AFM CFO Conference - Low risk free rates

The impact of lower risk free rates and guarantees under Solvency 2

Why are risk free rates important - fundamentals

- Insurers have guarantees
- With-profit insurers have guarantees of maturity proceeds, MVR free date proceeds, death benefits, accumulated account balances
- Historically, want to hedge those guarantees
- Risk free assets used as hedge
- Costing of guarantee – risk free asset return can cover the guarantee
- Remainder of return provides bonuses?
- Investment mix?

Risk free rates now and in the past....

Term	Gilts 27/06/2016	Swaps 27/06/2016	Risk Free 2015 YE	Risk Free 2014 YE
5 year	0.426%	0.622%	1.48%	1.36%
10 year	1.011%	1.014%	1.92%	1.77%
15 year	1.522%	1.211%	2.10%	2.02%
20 year	1.691%	1.262%	2.13%	2.15%

- Gilt yields reached 15% in the 1970s
- Fell to averaging 10%
- Then to 5%
- Then to 2% (historic average)
- Now to 1.5% with a risk free swaps rate of 1.25%.

Natural cost of guarantee

- Product is a single premium with-profits bond with 100% sum assured guaranteed MVR free at 10 years, 2% initial costs and 0.5% renewal costs
- Assume MVR free date provided for with risk free assets
- Day 1 investment in these assets will be and cost of policy:

	3% risk free	2% risk free	1% risk free
RF Asset Required	78.12%	86.17%	95.14%
Plus initial	80.12%	88.17%	97.14%
Available for equity	19.88%	11.83%	2.87%

Even more of a concern – maximum management charge changes from 3% to 2% to 1%

TESP example

- 90% of premiums as sum assured at 10 years
- 5% premiums as renewal, 60% initial costs
- 0.25% fund management costs including VAT
- Day 1 value……

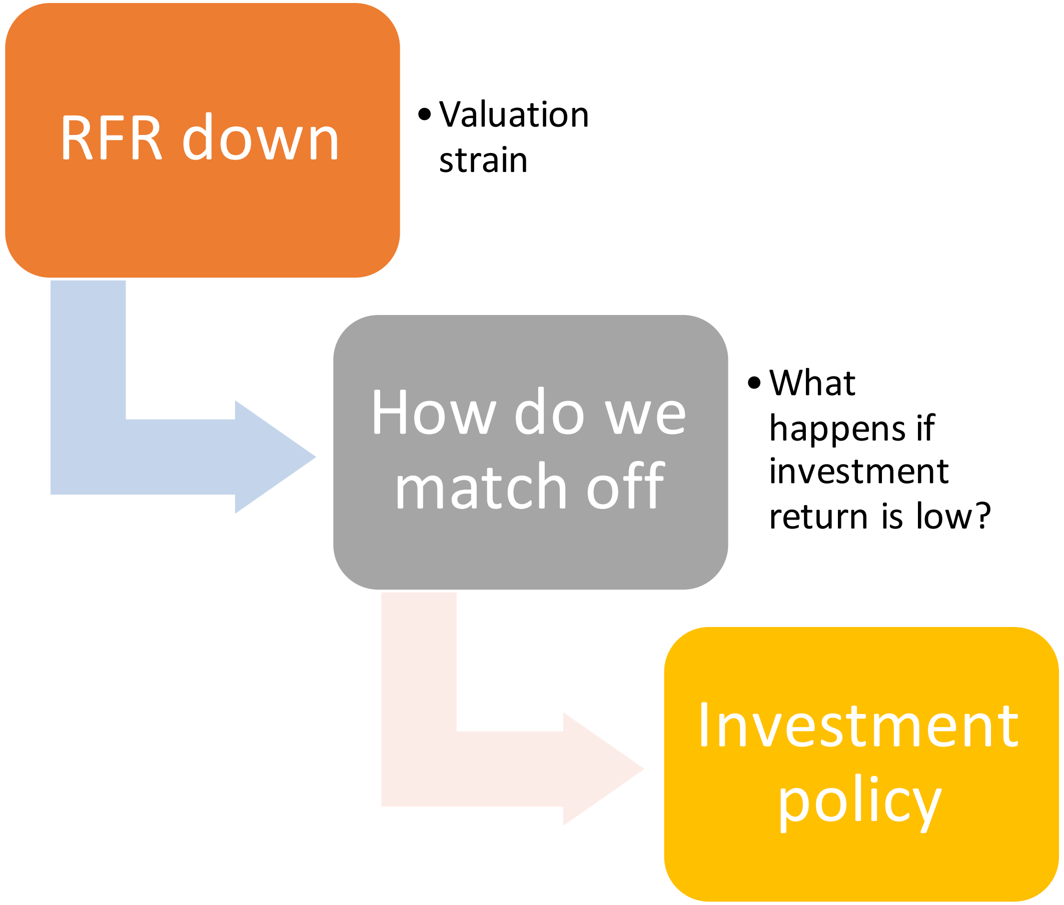
RFR	3%	2%	1%
Value at day 1	260.48	168.40	61.37

To restore same value available on day 1, reduce sum assured to 82% of premiums payable

Solvency II

- Uses risk free rates to discount liabilities
- Allow for future bonuses that equate asset shares to discounted value overall
- Include terminal bonuses as well as reversionary bonuses
- Need to allow for cost of guarantees – closed form option costing? – for any asset mismatch
- Result:
  - Reserves rise or bonuses reduce
  - Margin for future expenses in valuation declines on bonds
  - Bonuses reducing reduces discretionary benefits reduces coverage for SCR

Common sense…..



- Valuation strain
- What happens if investment return is low?
- Move to more RFR assets

Mixed asset portfolio

Asset categories	Returns	Cautious Matched	Managed type
Gilts	1.25%	75%	50%
Corporates	2.25%	15%	10%
Equities	4.25%	15%	25%
Properties	4.00%	10%	15%
Average return		2.31%	2.51%

So even if you had assets sufficient to justify a higher holding of equities

- Returns only 2.51% before costs
- Is this the deal that policyholders signed up to?
- What can we do?

Issues if assume change is long term

- Marketing literature and sales training
  - Lower returns in the longer term mean……
  - Lower illustrations – potentially will be required with KIDS
- Matching and risk
  - How much mismatch can you afford?
  - Investment returns driven plus SCR plus cost of guarantees in technical provisions
- Level of guarantees in products
  - Repricing basic guarantees
- Fundamental review of product range?