EDISON

UK motor P&C insurers series

Part 1: The increasing importance of investment returns

By Marius Strydom

Rising interest rates and yields are reintroducing the importance of investment returns to UK P&C insurers

Property and casualty (P&C) insurance companies make money in two key ways: underwriting risk and making a margin by delivering a combined ratio of less than 100% (an underwriting profit or margin); and generating investment returns on the regulatory capital they hold as well as on the assets backing their substantial insurance reserves (often referred to as the free float). Investors like Warren Buffett's Berkshire Hathaway have traditionally been attracted to P&C insurance companies because of this return on the free float, which helps such companies to deliver operating margins well ahead of their underwriting margins and to achieve superior net asset value (NAV) returns (return on free float adding to the return from underwriting margin and investment return on capital).

Since 2009, interest rates in developed economies, and in the UK in particular, have been at historically low levels and declined to close to zero when the COVID-19 pandemic hit. The wider insurance market, including P&C companies, has also adopted more conservative approaches to solvency, with most participants choosing to hold higher levels of capital than in the decade leading up to 2009. Over the past decade, the average solvency level for UK motor P&C insurers Direct Line, Admiral, Sabre and Hastings was c 180% of regulatory capital, where levels of 160% (on a Solvency II basis) were more common before.

Higher solvency levels resulted in higher levels of investments held (relative to premiums) from which to generate investment returns to boost operating margins. However, this benefit was meaningfully offset by low interest rates and yields. In addition, the higher solvency levels had a dilutionary impact on return on tangible NAV/equity (ROTE).

The net result of higher solvency and lower rates was therefore negative, with operating margins suffering from a lower return on the free float and low returns on additional capital, while ROTE suffered from lower returns on higher levels of capital.

Over the past decade, average investment return on assets for the peer group above was only c 1.5%, rarely contributing more than 10% to earnings over the period.

However, over the past year there has been a dramatic change in global and UK interest rates, with three-month Libor rising from close to zero to more than 3%, while the UK 10-year gilt yield increased from 0.9% to 3.5% after reaching 4.5% in September 2022 (both have been very volatile). This is a huge development for the UK P&C motor industry, and is expected to have a very positive impact on margins and returns.

Negative investment portfolio impact is temporary and should be followed by a strong uplift in investment returns

Published UK P&C company financial results for the first half of 2022 have been less than stellar, affected by high claims inflation and sticky premium rates, especially for UK motor insurers. We expect a marked turnaround in combined ratios, driven by strong premium re-ratings into 2023, which we will explore later in this series.

Earnings and returns during the first half of 2022 were further affected by higher yields on fixed interest portfolios. Capital losses on investment portfolios, which are not included in headline earnings but in total comprehensive income (TCI), were a feature for all the operators, pushing Hastings, Sabre and Direct Line into negative TCI territory and leaving Admiral with close to zero TCI. Annualised ROTE remained positive but dipped to five-year or more lows for all the companies. While we expect the underwriting performance for the sector to improve in the second half of 2022, we also anticipate the sharp rise in yields since June 2022 to continue, negatively affecting TCI and returns for the full year.

We expect these unrealised investment losses to turn around sharply in 2023 as yields normalise and bond and gilt portfolios approach maturity. With higher yields and interest rates, investment return is set to become a much more important contributor to earnings and returns.

Earnings could benefit between 15% and 20% and ROTEs could be lifted between 5% and 7% on the back of higher investment returns

UK P&C motor insurers invest the bulk of their assets (backing free float and regulatory assets) in fixed interest portfolios and cash, with a small proportion in collective investment schemes, direct equity investments and other assets. Over the past decade, Direct Line, Admiral, Sabre and Hastings delivered an average return on these assets of c 1.5% pa. With three-year Libor of over 3% and a UK 10-year gilt yield of 3.5%, investment returns for these companies are expected to rise by at least 2% pa once the negative portfolio adjustments in 2022 are fully accounted for.

Our analysis points to these higher investment returns adding between 15% and 20% (17% on average) to earnings for the peer group relative to pre-COVID-19 levels, all things being equal. This higher earnings delivery would lift ROTE by between 5% and 7% pa from an average of c 34% over the past decade to an average of c 40%.

The actual impact on earnings and ROTE will depend on other factors such as claims inflation, premium rate increases and volume growth, which we will explore later in this series. While inflation and volume growth are expected to be negatively affected by the uncertain economic environment, we are optimistic about premium rates, supported by re-pricing actions by all companies in the peer group, as well as a much-improved outlook disclosed by all four companies in their most recent results.

Outlook

The UK P&C industry, especially the UK motor industry, has experienced a difficult environment over the past decade, with high levels of competition, significant claims pressures, geopolitical uncertainty, meaningful disruption due to the COVID-19 pandemic, regulatory fluidity and large investments to deal with technological changes. The net impact was to curb premium rates increases and premium levels and to put pressure on combined ratios and operating margins.

In the near term, challenges are expected to continue with excess capital encouraging price competition, regulatory changes limiting corrective pricing adjustments, an acceleration in inflation creating claims pressures and higher investment yields leading to negative portfolio revaluations. We will explore the near-term impact on companies' results later in this series.

However, recent developments are largely supportive of a sustained turnaround in fortunes. Higher investment returns are set to add between 15% and 20% to pre-COVID-19 earnings (all things being equal) while ROTEs could be enhanced between 5% and 7%.

Regulatory certainty, pricing discipline and a hard re-insurance rate environment have created premium rate upside from a low post-COVID-19 base (to be explored later in this series).

In our opinion, the recent weakness in UK P&C motor companies' share prices creates a unique opportunity to access this much more optimistic future outlook at very attractive levels. We see upside based on ROTE versus price/NAV in all of the main listed players in the UK P&C motor industry, with the participants well positioned to outperform other sectors due to their sector-specific dynamics countering deteriorating economic prospects.