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Position Paper

Comments on ECB strategy review

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Summary

Insurance Europe would like to take the opportunity to share its views on the European Central Bank's (ECB) ongoing strategy review. Interest rates are of very significant relevance for the insurance industry, as they impact product offering, as well as the measurement of insurers' balance sheet positions and, more broadly, their solvency ratios.

The insurance sector agrees that a loose monetary policy was an appropriate reaction to the global financial crisis, as well as to the euro-area debt crisis. With the COVID-19 pandemic severely affecting the economy, responses also need to be timely, targeted and strong. However, they must be temporary. **The ECB strategy review should therefore include a strategy to exit loose monetary policy measures as quickly as possible. Market participants and governments should know that central bank support can only be temporary.**

Regarding ECB's strategy, the insurance industry notes that:

- **The ECB should assess more thoroughly the impact of its policies regarding interest rate levels and asset purchase programmes on long-term consumer savings and pensions**. Persisting inflation at moderate levels and negative interest rates, as well as permanently changing and at times unnecessarily rigid regulation, results in massive redistribution effects at the expense of traditional savers. It also has a direct and negative impact on policyholders' returns for savings products and on the pricing for non-life products. This brings about major challenges for the insurance industry, including:
    - Extremely low interest rates have lowered returns on investments, thereby significantly impacting the level of investment returns and guaranteed level of benefits that insurers can offer to long-term savers.

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  - Low – and especially negative – interest rates amplify the barriers created by Solvency II and create additional pressure on insurers to either discontinue offering or change the design of some traditional savings/pension products that offer significant value for consumers. This happens because Solvency II does not appropriately reflect the real economics and risks relating to insurers long-term business model and so forces insurers to hold more capital than is economically necessary and exposes them to artificial volatility in their balance sheets.
- **A focus on other policy areas should not result in trade-offs with the mandate of price stability**. There is a significant risk of overburdening monetary policy, if other policy objectives get a higher priority. It is key that the ECB maintains its independence status and concentrates on its main task of price stability. With respect to climate change, the insurance sector believes that tackling global warming should primarily be the responsibility of governments, which are better equipped to assess market impacts in terms of liquidity, stranded assets and financial green bubbles.
- **Transparency of monetary policy decisions is welcome**: The ECB should be more transparent about the discussions within its governing council, improve its explanations to the general public about the costs and risks of its interest rate policies and raise awareness about the limits of monetary policy.
- **The review of Solvency II must result in meaningful improvements** because the ECB's low interest rate policy amplifies problems already identified with Solvency II and the barriers that those problems create for insurers providing long-term products and long-term investment.

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Detailed comments

I. What does price stability mean for you?

The main contribution central banks can make to improving people's welfare is to maintain price stability. You may have heard about our recent measures to help counter the economic impact of the coronavirus pandemic. These have the overall aim of keeping prices stable. If the rate of inflation (the rate at which consumer prices increase on average from one year to the next) is positive, low and stable, this situation is consistent with price stability. We currently aim at an inflation rate below, but close to, 2% over the medium term.

1. How do changes in general price levels affect you/your organisation and your members?

Regarding insurance, inflation matters in life as well as non-life business. For life insurers and their customers, inflation is of central importance and is key to offer products with an attractive yield in real terms. Persisting inflation at moderate levels and negative nominal rates, affect directly and negatively policyholders returns for savings products and pricing for non-life products. Assumptions about the inflation of claims payments are also relevant for the calculation of premiums in property and casualty insurance.

2. Are you concerned about either deflation or inflation being too high?

Yes, inflation as well as deflation can lead to serious economic problems and, hence, welfare losses.

European insurers are not concerned about moderate price increases at levels slightly below the ECB price stability target. On the contrary, low and stable inflation is usually associated with positive effects because private households benefit from rising real purchasing power. Stable inflation over time – even if at somewhat lower levels than desired – facilitates the formation of inflation expectations. Otherwise, economic uncertainty, which is harmful to growth, and redistribution effects are major consequences of unexpected inflation.

However, it is **expectations about the future path of inflation**, not only actual inflation, that need to receive more attention from policymakers. This holds in particular for households' expectations. The cost of inflation is particularly high when unexpected deviations from price targets occur. In these cases, benefits and burdens can shift from borrowers to lenders, from landlords to tenants or from employers to employees in unforeseen and undesired ways.

3. For which types of goods and services do you feel the effects of price changes most?

Investing heavily in people and IT, the insurance industry is particularly affected when prices of IT goods or the costs of education and wages shift strongly and in unpredictable ways.

4. When you think about inflation, how relevant do you find the increase in the cost of housing?

The official price index should ideally reflect the everyday economic reality of private households as accurately as possible. Therefore, the cost of housing, which accounts for approximately 30% of total spending, should be included in the price index.

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II. What are your economic expectations and concerns?

We conduct monetary policy to make sure that the euro holds its value over time. To make our monetary policy as effective as possible, we want to better understand your expectations, as well as your economic concerns.

5. What economic concerns are you/your organisation and your members facing?

Persistently low, and in some cases even negative interest rates, represent major challenges for the insurance industry. Through different household investment behaviour, a period of prolonged low interest rates has massive redistribution effects at the expense of traditional savers (net creditors). Therefore, insurers with their long-term, security-oriented investment portfolios are particularly affected.

The extremely low interest rates have lowered returns on investments, thereby impacting significantly the level of investment returns and guaranteed level of benefits insurers can offer to long-term savers. This can have a significant impact on their future wealth. Where this results in a need for greater state support for the elderly, this can in turn negatively impact government finances.

In addition to various structural changes, monetary policy is a key driver of the current interest rate environment. A case in point is the portfolio balance effect. A monetary policy focused on low risk-free rates aims at improving financing conditions for the real economy by encouraging investors to invest into riskier assets. If monetary policy did not lead to lower risk-free rates, this would make unorthodox policies ineffective.

In this respect, the insurance sector agrees that a loose monetary policy was appropriate as a reaction to the global financial crisis, as well as to the euro-area debt crisis. With the COVID-19 pandemic severely affecting the economy, responses also need to be timely, targeted and strong. However, they must be temporary. The ECB strategy review must therefore include a strategy to exit loose monetary policy measures as quickly as possible. Market participants and governments should know that central bank support can only be temporary.

Since the global financial crisis, insurers face higher regulatory requirements in different parts of their business, which has led to higher compliance costs. In this respect, it is essential to keep a balanced level of regulation. The main concern is, and there is evidence for this, that the regulatory burden for the insurance industry has become too strong and has resulted in suboptimal business activities.

Solvency II, the prudential framework governing insurers, does not appropriately reflect the real economics and risks relating to insurers' long-term business model (regarding both the liabilities and the investments that back them). As a result, insurers are forced to hold more overall more capital than is economically necessary and are exposed to significant artificial volatility in their balance sheets. **Low, and especially negative interest rates, amplify the barriers created by Solvency II and therefore create additional pressure on insurers to either discontinue offering or change the design of some traditional savings/pension products that offer significant value for consumers**.

Finally, digitalisation marks a profound change for the insurance sector, with insurance companies overwhelmingly appreciating the benefits rather the costs associated with it.

6. How have changing economic conditions affected you in the last decade (for example, how have they affected your prospects of finding a job)?

N/A

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7. How do low interest rates and monetary policy in general affect you/your organisation, your members and the overall economy?

Low interest rates can have potential benefits in terms of stimulating the economy. However, the positive impact diminishes as the duration of the expansionary policy stance increases, and negative side effects become more pronounced. In the long-term, the consequences for savers, the insurance industry and the economy as a whole can easily become negative, for example with the emergence of inefficient business models. Increased saving efforts might also be needed to compensate the deteriorating outlook for pensioners.

Prolonged low interest rates can easily develop into a catch-22 situation. If spending increases as intended, increased debt levels could become unsustainable at higher interest rates. Subsequent normalisation of interest rates could even become impossible because many economic actors would default. Ultimately, in the process of moving to a new equilibrium, financial stability risks could arise with devastating consequences

The justification for and potential benefits of negative interest rates appear far less clear while the negative impacts begin to be greater, at least for insurers under the current Solvency II regime and their policyholders.

Firstly, **low interest rates greatly reduce the effectiveness of capital-based retirement schemes like life insurance** (see question 5). The sector expects interest rates at the zero-bound to significantly damage private old-age provisions. This is particularly worrying, as a reliable private insurance plan is more important than ever in view of the demographic changes ahead.

Life insurers took a number of steps to adapt to the low interest environment by extending the product range and by adopting new investment strategies. As a result, insurers and policyholders bear a higher investment risk. Life insurers are hence following to some extent the transmission mechanism of monetary policy, which focuses on greater investment in risky securities to stimulate growth. However, an aggressive ongoing monetary policy stance pushing yields further down increases the risk of an intensified search for yield behaviour among investors, which is so far limited.

Secondly, interest rates have a direct impact on insurers' balance sheet positions. Solvency II requires nearly all liabilities[1] to be valued by discounting at something very close to the risk-free rate. This is equivalent to forcing insurers to assume in the assessment of the balance sheet that all their assets backing liabilities are invested nearly risk free and earn nearly risk-free returns. Clearly insurers do not invest in this way and while returns on their assets have fallen significantly as interest rates fell, insurers, on average, earned returns above risk free.

Of course, there are risks associated with investing in real assets and the real economy, as current market conditions demonstrate. Solvency II requires insurers to hold significant capital to cover 1 in 200 type adverse market scenarios. Therefore, this approach to assessing insurer's base case balance sheet is extremely conservative and **with negative rates this can mean that insurers have to assume significant negative returns on assets. And, the longer the duration of liabilities, the greater the impact and barrier created for long-term products and long-term investment.**

The Solvency II framework was not designed or tested for situations where interest rates set by the ECB are extremely low or negative and the low rates exacerbate existing concerns about the Volatility Adjustment (VA) and the Risk Margin (RM). Specifically:

- The VA being too low: low rates amplify the problems caused by an unnecessarily conservative VA.

[1] About 98% of liabilities (post-Brexit) will be measured under Solvency II using either the risk free rate curve or the risk free rate curve plus the volatility adjustment (VA), but at end 2019 the VA was only 6bp and so had almost no impact

- The RM being too high and volatile: low rates increase the RM in two ways – by increasing the size of the projected Solvency Capital Requirements (SCR) used in its calculation and increasing the net present value of the projected capital costs. Low rates also amplify the artificial volatility that comes from changes to the RM.

Thirdly, ECB monetary policy and expectations about the future level of interest rates impacts the calibration of the Solvency II solvency capital charge for interest rate risk. Solvency II requires insurers to hold capital to cover a 1 in 200 low interest rate scenario. This is currently calibrated with a floor set at zero because this was considered in the past appropriate as a floor. Now that rates have gone negative there is, under the current review of Solvency II, a discussion about potentially setting a lower floor so the 1 in 200 event can be a negative rate scenario. This means, in addition to the issue above (ie forcing insurers to value their current balance sheet assuming all assets earn at or almost risk-free returns), insurers would have to hold extra capital to cover even more extreme negative rate scenarios than those we are already experiencing now. EIOPA and national supervisors are trying to answer the question of "how much more negative interest rates can go?". The decision over what level of negative rates insurers should be required to capitalise against is key and the ECB to a large extent controls the actual level of Euro-denominated interest rates. The European Insurance and Occupational Pensions Authority (EIOPA) has made proposals which effectively assume that the ECB may set short term rates as low as minus 2%, despite the knowledge now available on the risk of having reached the "reversal rate". If put into place, this would require insurers to hold huge additional capital reserves. The industry considers this type of recalibration to be unnecessarily extreme and damaging to insurers' long-term business model.

Fourthly, low rates can also significantly increase all types of capital charges, even those unrelated to interest rate risk because future losses incurred under the 1 in 200 extreme scenarios used by Solvency II to determine capital requirements are discounted at a lower rate and therefore result in a higher capital charge. In addition, convexity could further amplify the capital charge. In other words, at the current low interest rates, the capital charge for insurers can be much larger than at normal interest rate levels, because the value increases more than linear as interest rates go down. Not only does the value of liabilities increase, but also the SCR.

Given the current low interest rates it is therefore especially important that the current review of Solvency II addresses the current measurement problems and excessive conservativism by:

- Improving the VA so it better reflects the additional returns insurers can and do earn above the very low risk-free rates and how insurers combinations of assets and liabilities protects them from market volatility.
- Reducing the current excessive level of the RM and its contribution to artificial balance sheet volatility.
- Leaving the current risk-free methodology and calibration unchanged and avoid increasing even further the negative impact of low rates.
- Taking care that any recalibration of the interest rate capital charge allowing for negative rates incorporates an appropriate floor to avoid exaggerating the level to which negative rates can go.
- Ensure calibration of investment risk (equities and debt) is based on the real risks of long-term under-performance and not short-term market volatility.

III. What other topics matter to you?

The ECB's main task, its "primary objective", is to maintain price stability in the euro area. However, once price stability is guaranteed, it is the ECB's task to support the general economic policies of the European Union. These include, for example, the sustainable development of Europe based on balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

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8. Do you think the ECB should give more or less attention to these other considerations and why?

The ECB should concentrate on its main task of price stability and maintain its independence status. Insurers are concerned that a focus on other policy areas would result in trade-offs with the mandate of price stability. There is a significant risk of overburdening monetary policy, if other policy objectives get a higher priority.

For some time now, it has been widely discussed if central banks should use their tools to support climate policy objectives. Our position is that addressing the challenges of climate change is above all a political task, and that measures need to be geared towards the real economy, as carbon emissions are highest there. The insurance sector believes that tackling global warming should primarily be the responsibility of governments, which are better equipped to assess market impacts in terms of liquidity, stranded assets and financial green bubbles.

9. Are there other issues not mentioned above that you think the ECB should be concerned with when setting its policies?

In recent years, risk and side effects of monetary policy decisions did not receive the attention that they should get according to the principle of proportionality. While there is an extensive analysis of how different monetary policy instruments contribute to achieving price stability, there is no systematic approach to assess the impact on other policy areas. This is particularly relevant as accommodative monetary policies come with strong incentives and distributional effects which matter for society at large.

From that perspective, future monetary policy decisions should consider the principle of proportionality in their effects. Specifically, the ECB should set up a process to investigate the extent to which its decisions affect other policy areas.

10. How will climate change have an impact on you/your organisation, your members and the economy?

As provider of insurance, the European insurance industry is well aware of the impact of climate change and of global temperature increases. Climate change is already affecting the frequency and magnitude of natural catastrophes, bringing about large economic losses and making it harder for insurers to offer affordable cover. Beyond the losses due to natural catastrophes, the challenges posed by climate change will have significant consequences for investments as well as the underwriting business.

The insurance industry is well aware that it has to play an important role in the transition towards a sustainable economy. This is why a growing number of companies are already committed to sustainability objectives. However, reducing CO_2 emissions is first of all the responsibility of the real economy. With more than €10tn of assets under management, the insurance industry stands ready to financially support the necessary transition to carbon neutral, resource efficient and more sustainable economies, in line with the EU policy objectives. Ideally, insurance companies would like to direct more money to sustainable projects: eg sustainable infrastructure. Unfortunately, such projects are still scarce in supply.

IV. How can we best communicate with you?

We know that understanding how monetary policy works helps people make decisions about how to spend, save, invest or borrow money. We would like to find out how successful we have been in explaining what we do and why we do it.

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11. To what extent do you feel well informed about the ECB/your national central bank?

In general, the industry appreciates the transparency of the monetary policy decisions taken by the ECB. However, more transparency about the discussions within its governing council would allow a better understanding of the individual positions of council members. In that regard, the publication of voting results should be considered. Following the example of the Federal Reserve, the perception of the council members regarding key economic indicators (ie policy rate, inflation rate) could be published.

12. How could the ECB/the Eurosystem improve the way it explains the benefits of price stability and the risks of inflation being too high or too low?

Transparency also means that the general public has a good knowledge about the benefits of price stability. One option could be to reach out to the public by using “simpler” language. At the same time, it is equally important to raise awareness about the limits of monetary policy.

13. What could we do to improve your understanding of the decisions we take and how they affect you?

N/A

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe’s economic growth and development. European insurers pay out almost €1 100bn annually — or €2.9bn a day — in claims, directly employ over 900 000 people and invest nearly €10 200bn in the economy.