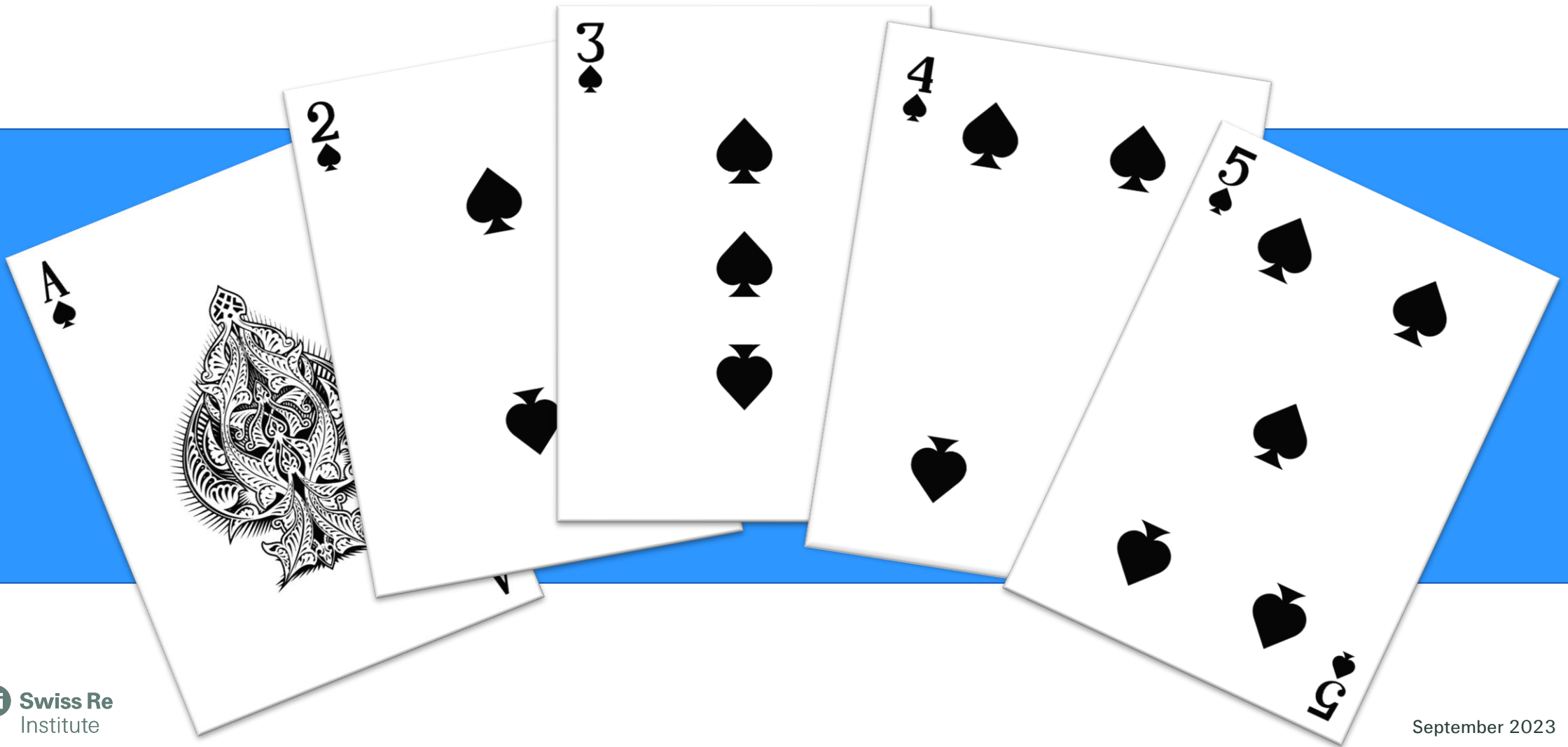


# *sigma* 4/2023: Raising the bar: Non-life insurance in a higher-risk, higher-return world

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# Setting The Scene



Key figures...

+100<sub>bp</sub> = +250<sub>bp</sub>

## Economic outlook: Recession delayed is not a recession avoided with global growth expected to slow down significantly and core inflation remaining sticky

- **Growth outlook:** Recession risks will remain elevated, with risks most pronounced in Europe
- **Inflation:** Still the key macro risk, even as headline inflation is falling. Core inflation remains significant and persistent
- **Interest rates:** Significant central bank policy divergence going forward, though the bar for rate cuts is very high
- **Balance of risks to the downside:** More monetary tightening given sticky inflation pressures

	Swiss Re Institute			Consensus	
	2022	2023	2024	2023	2024
<b>Real GDP (% change)</b>					
US	2.1	2.1	0.9	2.0	0.9
Eurozone	3.5	0.4	0.3	0.6	0.9
China	3.0	4.8	4.2	5.1	4.5
<b>CPI (% change)</b>					
US	8.0	4.0	2.5	4.1	2.6
Eurozone	8.4	5.5	2.6	5.5	2.6
China	2.0	0.7	1.9	0.7	1.9
<b>10y Gov. Bond Yield (%)</b>					
US	3.9	3.9	3.5	3.9	3.6
Eurozone	2.6	2.5	2.3	2.3	2.1
China	2.8	2.6	2.8	2.1	2.7
<b>Central bank rate (%)</b>					
US	4.375	5.38	4.38	5.38	4.13
Eurozone	2.5	4.5	3.5	4.25	3.75
China	2	1.7	1.6	N/A	N/A

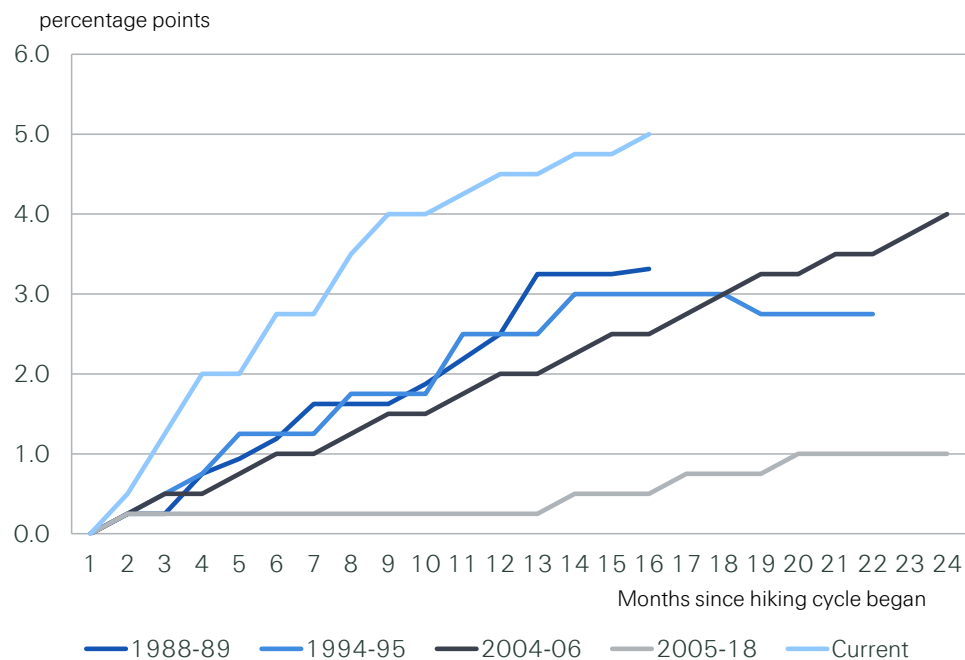
Source: Bloomberg, Swiss Re Institute

Note: SRI forecasts and consensus figures as of 7 September 2023

# Goodbye financial repression! The unprecedented tightening of monetary policy over the past 18 months has driven a sharp increase in the cost of capital

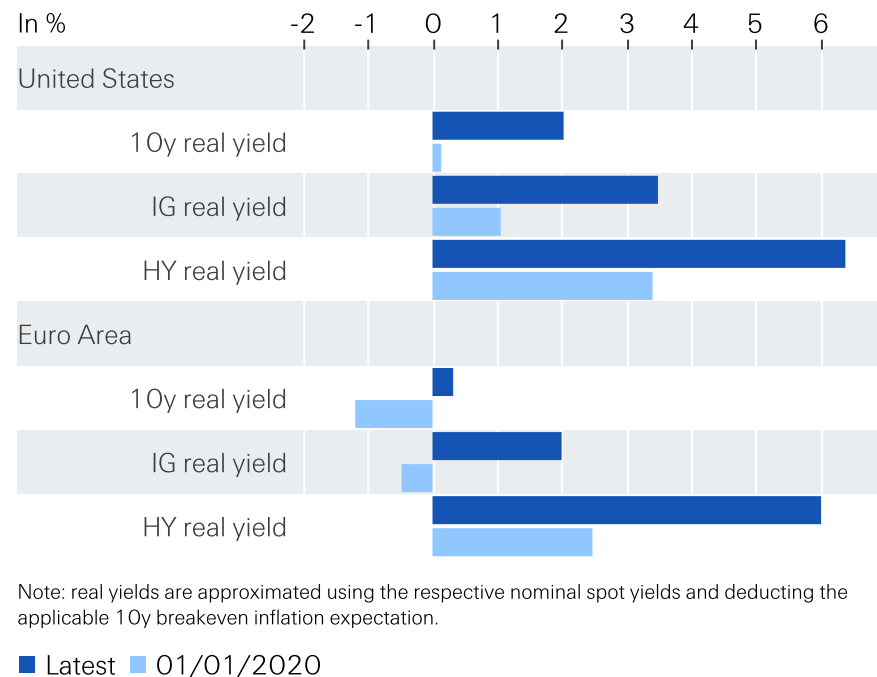
- The **2022-23 hiking cycle was the most intense tightening of monetary policy since the 1980s**
- The **end of financial repression** – policies that result in returns below the rate of inflation – is **generating strongly higher investment yields** as the **real cost of capital has risen sharply** to more normal levels

**US: Current hiking cycle is the fastest in 40 years**



Source: Macrobond, Swiss Re Institute

**US and Euro Area Real Yields**



Note: real yields are approximated using the respective nominal spot yields and deducting the applicable 10y breakeven inflation expectation.

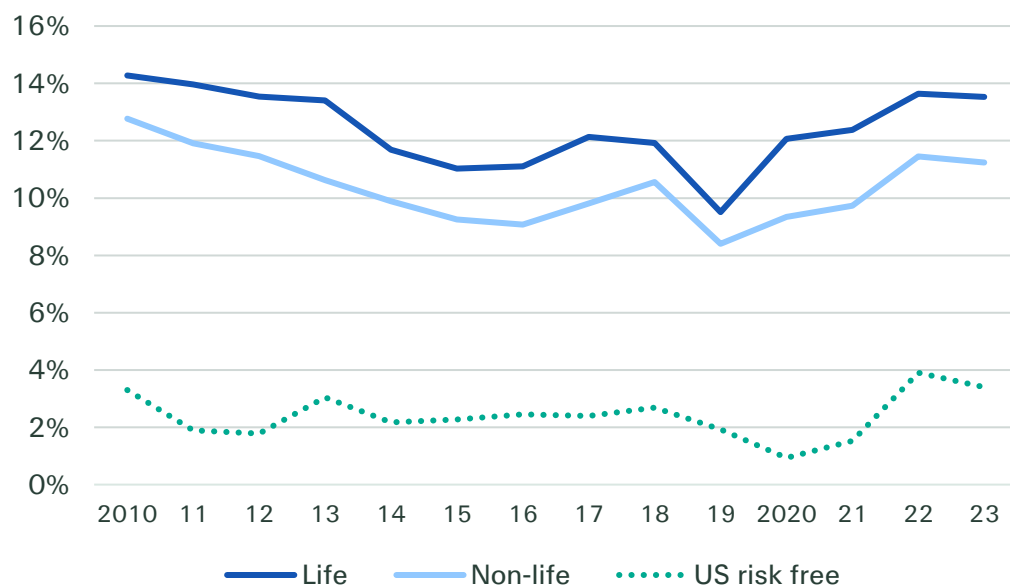
■ Latest ■ 01/01/2020

Sources: Bloomberg, Macrobond, Swiss Re Institute

# Insurers didn't earn their cost of capital which has risen now to its highest in more than a decade

- **Insurers overall did not earn their ROE targets** in the ultra-low interest rate era after the global financial crisis in 2008<sup>1</sup>
- **Higher interest rates and equity risk premia** have raised **Cost of Capital (CoC)** and profitability benchmarks significantly since 2020 (+170 bps global P&C, +110 bps global L&H)
- **European insurers saw the strongest rise in CoC of all regions**, reflecting a **larger jump in risk-free rates** (although not in Switzerland). Japan and China experienced the lowest increases/decline in non-life CoC

## Global shareholder equity weighted CoC estimates; 2010-2023



## CoC estimates by country and sector; 2021 vs 2023

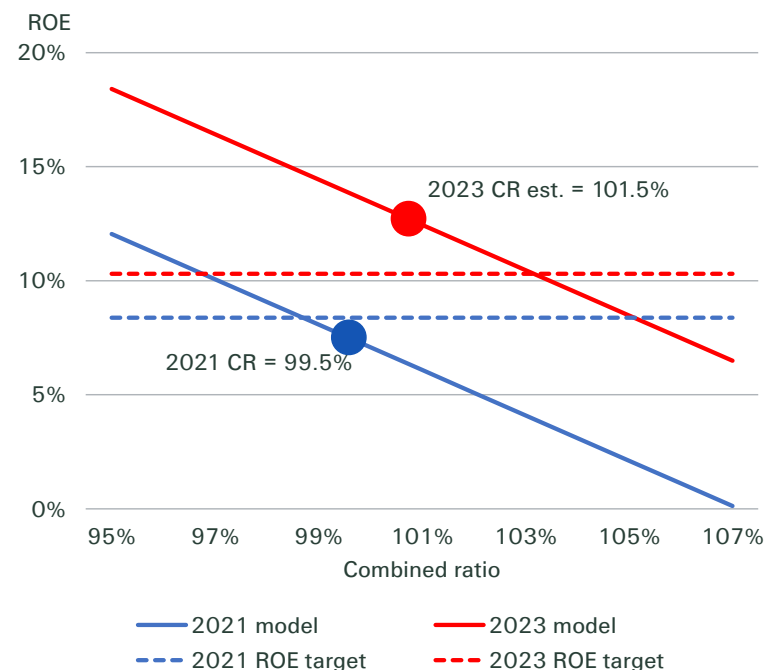
	Non-life CoC		Life CoC		SRI risk-free		Delta
	2020	2023E	2020	2023E	2020	2023E	
US	7.5%	10.2%	10.9%	13.5%	0.9%	3.6%	2.7%
Canada	7.4%	9.5%	10.4%	12.5%	0.9%	3.0%	2.1%
UK	7.8%	11.7%	10.8%	14.7%	0.3%	4.1%	3.8%
Germany	9.5%	12.6%	4.8%	7.9%	-0.6%	2.5%	3.1%
Italy	11.4%	14.7%	11.3%	14.6%	0.5%	4.1%	3.6%
Switzerland	7.0%	8.9%	7.9%	9.7%	-0.5%	1.3%	1.8%
Japan	7.0%	7.9%	6.2%	7.1%	0.0%	0.6%	0.6%
Australia	8.3%	10.8%	9.0%	11.6%	1.0%	3.5%	2.5%
South Korea	9.9%	11.4%	11.8%	13.4%	1.7%	3.3%	1.6%
China	12.1%	11.7%	13.7%	13.4%	3.1%	2.8%	-0.3%

Source: Bloomberg for equity risk premia and betas, Swiss Re Institute for risk-free rates

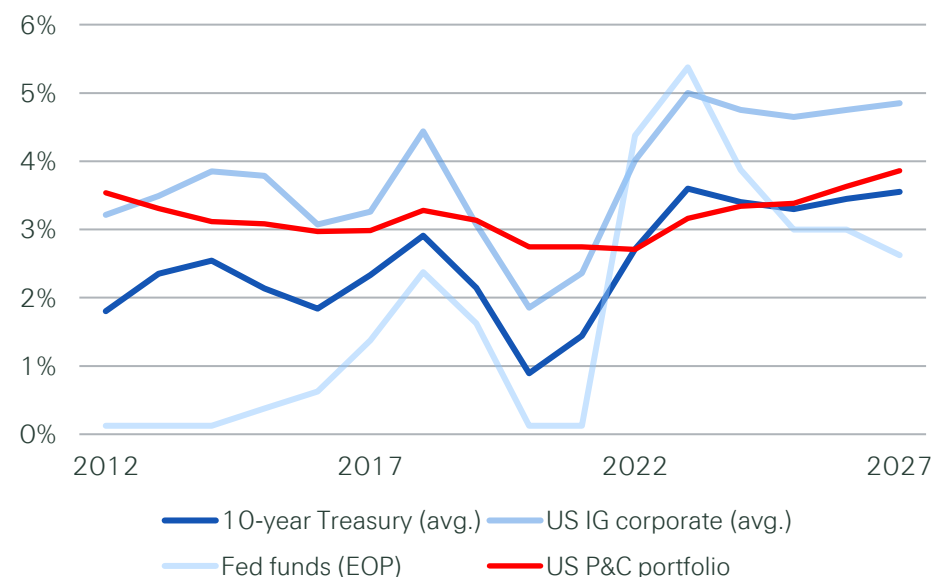
## Looking ahead, profitability gains from higher yields far outweigh the rise in Cost of capital (CoC)

- **100bps additional investment yield is roughly equivalent to 250bps improvement in the combined ratio for the average non-life business. The 240bps rise in reinvestment yields from 2.8% in 2021 to 5.2% in 2023 is equivalent to roughly 600bps of CR**
- **The profitability impact accrues gradually due to the relative size of legacy liabilities, with a six-year average time to maturity for the P&C industry fixed income portfolio**

### Interest rate sensitivity of US P&C new business: 2021 vs 2023



### Portfolio yield and predictions for US insurance segments



## Underwriting cycle (I/II): P&C hard market momentum likely to last through 2024 with new capital flows a key downside risk to watch

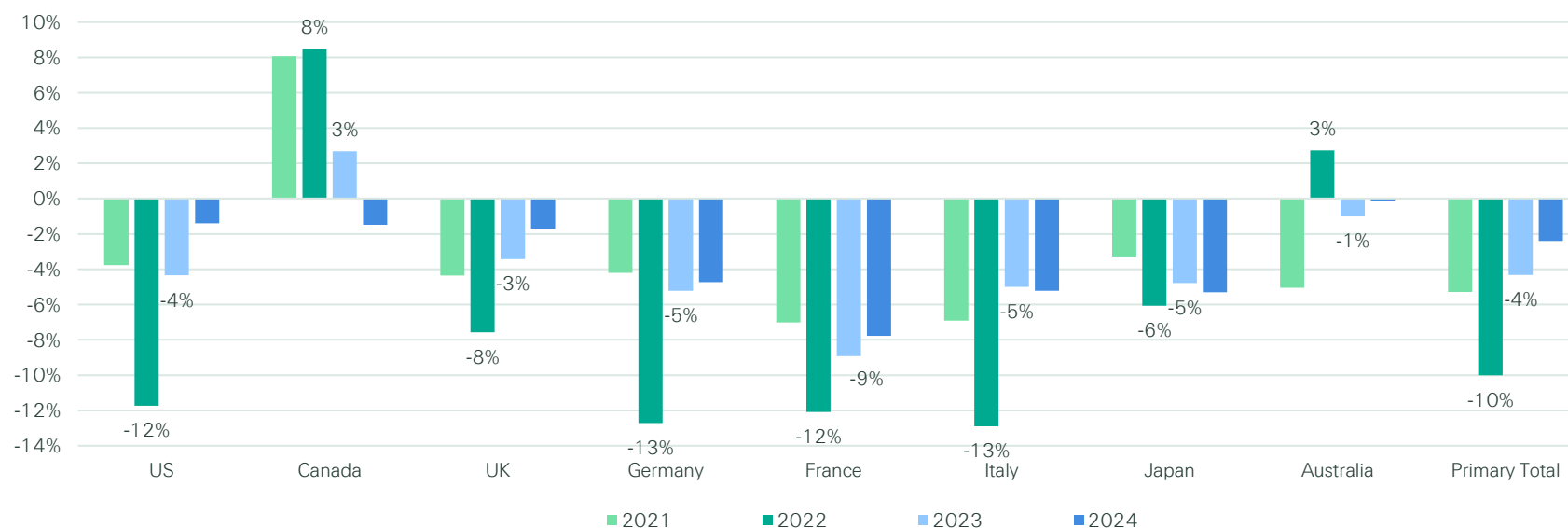
- **Traditional capacity is restrained while new business can be written on profitable terms**
- We attribute most of the current step-up in prices to **uncertainty around claims trends** (including **reserves adequacy**) and the **negative effect of higher interest rates on industry assets and capital**
- **Large capital inflows are a downside risk** to the staying power of the **underwriting cycle**

Component	Current trend	Medium-term trend
Underwriting profitability of new business	Improving	Higher than recent years
Catastrophe losses	Recalibration to higher trend, model uncertainty	Global exposure growth at 5-7% real p.a.
Claims trends	Elevated: inflation surge, post covid and war-related uncertainties	Disinflation; social inflation and model uncertainties continue
Investment yields	Up for new investments, repricing of yield curve	Reset at higher level (compared to pre-covid), steepening of yield curve
Traditional balance sheet capital	19% Below year-end 2021 (as of June 23)	Recovery (partial)
Alternative capital	Muted interest from long-term investors	Continued growth of cat bonds

## Underwriting cycle (II/II): The hard underwriting cycle is not over with insurance profitability gap narrowing but not closing yet in key markets

- **Higher interest rates strongly benefit new P&C business:** 100bps extra yield equivalent to ~250bps combined ratio improvement
- The primary **P&C insurance profitability gap will narrow, but not close in 2023 and 2024** in key markets
- All estimates point to more **attractive insurance profitability in 2023 and 2024**. Still, **capacity and competition are constrained by uncertainty over claims trends** and the **impact of higher interest rates on assets and capital**

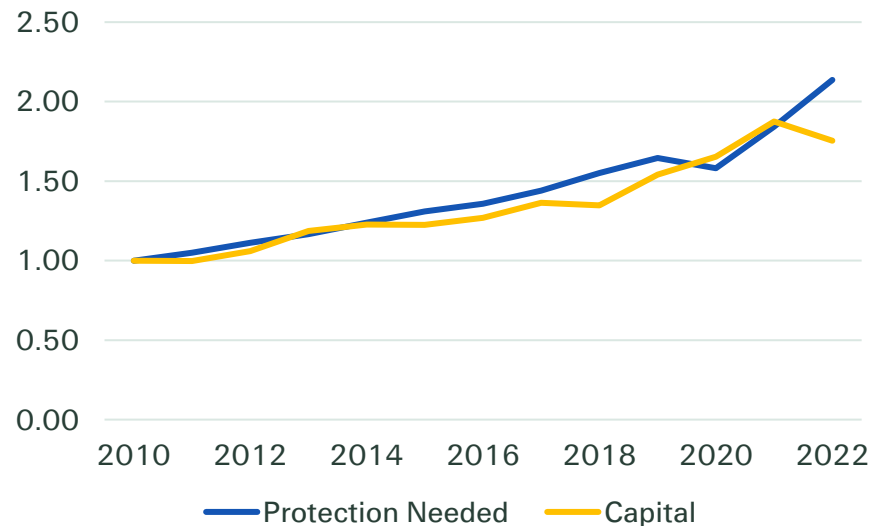
Evolution of the P&C profitability gap in % of NPE, 2021-2024



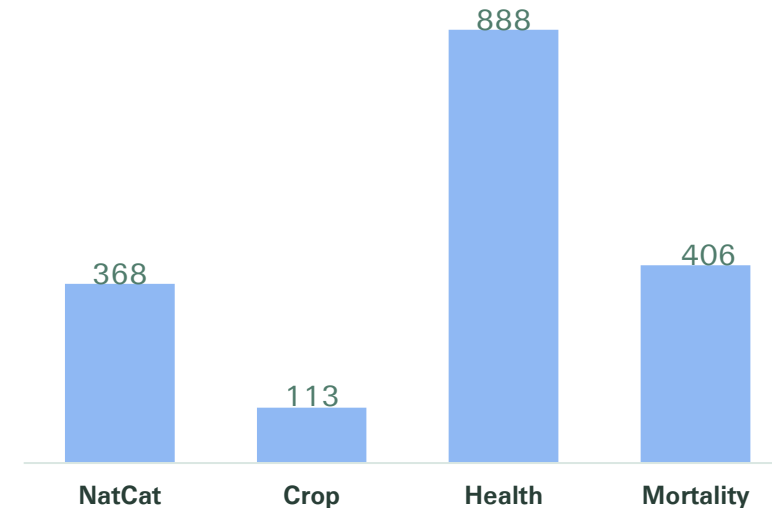
## Insurance sector's strategic role in narrowing protection gaps is being strengthened with the end of (nominal) financial repression

- The insurance industry is only sustainable if it can compensate the production factors (including CoC) and grow its capacity to meet the need of future demand
- After the decline in asset markets in 2022, a gap has opened between US industry capital and protection needed
- To narrow the global nat cat protection gap, P&C industry capital needs to outgrow nat cat exposures, which accumulate at a long-term pace of 5 to 7% per year in real terms

US: nominal nat cat protection needed and P&C industry capital index, 2010 = 100



Global protection gaps, USD 1.8 Trillion in 2023



Figures are shown in annual premium equivalent terms.  
Source: *sigma 2/2023*: Restoring resilience: the need to reload shock-absorbing capacity

## Key takeaways



The inflation surge and quickest monetary policy tightening since the 1980s have changed the landscape for insurers, elevating risks and potential returns



The interest rate benefit to new business, especially long-tail, is significant, but overall improvement including legacy liabilities is more gradual

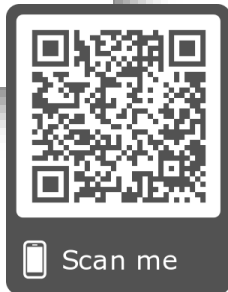
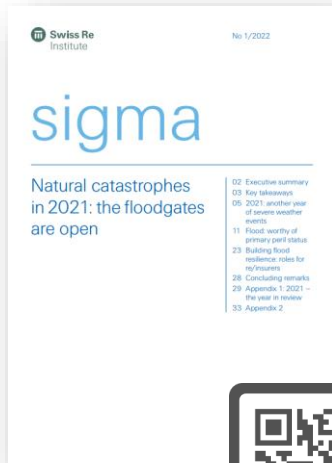


The benefit from higher yields outweighs the higher cost of capital and puts the industry on a more sustainable path, supporting lower protection gaps

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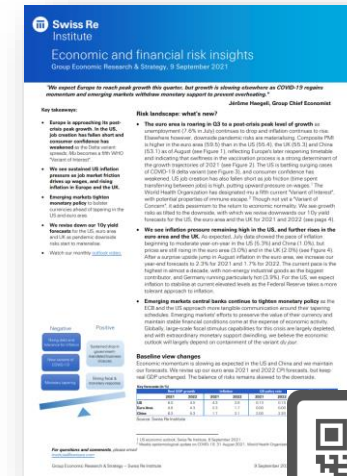
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