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Roundtable on the impact of the low interest rate environment on insurers and pension funds

4 December 2014, 10:00-13:00

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ROUNDTABLE ON THE IMPACT OF THE LOW INTEREST RATE ENVIRONMENT ON INSURERS AND PENSION FUNDS

4 December 2014, 10:00-13:00

OECD Conference Centre, Paris

1. The OECD discussed and published a report on “The Economic Impact of Protracted Low Interest Rates on Pension Funds and Insurance Companies” in 2011[1] which highlighted the possible scenarios in which insurers and pension funds could be affected. Given the continuing low interest rate environment in a number of OECD countries and the low inflation rates, a number of delegations have expressed their desire for the Insurance and Private Pensions Committee to revisit the issue in terms of the PWB 2015-2016.

2. In addition to the delegate responses to the PWB 2015-2016, qualitative responses to the OECD Global Insurance Statistics exercise for 2013 indicates that the effect of the low interest rate is materialising for some life insurers.

Box 1. Delegate responses on the low interest rate environment
--from the qualitative responses to the OECD Global Insurance Statistics 2013

Australia

The low interest rate environment in Australia continued to have an impact on long-tail insurers’ investment income. Investment income makes a substantial contribution to the funding of future long tail claim payments, which can take many years to settle. Insurers may need to re-price their new business to make up for the lower investment income. However strong levels of competition may impact their ability to do so.

…products with embedded guarantees are not wide spread in the Australian market and are essentially limited to the small (albeit rapidly growing) book in fixed term and lifetime annuities, and closed books of traditional business.

Belgium

Life insurance premiums declined very strongly last year, dropping from €20.7 billion in 2012 to €15.8 billion in 2013. This strong decrease can be explained by the low interest rate environment and the increase, as of 1 January 2013, in the tax on new life insurance premiums from 1.1 % to 2 %. A persistence of the low interest environment could weigh structurally on the new volumes of life insurance products that Belgian insurance companies will be able to sell, and eventually on their profitability if cost structures are not adapted to the reduced business volume.

Canada

Persistent low interest rates (and the accompanying potential for search for yield) remains an important source of risk for insurance companies although improvement occurred in 2013.

[1] OECD Financial Market Trends, 2011(1).

Czech Republic

Czech insurance market passed well through the low interest rate environment over last 3 years. However interest rate risk could increase its negative impact in the future if the period of low interest rates is prolonged.

Estonia

Low interest rate environment carries highest risk to life sector, so some undertakings are not providing products with guaranteed interest rate at all or have reduced guaranteed interest rate for pension annuities products.

Greece

The prolonged low interest rate environment is recognised as a high risk factor which could affect the economic position of the undertakings, mainly life insurers. However, undertakings adjust their own business strategies to cope with the low interest rate environment. Elements of these strategies are the development of new products with low guarantee interest rate, development of unit-linked products and the application of cost cutting plans allowing a positive technical result and regain profitability.

Korea

Persistent low interest rates have made the negative margin problems worse, and it is challenging for insurers to find a promising asset management destination in a low interest rate environment. The base interest rate decreased from 2.75% to 2.5% in May 2012, and it has stayed at 2.5% for 12 months.

Norway

In order to satisfy forthcoming solvency requirements, a number of life insurers must either acquire fresh capital and/or reduce risk. In the current situation featuring high long-term guarantees and low interest rates, large portions of the surplus return must be devoted to increasing technical provisions for rising longevity in the years immediately ahead. Persistent low interest rates a major risk for Norwegian life insurers, as the majority of insurance commitments carry guaranteed interest. The new solvency framework is accordingly particularly demanding when interest rates are low.

3. The IPPC will, therefore, be holding a Roundtable to discuss the effects the low interest rate environment is having on insurers and pension funds, and how insurers and pension funds are adjusting their business models to cope with these effects. Further, possible regulatory ramifications from these effects will be discussed.

4. The protracted and continuing period of low interest rate has the potential to adversely affect the balance sheet and profitability of insurers, in particular life insurers, and pension funds, as detailed in the 2011 report. Insurers continue to raise the low interest rate environment as one of their highest concerns and, as the period extends, the extent of the consequences is unclear.

5. The impact of the low interest rate environment has been written on in the context of life insurers in terms of how it may affect the balance sheet of life insurers,[2] and how they may react when interest rate begin to rise.[3] Other relevant research in this area has been about investment sensitivity to lower interest rates,[4] and risks relevant to the low interest rates.[5]

[2] Bergin & Grundl, The Effects of a Low Interest Rate Environment on Life Insurers (July 2014, ICIR Working Paper Series No. 15/14).

[3] Bruning, L., Life insurers to benefit from rising interest rates (January 2014, CIPR Newsletter).

[4] Sharpe & Suarez, The insensitivity of investment to interest rates: Evidence from a survey of CFOs (December 2013, Federal Reserve Board finance and economics discussion series, 2014-2).

6. With a shift to a lower interest rate environment, an insurer's existing portfolio would gain in value as bond prices increase as yields decrease. However, over the course of time, there would be a reinvestment risk as proceeds from investments in fixed-income securities may have to be rolled into lower yielding securities. Lowered investment income would offset market gains in some instances.

7. Further, if insurers have liabilities linked to guarantees, such as guaranteed interest-rate returns or guaranteed minimum income (annuity) streams, these would be directly exposed to lower interest rates. The minimum return set at contract inception cannot be changed during the lifetime of the contract in some countries. The natural implication of this product feature is the simultaneous existence in the insurer's portfolio of products with different minimum investment returns. In addition, the low interest rate environment renders the provision of explicit or implicit yield guarantees on long-term savings products more costly. Low interest rates may be becoming a particular issue for life insurers in countries such as Germany, Italy, and the United States, where saving products with high guaranteed returns sold in the past represent a prominent share of the total portfolio of life insurers.[6]

8. As insurers and pension funds attempt to adapt to the low interest rate environment, as described in the 2011 report, the search for yield may lead to insurers and pension funds entering new business territory, which could take the form of non-bank financial intermediation. Non-bank financial intermediation takes place when non-banks, such as insurers and pension funds, provide financing into areas which have been traditionally financed by banks. This could include, for example, SME financing. Insurers and pension funds may seek higher returns by investing more in alternative investments, such as foreign assets, long-term investments, and emerging market assets. As the yield curve of fixed income securities shift down, insurers and pension funds may invest in longer-dated instruments to gain greater yield. Returns on equities and possible revenue generation from non-bank financial intermediation would also affect the extent to which the shift into equities may influence the profitability of insurers and pension funds.

9. Due to the different products offered and their maturity in different countries, how the impact is realised and how insurers address them will be different. Insurers and pension funds can start offering lower guarantees for new policies, thereby progressively reducing their liabilities, although this may be a very slow process. There may be scope for insurers to adjust existing guaranteed policies.

10. Given the concerns raised by insurers to the possibility of investing in alternative assets in Solvency II, EIOPA issued the Long-term Guarantee Assessment which provides the most important form of capital relief for insurers and reinsurers for matching and volatility adjustment. However, whether Solvency II would assist in providing greater stability in a low interest rate environment, given the limitations insurers may face in making certain investments, is uncertain, as is the case with other risk-based capital regime being implemented.

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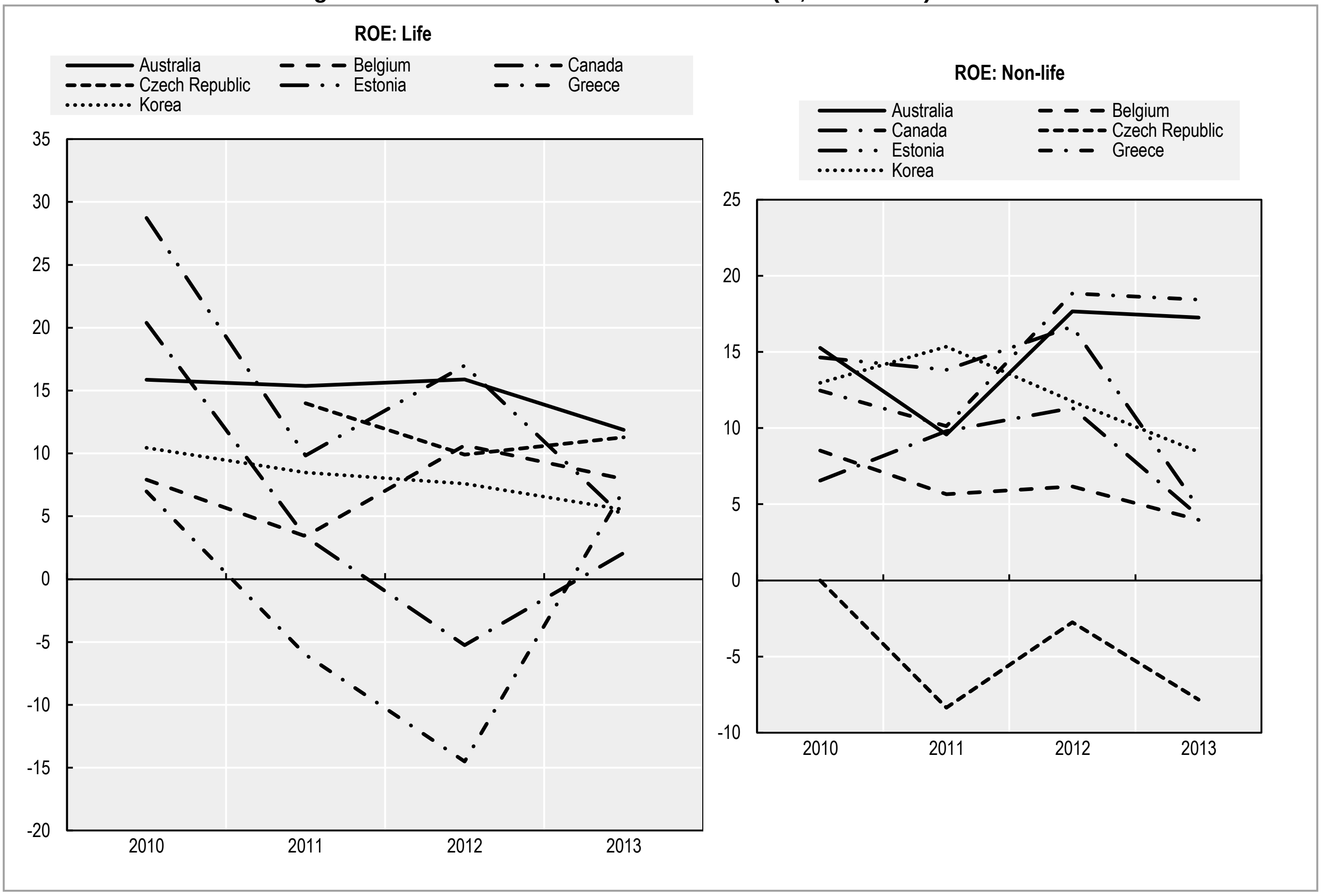
[5] Turner, P., The global long-term interest rate, financial risks and policy choices in EMEs (February 2014, BIS Working Papers No. 441), Cooke & Gavin, Three scenarios for Interest Rates in the Transition to Normalcy (October 2014, Federal Reserve Bank of St Louis Working Paper Series 2014-027A), and van den End & Hoeberichts, Low real rates as drivers of secular stagnation: empirical assessment (October 2014, DNB Working Paper No. 444).

[6] According to sigma (2012). *Facing the interest rate challenge.* Swiss Re, based on their product characteristics, Germany, Italy and the United States report the highest exposure to interest rate risk among major insurance markets around the world.

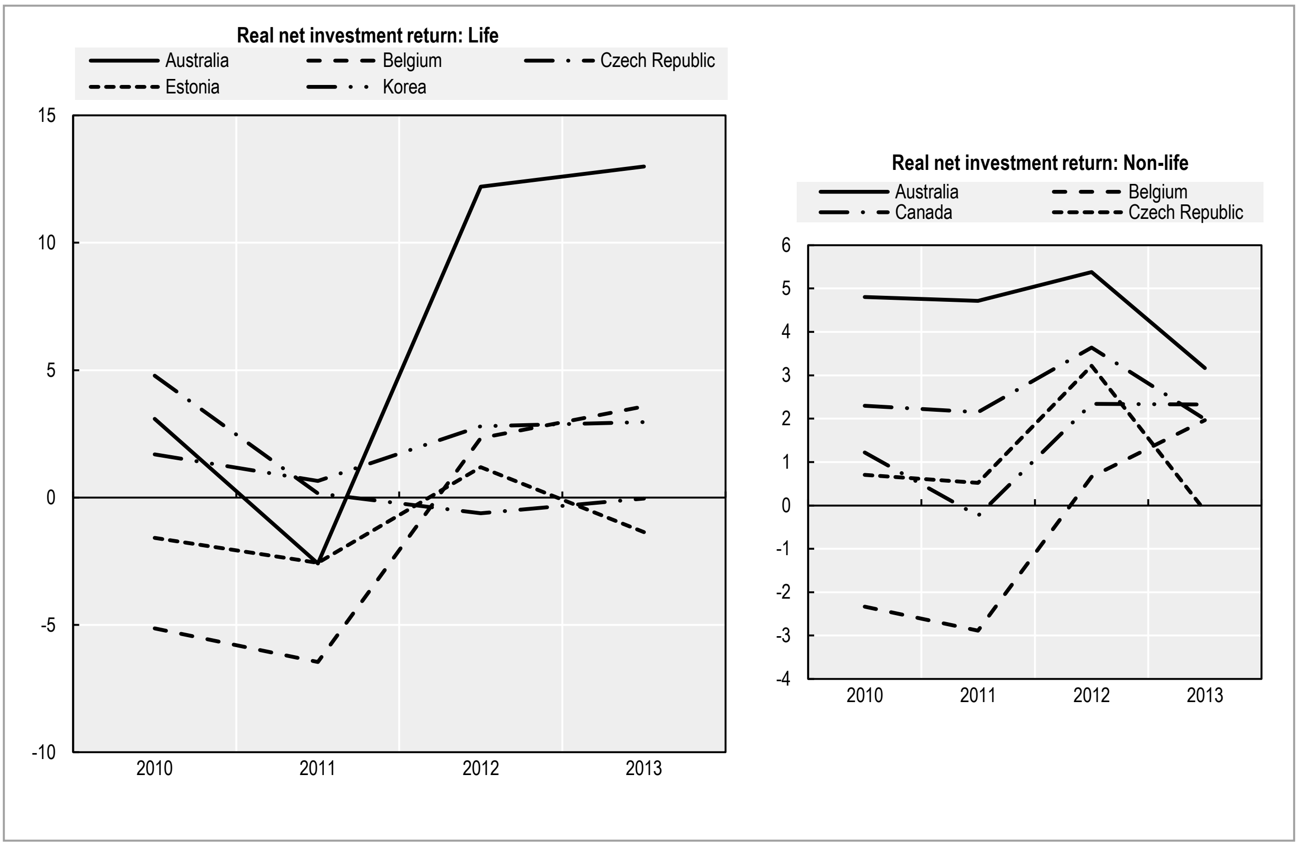
Figure 1. ROE of selected OECD countries (%, 2010-2013)



Note: ROE was calculated by dividing segment net income for the year N by average segment equity over N-1 and N.
Source: OECD Global Insurance Statistics.

11. Figure 1 compiles the ROE of countries indicated in Box 1. The downward trend of ROE of life insurers is evident although some recovery since 2012 is also evident. As for non-life insurers, a small decline is present, and the weak performance of insurers in Czech Republic stands out although it is not clear whether this is a result of low interest rates. This is consistent with the analysis of life insurers being more affected by the low interest rate environment.

Figure 2. Real net investment return of selected OECD countries (%, 2011-2013)



Source: *Global Insurance Market Trends 2012 and 2013* and OECD Global Insurance Statistics.

12. Figure 2 examines the net investment return of life and non-life insurers of countries raised in Box 1. Due to the lack of historical data for many countries, the trend between 2008 to 2010 cannot be well analysed, although there is a downward trend towards 2011 for life insurers. Also, there is clear recovery of investment returns since 2011 among the life insurers. As for non-life insurers, the trend was for recovery from 2011, although there has been a downturn in some countries since 2012.

13. Another area of concern is the impact of the low interest rate environment on the reinsurance market. Governor Carney of the Bank of England recently stated in his speech that "[l]ow [interest] rates are encouraging inflows of external capital into sectors like reinsurance. In effect, a "soft cycle" in financial markets is reinforcing a "soft cycle" in insurance – a particularly problematic combination. More capital boosts market capacity, but can also test underwriting discipline." Record-low interest rates have lured investors seeking higher investment returns to put up capital to back reinsurance risks. This has in turn lead to new entrants and greater competition, which may increase underwriting risks.

14. As accounting standards and regulatory capital standards shift to market-consistent value for liabilities, the low interest rate will have the potential to raise the level of liabilities, and need to increase regulatory capital. Solvency II does introduce volatility adjustments to address such interest rate risks, but this is primarily for the purpose of short-term fluctuations, and not necessarily for long periods of low interest rates. In terms of regulatory action taken to alleviate some of the issues caused by the low interest rate, the Swiss financial supervisor (FINMA), for instance, decided in 2012 to allow such alleviation for the valuation of liabilities for periods of low interest rates for the years 2013 to 2015.

15. In terms of supervision, stress tests may already include a scenario of protracted low interest rates when assessing the stability of the insurance and pension systems. These assumptions would provide an insight into the macroeconomic outlook by supervisors, and areas in which they foresee regulatory action.

16. Another aspect that requires consideration is, as the US and UK move to end their unconventional monetary easing, there is some expectation that interest rates may start to rise. If and when this happens, the maturity and guarantee of existing policies may affect the behaviour of policyholders. Higher surrender rates for long maturity products may take place if the potential benefits from surrender outweigh those from maintaining current policies.

17. Taking the above considerations into account, the Roundtable is proposed to take part in two parts. The first part will examine the impact of low interest rates and actions taken by insurers to address low interest rate environment, and whether this has been accompanied by changes in their business models. The second part will discuss regulatory and supervisory actions that have been taken to address the low interest rate environment, and whether further regulatory measures are necessary.

18. Questions to be discussed are:

Part I: Insurer action to address the prolonged low interest rate environment

- What has been the impact of the prolonged, low interest rates on profitability, return on investment, interest income and asset allocation of insurers in recent years?
- What actions have insurers taken to adjust their assets and liabilities?
- Given the shift down of yield curves, have longer-dated instruments been used in terms of gaining yield from fixed income securities?
- Have insurers shifted their investments into assets other than bonds in a material way?
- Has the low interest rate environment prompted insurers to enter the non-bank financial intermediation business, and if so, what types of transactions are these?
- Have insurers had to adjust their business model to cope with the low interest rate environment?
- What are the assumptions insurers are making in terms of interest rate movements and policyholder behaviour?
- Have insurers sought adjustments to the regulatory and supervisory framework and accounting rules to ease the impact of protracted low interest rates?

Part II: Regulatory and supervisory measures taken to address low interest rates, and whether further action is necessary

- What regulatory and supervisory measures have been taken towards insurers to address the prolonged low interest rate environment? And if so, have the regulatory measures taken to alleviate the impact of low interest rates resulted in improvements in profitability? Are such adjustments warranted as low rates continue?
- Has the low interest rate had an effect on the regulatory capital levels of insurers, and has the regulator had to address this?
- Have changes in business model from the low interest rate environment required regulatory measures?
- What scenarios relevant to low interest rates do the stress tests carried out assume?

19. Given that the Committee has expressed interest in pursuing this issue, feedback on whether this would be an area which the Committee should develop as a project is being sought. In order to carry out such a project, input and data that may be required are:

- Information on insurer business models to address low interest rates.
- Information from insurers on to what extent their liabilities and linked guarantees, investments and investment strategies might have been adjusted.
- Information on how insurers have adjusted their investments into certain assets, both in terms of investment maturity and asset class, to ensure gaining a certain yield.
- Information on the extent of insurer entrance into non-bank financial intermediation and its scale.
- Regulatory and supervisory measures authorities taken to adjust to low interest rates.
- Information on whether new risk-based capital regimes may affect insurers' operations in a low interest rate environment.
- Information on how insurers have adjusted their overall risk management to low interest rates, and whether the exit from a low interest rate environment could affect certain investments made in longer-dated securities.