Low or negative rates – Implications for Insurers

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Negative rates are negative for insurers

- The persistent low interest rate environment is a major source of risk for insurance companies and could accelerate changes in the structure of the industry.
- Life insurers continue to be hurt by low yields and, now, tightening spreads. The German Insurance Association estimates a current blended new investment yield of 1.79% for 18yrs and 1.39% for 12 years down from 3.5% and 3.0% respectively in Jan 2014. Business plans in the industry have not been build on the basis of zero real returns.
- Risk that investment yields fall below guarantees for life insurers causing losses and decline in capital. But Reserving has been established.
  - ZZR buffer in Germany cost insurers ca EUR 20bn in 2014/15. sustained low interest rates increases requirement for future years. Some estimates for 2024 accumulated ZZR requirement exceed EUR 100bn.
- Low rates are a global issue but impact on insurers vary by country (similar product landscape) and specific insurance company. key drivers are:
  - Proportion of guaranteed products and IR sensitivity in business mix
  - The weighted average guarantee on in-force policies
  - Spread between guarantee and investment returns and policyholder participation features
  - Asset-liability matching

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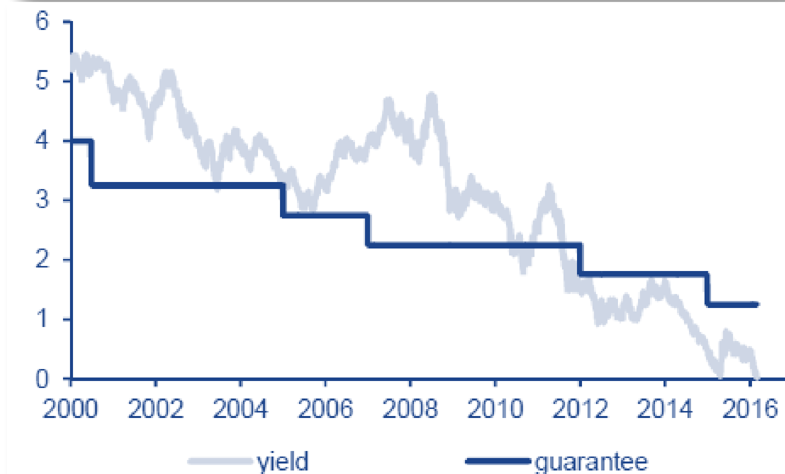
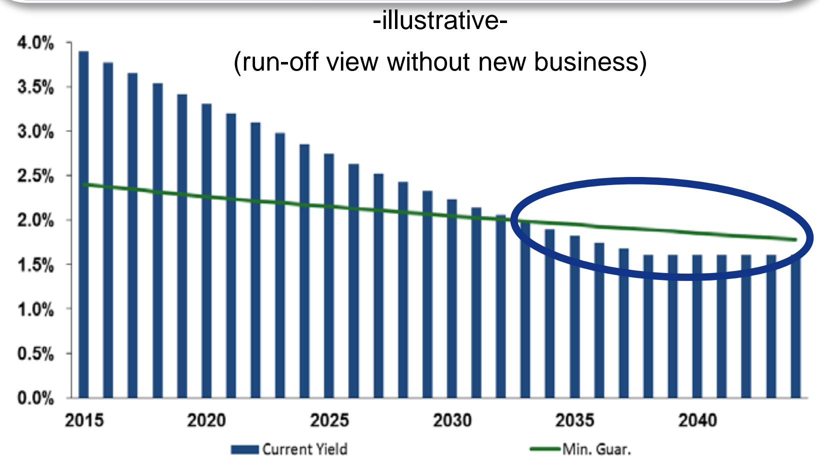
Life insurers in particular are impacted

Yields falling faster than guarantees - the German situation



German Life Insurer guarantee rate and average blended yield (Umlaufrendite).
Source: Bloomberg, Commerzbank Research, AIM

Current yield vs. guarantees - Life portfolio simulation



Illustrative simulation for life segment simulation based on reinvestment yield of 1.6 %
Source: AIM

- Measures on in-force book are needed in falling interest rate environment to protect the SII position
- P&C companies are less affected. Low rates will reduce profits but P&C companies can often raise premium as many products reprice annually

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The short end matters, but to a lesser extent

Cash considerations

- Insurance companies need to hold cash in short dated liquid investments for functioning liquidity and claims management.
- Depending on SII treatment, negative yields on such cash may actually lead to increasing capital requirement .

Illiquidity implications arise, but are less severe for insurance companies

- Insurers may suffer depending on business line.
- High volatility of prices and liquidity makes investing difficult but opportunities arise from capturing illiquidity premium.

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Responses and changes to the life insurance business

- Lowering Credited rates on in-force policies
  - Reduces risk of declining profitability but makes traditional savings products less attractive to policyholders. May decrease sales and increase lapses
- Offering lower guaranteed rates on new business / Introduce new products
  - Offer lower guarantees vs higher upside potential (e.g. Allianz Perspektive, Komfort Dynamik, Alpha Balance, etc..) Reduces average guaranteed rate over time but low immediate impact
- Diversifying into unit linked / asset management business
  - Reduces exposure to investment results and increases fee based income. Increases competition in asset management. May lead to declining margins
- Changing the asset allocation
  - Increasing investment income but could increase asset risk and decreases asset side liquidity. Depth, breadth and scale is key to success
- Implement hedging strategies / Reserving
  - Using derivatives. Suitable to manage duration gap but reduces investment result (particularly expensive if rates are already low). Introduces challenges on collateral management
  - Regulator as well as individual companies have introduced additional reserving

Insurers can cope. They can hedge and they need good asset and liability management strategies

Changes to the investment strategy are short term effective but may lead to unreasonable risk taking, changes to product offering are crucial but takes long time to develop impact

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Implications for bond markets from changes in investor behavior

- Tightening of credit spreads
  - Shift of real money investments towards non Eurozone markets
  - Shift of investments from investment grade towards high yield markets
  - Shift towards less liquid investments
  - A 1ppt movement in asset allocation of European insurers implies a EUR 54bn change[1] so small shifts could have a large impact (source: MS Research)
- Liquidity
  - Overall deteriorating due to APP and broker regulation but markets not dysfunctional
  - Transaction risk shifting from market makers to real money
  - Electronic trading spurs volatility but can also increase efficiency
- Derivatives
  - Derivate based hedging requires to hold short term collateral with negative yield : increases cost of hedging.
  - Different (documentation) standards still exist and a level playing field has to be established

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Discussion points

1. What are the experiences of market makers in terms of low/negative rates impacting bond market liquidity ?
2. What if rates go more negative and/or persist for a long period? At what point do banks charge for retail deposits?
3. Are negative rates influencing expectations in a suboptimal way and hindering spending and investment; i.e. the opposite of what is intended?
4. Is there a lower bound and what is that?
5. Are negative yields setting incentives for risk taking by real money or punishing risk management ?
6. Rising correlation between equities and risk free rates – does portfolio rebalancing work ?
7. Current central bank policy has eliminated most of the information contained in risk prices. What is appropriate level of risk adjusted return for savings and pensions ?
8. Will everyone be able to successfully follow an alternative investment strategy (and succeed) ?
9. What should be the level of interaction between regulators and central banks as business models get seriously affected ?

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