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NAVIGATING CURRENCY VOLATILITY IN 2023

Insights for insurance CFOs

LUMON

*With **three leaders** and **four Chancellors** in **less than a year** and the **pound fluctuating** amid **political uncertainty**, many are asking **what's next**?*

*In this **volatile backdrop**, it's important now more than ever that **CFOs protect their profit margins** from **currency risk**."*

JAMIE JEMMESON
HEAD OF STRUCTURED PRODUCTS

THE CURRENT MACROECONOMIC LANDSCAPE

Recent political events have caused uncertainty to ripple through the macroeconomic landscape with both inflation and interest rates increasing. Certainty is required by insurers across the UK, but the constant U-turns of the government cause further challenges. Now, more than ever, CFOs in insurance must understand and manage FX risk and protect profitability.

Market pressure continues into 2023

With the cost-of-living crisis and rising inflation, insurers may be forced to scale back their services as new business decreases and premium prices push upwards. They face an environment where sustainable growth and revenue returns are difficult.

The Bank of England recently announced that the UK is expecting a two-year long recession, having seen the biggest hike in interest rates since the 1980s – jumping from 2.25% to 3%. Inflation, at a 40-year high of 10.1%, has not yet reached its peak with a forecast of 11%.

As inflation fades, will interest rates ease, or will they remain at elevated levels? In terms of when inflation will drop, the Bank of England's forecast predicts inflation to be at 2% by 2024. It will be interesting to see the path of interest rates throughout 2023. Interest rates in the UK have been predicted to peak at 4.75%. Similarly, US interest rates are forecast to peak out around 5% as well.

These macroeconomic factors affect the exchange rate and dictate the UK's borrowing costs and interest rates. With the UK's credit rating outlook recently downgraded, the country's debt-to-GBP ratio will negatively affect sterling, further squeezing profit margins for CFOs.

Sterling volatility

The UK is one of the largest insurance markets in the world, with a total of €248.58 billion of premiums written in 2020. For companies with premiums derived from business outside of the UK, the impact of currency fluctuations is considerable, affecting insurers' ability to forecast and plan ahead.

During the pandemic, sterling dropped significantly against the US dollar. Recently, the market has seen fresh lows making it highly likely that many UK based insurers with overseas operations will see a significant increase in profits from non-sterling revenues, due to sterling's weakness.

The reverse can also happen. While the market witnessed sterling's "fall from grace" over the past 12 months, if a little certainty crept back in (i.e. the war in Ukraine started to dissipate and supply chains cleared up), inflation may well fall back. Sterling may regain some of its ground. When insurers translate their dollar revenues back into sterling, they might see a drop in profits .

What challenges do insurers face?

Insurance companies face different challenges with respect to currency fluctuations. Premiums can be denominated in US dollars or euros, creating a "mismatch" in currency flows, forcing insurers to absorb unwanted foreign currency risk. Currency fluctuations can also affect the payment of overseas claims and claims that are paid in the premium currency.

What approaches can be taken?

Provided insurers have a clear view of future receipts of overseas premiums, they can mitigate the risk of currency volatility by hedging. For instance, if an insurance company receives monthly overseas premiums in US dollars or euros, these premiums can be secured back to sterling by taking out forward trades to lock in a favourable exchange rate .

Similar strategies can also be used for the payment of overseas claims. Insurers may identify the net transactions of premiums in US dollars or euros, and consider if they need to hold different currencies for overseas payouts or operational costs.

How much time should be invested in FX?

CFOs should define the impact of currency movements, factoring in price elasticity and their market position. It all comes down to the company's degree of flexibility and "stretch" on costed levels. For instance, if FX costs increase by 10%, is the business in a position to pass on these costs? If the answer is yes, hedging currency risk may not be a significant issue and not require much time invested.

On the other hand, if insurers find themselves in a competitive marketplace and cannot "pass on" these costs, they will need to review their profit margins on products. Insurers working on extremely tight profit margins of 20% or less may feel a significant impact from currency movements. A 10% move on a currency pair* would equate to 50% of its profit margin disappearing. In this instance, an insurer can create a hedging strategy to smooth the effect of market volatility and protect its profit margins.

* Throughout 2022, sterling fell 25% against the US dollar

What FX solutions could CFOs consider?

There are many different strategies CFOs can explore, depending on their risk appetite, forecastable exposures and timeframes. Insurance companies can reduce the impact of currency movements by deploying timely strategies or using specific solutions like spot or forward trades to achieve business goals.

For example, insurers can book forward trades, using a certain amount every quarter. If they have more foreign currency than they expected, they can transact this surplus at the prevailing market rate, creating a blended rate across the full amount of currency. If the market moves against them, they have the security of forward contracts at the costed rate for their anticipated amount.

Alternatively, they can implement a rolling hedge programme, buying tranches of currency for different periods. They can top up these tranches systematically, reducing FX volatility and providing another line of sight for the pricing of products.

With each of these solutions, variation stress tests can be useful in developing a formalised strategy. These tests are conducted against real-time market data to understand the impact of currency risk.

How far forward should insurers hedge?

When developing a strategy, it's essential to consider the length of the FX policy and a business's risk appetite. Insurers have varying risk appetites, some companies are comfortable hedging requirements over 12 months, while others require additional cover for longer periods. Timeframes are determined by the currency needs of the insurer, business tenor and tolerance of exchange rate variance.

To ensure the effectiveness of any risk management approach or accommodate a change in the market environment, hedges may need to be restructured to remain within policy and meet business objectives.

CFO'S STEP-BY-STEP GUIDE TO WORKING WITH A SPECIALIST

1. A currency specialist will gather an in-depth understanding of the company's requirements, exposures, pain points, and risk appetite.
2. The specialist will help develop a strategy to minimise risk over a set period and protect profits.
3. After implementing the strategy, the currency specialist will report on its performance, providing in-depth analysis and real-time market insights throughout the life of the hedge.
4. The business itself should regularly review or amend the policy in line with business objectives and market movements.
5. If a business has any changes to the forecasted cash flows over the defined hedge period, the specialist will help review and realign the strategy to ensure optimal performance.

HOW INSURERS CAN DEVELOP A CURRENCY STRATEGY

The following case study demonstrates the value of working with currency specialists to develop a tailored currency strategy.

Company

A global leading insurance broker with over 500 staff worldwide, placing nearly $3 billion in premiums globally and 4,000 clients.

Background

Prior to working with Lumon, the insurance broker executed overseas payments through its primary bankers. Due to a rising sterling to US dollar rate through 2021, the company executed its spot trades quickly to reduce balance sheet losses versus a budget of 1.3000. This left the broker with an underlying annual exposure of over $150 million to sterling.

With the help of Lumon's currency specialists, the broker gained a better understanding of its existing hedges and foreign exchange policy. We worked together to identify areas for improvement, supporting hedges of up to three years with a facility which enables them to hedge their 9 figure exposure.

Additionally, the broker restructured existing hedges and executed further hedges to achieve a more stable, effective rate over two years. Finally, the hedging parameters were updated from 24 to 36 months, giving greater resilience. This allowed it to enhance the effective rate with spot trades.

Once formalised, the broker's FX policy was continually back-tested against live market data to ensure its effectiveness.

Outcome

£1m

THE INITIAL RESTRUCTURE CREATED SHORT-TERM CASH FLOW GAINS OF £1 MILLION

£1.5m

THE SECOND RESTRUCTURE PROVIDED ADDITIONAL INCREASES OF £1.5 MILLION

Lumon's team of experts supported the insurance broker, helping it better understand and manage its currency risk. The broker now has a formal three-year, quarter-on-quarter hedging policy supported by defined parameters. This policy gives flexibility and suitability throughout the rolling hedge.

PLEASE DO GET IN TOUCH

Lumon are specialists in managing currency risk, helping companies review long-term solutions. We know what it takes to get the most value from foreign exchange.

If you have a perspective you'd like to share with us or would like to explore our range of FX solutions, please get in touch:

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