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STAYING AGILE:

Managing change and shocks is now business as usual for insurers

BNP PARIBAS
ASSET MANAGEMENT

Staying agile: Managing change and shocks is now business as usual for insurers

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- *Insurers manage their asset portfolios in a multidimensional and complex environment, combining multiple objectives and constraints. Recent history shows that all parameters are interdependent and evolving, including sudden and non-linear macro shocks*

- *Beyond current circumstances, insurers should contemplate how they can strengthen their investment and risk management frameworks – and consider exploiting a broader set of asset classes and investment management techniques*

- *Enhancing investment and risk management frameworks is not straightforward and requires reinforced resources, skills, tools and processes. Insurers may have to make strategic decisions to determine the optimal level of outsourcing, from building blocks to more holistic solutions*

We live in a complex, uncertain and fast-changing world, where organisations need to adapt to thrive - and this is especially true for insurance companies, whatever their market or business line. Insurers manage balance sheets and asset portfolios in complex, and multidimensional, local and global frameworks. They must build and manage a portfolio which matches their liabilities while protecting and stabilising their economic and regulatory capital position.

In addition, insurers need to navigate macroeconomics, alongside financial markets, and maximise policyholder and shareholder investment returns in a risk-controlled manner. They must steer their financial results and contain profit and loss volatility under different accounting standards and factor in sustainability, climate risk and impact on society.

These are all dimensions which need to be taken on board by insurers, and the equation is becoming ever more complex as these parameters are interdependent and evolving over time.

A story of constant adaptation

The past 20 years have been a bumpy road for insurers, especially in Europe. The global financial and eurozone debt crises and the subsequent low growth/low inflation era led central banks to introduce unconventional monetary policies which plunged insurers into a decade of ultra-low interest rates, forcing them to significantly reshape their asset portfolios and adapt their business models.

Financial market turbulence and lower-for-longer yields deteriorated solvency positions, especially in markets exhibiting high levels of guarantees and significant duration gaps. This meant insurers had to strengthen their asset liability management and engage in a global hunt for yield.

Insurers have lengthened their asset duration, including via increased usage of derivatives. In addition, we have also observed a higher tolerance for lower quality bonds, a diversification into foreign credit investments (mimicking what Japanese insurers did years before) and a growing allocation to alternative asset classes.

Insurers have also found a more structural remedy in the design and distribution of more capital-light insurance and savings solutions supported by a growing retirement funding gap.

In Europe, further adaptation of insurance balance sheets and asset portfolios was triggered by Solvency II coming into effect in 2016.[1]

This forced insurers to strengthen their liability matching and led to changes in asset allocation – notably a reduction of listed equity investments, and the adoption of specific risk mitigation techniques, allowing them to potentially optimise the return on capital requirements.

[1] Solvency II - European Insurance and Occupational Pensions Authority

New backdrop, new challenges

2020 marked a paradigm shift for insurers. After a decade of ultra-low interest rates, post-pandemic-driven supply side disruption, and the Russia-Ukraine conflict, led to an unprecedent inflation spike and ultimately a surge in interest rates and interest rate volatility.

This period offered a fresh mix of challenges and opportunities for insurers. Inflation puts pressure on property, casualty, and health insurance companies, as it can impact both assets and liabilities and ultimately insurers' profitability and solvency.

This reminded insurers that inflation risk, which was subdued for years, should be factored into their asset and liability management framework, and that this can potentially require asset allocation adjustments and hedging strategies.

Rising interest rates can however have a positive impact on insurers' capital position, notably for life insurers with long-dated liabilities and a negative duration gap, while reinvestments can be made in higher yields.

Conversely, non-life insurers who tend to have a positive duration gap can be squeezed by increasing claims and interest rates. Beyond the interest rate surge and the opportunity to rebuild book yields, interest rate volatility, mainly resulting from uncertainty around the persistence of inflation, has been challenging for insurers.

Duration and convexity gaps, and therefore capital ratios, can be highly sensitive to interest rate curve movements and are difficult to manage when matching fixed income portfolios exhibit significant unrealised losses.

In this context, interest rate derivatives proved to be valuable portfolio management tools. Another challenge faced by insurers during this period has been the reemergence of liquidity risk.

The swift normalisation of interest rates and curves distorted asset allocations, as public assets and fixed income investments have significantly decreased in value, while the valuation of private assets, often packaged as floating rate investments, remained relatively stable.

This distortion modified insurance portfolios' liquidity profile, while surrender risk materialised in certain markets and insurers had to meet significant margin calls related to their long-dated receiver interest rates swaps positions.

Combined with significant amounts of unrealised losses across portfolios this created a tricky situation which came under regulatory scrutiny. The UK pensions crisis in autumn 2022 is a good example of how liquidity risk can become a concrete reality.

Insurers have a long-term investment horizon and are natural providers of liquidity. They are therefore well placed to provide long-term and stable funding to businesses through private and illiquid capital markets.

Insurers should also continue to benefit from the flexibility brought using derivatives, but recent experience shows that insurers must properly factor liquidity risk into the design of their strategic asset allocation as well as in asset portfolio structuring and management. They should also be encouraged to strengthen their liquidity risk management framework and toolbox.

Another key development in recent years was the introduction of IFRS 9 and IFRS 17 financial reporting standards in 2023. These influence how insurance companies structure and manage their asset portfolios, notably regarding the nature of their liabilities.[2]

This change also introduced new challenges and opportunities, and is still in the process of being managed, as are those changes brought in by the adoption of market consistent and risk-based capital regimes in Asia and Japan.

Managing change is business as usual

Inflationary and monetary conditions have been progressively easing, albeit at varying paces, across different economies.

Europe's gloomier macroeconomic conditions and its faster convergence toward its target inflation rate pushed the European Central Bank to start normalising policy rates as early as mid-2024, with its benchmark rate reaching 2% in mid-2025.

[2] IFRS - IFRS 17 Insurance Contracts
IFRS: International Financial Reporting Standards

The US situation is very different - the world's largest economy is supported by solid consumption and a massive artificial intelligence-related capital expenditure boom, but as inflation remains above target, the Fed Funds Rate also remains high.

Prior to the Middle East conflict - and putting the specific case of Japan aside - the view was that growth would be soft but remain resilient. The consensus expectation was that expansion would be bolstered by AI-related investments and fiscal expansion (e.g. Europe's drive towards strategic autonomy), that inflation would ease towards target levels and the US and UK central banks would continue to cut rates.

But multiple risks were already on the radar for investors. Despite a softer growth and inflation outlook, interest rate curves have steepened in most major markets.

This reflects political uncertainty; the expected increase in sovereign debt net issuance combined with central banks' balance sheet reduction; and the resurgence of concerns around fiscal expansion, fiscal deficits and debt sustainability.

For life insurers with long-dated liabilities and a negative duration gap, higher long-term rates can boost balance sheets but volatile interest rates and widening swap spreads can also hurt capital positions, requiring again a close management of duration and convexity gaps.

While sovereigns are under pressure, risk premia on risk assets remain compressed despite the political uncertainty, tariff concerns, a softening growth outlook and rising geopolitical risks.

High all-in yields across the credit spectrum have supported strong credit demand over the past few years. So far, credit fundamentals have proven to be resilient, but the sector remains vulnerable to shocks.

The same applies to equity markets, at least in the US. Optimism around AI's potential benefits have led to massive amounts of capital being deployed across a handful of companies. As a result, concerns have risen over whether earnings will be proportionate to the general enthusiasm around the Artificial Intelligence (AI) boom.

In addition, potential AI-related disruptions across industries are still to be fully assessed, including in the private credit sector.

The Middle East conflict has reshuffled the cards, fuelling volatility and impacting inflation, as well as growth and monetary policy forecasts. The sustainability of the resolution will obviously matter, but insurers are once again faced with a type of non-linear macro shock which comes on top of pre-existing challenges.

All factors at play can have significant impacts on balance sheets and portfolios - and once again, insurers must adapt to a very fluid environment.

Insurers will have to manage market volatility while preparing for Solvency II reform in 2027. This reform has the potential to be more counter-cyclical (equity symmetric adjustment, volatility adjustment), to release capital (risk margin, long term equity investments) and to provide new investment opportunities (securitisation).

But it also brings more complexity, notably as the discounting curve of reference will be more market sensitive and interest rate shocks much wider than in the current formula. This should incentivise insurers to further strengthen their asset liability management to protect their regulatory capital position and solvency ratio.

Stronger diversification, constrained but beneficial

Against an uncertain backdrop, the golden rule remains to properly diversify risk exposures. Further diversification of asset portfolios not only helps to mitigate market risks but also to exploit structural trends, value opportunities, and to enhance risk-adjusted returns, especially when insurers usually have a very strong domestic bias in their portfolios.

And while insurers have already engaged in a global diversification of their asset portfolios, which is stronger than the diversification of their liabilities, we believe there is still some room for improvement.

A EIOPA Financial Stability Report shows that as of end-2024, European insurers had close to 84% of their asset portfolio allocated to European Economic Area-issued instruments, with the bulk of non-EEA exposure being concentrated in the US, UK and other developed markets. [3]

Looking at the top 10 European Union countries, by non-EEA investments, the analysis reveals heterogeneity with non-EEA investments varying from 37% to 7% of total investments in the respective markets. The average was some 16% of investments in non-EEA instruments, and numerous insurers have a much stronger domestic tilt.

[3] Financial Stability Report December 2025 - European Insurance and Occupational Pensions Authority (EIOPA)

The market drawdown that followed Russia's invasion of Ukraine did not have the same magnitude across countries and regions, and volatility has picked up more dramatically in the eurozone compared to the US.

Similarly, the Middle East conflict's consequences have been, and will be, uneven across economic regions, reinforcing the case for further diversification to mitigate against geopolitical risks.

By construction, the bulk of an insurance general account portfolio is composed of fixed income investments. Diversifying core fixed income matching portfolios into foreign credit markets requires investments to be structured in a way that is compliant with asset liability matching, regulatory capital and accounting frameworks.

Diversifying into foreign currency assets means properly managing unwanted risks, in particular foreign currency and interest rate risks. This can be achieved via derivative-based hedging techniques and other structuring solutions while factoring in capital requirements and accounting volatility.

In this regard the new IFRS 17 standards applicable to life with-profit portfolios (Variable Fee Approach model/Contractual Service Margin) provide much more flexibility to insurers.

Consistent with the European sovereignty and strategic autonomy agenda, including the Finance Europe label launched in 2025, Solvency II reforms bring one limitation to further diversification outside the eurozone for European insurers, which is related to the computation of the Volatility Adjustment (VA) spread used to valuate liabilities.

Indeed, the reform introduces the concept of Credit Spread Sensitivity Ratio (CSSR), a mechanism aiming at adjusting the VA spread for the mismatch in credit spread duration between assets and liabilities, and the CSSR only considers investments in bonds, loans or securitisations in the domestic currency.

This could restrain insurers from diversifying further away from the eurozone, but the computation of the CSSR also considers investments in the shareholder funds, which should leave room for manoeuvre.

In regard to the VA, when diversifying insurers should also be cognisant of the potential differences between the composition of the representative portfolio used to compute the VA spread and the composition of their own portfolio.

Beyond geographic diversification, insurers might also consider diversifying further across asset classes and strategies. For instance, insurers can now find more opportunities to diversify their matching portfolio via bonds issued by European institutions or supranational organisations, which can contribute to mitigate the domestic swap spread risk.

There are degrees of possible diversification in a fixed income portfolio - the ultimate step being to implement a more global and multi-sector approach, and to exploit the entire risk spectrum across developed, emerging, public and private markets.

For instance, for a similar level of rating, certain asset-backed securities can potentially exhibit a significant risk-adjusted spread pick-up compared to corporate bonds. Of course, insurers must also consider the return on capital requirements, and in this regard, the lower capital charged proposed in the Solvency II reform for securitised products will likely reduce the breakeven.

Exploiting the power of derivatives

Building resilience goes beyond mere diversification and derivatives can potentially bring significant value. Beyond hedging unwanted risks related to investments into foreign assets, derivatives can potentially help manage balance sheet risk, stabilise capital ratios, and optimise return on capital.

Interest rate derivatives provide more flexibility to manage duration and convexity gaps, especially when asset rotations are constrained by accounting impacts. They can also prove useful in mitigating the negative consequences of policyholders' redemptions.

The higher sensitivity to market rates brought by the new curve extrapolation methodology under the Solvency II reform might incentivise insurers to make more use of interest rate derivatives.

Interest rate derivatives can also potentially help provide more leeway in managing credit risk exposures by distinguishing between spread and interest rate risk factors in a portfolio.

By being less liability dependent, credit portfolios can be more actively managed and adapted to market conditions. In the current environment matching part of liabilities with interest rate swaps can also contribute to mitigating the swap spread risk on government bonds.

Related to risk asset exposures, risk management derivatives overlay strategies can also help to manage volatility and drawdown risks in equity and credit portfolios.

Derivatives can be a valuable tool but require financial engineering, execution expertise as well as proper structuring solutions to manage accounting and regulatory capital constraints. They also require a robust liquidity and collateral management framework.

Insurers who run portfolios valued using the VFA model under the new IFRS 17 standards should find this new accounting framework provides more flexibility to manage the risk return profile of portfolios more actively and seize this opportunity, within the limits imposed by their local accounting framework.

But more broadly, we believe there is some room for manoeuvre across all portfolios whatever the applicable regulatory framework, meaning insurers have the scope to adapt, and vitally, to thrive.

Innovation for the future

Ageing populations, growing pension funding gaps and a massive wealth transfer to younger generations should fuel a strong demand for savings and retirement solutions over the coming years, beyond traditional life insurance products.

Insurers have already made significant efforts to develop and grow their unit-linked, retirement savings (defined contribution) and wealth management businesses, notably as a response to growing regulatory pressures and more stringent capital requirements applicable to traditional and capital-intensive life insurance products.

Insurers have an important societal role to play – and a massive growth opportunity to seize – provided they offer innovative solutions and can leverage digital and efficient end-customer relationship management tools.

Younger generations may not want to invest in traditional portfolios of bonds and stocks like their parents and are likely to show more interest in innovative and sustainable investment opportunities, technology and digital tools.

Buy or create: A key strategic challenge

Recent history shows insurers need to be ready and equipped to manage change and uncertainty given their implications for insurers' balance sheets and asset portfolios.

Beyond answers to current circumstances and market conditions, which are necessary, it is also a matter of developing a framework that helps navigate future changes and shocks.

Enhancing investment and risk management frameworks and being more agile is not straightforward; it requires more resources, skills and processes.

When the barrier is high, insurers might have to make the strategic decision to either create or purchase solutions. And in terms of the latter, there are questions over the optimal level of outsourcing - from building blocks to more holistic solutions.

The same applies to the development of unit-linked, retirement savings or wealth management solutions which not only require a full suite of innovative investment products, but also an efficient platform to service clients.

Given the investment backdrop has become ever-more intricate and regulatory frameworks continue to evolve, insurers must prioritise agility and innovation in their portfolio and risk management strategies.

Embracing diversification, leveraging advanced investment techniques, and engaging with emerging technologies will be essential to building resilience and capturing long-term growth opportunities.

As the industry navigates these transformative shifts, we believe those who proactively adapt their portfolios, invest in innovative solutions, and strengthen their operational capabilities will be best positioned to thrive.

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