How Can Insurers Hedge Effectively During the Pandemic?

Recent market volatility caused by the COVID 19-induced financial market crisis has created a scenario wherein insurers' hedge positions risk is becoming ineffective. If the change in fair value of the derivative used for hedging moves outside the 80%-125% range, it ceases to be 'effective' from an accounting perspective and raises implications for insurers' profit margins.

The issue of effectiveness potentially impacts a wide range of derivative instruments, including swaps, futures, options, forward contracts and more, hedging the equity, fixed-income and securitized debt components of insurers' portfolios.

Insurers have typically used hedge accounting because a hedge pairs a derivative and an investment with values that change inversely to each other. This is a prudent way for organizations to manage exposure to various risks such as: interest rate, foreign exchange, price and credit risks.

In practice, a cash flow hedge could help when an insurer owns a bond that accrues interest according to the London Interbank Offered Rate or LIBOR. As the LIBOR rate changes, so does the amount of interest the insurer will receive for their bond, making cash flows unpredictable. A hedge can mitigate this fluctuation by using a swap derivative, which pays a floating LIBOR rate and receives an agreed fixed-interest rate. This locks in future payments and removes any uncertainty or volatility that movements in LIBOR would otherwise cause.

Market conditions such as COVID-19 have the potential to disrupt the overall predictability of an insurer's portfolio income if a hedge must be de-designated, which subsequently introduces volatility to the income statement.

We advise that insurers should monitor their hedges at the point of inception, whenever financial or earning statements are reported, and on a regular ongoing basis (at least every three months). Insurers also need to check their derivative positions with a view to preempting what a loss of effectiveness may mean and be prepared to terminate the hedging relationship where a hedge has become or is imminently to become ineffective.

State Street's insurance services team can assist by monitoring the financial impact of hedge de-designation, and their PAM® software solution can also produce effectiveness reports that calculate whether the change in fair value of the hedging instrument and the hedged item are in the 80%-125% range.

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