

RISKS AND
FINANCIAL
STABILITY

SUPERVISORY STATEMENT ON THE IMPACT OF THE ULTRA-LOW/NEGATIVE INTEREST RATE ENVIRONMENT

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Executive summary

1. **Challenges of a low interest rate environment.** The weak economic conditions across the European economy imply that monetary conditions in the euro area are likely to remain accommodative to the prevailing economic environment for the coming years.¹ As widely acknowledged, however, low/negative interest rates also have negative side effects, which should be closely monitored. For the insurance sector, such an environment has an impact on both asset- and liability sides of the balance-sheet affecting solvency position and profitability of undertakings. Furthermore, a protracted low interest rate environment may also lead to risky behaviours such as “search for yield” behaviour with consequences on the stability of the financial system.
2. **Need for action.** EIOPA considers that the current ultra-low interest rate environment constitutes one of the most important sources of systemic risk for insurers for the coming years and encourages NSAs and undertakings to continue taking actions to mitigate the impact on the EU insurance sector.²
3. **Aim and addressees of the Supervisory Statement.** This Statement is addressed to the supervisory community and the insurance industry. Its aim is raising awareness and ensuring that the insurance sector continues to be financially resilient. It also seeks to inform consumers and policyholders about supervisory measures and actions taken aimed at protecting their interest.
4. **Content and recommendations.** This Supervisory Statement starts by analysing the impact of ultra-low/negative yields on the European insurance sector, provides an overview of the supervisory responses and undertakings’ reactions to such an environment, and finalises with a set of recommendations, which are summarised in the box below.

A) Short-term actions

- NSAs should intensify the monitoring and supervision of insurers identified as facing greater exposure to the low interest rate environment;
- NSAs should engage into a dialogue with undertakings to explore actions they could take to improve their financial resilience;
- NSA and undertakings should pay special attention on pre-emptive recovery and resolution planning to reduce the likelihood and impact of insurance failures; and
- NSAs should broaden the analysis of the low interest rate environment and also consider the potential build-up of systemic risk.

B) Medium to long-term actions

- NSAs should identify whether there are any tools or powers missing in their current toolkit and request from the (national) relevant authorities the missing powers if a gap is identified. The implementation of these new powers would probably be possible in the medium or longer-term.

¹ This has been stated by the ECB President at the press conference that followed the meeting of the Governing Council on 12 September. “The Governing Council reiterated the need for a highly accommodative stance of monetary policy for a prolonged period of time and continues to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry”.

² See [Systemic risk and macroprudential policy in insurance](#) for additional information on the sources of systemic risk in insurance.

5. This Supervisory Statement should be read together with the background note on the supervisory powers and measures and companies' reactions to the low interest rate environment. Furthermore, the content of this document is aligned and should be read in conjunction with the policy proposals contained in the [Consultation Paper on the Opinion on the 2020 review of Solvency II](#).³

³ Indeed, EIOPA's analysis contained in the Consultation Paper touches upon several relevant aspects, such as the importance of a credible extrapolation of the long end of the yield curve (section 2.2), the supervisory powers to block dividends in case of a breach capital requirements when the solvency position is calculated excluding the UFR/VA (section 2.7), or the importance of a proper calibration of interest rate risk (section 5.1).

1. Introduction

6. As described in [EIOPA Opinion on Supervisory Response to a Prolonged Low Interest Rate Environment](#) published in 2013, a persistent low interest rate environment poses real challenges to both life and non-life insurers. Particularly affected are insurers offering high guaranteed rates of return to policyholders. However, non-life insurers pursuing a business model, where investment returns are used to compensate for weak underwriting results, could also be severely affected.
7. Persistent low interest rates affect insurers in different ways. On the liabilities side, they lead to an increase in undertakings' obligations in present values, given that insurance liabilities are discounted using the risk free rates as a basis. This may lead to a significant deterioration in their solvency position.
8. On the assets side, declining interest rates lead to positive changes in the value of the portfolio, which depend on the share of fixed-income assets, the evolution of spreads and of equity markets. At the same time, low interest rates also lead to a decrease in the interest income and an increase in the reinvestment risk of assets. This has an adverse impact on the profitability of the undertakings and may put at risk the commitments with policyholders, in case undertakings are not able to honour them.
9. In a protracted low interest rate environment, undertakings face a significant challenge in terms of finding sufficiently good quality yielding assets to invest.⁴ Most of the EU government bonds experience negative real yields at some maturities due to a flight to quality. This may lead to shifts in the asset allocations towards higher-yield assets, which are also riskier, e.g. lower rated or less liquid assets, increasing the overall risk of the portfolio. This trend is commonly known as "search for yield" behaviour. This could increase risks on the asset side of the balance sheet if the investment risks exceed the risk bearing capacity of undertakings. Nonetheless it should be acknowledged that Solvency II is a risk-based framework where the risks of investments are reflected in the capital requirements.
10. In addition, in case there is a sudden rise in yields due to rising credit spreads, insurers would suffer immediate losses in their fixed-income investment portfolio, which may be offset through a lower value of liabilities depending on the evolution of the risk-free rate.⁵ Furthermore, the sharp increase in yields may trigger an upsurge in lapses and surrenders potentially leading to liquidity constraints triggered by policyholders that may want to profit from the higher interests.
11. In this environment, and especially in the context of the risks mentioned, undertakings should take effort in having sound risk and capital management, which includes sound capital planning and building up the necessary buffer in case the interest rates remain low for a long period. EIOPA considers that undertakings with smaller buffers should exercise restraints when distributing dividends, and to consider the need to increase resilience for the long term, and especially those undertakings under the transitional period.
12. Conscious of these risks, EIOPA has been taking different initiatives in the last years to better understand the risk and support the supervisory responses, such as publication of Opinions and documents, consideration of different low-interest rate related scenarios in various EIOPA stress tests and publishing recommendations thereafter.

⁴ For example, in terms of finding A-rated government bonds with positive capital income and interest income in excess of guaranteed rates.

⁵ EIOPA (2019): Financial Stability Report – June 2019.

2. Analysis of latest developments

13. EIOPA is carrying out an extensive analysis on the impact of the low interest rate environment on the EU insurance sector. A comprehensive report will be published in due course. Some preliminary observations can be made:

Asset allocation

- Although, insurance companies' investments remain broadly stable, a slight movement towards more non-traditional investment instruments, such as unlisted equity and mortgages and loans, could be observed at EU level.
- Looking at Q2 2019 as a period with an extreme drop in yields, insurers were net buying more equities than government or corporate bonds in absolute terms when removing the price effect.^{6,7}
- However, they were also buying bonds with negative yields in Q2 2019, in particular life insurers.⁸

Reinvestment risk

- An analysis of the maturing bonds over year shows that the yields of the replacing bonds are on average significantly lower when compared to original yields across the different maturity buckets.
- The analysis of cash-flow projections stemming from government bond portfolio capturing reinvestment risk suggests that the weighted average yield would drop around 50% over the next 10 years. As similar conclusion can be reached for corporate bonds.

Profitability

- When looking at the income/gains and losses⁹, it can be seen that the interest income on fixed income securities was stable in the last 3 years. If interest rates will remain low, interest income will slowly decline in the next years due to reinvestment in lower yielding assets.
- In addition, the low interest rate environment puts pressure on profitability of insurance companies, in particular life insurers with guaranteed-return business models or non-life insurers that rely heavily on investment returns.

Solvency

- Overall, the impact of drop in RFR curves have been reflected by a significant increase of technical provision values of life insurers that has not been fully compensated by an increase in assets.
- The change in yield curves is also reflected in decreasing values of SCR ratios, especially for life insurance companies. Given the current low yield environment will remain, this observed trend is expected to further continue.
- According to Solvency II, liabilities with long durations are valued based on the UFR curve, which is higher than the market yield curve that is for the valuation

⁶ For bonds, net buying/selling is computed as the difference between maturing/sold and bought bonds (by looking at the "par-amount" or quantity depending on what is reported). For equities, the net buying/selling is computed as the difference between selling and buying (by looking at the quantity change from one period to another multiplied by the initial price of the stock).

⁷ In Q2/2019 European insurance undertakings net purchased on aggregate approximately EUR 13bn equities, EUR 5 bn. government bonds and EUR 11 bn. corporate bonds.

⁸ On aggregate, insurers were buying approximately 32 bn. EUR government bonds with a negative yields in Q2 2019 (approximately 1.3% of the overall government bonds portfolio).

⁹ Income/gains and losses reporting templates (S.09.01).

of risk free assets. This means that if times passes, the value of these liabilities increase more than the risk free assets. Insurers might not be able to make up this difference by enough capital generation. This risk ('the UFR-drag') increases substantially in an enduring low yield environment.¹⁰

14. In summary, based on the existing evidence, the current ultra-low/negative environment is significantly impacting the EU insurance sector in terms of asset allocation, reinvestment risk, profitability and solvency.

3. Supervisory powers and measures and industry responses

15. The supervisory community has been closely monitoring and analysing the effects of a low interest rate environment for some time. Furthermore, several measures have also been taken with the aim of minimising its impact not only on a company level, but also on the insurance sector as a whole. The background note accompanying this Supervisory Statement offers additional information on the survey carried out with the aim of providing an overview of supervisory powers and measures taken as well as companies' reactions to the low interest rate environment. 26 NSAs provided information during October/November 2019. Some conclusions can be drawn from this analysis:

Supervisory powers and actions

- Authorities have a wide range of powers available to deal with the current ultra-low/negative interest rate environment. However, the powers mostly available are usually soft in nature, such as requesting undertakings to include LIR scenarios in the ORSA analysis (available to all NSAs), intensifying monitoring and/or increasing reporting requirements (22 NSAs) or issuing recommendations or public statements (21 NSAs).¹¹
- NSAs powers are more restricted when it comes to strong powers to address the challenges with regard to existing business. This could mostly be addressed only by using softer powers and pushing companies to assess the dimension of the problem and consider potential remedial actions. Examples of these soft powers are the mentioned power to request undertakings to include LIR scenarios in ORSA analysis, or the power to request pre-emptive recovery plans, i.e. before the breach of the SCR occurs (18 NSAs).
- Measures forcing undertakings to build up additional resilience to protect policyholders, such as requiring the establishment of additional provisions for interest rate risk in annual accounts or limiting the allocation of remunerations and bonuses are also available to around 50% of the NSAs in the sample. In addition to the powers in figures 1-3 in the background note accompanying this Supervisory Statement, four NSAs also reported the power to restrict the distribution of dividends.
- Intrusive and strong measures such as restructuring, limiting or writing down insurance policies or reducing maximum guarantees/rates for future premiums of existing business, which are more difficult to implement because of the strong impact on policyholders, are generally not available to NSAs, at least not outside a resolution process.

¹⁰ This issue could be alleviated by a change of the LLP in the 2020 review.

¹¹ In fact, it can be considered that most of the tools are actually to identify and monitor the risk, and that authorities are more limited when it comes to actual powers to manage it.

- In terms of actions taken over the last three years, aside from intensifying monitoring and reporting and requesting undertakings to include LIR scenarios in the ORSA analysis, it is interesting to see that 10 NSAs required the establishment of additional provisions for interest rate risk, i.e. 77% of those NSAs that have this option within their toolkit. 8 NSAs required a reduction of maximum guaranteed rates for new business.
- Going forward, NSAs plan to follow a similar approach and keep on intensifying monitoring and reporting requirements, requesting undertaking to include LIR scenarios in the ORSA analysis as well as requesting pre-emptive recovery plans. 11 NSAs are planning to request or keep on requesting the establishment of additional provisions for interest rate risk. NSAs clearly point out that, in any case, the actions to be taken will largely depend on the way developments evolve.

Undertakings' reactions

- The majority of NSAs reported that undertakings are decreasing the guarantee levels of new contracts (23 NSAs), changing their product strategy, focusing more on products with no guarantees at all or less dependent on the investment income, such as unit-linked products (23 NSAs) or even discontinuing the sale of certain guaranteed products (observed in 22 jurisdictions).
 - With regards to the strategy followed for the existing business, undertakings seem to have been campaigning incentivising policyholders to switch to new product conditions or other types of products (17 NSAs). In some cases, they have also been setting up additional resilience in the form of preventive reserve funds of technical provisions (12 NSAs). In 10 jurisdictions, NSAs have also observed a renegotiation of the contract terms for those contracts that allow it.
 - In terms of ALM strategy, the input provided by NSAs shows that in a majority of countries, a certain type of “search for yield behaviour” is being observed, given that undertakings seem to be increasing the share of other higher yielding instruments/assets (reported by 18 NSAs). The same number of NSAs report that undertaking are implementing efficiency/cost cutting actions. NSAs witnessing a restriction in the distribution of dividends only in 11 jurisdictions.
16. Overall, as explained, both the supervisory community and the undertakings are reacting to the current ultra-low/negative interest rate environment. As will be explained, however, it is important to intensify these actions and supplement the current framework with additional tools and measures both from a microprudential- but also from a macroprudential perspective.

4. EIOPA's powers

17. In accordance with the current regulatory framework, EIOPA has different powers that could be used in the current low interest rate environment, depending on the developments. These are summarised in the table below.

	Adverse development	Emergency situation	Exceptional adverse situation
Legal basis	Article 18(1) of EIOPA Regulation	Article 18(2) of EIOPA Regulation	Article 138(4) of Solvency II Directive
EIOPA's role	Facilitation and coordination, in the case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union	Issue a confidential recommendation addressed to the Council	Assess and, where deemed necessary, declare the existence of an exceptional adverse situation (extension of the recovery period)
Scope	EU-wide/National	EU-wide	National
Who declares?	No specific declaration needed	EU Council	EIOPA

18. Article 18.1 of its Regulation states that in the case of adverse developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union, the Authority shall actively facilitate and, where deemed necessary, coordinate any actions undertaken by the relevant national competent supervisory authorities. Furthermore, based on Article 34 of the EIOPA Regulation, EIOPA “may, [...] on its own initiative, provide opinions to the European Parliament, the Council and the Commission on all issues related to its area of competence.”
19. EIOPA is closely following the impact of a low/ultra-low interest rate environment on the insurance sector by, for example, intensifying monitoring and focusing on credible and robust stress-tests for several years and providing recommendations,¹² and will continue to do so as long as the macroeconomic environment implies a risk for the insurance sector.
20. In line with Article 18.2, where the ESRB or the Authority considers that an emergency situation may arise, it shall issue a confidential recommendation addressed to the Council and provide it with an assessment of the situation. If the Council determines the existence of an emergency situation, it shall duly inform the European Parliament and the Commission without delay. The declaration of an emergency situation by the Council grants EIOPA with additional powers under Article 18(3), namely the adoption of individual decisions requiring competent authorities to take the necessary action and, where a competent authority does not comply with the decision within the period laid down by EIOPA, the adoption of an individual decision addressed to a financial institution under Article 18(4).
21. Another tool granted to EIOPA by means of Article 138(4) of the Solvency II Directive is the possibility to declare the existence of an exceptional adverse situation. Indeed, in case undertakings fail to comply again with SCR levels by the end of the 6- or 9-month recovery period, NSAs could decide to extend the recovery

¹² No stress-test exercise is, however, scheduled for 2020.

period of the affected undertakings by an appropriate timeframe of a maximum seven years, if EIOPA has in the meantime declared the existence of an exceptional adverse situation.¹³

5. EIOPA's recommendations

Taking the above into consideration, EIOPA recommends the following supervisory responses or measures to NSAs:

A) Short-term actions

➤ NSAs should intensify the monitoring and supervision of insurers identified as facing greater exposure to the low interest rate environment

22. NSAs should intensify the monitoring and supervision of insurers identified by them as facing greater exposure to the risks posed by a prolonged low interest rate environment. From a conduct of business perspective, it is particularly important to monitor potential actions by insurers adapting to the low interest rate environment that may be detrimental for consumers. Furthermore, also “search for yield” behaviours that exceed the risk bearing capacity of undertakings should be monitored, as this may lead to procyclical behaviours.

➤ NSAs should engage into a dialogue with undertakings to explore actions they could take to improve their financial resilience

23. Undertakings should explore, in dialogue with the NSA, actions that undertakings could take to improve their financial resilience. This is especially important in relation to “in-force” business. In particular, the following should be considered by NSAs:

- o To challenge business models that are identified as being unsustainable and to encourage insurers to take appropriate actions. This refers, in particular to:
 - Life insurers offering unsustainable guaranteed products, and
 - Non-life insurers pursuing a business model where investment returns are used to compensate for weak underwriting results.
- o To make sure that insurers have a sound capital planning, including measures to enhance the capital position of undertakings (e.g. in the form of a capital add-on as currently considered in the legislation if certain requirements are met), limiting the allocations of remuneration and bonuses or restricting the distribution of dividends, which may be the only solutions for existing business.
- o To incentivise insurers to properly assess the risks they are exposed by adopting an economic perspective of the balance sheet and making use of Pillar 2 tools related measures for an effective risk management. For example, undertakings should be requested to include severe enough LIR scenarios in the ORSA analysis.

➤ NSAs and undertakings should pay special attention on pre-emptive recovery and resolution planning to reduce the likelihood and impact of insurance failures

24. In the current environment, special attention should be paid to pre-emptive planning. To the extent possible, NSAs should request that undertakings prepare

¹³ Article 138(4) sets out what constitutes the existence of an exceptional adverse situation, with a persistent low interest rate environment being one of the conditions named.

pre-emptive recovery plans (i.e. before the breach of the SCR). In similar terms, the authorities in charge of resolution should also consider developing and maintaining resolution plans and conducting resolvability assessment.¹⁴ In both cases, the principle of proportionality should apply.

- NSAs should broaden the analysis of the low interest rate environment and also consider the potential build-up of systemic risk

25. Given that the ultra-low interest rate environment entails macroprudential concerns on top of the microprudential risks, NSAs should also analysis the potential build-up of systemic risk. From a macroprudential point of view, a prolonged period of low interest rates puts pressure on three of the operational objectives identified by EIOPA in its work on systemic risks and macroprudential policy in insurance, i.e. the need to ensure that the insurance sector has sufficient loss-absorbing capacity as a whole, identify risky behaviours and potential procyclical concerns.¹⁵

B) Medium to long-term actions

- NSAs should identify whether there are any tools or powers missing in the current toolkit and request from the (national) relevant authorities the missing powers if a gap is identified. The implementation of these new powers would probably be possible in the medium or longer-term.

26. EIOPA is assessing the need for additional tools and powers already for some time.¹⁶ In particular, EIOPA calls for minimum harmonised and comprehensive recovery and resolution framework for (re)insurers to deliver increased policyholder protection and financial stability in the European Union.

27. An effective recovery and resolution framework is fundamental in a fragile market environment. This is the case of the current prolonged low interest rates environment, which – as mentioned – puts pressure on the solvency and profitability of insurance companies. Furthermore, there is also a risk of a sharp reversal in asset prices.

28. A harmonised recovery and resolution framework, including an adequate set of early intervention, recovery and resolution tools and powers, would contribute to a) reduce the likelihood of undertakings failing because of an ultra-low interest rate environment by proper preparation and planning; b) minimise impact in case of failures by broadening the toolkit; and c) enhance cross-border cooperation and coordination. Harmonisation in the field of IGS – another area where EIOPA is doing a significant amount of work – is also key to deal with insurance failures and minimise the impact on policyholders.

29. In similar terms, EIOPA is of the view that Solvency II should be revised to include the macroprudential dimension and broaden the toolkit available to Authorities to address the different sources of systemic risk identified, such as the low interest rate environment.

30. In the meantime, until the current framework has been broaden and harmonised and a higher degree of supervisory convergence achieved, EIOPA is of the view that NSAs should identify whether there is any tool or power missing in their current toolkit and, if this is the case, to request those missing powers from the relevant (national) authorities.

¹⁴ This recommendation is also linked to the medium-term actions explained below.

¹⁵ See “[A potential macroprudential approach to the low interest rate environment in the Solvency II context](#)” and Chapter 11 of EIOPA’s [Consultation Paper on the Opinion on the 2020 review of Solvency II](#) for further information.

¹⁶ The different policy proposals can be found, in particular, in Chapters 11-13 of the recently published EIOPA’s [Consultation Paper on the Opinion on the 2020 review of Solvency II](#).

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