S P E E C H

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A unique environment – how does it affect our supervision?

As Finansinspektionen (FI) has indicated on previous occasions, we are currently experiencing extraordinary economic conditions. This affects all actors on the financial markets, even private individuals. Today I will primarily focus on how the macroeconomic trends and developments on the asset markets affect the insurance market and insurance companies, in particular companies that offer long-term saving products with financial guarantees, and how FI needs to handle this in its supervision.

We are not only currently experiencing extraordinary conditions, but in many respects we are also in uncharted territory. Many developed countries have been experiencing weak growth and low inflation since 2008, which has contributed to the central banks in many countries undertaking an expansive monetary policy with extremely low, and in some cases negative, policy rates and extensive purchases of treasury bonds. Sweden stands out with its strong economy and strong growth, but it also has extremely low interest rates. This a unique combination of circumstances in which we have limited experiences.

Monetary policy has affected the entire fixed-income market and the possibilities for generating returns on this market. For insurance companies that offer long-term savings products with financial guarantees, the falling interest rates and a mismatch between commitments and the interest-bearing assets has meant that the size of their commitments has increased more than the value of their interest-bearing assets. At the same time, the equity market has demonstrated extremely strong growth over the past few years, with an average annual growth rate of 10 per cent or more. At the same time, this means that companies in many cases have been able to achieve good total returns, despite lower returns from their fixed-income portfolios.

In terms of liabilities, the low interest rates have meant that the value of insurance companies' debt has increased. But the rules for the discount rate curve – which is based on market rates and an assumption of a long-term equilibrium interest rate of 4.2 per cent – mean that the effect of low interest rates is not fully reflected in today's debt valuation.

We are able to determine that, as a whole, despite the development in interest rates in recent years, the combination of rising equity prices and liabilities measured using partly modelled interest rate assumptions paints a positive picture of the solvency of insurance companies.

FI believes that both the stability and predictability of a model-based, long-term equilibrium interest rate play an important role for companies with long-term commitments, and thus also for their customers. By to some extent releasing the measurement of long-term commitments from market rates, companies face better possibilities for applying a long-term investment strategy. This not only benefits companies and their customers but also has a positive impact on the markets and other market participants by reducing the risk of procyclical behaviour.

However, we must also be aware that a model-based interest rate introduces real economic risks. When prevailing market rates remain under the modelled rate for a long period of time, there is a risk that companies will systematically underestimate the size of their commitments. There is also a risk in such a scenario that companies will not face sufficient incentives to adapt their products and their business concept to the existing economic risks. Since these risks are not fully reflected in the legal solvency reporting, it is possible that non-sustainable products and business models can be hidden for a long time. This could introduce problems not only for pension savers, who might not get the pension they were promised, but could also affect financial stability if many companies are forced to simultaneously react to falling solvency levels. Firms manage more than SEK 2,000 billion in savings products with guarantees, which corresponds to approximately half of Sweden's GDP. The actions taken by these firms are therefore important.

What am I trying to get at with this? The market rates and the market's expectations regarding the change in interest rates indicate that there is a discrepancy between the assumptions in the model and the actual economic conditions. Both the firms and FI therefore need to consider which risks this may lead to, and how these risks can and should be best managed. A modelled equilibrium interest rate aims to reduce volatility in the firms' debt valuation and enable a more long-term investment strategy, but the model needs to agree with reality over time if it is to be appropriate and credible.

Today's equilibrium rate is based on assumptions of a long-term real interest rate of 2.2 per cent and inflation of 2 per cent. This rate is used in both Solvency II and the national rules that apply to firms with occupational pension activities. The assumptions are based on historic data and experiences. The major question is whether we can assume that our past experiences are representative of the future? Or, in other words, can we expect to see a return to historic averages for real interest rates and inflation or are we in the middle of a paradigm shift? This is a contested topic these days.

Within Europe, a discussion is currently ongoing about whether the level of the long-term equilibrium rate used in Solvency II needs to be adapted to the current interest rate level. Some are questioning quite simply if the calculation method and assumptions that serve as the basis for the current level are reasonable. Of course, the underlying problem is that no one knows what will happen as far into the future as we are discussing here.

I do not have an answer for what an appropriate level for the equilibrium rate would be in the model, but I can say that both FI and the firms need to take into account both the requirements in and the conditions for the regulations as well as the current economic reality. How does the current situation affect firms' actual capacity for meeting their commitments and their risk management? And how are they affected if the low interest rates persist? Neither you nor we can predict the future, but we can look at the current reality and analyse the current conditions, as well as the expectations regarding future conditions, and reflect on what they mean, both for insurance firms and the market. Today, but also in the future.

Even if we have seen a slight increase in the market rates lately, they are expected to remain at historically low levels for the next few years. At the same time, we cannot expect, and neither should we rely on, the stock markets continuing to show as strong growth as they have done in recent years. It is more reasonable to assume that sometime in the future we will see a return to an average risk premium on shares that over time is lower and more at a level that we have seen historically. Of course, this can happen in different ways, through either a gradual stabilisation or sharp corrections. Either way, such a development will affect firms' returns and their solvency.

The problems and risks of low interest rates over the long term can be illustrated in several ways. The diagram in the slide shows the results from the European stress test in 2016, which included the largest Swedish life insurance companies. The initial calculation of the solvency ratio, calculated under full Solvency II, is 199 per cent. Under a stressed scenario where low interest rates persist for a long time and the long-term interest rate is reduced to 2 per cent, the solvency ratio falls to 155 per cent. This scenario also corresponds well to current levels of market rates.

Even if the stressed outcome still comfortably exceeds the requirement of a solvency ratio of 100 per cent, the solvency is significantly weakened. This illustrates the underlying economic problem, namely that a stable interest rate in and of itself is not sufficient for firms to maintain their current solvency ratio if the actual return simultaneously falls below the expected return on the discount rate curve.

In the next slide we have assumed the low interest rate scenario from the previous slide and conducted several simple simulations. I would like to once again emphasise that the scenario corresponds relatively well to current market

rates. Under an assumption of an annual return on other, non-interest-bearing assets of 4 per cent, we see a development where solvency is strengthened from a ten-year perspective. If prices on other assets were to fall 35 per cent, for example if the stock market were to crash, solvency would fall below the capital requirement. In such a situation, firms may be forced to reduce the share of risky assets that they are holding and invest in interest-bearing assets, which potentially could further aggravate the problems. As I mentioned earlier, this can also have an impact on financial stability.

I would like to underline that the simulations are based on several assumptions and they should not be viewed as forecasts. What they show, however, is the importance of the return on other investments for firms' solvency ratios if interest rates continue to be low. Even if the calculations do not correspond to the legal capital requirement, they reflect economic reality.

In conclusion, in my view, the firms in the pension industry must handle major challenges in the future. Being able to meet their commitments in a scenario that includes both long-term low interest rates and declining asset prices places considerable demands on their risk management. It remains to be seen what will happen on the fixed-income and asset markets in the future, but it is entirely possible that in several years these firms will not appear as financially strong as they are today. This is an issue that FI is wrestling with, and an important reason why FI conducted an overview of its traffic-light model last year.

We have said it before, but it is worth repeating - the traffic light model has been an important tool in FI's supervision of the insurance sector and it also continues to be an important tool in our supervision of firms that conduct occupational pension activities. But FI has identified a number of deficiencies in the model, deficiencies which in several respects are related to the model not being fully adapted to the market conditions we are currently experiencing. This means that some of the firms' risks, and thus their need for capital, are being underestimated. For example, negative interest rates are a reality today, but the traffic-light model applies a floor to the calculation of the discount rate that prevents the use of negative interest rates. FI also makes the assumption in the model that financial risks are not correlated, an assumption that on several occasions has been proven to be incorrect. As a whole, the traffic light model risks generating a misleading estimation of a firm's actual risk level in a stressed scenario.

At the same time as we saw a need to correct the model's deficiencies, we were also able to note that, in practice, the traffic light model is perceived to be a capital requirement. Changes that result in a significant increase in the capital requirement can thus have potentially large effects on the concerned firms' asset allocation as well as the Swedish capital markets. FI therefore decided not to proceed with the proposal that was submitted for consultation. When making this announcement, we also emphasised the importance of managing the

deficiencies in the current model. In other words, we need to find other ways to be able to fulfil our supervision assignment and make it possible for us to identify and start a dialogue on time with firms that we believe may have difficulties to fulfil their commitments in a stressed scenario in the future.

The fact that we are choosing to move on to a new approach does not mean that we are relaxing our focus on ensuring that the firms have satisfactory risk management in the current market conditions. For obvious reasons, a good, competitive return on customers' deposited pension capital is very important for both pension savers and society. A balance between security and risk-taking is therefore necessary. However, this does not mean that difficulties in creating returns in a low-interest-rate environment or structural imbalances in the Swedish capital markets that make it difficult for the sector as a whole to manage interest rate risks are reason enough for FI to compromise the protection in place for pension savers. Quite the opposite, really. It is the responsibility of the firms to manage their risks given the economic circumstances, in part by reviewing the design of their products and analysing the risks associated with their bonus model. A firm should be able to meet its commitments regardless of the market conditions. This is the commitment the firm has undertaken.

In order to obtain a satisfactory overview of the actual risks to which the concerned firms are exposed, we will therefore request information during our ongoing supervision about exposures to both financial risks and certain insurance risks. With this information we aim to be able to identify risks and circumstances that are not captured in the traffic light model. The first request for information, which refers to Q1 2017, focuses on firms' exposure to interest rate risk. By analysing the firms' sensitivity to interest rate risk when comparing the traffic light model to the application of market-based discounting rates, FI will be able to gain an understanding of how changed assumptions in the discount rate curve affect a firm's solvency.

An important lesson that we take with us from the overview is that there are important stability aspects to consider even in the occupational pension sector. The consultation feedback FI received indicates that the occupational pension sector's importance for the Swedish financial system needs to be investigated and discussed in more detail. An important issue is to look more closely at how firms handle the structural imbalances on the Swedish capital markets and what this means for the sector's impact on markets under stressed conditions. We will need to return to the risks in the occupational pension sector and how these should be reflected in laws and regulations when the Ministry of Finance prepares new legislation for occupational pension providers.

I would like to conclude by link back to the importance of having a balance between security and risk-taking in another part of the pension savings, namely the premium pension system. The Ministry of Finance has recently received the consultation comments on its *Fokus premiepension* report, which was tasked with reviewing the rules for selecting funds in the premium pension system.

The investigation stops at measures to reduce the risk of savers remaining in old fund selections, but does nothing about the options themselves. Past experience shows that there are too many funds. And there are also funds that are too risky and too expensive. We have also noted that there are too many participants on the market who try to get savers to invest in these inappropriate and expensive funds. It must be easier to do the right thing and more difficult to do the wrong thing, whether making your own decisions or following dishonest advice.

In our consultation response we emphasise the paradox that the government, in a system that is based on coercion when it comes to how much must be saved, turns over to the individual the responsibility of determining the balance between risk and return. As FI writes in its response, if there had not been any doubt about the individual's ability and willingness to adopt a long-term approach to sustenance in the later years of life, there would be no reason to have a national pension system. But this consideration also needs to be reflected in the individual's ability to choose funds. Both past experiences and grounds of principle indicate that the fund selection should be reduced to a few, standardised funds.

I am aware that the topic of limited options is an oft-debated one, but if everyone is to be able to receive a reasonable premium pension, it must be easy to do the right thing. Fewer funds are an important step in reaching this goal.

Thank you!