ALBERTO CORINTI
Member of the Board of Directors - Italian Insurance Supervisory Authority (IVASS)

The impact of the sudden increase of interest rates on insurance

The "low for long" interest rate context of some years ago represented one of the main global challenges for life insurance. The subsequent sudden and dramatic increase of interest rates has presented different but equally serious challenges which we must not disregard, but rather learn from.

In Italy, on average, the increase in interest rates has impacted insurance companies through a combination of increased surrenders on the liability side and of valuation losses on the asset side. The consequent materialization of liquidity risk was not related to the inability to convert assets into sufficient cash flows to face increased liquidity needs, but instead to the difficulties in getting those cash flows without selling depreciated assets and realizing economic losses.

The intensity of the impact on individual companies depended on a number of factors; the main ones being:

- The degree of liquidity of the liabilities: i.e. the easiness for policyholders to surrender the policies in response to market factor movements. Insurance policies are normally associated with lower liquidity than pure financial products. However, their design and other market factors (e.g. level of surrender penalties, significance of the protection component compared to the pure investment component, habits of consumers) could make the level of surrenders more sensitive to the return that can be earned by investing in pure financial products;
- The type of distribution channel: banking or financial distribution networks tend to emphasize the financial component of insurance policies, using selling practices that present insurance policies as an alternative to pure financial products. This is particularly relevant in case of non-proprietary networks, where the interests of the insurance company might not always be aligned with those of the distributing entity. Market evidence in Italy showed this very clearly;
- The company's asset allocation and the correlated amount of valuation losses: this obviously depends on the amount and duration of fixed interest bonds in the portfolio.

Liquidity becomes a concern whenever the design of the products departs from traditional insurance.

In principle, the combination of the above features has the potential to impact the solvency position of companies and - on a large scale - trigger systemic effects.

What can we, as supervisors, learn from that?

First of all, experience confirmed that, even if liquidity is not in principle a primary risk for insurers, there are situations that require appropriate monitoring tools, effective preventative measures and capacity to intervene if necessary. The closer a company's business model resembles that of a bank or an investment firm, the more the typical insurance supervisory tools and practices need to be enhanced. The review of Solvency II will introduce new tools to monitor and manage liquidity risk and the IAIS, in the context of the Holistic Framework, has enhanced its prudential standards in this regard, also as a mitigation of systemic risk. It remains to be seen whether this will be sufficient. In any case, supervisors should pay attention to the companies' combined liquidity risk exposure, also considering structural and qualitative aspects such as the design of their products, their distribution model and the features of any related commercial agreement.

Also, experience has shown that the exposure to liquidity becomes a concern whenever the design of the products departs from traditional insurance. This is also connected to the wider issue of the social role of life insurance and the importance of maintaining the protection purpose at the core of the insurance business model. A life insurance market where the protection component is negligible might not only fail to fulfil the need of consumers, but also become less sustainable in the long run.

Finally, the experience underlined the importance for insurers to take all risk exposures into account in their risk governance system, including risks which are not considered in the standard calculation of capital requirements. Indeed, asset allocation or other management actions could sometimes be shaped to a dangerous extent with the only purpose to minimize capital requirements on certain risks - thereby disregarding the consequences on other risks, including those that do not imply capital requirements, such as liquidity risk.

We have to recognize, however, that the current economic context is quite extraordinary and that, despite its challenges, the insurance sector has demonstrated resilience, also thanks to its good solvency position and risk governance.