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The Insurance Channel of Monetary Policy

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Bank of Italy, 5 December 2024

From insight to impact.

Insurance Channel of MoPo: changes in insurance prices – reduced household borrowing capacity – feedback effect on mortgage markets

Research Question: How does monetary policy affect the insurance markets and subsequently the broader economy?

Key findings

- **Impact of Monetary Policy on Insurance Prices**
  - Monetary policy rate hikes reduce the market value of insurers' asset investments, tightening their financial constraints
  - Insurers respond by increasing the prices of insurance products
  - The effect is more pronounced in insurers with higher sensitivity to market value losses and tighter regulatory constraints

- **Transmission to the Housing Market**
  - Higher insurance prices reduce the demand for housing and mortgages, leading to a decline in home prices
  - The effect is more pronounced in areas more exposed to monetary-policy-sensitive insurers.

Contribution Summary

- Mechanism
  - In a frictionless market, rate hikes lower insurance prices
  - With regulatory capital constraints, insurers face a trade-off, leading to increased prices to offset the reduced market value of their financial assets

- Empirical Evidence
  - U.S. data on homeowners' insurance and monetary policy surprises
  - Constrained insurers with interest rate-sensitive portfolios exhibit larger price increases
  - Areas with more exposed insurers experience larger declines in housing demand and prices following monetary tightening

Do insurers recognize “insurance channel”?

“A 1970s-style stagflation scenario, meanwhile, would stress underwriting performance most. Demand for both life and non-life insurance would be curbed, and non-life insurers would be most exposed to the inflation shock through increased claims severity and weakened profitability. As rates rise to meet claims costs, nominal premium growth would be strong, but high inflation would result in lower real premium growth than in our baseline scenario. The adverse impact on investment income would depend on the degree of ALM matching (ie, the extent to which higher reserves are immediately matched with additional assets, which lose value with higher yields). Reinvestments in higher-yielding bonds, however, could support longer-term investment income.”

Swiss Re Economic Insights, October 2023

Comment 1: Inflation expectations

- The key focus is on the relationship between the higher interest rates, lower investment income, and an increase in the insurance prices
- Higher interest rates can also indicate higher inflation expectations, leading to
  - Lower demand for insurance, due to income effect
  - Higher claims costs, as the size of the claim depends on price levels in the future and, to some extent, the real estate prices (liability side)
- Higher interest rates can also make reinvestment more attractive
- Caveat: The sample period is during the period of below target inflation, 2009-2019

Comment 2: Legal entity or group level of aggregation

- What is the level of observation, legal entity or group?
- An issue: the identification hinges of differences in the conditions across states
- The local conditions may matter for small insurers
- For large groups with substantial internal capital market, the effect will be more nuanced, and other factors cited by the insurers may become more pronounced

Comment 3: Effective availability of insurance/ insurance demand may decrease even when there is no price changes

- Insurance is *a promise* to pay upon the realization of a loss
  - Insurers with higher financial strength can sell policies at higher prices

- Premium volume is the product of the average rate per exposure and the number of exposures, thus premium growth can be achieved two ways:
  - Insurers can raise prices, for the same level of exposures
  - Alternatively, insurers can maintain (or even decrease) prices but make the exposures riskier, overall increasing the risk

- As a result, the 'insurance channel' can occur even without changes in insurance prices but rather by changing the risk of the exposures and reducing the financial strength of the insurer
  - Check AM Best ratings

Comment 4: Price regulation and NatCat exposures

- Prices are regulated at the state level
  - Different states have different level of tolerance to price changes
  - The stringency of price controls also correlates with the exposure to NatCat (not by chance, it's a policy/political decision), e.g. CA and FL

  - Do you find the effects within the same state at the county level (maybe a challenging question)
  - How do the result depend on the stringency of state price controls?
  - How do the results depend on the level of competition in the state?
    - This is also related to state price controls which induce exit and lead to large residual markets run by the state

Comment 5: Other channels – Reinsurance and dividends

- If the objective is to manage regulatory capital constraint, reinsurance is an alternative which does not necessarily require a price increase
  - Reinsurance can also be obtained from more risky reinsurers, effectively reducing the quality/amount of insurance per unit of exposure

- Similarly, insurers may reduce the dividend payouts

Comment 6: Elasticity of housing supply

- The objective is to document the mechanism of reduced demand for mortgages in response to price changes
- One can use the difference between the elasticity of supply of housing in various counties, even with the same state
- The variation in the elasticity of housing supply can be used to identified the demand channel

Summary

- Very interesting idea
- Important project to understand the monetary policy transmission through non-banks
- The practical implications for regulators or insurers can be developed further
  - For example, how should policymakers mitigate unintended consequences of monetary tightening in high-risk insurance markets?