EIOPA-BoS-12/110
28 February 2013

Opinion

of the European Insurance and Occupational Pensions Authority of 28 February 2013 on

Supervisory Response to a Prolonged Low Interest Rate Environment

Introduction and Legal Basis

1. This Opinion is issued under the provisions of Article 29(1) (a) of Regulation (EU) No1094/2010 of the European Parliament and of the Council of 24 November 2010 (hereafter the 'Regulation'). As established in this Article, EIOPA shall play an active role in building a common Union supervisory culture and consistent supervisory practices, as well as in ensuring uniform procedures and consistent approaches throughout the Union.
2. This Opinion is being issued in fulfilment of EIOPAs responsibilities to facilitate and coordinate supervisory actions under Article 18(1) and Article 31(e) of the 'Regulation'.
3. The information gathering requirements in the Opinion are included under the provisions of Article 35 of the 'Regulation'.
4. This Opinion is addressed to the national competent authorities represented in EIOPA's Board of Supervisors.
5. The Opinion includes an appendix setting out key tasks for EIOPA and National Supervisory Authorities.

Context

6. The Japanese experience in the 1990s and early 2000s demonstrates both the plausibility of a prolonged period of low interest rates, as well as the impact of such a scenario. Many Japanese life insurers had built up substantial books of guaranteed business from the 1980s and were vulnerable to a prolonged period of low interest rates. The result was that between 1997 and 2001, seven Japanese firms failed and legislation was passed to allow insurers to alter guaranteed rates on policies where they face a high probability of bankruptcy.

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7. EIOPA has been highlighting for some time the potential solvency risks arising from a prolonged period of low interest rates. In 2011 EIOPA carried out a stress test including a "low yield scenario" to assess the effects on the EU insurance sector of a prolonged period of low interest rates/yields. Two scenarios involving different profiles for yields were tested[1]. The exercise concluded that "5% to 10% of the included companies would face severe problems, in the sense that their MCR ratio would fall below 100%. In addition, an increased number of companies would observe that their capital position would deteriorate with MCR rates only slightly above the 100% mark, whereby they could become vulnerable to other potential external shocks." It is also highlighted in the recently published EIOPA Risk Dashboard as a significant risk identified by national supervisory authorities.[2]

8. The EIOPA Financial Stability Report for the second half of 2012 highlights the complex and uncertain financial and economic situation facing European insurers[3]. EIOPA has focused to date on insurers but the low interest rate environment is also having an impact on occupational pension funds. EIOPA plans to explore this more fully during the course of 2013.

9. On one hand, weak economic conditions across the European economy imply that monetary conditions in the EU are likely to remain adaptable to the prevailing economic environment. This is reflected in the official interest rates in Europe that remain at low levels and on a downward trend. On the other hand, European government bond yields continue to be divergent with some countries experiencing negative real yields at some maturities due to a flight to quality, while others are experiencing highly positive real yields across most maturities reflecting creditworthiness concerns and other uncertainties.

10. Long term interest rates are of critical importance to life insurers, since these institutions typically have long-run obligations to policyholders that become more expensive in today's terms when market rates are low. Consequently, the financial position of these firms typically deteriorates under such conditions, in particular where the duration of liabilities exceeds that of assets. This problem is even more pronounced where guaranteed rates of return have been offered to policyholders.

11. A prolonged period of low interest rates may also have an adverse impact on non-life insurers pursuing a business model where investment returns are used to compensate for weak underwriting results. In some cases, buoyant investment returns have facilitated intense price competition for market share with some firms operating with technical underwriting losses. If underlying insurance business is being supported by investment returns this business model will be challenged by a prolonged low yield environment if no management action is taken to change the business model.

12. Non-life insurers may also be affected in a situation where low yields do not provide sufficient returns to counteract the effects of inflation on longer tailed business. This is a more difficult situation, since it requires inflation hedging over a long maturity.

13. The precise timing of when the effects of a prolonged low interest rate environment would manifest themselves on insurers' balance sheets depends on the accounting methodology in use, as well as the business lines being written.

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[1] EIOPA Financial Stability Review 2011 – Second half year report, EIOPA-FSC-11/057
[2] EIOPA Risk Dashboard - September 2012
[3] EIOPA Financial Stability Report 2012 – Second half year report, EIOPA-FS-12-097

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14. If market value is in use, the impact is very rapid since any decline in benchmark interest rates is reflected in the discount rate applied to liabilities. This effect being amplified where the duration of liabilities is greater than that of assets. The outcome is that available assets to cover solvency are eroded. A relatively small number of EU jurisdictions utilise market value in insurance at present and they have already felt the impact of low interest rates.

15. If historic cost accounting is used then the impact on an insurer's balance sheet appears more slowly since it emerges through lower profits or losses that are ultimately taken to the balance sheet. The fact that the effects of low interest rates are slow to emerge in balance sheet terms does not mean the problem is not there and there is a real risk that firms could build up hidden problems. This argues for the examination of a wider set of metrics when assessing the performance and condition of firms exposed to this risk. Examination of market value and historic cost accounting balance sheets can provide useful comparative information, while analysis of firms' cashflows provides an insight into emerging imbalances.

16. In life insurance, guaranteed business is the most exposed to a prolonged period of low interest rates since there may be a "yield spread compression". In this case, as assets are (re)invested the achievable spread between returns on assets and guaranteed rates shrinks. This reinvestment risk is the primary means by which the impact of low interest rates affects the financial position of firms in a historic cost accounting environment.

17. In terms of official solvency requirements, Solvency I is mainly based on historic cost accounting and is not a risk based framework. As a result, the potential solvency impact under Solvency I is limited and may take some time to emerge in terms of solvency cover. Nevertheless, some national supervisory authorities rate a prolonged low interest rate environment as an important risk for the insurance sector.

18. The implementation of Solvency II would see a move to market value and a risk based solvency requirement that would explicitly calculate the interest rate risk capital charge and would discount insurance liabilities using risk free rates as a basis. In this context, it is important that insurers do not store up risks that may crystalize suddenly with the implementation of Solvency II. Any delay in the full implementation of Solvency II should be used as a window for national supervisory authorities and insurers to deal with the issue.

19. The impact of the current period of low interest rates has been felt in several European jurisdictions, where the national supervisory authorities have already taken a range of different measures to deal with the issue.

20. Internal research by EIOPA has highlighted the challenges faced by national supervisory authorities and individual insurers in responding to the risks posed by low interest rates. In terms of guaranteed business, there are no immediate options available in relation to existing business which must be addressed through more medium term measures, such as increased reserving. New business, on the other hand presents more options in terms of changes in product design to "de-risk" them or changes in the mix of business. Firms have already started to respond by utilising these options.

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Taking the above into consideration, EIOPA recommends the following supervisory responses:

Scoping the Challenges

21. National competent authorities, if they have not already done so, should actively assess for the insurance industry in their jurisdiction the potential scope and scale of the risks arising from low interest rates. National competent authorities should then report to EIOPA their findings regarding potential scope and scale of risks.

22. EIOPA would coordinate a further exercise to assess the conditions that would be required for significant adverse solvency and/or systemic stability problems to arise, as well as to estimate when such problems would arise.

23. National competent authorities should intensify the monitoring and supervision of insurance undertakings identified as having greater exposure to the risks posed by a low interest rate environment. This should follow a clear escalation of supervisory activity dependent on the situation of the individual firm being considered.

Promoting Private Sector Solutions

24. Unsustainable business models in particular should face challenge from supervisors at an early stage and it is expected that insurance undertakings should be encouraged to resolve their own problems. Even in those countries where the capital impact of low interest rates has already been recognised through market-consistent accounting, a threat to business models still exists. Persistent low interest rates may damage the underlying value proposition of insurers, resulting in a downward pressure on sales and consequently pressures on expense ratios. Additionally low interest rates may encourage other business model changes such as alterations in asset allocations in a "search for yield", which may create new risks on the asset side of the balance sheet.

25. National competent authorities should actively engage with insurance undertakings in exploring private sector measures to address the risks raised by a prolonged period of low interest rates. They should take into consideration the maintenance of the stability of firms and policyholder interests in this engagement. In particular, they should consider the balance of risk exposure between insurance undertaking and policyholders. This effort should cover both "in-force" business (policies already written) and new business.

26. National supervisory authorities should explore with insurance undertakings measures to improve undertakings' own financial resilience. This is especially important in relation to "in-force" business, where measures such as increased reserving are likely to be the only options. In terms of new business, if product redesign is not being considered, then national supervisory authorities should explore what measures firms would take to ensure their financial resilience.

27. National supervisory authorities should explore with insurance undertakings the other measures that could be taken regarding new contracts. Such measures might include adaptation product designs in such a way as to address the risks arising from low interest rates. The latter could include a de-risking of products or measures to increase their flexibility.

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Supervisory Action

28. If national competent authorities have taken or are considering taking measures that would be applied to all firms in their jurisdiction facing these risks, EIOPA recommends that such measures should incorporate, as appropriate, conditionality and exit features if needed. It is expected that conditionality would set out clear criteria for availing of the measures being offered. Equally, there should be clear exit criteria for the cessation of such market wide measures, if feasible.

29. If national competent authorities are considering taking market-wide measures then they should notify EIOPA and its Members of this intention. This will allow better coordination of measures across jurisdictions in terms of timing and broad design. Discussion of proposed measures with EIOPA Member authorities that have already taken such action would also help to improve policy design.

30. EIOPA would engage in a follow-up exercise with Members in 2014 to explore what actions have been taken in light of this Opinion. A formal report would be prepared for consideration at the EIOPA Board of Supervisors.

This opinion and its Appendix (Summary of recommended Key Tasks and Deliverables) will be published on EIOPA's website.

Done at Frankfurt am Main, 28 February 2013

[signed]

Gabriel Bernardino

Chairperson
For the Board of Supervisors

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Appendix – Summary of recommended Key Tasks and Deliverables

National Supervisory Authorities (NSAs)

1. NSAs to carry out a coordinated exercise to quantify the scale and scope of the risks arising from a prolonged low interest rate environment (coordination by EIOPA – see below point 2).
2. To intensify the monitoring and supervision of insurers identified as facing greater exposure to the risks posed by a prolonged low interest rate environment.
3. To engage with insurers to explore private sector measures to address the impact of low interest rates that balance both financial stability and policyholder interests. This would include exploration of actions that firms could take to improve their financial resilience. In particular, NSAs would actively challenge business models that are identified as being unsustainable and to encourage insurers to take appropriate actions.
4. To explore measures to "de-risk" new business and also measures related to "in-force" business to improve financial resilience.
5. To report progress in these areas to EIOPA, preferably, on a half yearly basis and to participate in an EIOPA coordinated stocktake in 2014.
6. Where NSAs are planning to, or are about to, take supervisory action, to notify EIOPA and its Members.

EIOPA

1. To develop with NSAs an agreed framework for the quantitative assessment of the scope and scale of the risks posed by a prolonged low interest rate environment.
2. To coordinate the exercise described above under point 1 and collate results for reflection back to NSAs.
3. To develop a reporting template for NSAs to report on a –preferably– half yearly basis progress in supervisory interaction with firms on this subject. EIOPA will work with NSAs to agree details of the information to be reported, so that this can be effectively collated, analysed, and reflected back to NSAs.
4. To undertake a stocktaking exercise in 2014 to assess progress in dealing with the impact of a prolonged period of low interest rates.

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