KPMG

Negative Interest Rates: From possibility to reality?

Many areas within insurance companies and pension plans may be impacted. Are you ready?

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Introduction

Where are interest rates going? As a company, have you considered and prepared for an environment of negative interest rates?

– We are experiencing a prolonged environment of very low interest rates, which is reinforced by the global economic recession induced by the COVID-19 pandemic that started in the early spring of 2020.

– Countries in Europe and Asia have experienced negative interest rates situations for many years and have instituted a Negative Interest Rate Policy (NIRP). The primary reasons for this have been economic stimulus, currency stabilization and stabilization in the national current accounts.

– The falling interest rates in current markets impose challenges for the modelling of market consistent valuation of financial options and guarantees inherent in insurance products and pension plans.

– The negative economic impact of COVID-19 may be more severe and last longer than anticipated.

– Negative interest rates, where not already in use, may be the next lever used by central banks.

Prevalence of Negative Interest Rates

Negative Interest Rates recent history

1. **A Negative Interest Rate Policy** (NIRP) is a policy tool that primarily **aims at economic stimulus**, **and currency stabilization**. The exercise of that monetary policy is extensively **utilized by central banks in Europe** (Denmark, European Central Bank (ECB), Sweden and Switzerland) and **The Bank of Japan**, **since 2012**;
2. As a result, jurisdictions with NIRP have experienced **widespread reductions in interest rates** - government and corporate bond yields, deposit rates and loan rates for individuals and businesses;
3. The NIRP has been maintained since its introduction in four out of five jurisdictions. Sweden ended its negative interest rate stance in 2019. As of May 2019, the rates ranged from a high of **–0.05%** in Japan to a low of **–0.75%** in Switzerland;

Are Negative Interest Rates coming to Canada?

1. **Before COVID-19**, interest rates were at a relatively low level
2. Vast fiscal stimulus packages are in place and yet **economy is stalled**
3. **Reduced global demand and supply**
4. **Long period of economic downturn** with **great uncertainty about recovery**
5. **Little room to reduce interest rates** and **monetary policy** may become **ineffective**
6. Allowing interest rates to become negative provides governments **an additional tool to stimulate the economy**
7. **Downturn unlikely to have short duration** thereby encouraging governments to institute NIRP
8. Generally applicable for a small range below zero rates. **Beyond a certain limit**, **negative interest rates may become contractionary**.

Assisting you with Negative Interest Rates: Life Insurance

Here are the services we can help you with in a NIR context:

Stochastic modeling of financial options and guarantees:

- Including key scenarios
- Discount factors and payoffs with Monte Carlo simulations
- Effectiveness of hedging policies
- Setting rate guarantees

Product design and pricing support:

- Setting of the credited interest rate
- Setting rate guarantees
- Fund offerings
- Target premiums

Capital analysis and stress testing support:

- FCT scenarios with sustained period of negative interest rates
- Assessing risk appetite
- Revising internal target capital ratios

Peer review decisions of insurers:

- Capital management strategy
- Policyholder dividends
- Asset liability management

Valuation support:

- Surveys about lowest CALM scenarios and anticipated actions
- Revision to valuation interest rate assumptions

Enhancement to liquidity plan:

- Mapping cash cycles
- Developing early warning indicators
- Monitoring and updating forecasts

Calibration and validation of market-consistent valuation models from audit perspective:

- Models permitting negative interest rates
- Real-world and market-consistent scenarios

Sustainability of Pension Plans

-1% Discount Rates

- Pension Plan discount rates are at near all-time lows.
- In order to hedge against interest rate declines, many plans have implemented de-risking strategies, such as
  - asset/liability matching, and
  - settlement through the purchase of annuities from external insurance companies.

+ ~15% Pension Obligations

- Decreases in rates cause decreases in income and higher balance sheet obligations for plan sponsors.
- For Canadian plans for which solvency funding is required, cash funding requirements have increased significantly.
- Declines in discount rates (coupled with increases in longevity) have made defined benefit pension plans very expensive and, in some cases, unsustainable.

We at KPMG would be pleased to assist you:

- To establish your needs
- To provide insights and analyses about what we hear and see in the market
- To guide and help you making the changes you want/you need

Contact us

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