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Quarterly insurance update

Q4 2024

ROYAL LONDON
ASSET MANAGEMENT

Summary

Welcome to the Quarter 4 2024 investment update designed for insurers and produced by Royal London Asset Management. Throughout the last quarter, markets continued to focus on central bank actions, as both the Federal Reserve (Fed) and Bank of England (BoE) followed the European Central Bank in making the first rate cuts this cycle. This follows the significant rises through 2022 and 2023 as part of efforts to reduce inflation. Along with a significant stimulus package in China, this policy shift generally helped fixed income markets to perform positively over the quarter as yields fell to reflect lower central bank interest rates.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress. In the UK, The Prudential Regulation Authority (PRA) has introduced several key changes in their policy statement. The PRA have also issued their approach to the Life Insurance Stress Test (LIST) 2025. This sets out their objectives and purpose of the LIST, as well as the main elements of the framework for the 2025 exercise. Additionally, Gareth Truran, Executive Director of Insurance Supervision, highlighted significant reforms to the Matching Adjustment (MA) regime under the Solvency UK framework. In Europe, Insurance Europe published a statement on behalf of the insurance industry. The statement urged the member states of the European Union (EU) to use the current consultation period of the review as a 'golden opportunity'. As well as this, the European Insurance and Occupational Pensions Authority (EIOPA) launched its public consultation on the future implementation of the new proportionality framework.

Within this quarterly update, we cover developments in the two main areas most prevalent to the asset side of insurers' balance sheets - investment markets and regulations. In addition, we highlight investment and economic themes we believe are pertinent to many insurers at the present time.

Market update:

- Government yields generally fell over the quarter, reflecting the start of the rate cutting cycle.
- The sterling investment grade credit market returned 2.28% over the quarter, with the average sterling investment grade credit spread ending the period unchanged at 1.03%.
- Equity markets were broadly flat, reflecting heightened geopolitical tensions in the Middle East and ongoing inflationary pressures on the global economy, against the hope that the policy easing would result in a 'soft-landing for the economy with the US S&P 500 index hitting an all-time high.

Regulatory update:

The regulatory environment for insurers continued to develop. Over the quarter:

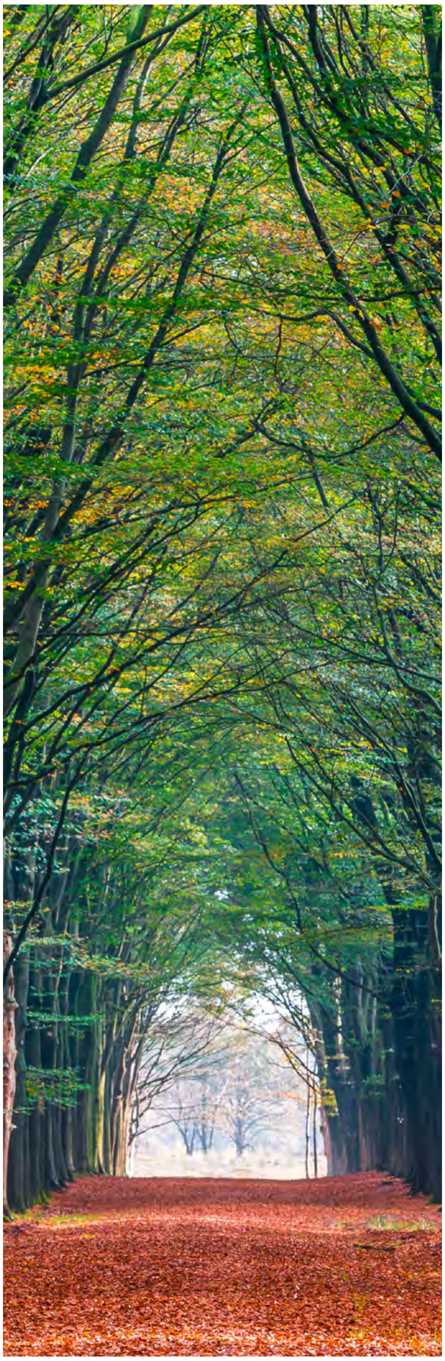
Europe

- Insurance Europe published a statement on behalf of the insurance industry. The statement urged the member states of the EU to use the current consultation period of the review as a 'golden opportunity' to unlock additional capital and support the green and digital transitions.
- Following Insurance Europe's statement in the previous month, on 2nd August 2024 EIOPA launched its public consultation on the future implementation of the new proportionality framework.

UK

- The PRA published Policy Statement (PS) 13/24 on 26 July, 2024, which outlines the amended policy on funded reinsurance arrangements under the new Solvency UK regime. This policy statement follows the consultation paper (CP) 24/23 and incorporates feedback from industry stakeholders.
- The PRA have also issued their approach to the Life Insurance Stress Test (LIST) 2025. This sets out their objectives and purpose of the LIST, as well as the main elements of the framework for the 2025 exercise.
- Gareth Truran (Executive Director, Insurance Supervision) gave a speech at the Insurance Asset Risk webinar. The speech highlighted significant reforms to the Matching Adjustment (MA) regime under the Solvency UK (SUK) framework. These reforms aim to enhance the investment flexibility of insurers while maintaining the core safety and risk profile of insurers.

We explore these areas in more detail, also highlighting what these could mean for insurers going forward.



Insurance investment themes:

We have historically set out an investment idea or theme for insurers that we believe is well placed, and relevant, relative to the future economic and regulatory environment. For this quarter's publication we have focused on Economics:

- **Economic update:** Categorised as a super election year, 2024 has been marred by double-digit inflation in many developed economies, rapid and substantial hikes following a decade of near zero or ultra-low interest rates as well as continued and heightened geopolitical tensions. In this section we will share Royal London Asset Management's view on interest rates, the cuts that are already priced into markets as well as the potential path of inflation, and the impact of the election of the next leader of the free world.

Market update

	Yield (%)*		Total 3 month return*	
	28 June 2024	30 September 2024		
Euro Treasuries†	3.20	2.62	4.35% (GBP)	4.02% (EUR)
UK Gilts†	4.43	4.28	2.32% (GBP)	
US Treasuries†	4.57	3.76	4.59% (GBP)	4.25% (EUR)

	Spread (bps)*		Total 3 month return*	
	28 June 2024	30 September 2024		
Global IG Corporates†	103	99	4.86% (GBP)	4.52% (EUR)
Euro IG Corporates†	114	113	3.26% (EUR)	
UK IG Corporates†	107	107	2.30% (GBP)	
Emerging Market Debt†	391	361	6.46% (GBP)	6.12% (EUR)
Global High Yield†	261	262	4.24% (GBP)	3.91% (EUR)

	Price index*		Total 3 month return*	
	28 June 2024	30 September 2024		
Global Equities†	20972.93	21023.08	0.24% (GBP)	2.14% (EUR)
Euro Equities†	4894.02	5000.45	2.17% (EUR)	
UK Equities†	4451.92	4511.00	2.26% (GBP)	
Emerging Market Equities†	678.05	694.74	2.46% (GBP)	4.41% (EUR)

	Index*	
	28 June 2024	30 September 2024
Volatility†	12.44	16.73

*Source: Bloomberg, IHS Markit.

†See appendix for details on index used and returns quoted.

Past performance is not a guide to future performance. The value of investments and any income from may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Overview

Markets continued to focus on central bank actions during the quarter, as both the Federal Reserve (Fed) and Bank of England (BoE) followed the European Central Bank in making the first rate cuts this cycle. This follows the significant rises through 2022 and 2023 as part of efforts to reduce inflation. Along with a significant stimulus package in China, this policy shift generally helped fixed income markets to perform positively over the quarter as yields fell to reflect lower central bank interest rates. After initial weakness, equity markets started to rise once more, reflecting the hope that the policy easing would result in a soft landing for the economy with the US S&P 500 index hitting an all-time high. Despite guidance from central banks that further cuts will be measured, markets are still pricing in material rate cuts over the next year or so.

After elections in the UK and France grabbed headlines in the second quarter, attention moved firmly to the forthcoming US elections. Markets believe that a Trump presidency would see looser fiscal policy and higher tariffs and protectionism. Sentiment has swung on the fortunes of the early days of the race, first following the Trump assassination attempt and debate against President Biden, which appeared to favour Trump, but then swung back as Kamala Harris emerged as a credible candidate and performed strongly in her debate with the former president. Somewhat remarkably, markets have remained sanguine about rising geopolitical tensions in the Middle East.

The Fed cut rates by 50bps to 4.75%-5%. This was in contrast to most economist expectations, but in line with what the market had been increasingly pricing. The Fed see diminished upside risks to inflation and increased downside risks to employment and eased policy accordingly. Their forecasts and language indicated that they anticipate the change as the beginning of a series of cuts, returning rates "to a more neutral stance." As of their September meeting, the median forecast of participants showed another 50bps of cuts over the rest of 2024, then a further 100bps easing over 2025. Inflation data released over the quarter was relatively reassuring, while Q2 GDP was strong and forward-looking indicators were consistent with a continued robust pace of growth in Q3 by the end of the quarter. These mixed data signals contributed to ongoing volatility in US treasury markets.

In the Euro area, the ECB cut the deposit rate 25bps to 3.50% on the back of inflation data coming in "broadly as expected" and "still subdued" economic activity. Lagarde's comments at the time didn't give much away in terms of the likely pace of future cuts (beyond that they expect to be lowering rates further). Euro area CPI moved lower but there was little change in core or services inflation, which remains stubbornly above target levels. French politics were a focus for the early part of the quarter with a hung parliament the result from the July election. Following these election results Michel Barnier – who previously negotiated with the UK over the terms of Brexit - was selected as PM in September and delayed a target to bring the deficit back within EU rules until 2029.

UK data released in Q3 were consistent with the UK economy growing modestly, while headline inflation has been running close to the 2% target. Later in the period there was a worrying fall in consumer confidence in September, which may have reflected some concern over what the October Budget might bring after the new government flagged that "painful" decisions may be required. The BoE cut rates by 25bps, though with (only) a 5-4 vote, warning that they need to be careful not to cut too quickly – duly leaving rates unchanged in September.

Government bonds

Government yields generally fell over the quarter, reflecting the start of the rate cutting cycle. In the US, 10-year treasury yields fell from 4.40% to 3.79%, while German 10-year bunds similarly saw yields fall from 2.50% to 2.13%. Benchmark 10-year gilt yields dipped from 4.18% to 4.01% - although gilt yields rose slightly towards the end of the period reflecting concerns that the Budget might see a further increase in gilt issuance.

Index linked markets saw similar moves, with real yields on US and Germany 10-year real yields all ending the quarter lower than they started, while UK equivalents ended broadly unchanged at 0.58%, although this hid significant intra-quarter volatility, with these trading as high as 0.67% and as low as 0.40%. Breakevens edged lower.

Credit

The sterling investment grade credit market (iBoxx non-gilt index) returned 2.28% over the quarter, with the average sterling investment grade credit spread ending the period unchanged at 1.03% (iBoxx). Given the modest fall in yields, sectors such as social housing performed due to the greater proportion of long-dated bonds, while real estate also did well due to the sensitivity of the real estate market to interest rates. Of the major sectors, supranationals slightly lagged the market, while banks and insurance outperformed.

In the high yield market, the ICE BofAML (BB-B) Global Non-Financial High Yield Index (sterling hedged) benchmark returned 4.21% in the quarter with spreads at 283bps. At the end of the period, the index's yield-to-worst stood at 6.20%, slipping in July but was then steady throughout the quarter, but is down from 7.05% at the start of the year. In the broader-based high yield index, which includes CCC rated bonds, spreads tightened to 345bps, with a yield-to-worst of 6.83%.

Equities

Equity markets were broadly flat, reflecting heightened geopolitical tensions in the Middle East and ongoing inflationary pressures on the global economy, against the hope that the policy easing would result in a 'soft-landing' for the economy with the US S&P 500 index hitting an all-time high. Global equities have still posted gains on a year-to-date basis.

The UK equity market rose 2.3% (FTSE All-Share index), advancing on the second quarter's growth of 3.7% and the 3.6% added in the first quarter. In overall terms, UK equities outperformed the Europe ex UK index and World index in the third quarter – which were broadly flat, in sterling terms, as the UK market typically performs well when we see tech sector volatility. Top performing sectors in the quarter were consumer staples, utilities and real estate, while technology and energy underperformed.

Regulatory updates

1. Insurance Europe - Solvency II a 'golden opportunity' to unlock billions of capital for Europe

On 23rd July 2024, Insurance Europe published a statement on behalf of the insurance industry. The statement urged the member states of the EU to use the current consultation period of the review as a 'golden opportunity' to not only:

- Unlock additional capital and enhance competitiveness but also.
- Support the green and digital transitions by creating a more efficient capital market slightly for other fixed income market

In its statement accompanied by its own response to the consultation, Insurance Europe said that the details within the review must closely reflect the political agreement made last year by the EU's co-legislators, the European Council and Parliament. These details included:

- A call for reducing the risk margin: Insurance Europe proposed reducing the risk margin, which currently reduces available capital by €141bn. Improvements would approximately halve the size and volatility of the risk margin, which in turn would increase the industry's risk bearing capacity by up to €70bn. In comparison to other regions, Europe's current risk margin is significantly higher than the UK, Japan, and the US, implying that the current buffer is excessive and unnecessary which hinders economic growth.
- Other important issues raised included the extrapolation of risk-free interest rates, volatility adjustment, and the long-term equity submodule, which are crucial for the insurance long-term business model.

What does it mean for insurers?

The statement highlighted the potential impact the Solvency II review will have on insurers. Of particular note, the changes on proportionality will have some helpful improvements for very small insurers, such as reduced and less onerous reporting requirements. However, in aggregate the proposals would lead to an increase in operational costs i.e. every change to reporting creates the need for an IT project, data sourcing, validation and management processes.
In our view it is vital that improvements are made to reduce the burden on insurers, including smaller ones.

Changes to the framework, such as the extrapolation of risk-free interest rates, volatility adjustment, matching adjustment, risk margin, and long-term equity submodule, will significantly impact the insurance long-term business model. These changes, as stated by Insurance Europe, are crucial for safeguarding the ability of insurers to offer guaranteed products, invest long-term, and avoid unnecessary procyclical behaviour.

2. EIOPA consults on new proportionality regime under Solvency II

Following Insurance Europe's statement in the previous month, on 2nd August 2024 the European Insurance and Occupational Pensions Authority (EIOPA) launched its public consultation on the future implementation of the new proportionality framework.

EIOPA's consultation aims to refine the methodology for classifying small and non-complex insurers and set conditions for granting proportionality measures to other insurers. The revised framework establishes criteria for identifying small and non-complex insurers based on risk nature, scale, and complexity, allowing regulators to grant or withdraw proportionality measures.

In terms of next steps insurers were invited to provide feedback by 25 October 2024, with EIOPA to review input and submit final advice to the European Commission by 31 January 2025.

What does this mean for insurers?

In terms of being classified as small and non-complex, insurers will need to evaluate whether they meet the criteria. This classification would likely reduce the regulatory burden, as these insurers may benefit from simplified reporting and compliance requirements.

For those insurers not classified as small and non-complex, proportionality measures would require regulatory approval. These measures allow for a more tailored approach to regulation, considering the specific risk profile and business model of the insurer.

Insurers are encouraged to participate in the consultation process by providing feedback and suggestions. This engagement can help shape the final implementation of the proportionality framework, ensuring that it is practical and effective for the industry.

Overall, the new proportionality framework aims to create a more balanced regulatory environment that considers the size and complexity of insurers, reducing unnecessary administrative burdens while maintaining robust oversight and protection for policyholders.

1. Reforms to funded reinsurance – PRA Policy Statement

The Prudential Regulation Authority (PRA) published Policy Statement (PS) 13/24 on July 26, 2024, which outlines the amended policy on funded reinsurance arrangements under the new Solvency UK regime. This policy statement follows the consultation paper (CP) 24/23 and incorporates feedback from industry stakeholders.

Key Changes in the Policy Statement

1. **Diversification and Counterparty Risk** – The PRA has added a clarifying statement that firms should consider diversification between funded reinsurance counterparties and associated risks, particularly those arising from the concentrated use of a few counterparties. This change emphasizes the importance of diversification across multiple counterparties to mitigate the impact of any single counterparty's failure.
2. **Internal Investment Limits** – Firms are now expected to set internal investment limits, particularly concerning the recapture from a single counterparty. This includes establishing metrics to assess the impact of immediate recapture before any management actions are taken.
3. **Collateral Policies** – Adjustments have been made to clarify how firms should consider the underlying nature of collateral assets and document these policies, which is expected to sit within the broader risk management framework of insurers. This clarification includes detailed policies for illiquid assets in collateral pools and the use of collateral haircuts. Furthermore, the PRA proposed that firms take into account their current Matching Adjustment (MA) approvals when considering the MA eligibility of additional collateral assets.
4. **Board Involvement** – Boards will now be expected to approve and oversee any recapture plans, ensuring they are robust and actionable.
5. **Managing Uncertainty in Internal Models** – Clarifications have been provided on how firms should manage any uncertainty in internal model outputs for funded reinsurance arrangements. This includes considering the time horizon in respect of collateral mismatch risk.

What does this mean for insurers?

The changes introduced in the PRA's funded reinsurance policy statement are designed to enhance the resilience and stability of insurers' investment portfolios. The emphasis on diversification and internal investment limits will require insurers to adopt more sophisticated risk management strategies. This may involve reassessing current reinsurance counterparties and potentially seeking new partnerships to ensure compliance with the new policies.

Managing uncertainty in internal models and setting precise internal investment limits will necessitate some operational adjustments. Insurers will need to invest in advanced modelling tools and may need to enhance their actuarial capabilities to meet these new requirements – all resulting in an increased operational burden and further costs. The requirement to document and manage collateral policies, especially for illiquid assets, will increase the reporting and operational burden on insurers, but should not be so great that it disincentivises allocations to these key asset classes.

2. Solvency UK, Time to Build – Insurance Asset Risk Speech

On the 9th July Gareth Truran (Executive Director, Insurance Supervision) gave a speech at the Insurance Asset Risk webinar. The speech highlighted significant reforms to the Matching Adjustment (MA) regime under the Solvency UK (SUK) framework. These reforms aim to enhance the investment flexibility of insurers while maintaining the core safety and risk profile of insurers.

The speech covered the following key changes to the MA framework:

- **Expansion of Eligible Assets** – The MA regime now includes a broader range of assets, specifically those with highly predictable cash flows. This expansion allows insurers to incorporate assets such as infrastructure investments and green energy projects into their MA portfolios, which were previously excluded due to their cash flow characteristics.
- **Streamlined Application Process** – The PRA has simplified the application process for MA approvals. This includes reducing the documentation requirements and increasing reliance on insurers' internal processes and controls. The streamlined process aims to expedite the inclusion of new assets and liabilities in MA portfolios.
- **Enhanced Risk Management Requirements** – Insurers are now required to provide explicit attestations regarding the appropriateness of the MA benefit for their underlying assets. This new requirement ensures that insurers maintain robust asset-liability matching and manage risks effectively.
- **Proportionality in Attestation** – The attestation process has been made more straightforward for assets with standard market features. This change aims to reduce the administrative burden on insurers while ensuring that the MA benefit is appropriately justified.
- **Flexibility in Implementation** – The PRA has provided additional time for insurers to meet new expectations, recognizing the need for a smooth transition to the updated regime. This flexibility is intended to help insurers adapt their investment strategies without undue pressure.

What does this mean for insurers?

The reforms to the MA regime represent a positive step towards enhancing the investment flexibility and risk management capabilities of insurers. By expanding eligible assets, streamlining processes, and emphasizing robust risk management, these changes support the long-term growth and competitiveness of the UK insurance sector. Insurers are now better positioned to invest in productive assets that contribute to the UK economy while maintaining the safety and soundness of their portfolios. The expansion of eligible assets under the MA regime opens up new investment opportunities for insurers. Facilitating investment across a new wider range of long-term productive assets, such as infrastructure and green energy projects, which can enhance portfolio diversification. Furthermore, the simplified application process and proportionality in attestation reduce the administrative burden on insurers.

3. PRA request technical input for LIST 2025

The PRA have issued their approach to the Life Insurance Stress Test (LIST) 2025. This sets out our objectives and purpose of the LIST, as well as the main elements of the framework for the 2025 exercise.

The PRA also requested technical input, providing an opportunity for insurers to provide feedback on our proposed guidelines and specifications ahead of the formal launch of the LIST in January 2025. The request covers the scenario specification, guidelines and instructions, quantitative data templates, and the Results and Basis of Preparation (RBP) report that will go onto support the quantitative results.

However, the opportunity to provide technical feedback has already passed, closing on the 6th September 2024.

Insurance investment themes:

Economic Update

Whilst historically this section has focussed on a relevant investment theme, this quarter centres on economics.

Categorised as a super election year, 2024 has been marred by double-digit inflation in many developed economies, rapid and substantial hikes following a decade of near zero or ultra-low interest rates as well as continued and heightened geopolitical tensions.

In this section we share Royal London Asset Management's view on interest rates, the cuts that are already priced into markets as well as the potential path of inflation, and the impact of the election of the next leader of the free world.

What can we expect from rates?

Markets over the quarter continued to focus on central bank actions as both the Federal Reserve (Fed) and Bank of England (BoE) followed the European Central Bank in making the first rate cuts this cycle, the first drop for more than four years. As expected in September, however, the BoE kept rates on hold at 5.00% despite the Fed firing the starting gun on its rate cutting cycle with a full 0.50% rate cut the day before. Regardless, a 0.25% rate cut in November, is fully priced and the market will be paying close attention to the economic data as well as the as the actions of other central banks to determine whether a further rate cut is warranted.

Does November make sense for the next cut?

Despite only one out of nine UK's MPC (Monetary Policy Committee) members voting for a rate cut in September, we think it still seems reasonable to expect another rate cut in November. They will have an updated set of forecasts and analysis and having made a move towards scenario analysis; it makes sense that they would want a chance to fully refresh that again before cutting. Meanwhile, there is an absence of data suggesting that the UK economy is seriously turning down and that the Bank therefore needs to move quickly. Much of the UK activity data has held up well, including relatively robust PMI business surveys and a fall in the unemployment rate. In addition to this, we have also seen a recent trend downwards in inflation to 1.7% in the year to September, the lowest rate in 3.5 years, which suggests a strong indication for interest rate cuts. However, in line with them cutting further in the months ahead, on the unemployment rate, they note that it was very difficult to gauge the underlying state of labour market activity given data quality issues and that their own model suggested that "underlying unemployment had increased steadily over the past few quarters." They also note further evidence supporting a moderation in pay growth for example.

…Or will this be delayed?

If the activity data continues to hold up as it is and with inflation a bit above target (and expected to rise into year-end on a rise in energy bills), there must be a chance that the next move is in February rather than November. It's been noted, for example, that a continuation of the current pace of underlying GDP growth would imply less spare capacity opening in the economy than they had forecast. They also note that their forecast for spare capacity "in part reflected the previously announced medium-term tightening in the stance of fiscal policy". A stimulative Budget could knock their forecasts even further off course.

How have markets reacted to geopolitical risk?

Despite escalating conflicts in the Middle East, financial markets remain optimistic, buoyed by shifts in oil production and global monetary policies. However, the threat of supply disruptions and geopolitical risks persists. So far, commodity markets have reacted most clearly to the worsening conflict in the Middle East, as fears have risen around potential supply disruptions. At the beginning of October, Brent oil posted its strongest price increases since January 2023, rallying by 8% amid fears of a wider regional war and lingering risks to Iran's oil supply.

While we are nervous around geopolitical tensions in the near term, we remain broadly positive on equities in the medium term based on improving global macro conditions. While geopolitical risk does pose a threat to markets in the near-term and reins in our confidence levels, we maintain an overall positive view on stocks. The economic backdrop and monetary policy loosening could continue to support markets and investor sentiment from here.

US Election:

After elections in the UK and France grabbed headlines in the second quarter, attention moved firmly to the forthcoming US elections. Markets believe that a Trump presidency would see looser fiscal policy and higher tariffs and protectionism. Sentiment has swung on the fortunes of the early days of the race, first following the Trump assassination attempt and debate against President Biden, which appeared to favour Trump, but then swung back as Kamela Harris emerged as a credible candidate and performed strongly in her debate with the former president. Geopolitics has played a greater role in markets over the past few years after a lengthy period where it was often seen as mere background noise. The forthcoming US Presidential election is too close to call as we head into October, but with meaningful differences between the two candidates, this will weigh on markets in the run-up to election day.

What next?

As we enter the final months of 2024, market focus has moved from when central banks will first cut interest rates, to the scale and timetable of those cuts. As we saw at the start of 2024, markets have generally been overly aggressive in their expectations – at one point in September two year and five-year treasury yields had dropped further below the Fed Funds rate than any point in many decades. While this has at times been supported by commentary from central bank members, we have generally been more cautious. Our caution reflects that while headline inflation may have come down, service and wage inflation are still generally at levels that are not normally consistent with significant rate cuts. After a decade that includes a world-wide pandemic, a European land war, and the election of a TV reality star as US president, perhaps there is no 'normal' to fall back on, but we are certainly more cautious about the rate outlook.

What does this mean for insurers?

Insurers are exposed to multiple macroeconomic risks from interest rates impacting the discounting of liabilities to inflation influencing claims levels. Arguably 2024 has been a volatile year to date on many fronts and this seems likely to continue. Those insurers able and willing to be nimbler in decision making are likely to weather this storm better than others

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Appendix

Fixed income	Index Used	Returns Quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged

Equities	Index used	Returns quoted
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged

Volatility	Index used
Volatility	Cboe Volatility Index (VIX)

Source: Bloomberg, HIS Markit

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