

Low Interest rates and Insurers

Olav Jones

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Note this presentation represents own views and not necessarily those of IRSG members or Insurance Europe

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The risk of an extended period of low interest rates is a significant concern

- However, it is important to have a full understanding of the issue before arriving at conclusions over potential impact and actions
- Low interest rates for 10 or more years is possible but is not the base case
 - And note that “Studies have demonstrated that forward rates do not do a good job at predicting future interest rates”*
- What matters economically for insurers with long-term guarantees is investment yields and not risk free rates
 - Locked in investment yields backing liabilities, Current (long-term) investment yields, Future (long-term) investment yields
 - Investment yields, interest rates and Solvency II risk free rates are related but not the same

*Source: *Treasury Securities and Derivatives* by Frank Fabozzi, Wiley 1997

Huge impact on people's long-term savings

- Consider a 25yo saving for retirement at 65

Investment returns	% of salary to save for 50% of salary at retirement*
5%	~15%
3%	~35%
1%	~75%

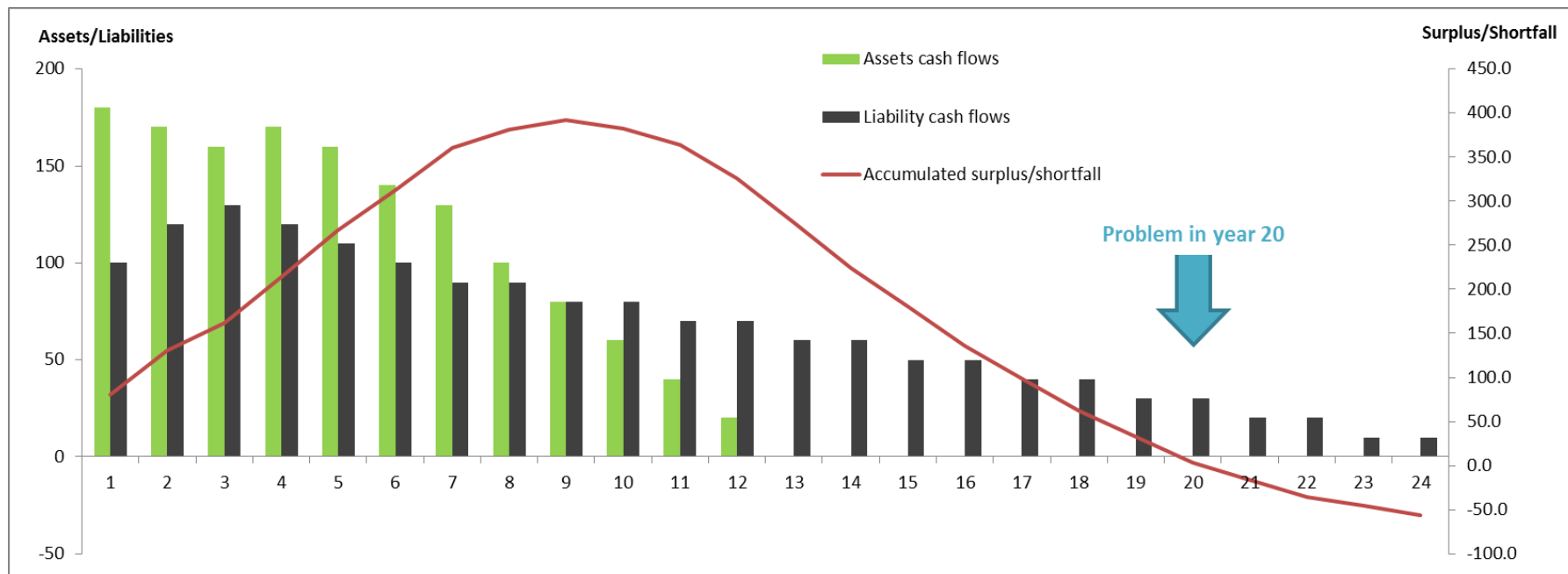
- Also increases price of protection products, like home and motor insurance, because these products rely on investment returns to keep premiums low

*Source: <https://www.calcxml.com/calculators/retirement-calculator?skn=>

Impact on insurers who provide guarantees

- Guarantees can be great for policyholders but if investment returns are very low for very long periods insurers will have to be able to fund the shortfalls
- The vast majority of the industry has sufficient capital or profits from other sources to cope for a long time and/or has asset and liabilities well matched
- Real economic impact for individual companies will depend on:
 - Level, length and strength of guarantees
 - Actual investment rates they can earn now and over coming years
 - Level of matching between assets and liabilities
 - Hedges, profit sharing rules and other risk mitigation
 - Level of capital and other profits they have
- Solvency II impact is not quite the same as the real economic impact and also has to be managed

The long-term nature of the potential problem gives time to address it



- In this example the problem will only arise in 20 years time
- If interest rates rise before then, the problem can reduce or disappear
- Solvency II measurement does not treat short-term liquidity and long-term funding issues as very different (although extended recovery periods rules can help take this into account)

What insurers can and have been doing . . .

There are a range of actions that can help deal with potentially long periods of low rates

- On existing products with guarantees
 - Optimise investment returns and asset liability management
 - Note that searching for yield is a key part of the service and product we provide and is expected and needed by policyholders
 - Hedge

- On new products
 - Lower guarantees
 - Align pricing to reflect guarantees and risk
 - New guarantee product design
 - Allow customer to take the risk - unit linked

- Other
 - Lower costs
 - Increase other revenue streams (e.g. protection products)
 - Increase solvency capital

Solvency II, rightfully encourages early action but care must be taken to avoid over-reaction

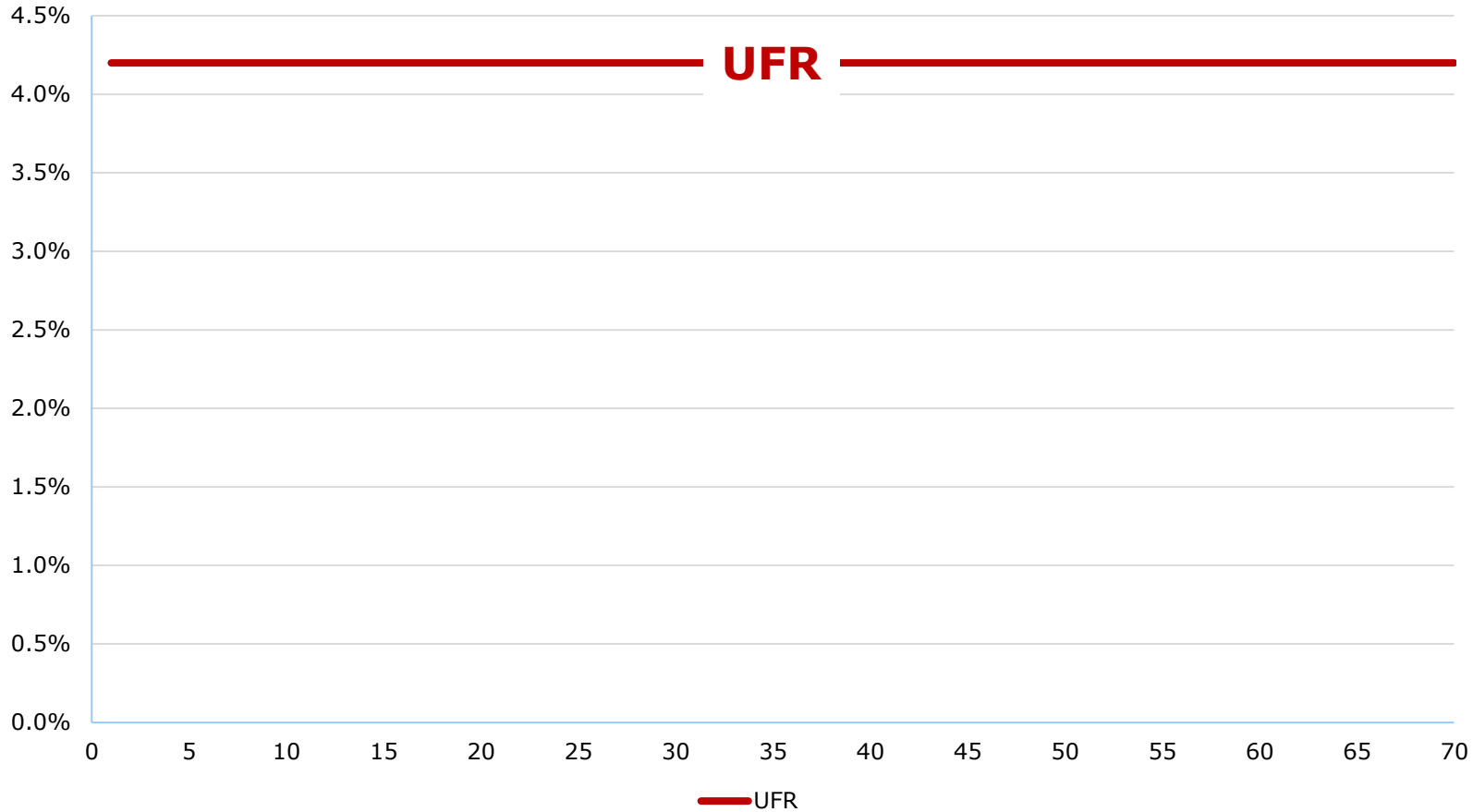
- Solvency II is a risk-based approach that correctly requires companies to:
 - Project liabilities on a realistic and up to date “best-estimate”
 - Recognise re-investment risk and that risk that assets under-perform
 - Recognise that guarantees and options have a cost/risk
 - Have very strong governance and risk requirements including necessary expertise and control over investments
 - Take action early where problems are identified
 - Hold capital for all material risks including even lower interest rates

- However, the market consistent methodology can create a very conservative view on a company’s ability to meet its liabilities, especially when interest rates are low
 - Generally assumes all assets are invested risk free
 - Includes non-cashflow items in the liabilities which can increase significantly when interest rates are low: Risk Margin and “Time-value” of Options and Guarantees (TFOG)

Impact . . .

Solvency II discount rates for valuing liabilities are far below actual yields and the UFR of 4.2%

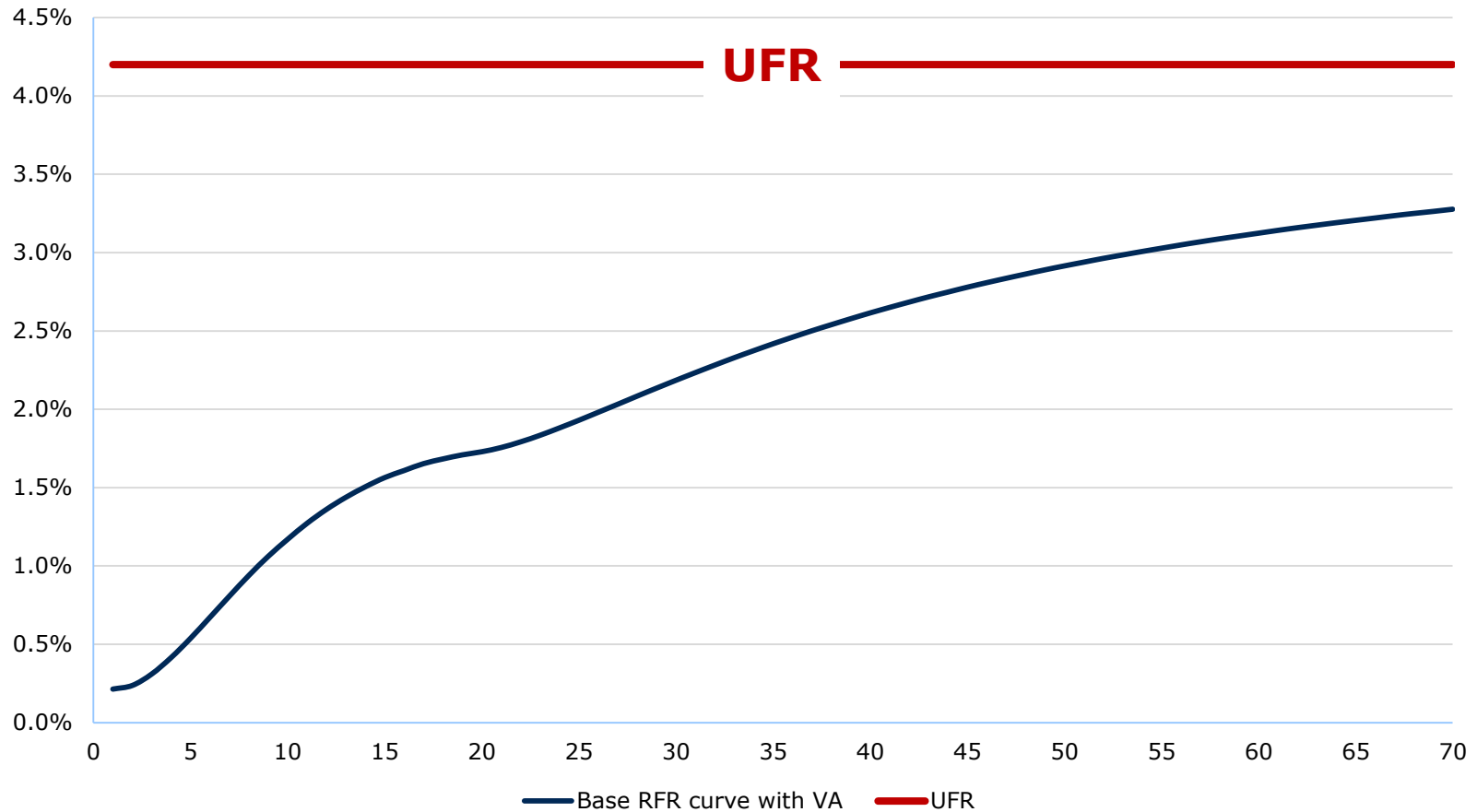
Risk Free Rate Curves for Euro (with VA)
September 2015



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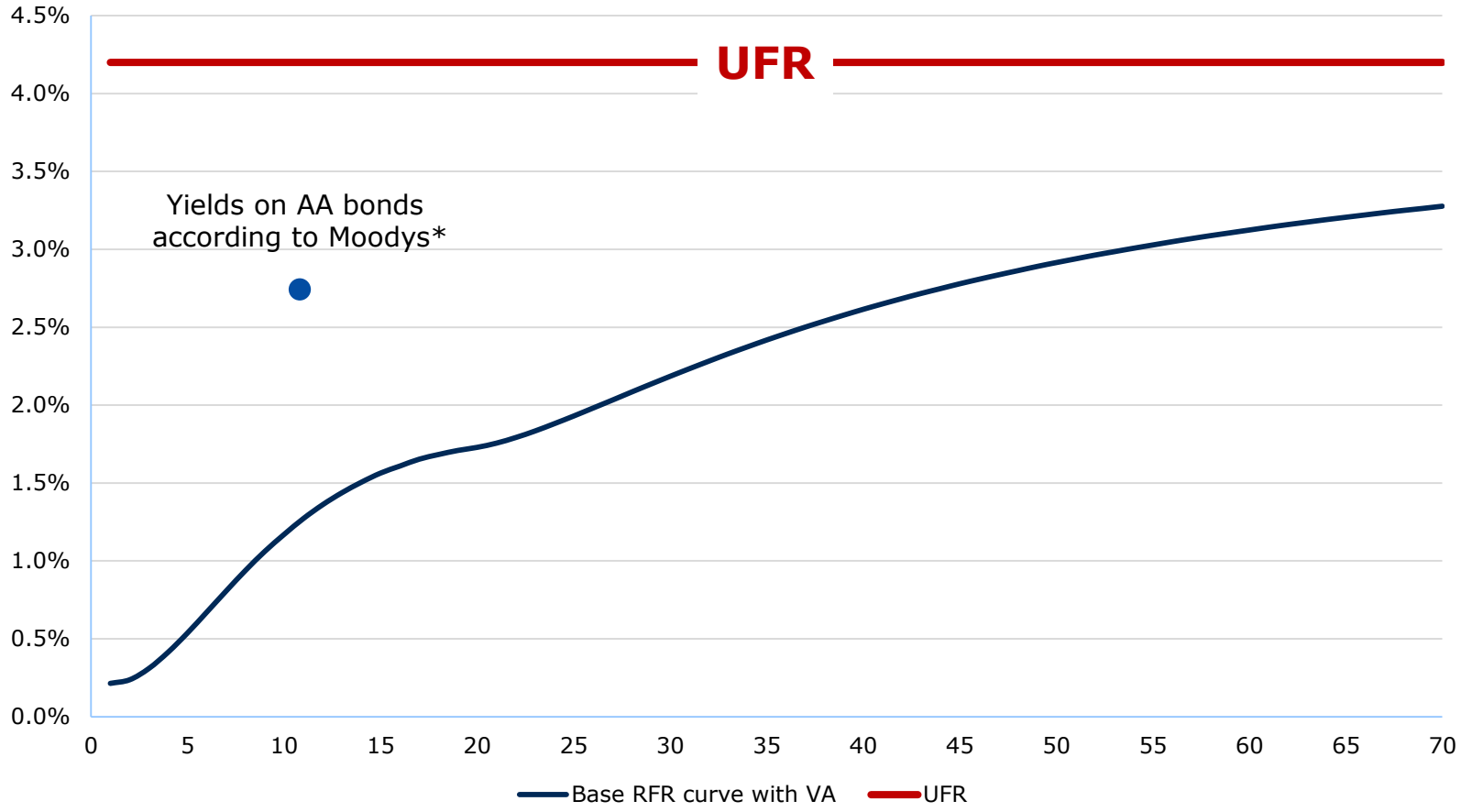
* Source: Moody's analytics, "Operating Lease and Pension Interest Rates, 6 November 2015

"Median yields for regular coupon (no zero coupons or floating rate) bonds rated by Moody's with maturities between six and eight years and outstanding values of more than \$50 million. Each observation is unweighted in the sample, and the yields are calculated for end-of-month values"

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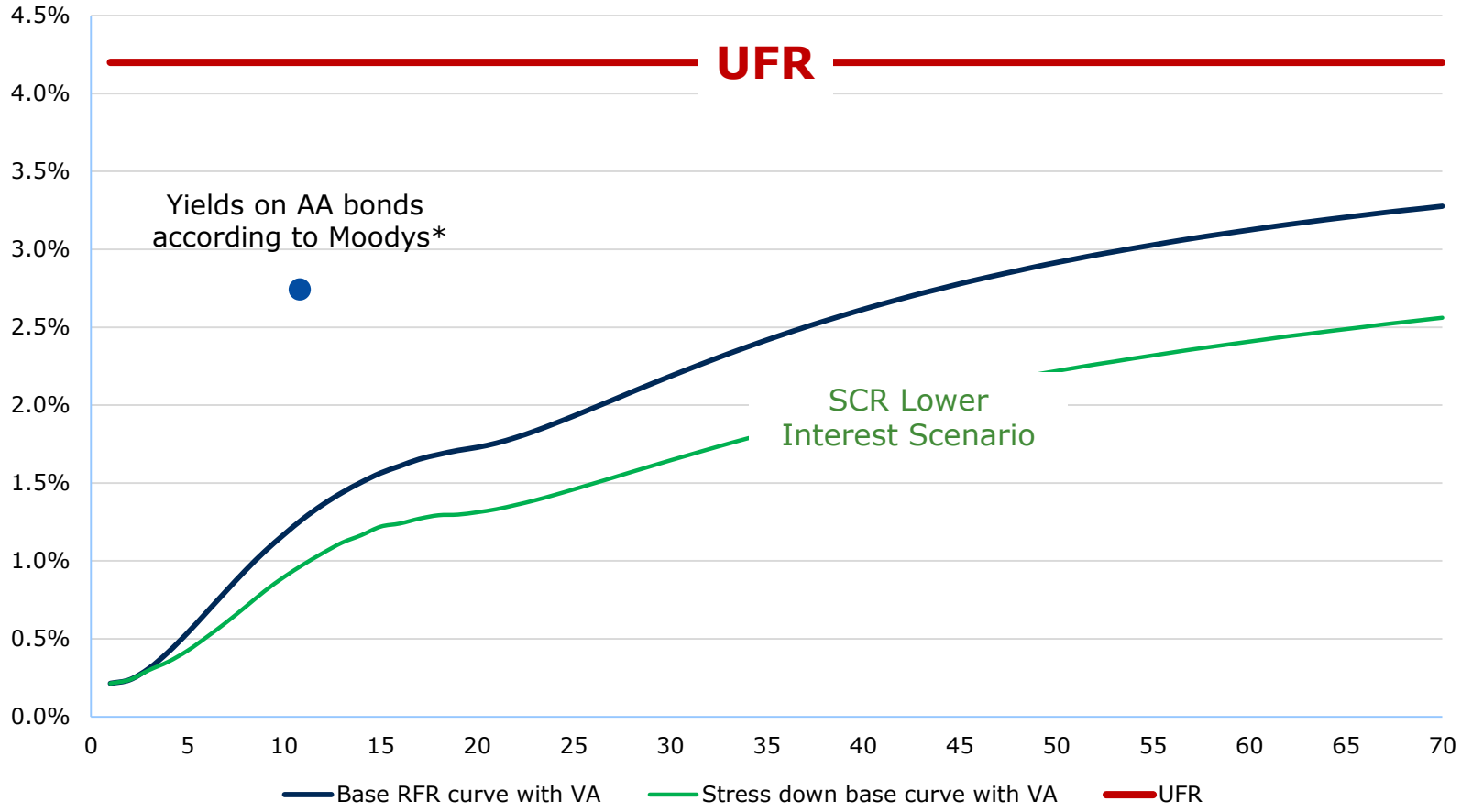
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Impact . . .

Solvency II builds in layers of protection

(illustrative – not to scale)

Assets
(AA bonds)
Needed to match
cashflows from
Best Estimate
Liabilities
and Costs

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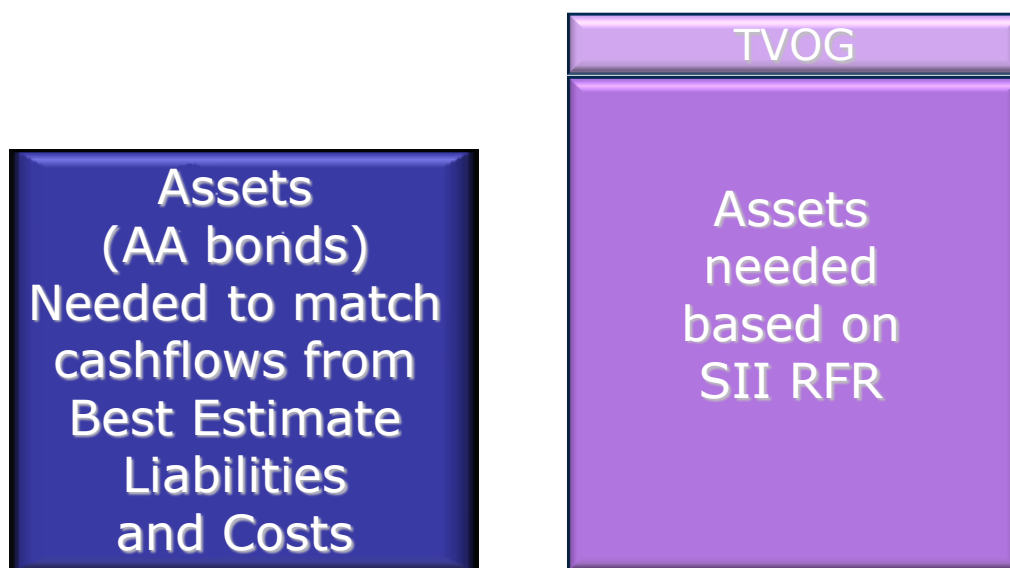
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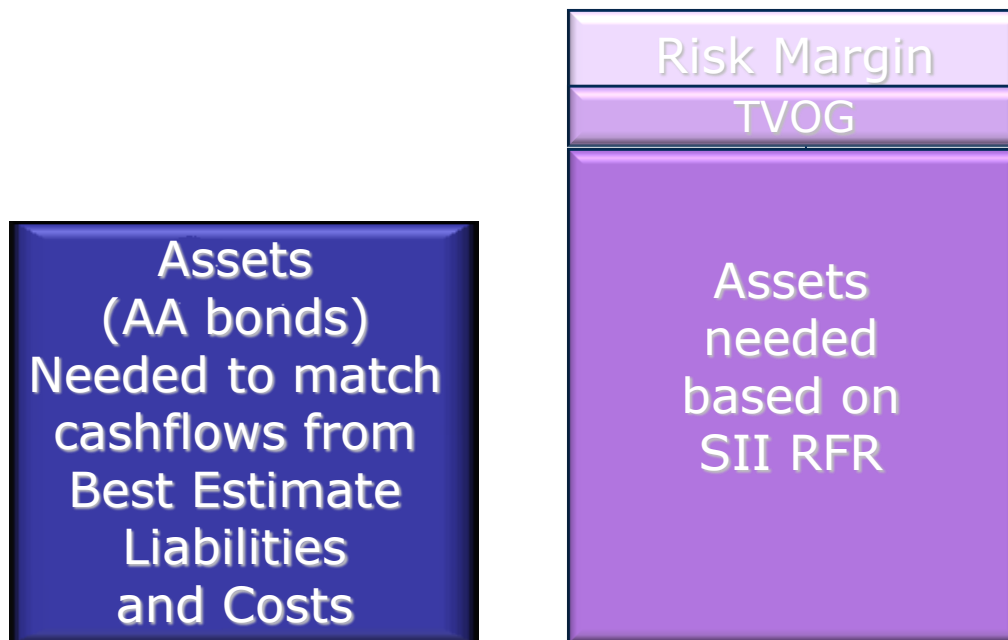


- Time-value of options and guarantees (TVOG) becomes part of valuation of liabilities under SII's market consistent approach
- Can become large even for capital only (0%) guarantees when interest rates are very low

Impact . . .

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- Risk Margin also increases under low interest rates and can add to volatility of the balance sheet

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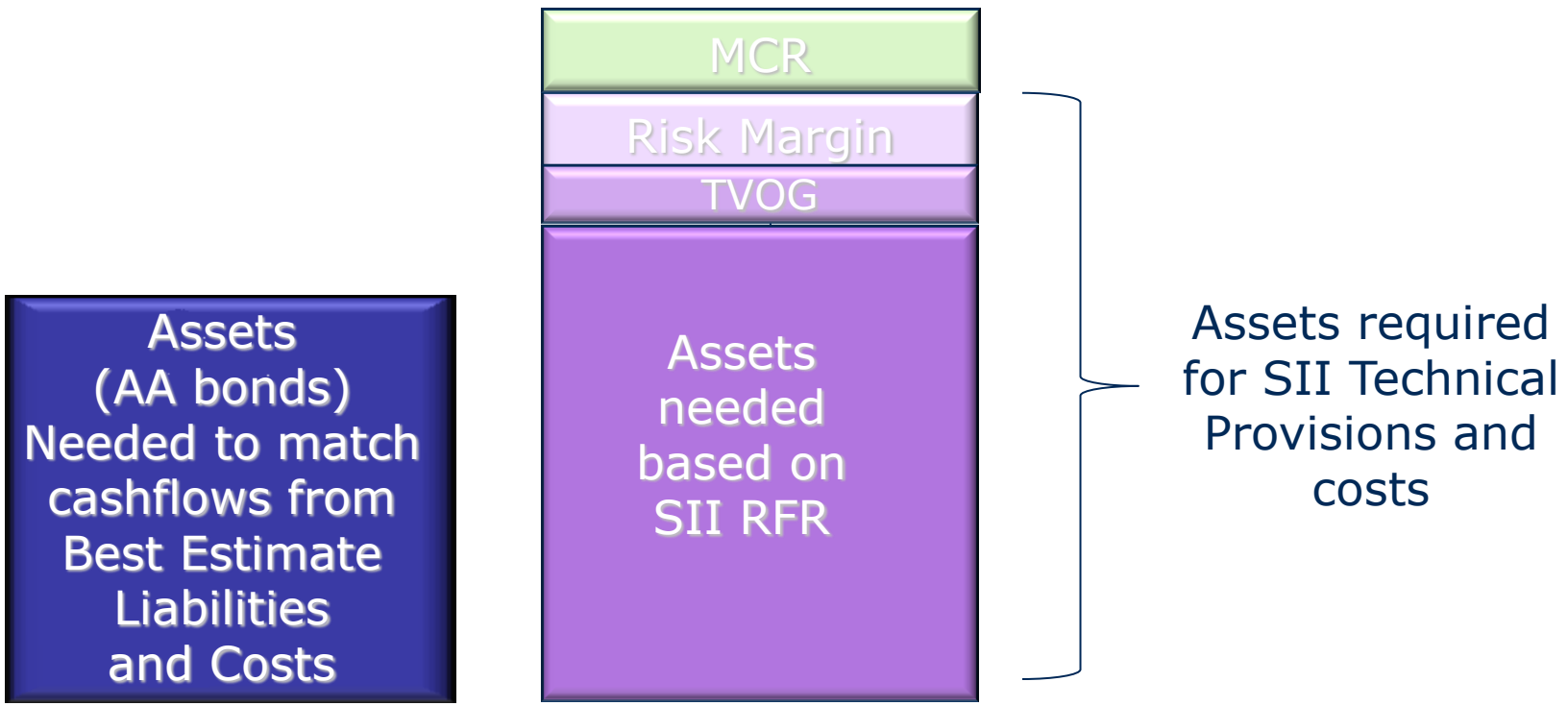
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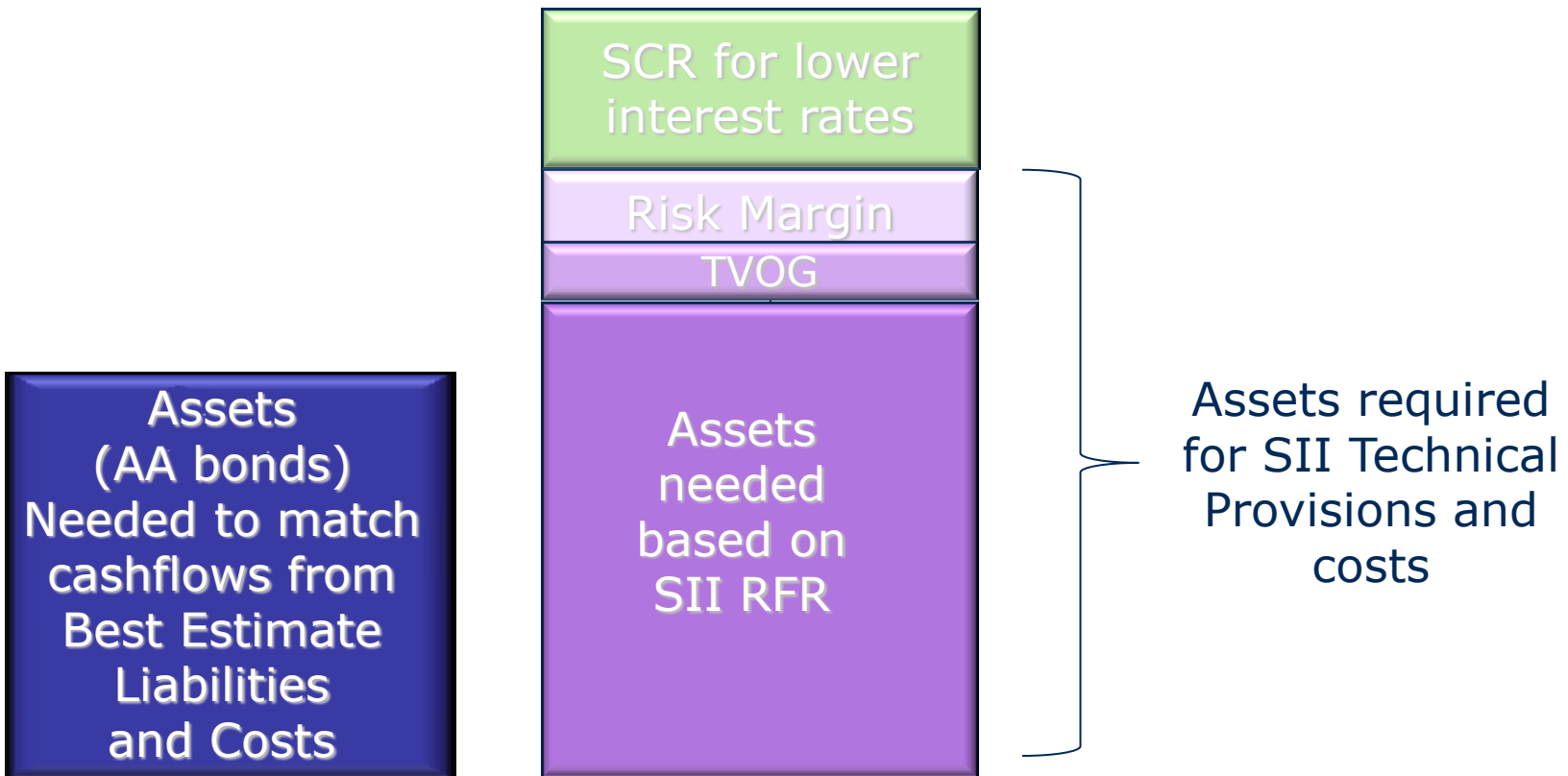
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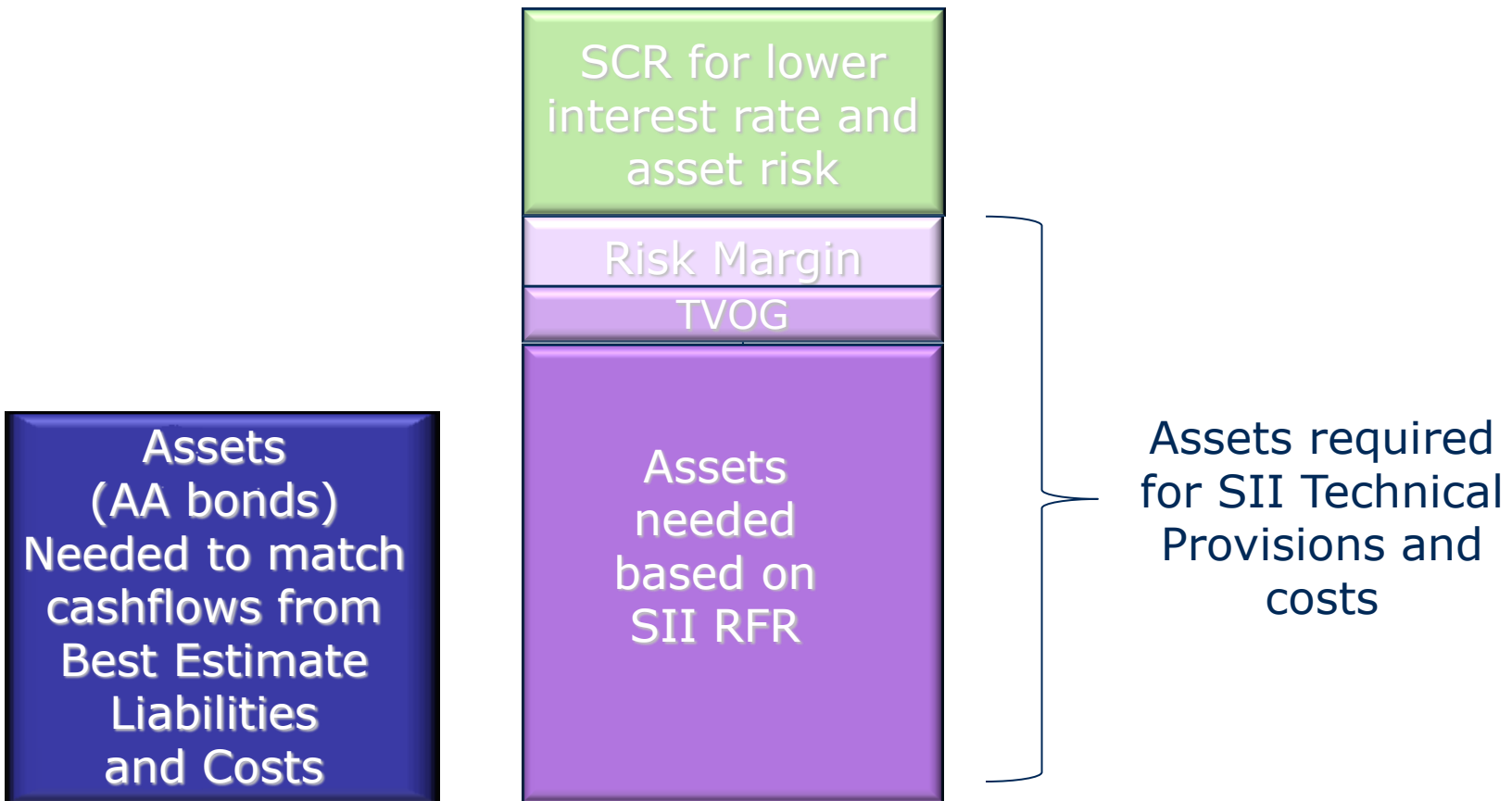
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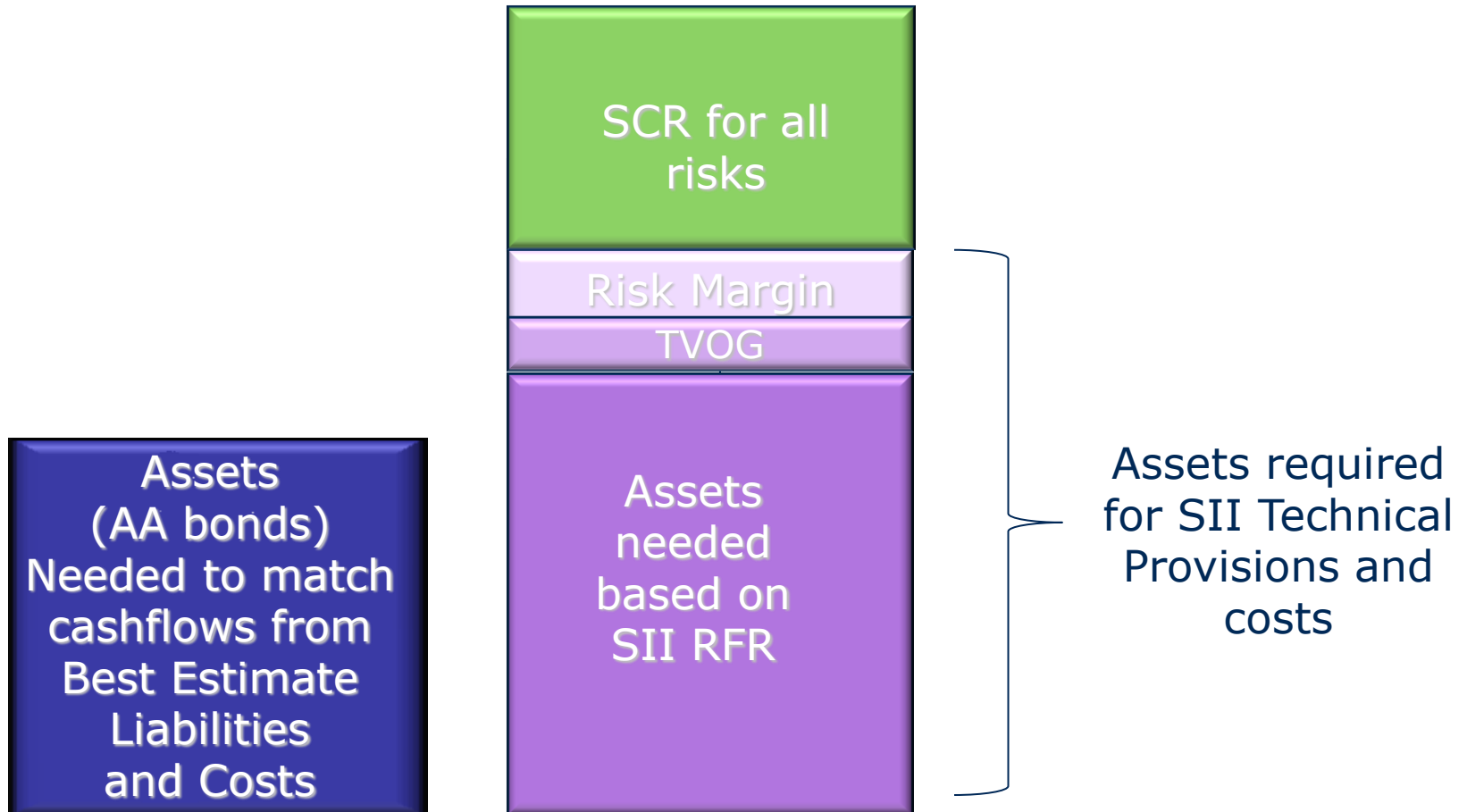
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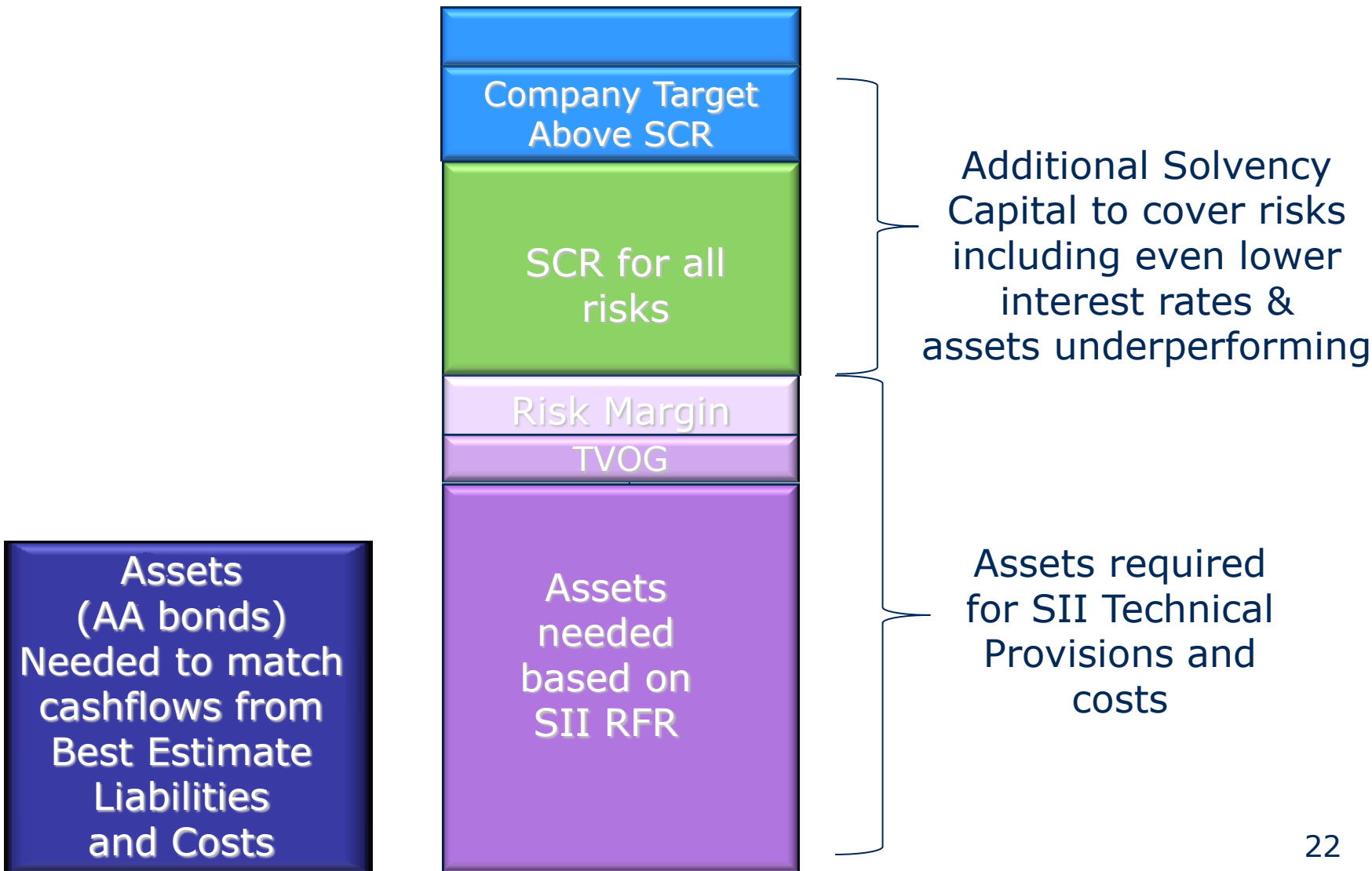
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Important to react, but not over-react

- The risk of extended period of low interest rates is a major concern but most companies can and are adapting and coping
- Individual companies with potential problems need to continue to take appropriate actions – no one should take a “wait and see” approach
- Policymaker reaction should recognise that this is a long-term problem with long-term solutions and take into account important features of Solvency II
 - How its measurement basis works, especially under low interest rates
 - Its conservative nature and very strong solvency requirements
 - Its very high standards of governance and risk management
 - The very extensive reporting which allows supervisors to monitor individual companies and industry segments
- Now is not the time to burden the industry with ever greater conservative requirements