Interest-Rate Environment Provides Opportunity to Focus on Risk and Performance Integration

Historically low interest rates that are presenting significant current and future challenges are compelling boards and management of insurance companies across industry sectors to take a forward-looking and proactive approach to managing their business operations and risks.

Although outright solutions are elusive due to the convergence of a number of economic, financial, and regulatory forces shaping the industry landscape, we offer a number of ideas that taken collectively or individually may mitigate the impact of falling rates. It is important to recognize that low interest rates affect much more than an insurance company's assets. Instead, the impact is on such varied topics as products, risk management methodologies, core business alignment, cash-flow management, and the blend of businesses within insurance organizations.

The approach we offer may be best viewed across four interrelated dimensions (see Figure 1), involving risk management imperatives, the organization's asset-portfolio strategy, its product-portfolio strategy, and its operating model. The approach is meant to begin a dialogue and spark debate, out of which may come ideas for moving forward in a quick-changing environment steeped in risks that, until only a short time ago, may have been unthinkable.

With the yield on 10-year U.S. Treasuries hovering in the 2 percent range—down from double that rate just several years ago (see Figure 2)—the industry is grappling with paltry investment returns that continue to squeeze underwriting profits, narrowing product spreads and negatively affecting earnings on current asset portfolios as well as reinvestment alternatives. For the short term at least, the industry must deal with the compression of profit margins, lower dividends, pressures to increase premiums in a climate of low consumer confidence and high unemployment, and the potential for the deterioration of balance sheets. The adjustments made now by insurance companies are sure to have a significant impact on the businesses for years to come.

In order to possibly lessen the negative impact of the current market conditions, the chart on page 2 presents a snapshot of a suggested approach to integrate risk and performance, which increasingly is being viewed as a key differentiator in the industry and is of keen interest to consumers, investors, regulators, and ratings agencies. By taking this proactive approach, even in some of the categories listed, organizations may be better positioned to manage today's and tomorrow's complexities.

Figure 1

Risk Management	Asset Portfolio Strategy	Product Portfolio Strategy		Operating Model
• Stress test – Focus on operational improvement; not only compliance • Asset liability management	• Review asset mix • Consider "alternative investment" assets • Hedging strategies • Private equity	• In-force management actions – Changing premiums – Monitoring premiums and building into pricing • New business – Pricing considerations	• Rebalancing – Sell more or less of a specific product – Close an existing business – Buy a new business – Reinsurance	• Strategic review of core business for alignment • Cost efficiency – Attack the "aging IT" legacy issues • Business information analytics

Figure 2
10-Year Treasuries

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Percentage	5.02	4.61	4.01	4.27	4.29	4.8	4.63	3.66	3.26	3.22	1.95

Risk Management

Although complexity in virtually every facet of insurance operations has placed significant burden on an organization's ability to create, deploy, and refine rigorous risk management systems, the time is right to stress test those systems across the entire enterprise and at the unit level. Even though companies largely have, in the wake of the 2008 finance crisis, built stout compliance-oriented risk management functions, a significant question arises regarding whether organizations are broadening and deepening their risk management efforts to allow for operational improvement.

Boards and senior management may want to conduct stress testing in order to consider a fundamental question: Are our risk management functions truly embedded in the organization in terms of how we operate, how we make business decisions, and in our analytics? Organizations will need to thoroughly examine whether their day-to-day risk management focus is only on crisis and compliance issues at the expense of broader operational issues.

The convergence of performance and risk means that the organization must shift its business-intelligence objective beyond reporting to delivery of information that enhances the business performance outcome, while minimizing risk. If nothing else, the events of the past several years require that an integrated risk management approach must be an operational imperative – it is no longer simply a goal.

Insurers also face risks that derive from the assets they hold, their liabilities, and the relationship between the two. An effective asset/liability management (ALM) framework would include an in-depth review of its functional, technical, and organizational aspects. In order for an organization to understand the ALM risk profile of the balance sheet in the current interest rate environment it must take measures that result in a value analysis (duration, value sensitivity, value at risk), earnings analysis (earnings sensitivity, earnings at risk), and liquidity analysis (liquidity gap, liquidity gap sensitivity, liquidity at risk).

Asset Portfolio Strategy

The current interest rate environment and volatile equity markets have placed considerable emphasis on the asset portfolio strategy adopted by insurers, especially considering how options have been narrowed for such traditional assets as fixed-income investments, including structured securities, and real estate investments, whose returns may not be covering default costs. Frequent review of the asset mix is imperative, especially when rates are low and may remain so over an extended period because of the potential for an increase in the present value of liabilities and an increase in the likelihood of insolvency. Adding to these difficulties, there is the possibility that a prolonged period of low interest rates could lead to increased inflation.

This difficult investment market may provide an incentive for insurance companies to consider a more significant portion of their asset allocation into higher-risk investments such as private equity investment funds, joint ventures, partnerships, or other businesses. Of course, any decisions that move the asset portfolio mix into riskier assets must be considered in light of risk based capital considerations. At the same time, hedging programs, designed to mitigate risks in certain product guarantees, are being considered or used. Some companies, for example, employ macro hedges to cover minimum long-term interest rate guarantees. Companies that have used hedges in this way have a greater likelihood of being unable to support these guarantees. There is clearly a transactional cost to hedging that needs to be balanced with the desire to mitigate the risks. Further, enterprise risk management systems often embed a reluctance to invest in those types of alternative investments, and it is uncertain if insurance company management and boards will understand or accept the risks involved.

Nevertheless, in this interest-rate environment, companies may need to employ tools that until now have not been considered in order to gain the flexibility they may need in order to react quickly to changes in the markets and to focus on optimizing investment returns. Companies should at least understand how such strategies could allow an organization to be nimble enough to react to swiftly changing market forces, or how to move out of their bond portfolio to pursue additional investment returns if rates begin to rise. Organizational leaders should also monitor interest rates constantly and consider usage of projection tools, as a difference of only a few basis points can lead to a significant change in their overall investment return.

Product Portfolio Strategy

With the possibility – perhaps even the likelihood – of declining investment income and the potential mismatch of products due to declining yields in their portfolios, the imperative for a thorough examination of an insurer's product portfolio strategy could not be any clearer. Insurance company executives and boards must consider and plan for a whole host of steps, such as in-force management – including, among other actions, the reduction of interest crediting rates and policyholder dividends – increasing policy premiums, rebalancing their portfolios through selling more or less of a product, enhancing their distribution capabilities, closing or selling an existing business, or acquiring a new business. A recent KPMG Pulse Survey, for example, shows a majority of organizations expect to take an aggressive posture in the M&A market: Nearly two-thirds (63 percent) of executives at U.S. insurers who responded to the survey reported that they expect their company to be involved in a merger or acquisition in the next two years, including 54 percent saying they'll be buyers.

Balancing the risks associated with altering an organization's product portfolio strategy will require analysis of expected customer and wider market reaction, a review of contract guarantees, and legal supervision. But for some organizations that are facing losses on some products because of a current mismatch of yields and product guarantees, an in-depth review and rebalancing of their product portfolio cannot wait.

Low interest rates usually force property and casualty companies to improve, or at least monitor, their pricing efficiency. This could lead to a tightening in the market or at least a rise in rates. For life insurance companies, there is even more compression of the pricing spread, which further reduces profits. Additionally, life insurance companies are reviewing their loss recognition and recoverability tests to determine the appropriateness of deferred acquisition cost (DAC) balances. This requires a number of judgments, particularly with respect to the level of interest rates assumed for the future, and these judgments may result in a significant unlocking effect or write-down of DAC.

Operating Model

With profit and overall performance at risk in an environment of historically low interest rates, slow growth, and a fragile recovery, insurers may want to finely tune their operating model on a regular basis. Simply reacting in the current environment may not be adequate. Success in the industry may require a precise roadmap that integrates a number of key elements, including a clear and articulated vision for the future, the development of near-term and longer-term strategic initiatives, and ongoing organizational focus.

The effort should begin with an unblinking eye on the organization's core businesses, seeking to determine if those businesses are in alignment with the future vision of the company – given the current market realities that are being impacted by low interest rates. Such an assessment, for example, may lead to the sale or purchase of a business, which would place emphasis on the organization's due diligence efforts and capabilities. It may also lead to the examination of information technology (IT) systems, which present numerous challenges for many insurers who are struggling with the integration of IT systems, and the compatibility of legacy systems.

The interest rate environment risks also are leading organizations to consider investments in data architectures, business-information platforms and the analytical tools, including Web-based dashboards and reporting tools that are integrated with core insurance applications and services. With the industry ramping up investment in technologies designed to enhance data quality and how it is accessed, an examination of how IT and business information analytics fits into an organization's operating model is critical.

Next Steps

So the question becomes what should insurers start doing right now? At a minimum, it seems that more attention in the risk management function and more comprehensive time spent on stress tests seems prudent. Leading companies are taking steps not only in risk management but in all the other areas mentioned including asset and product portfolio strategies as well as operating models. There is always a balance in the number of efforts or initiative involved, but to explore solutions in all these areas helps to link risk and performance management especially in this persistently low interest rate environment.

Contact us:

Laura J. Hay
National Sector Leader, Insurance
ljhay@kpmg.com
212-872-3383

Lourdes Munier
National Marketing Director, Insurance
lmunier@kpmg.com
201-505-3732

Contributing authors:

David L. White Jr.
Principal, Advisory
dlwhite@kpmg.com
404-222-3006

Scott P. Weinstein
Principal, Advisory
sweinstein@kpmg.com
404-222-3594