Under Pressure

Ken Griffin, Managing Director, Head of Insurance Solutions for Barings, said that while asset market values have declined, so has the market value of their liabilities. "Economically, insurers should be in a reasonable position, if not in a better position, than they were before the rate shocks as reinvestment rates are relatively high for firms that can capture unique opportunities in credit and structured asset classes," he said. Following are excerpts from an interview.

Ken Griffin
Managing Director
Head of Insurance Solutions for Barings

"There is some uncertainty about the behavior of policyholders in this higher rate environment, which could cause some strain."

Visit the Issues & Answers section at *bestsreview.ambest.com* to watch an interview with Ken Griffin.

What's keeping insurers up at night?

Insurers are under pressure on a number of fronts. Currently, most significant is the rapid increase in interest rates over the past year, which has caused a steep drop in the market value of their insurance investment portfolios. This has many knock-on effects for how they conduct business. There are accounting and capital implications of this, which the industry is in the process of working through. There are also several regulatory changes being proposed, which will create uncertainty for insurers that they'll need to navigate.

How has the changing interest rate environment impacted insurers?

During the low rate environment, insurers often said higher rates would provide welcome relief for ever-compressing profit margins in spread businesses—but just not having higher rates all at once. Unfortunately, this is essentially what's happened with Treasury rates as they've increased quickly, even beyond many of the worst stress scenarios insurers use to test their portfolios. Credit spreads also increased, which has caused a significant increase in the unrealized loss position of the fixed-income portfolios. Insurers typically have prudent risk management approaches in place, so while asset market values have declined, so has the market value of their liabilities.

What are the accounting and capital implications of this environment?

For life insurers, there is an accounting feature that captures realized gains and losses in an interest maintenance reserve (IMR) and this amortizes into income over time. This has worked well through decades as rates have generally fallen, gains have been realized, and IMR has had a positive balance. Unfortunately, there's an antiquated rule in place that does not allow for negative IMR balance to be an admitted asset. So as losses are realized and IMR is depleted, these losses will become a direct hit to surplus, thus giving a false impression that capital adequacy is impaired although economically insurers with proper risk management in place are strong. This can also distort an insurer's ability to rebalance their portfolios to manage risk and can exacerbate liquidity needs as longer liquid bonds can become off-limits to sell.

What are the other regulatory concerns?

From an investment standpoint, there's increased scrutiny by regulators to better understand the growing asset classes for insurers. For instance, CLOs have attracted significant interest from insurers, and regulators are concerned that a capital arbitrage may be taking place there. At origination, a structured CLO may have a lower capital charge than holding the underlying bank loans, but over time, as the higher-rated securities run off, the remaining lower-rated, higher-charge tranches lead to a higher overall capital charge. So needless to say, more analysis is needed before any capital factors are changed, and the NAIC has stated a commitment to doing this evaluation in a transparent way. And today it's perhaps even more important than ever to partner with an experienced team of investment professionals to help navigate these economic, accounting and regulatory issues.