## Xavier Larnaudie-Eiffel

Deputy Chief Executive, CNP Assurances

# Low interest rates: What should policymakers do?

Interest rates have been at historically low levels for many years and are widely expected to stay low for some time. Low interest rates drive down returns on new and re-investments and this can have some major negative impacts on insurers and also on their customers.

For customers, low rates mean higher non-life insurance prices, lower guarantees, fewer long-term savings and — potentially most damagingly — lower pensions when they retire. For insurers, in addition to lower returns on investments, low interest rates can significantly increase the valuation of liabilities and capital requirements and make it more difficult to offer long-term products and guarantees, particularly in respect of long-term business and investments, which tend to exaggerate liabilities and capital requirements. Very low and especially negative interest rates amplify these measurement problems.

Insurers have been taking actions and adapting for many years in response to low rates and this has helped them to remain strong and profitable. Actions taken include looking hard for investments (such as infrastructure) that can provide a reasonable trade-off between risks and returns, even under current market conditions. On the liability side, companies have adjusted prices and lowered guarantees on new business in line with the lower returns available. In some cases, products have been redesigned, costs cut and there has been a shift towards unit-linked business. And, of course, asset/liability matching and hedging remain key tools that are used to manage interest rate risk.

So, what should policymakers do? Firstly, in setting monetary policy, they need to consider, along with the potential benefits, the wider and negative impacts of low interest rates on long-term consumer savings and pensions. While, the need for low interest rates following the global financial crisis and now the COVID-19 pandemic is well understood, the monetary policy behind the low rates should be continually reviewed and planned with an exit strategy in mind.

Secondly, policymakers should make use of the current review of the Solvency II insurance regulatory framework to address measurement flaws that can create important barriers to long-term business and investment. Some of these flaws are amplified by the low interest rate environment. Addressing these is especially important, given the need to encourage insurers to contribute to supporting the recovery from COVID-19, to supporting sustainable long-term growth and financing transformation to net zero carbon and to tackling the pension savings gap — rather than preventing them from doing so.

There are two main improvements needed related to the valuation of liabilities. One is the Volatility Adjustment which is intended to reflect the additional return above the risk-free rate insurers can earn on the assets backing liabilities in order to avoid artificial volatility in the balance sheet. This is currently designed and calibrated unnecessarily low and also results in too much artificial volatility in insurers' balance sheets. The other is the Risk Margin which is a notional amount above the amount actually needed to pay all costs and claims and is added to make liabilities transferable in a market context. However, in 2019 it reduced European insurers' total capital by over €180bn and is another source of artificial volatility. These two issues unnecessarily reduce the industry's capacity for and interest in long-term products and investments.

Changes in interest rates, including if they go negative, are already immediately reflected in the valuation of insurers' assets and liabilities. The interest rate methodology used in Solvency II as part of liability valuations is already conservative enough and should not be changed. For example, the euro risk-free rates in Q1 2020 were -0.12%, 0.12% and 1.49% for years 10, 20 and 40 respectively. The current solvency capital requirement (SCR) to cover the risk that interest rates go even lower needs some change because it does not currently allow for negative rates. However, care must be taken in setting an appropriate and plausible "floor" on how negative interest rates can go.

Low interest rates are already a challenge for insurers and customers. Policymakers should use the Solvency II review to fix measurement flaws and so help insurers play their role in protecting and investing. ●