

{ INTEREST RATES }

JEREMY WARNER

The consequences of ultra-low interest rates are getting harder to live with

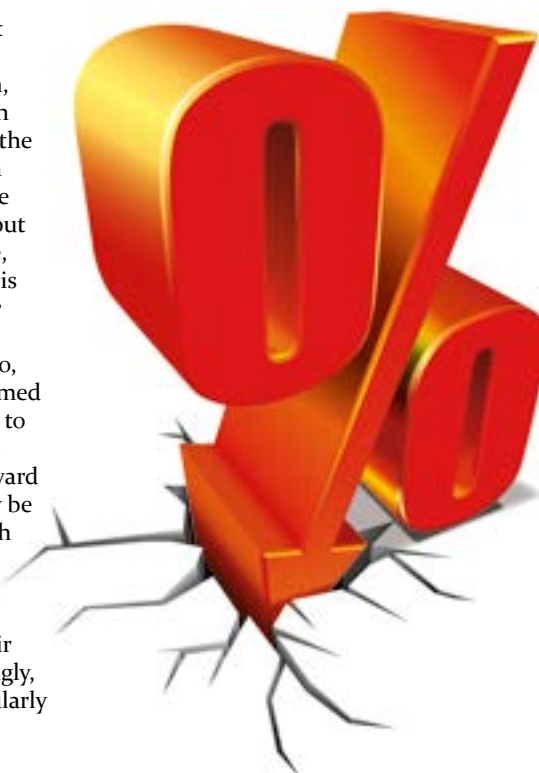
Ultra-loose monetary policy has undoubtedly played an important part in saving the world from some of the worst consequences of the financial crisis. But, in nearly all other respects, its effects have been decidedly unwelcome; by destroying the market's normal pricing disciplines, it is almost certainly incubating serious problems for the future.

Here are a couple of examples of these undesirable side effects, both to do with the distortions that the zero interest rate policy has introduced into the insurance market. Trivial though they may seem in the context of the overriding problem with negative real interest rates – that they have obliterated investment returns – they nevertheless neatly illustrate the sort of anomalies we are beginning to see the length and breadth of the commercial landscape.

The first concerns the so-called 'Ogden rate', part of a range of guidelines used in the UK to determine the size of insurance claims in cases of personal injury. A few months ago, the Ministry of Justice announced that it was cutting the discount rate, applied to lump-sum compensation to claimants who have suffered life-changing injuries, to -0.75% from +2.5% to reflect the much lower interest

rate environment that now rules. It's one of those decisions which, though logical enough in principle, is round the bend in practice, with some very unfortunate consequences for all but the claimant. For sure, any lump-sum award is bound to earn a lower rate of return over a lifetime than it used to, but, because the assumed rate of return is going to be so much lower, the original lump-sum award must correspondingly be much greater to match the decided level of compensation. Many insurers have had to significantly raise their provisioning accordingly, and nearly all, particularly in motor insurance (where the great bulk of these claims take place), warn of a big rise in premium charges to come. Great result. It's like something out of the Mad Hatter's tea party.

The second example concerns the growth of 'alternative reinsurance capital'. This is very much a phenomenon driven by low interest rates. Poor returns from more traditional investment assets have sparked a worldwide hunt for yield. Investors with little



or no experience of insurance – hedge funds, sovereign wealth funds, pension funds and mutual funds – have been piling into the sector in the hope that it offers a better form of low-risk investment than they are getting elsewhere.

Such new sources of capital have been growing like Topsy since the financial crisis, when unconventional monetary policy became the order of the day. Aon Benfield estimates that, from a standing start, alternative capital has come to account for between 40% and 50% of catastrophe reinsurance worldwide.

This has, in turn, blurred the boundaries between

traditional insurance broking and underwriting, with brokers increasingly offering clients an end-to-end proposition that both chooses, underwrites and reinsures the risk using these new, external sources of capital. The potential for conflicts of interest, and possibly eventual inability to pay, scarcely needs pointing out.

It is, of course, possible to put a more positive spin on the growth of alternative capital, which has considerably expanded the capacity of the market, arguably making it more competitive and driving down reinsurance rates. Yet its rapid emergence as a force to be reckoned with also raises the question of what happens when interest rates start to rise again, or indeed what happens when we return to a more normal pattern of catastrophe events, let alone a really bad run of them. In any case, both alternative capital and the market as a whole could be in for a rude awakening.

As I say, the low interest rate environment is giving rise to all manner of market anomalies. Many of them are an accident waiting to happen. ♦

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