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SAFE Finance Blog

Life Insurance: Rising Interest Rates can Lead to Challenges

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Helmut Gründl: In the short term, a strong and rapid increase of interest rates can be problematic for insurance companies



The persistently low interest period and the large number of long-standing contracts with a guaranteed interest rate of up to 4 percent pose major challenges for European life insurers. Many of these companies are therefore looking forward to a higher level of interest rates. And indeed, interest rates have already risen slightly over the past two years. At first glance, it seems that higher interest rates have a stabilizing effect on the balance sheets of life insurers. Everything all right then?

Not quite: The reason lies in different interesting effects of rising interest rates on the trade balance and the solvency balance sheet according to Solvency II. Under the principle of lowest-value (“Niederstwertprinzip”), insurance companies would have to swiftly write-off bonds in the trade balance

sheet, while the value of the obligations on the liability side would even rise in the short term due to the additional interest rate reserve regulations, and would only drop thereafter. This would lead to short-term trade losses for the company. In the sense of a "true and fair view", it would therefore be advisable, in the case of rising interest rates, to amend the regulations on additional interest rate reserves so that insurance companies can dissolve them quickly.

In the solvency balance sheet, however, rising interest rates for life insurance companies have a clearly positive effect due to the appropriate market-consistent valuation. Solvency, i.e. the endowment of the insurance company with own funds, improves.

However, a sudden, sharp increase in interest rates may pose risks for the insurance industry and thus for clients as well, if policyholders discontinue their contracts due to rising interest rates and invest in higher yielding assets. Although, cancellations usually result in trade balance profits due to cancellation fees, they can contribute to a reduction in own funds in the solvency balance sheet.

In conclusion, it can be said that on the one hand a moderate, slow increase in interest rates would clearly have positive effects for life insurance companies. On the other hand, a very strong and rapid increase in interest rates could lead to problems.

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More about this topic: Elia Berdin, Helmut Gründl, Christian Kubitz: Rising interest rates, lapse risk, and the stability of life insurers (http://www.icir.de/fileadmin/user_upload/Berdin_et_al__2018_05_.pdf), ICIR Working Paper No. 29.

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