Impact of rising interest rates

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The results of the US presidential elections and some preliminary statements from officials of the new administration have resulted, amongst other things, in a sharp spike in US interest rates. This has reinvigorated the debate around fiscal policy, growth and future expectations for the US economy and also for the global outlook. Expectations of raising interest rates impacts sharply the outlook for financial stocks (banks, life insurers and non-life insurers). It is important to remember that in the case of Tryg and the Danish insurers the impact of raising interest rates is somewhat different compared to Nordic/European peers.

Full discounting of claims reserves mandatory in Denmark

Under Danish FSA rules, insurance companies in Denmark are required to mark to market fully all assets & liabilities. Tryg therefore discounts all claims reserves (liabilities on the balance sheet). This means that when interest rates increase, Tryg will book less claims in the P&L hence an improved claims ratio (all else equals) and an improved combined ratio. This accounting practice follows local Danish FSA rules and is somewhat unique in Europe and even amongst Nordic peers (i.e. non-Danish peers) and results in a different impact on our figures compared to peers.

Matching strategy mitigates initial loss

When interest rates rise, Tryg will book a loss on its fixed income portfolio but at the same time gain from the higher interest rate used to discount the liabilities. The match portfolio (DKK 29.1bn) is primarily composed of fixed income assets with the purpose of matching the duration of the insurance liabilities, so that fluctuations resulting from interest rate changes are offset to the greatest possible extent. It is not possible to make a perfect ‘match’, but Tryg has now been working on this for a number of years to make this as close as possible.

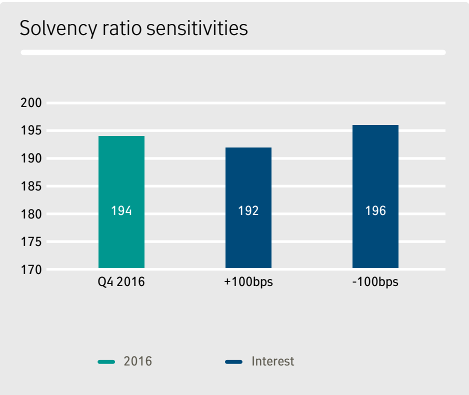
In the free portfolio (DKK 12bn), Tryg has approximately DKK 7bn of fixed income assets with a duration of around 2 years. Tryg will report a loss of some DKK 140m on this exposure at the actual moment of a 100bps interest rates rise.

This is visible in the Solvency II sensitivities (see chart below) which show a fall of the solvency II ratio from 194% to 192% when interest rates rise 100bps, primarily driven by the loss on the bonds in the free portfolio.

Discounting improves claims ratio by approximately 100bps

Following the interest rates raise, Tryg will discount all claims reserves with a 100bps higher interest rates and this will result in a positive impact (i.e. lower amount of claims) on the claims line in the profit & loss. Tryg's claims ratio will be improved by approximately 1% or around DKK 180m if interest rates rise 100bps.

Additionally, if interest rates rise 100bps, Tryg will report an approximately DKK 50m higher return on insurance provisions (1% of approximately DKK 5bn of premiums provisions) that will be transferred to the technical interest (note 4 in the Annual report 2016).



The technical interest line is made-up by the return on insurance provisions minus the discounting transferred from claims provisions. The higher return on claims provisions will be negatively offset by a higher discounting on claims provisions. Therefore, the remaining part will only be the higher return on premiums provisions (the aforementioned DKK 50m).

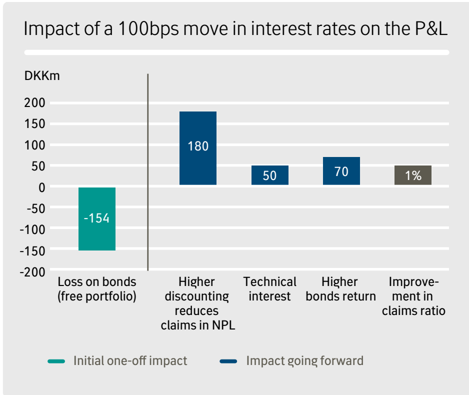
Finally, Tryg will earn a higher investment return on the fixed income exposure in the free portfolio. There are approximately DKK 7bn of fixed income securities in the free portfolio hence assuming a 1% higher level of interest rates, Tryg will earn some DKK 70m higher investment return.

The sum of these three impacts; lower claims in the P&L from higher discounting, a higher technical interest and a higher return on the bonds in the free portfolio equals to approximately DKK 300m.

Other important considerations

There are also two additional items which are impacted by a 100bps increase in interest rates. Firstly, Tryg will pay approximately DKK 25m p.a. more in interest expenses on the subordinated debt, secondly, the Norwegian pension liabilities will be approximately DKK 170m lower but this will be booked directly against shareholders' equity and not pass through the P&L. More information on the subordinated debt and pension liabilities can be found in the Annual report in note 1 and 6 (pages 52, 59 and 83).

The practice of discounting the claims reserves has also an important impact on Tryg's balance sheet. In the Annual report 2016 (note 1 on risk and capital management, page 52), Tryg discloses that the net effect of a 100 bps increase in the interest rates curve is DKK -70m made up of a DKK 1,131m loss on the fixed income assets and a DKK 1,061m gain from a higher discounting of claims provisions. Analysts and investors trying to benchmark reserves adequacy and reserves level in general ought to remember insurers' different accounting practice. If interest rates rise 100 bps, Tryg claims reserves will fall by DKK 1,061m hence, all alse being equal, Tryg claims reserves ratio (claims reserves on the balance sheet / premiums) will move from 144% to 138%. Therefore external readers ought to be cautious in drawing conclusions based on reserves adequacy just looking at reserves ratios.



Disclaimer

The intention of this newsletter is to show the impact of a 100bps parallel shift of the interest rate curve on Tryg's P&L and balance sheet in isolation. We deliberately do not assume any other side-ways impact, such as increased claims inflation which would follow higher interest rates or other scenarios, as the picture would become significantly more complex and different elements would play a role.