Impact of the Low-Interest Environment in Europe on the Finances of Insurance Companies

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The latest financial crisis has had negative impact on the European economy, particularly on the financial services sector. All over the world, the inter-bank market nearly collapsed as the banks practically stopped trading with each other for fear of dubious asset-backed securities. In 2009 this led to a 4.5% decline in GDP in the eurozone compared with the previous year. In response, the European Central Bank (ECB) lowered the base interest rate within months from 4.25% to 1.0% to support lending and improve financing terms. Since 2011, the national debt crisis in various countries in the eurozone, especially Greece, Portugal and Ireland, has led to declining economic indicators, volatile financial markets and increased unemployment.

On 10 March 2016, the ECB reduced the base rate to 0%. This means that savers receive little or no interest on their savings and therefore have no incentive to save. By contrast, borrowers – especially governments – are benefitting from historically low interest rates because they can refinance their debts at very favourable rates. This is a situation that the ECB wants to see, in order to offer troubled states a way out of their national debt crisis. However, even among the experts there is currently no certainty that the ECB's chosen path will lead to success.

Impact on the insurance sector

This low-interest period affects the entire insurance sector, including policyholders.

Life insurance companies are under particular pressure because of their guaranteed performance bonds. They calculate a long-term guaranteed minimum rate of return for customers on the capital paid in, as well as a non-guaranteed share of profits based on sample calculations. Despite the constant decline in the maximum technical interest rate, which is currently 1.25% in Germany and is likely to be reduced further to 0.9% on 1 January 2017, a large proportion of policies entail guaranteed rates of 3.25% or more. Generating these returns on the capital markets in order to be able to continue to finance performance bonds in the future is causing huge difficulties in the moment

Content

for life insurance companies working with the investment options available to date.

Occupational pension bodies are also affected by the low-interest period. In their case, the situation is aggravated by the fact that they tend to have younger portfolios than life insurance companies and they have fewer high-interest, fixed-rate securities.

With the implementation of Solvency II, the previous, very detailed provisions that were contained in the German Investment Regulation and related to restricted assets, were abandoned. The capital investment side was granted more leeway but also given greater responsibility for its own actions.

It is not just in the area of long-term investments that company managers are feeling the effects of the ECB's interest policy – the pressure is also increasing for time and cash deposits. Not only are banks not paying any interest on in-credit accounts, they are now demanding negative interest when deposits reach a certain level. In this way, banks are increasingly responding to the penalty rates the ECB charges banks for parking money with it.

Another area of impact is caused by the ECB's monetary policy in the form of bond purchasing schemes: the direct purchase every month since March 2015 of bonds worth EUR 80 billion. With this policy, the ECB is copying the Quantitative Easing programme set up by Ben Bernanke, the former Chairman of the Federal Reserve in the U.S., with the aim of injecting fresh capital into the markets. One of the programme's aims is to prevent impending deflation by increasing the volume of money in circulation and raising the inflation rate to around 2.0% in the eurozone. This makes the ECB a competitor to the insurance sector, since insurance companies are also looking for safe investment opportunities, and it considerably reduces the supply of bonds.

Possible courses of action

One way in which insurers can increase investment earnings is by adapting their investment strategies and increasing the amount of diversification when it comes to asset categories. There are numerous investment options here, including, for instance, investments in timber, infrastructure and aircraft. In the area of timber investment, investors – usually institutional investors – purchase large areas of forest and generate income through the regular sale of timber. Earnings can be increased through higher timber quality, higher timber prices or larger areas of forest. The risks include a fall in the value of the timber or land, but also the risk of forest fires.

When it comes to infrastructure projects, investment involves participating in the expansion of power supply or transport networks, such as grids, wind parks and roads. A possible benefit is that the insurer can expect a comparatively safe and regular cash flow. This supports the business model of issuing guarantee undertakings over many years. It should be borne in mind that this form of investment is extremely illiquid, so it cannot be used on a large scale.

Aircraft financing can be also be used as an investment. In this case, the insurance company helps finance an aircraft and participates in the subsequent regular income generated through operation of the aircraft. The continual increase in passenger numbers confirms the potential that exists for this alternative form of investment. The ability to change the purpose of an aircraft, for instance to start using it as a cargo plane, makes the investment more flexible in the event that trends change. Here too, however, there are risks in the form of crashes, technological progress and an over-supply on the market.

Overall, alternative capital investments can increase returns, but insurance companies should see them only as a supplementary investment and not as the main focus of their investment strategy.

Since mid-2013, in response to the ongoing low-interest period, some insurance companies in Germany have started offering policies without a guaranteed yield, which is a first in the history of classic life insurance policies in Germany. With these policies, the policyholder receives a guarantee only for the premiums paid in, but not for the interest paid on the savings element. With previous policies, the insurance companies offered a guaranteed minimum return on the savings element paid in, which cannot be adjusted after the event. A tariff without a guaranteed rate frees insurers from the performance bond guarantee and increases flexibility, since they do not have to keep such high capital buffers. This gives them greater freedom when it comes to capital investments. Other products without a guaranteed yield include unit-linked life insurance policies and index-linked pension schemes.

Another alternative course of action is to reduce profit participation. This non-guaranteed bonus is calculated annually and gives the customer a share in the company's success.

As a result of the low-interest period combined with the new requirements under Solvency II, life insurance companies need more capital for investments, so they are increasingly looking for alternative solutions. One popular way of boosting capital is through subordinated loans and participatory capital. In the event of insolvency, the subordinated capital is repaid only after senior debt claims have been paid. In return, the investors charge interest on the capital invested. Subordinated lending is often carried out within a holding company.

In response to the high capital requirements or excessively high guarantees, some (life) insurance companies have suspended their entire life insurance operations or have stopped issuing life insurance policies with guarantees. In addition, some are considering transferring their portfolios. Even life insurance companies have been doing this in recent years in response to the more challenging market environment. The providers are closing individual divisions and concentrating on the profitable branches of the business, while their existing portfolios are often taken over by run-off insurers, freeing up capital and reducing administrative costs. Consequently, premium income is falling, portfolio diversification is shrinking and underwriting results are becoming increasingly volatile. At the same time, cost savings are appearing in the areas of new business commissions and the administration of existing policies.

Outlook

If we look at the economic situation of the European Union over the past 10 years, we can see only slight growth, despite the expansive monetary policy and zero interest rates pursued by the ECB. At the same time, the largest European member states have a huge, almost intolerable, debt burden. The situation is reminiscent of what Japan has been facing. The comparison with Japan, the parallels and current monetary policy all suggest that the low-interest period will continue for some time. Life insurance companies will have to prepare for continuing difficult times in a low-interest environment.

The base rate probably cannot be increased even in the longer term, since the economy has already adjusted to the low-interest level and could crash if it is increased. This supposition is supported by the negative reactions on the U.S. market when the Federal Reserve Bank wanted to increase interest rates in small steps this year. The increase has now been postponed.

In addition, the ECB started its Corporate Sector Purchase Programme on 8 June 2016, involving the purchase of corporate bonds from investment-grade European companies and subsidiaries. In this sector too, the ECB is competing with insurance companies.

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