ACTUARIAL ASSOCIATION OF EUROPE

Low Interest Rates Working Group

Results of the Survey

INSURANCE COMMITTEE, BRATISLAVA

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Matthias Pillaudin (Chair)
Daphne De Leval, Ivana Skolpjanac, Martin Leitz-Martini, Lauri Saraste, Tony O'Riordan

Agenda items

1) Context
2) Life/Pension
3) P&C insurance
4) Next steps

Context – Survey

Objectives and limitations

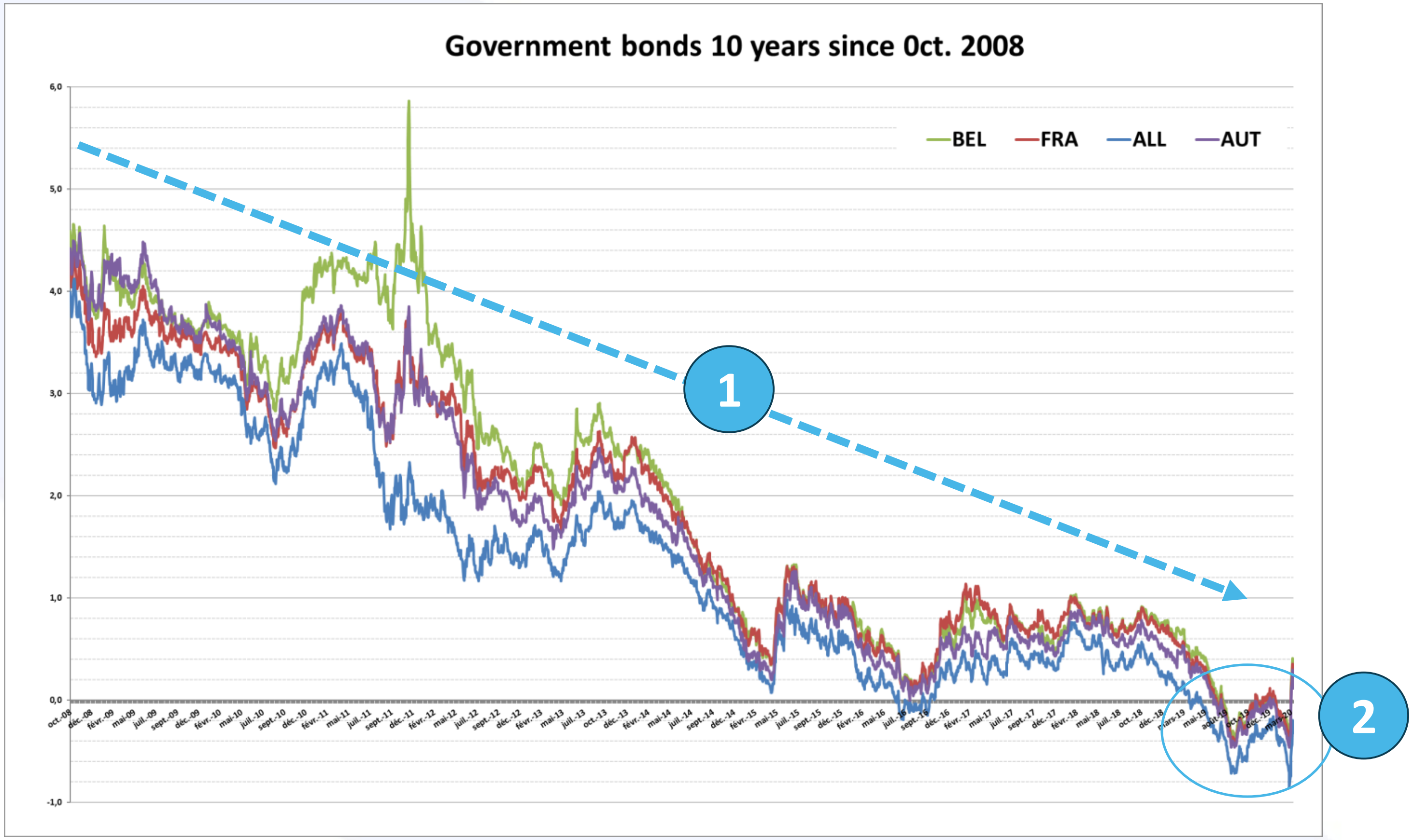
- In 2016, the AAE published a paper on its conclusion of the consequences of low interest rate environment in Life Insurance across Europe(see annex) .
- In January 2020, the LIRWG launched a new survey
- Aiming to assess how low-yield period known since 2015, have affected the strategy of Life, Pensions and P&C insurers across Europe
- 10 member states participated in Survey

Thank you for your participation !

- Limitations:
  - ✓ No consideration of a sudden rise in interest rates
  - ✓ Survey performed before the COVID-19 crisis in Europe

Context

Breakdown of government bonds yields

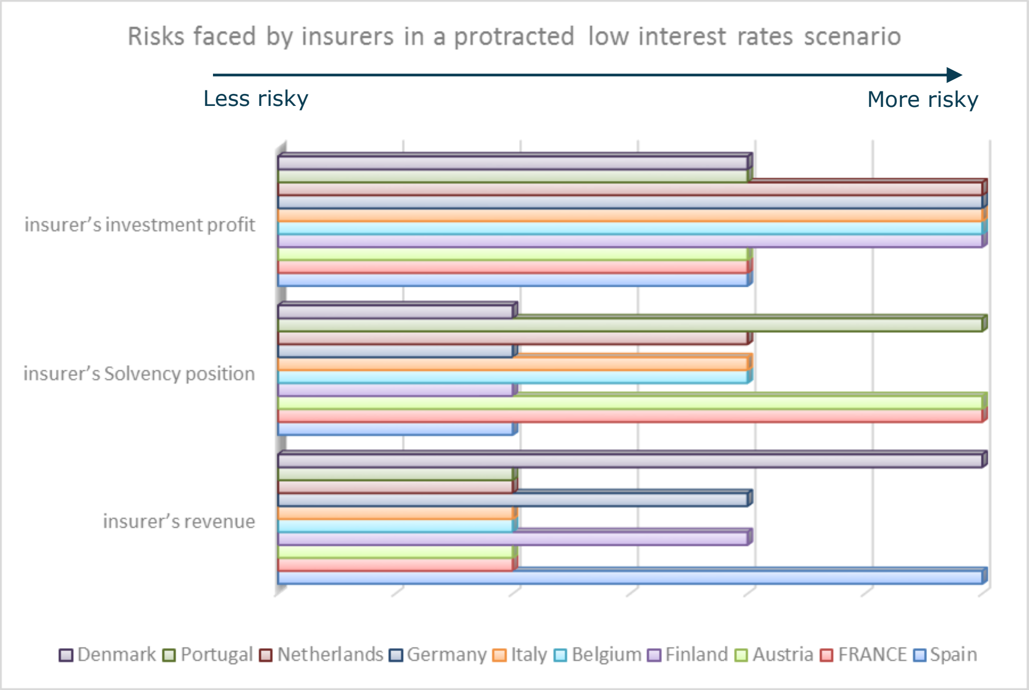


1 In 2019, the graph shows that the **average government bond rate (10Y) is around 0%.** At the same time, the results of the survey shows that the **average guaranteed interest rate is around 1%** for more than 4 000 billions € reserves.

2 Since 2012, insurers faced a decrease of governments bonds yields from around 4% en 2008 to 0% in 2019. During this period, some countries also faced a spread increase.

Context – Survey

Common issues



The decrease of fixed income returns seems to be the main risk highlighted by the respondents

Could the observed differences be explained by a difference in the use of the transitional measures?

Could the observed differences be explained by a difference in tax regulation?

Key findings and messages

- Life insurance : Insurers will have to face lower margins due to lower assets return -> focus on products with less or no guarantee (beyond one year) -> may lead to reputational risk.
- Pension : issues concerning guarantees linked to price inflation
- Health insurance : mainly short term with repricing -> premium increase for customers / cuts in management costs.
- P&C insurance : similar answers to health insurance, except for life time annuity stream where asset and liability mismatch issue arises.
- Main challenges noted by the respondents are : consumer behavior, insurance business model and actuarial valuation with negative interest rates.

Context – EIOPA Statement

Impact of the ultra-low/negative interest rate environment (Feb 2020)

EIOPA aims via this paper at raising awareness and ensuring the resilience of the insurance sector in an ultra-low/negative interest rate environment. It also seeks to inform the different stakeholders and consumers about future supervisory actions.

Latest developments [1]

- Strategy for new products: decreasing guarantees, focusing on unit-linked, discontinuing some products
- Strategy for existing business: incentives to switch, additional reserving, renegotiating the contract terms
- Change in asset allocation: move to more untraditional investments in search for yield, more equity exposure but also buying bonds with negative yields
- Reinvestment risk: significant lower average yield
- Profitability: declining interest rate income and pressure on (life) guaranteed-return business
- Solvency: significant increase in TP (not fully compensated by assets), UFR drag[2], decrease in SCR ratios
- Efficiency/cost cutting actions and dividend restrictions

EIOPA recommendations to NSAs (Short Term and Long Term)

Actions	Description	Actions	Description
1- ST: Monitoring and supervising insurers that are greatly exposed to LIR environment	• Intensify the monitoring and supervision of those undertakings • E.g. conduct of business and consumer protection, "search for yield"	**3– ST: Special attention on pre-emptive recovery & resolution planning (with proportionality)**	• Request undertakings to prepare recovery plans before SCR breach • Develop resolution plans and conduct resolvability assessments
2 – ST: Engaging in a dialogue to explore actions to improve financial resilience (IF business)	• Challenge business models • Make sure insurers have a sound capital planning • Effective risk management (ORSA with enough severe LIR scenarios)	**4– ST: Considering systemic risk**	Assess sufficient loss-absorbing capacity as whole, identify risky behaviours and potential procyclical concerns
5- MT/LT actions: Identifying missing tools and powers in the current toolkit	In case of GAP identification, implementation of those new powers in the medium/longer run, e.g.: • Minimum harmonised and comprehensive recovery and resolution framework • S2 revision to include macroprudential dimension and broaden available toolkit to address sources of systemic risk such as LIR environment		

1- EIOPA is conducting an extensive analysis – the report will be published in due course.
2 – Risk that when time passess, the value of the liabilities increase more than risk free assets and can not be compensated by enough capital generation in an enduring low yield environment.

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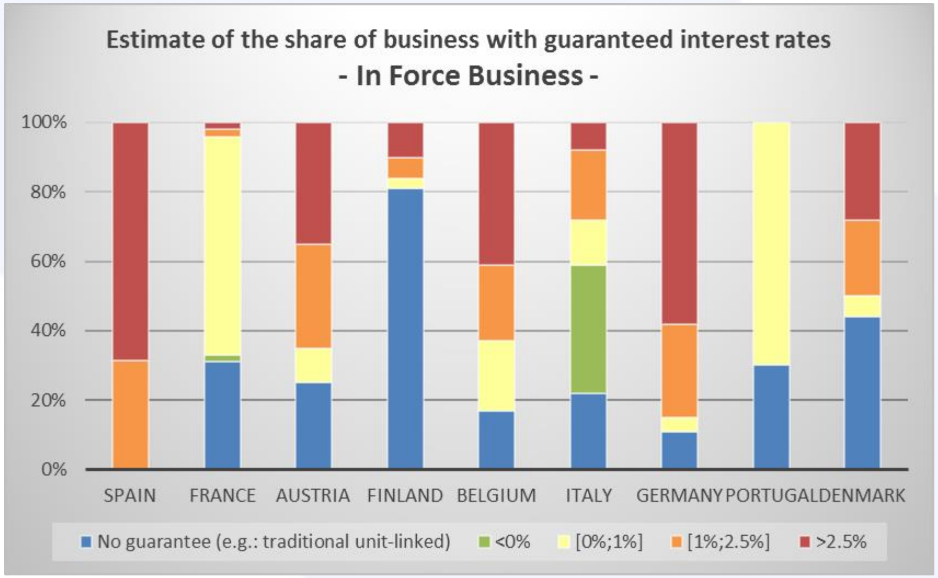
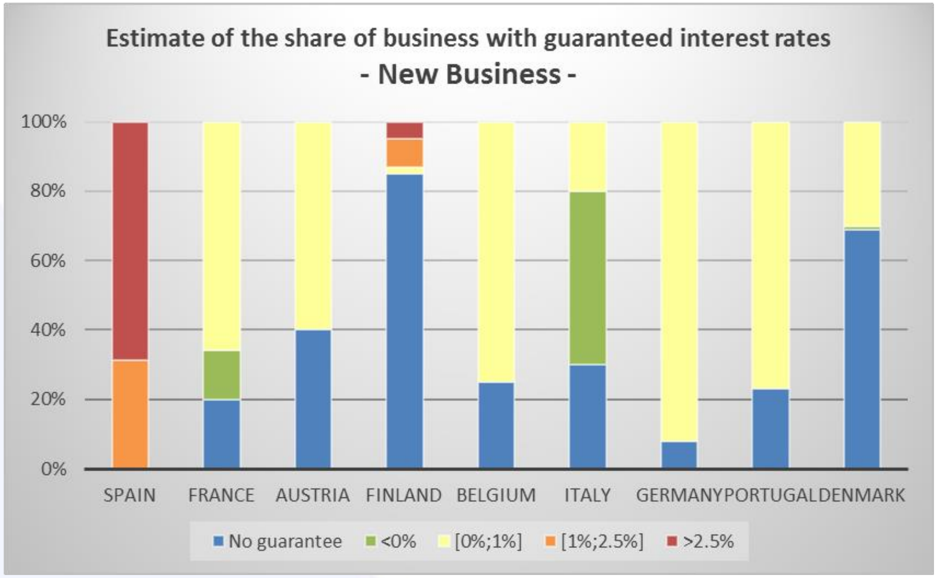
Life/Pension

Structure of business in European market (1/2)



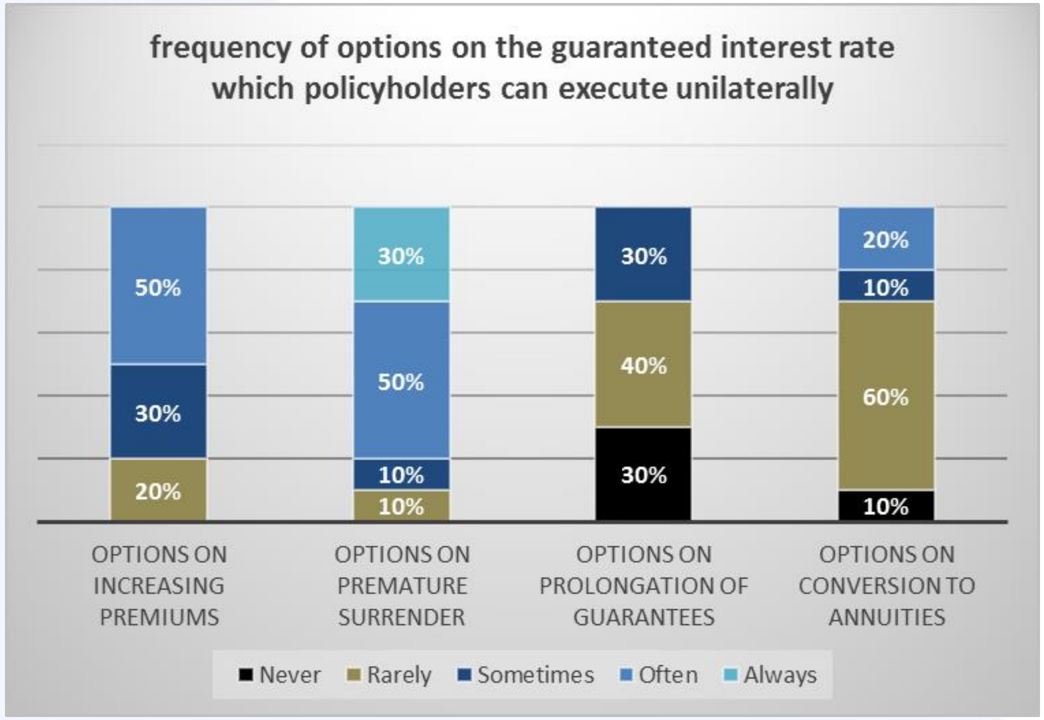


Key findings and messages

- Many countries show high rate commitments that may be difficult to sustain in an protracted low rates scenario.
- In most of the countries surveyed, new business offers less guarantee on interest rates, which suggests that the average guaranteed interest rate will decrease over the next few years. However, it is highly likely that in most countries where the life insurance market is "mature", the stock inertia will cause significant sensitivity to interest rate risk over the next few years.
- Most contracts do not include a regular premium payment plan. In general, a possible change in the terms and conditions included interest guarantees of existing insurance contracts depends to policyholder. However, in several for instance they may be changed in case of company insolvency.

Life/Pension

Structure of business in European market (2/2)

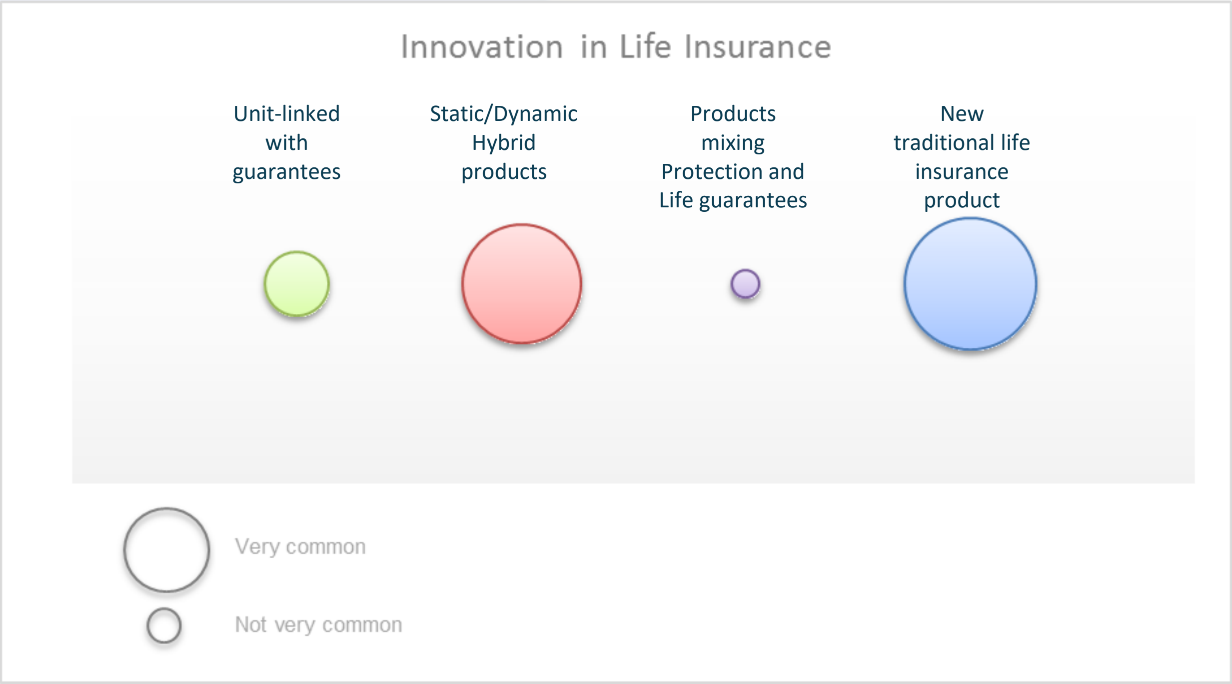


Key findings and messages

- While the existence of a surrender option seems widespread across Europe, the possibility of converting a savings contract into annuities seems more specific to each market.
- Most of respondents noted a decrease in the options provided for new business. In addition, some of them noted an inflection in the behavior of policyholders which could increase the sensitivity of the insurance market to a low interest rate environment: more conversion into annuities and less surrenders

Life/Pension

Innovation in Life insurance (1/2)

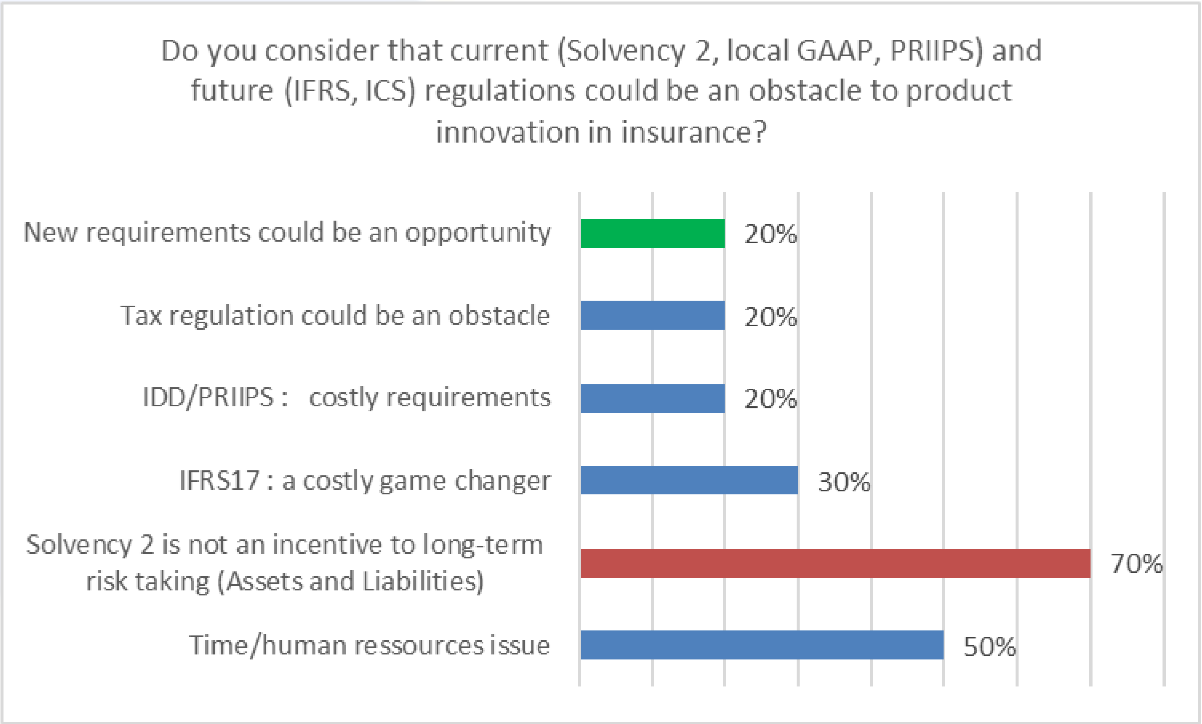


Key findings and messages

- The insurance contracts with guaranteed interest rate remain globally attractive and widely offered across Europe but with less financial options and guarantees.
- To cope with an lower and lower interest rates, many respondents mentioned hybrid products.
- Innovation concerning products mixing Protection and Life guarantees seem to be very limited : prohibited by local regulation?

Life/Pension

Innovation in Life insurance (2/2)

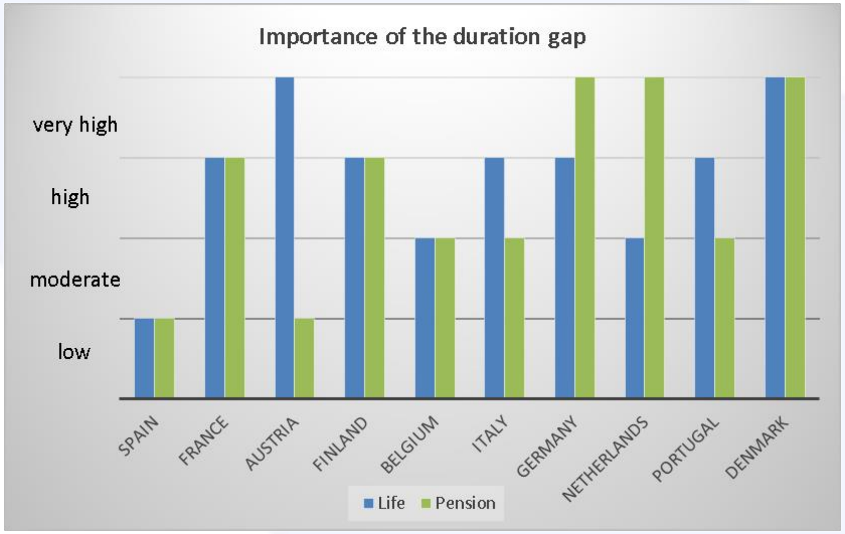


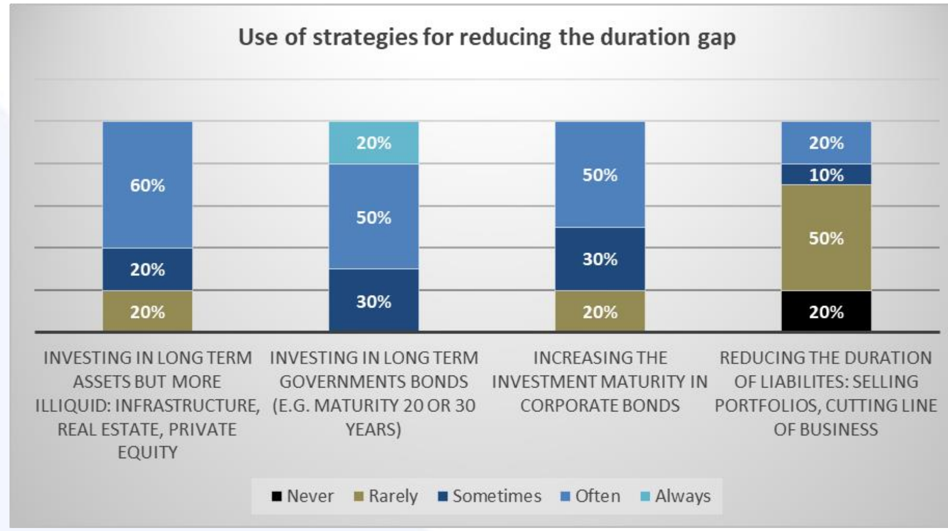
<u>Key findings and messages</u>

- Most of respondents mentioned that Solvency 2 is the main element that limits the product innovation : no incentive to insure long-term risks.
- Some respondents also mentioned that new regulations could be seen as a incentive to explore new fields for product innovation.

Life/Pension

Duration gap and ALM strategies



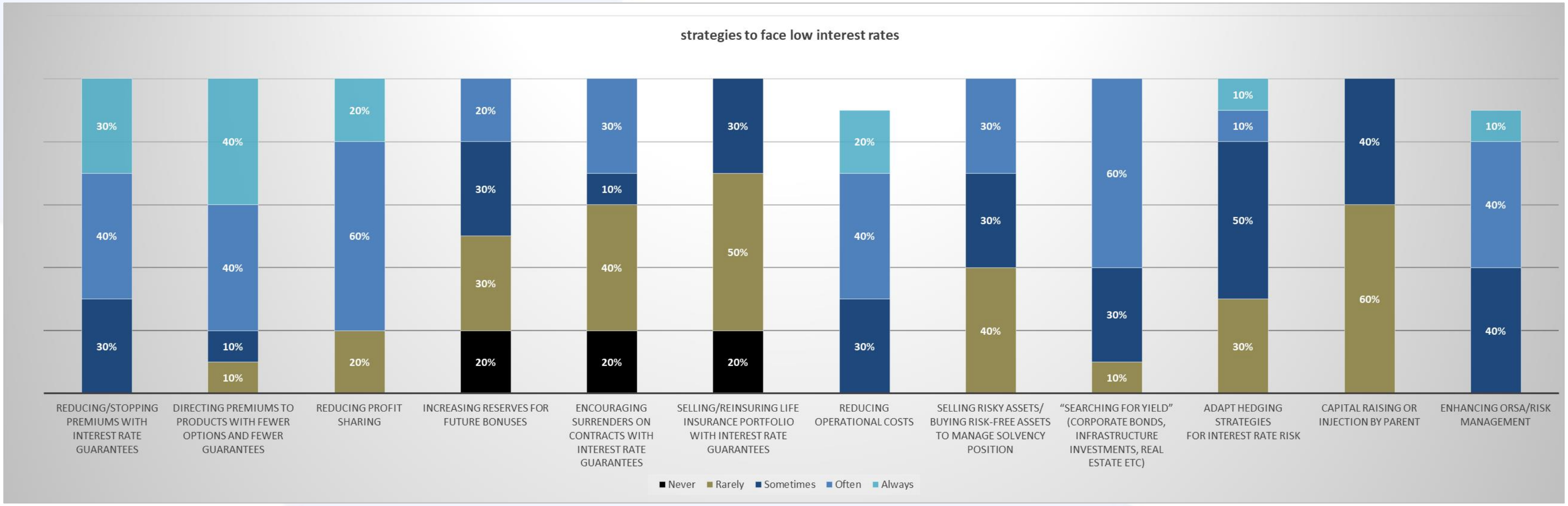


Key findings and messages

- In most countries there is a moderate to (very) high issue concerning the duration gap. This is normally handled by a long term bond strategy – especially government bonds.
- One main problem is the lack of long-term investment possibilities with sufficient interest rate sensitivity and sufficient return to earn the guaranteed interest rate.
- Strategies to reduce the liability's duration are seen as reputational risky and are not very common.

Life/Pension

Strategies to face and changes due to low interest rates

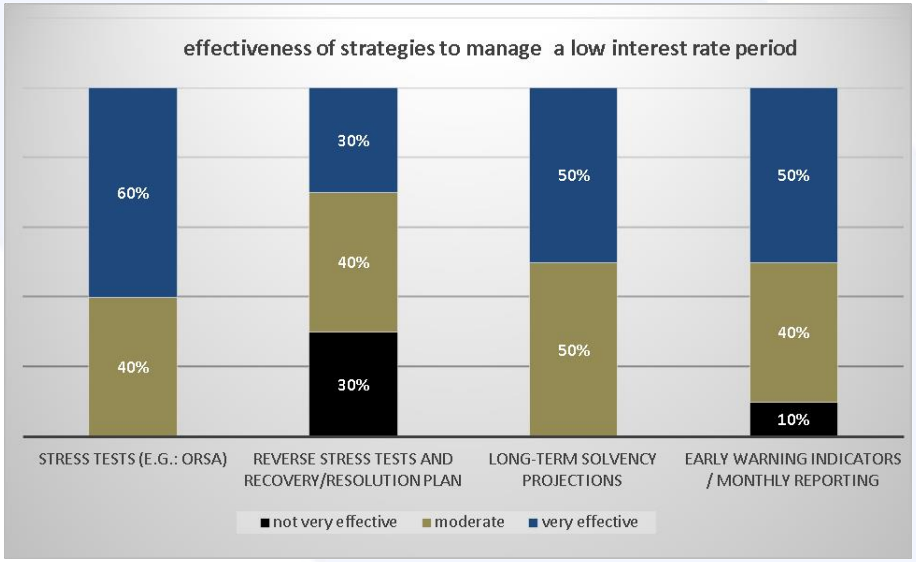


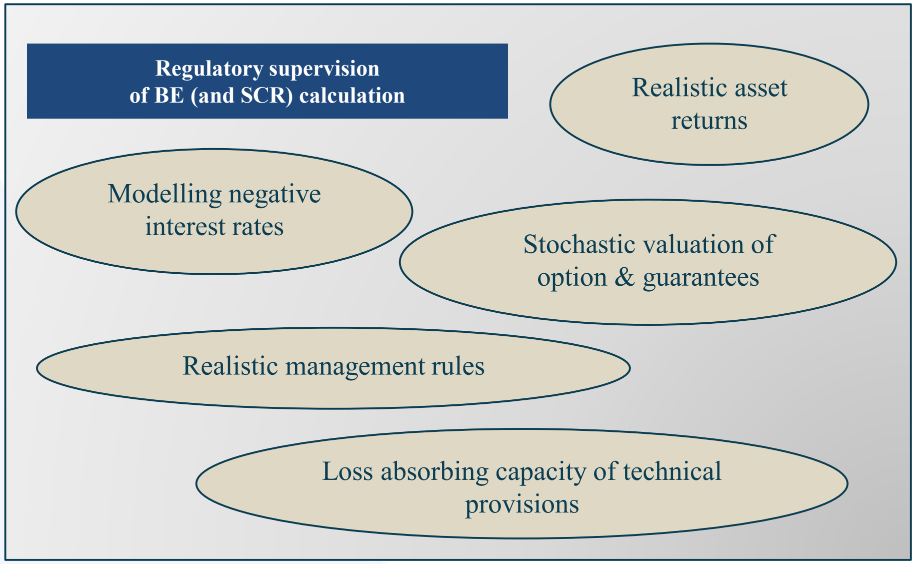
Key findings and messages

- The main focus is on strategies for lowering the future guarantees in the business by selling products with less guarantees.
- Secondly on the asset side the search for yield and interest rate hedging are important.
- Also in local GAAP there are changes (e.g. additional reserve for low interest rates, smoothing of profit sharing to p/h, etc.)
- The use of LTG measures hasn't changed significantly.

Life/Pension

Duration gap, ALM strategies and use of management actions under Solvency II models





Key findings and messages

- Stress tests (ORSA) and long-term solvency projections eventually with early indicators give the most effect in managing low interest rate periods.
- The supervisors are focusing more and more on several deep modelling aspects in the calculation of the best estimate. The model should reflect reality.
- If guarantees cannot be met then problems occur. Almost no guarantees in new products. Profit participation is reduced for in force business.
- For the moment insolvency could be avoided.

Life/Pension

Conclusion & key messages

- The life insurance sector has begun a transformation for several years in order to be more resilient to an environment of protracted low interest rates : less options and guarantees for new business, product innovation, ALM strategies, additional reserve for low interest rates, smoothing effect of the profit sharing mechanism.

- However, many issues remain which could put these conclusions into question, including :
  - ✓ Life insurance business model is at stake : no guarantee => no value for money? guarantees linked to inflation index in Pension ?
  - ✓ Policyholders behavior : more surrenders or less in the future ?
  - ✓ Actuarial valuation : negative interest rates : lower bound ?
  - ✓ Hedging strategies and investment strategies, considering Solvency II framework : how could we reduce the duration gap ?
  - ✓ New framework and regulations : income statement volatility under IFRS17, 2020 Solvency II review -> more reporting – less product innovation

- In this framework, it appears that the enhancement of the ORSA, long-term solvency projections eventually with early indicators give the most effect in managing low interest rate periods

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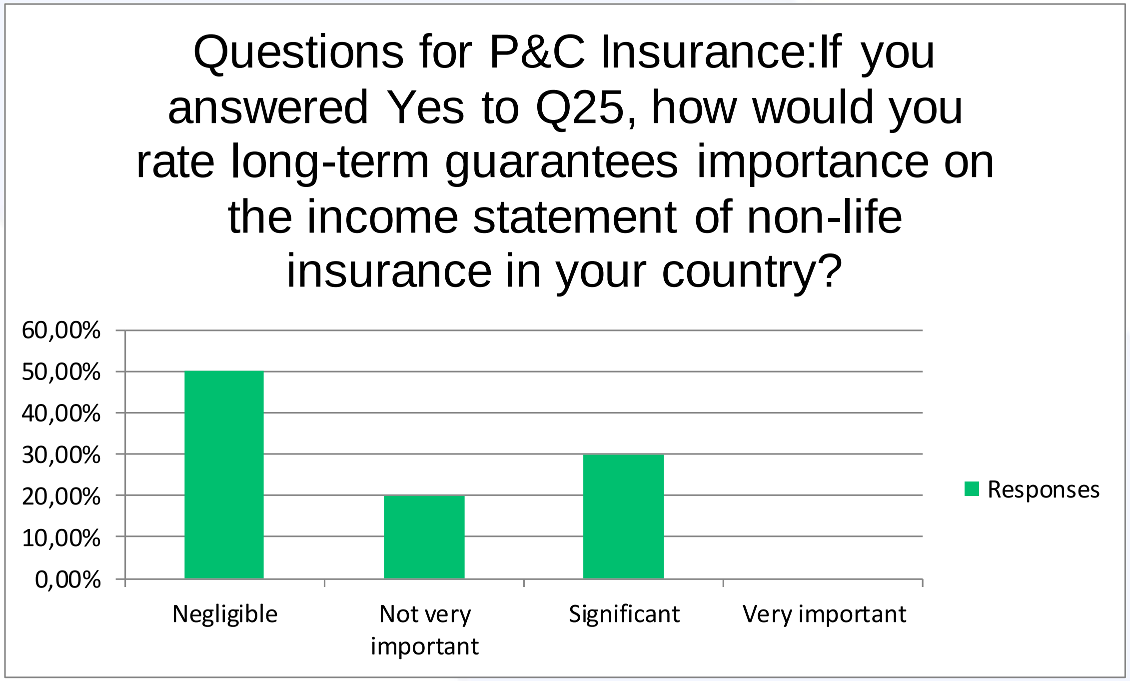
P&C Insurance

Results

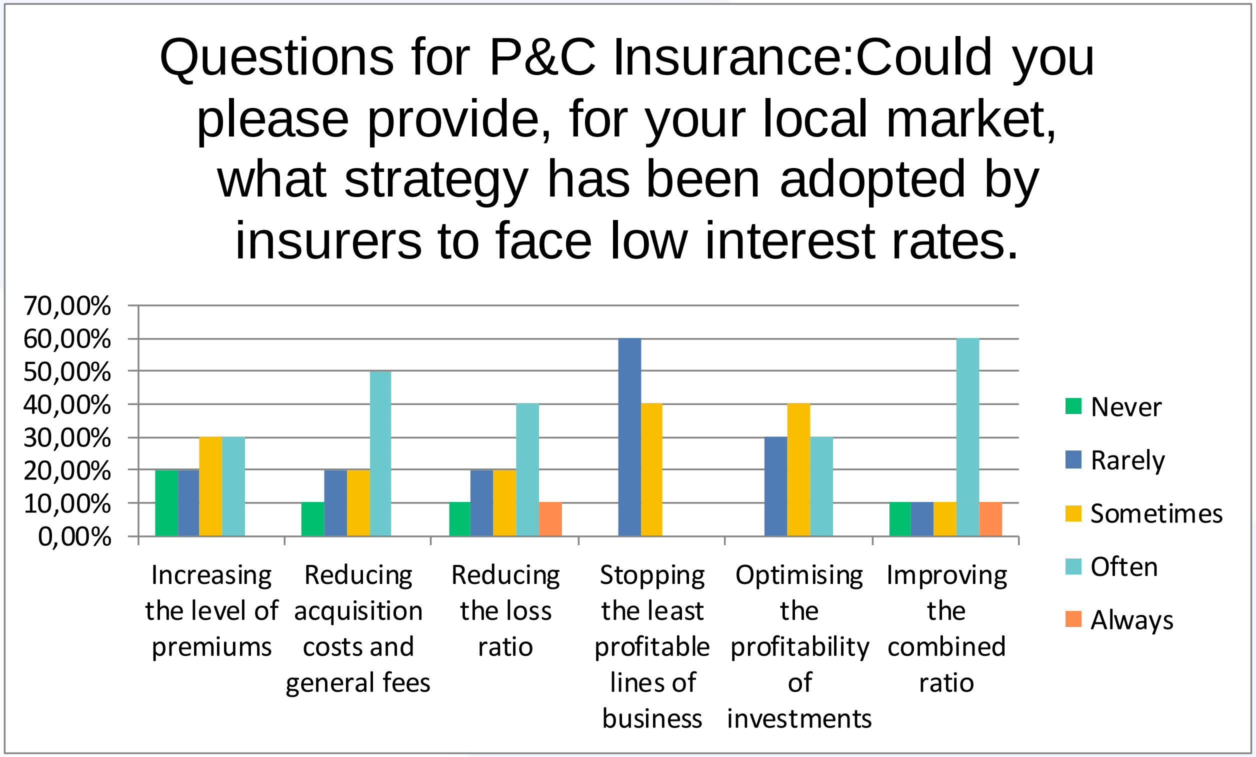
- 50% of respondents have stated that a long term guarantees are a feature of Non-Life insurance market
- 30% of respondents consider importance of long term guarantees on income statement to be significant, while 70% consider it to be negligible or not very important.



P&C Insurance

Results

- The future benefit payments in the market, usually depend on several factors: fixed payments, price index inflation, wage index inflation etc.
- Claimants usually don`t have an option to take a lump sum (70%)
- A various strategies have been adopted for local markets in order to face low interest rate environment



P&C Insurance

Conclusion & key messages

- Low interest rate environment will have an impact on Non-Life insurance market, mostly with business related to long term guarantees, such as annuity payments, but could also have a significant impact on liability and other long tail insurance (MTPL, GTPL, Accident...)

- The impact will reflect on Income statement, but also on solvency position.

- Various strategies will be adopted by Non-Life insurers, such as: increasing the level of premiums, reducing acquisition cost and general fees, reducing loss ratio, improving combined ratio, stopping the least profitable lob`s, optimizing the profitability of investments.

- Non-Life insurers that are significantly dealing with long term business could have significant effects of low interest rate environment: due to the fact that within LIR environment earnings from asset side will be missing, insurers might increase their premiums, or on the other hand try to realize better yields on investments, by taking a more risky market positions. Which ever strategy they choose, there will be an impact on income statement and solvency position for them.

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Next steps

- The LIRWG proposes to the insurance committee the following work plan for 2020:
  1. Working on a paper presenting key findings and messages of the survey. This paper could be addressed to European authorities or/and MAs. This paper should answer to the following questions:
     - What are the medium / long term risks of a protracted low rates for insurers?
     - Obstacles/Benefits of the current regulation ? -> how to move to more a resilient system
     - What indicators / tools should be promoted at the micro and macro level?
  2. Proposing a webinar to the insurance committee

- The LIRWG proposes contributing actively to the AAE initiative in relation to the COVID-19 crisis

ANNEXES

ANNEXES - Low Interest Rates Environment

Key findings of the survey performed in 2016

In 2016, the AAE published a paper on its conclusion of the consequences of low interest rate environment in Life Insurance across Europe. This paper was based on a survey led by the insurance committee. It concludes that :

- The persistent low interest rates have a discernible influence on life insurance markets. For new business, the markets seem to have learnt their lessons and show the necessary reactions. However, an argument not to increase the pressure resulting from valuation could result from acknowledging the absence of a deep, liquid and transparent market for long durations, and the liability driven investment strategy.

- Implicit options in insurance contracts could lead to a heavy burden. Moreover, low interest rates have important influences on the local GAAP and on the asset management. In particular, there appears to be a need for long-term assets providing attractive terms, e.g. infrastructure investments.

For more details, please contact the Low Interest Working Group : AAE_LIR@lists.actuary.eu

ACTUARIAL ASSOCIATION OF EUROPE

Actuarial House

1 Place du Samedi

1000 Brussels

Belgium

www.actuary.eu

Follow us on twitter: @InfoAAE