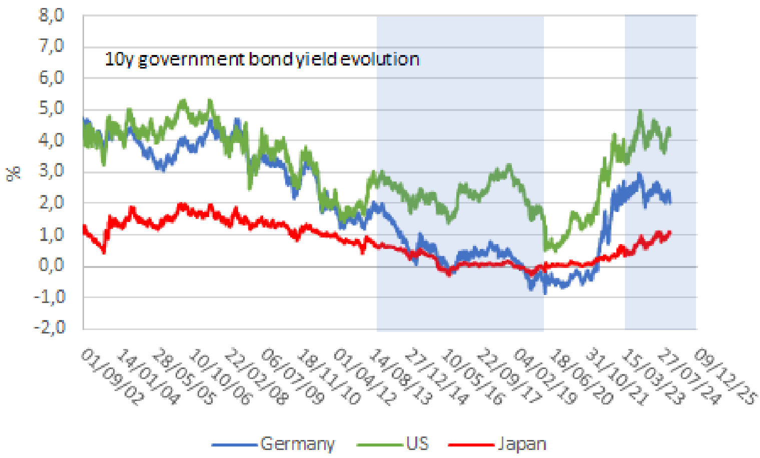
Given the uncertainty over macroeconomic and market conditions and the complex combined effects of more market-consistent regulatory capital frameworks and IFRS standards (and their potential interactions or contradictions with local accounting and regulatory capital rules), there is a risk of turbulences for insurance companies ahead.

We think that two main strategies should remain in focus for 2025. First, strengthening the management of financial risks in balance sheets to aim to protect capital positions and second, boosting fixed income management strategies to seek to maximise or at least protect investment earnings.

Strengthening financial risks in balance sheets

This is where a hint of sophistication can make a difference. Market-consistent regulatory capital regimes which establish or reinforce the alignment of the value of liabilities with market sensitivities call for a more disciplined monitoring of duration and convexity gaps. This is even more needed when interest rates are expected to decrease and/or to follow a volatile trajectory.

Figure 3: A potential US/euro rates divergence



Source : BarclaysLive – 28 November 2024

An open gap[8] in a decreasing rates environment, especially when long-dated life liabilities embed minimum guarantees and options, can severely hit capital ratios. If we add to that more severe interest rates shocks and subsequent capital requirements, there is a potential double penalty to come.

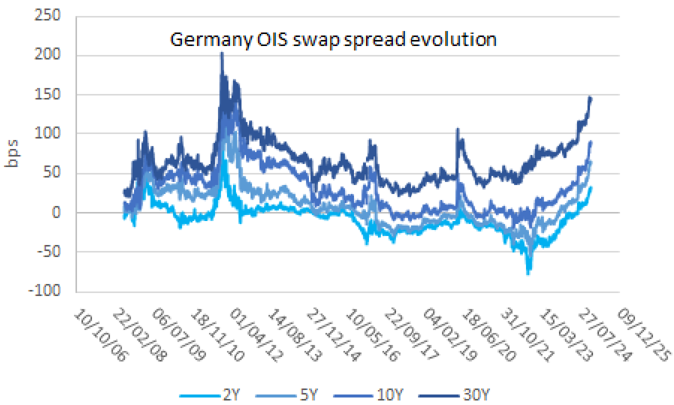
Insurers who still have a gap open may wish to close it while yields are still at decent levels and to strengthen their monitoring and management capacities when needed. They could tackle this by developing or reinforcing the required setup to make efficient usage of interest rate derivatives in a secured manner, that is to say with a robust liquidity risk and collateral management framework.

In this regard it is potentially better to implement derivatives close to available collateral assets and to favour margining with securities when possible, which many UK pension schemes have certainly factored in since the liability-driven investing crisis in autumn 2022.

An efficient and secured use of derivatives, such as interest rate swaps or options, can have multiple benefits. First, it allows hedging programmes to be implemented quickly and without rotating fixed income portfolios too much, which could realise unwanted accounting impacts. Second, in a context of uncertainty and tight spreads in the corporate bond space, derivatives allow distinguishing between the interest rate and the credit risk factors and can provide flexibility in the management of the credit exposure which becomes less dependent on liability-matching objectives.

As discussed, another financial risk to insurers' balance sheets is the swap spread risk on government bonds, which have a significant place in strategic asset allocations. For insurers applying the Solvency II standard formula, the volatility adjustment is a structural risk mitigant. The Solvency II review will factor in insurers' specific characteristics in the volatility adjustment spread computation, but this mechanism will never hedge the entire risk borne in asset portfolios and the current approach, which is more uniform, will continue to prevail in the coming years.

Figure 4: Euro swap spreads at recent highs



Source : BarclaysLive – 28 November 2024

We think that insurers should reassess the opportunity to diversify their swap spread risk, within their currency area but also potentially through investments denominated in foreign currencies. With well-designed hedging strategies (e.g. cross-currency asset-swapped foreign government bonds), diversifying can even in some instances contribute to maximising investment earnings in addition to reducing risk. Insurers might also consider the use of derivatives-based hedging strategies such as 'spread-locks' and credit default swaps.

More generally, we believe that derivatives-based risk management overlays are valuable tools to manage financial risks in an insurer's balance sheet. Overlay strategies can be seen as an insurance, and insurers are well placed to know that one does not subscribe to an insurance once the risk occurred.

Risk management overlay strategies can be efficient ways to protect an insurer's own funds, and can also contribute to optimising the return on capital by reducing the solvency capital requirements related to certain market risks, provided that the design is compliant with the risk mitigation techniques and rules specified by the regulator. As for any insurance, a derivatives overlay can cost a lot without paying off, and this is an area where expertise and advanced derivatives management techniques can make a difference.

Boosting fixed income management strategies

This is where a pinch of agility can make a difference. For fixed income portfolios backing P&C or non-participating life businesses (non-VFA portfolios), the transition to IFRS 9 and 17 has fewer implications than for portfolios backing life participating businesses. The impact of management actions and asset rotations in the P&L continues to be a key focus, both under IFRS and under local Generally Accepted Accounting Principles (GAAP), the latter remaining the reference to determine the potential of return to policyholders and shareholders. Consequently, the traditional buy and maintain approach continues to dominate. In a scenario where interest rates and yields decrease, a key risk for insurers is a potential progressive dilution of book yields and subsequently a reduction in investment earnings.

There are multiple actions that can mitigate this risk. Diversifying across geographies and market segments is not only a way to mitigate credit and spread risks, but also the only way to broaden the playing field and to capture more relative value opportunities. There are different degrees of possible diversification in a fixed income portfolio, the ultimate step being to implement a global multi-sector approach and to exploit the entire risk spectrum across developed, emerging, public and private markets.

For instance, for a similar level of rating, certain asset-backed securities can potentially exhibit a significant spread pick-up compared to corporate bonds. Of course, the spread relative value is not the only decision factor and insurers should pay attention to the capital treatment and to the impact on the liquidity profile of the whole portfolio. When diversifying into foreign credits, the efficient hedging of unwanted risks, namely foreign currency and interest rate risks, is paramount. Diversifying across maturities, mindful of expected future cashflows, is also a way to mitigate the reinvestment risk.

Beyond diversification, and even though non-VFA portfolios remain constrained, insurers can implement a more agile and active investment management approach. Buy and maintain can be traditionally understood as a strategy in which asset sales and rotations are mostly triggered by expectations of credit deteriorations. However, insurers can consider an enhanced buy and maintain approach where optimising earnings supersedes the more common goal of maximising book yield.

For a fixed income matching portfolio under accounting and capital constraints, a more active management approach requires a more thorough and systematic monitoring of market relative value opportunities, return on capital requirements, and unrealised gains or losses per maturity bucket. This allows insurers to identify possibilities of accounting compensation, meaning ways of rotating assets with minimal accounting impacts and to optimise the management of the reinvestment risk in the portfolio. That said, when expecting interest rates and yields to decrease, selling short-dated bonds at an accounting cost can be relevant if it allows locking in a higher stream of earnings for a duration which extends well beyond the loss 'payback period'.

Derivatives can also potentially bring value in an enhanced buy and maintain fixed income solution, especially as derivatives like to sit close to their source of collateral. It should be noted that for non-VFA portfolios, IFRS 9 fully applies and derivatives are classified as FVTPL by default, requiring hedge accounting techniques to neutralise or mitigate the P&L volatility.

For asset portfolios backing life participating businesses, the opportunities offered by the new IFRS are much bigger. Asset rotations do not impact the P&L directly, but only progressively through the amortisation[9] of the Contractual Service Margin which absorbs by the risk and return of the asset portfolio. This brings much more flexibility and allows for the implementation of a true total return strategy and the use of a much broader set of instruments and strategies. For instance, open-ended funds, including ETFs, or derivatives can be used without any direct impact in the P&L.

There are limitations to this, including:

- Portfolios remain constrained by the necessity to properly match liabilities and to manage duration and convexity gaps (the sensitivity of the duration gap to interest rates) closely. In these cases, an enhanced buy and maintain approach may be more suitable

- Portfolios still must be optimally managed under local GAAP to steer the distribution to policyholders and shareholders. Insurers can be treated differently depending on their jurisdiction and discrepancies between the IFRS and the local accounting framework can be more or less pronounced and constraining. For instance, IFRS 17 has been transposed into the local framework in Hong Kong, giving more flexibility to the new standards. In France, there are still significant differences, but total return strategies can be implemented in dedicated funds which are not looked-though[10] nor consolidated but subject to impairment risk. Total return strategies require more precautions and a robust risk management framework. We think that managing these strategies under a Value-at-Risk budget, associated with a total return objective appropriate, especially when the impairment risk has to be factored in.

For all these reasons, insurance companies' asset portfolios will likely never be entirely managed under a total return approach and the proper balance remains to be empirically and theoretically defined.

But insurers should not wait for the new framework to be tested and proven before getting prepared and taking action. Insurers which are not subject to IFRS might also consider the opportunity to strengthen their investment management approach.

[1] Solvency II - EIOPA

[2] Swaps – an agreement between two parties for a financial exchange at a set time/frequency
[3] International Accounting Standards
[4] A with-profits product in effect allows a policyholder to benefit from profits the insurance company earns on its investments, while paying a higher premium to do so.

[5] A financial contract where its value is based on the value of an underlying asset
[6] How to choose the measurement model, Institute and Faculty of Actuaries, retrieved June 2023
[7] SPPI refers to 'solely payments of principal and interest' test which would rule out all equity and derivatives investments, as well as certain bonds which may carry equity-like risk.
[8] A negative gap where liabilities have a longer duration compared to the duration of the assets backing the liabilities

[9] A strategy used to over a period of time decrease the book value of a loan or other asset
[10] Look-through: Under French GAAP a dedicated fund is accounted as one line in the balance sheet, instead of the underlying assets/components appearing separately in the balance sheet