RISKS AND FINANCIAL STABILITY

BACKGROUND NOTE

Supervisory Statement on the impact of the ultra-low/negative interest rate environment

EIOPA-BoS-19/587 (Background note)-rev
19 February 2020

European Insurance and Occupational Pensions Authority

Preliminary notes:

- This note provides additional background information to the Supervisory Statement on the impact of the ultra-low/negative interest rate environment (EIOPA-BoS-19/587).

- This analysis is based on information gathered from 26 NSAs during October/November 2019.[1] The survey was based on closed qualitative questions to allow the comparability of the information. In addition, NSAs were given the opportunity to clarify certain aspects or provide additional information where deemed necessary.

- NSA powers and measures: the charts provide a high-level indication of where NSAs could and potentially would apply their powers, but this should not be understood as a definitive position. This is contingent to the developments.

- Industry responses: the charts provide a high-level overview of relevant trends identified in the respective markets. In some occasions, a negative answer might actually mean that no information on a significant trend is available.

[1] AT, BE, BG, CZ, DE, DK, EE, ES, FI, FR, GR, HR, HU, IE, IT, LI, LU, MT, NL, NO, PL, PT, SE, SI, SK and UK.

1. Powers and LIR measures taken by NSAs

Figure 1: Availability of powers

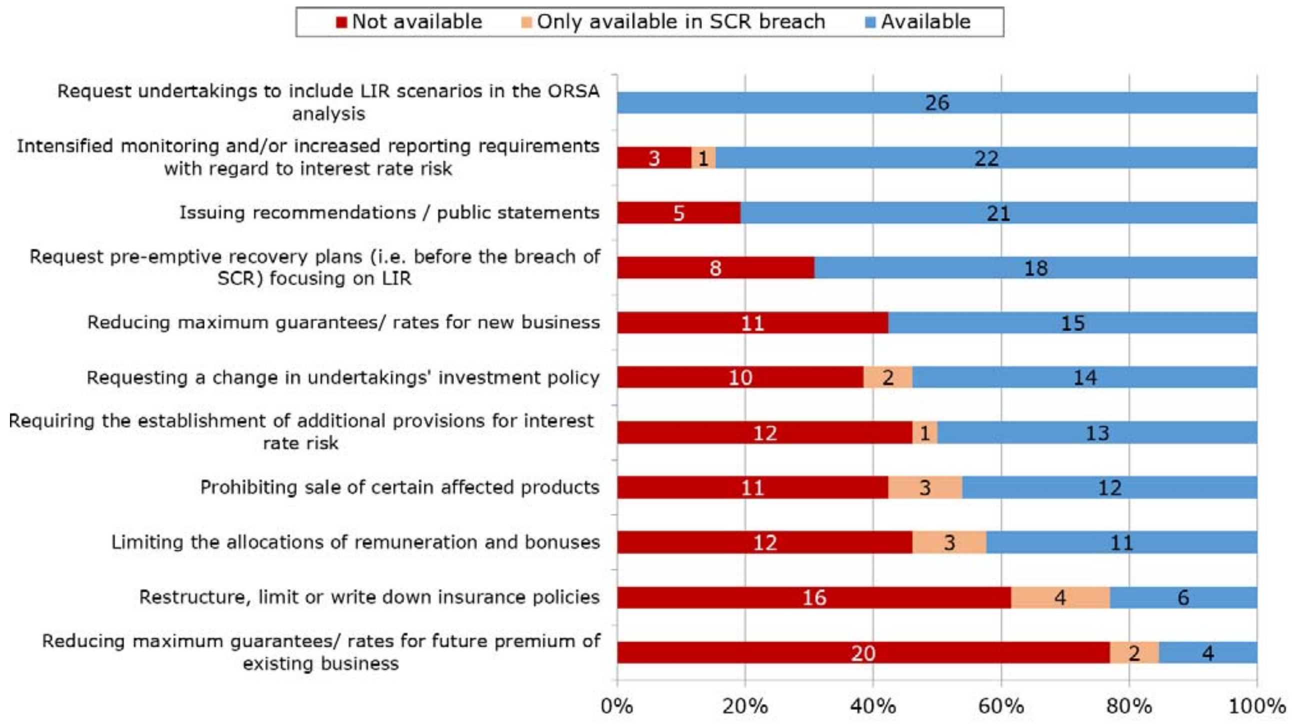
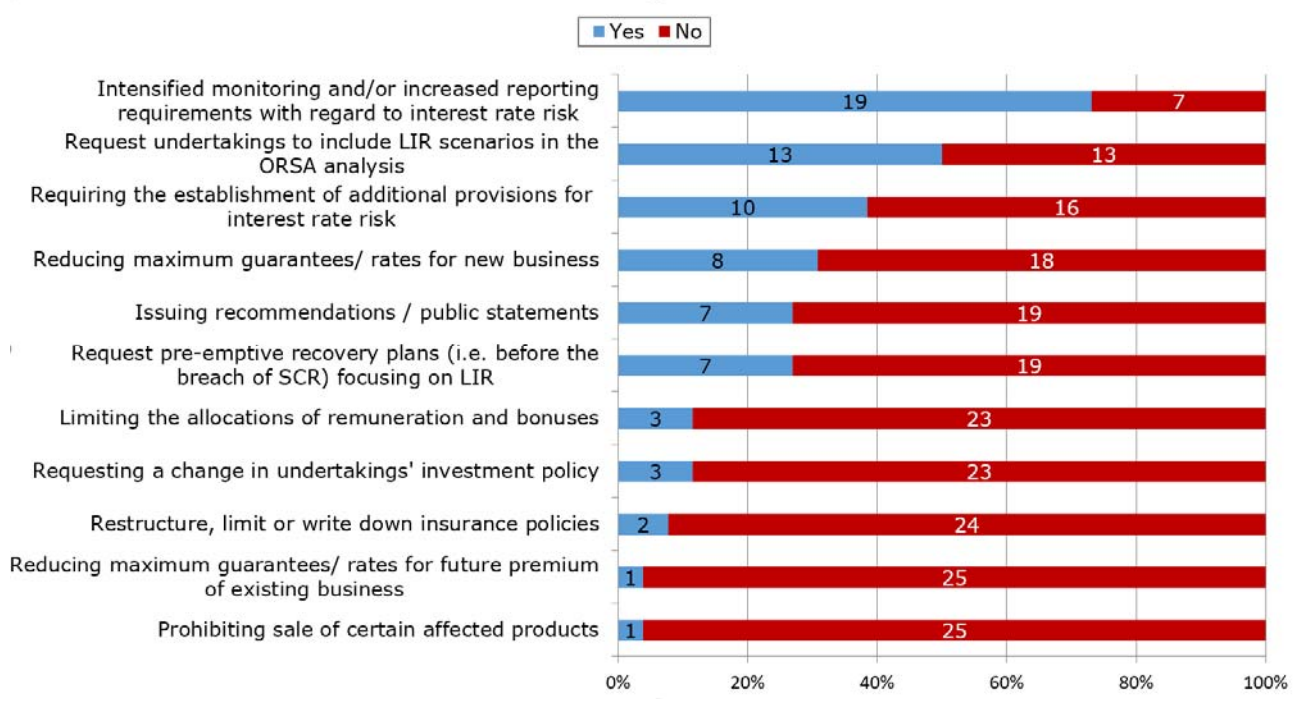
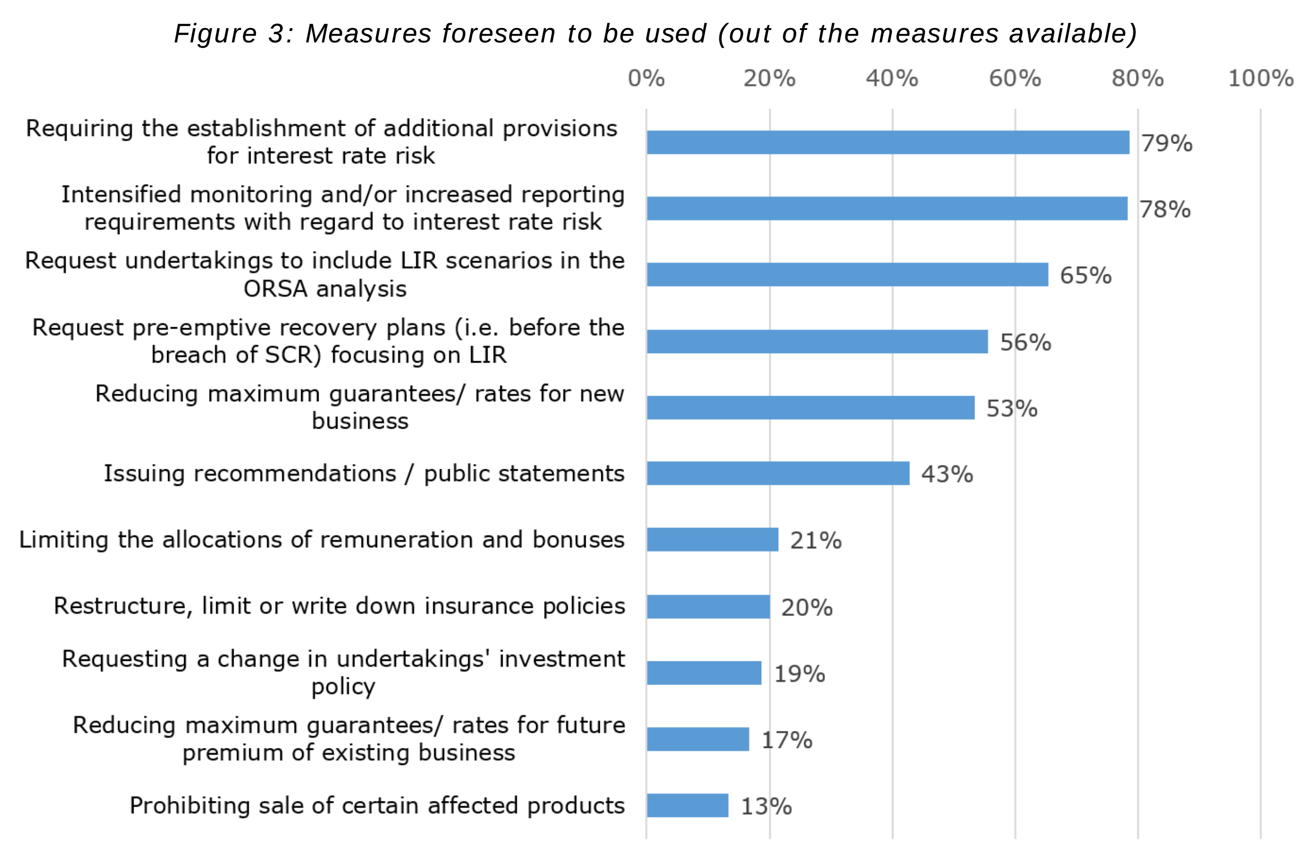


Figure 2: Measures used by NSAs in the past 3 years





Additional information:

a) Measures for new business

- Reducing maximum guarantees/rates for new business. Given the constant decrease in the risk free rates for the calculation of the technical provisions, undertakings are forced to adapt the guarantee interest rate accordingly. When this measure was used, several options were reported. In some cases, a maximum interest rate or the discount rates for accounting purposes for these contracts is fixed by the relevant authority (e.g. Ministry of Finance) or linked to the evolution of the long-term interest rates (e.g. 10Y sovereign bond).
- Prohibit the sale of certain affected products. Several NSAs mentioned that undertakings themselves are adapting the products to the macroeconomic environment. However, in several jurisdictions, NSAs have indeed the power to reject the launching of new products if, for example, they are not based on sound actuarial principles or they might endanger the stability of the financial system.

b) Measures for existing business

- Reducing maximum guarantees/rates for future premiums of existing business. This power is generally not available and, where it has been reported, it is usually associated with resolution/winding-up procedures or as a last resort measure to prevent the insolvency.
- Requiring the establishment of additional provisions for interest rate risk. Those NSAs that reported this power pointed out that it was based on statutory accounts. The aim is establishing an additional interest rate provision to ensure that the commitments with policyholders are met. The underlying principle of these provisions is to close the gap between market rates and guarantees offered.
- Intensified monitoring and/or increased reporting requirements with regards to interest rate risk. This measure is available to almost all NSAs participating in the

survey. Indeed, as part of their supervisory duties, NSAs can generally request all necessary information and intensify monitoring. In particular, undertakings' sensitivity to movements in interest rates as well as their risk management policies and strategies are being intensively monitored by NSAs. Several of them informed about dedicated surveys and additional reporting requirements to assess the magnitude of the problem and intensify supervision accordingly.

- Restructure, limit or write down insurance policies. This power is generally not available, aside from bankruptcy procedures or when the terms and conditions include this option.
- Request pre-emptive recovery plans (i.e. before the breach of the SCR) focusing on LIR. No further details of the content and structure of recovery plans was provided and, as a result, there might be slightly different interpretations of what a recovery plan should cover. It is clear, however, that several NSAs are requesting some kind of scenario-planning and consideration of potential measures to be taken in relation to LIR.
- Request undertakings to include LIR scenarios in the ORSA analysis. The ORSA analysis is a company-specific tool. Undertakings should consider all material risks they are subject to. NSAs point out that this is indeed happening with the LIR environment. In any case, supervisors can discuss and, eventually challenge the scenarios considered if they do not properly reflect the risks. In some cases, a specific recommendation for ORSA reporting was issued. Other NSAs reported that they have directly asked companies to replicate EIOPA stress-test scenarios and/or calibrate them accordingly.

c) ALM strategy and other

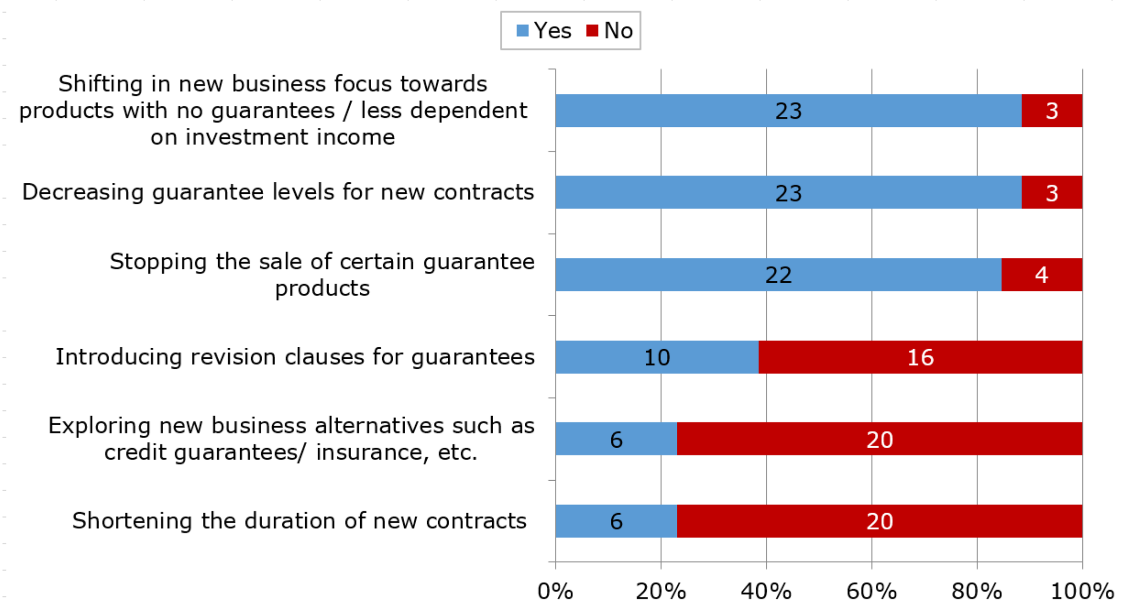
- Issuing recommendations / public statements: NSAs can and have made use of this (usually non-binding) power. There are different tools that can be used, ranging from communications or public statements, use of annual reports or risk outlooks to dedicated recommendations that seek to influence the insurers' behaviour.
- Requesting a change in undertakings' investment policy. This option is available to approximately half of the NSAs that responded. However, the degree of enforcement differs. While several NSAs mentioned that they can indeed enforce such a measure, for example, as a result of the supervisory activities, if the company is not properly managing the risks or not complying with the prudent person principle, other NSAs mentioned that they can basically challenge undertakings and use moral suasion. Two NSAs pointed out examples of influencing the investment policy. In one jurisdiction, the NSA has issued a prudential expectation for insurers offering mortgage loans. Another NSA mentioned regular discussion with undertakings about hedging strategies to deal with the current LIR.
- Limiting the allocations of remunerations and bonuses. This tool is usually exercised by means of public statements and recommendations. Only in a few cases NSAs indicate that they can impose it, e.g. if the NSAs finds that the company seriously violates the risk management rules or if the remuneration practices provide an incentive for illegal or deviant activities with respect to ethical standards, or induce risk-taking attitudes that conflict with the sound and prudent management of the business.

d) Other powers/measures

- The power to restrict the distribution of dividends was reported by four NSAs.

2. LIR measures taken by industry

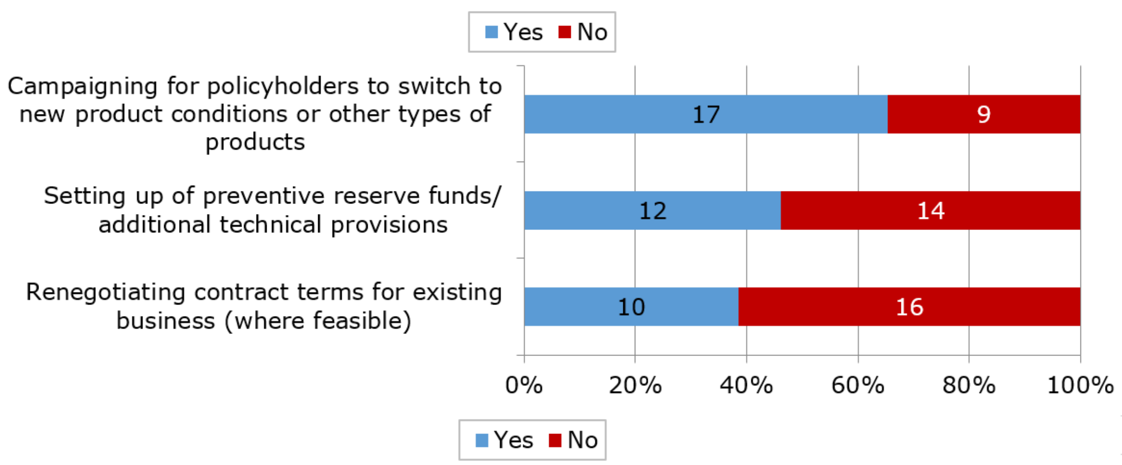
Figure 4: Product strategy for new business



Additional information:

NSAs stressed that the most significant trends observed are a decrease in the level of guarantees offered (or more flexible guarantees) and a shift towards product with no guarantees / less dependent on investment income, such as unit-linked, pure risk covers and combinations.

Figure 5: Product strategy for existing business

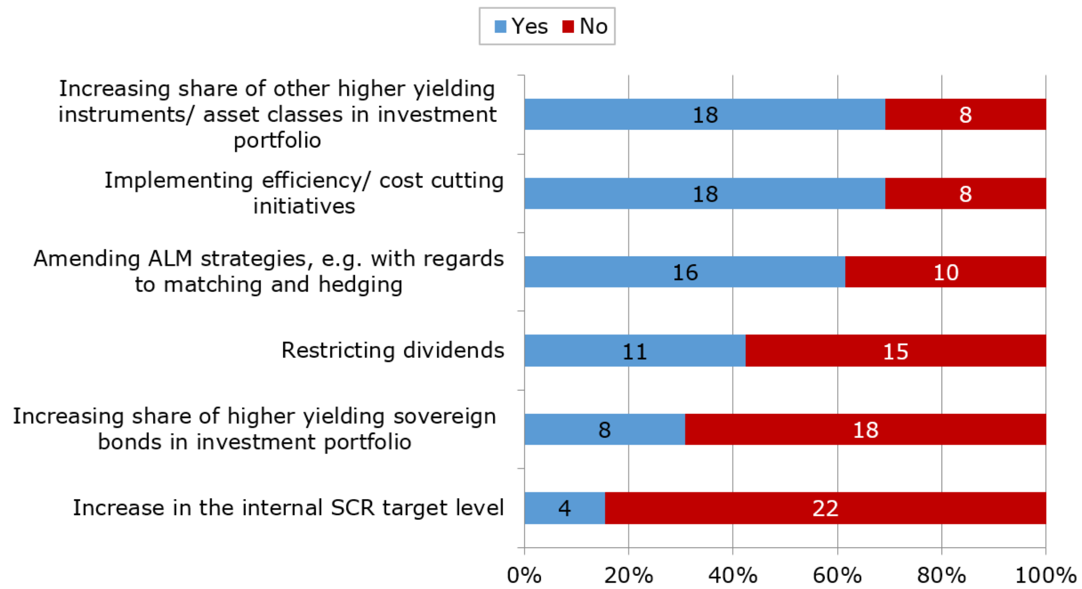


Additional information:

Some information on the additional reserves funds / technical provisions is already provided above. Other issues observed by different NSAs to create some buffer is decreasing profit participation to preserve reserves that can be used to compensate potential losses, or encouraging policyholders with participating products to accept non-participating alternatives, subject to legal and regulatory safeguards.

Regarding policyholders, a renegotiation of contracts where guaranteed rates were infeasible high (i.e. 20-year old contracts) was carried out in one country. Another NSA reported the inclusion of surrender options to policyholder in order to reduce the undertaking's exposure to the guarantees.

Figure 6: ALM strategy and other



Additional information:

NSAs provided additional information, in particular, on the following issues:

- Increasing the share of higher yielding sovereign bonds. Two NSAs provided additional information on the observed increase in the share of higher yielding sovereign bonds issued by non-domestic issuers, which are located in the EU.
- Increasing share of other higher yielding instruments/asset classes in investment portfolio. A certain "search for yield" behaviour has been explicitly identified by several NSAs. Among the issue observed: reallocation of portfolios towards corporate bonds, equity, real estate, loans and other alternative investments (e.g. private equity).
- Amending ALM strategies. Two NSAs have observed an adjustment in the duration of the asset portfolio over the last past years to bring them in line with the duration of the liabilities. In another jurisdiction, some firms are using dynamic hedging programmes to hedge interest rate risk. Two countries also mentioned that undertakings are considering to apply for the matching adjustment, the volatility adjustment or partial internal models, in order to reduce the senility to interest rate movements.
- Increase the internal SCR target level. One country explained that some undertakings have self-identified a need to hold additional capital for interest rate risk, within the own solvency needs assessment. In many cases, the target solvency ratio is set to be able to maintain a 100% solvency coverage ratio following a stress.

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