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What a Dovish Federal Reserve Means for the Insurance Industry

The Federal Reserve on Wednesday announced a 50 basis point interest rate cut on the Federal Funds Rate in what marked the start of quantitative easing from the world's most important central bank for the first time in four years. Currently, the Federal Funds Rate stands at a range of 4.75-5% with further indication that interest rates will fall by another 0.5% before the end of the calendar year. Consequently, we will look at how lower interest rate environments will impact the insurance industry.

Analysing Historical Trends

Historical data analysis has suggested that insurance companies tend to be more profitable during periods of high interest rates. Generally, an increase in the profitability of insurance companies is in lockstep to an increase in interest rates. This is mainly attributable to a boost in sales of pension and life insurance products. High interest rate environments usually provide for more attractive options to customers as a way to secure their retirement income. Policyholders will get higher returns for their pension products for the same level of risk that they are exposed to. For example, pension products that invest in bonds will be more attractive as investors can get a higher yield during high interest rate environments while being invested in a safer asset class. (bonds are often regarded as one of the safer or more conservative asset classes)

The Outlook for Lower Interest Rate Environments on the Industry

Lower interest rate environments will definitely impact the profitability of insurance companies. For one, lower interest rates have a direct impact on fixed-income linked products as investors generally tend to favour higher-yielding assets albeit with higher risks. Additionally, a decrease in sales translates to lower premiums collected and thus decreased profitability. Moreover, the assets of insurers will be affected as the majority of them are invested in interest rate sensitive assets. However, a lower interest rate environment presents a prime opportunity for insurers to adjust and recalibrate their portfolio allocation. If these insurers had bought long term bond issues with a higher interest rate locked in, they will receive higher coupon payouts which they can then shift their focus to invest in other asset classes that perform during periods of low interest rates like equities or REITs. This would then allow insurers to sell more products that are linked to non fixed income products.

Concurrently, falling interest rates will typically experience a resurgence in reinsurance transactions as insurance companies have a growing need to reinsure or transfer interest rate risks to other counterparties. Additionally, mergers and acquisitions activity will also see an uptick as valuations tend to ease during low interest rate periods. In a nutshell, when interest rates decrease, insurance companies are presented with a prime opportunity to refocus on their product offerings. Although there may be decreases in sales for one product, a swift and robust reaction to introduce new products could help to cover the decrease.

Opportunities in Alternative Asset Insurance

In our previous article, we discussed the correlation of cryptocurrency markets and macroeconomic factors which pointed to higher price levels for Bitcoin in low interest rate environments. Insurers who specialise in alternative asset protection like NIACE usually experience higher sales during low interest rate environments. As interest rates ease, investors generally have a larger risk appetite which would usually see fund flows from conservative assets like bonds into riskier assets like Bitcoin. Coupled with the looming United States elections happening in November, the cryptocurrency market could see more inward fund flows as investors and speculators pile in on a cryptocurrency market that is experiencing increasing volatility.
This phenomenon would be advantageous to alternative asset insurers as investors potentially would want to protect their cryptocurrency portfolio. Additionally, lower interest rates might see a natural entry price for investors who wish to hedge their wealth against their own home currencies which might be very sensitive to market forces.

NIACE will continue to monitor geopolitical and macroeconomic events that are forecasted to take place in the next few months. The company is aware that these events could have the potential to impact our clients and we hope to weather the storm together. NIACE remains committed to providing our clients with the best in-house coverage and policies and thank each and every one of our clients for their continued support as we look ahead into a period of transition into lower interest rate environments against the backdrop of a volatile geopolitical landscape.

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