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Finding value: How smaller insurers can compete

It's no secret that insurers have faced a challenging environment over the past decade. Stunted interest rates, low bond yields and a tighter regulatory environment have all buffeted the sector. Large insurers, with their significant human and capital resources, have been better able to bring in the necessary expertise, create operating efficiencies and diversify their sources of risk to protect against these headwinds.

Small and medium insurers, on the other hand, have felt the changes particularly acutely. One possible characterisation of a small insurer is having less than £100 million of gross written premiums and best estimate liabilities of less than £1 billion, these insurers are constrained by fewer resources, a less diversified line of business and a lower degree of flexibility when it comes to managing their business in general and particularly their investment portfolios.

Even so, it is still possible for them to derive value in the evolving insurance environment, within their current resource constraints – and this can be simpler than insurers would suspect.

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The challenges facing smaller insurers

The insurance industry has been confronted by multiple challenges in recent years, the effects have been amplified for smaller insurers for a couple of reasons. For starters, certain functions that are performed in-house at large insurers – such as oversight of investment management or actuarial work – can be outsourced to external firms. In some cases this may result in the investment side of the business not effectively communicating with the underwriting side of the business which may lead to inefficient asset-liability management. This may also result in suboptimal allocation of risk between assets and liabilities and use of regulatory capital.

In a similar vein, smaller insurers face a higher degree of balance sheet volatility. This is a function of comparatively less diversification in their assets and liabilities which increase the balance sheet sensitivity to market shocks and liability events.

Another challenge for smaller insurers is the regulatory environment in which they operate. In some jurisdictions, smaller insurers may be forced to rely on prescribed regulatory capital calculations due to the lack of resource and inherent complexity of using available bespoke methods. This can limit their flexibility in terms of available asset classes as prescribed methods tend to be more penal for certain assets such as unrated debt, for which bespoke methods may be relied upon to justify a less penal treatment. This is certainly true for many risk-based regulatory regimes such as Solvency II. On top of all of this, the tendency of smaller insurers to focus on a small market or a closed demographic means they have less diversified and more vulnerable sources of revenue. This has led to a flurry of mergers and increased consolidation at the smaller end of the market as insurers seek to ensure their survival.

Four steps to sustainability

While the market has become more complicated, we believe this presents an opportunity for smaller insurers. We have identified four areas where small and medium insurers can quickly and efficiently realise value.

1. Balance sheet and risk budget review

The world in which insurance companies operate has gone through a seismic shift over the past decade, making it important for insurers to perform a comprehensive review of their risk appetite and risk exposure, to ensure they are not exposed to unrewarded risks. We already know that insurers have been forced to reposition their portfolios to take into account low interest rates, high asset values and paltry bond yields. The next leg in this exercise is to consider how the future economic risks specific to the insurance industry, such as falling premiums, increasing reinsurance rates and rising long-term interest rates, may affect the insurer's balance sheet.

The key objective would be to understand how the asset and liability risks behave relative to one another and how this could be categorised.

2. Update the risk management statement

After reviewing risk budgets, insurers should reflect any changes in their risk management statement. This needs to be articulated in a quantitative and measurable manner that can be understood and easily repeated. For example, insurers may want to consider whether the risk budget between investment and underwriting risk reflects the evolving environment as well as the most applicable capital measure to reflect these risks.

3. Review asset liability management

Given that profit levels and balance sheet strength are centrally important factors for insurers, it makes sense to conduct a review of asset liability management. This involves identifying key scenarios and stresses that may have a significant negative impact on profitability and balance sheet strength. It is particularly important to identify any liability risks that may be correlated to investment risks in the portfolio and manage these relationships.

For example, during economic and market downturns claims tend to increase as a result of several factors, for example, higher criminal activity, more 'notification of claim' events as insureds are less able to absorb costs than in boom times, and so on.. Moreover, a recession can cause lower returns on risk assets at the point when higher returns are required to balance out a potential knock to the underwriting performance. This can result in a mismatch between assets and liabilities, depending on the relative exposures.

4. Position portfolios to reflect new risk appetite

Having reviewed the risk budget, understood the relationship between assets and liabilities under normal and stressed conditions and identified an improved way to match assets and liabilities the final step is to position the investment portfolio to reflect these changes and maximise the margin over required investment returns. This is an important step for smaller insurers because they do not have the resources or budgets to invest in a broad range of asset classes. A good asset manager should provide access to assets in a capital-efficient manner and be able to understand and manage the asset-liability risks.

Straightforward solutions with clear benefits

A focus on 'low hanging fruit' reduces the cost and time a required to strengthen the insurers business position

A more robust balance sheet that is somewhat immunised against the most adverse outcomes to the insurer

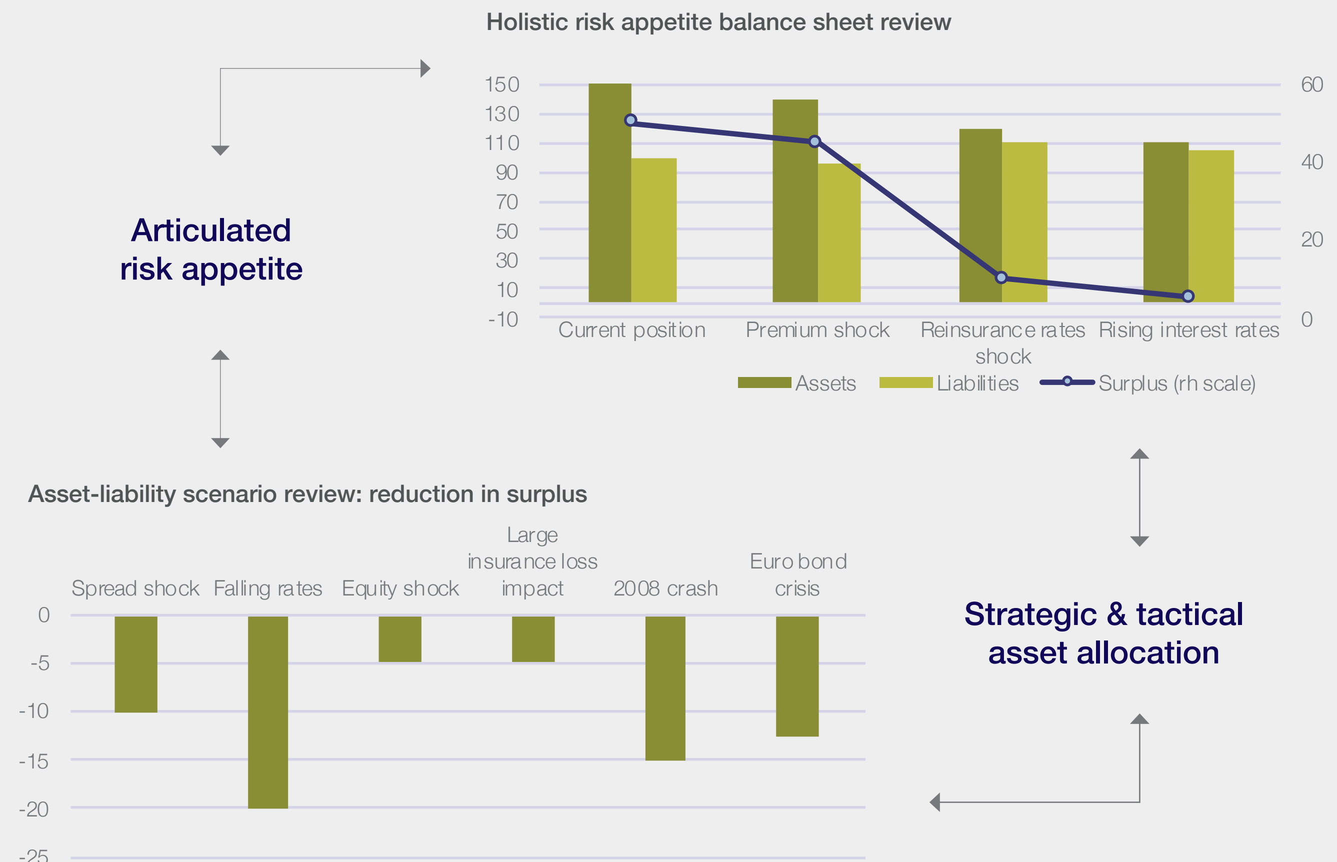
In most cases a natural outcome of this type of approach will be a lower and more efficient regulatory capital position (Solvency II focuses on the 1 in 200 event which would systematically be accounted for with this approach)

Working with an investment manager that understands and can execute investment strategies in line with insurers liability requirements creates a positive feedback loop that should result in a stronger portfolio and balance sheet over time

A more efficient capital position allows release of assets that may be used to improve ALM or seek extra return

If you'd like to discuss this further with Kate or another member of the team, please don't hesitate to get in touch. Either give us a call on +44 20 7396 3200 or alternatively email insurance@londonandcapital.com

Risk management in practice



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