News release

Swiss Re

Swiss Re's latest *sigma* study explores how interest rates affect insurers, and why low interest rates are particularly strenuous for life insurers

Contact:

Media Relations, Zurich
Telephone +41 43 285 7171

Lukas Steinmann, Zurich
Telephone +41 43 285 4687

Thomas Holzheu, New York
Telephone +1 212 317 5190

Clarence Wong, Hong Kong
Telephone +852 2582 5644

Swiss Re Ltd
Mythenquai 50/60
P.O. Box
CH-8022 Zurich

Telephone +41 43 285 2121
Fax +41 43 285 2999
www.swissre.com

- **As large investors, insurers are all impacted by interest rates. Interest rate sensitivity varies greatly by line of business and market.**
- **For life insurers, interest rates primarily affect savings products, where investment income is a key source of profits.**
- **Non-life insurers could react to declining interest rates by raising premium rates to restore profitability.**

Zurich, 10 September 2012 — Swiss Re's latest *sigma* 4/2012, "Facing the interest rate challenge", explores how interest rates affect insurers and explains why a rapid rise in or sustained low interest rates can be a challenge. Life insurers are more impacted than non-life insurers, but even within life insurance, interest rate sensitivity varies by product, with savings business being the most affected. Consequently, life insurers must re-price their guarantees and also adjust their product offerings to mitigate their exposure to interest rate risk. Non-life insurers need to raise premium rates to compensate for low investment yields.

Interest rates have been falling for decades and are now very low
Interest rates have been trending downwards for the last 30 years, with yields on 10-year government bonds falling well below 2% recently in many markets. While the current low interest rates help over-indebted borrowers deleverage their balance sheets, not everyone benefits from them. Insurers, as large institutional investors managing around USD 25 trillion or 12% of global financial assets, suffer greatly from low investment yields. The impact of low interest rates on insurers also affects policyholders because the cake shrinks for all – translating to fewer benefits or to higher premiums for equal protection.

Low interest rates affect insurers slowly because only current premium income – a fraction of total investments – is invested at market yields. Astrid Frey, co-author of the *sigma* study says: "Interest rates have a delayed impact on insurance investment portfolios, allowing insurers time to react but also tempting them to postpone necessary remedial action in hopes that interest rates will rebound." Insurers can usually cope well with stable and mean-reverting interest rates, but sudden swings from one regime to another are a challenge to the industry.

Not all lines of business are impacted equally
Although interest rates affect all insurers, some lines of business are much more vulnerable than others. Interest rates have the largest impact on long-term business where investment income is a major source of earnings. In non-life insurance, however, the interest rate risk in long-tail business (such as casualty) can be contained through prudent asset-liability management. On the life insurance side, savings products are the most exposed to interest rate risk because investment income is the main source of profit. In addition, hard-to-predict policyholder behaviour, such as lapses, makes it difficult for insurers to project their cash flows, thus complicating their asset-liability management.

"Even within the life insurance savings business, interest rate sensitivity varies tremendously. Sensitivity to interest rates is highest where guarantees are rigid and business duration is high," says *sigma* co-author Lukas Steinmann. Policyholder options, such as the possibility of withdrawing money without penalty, can also increase insurer sensitivity.

Life insurance product design will play a key role in the future
For many life insurers, solutions to low interest rates are limited because policy terms for in-force business with generous and rigid guarantees cannot be changed. However, life insurers can optimise their asset management, hedging, and operational costs. They can also offer to exchange existing policies for new products that offer similar benefits, but are easier to hedge. Kurt Karl, Chief Economist of Swiss Re, suggests: "New life insurance products need to be re-priced and their guarantee levels adjusted, but also they should be redesigned so that they can be more easily hedged against interest rate risks. Regulators can facilitate this."

Moreover, the life industry will need to address a fundamental question: how do the economic costs of guarantees offered compare with policyholder willingness to pay for them? "Difficult-to-hedge guarantees that create little value for customers at the point of sale must be eliminated. The current low interest rate environment offers an opportunity to create a win-win situation for both insurers and policyholders, ensuring that all parties are better prepared for any interest rate scenario in the future," Steinmann adds.

Non-life insurers need to raise premium rates
The road ahead is less thorny for non-life insurers. To manage sudden rises or drops in interest rates, they can use renewal periods to re-price their products. "In the current low interest environment, raising prices would allow the non-life insurance industry to restore profitability. Non-life insurers would face bigger problems if inflation were to spike unexpectedly. Such inflation spikes are often – but not always – related to increasing interest rates," says Frey.

Notes to editors:

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The English, German, French, and Spanish versions of the *sigma* study No 4/2012, "Facing the interest rate challenge", are available electronically on Swiss Re´s website: www.swissre.com/sigma. The versions in Chinese and Japanese will appear in the near future.

Printed editions of *sigma* No 4/2012 in English, French, German and Spanish are also available now. The printed versions in Chinese and Japanese will be available shortly. Please send your orders, complete with your full postal address, to:

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