CAN PENSION FUNDS AND INSURANCE COMPANIES KEEP THEIR PROMISES?

IN A LOW GROWTH AND LOW INTEREST RATE ENVIRONMENT

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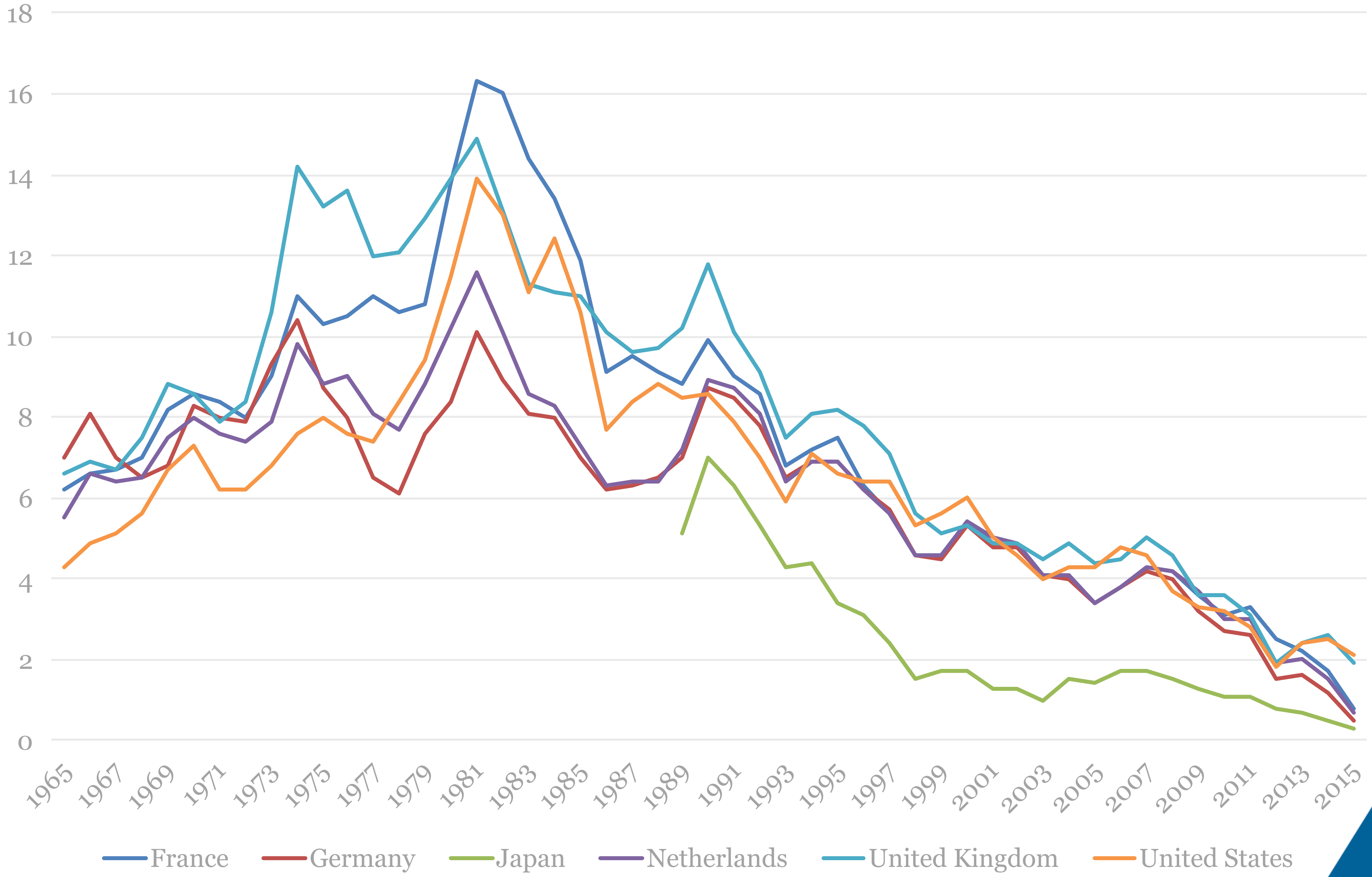
Structure of the presentation

- Low interest rates are here to stay
- The impact of an environment of prolonged low interest rates on pension funds (PF) and insurance companies (IC): solvency position
- Tools to address the challenges posed by persistently low interest rates on PF and IC
- Main concern from the perspective of financial stability: 'search for yield'

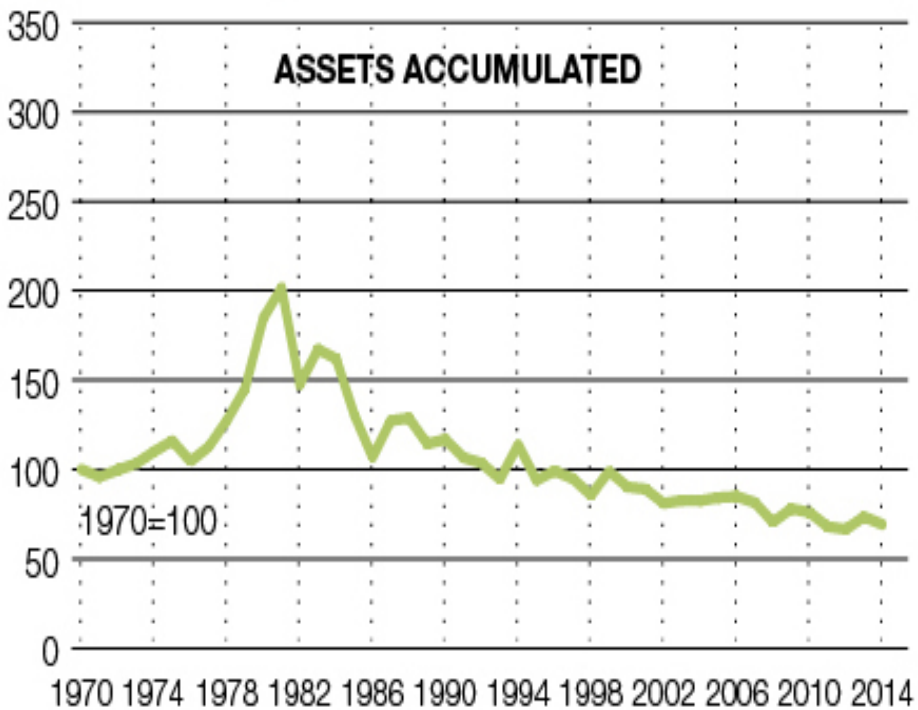
Low growth, low interest, low returns

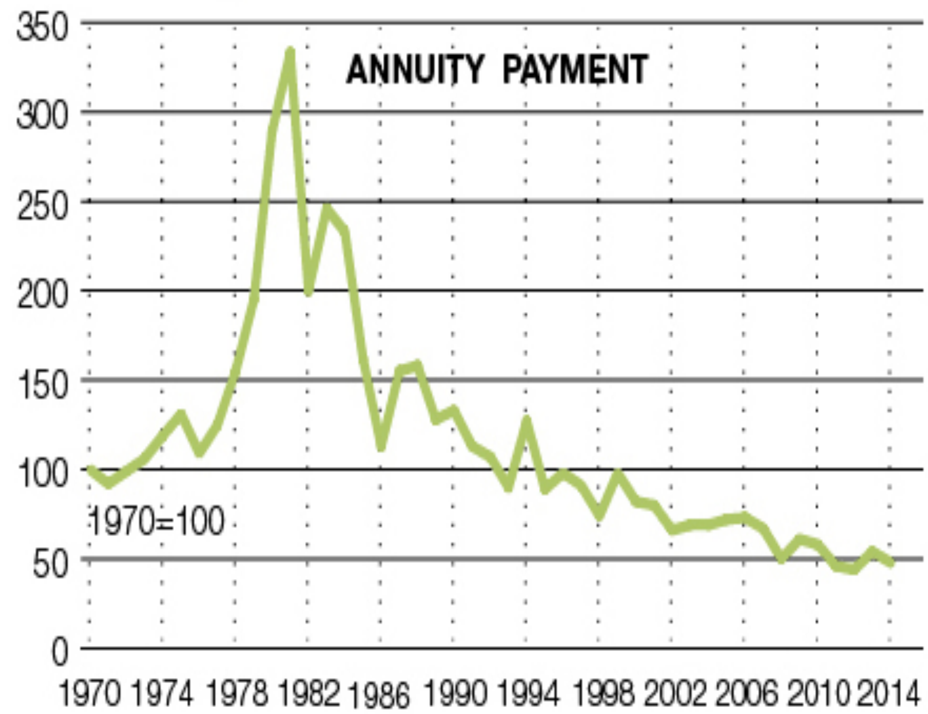
- This new world may be here to stay
- Long-term (potential growth) depends on productivity growth and employment growth
- Ageing is reducing working age population and thus employment growth
- Productivity growth low since the 1980s, except the 1995-2000 period
- Focus on productivity growth: how to?
- Pensions systems take this environment as externally given and adjust to make the best possible out of it.

Low interest rates could persist for a long time



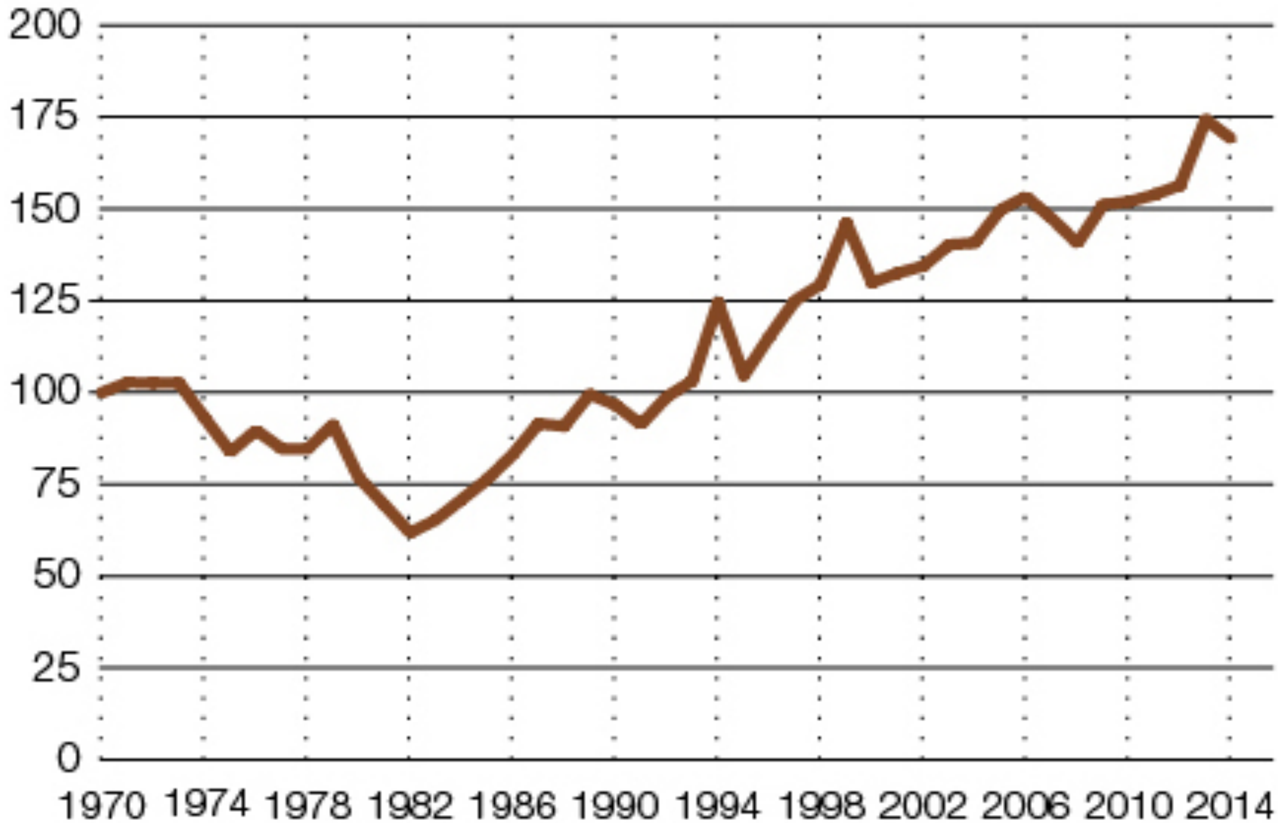
Changes in retirement income as interest rates change





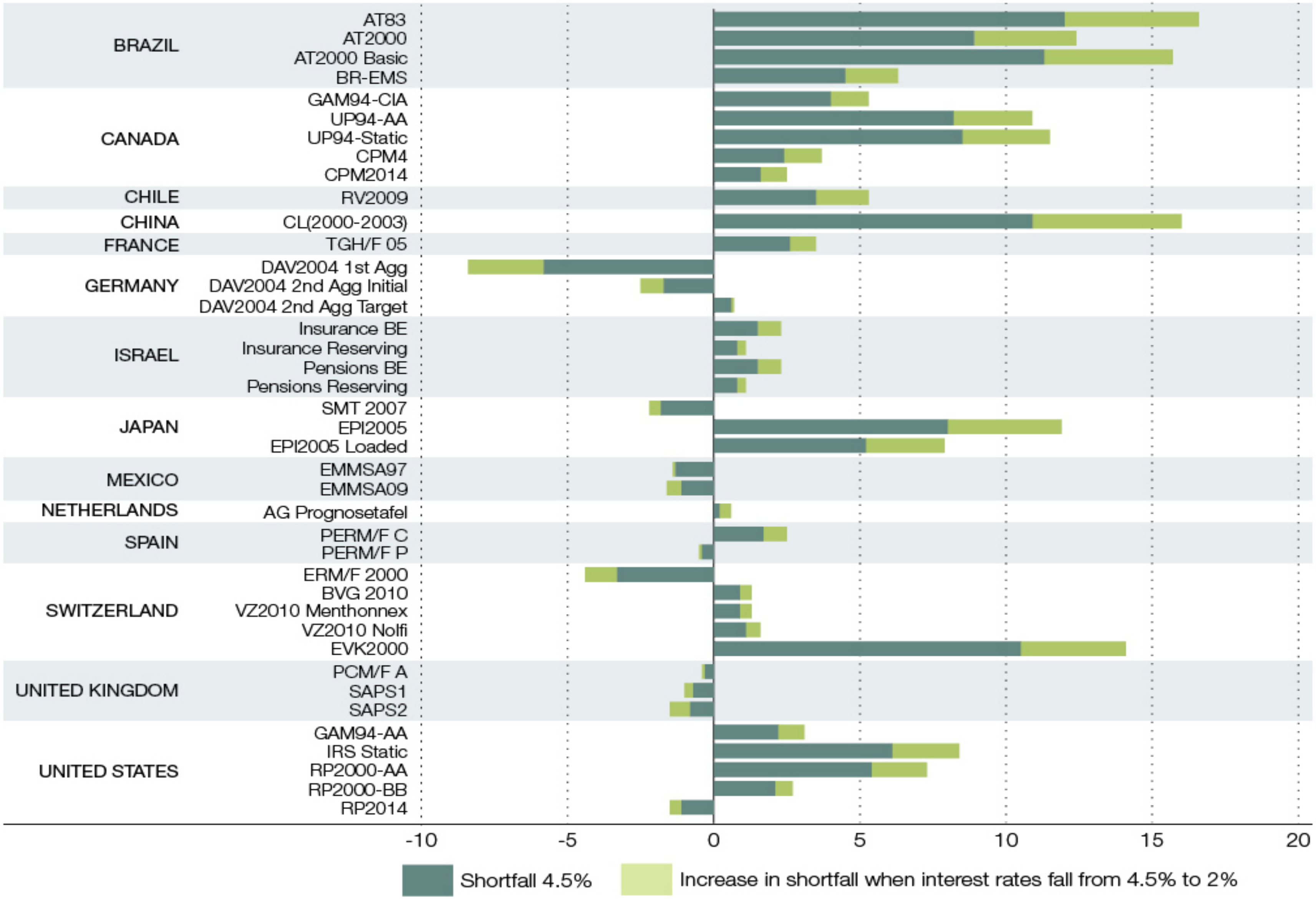
Source: OECD calculations

Evolution of the present value of a hypothetical fixed cash flow promise payable over 20 years when interest rates fall



Source: OECD Secretariat calculations.

Drop in interest rates increases exposure to longevity risk of mortality tables across countries – average shortfall for females, age 65



Source: OECD calculations using OECD work on Mortality Assumptions and Longevity Risk.

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Purpose and message

- Asses the impact that an environment of prolonged low interest rates may have on the **solvency position** of pension funds and insurance companies?
- The analysis cover DB pensions and insurance companies offering life annuities (also DC pensions)
  - DB and providers of annuities: prolonged low interest rates affects their asset and liability side (promises)
  - DC: prolonged low interest rates affects their asset side. No liabilities (unless guarantees). But prolonged interest rates may make difficult to fulfil the expectations about retirement income (crashing the system?)
- The outlook for their solvency position – degree to which current assets cover current liabilities – is one of concern as their solvency will deteriorate unless they adopt certain measures.

Outlook is one of concern

- The outlook depends foremost on the **nature of the promise** made.
  - The adverse effect of low interest rates on the liability side of pension funds and insurance companies is higher when the liabilities consist of fixed investment returns or fixed benefits or pay-out promises
- The **current value of assets** will fall. The magnitude of the fall depends on the share of their portfolio invested in fixed income securities.
- Moreover, as the **duration** of assets tend to be lower than the duration of their liabilities, they run the **re-investment risk** if interest rates and returns remain low for long.

Outlook is one of concern

- Prolonged low interest rates will increase the potential impact of longevity risk on pension funds and annuity providers: long-term impact with higher weight to future liabilities
- Annuity providers will increase annuity premiums reducing the amount of retirement income that the same pot of money can buy.

Tools to address the challenges posed by persistently low interest rates

- Necessary to distinguish between future retirees and new contracts, and current retirees and current contracts
- On new contracts and future retirees the obvious recommendation is to alter or adjust the promise
  - Alter the terms of new policies (lowering gurantees) thereby progressively lowering liabilities
  - adjust retirement promises to given contributions and new values of different actuarial parameters (e.g. life expectancy, interest rates, returns)
  - Many countries have already allow pension funds discretion regarding the level of indexation of pension promises and can sometimes adjust accrued benefits.

Tools to address the challenges posed by persistently low interest rates (current)

- In exceptional circumstance, insurers and pension funds may need to renegotiate or adjust existing contracts and promises.
- Pensions and insurance supervisors should step up monitoring. Policymakers should avoid putting excessive pressure on institutions to correct funding deficits at a time of market weakness (regulatory forbearance)
- In the case of DB pension funds, pension-plan sponsors – and where relevant, plan members – could increase contributions to the pension fund.

Main concern from the perspective of financial stability is “search for yield”

- The extent to which insurers companies and pension funds will seek higher yields via riskier investments in an attempt to match the level of returns promised to beneficiaries or policyholders
- Regulatory framework has an important role to play here:
  - Make sure that higher capital reserve requirements when increasing the risk profile of their portfolios are enforced to prevent excessive “search for yield”

Main concern from the perspective of financial stability is “search for yield”

- The data available (GPS) suggest that there has been a large increase in the amount invested by pension funds in alternative assets (more than 7 trillion US$ end 2014 from just over 2 trillion end 2001)
- However, as a percentage of the portfolio of pension funds, the increase is around 5 percentage points on average for OECD countries.
- The increase in the percentage of pension fund portfolio invested in alternative assets in the UK has increased from 15% in 2001 to around 40% end 2014

THANK YOU VERY MUCH!

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