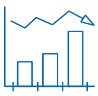
ARTICLE

Balance sheet resilience

Time to examine what's lurking beneath the surface?

Do not wait to reinforce your balance sheet – a storm is on the horizon.



Interest rates have fallen to historic lows and credit spreads have widened over the last 3-4 months.

GDP

Economists have entertained us with U, V, W, L and more shaped predictions of GDP growth.

Even the America's Cup yachts must go into dry dock to make sure their hulls are in optimum condition for the races to come. In a similar respect, an insurer's balance sheet needs to be race ready as we emerge in the coming months out of lockdown into what essentially are uncharted and choppy waters ahead.

Following the start of Solvency II four years ago and a few rounds of "capital optimisation" programs, European insurers entered 2020 with their balance sheets looking shipshape. Since then we have seen high equity market volatility, a further fall in interest rates to historic lows and the widening of credit spreads over the last 3-4 months. Despite this, insurers' balance sheets have held up very well. In conversations with our clients there is a glimmer of optimism that despite initial fears, they have a foundation to tackle head-on what is to come. Insurers are now operationally up and running and servicing their customers at pre-lockdown levels but to continue at that level they must remain financially robust.

I think at best we shall see a U-shaped recovery but honestly, I think it will be an L

There are many opinions on how quickly the global economy will recover. A plethora of economists have entertained us with U, V, W, L and more shaped predictions of future GDP growth.

Future strategic plans, and therefore financial projections, for insurers must take a view on how the economy will recover, or not, in both the short and the long term to give confidence to all stakeholders including regulators, shareholders and policyholders that they are here to stay.

What should you as an insurer be doing to keep on an even keel?

You could batten down the hatches and hope to weather the storm, but your competitors will be taking proactive measures to take advantage of the opportunities that arise. We would not recommend this "wait and see" approach.

Get ahead by:

1. Taking a house view on the possible scenarios underlying the macro-economic future of the markets in which you write business. Test your balance sheet resilience against these different views of GDP contraction and growth with your current strategy. Revise that strategy where appropriate to increase resilience.
2. Being aware of future adverse events. As short-term pandemic responses of governments, such as furloughing employees, unwind there will be shocks to insurers' balance sheets. Part of your future capital and risk management should ensure that your balance sheet can withstand these shocks.

   In the long term, there will economic dislocations from what was the "normal" pre-pandemic view of the world. For example, equity valuations of certain industry sectors will be very different in the future. This may take 1-2 years to manifest itself and for corporate debt defaults to surface and weaken your balance sheet.
3. Revisiting your capital optimisation framework to make sure you are using all the available tools to keep your balance sheet from capsizing. Techniques or actions that you would not have dreamed of using 2-3 years ago might now be sensible, if not necessary, steps to take for your business to get ahead of the competition.

As we approach the strategic planning season, now is the time to take positive action and steer clear of getting grounded on potential sandbanks or even worse, crashing on the rocks with a large hole in the hull.

FTI Consulting is helping companies navigate decision-making in light of these challenges. Learn how insurers can build resilience here: https://ftiemea.to/winningrebound #WinningOnTheRebound

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