



## Actuarial and Insurance Solutions

# Financial Market Analysis at year-end 2015

10 February 2016

Audit. Tax. Consulting. Financial Advisory.



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# Executive Summary

Welcome to the Financial Market Analysis for insurers in Switzerland. 2015 was an exciting year marked by a series of striking events; the Greek debt crisis, turbulences in international stock and commodity markets, and controversial interest rate policies of central banks. Although Switzerland was clearly affected it has withstood the turmoil better than many other European countries, despite the very strong Swiss Franc. This report aims to give an overview of the developments in the Swiss market by looking at key indicators that are commonly used in insurance business.

Until the end of 2015, Swiss government bond and swap yields continued to decrease to the point that bonds with a maturity of up to 10 years show negative interest rates. While the yields for Eurozone countries decreased as well, they still remain high for countries like Italy and Spain, implying a remaining level of uncertainty, and the ongoing demand for corporate bonds has narrowed the credit spreads of bonds with different risk ratings. In order to lift the pressure put on the insurers by low interest rates, the Swiss Federal Council finally agreed on lowering the BVG rate, although this long waited correction might not suffice.

The drastic rise in strength of the Swiss Franc after the removal of the cap on the Euro rate in January was followed by a continued weakening through the rest of 2015. During the same period, the Consumer Price Index indicates an ongoing period of deflation and equity markets displayed a continuing high volatility. Soon after our mid-year update, worldwide stock prices suffered from turbulences in Chinese markets. In contrast to the US, Swiss and European stock markets have not yet fully recovered. At the time of writing, in January 2016, Chinese markets hit the news again with a dramatic overnight drop in stock prices.

In summary, 2015 was characterized by record-low bond yields, an increasingly volatile equity market, a strong Swiss Franc, a high deflation rate and a stable real estate market. In order to match solvency requirements and maintain productivity insurance companies are challenged to find alternative investment opportunities.

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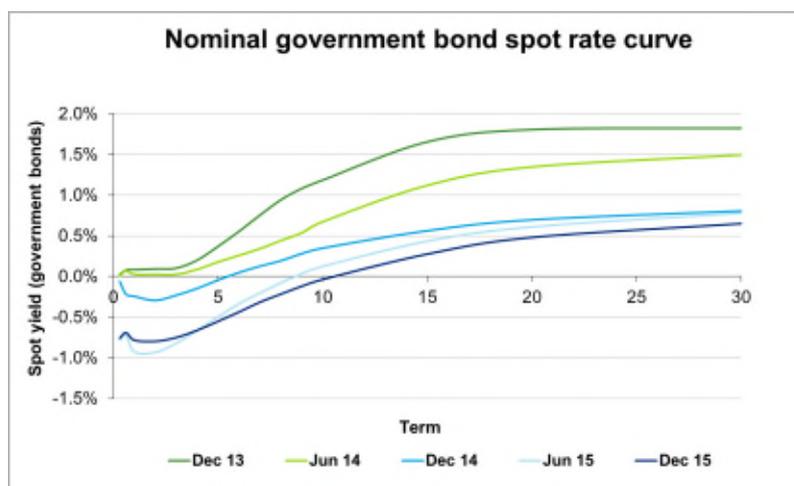
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# 1 Interest Rates

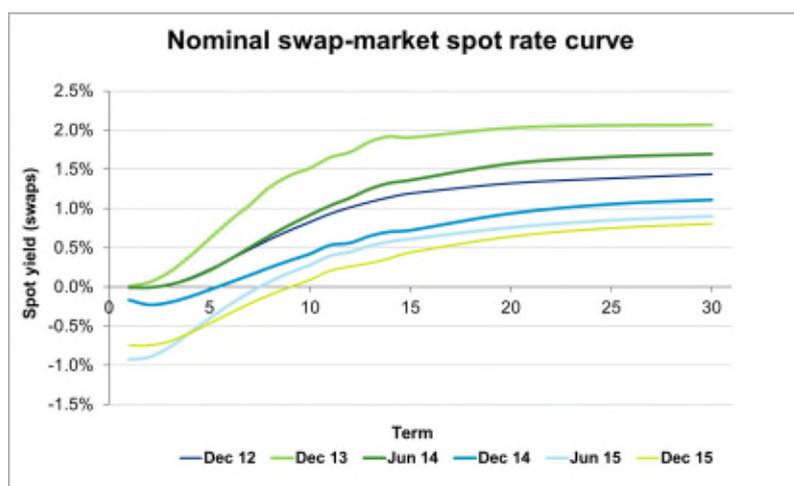
## Switzerland

Government bonds are a material asset position on the balance sheet of insurance companies. In the second half of 2015 the yields of Swiss government bonds slightly increased for maturities of up to four years, as compared to the first half of the year. In contrast, for larger maturities we observe a decrease in yields and as a consequence even 10 year bonds now yield negative rates. Therefore, the pressure remains on the profitability of life insurers.



(Source: Bloomberg)

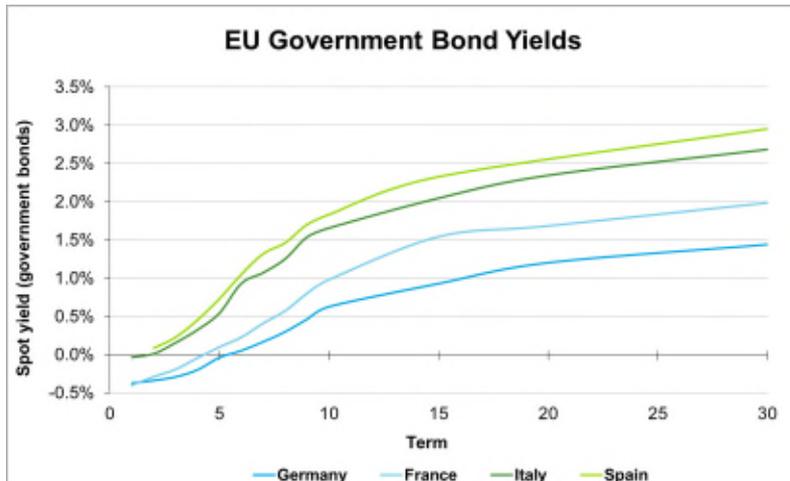
Swiss swap rates showed a development similar to government bonds in 2015: a marked decrease, to reach negative yields for maturities up to 9 years. The spread between swap and government yields decreases slightly for maturities up to 3 years.



(Source: Bloomberg)

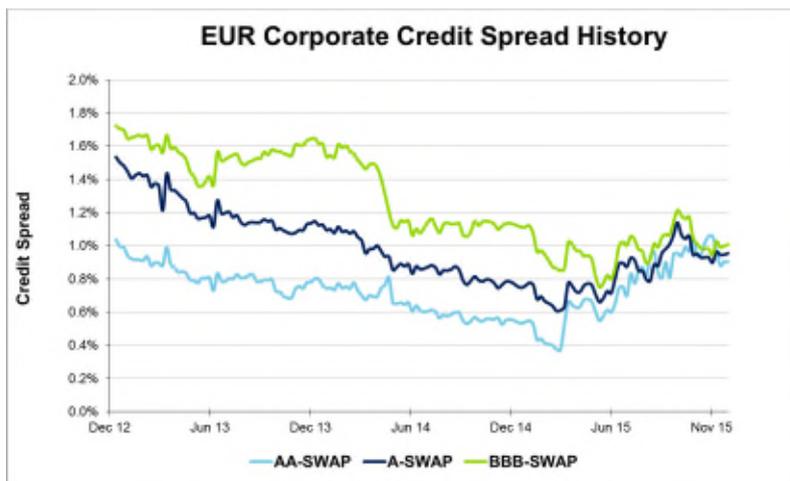
## Eurozone

To gain insight into the current government bond situation in the Eurozone, we looked at the yield curves of four major European economies: Germany, France, Spain and Italy. We can observe the same downward trend in Swiss government bonds. The yields of Spanish and Italian government bonds decreased between 50 bps and 100 bps over all maturities, to yield lower than 2% up to 10 years maturity. The yields of German and French government bonds also decreased and now are negative for maturities up to five years.



(Source: Bloomberg)

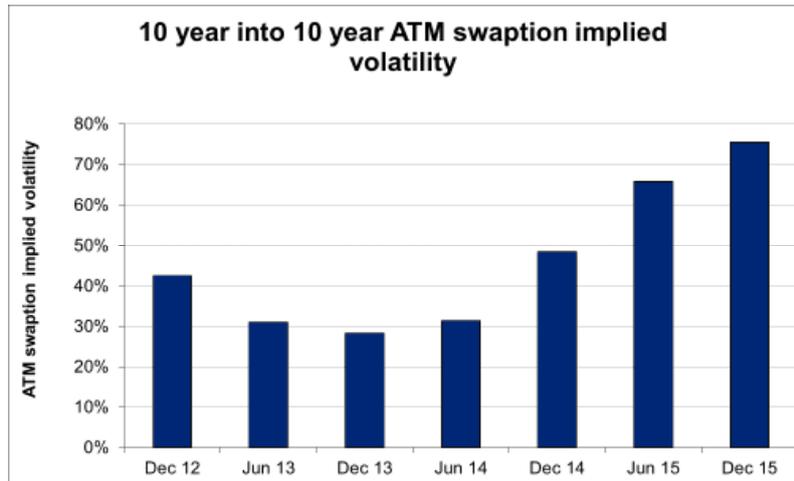
For corporate bond markets, we analyzed the EUR credit spread history for 10-year corporate bonds rated AA, A and BBB as compared to the EUR swap yields (a similar analysis for the Swiss market was not possible because of insufficient market depth). The decreasing trend for this spread over the last few years came to a halt in 2015. In the course of the year, all spreads started to increase again until the third quarter of 2015. Remarkably, the yields for the three ratings under consideration are converging, reflecting the large demand for corporate bonds.



(Source: Bloomberg)

## Swaption implied volatility

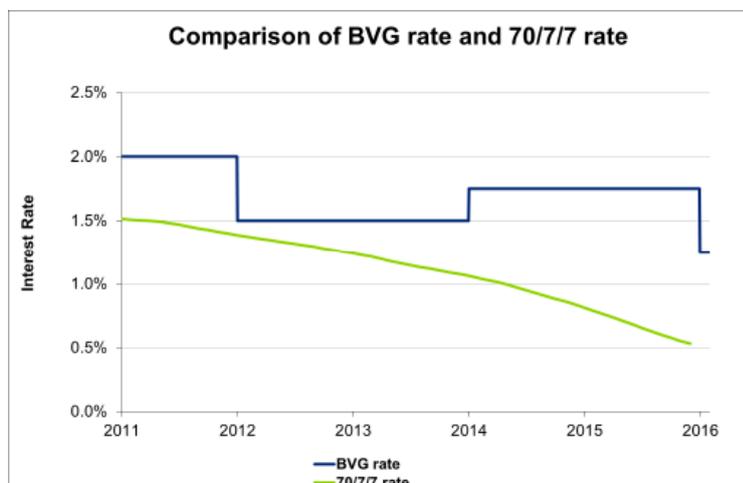
Swaptions are options that allow the buyer to enter into an underlying swap. These options are more directly related to interest rates than other derivatives and can be used as an indicator of interest rate volatilities. Here, we use a 10 year into 10 year at-the-money (ATM) swaption, which is usually the longest option and swap term readily available in the market. This is one of the most important volatilities used to calculate the Time Value of Financial Options and Guarantees (TVFOG) in (life) insurance portfolios. We observe an increase in the implied volatility until the end of 2015.



(Source: Bloomberg)

## Group pensions business (BVG savings process)

In group pensions business, the technical interest rate of the BVG (Berufliches Vorsorge Gesetz) savings process is determined by the Swiss government as the outcome of a political process. Despite its political nature, insurance companies also need to forecast the BVG rate for valuation and risk modelling purposes. The Swiss Solvency Test SST suggested taking 70% of the 7-year average of 7-year par government yields to give a reasonable estimate for the BVG rate for different economic scenarios. In January 2016, the BVG rate was reduced to 1.25% from 1.75% in January 2015. However, the spread between the BVG rate and the “70-7-7” rule remains significant.



(Source: Analysis by Deloitte, Schweizerische Nationalbank)

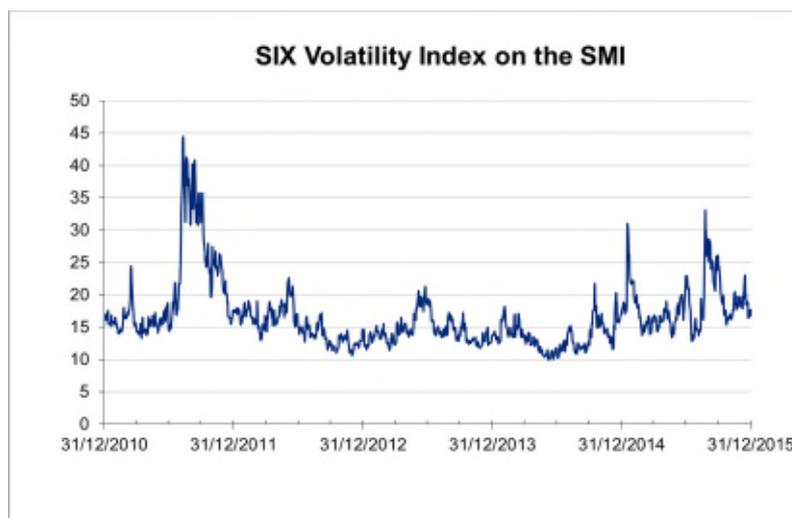
## 2 Equity Markets

The SMI index faced a strong, abrupt decrease at the beginning of 2015 because of the decision of the SNB to remove the cap on the EUR/CHF exchange rate. The increase in value of the European and Swiss indices during the first half of 2015 came to a halt in the second half. In August 2015, a steep plunge could be observed in stock prices for all three markets that is most likely linked to turbulence in China's stock market. However, market indices recovered in the last quarter of the year.



(Source: Bloomberg)

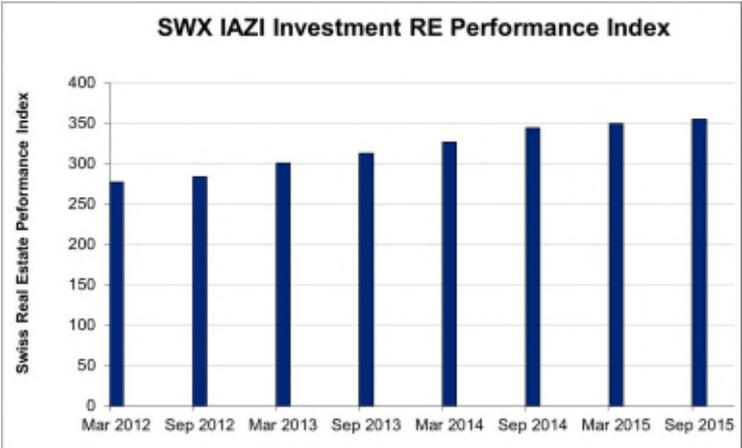
The SIX Volatility Index on the SMI (VSMI) aims to provide a tradable index that reflects the volatility of the Swiss market. In the first and third quarter of 2015, the VSMI was subject to strong oscillations. Compared to the previous years, the volatility remains on a high level not seen since the third quarter of 2011.



(Source: SIX)

# 3 Property Markets

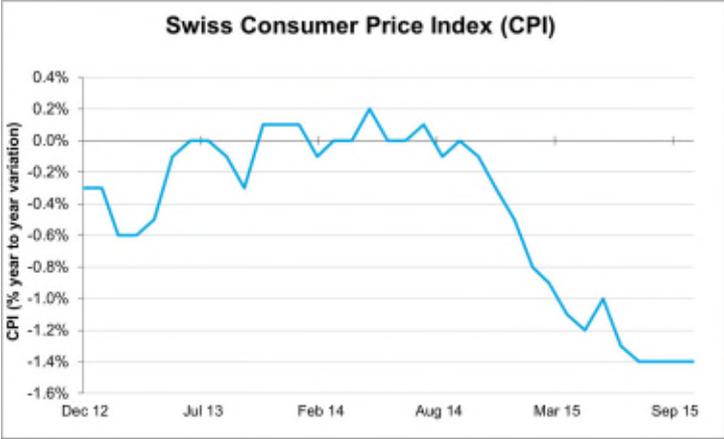
Like government bonds, real estate is a key component in the portfolios of Swiss insurers, in particular life insurers. As a measure of the swiss real estate market we refer to the IAZI Investment Real Estate Performance index. This quarterly index takes into account the net cash flows and annual change in value of the underlying properties. Compared to the previous quarters, the index is slightly increasing but losing momentum.



(Source: Bloomberg)

# 4 Inflation

The development of price inflation is of interest for insurers, as it is linked to expenses as well as P&C claims. The Swiss CPI measures the private households' consumption in Switzerland. In September 2015, the CPI decreased by 1.4% compared to September 2014. This negative trend started earlier in the year driven by the removal of the capping policy in the EUR/CHF exchange rate.



(Source: Bundesamt für Statistik)

# 5 Exchange Rates

The graph below depicts the development of two major currencies, the Euro and US Dollar, against the Swiss Franc since December 2013. Following the sudden appreciation of the Swiss Franc at the beginning of 2015, due to the abandonment of the cap on the EUR/CHF rate, the EUR/CHF exchange rate went up to 1.05 in June 2015 and almost 1.10 at the end of the year. In comparison, the USD/CHF shows the same upward trend, with larger fluctuations.



(Source: Bloomberg)

# Contacts



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