Credit Benchmark

Global Insurance in an Era of Heightened Risk

December 2021

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Executive Summary

- Insurance sector credit has outperformed banks and other financials. Life and Non-life companies show similar recovery patterns. Overall, the sector has weathered COVID very well, but challenges of the "new normal" are increasing.

- **Life companies**: Credit recovery is strongest in North America. Risks of rising inflation, higher interest rates and potentially higher mortality rates could bring deterioration in assets vs. liabilities.

- **Non-life companies**: Credit recovery is also strongest in North America. Climate, health and economic risks are rising. A possibly difficult adjustment period while higher premiums introduced to address these risks accumulate into stronger reserves.

- **Insurance company assets**: Credit for major investments has recovered in most categories, but global REITs have lagged. Increased use of private assets highlights the need for credit data on otherwise unrated issuers.

- **Insurance buyers**: Social distancing in the face of new COVID variants continues to challenge Travel & Leisure, especially Airlines and Hospitality sectors. Supply chain disruption is a major issue for corporate buyers of insurance products generally, and trade credit insurance is increasingly important as part of supply chain logistics management.

- **Counterparty risk**:
  - Financial counterparts have stronger credit quality than Corporates and suffered less COVID-related damage.
  - Current use of CCPs highlights need for detailed credit monitoring
  - CCPs are stronger credits than CCP members, but credit trends are neutral to benign for both
  - Insurers see a possible future role in CCP waterfalls

After two tumultuous years, the global insurance market has proven its resilience. The sector has weathered COVID and ongoing trade and supply chain disruptions to emerge with stronger credit quality and recovery patterns than those of banks and other financial counterparts.

The storm clouds have not fully dissipated for the industry however, with regional advantages apparent. Where North American firms have rebounded to and, in some cases, surpassed pre-COVID credit quality levels, European companies show higher rates of deterioration or stagnation.

Climate change risk may prompt more frequent and larger claims, but also creates an opportunity for business generation and product development. As society adapts to an era of increased risk, insurers must keep pace to ensure premiums exceed payouts. While the 'new normal' presents challenges, the insurance industry is well-placed to face the unexpected.

About Credit Benchmark

Credit Benchmark produces a comprehensive view of credit risk by creating Credit Consensus Ratings ("CCRs") and analytics on the credit quality of companies, financial institutions, sovereigns, and funds.

The data is sourced from more than 40 global financial institutions, representing the work of over 20,000 analysts and is also used by regulators to monitor Basel rules on capital adequacy.

Credit Benchmark collects a specific measure of credit risk: a one-year, forward-looking Probability of Default (PD) and forward-looking senior unsecured Loss Given Default (LGD).

The underlying inputs are subject to a rigorous data quality approval process and derived from models that are approved by regulatory authorities. The resultant accuracy of each PD and LGD leads to a credible market view of credit risk for each given entity.

After being anonymized and aggregated, the contributed risk estimates are mapped to the appropriate credit category on the Credit Benchmark Consensus scale, which is calibrated periodically and can be used as a comparison to the scales published by the rating agencies.

Credit Benchmark produces regular data updates with history going back to 2015.

1. Introduction

Global insurance premiums amount to $6.3trn annually. Of this, Life businesses account for $2.8trn. Despite (and partly because of) the pandemic and trade disruptions, the macro-economic environment has been broadly favourable for insurance companies. But there may be some clouds on the horizon; Table 1.1 shows the key background statistics.

Table 1.1: Key Drivers of Insurance Company Performance 2021 YTD

Equities (MSCI World)	+19%
10-year Bonds (USD)	1.63%, up 68 Bps
Inflation (US)	4%+
Non-Life Loss Ratio (2020)	c.95% - stable to down (except Credit & Surety and Misc Financial Loss)
Global Life Expectancy	Down by 1 - 2 years in most middle to high income countries

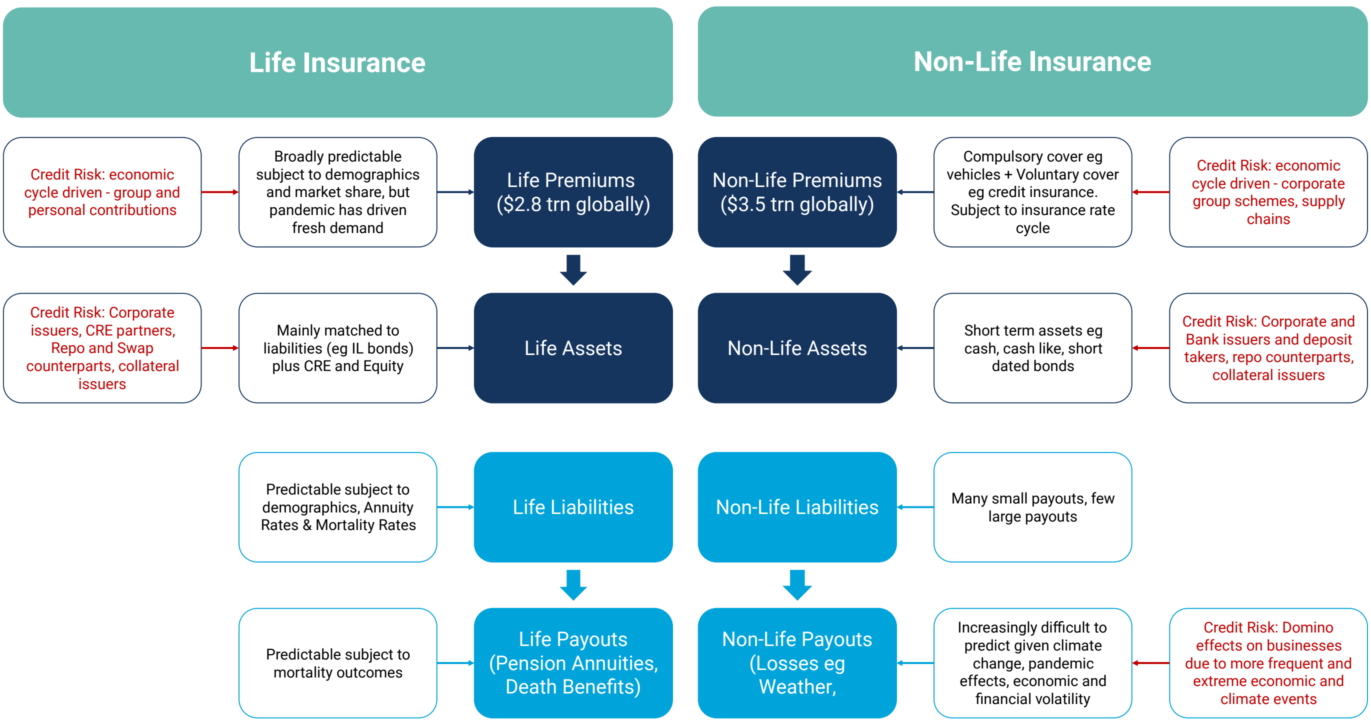
The Blackrock Global Insurance Report highlights the following key sector trends for 2022 and beyond:

- Geopolitical risk remains the top concern
- Environmental risk is a strategic issue; climate risk metrics are increasingly important
- Accelerating emphasis on sustainable investments
- Increase in risk appetite and diversification into non-core, high-yield assets
- Private (i.e. unrated) assets to rise from 11% to 14% of portfolios
- Liquidity remains a key priority
- Accelerating technology investment driven by the pandemic

Credit risk permeates most of these themes, affecting the stock of assets and the flow of premium income. For long periods, credit risk may have no direct financial impact, but during times of economic, social, medical and environmental stress it can become critical.

The graphic below plots the relevance of credit risk for life and non-life insurance businesses.

Table 1.2: Credit Risk and Insurance: Impact Points



Insurance companies are effectively option sellers, collecting fixed premiums and promising to pay variable liabilities.

For life companies, profitability and solvency are driven by the long-term interplay of asset values, annuity rates and mortality. The pandemic is probably the single most important disrupting factor seen by these companies in decades. Mortality rates have changed, the appetite for life insurance has spiked, and further interest rate cuts have reduced annuity rates and increased liabilities.

For non-life companies, short-dated policies are best hedged by liquid and short-dated assets; the typical pay-out profile is a large number of small claims and a small number of large claims. Any increase in the frequency of large claims can push a single company annual insurance result into loss; while a systemic increase in loss rates is damaging for the entire industry until it is recovered via higher premiums in the future.

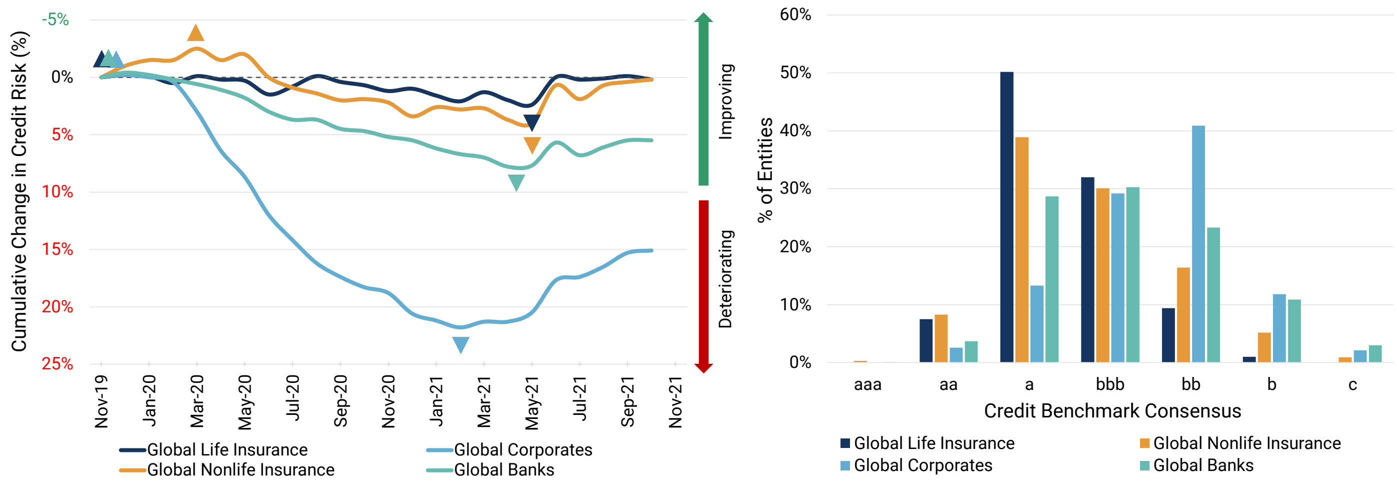
Insurance companies face direct credit risk through their many counterparts – mainly other financial institutions, but also direct investees and borrowers, as well as companies with group policies where a corporate failure may result in unrecovered funds. CCPs are potentially increasingly important as insurance counterparts; and there has been some industry discussion about insurance firms as backstops in the CCP "waterfall".

COVID has had some dramatic effects on consensus credit ratings; and climate change impacts are becoming more material. What does consensus data tell us about recent trends?

2. Insurance Credit Trends During COVID

Figure 2.1 shows the global credit trends for Insurance (Life and Non-Life) compared with Banks and Corporates.

Figure 2.1 Global Credit Trends: Insurance, Banks and Corporates



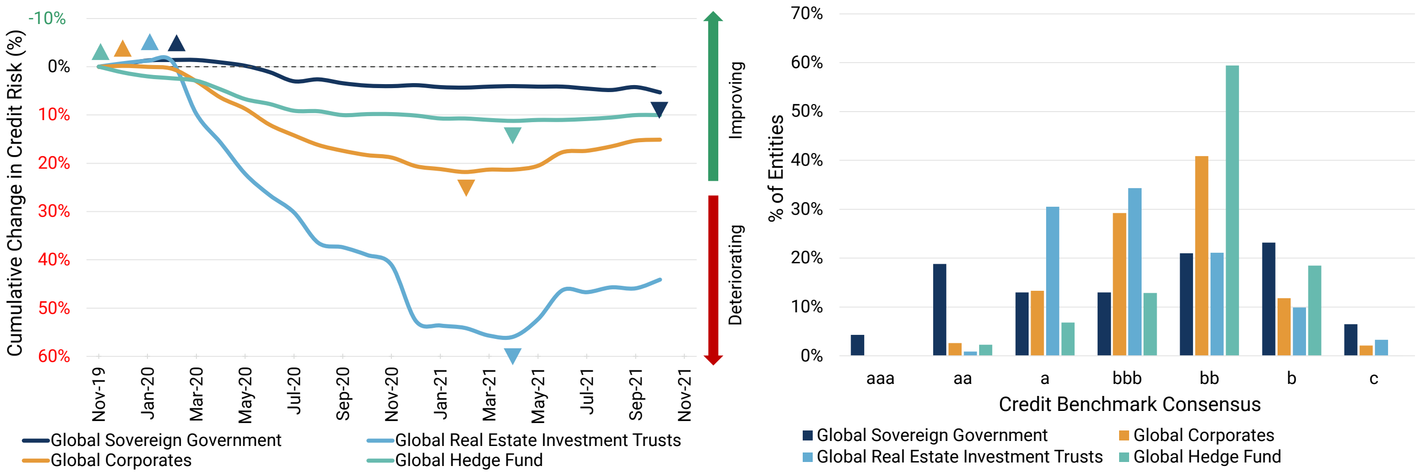
Insurance credit quality – both Life and Non-Life – held up very well during the pandemic. Banks show a modest deterioration (risk is up 6% over the past two years) while Corporates show a 15% increase in average credit risk. But Insurance is net unchanged over the same period. Both insurance segments show stronger credit profiles compared with Banks and Corporates; Life has the stronger profile vs. Non-Life.

For Property & Casualty companies and for Reinsurers, the growing climate crisis is a threat and an opportunity. A spate of extreme climate events mean that recent loss experience has been negative, but the demand for suitably priced protection is on a rising trend. Rising rates will over the medium term attract more insurance capacity, but it is probably needed.

Rising equity markets are moderately positive for life insurance company solvency; while rising bond yields are negative for bond asset values, they also reduce liabilities – the net effect depends on the asset mix. Lower life expectancy is a positive for the life sector. The impact of inflation should be neutral, if life companies hold Government-issued immunizing assets; but unexpectedly high inflation my cause problems for some firms.

Figure 2.2 shows credit trends for some of the major credit-risky investment asset classes

Figure 2.2 Credit Trends: Selected Major Asset Classes



Global Sovereigns show the impact of COVID – on average, global sovereign credit risk is up about 5%. Some Sovereign ratings have declined by a significantly larger amount, with implications for the enormous holdings of Government bonds by insurance companies globally.

Hedge fund credit risk has increased by 10%; possibly a combination of increased market volatility in the early stages of the pandemic and increased leverage in response to cheaper funding.

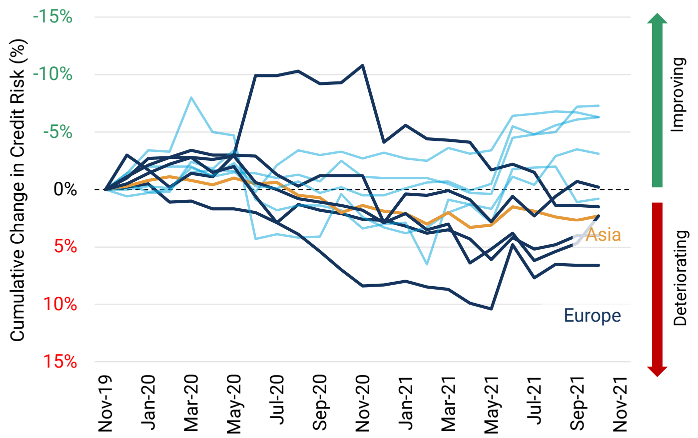
Corporate risk rose 20% at the peak, and have now recovered some of that. Individual sectors (see section 3) have seen much larger declines; in some cases by multiple credit notches.

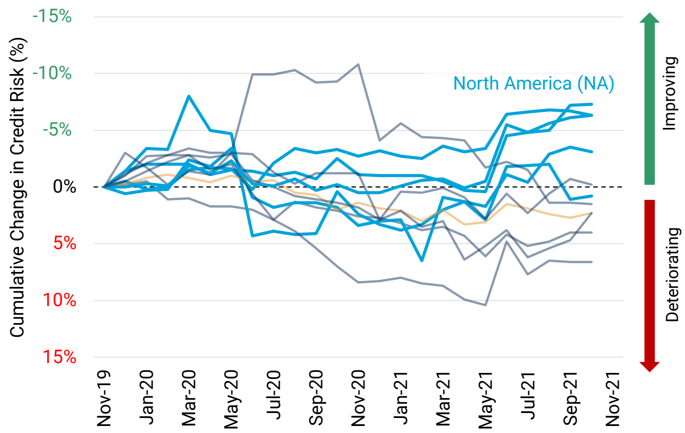
Real Estate Investment Trusts saw a major credit impact, with risk rising 56% at the peak in April 2021. The recovery has been modest and seems to have stalled. It is ironic given the “race for space” triggered by the pandemic, but it will also reflect the impact on commercial real estate – in some countries and in specific cities this sub-class has been badly affected by COVID.

3. Regional Insurance Credit Trends

Comparing credit trends of all Insurance sectors in North America and Europe reveal some interesting patterns as presented in Figure 3.1. This shows that the impact of the COVID crisis is longer lasting in Europe, where credit risk of Insurance sectors either still deteriorates or stagnates. On the contrary, North American Insurance sectors experienced a rebound in 2021 and most of them have currently a better credit quality than two years ago.

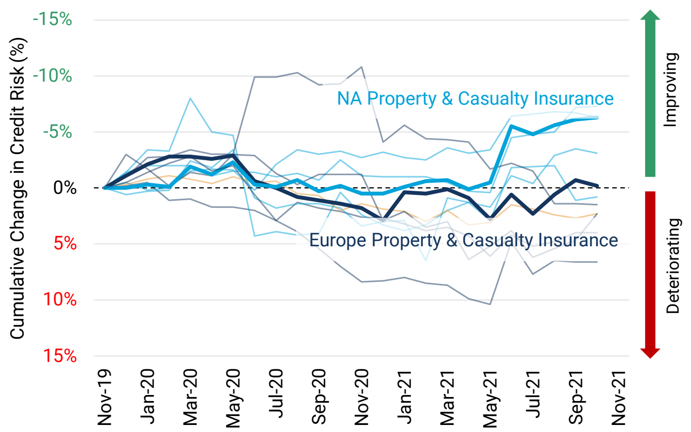
Figure 3.1 Regional Credit Trends: North America vs Europe

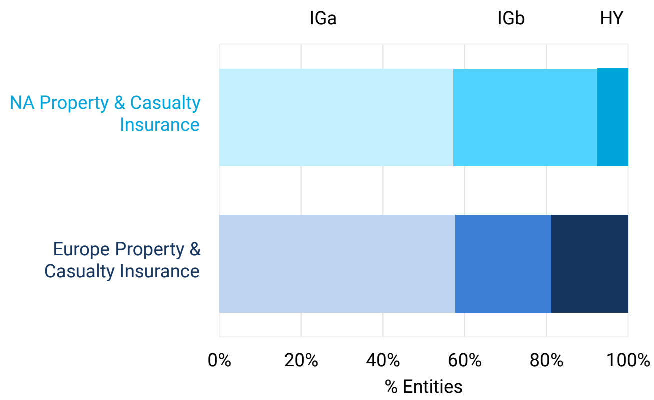




Figures 3.2 to 3.4 focus on the regional credit trends for the P&C, Reinsurance and Life Insurance. Other Insurance sectors included in the figures but not highlighted are Insurance Brokers and Full Line Insurance.

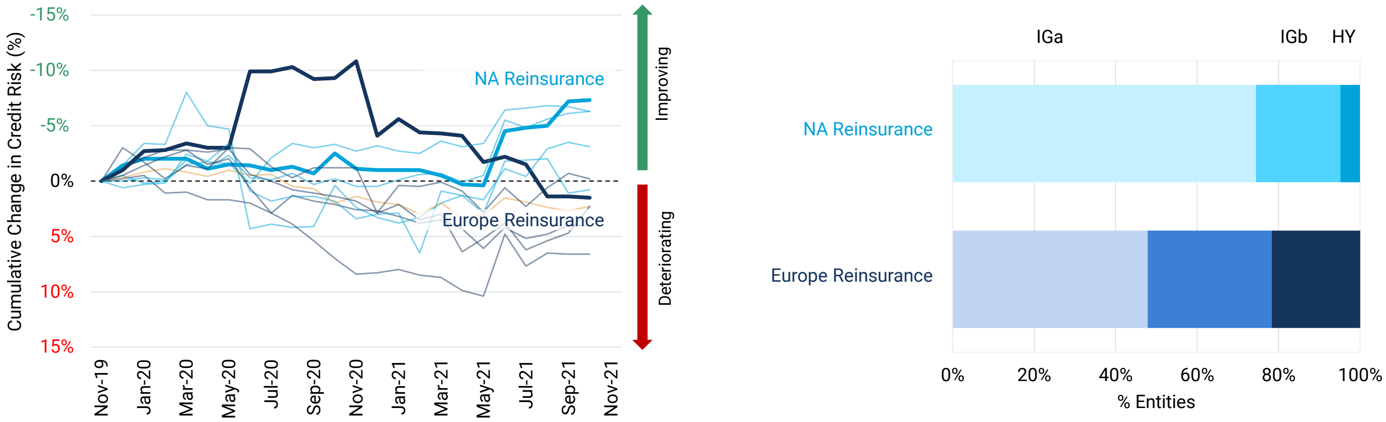
Figure 3.2 Regional Credit Trends: Property & Casualty





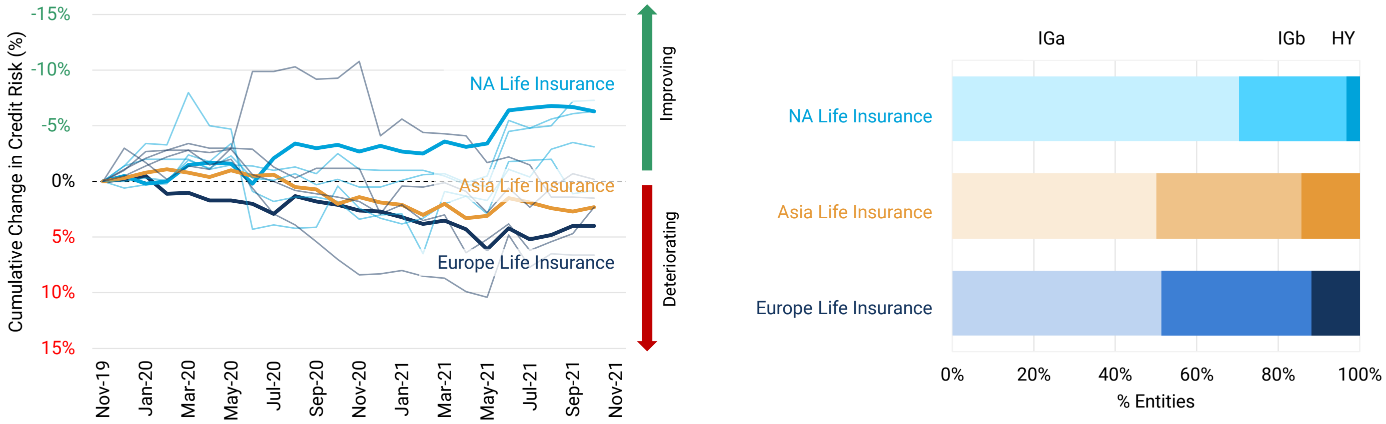
P&C credit quality is broadly stable, but North America has recently pulled modestly ahead of Europe. North America also has a stronger credit profile.

Figure 3.3 Regional Credit Trends: Reinsurance



Reinsurance mirrors P&C with North America again pulling ahead; but Europe has been deteriorating since late 2020. Again, North America has a stronger credit profile.

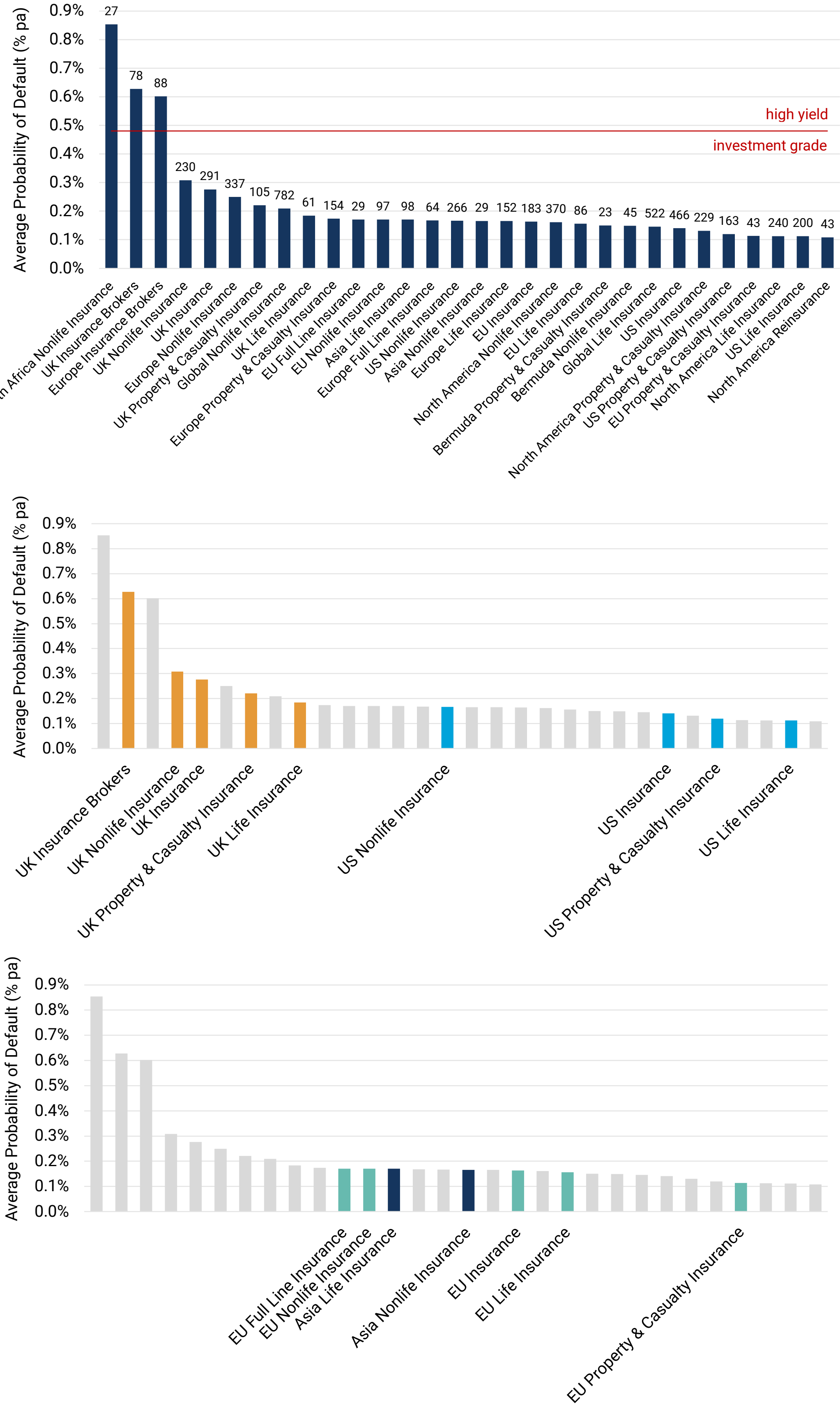
Figure 3.4 Regional Credit Trends: Life Insurance



Life Insurance also shows the same pattern as P&C and Reinsurance: North America pulling ahead; and as with P&C, Europe is stable. Asia is tracking Europe quite closely. Of the three regions, North America once again has the strongest credit profile, with Asia the weakest.

Figure 3.5 plots the average annualised probability of default ("PD") for the full universe of insurance sector aggregates, sorted in descending order. The number of individual legal entities in each category is shown above each bar.

Figure 3.5 Average Probability of Default, Q4 2021, Insurance Aggregates



There are some obvious clusters: UK aggregates are in the higher PD zone, US are lower. Europe and Asia are mainly between the UK and US, with EU risks typically slightly higher than Asia. Insurance Brokers, both UK and EU, are on average in the non-investment grade category.

4. Credit Trends of Corporate Insurance Buyers

The BIS has estimated that trade finance[1] is used in up to a third of international trade flows; these transactions all contain some element of credit risk. Across corporates that choose to insure, the annual trade credit insurance premium is around $6bn. This is tiny in the context of global insurance premiums, but if supply chain volatility is the new normal, trade credit insurance is likely to expand.

Supply chain disruption has made trade credit pricing more difficult, but a surprisingly large proportion of suppliers have – so far – managed to stay in business albeit with reduced volumes and with an insistence on being paid up front where they have the bargaining power to do so.

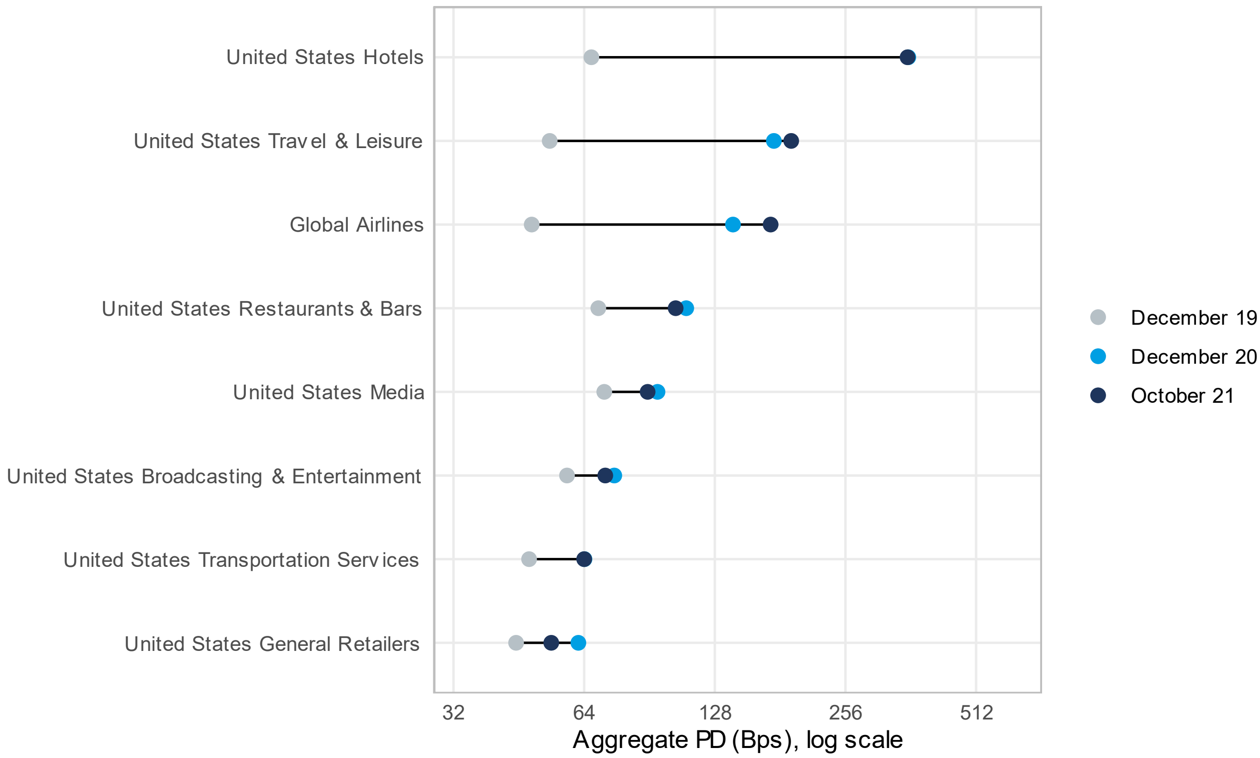
Providers of trade credit and business interruption insurance faced a particularly challenging period in the early phase of the pandemic before Government-led programs and takeovers provided some support.

This benign environment could last for some time yet[2], but the artificially low default rate is likely to climb as interest rates rise and Central Banks shrink their balance sheets.

COVID was especially damaging for travel, leisure, hospitality, traditional retail, and the numerous ancillary businesses that support these sectors.

Figures 4.1 plots the recent trends for a range of US and Global sectors – some of these were very badly hit by COVID, while others show a modest but still significant deterioration. For comparison, Global Corporates deteriorated by a maximum of just over 20% in the past two years.

Figure 4.1 Change in Aggregate Credit Risk: Chosen US and Global Sectors



Travel and Leisure generally, and Hotels and Airlines in particular, have had a difficult two years with no signs of recovery. Multiple notch downgrades have increased the average credit risk from 53 Bps (**bb+**) to 192 Bps (**bb-**), with less than 20% of each sector still in the investment grade category and significant proportion in the **b** and **c** categories.

[1] Includes letters of credit, receivables and invoice financing, credit agency services, export financing and bank guarantees.
[2] Mamasky, H., Altman, E. (2021, November). *Is Credit in a Bubble?* [Webinar]. KBRA.

Restaurants & Bars, and General Retailers suffered with the lack of footfall especially during the early severe lockdowns. Both sectors have avoided the scale of declines seen in Travel & Leisure, but they have some way to go before fully recovering; and part of that recovery may come in the form of survivor bias as the weaker companies are taken over or go out of business. Both sectors are dominated by non-investment grade categories but mainly in the higher quality **bb** area. General Retailers in particular have a reasonable proportion in the investment grade area and experienced the strongest recovery out of the chosen sectors in 2021.

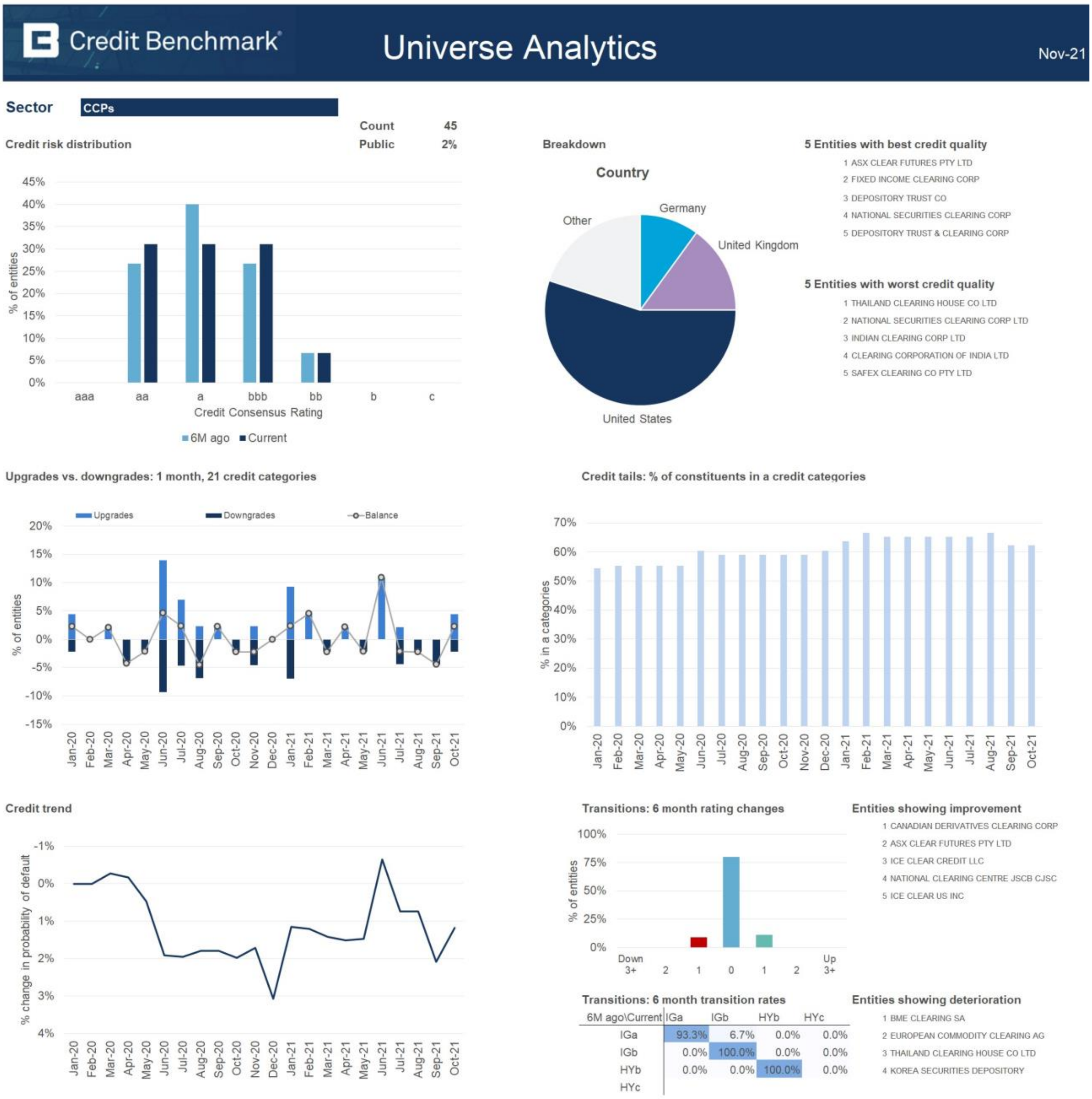
Media and Broadcasting suffered from a drop in advertising revenues and difficulties in providing new content; Transportation struggled due to a collapse in demand in a broad range of sectors. Recovery is underway, but it has not been dramatic. All these sectors are dominated by the **bb** credit category.

5. Counterparties and Credit Portfolios

From a credit risk management perspective, counterparts, trade insurance portfolios and supplier lists can all be monitored and managed using analytics derived from consensus data. The analytics in this section are based on the universe of central counterparties and their members as examples of credit portfolio monitoring.

Figure 5.1 shows credit portfolio monitoring analytics for the global universe of Central Counterparties.

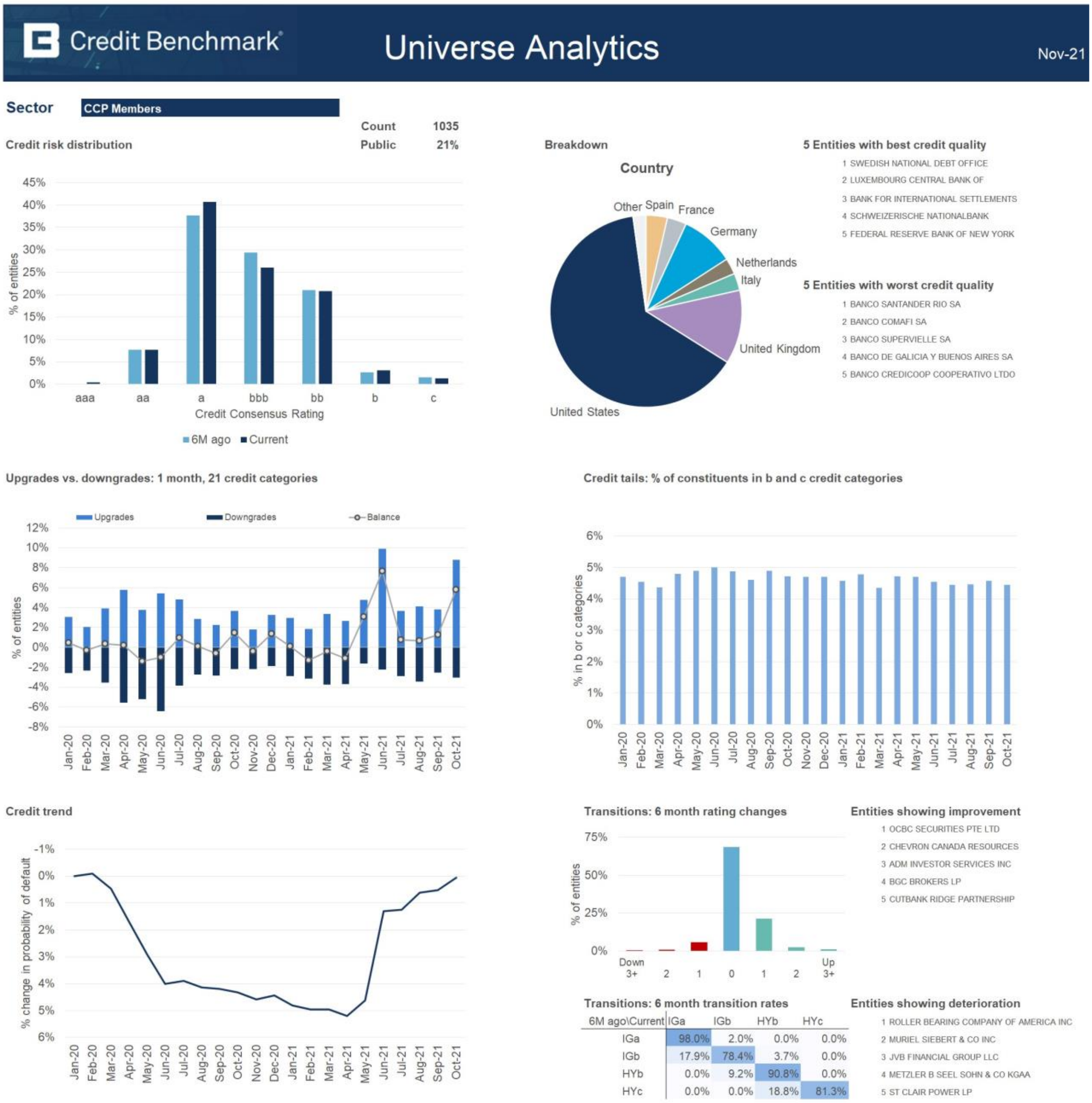
Figure 5.1 Universe Analytics for CCPs



Most of the CCPs are investment grade, but there has been a two-way pull in the past 6 months, with an increase in the **aa** category as well as an increase in the **bbb** category. The majority of CCPs are in the US, with Fixed Income Clearing Corporation and the DTCC at the top of the credit quality ranking. The balance of upgrades vs. downgrades is stable, although large upgrade spikes are slightly more frequent. Average default risk is stable, with a deterioration of just 3% during 2020; this was reversed in 2021, peaking in mid-year. CCPs that show the most credit improvement include ICE Clear Credit and the Canadian Derivatives Clearing Corporation. Deteriorating names include the Korea Securities Depositary and Thailand Clearing House Co. Ltd.

Figure 5.2 shows credit portfolio monitoring analytics for the global universe of Central Counterparty Members.

Figure 5.2 Universe Analytics for CCP Members



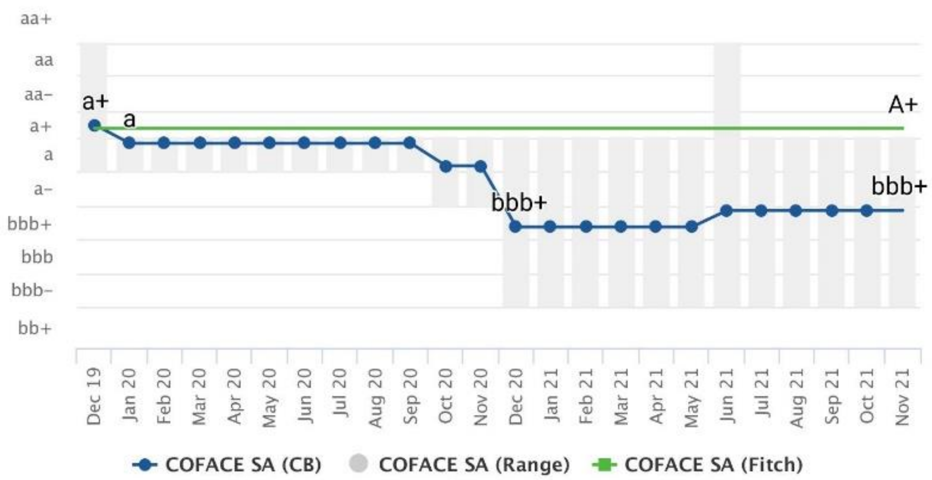
Most of the CCPs members are investment grade, but about 20% are in the **bb** category and just under 5% are in the **b** or **c** categories. The credit profile shows little change over the past 6 months. About two-thirds of the CCP members are in the US, with the Central Bank of Luxembourg and the Swedish National Debt Office showing the strongest credit. The balance of upgrades vs. downgrades is stable, although the largest single spike is an upgrade in mid-2021. Average default risk is stable, with a mild deterioration of 5% in early 2021; this has recently reversed and is trending better. CCP members that show the most credit improvement include OCBC Securities and Chevron Canada Resources. Deteriorating names include the Roller Bearing Company of America Inc and Muriel Siebert & Co Inc.

These two reports demonstrate the value of risk-sharing in creating stronger clearing entities; it also shows how consensus credit data can be used by insurance companies if they need to (a) allocate position limits to CCPs (b) are involved as backstops to the CCP waterfall.

6. Insurance Companies: Single Name Examples

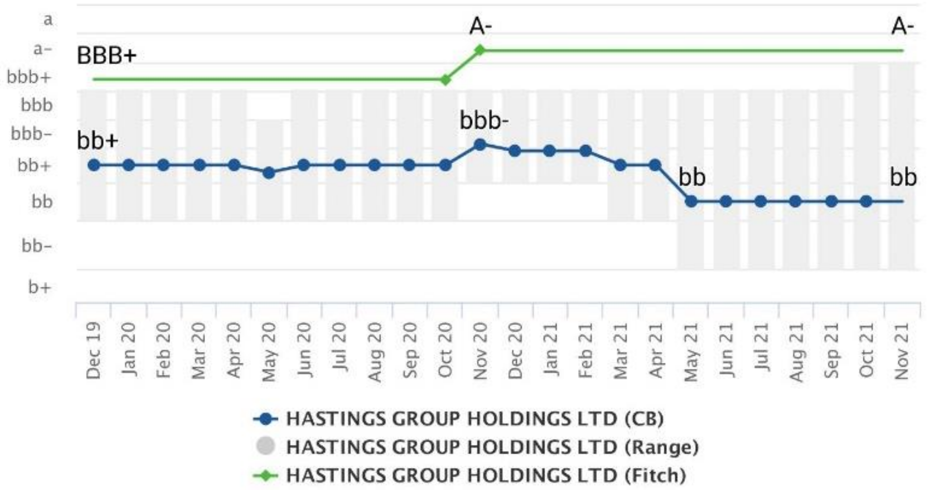
The following charts show 2-year trends and ranges for the credit consensus for a variety of larger insurance companies. The full universe of consensus ratings covers around 1,000 legal entities in this sector.

Figure 6.1: Coface SA



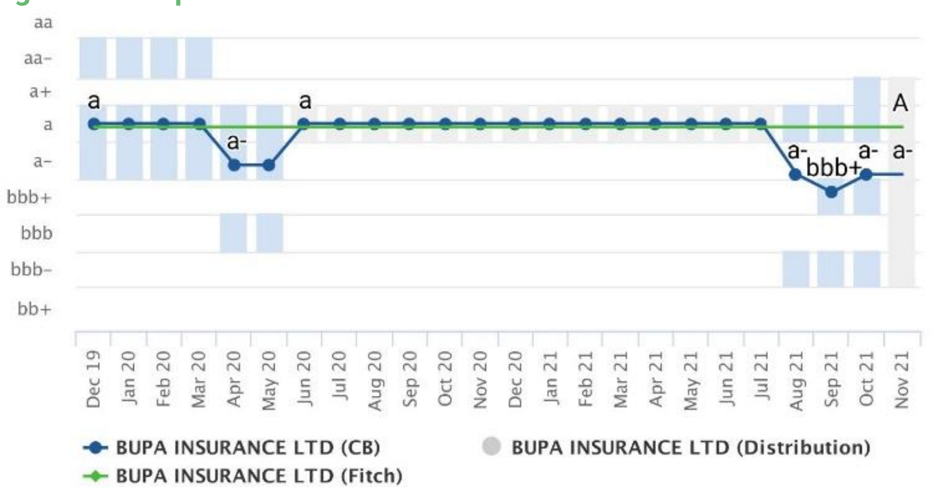
Coface moved to **bbb+** at the end of 2020, and it has remained there this year. The Fitch rating is stable at A+.

Figure 6.2: Hastings Group Holdings Ltd



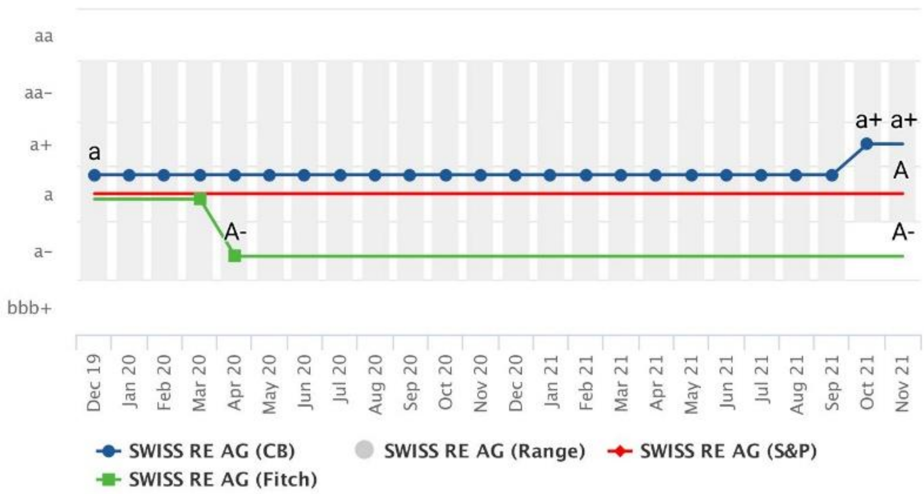
The consensus for Hastings has generally been in the high end of non-investment grade. The Fitch rating has been at A- for the past year.

Figure 6.3: Bupa Insurance Ltd



After a prolonged period in the **a** category, where it was aligned with an A rating from Fitch, the Bupa consensus has moved away from the **a** category. The range has also recently widened, with the lower bound at **bbb-**; one notch above non-investment grade.

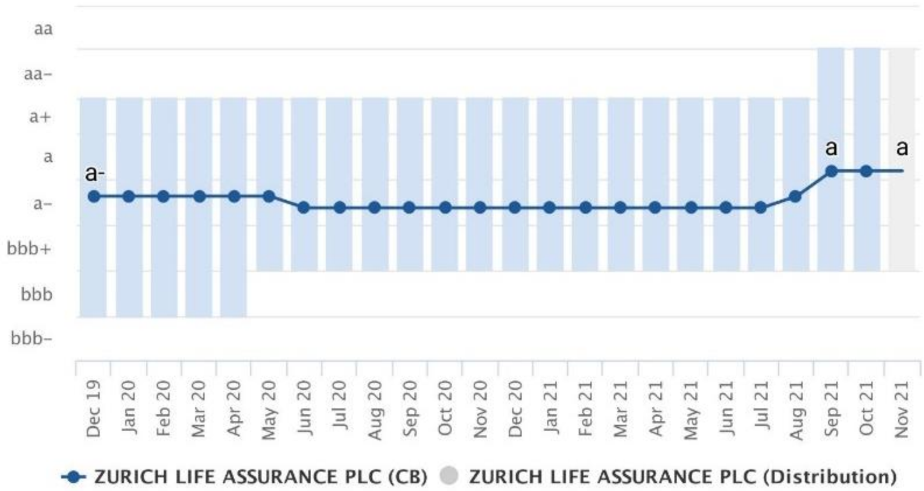
Figure 6.4: Swiss Re AG



The consensus for Swiss Re has recently moved up a notch to **a+**. S&P have been unchanged at A for the past two years, and Fitch have been at A- for most of that period.

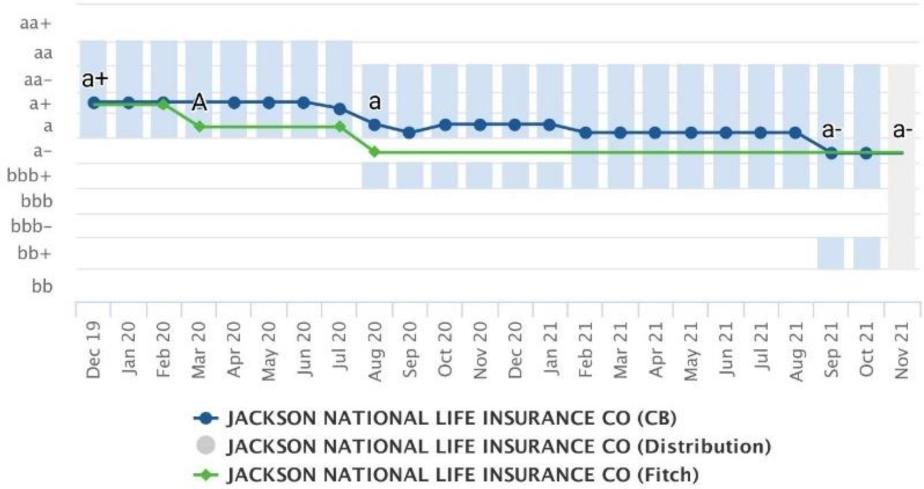
The consensus range has also recently narrowed.

Figure 6.5: Zurich Life Assurance PLC



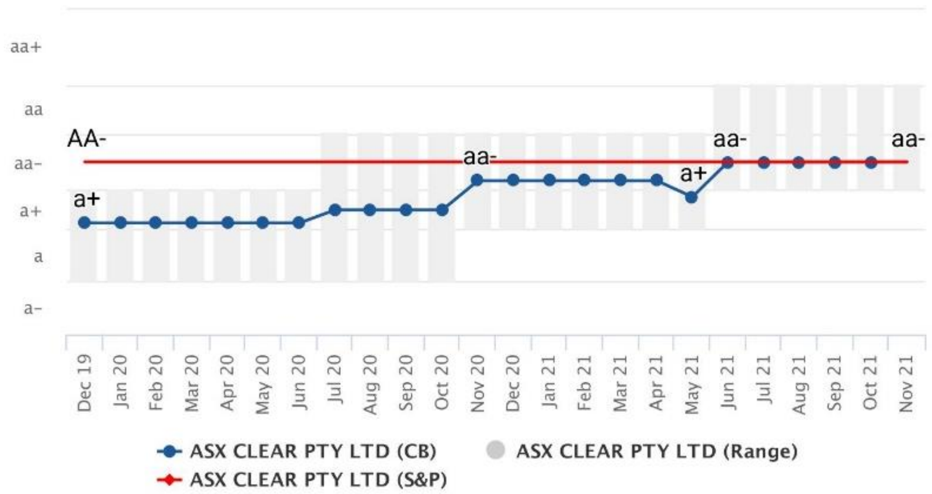
Zurich Life has also improved by one notch, from **a-** to **a**. The upper end of the range has also recently improved.

Figure 6.6: Jackson National Life Insurance Co



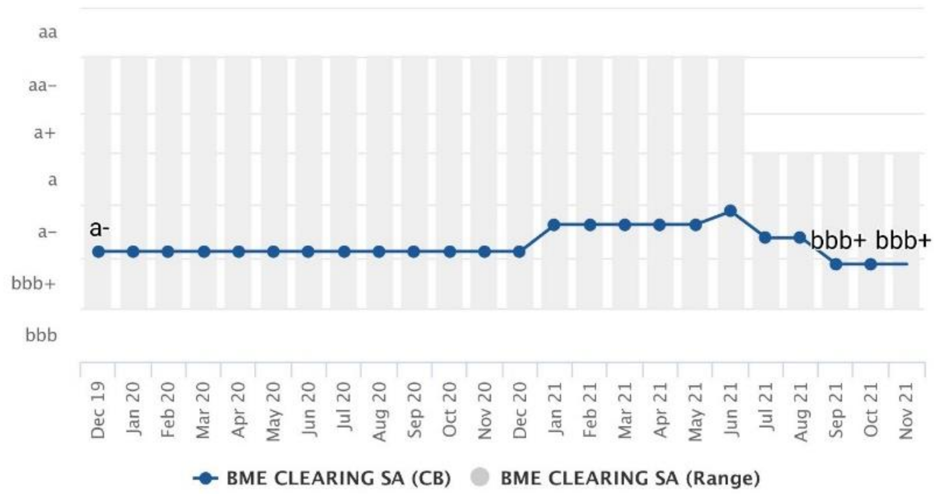
Jackson National Life has been similar to Fitch over most of this period, and both have been trending lower. The range of contributed estimates has recently widened, with the lower bound in the non-investment category **bb+**.

Figure 6.7: ASX Clear Pty Ltd



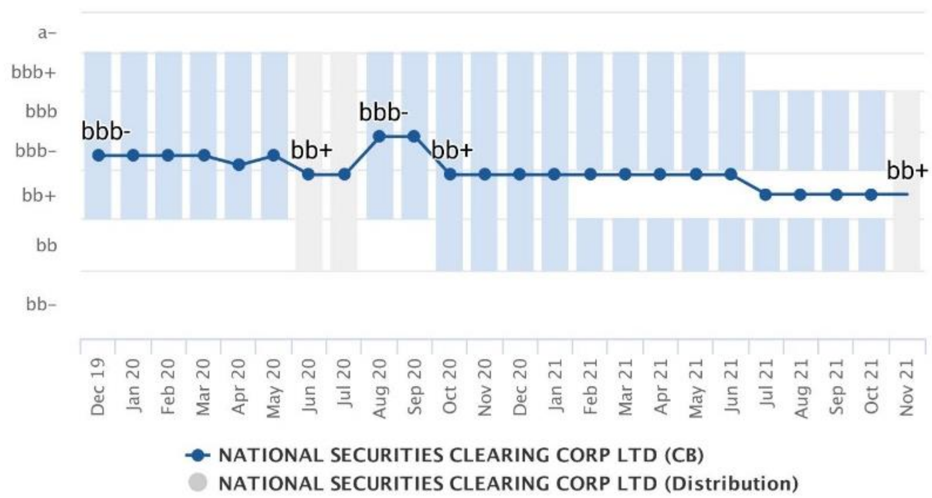
The consensus for ASX Clear has recently moved up a notch to **aa-**, converging towards S&P. S&P have been unchanged at AA- for the past two years.

Figure 6.8: BME Clearing SA



BME Clearing has recently downgraded a notch to **bbb+**. The consensus range has also recently narrowed.

Figure 6.9: National Securities Clearing Corp Ltd



National Securities Clearing Corp has moved from investment grade to high yield over the last two years. The consensus is currently **bb+**.

The consensus range has also recently narrowed.

7. Climate Risk and Insurance

The recent COP26 meeting saw climate change described as the "ultimate systemic risk" – but also a major opportunity for insurance firms. These comments were from John Neal, CEO of the Lloyd's insurance market in London, and they summarise the mood across the insurance industry. For general insurers, climate change means more frequent and larger claims; for much of the industry it also means more risk in the assets that are held against liabilities.

Higher premiums for climate-related risks seem inevitable, but insurance policy rates also offer a reality check to the climate debate, where "facts" and "alternative-facts" can be hard to verify[3]. For example, if flood claims start to rise in Germany, then the industry will quickly factor that as an unexpected consequence of climate change.

Hedging climate risk is major challenge, and one approach highlighted in the BlackRock survey is to invest in companies that will either benefit or at least outperform their less sustainable peers. The concept is that asset reallocation by the entire industry will, over time, solve part of the climate change issue.

The aim of sustainable investing is to limit the availability of low-cost funding for problem industries, increasing it for cleaner technologies and lifestyles. In theory this puts insurance at the forefront of the "E" in ESG investing. And this is already being put into practice: Swiss Re have moved at least $100bn into sustainable investments.

But Property and Casualty insurers face a disconnect in the time horizons for assets and liabilities. Some of them argue that the impact of sustainable investing is a long-term process, while their policies are very short term. They may lay off risks to Reinsurers, but they can also handle rising risk by simply increasing premiums.

Life insurance companies have the advantages and disadvantages of a long-term horizon, so their ESG investment strategy is critical for their assets, even though the impact of climate change on their liabilities is likely to be small, at least in the short to medium term[4].

8. Conclusion

The outlook for life insurance depends on how the asset-liability profile reacts to rising inflation, higher interest rates and potentially higher mortality rates. The macro balance is probably turning slightly negative.

For non-life insurers, the future is one of rising global risks – health, climate and economic. Against this background, premiums need to keep pace and insurers may see periods of heavy pay-out before the accumulated premium total catches up. So general insurers may be heading into a more difficult period where cash outflows exceed cash inflows.

From a credit perspective, insurance companies have so far weathered COVID better than most sectors of the global economy, but the "new normal" is likely to be more challenging.

[3] See https://www.verisk.com/top-risks/climate-change-a-complex-global-challenge/ for some detailed papers on climate change fact-checking for insurance purposes

[4] The COVID pandemic has increased premature mortality rates – and while the expectation is that this was an isolated event, climate change is likely to bring changes to human health in a number of ways that could further distort life insurance outcomes.

More from Credit Benchmark

Credit Benchmark brings together internal credit risk views from 40+ of the world's leading financial institutions to provide credit consensus ratings and analytics on 60,000+ corporates, financials, funds, and sovereigns, over 75% of which are publicly unrated. The contributions are anonymized, aggregated, and published twice monthly to provide an independent, real-world measure of risk.

The data is available via the Credit Benchmark Web App, Excel add-in, flat file download, and **third-party platforms including Bloomberg.** High level credit assessments on the single name constituents of the sectors mentioned in this report can be accessed on CRPR <GO> or via CRDT <GO>.

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More of our original research and regular credit risk surveillance reports can be found on our website, including the following monthly reports:

- The Financial Counterpart Monitor provides a unique analysis of the changing creditworthiness of financial institutions. The report, which covers banks, intermediaries, buy-side managers, and buy-side owners, summarizes the changes in credit consensus of each group as well as their current credit distribution and count of entities that have migrated from Investment Grade to High Yield.

- The Industry Monitor shows the changing creditworthiness of a selection of industries and sectors. The report shows the number of entities per category with a Credit Consensus Rating, their month-on-month changes in credit distribution, and their transitioning credit quality.

- Credit Consensus Indicators (CCIs). The CCI is an index of forward-looking credit opinions for US, UK and EU Industrials. The CCI tracks the total number of upgrades and downgrades made each month by credit analysts to chart the long-term trend in analyst sentiment for Industrials.

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