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Managing Interest Rate Risk in a Changing Regulatory Environment

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Introduction

The Western world is experiencing a prolonged period of low interest rates and the jury is still out on whether this situation will come to an end when Europe and the U.S. emerge from the economic crisis. In November 2013, the OECD saw the global economy as a whole strengthening in 2014 and 2015 which suggests the pressure to keep interest rates low may subside. What this means to an insurance sector that is aiming to become less sensitive to market risks is discussed below.

Low interest rates: two sides of the same coin

In 2007, when the financial crisis really started to bite, central banks and governments took hitherto unseen measures to stabilize the banking sector, including offering banks almost unlimited access to liquidity at low interest rates. This strategy enabled banks to overcome the funding constraints resulting from the shut down of the interbank financing markets. In 2012, these measures were followed by the much-lauded move by Mr. Draghi to facilitate European states to finance themselves, as he indicated that he would defend the Euro at all costs. Both moves, coupled with Western economies that are still operating below capacity levels, as they adapt to the new, post-crisis, reality, are underpinning, for now, a historically low interest rate environment.

At the same time, the low interest rate environment has taught insurers some hard lessons on interest rate risks, as return guarantees embedded in products sold in the past got "in-the-money", leading to significant capital consumption due to higher provisions and low profitability. As a consequence, various insurers have chosen to enter into significant hedge programmes to reduce their interest rate exposure. Moreover, a large number of players have even shifted their strategy from interest rate-based towards fee-based products.

Whereas the initial decline in interest rates led to substantial mark-to-market results on investments available-for-sale, those positive accounting gains reduced when the financial crisis continued. At that time the uncertainty around the severity of the financial crisis made insurers hesitant to re-risk their assets. The resulting pressure on profitability has forced many insurers to reshape their business models.

With the recovery comes more uncertainty on future interest rates

The recovery of the American economy appears to be well underway, although every mention of the start of "tapering" is greeted with considerable anxiety from the capital markets.

Whereas the crisis appeared to bring one certainty, a low interest rate environment, the economic recovery looks to bring at least some uncertainty, as a number of thought leaders are not questioning whether but when interest rates will start to rise. In their view it is only a matter of time before inflation starts to rise due to the abundant supply of liquidity and the decreased necessity to support banks with low interest rates as they start to become appropriately capitalised and return to profitability. Exactly how fast or slow such an increase in interest rates may unfold is subject to much debate. The English regulator has already commissioned research to assess the vulnerability of the financial sector to a sudden interest rate hike.

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On the other hand, various commentators believe that the Western world should prepare itself for a scenario such as that seen in Japan, with a prolonged period of low interest rates. As most Western states are highly indebted and run budgetary deficits, there also continues to be a strong case for low interest rates.

The sheer diversity of the potential outcomes of future interest rate developments poses a challenge to risk and capital managers, in particular of life insurance companies. Insurers need to determine to what extent they intend to run interest rate risk and ensure this is reflected in the hedge strategy they put in place.

Inconsistencies in accounting and regulatory concepts affect hedging strategies

The inconsistency in the treatment of changes in assets and liabilities for regulatory and accounting purposes leads to a fundamental conceptual challenge: insurers are being forced to choose between either developing their hedging strategy to reduce capital volatility from a regulatory perspective or reduce volatility of earnings. On the one hand, under current international accounting rules, liabilities are considered applying a cost-type convention, with only a limited number of insurers opting for a "market value" accounting approach. On the other hand, solvency regulations demand a calculation of provisions based on observable market-based assumptions.

In particular, under the Solvency II rules that are now envisaged to be implemented by 2016, a market prices-based calculation of the provisions is required. Therefore, reducing the exposure to interest rate-based products may be the only way to reduce both regulatory and accounting volatility.

The increased uncertainty around interest rates comes at a time when most large European insurance companies have put the crisis behind them, as they have replenished their capital positions and are generating considerable free cash flows. This in turn means that those insurers are reconsidering their preference of regulatory over accounting volatility, which also affects their hedging strategies.

Regulatory change adds additional complexity

In particular for long-term liabilities this is not the end of the story. The heated debate around the parameterisation of the calculation of provisions for long-term liabilities has eventually led to definitions of the last liquid point (LLP) and the ultimate forward rate (UFR) that are clearly the outcome of a political process.

This outcome leaves insurers to decide how to go about hedging their interest rate risk beyond the LLP: should a company focus on economic capital models or should it hedge the risk that is run based on regulatory capital calculations?

In addition, fairly strict eligibility criteria will come into effect under Solvency II for insurers that use the Matching Adjustment for assets that can be used to match the insurance liabilities. This may force insurers to reassess their investment strategy and may increase the costs of creating and maintaining a suitable investment portfolio.

Recent regulatory changes in the market infrastructure (EMIR) create additional challenges as long-duration hedges (swaps) are forced to be entered into through instruments that are cleared with central counterparties. As set out by Simon Hotchin of HSBC, this leaves an insurer to either keep hedging through the use of swaps, which now leads to potential liquidity risk as a result of collateral calls, or hedge through entering into long-dated bonds. The latter hedging strategy forces insurers to take on the credit spread risk of a potential widening of the difference between the yield on the bond and the swap rate.

Conclusions and recommendations

Conclusions

The green shoots of recovery also bring increased uncertainty regarding the future development in interest rates. This comes at a time in which the relative importance to management of accounting versus regulatory volatility resulting from interest rate developments may also change. Shareholders are likely to attach value to greater visibility on future earnings and, as regulatory requirements are met, investors' requirements are likely to play a more important role going forward.

Undoubtedly a move towards offering more fee-based products would help in providing more stable earnings, but such a decision clearly has to be aligned with the broader product strategy and profile the insurer intends to maintain.

The move from a Solvency I to a Solvency II world coupled with regulatory change in other fields, such as IFRS and EMIR, creates further complexity where it relates to both hedging and investment strategies.

Recommendations

The recommendations for insurance companies operating under such conditions would appear to be as follows:

- Develop a clear understanding of the expectations of the various stakeholders regarding capital and earnings volatility
- Based on the above, develop a well-articulated, concise risk appetite statement that drives the decision-making on the overall product strategy as well as the related risks
- Conduct a clear assessment of the implications of new regulatory requirements on both the hedging and investment strategies
- Implement a hedging and investment strategy that reflects the profile of the insurer and is based on the risk appetite statement.