SYNOPSIS

How Can Life Insurers Optimise Customer Outcomes in a Low Yield World?
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Key words: Low interest rates life, insurance, customer outcomes, retirement, saving, government, reserve bank, ALM

Purpose of your paper: This paper looks at the potential implications of low interest rates on Australian life insurers and the future outlook under different economic scenarios and makes comparisons to the situation in Japan and Germany.

Synopsis:
In the aftermath of the 2007-2008 global financial crisis, many prominent developed economies including the US, Germany and the UK have seen interest rates drop to unprecedented low levels. In fact, interest rates on 10-year government bonds in Germany turned negative in July 2016. Australia has not been immune from this, with interest rates setting new historical lows across the term structure throughout the first half of 2016 and potentially into 2017.

If interest rates remain low for decades to come this will impact the profitability and viability of a range of products with embedded guarantees, the vast majority of which were developed at a time when assumptions relating to interest rates and investment returns were much higher.

Life insurance companies will need to carefully consider the legal implications of actions they take to manage the situation – especially those relating to policyholder reasonable expectations. In several other markets companies have responded in a number of ways:

- Accepting a lower level of return on these business lines
- Increasing premiums and making policy terms less generous over time in order to reflect the current economic climate
- Reducing guaranteed benefits, with government approval, in order to remain solvent
- Hedging interest rate risk using derivatives in order to protect against further interest rate cuts
- Investing a larger/lower portion policyholders' premiums in riskier asset classes with higher expected returns

Such actions have a range of potential impacts on customer outcomes, and overall tend to shift some of the problems of lower interest rates and investment income from shareholders to customers. Those customers who can afford increased premiums and lower returns may choose to delay consumption today in order to ensure they have adequate savings to sustain them in retirement. Those who cannot afford to may extend their working lives or go back to work after they have retired. Some policyholders may choose to accept a lower level of guaranteed benefits relative to their premiums and invest more into riskier assets.

These concepts and issues will be explored thoroughly in this paper using a case study approach by looking at how companies in other life insurance markets have been dealing with this problem of chronically low interest rates. In doing so we will also look at emerging trends in these markets, with a particular focus on how insurance professionals are thinking about this problem differently and coming up with novel solutions. By evaluating the approaches used in these markets, we intend to "think differently" about the issue of ongoing low interest rates their impact on customers and life insurance products in order to co-design optimal outcome with customers, while at the same time preserving company stability and shareholder's return on investment.

This paper will consider:

- The likelihood of prolonged low interest rate environment given central bank's interest rate policy and inflation targeting credibility
- Possible management approaches for guaranteed life insurance products should interest rates remain at historically low levels for decades,
- Possible risk sharing mechanisms, management actions and their impact on consumer outcomes.
- How life insurers can think differently about the way these products are managed and developed in order to optimize customer outcomes without undermining their stability or shareholder returns?
- How might customers begin/need to think and act differently if interest rates remain low for decades and how can life insurance companies think differently to address these changes:
    - Can young people, simply start saving from an earlier age in order to achieve their desired quality of life in retirement
    - How might the pooling of mortality/longevity risk provide customers a buffer against the impact of reduced returns?
    - What mindsets/skills/tools might customers need to effectively manage the challenges of pooling/not pooling risks?
- How do different approaches to solving this problem stand up to differing economic environments?

Ultimately, if the life insurance industry is to play a continuing role in optimizing customer's retirement outcomes and protecting their family's financial security we need to begin thinking differently about how to respond to chronically low interest rates, which pose a substantial challenge to these goals.