Swiss Re

New Swiss Re *sigma* study examines how inflation impacts insurers and ways to respond to the challenge

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Zurich, 19 October 2010 – Recent commodity price spikes and the current easy monetary policy have increased inflation concerns. Many insurers have identified it as one of their key risks. Swiss Re's latest *sigma* study "The impact of inflation on insurers" finds that insurers can limit the impact of inflation on investment returns, asset valuations and future insurance liabilities by using inflation hedges, adding index clauses to contracts and buying reinsurance.

Inflation is the economic phenomenon of increasing prices for goods and services. It impacts insurers' claims and general expenses, the value of liabilities and, less directly, the value of assets. Growth in insurers' claims costs has historically exceeded inflation due to additional factors, referred to as "social cost escalations". These social cost escalations, which are in addition to inflation costs, include the effects of increased litigation, changes in social norms, and rising expenses for medical treatment.

Inflation affects life and non-life insurers in different ways
For non-life insurers, unanticipated inflation leads to higher claims costs, thereby eroding profitability. Thomas Holzheu, one of the authors of the new *sigma* study, said: "Extended periods of accelerating inflation are especially problematic for long-tail lines of business." Holzheu added, "Insurers can mitigate the impact by adjusting premium rates, but sometimes this is not possible if regulation or the competitive environment do not allow for such adjustments."

For life insurers, both inflation and deflation are risks. Inflation is often accompanied by rising interest rates, which reduce the value of return guarantees. Rising inflation can have a negative effect on demand, and may lead to policyholders cancelling their policies as well as increasing costs for insurers.

In the case of deflation, or if very low inflation persists, interest rates tend to fall. Kurt Karl, Swiss Re's Chief US Economist and another of the study's authors, said: "This makes it more difficult for life insurers with large portfolios of minimum interest rate guarantee savings products to earn the appropriate asset returns."

Insurers have several options for mitigating inflation risk

Insurers concerned about inflation risk can mitigate this risk in several ways. David Laster, another of the study's authors, said: "On the asset side, insurers can invest in commodities, real estate and inflation-indexed bonds, which we find to be the most viable inflation hedges. These investments have performed well during periods of high inflation."

Insurers can also modify insurance contracts to shorten the tail and hence the development risk. Holzheu stated, "Insurers can introduce 'claims made' policies or sunset clauses to address the issue of latent claims. They can also add index clauses linking premiums, limits and deductibles/retention to an inflation-related index."

Reinsurance can also offer insurers protection against inflation surprises. It is particularly helpful in emerging markets, where the risk of high inflation is greatest.

Inflation is a possible threat in the medium term

Karl stated, "While aggressive monetary policies and record government spending have triggered concerns that inflation could sharply increase, this is unlikely in the next 1 to 3 years because unemployment rates are elevated and there are few capacity constraints." Karl added, "But inflation could rise if monetary policy remains loose for too long and growth accelerates rapidly."

Table 1: Medium-term US inflation expectations (2011-2014)

Type of investor, US	**Percentage who expect inflation to be:**				**Mean expected inflation rate, %**
	Below target	Close to target	Above target	>2.5% above target	
Fund managers	9	30	41	20	3.0
Hedge funds	16	22	37	25	3.0
Banks	16	26	42	16	2.8
Pension funds and endowments	13	24	41	22	2.0
Insurance companies	6	25	41	28	3.3
Corporates	8	28	44	20	3.0
Private banks	9	25	41	25	3.1
ALM mandates	9	39	33	19	2.8
Grand total	11	27	41	21	3.0

Note: In this survey, 'target US inflation' was defined as 1.75%.
Source: "J.P. Morgan Inflation Expectations Survey", July 2009

Table 2: Medium-term Euro area inflation expectations (2011-2014)

Type of investor, Euro area	Percentage who expect inflation to be:				Mean expected inflation rate, %
	Below target	Close to target	Above target	>2.5% above target	
Fund managers	16	48	26	9	2.5
Hedge funds	21	42	25	12	2.6
Banks	19	50	27	4	2.4
Pension funds and endowments	15	41	35	9	2.7
Insurance companies	13	43	33	11	2.7
Corporates	12	45	33	10	2.7
Private banks	11	51	32	6	2.6
ALM mandates	19	53	17	11	2.4
Grand total	17	46	28	9	2.6

Note: In this survey, 'target Euro area inflation' was defined as 2.0%.
Source: "J.P. Morgan Inflation Expectations Survey", July 2009.

Notes to editors

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How to order this *sigma* study:
The English, German, French and Spanish versions of the *sigma* study No 4/2010, "The impact of inflation on insurers" are available electronically on Swiss Re's website: www.swissre.com/sigma. The versions in Chinese and Japanese will appear in the near future.

Printed editions of *sigma* No 4/2010 in English, French, German and Spanish are also now available. The printed versions in Chinese and Japanese will be available shortly. Please send your orders, complete with your full postal address, to:

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