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European Life Insurers Are Playing The Long Game With Product Shifts

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European Life Insurers Are Playing The Long Game With Product Shifts

Life is tough for Europe's life insurers. Persistently low interest rates are squeezing already tight margins and making it difficult to cover rising capital requirements from prudential regulation. To combat these challenges while meeting customers' demands in this highly competitive market, insurers are rethinking their game plans and product offerings. Many are making a clear shift toward so-called "capital-light" products, such as unit-linked (UL) products or products with lower or no guarantees, with the aim of consuming less of the required capital holdings under Solvency II regulations.

Yet reducing product risk--that is, exposure to earnings volatility stemming from inherent product features--won't be a quick win. While life insurers can theoretically adjust their product offering relatively swiftly, market dynamics, as well as policyholder needs and expectations, may slow the uptake of capital-light products. What's more, life insurers' heavy back books, which are embedded with guarantees, will continue to weigh insurers down. Reducing their product risk will be like trying to turn around a supertanker--slow going. It will likely be years, or even decades before insurers see product moves translate into technical provisions with reduced guarantees in their back books and stronger risk profiles. For some insurers, this payoff might come too late.

Life insurance markets within Europe are taking various approaches to adapting their product strategies to these challenges. In this article, we will discuss their impact on the insurers' back books and their creditworthiness.

Overview

- European life insurers' product risk varies considerably in its forms across markets, but we believe that risks stemming from high guarantees will remain the most prominent for insurers in markets dominated by traditional savings policies.
- We expect that the trend toward capital-light products to counter low interests and higher capital requirements will continue, but we believe it will take years or even decades for insurers to realize the desired strengthening of their risk profiles.
- For some life insurers, this product shift might be insufficient to solve current challenges.
- In our view, product risk will remain a key factor in our overall assessment of many European life insurers' creditworthiness.

Product Risks And Strategies Vary Across Markets

Although European life insurers face similar macroeconomic and regulatory pressures, we consider that their product risk varies considerably by country--both in severity and the type of product risk to which they are exposed. These differences stem from insurers' varying historical product offerings, their development over decades in the individual markets, and often from political interference.

For example, Germany, the Nordics (refers to Denmark, Finland, Norway, and Sweden in this article), the Netherlands, and Switzerland all face significant guarantees on their back books (see table 1) and with it asset-liability mismatch (ALM) risk, or more general interest rate risk. Conversely, in the U.K., we see longevity risk as the prevailing type of product risk, and in Italy and France surrender risk.

Table 1

European Life Insurance Markets' Back Book Composition And Product Risk Scores

Country	Total technical liabilities including UL* (€ bil.)	UL technical provisions (% of total technical liabilities)*	Average guaranteed rate on back book (%)	Observed guarantee rate new business (%)	Product risk†
U.K.	2,083	66	N.A.	N.A.	Neutral
France	1,956	16	0.50-1.00	0.00	Neutral
Germany	1,306	9	2.50-2.90	0.90	Negative
Italy	667	21	1.20-1.30	0.00	Neutral
Netherlands	364	27	3.5	N.A.	Negative
Denmark	327	42	2.50	0.00-0.50	Negative
Switzerland	232	6	1.80-1.90	1.00-1.25	Negative
Sweden§	199	56	3.00	1.00	Negative
Spain	185	9	2.50-3.00	0.00-1.00	Neutral
Norway	133	20	2.8	2.00	Negative
Finland	57	60	3.00-3.50	0.00-1.50	Negative

Source: S&P Global Ratings, EIOPA, FINMA, European Supervisory Authorities, European Insurer Associations. *Switzerland as per 2016; other countries as per Q2 2017. §Contracts can offer a guarantee of 85%-100% of gross premiums paid. †Product risk is reflected in our Insurance Industry And Country Risk Assessments. UL--Unit-linked. N.A.--Not available.

That said, we note that there are different concepts and approaches for determining the "duration" of assets and liabilities, particular on the liabilities side. This makes comparing durations and their mismatch very difficult. For instance, while the European Insurance and Occupational Pensions Authority (EIOPA) in its 2016 Stress Test Report indicated that Germany and the Netherlands displayed one of the longest liability durations, exceeding the asset duration by a wide margin, EIOPA did not state any explicit duration mismatch. As such, in this report, we will refer to ALM risk cautiously, and focus also on more general interest rate risk. In general, we consider risks stemming from high guarantees as the most severe product risk, particular in the current low-yield environment.

The Market Shift Toward Capital-Light Products To Continue

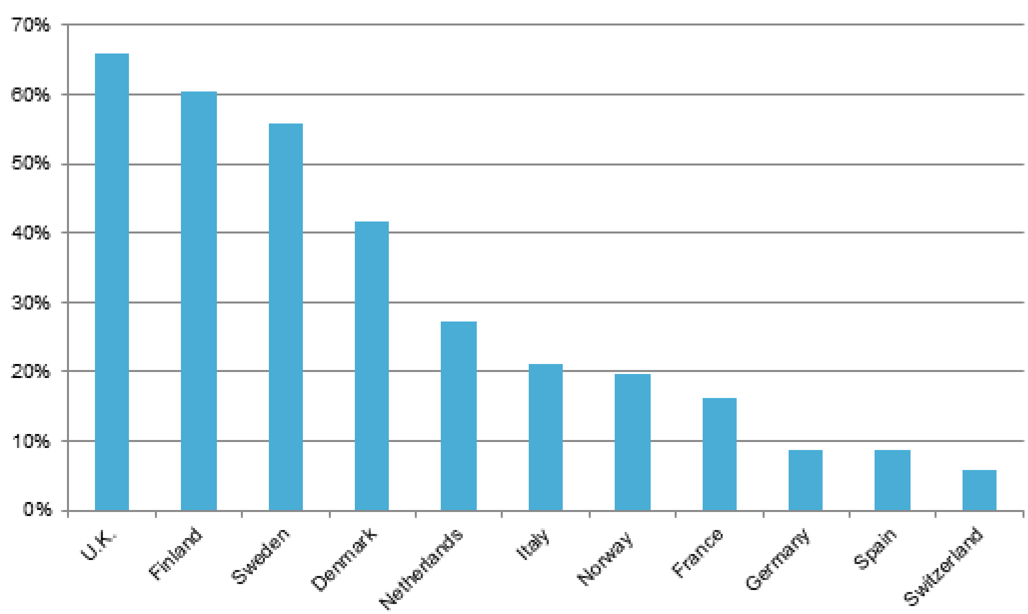
In response to rising product risk, we are seeing European life insurers make a clear shift in their strategies toward capital-light products. These offerings include savings products with reduced or no guarantees, UL products, and pure biometric products, such as risk term or disability products. At the same time, many insurance companies have stopped selling traditional savings products with guarantees, and put their existing portfolios of them into run-off, or sold them to run-off platforms. As such, run-off platforms, which a few years ago were active mainly in the U.K., are now gaining business in Continental Europe, particular Germany. Following in the example of the large-scale U.K. resolution, which started to take place from the early 2000s, German run-off platforms, such as Viridium Gruppe, Frankfurter Leben-Gruppe, and Athene Lebensversicherung AG, have recently started to gain traction.

There are numerous reasons for this shift in the market, in our view. Solvency II requirements, which came into force in 2016, incentivize capital-light products. What is more, given the low-interest environment, promised guarantees to policyholders constrain current and future earnings. We also see increasing customer demand for biometric products, specifically disability products, in Germany. These products require less risk capital, and their profits (i.e., the margins between actual and assumed [prudent] actuarial assumptions) are to a large extent independent of the economic environment. Regarding savings products, we believe that customer preferences are characterized by partly divergent goals: the desire to attain somewhat high yields (e.g., above inflation rate), while still having guarantees and in many cases maximizing tax benefits.

We believe the trend toward capital-light products will continue, particular in markets with capital-intense products, which inherently have heightened ALM or longevity risk. However, it will take time before insurers start to see the benefits of this shift in products in their back books. This is important to note, as regulatory solvency requirements are heavily influenced by the structure of technical liabilities. From our view, the trend toward savings products with reduced guarantees or UL products is widely accepted by customers, however, there are differences between the individual markets (see chart 1). We will explore below in our "Country Spotlight" section the individual markets and their approaches to manage and alleviate mounting product risk.

Chart 1

Amount of Unit-Linked Technical Provisions Per Market



Source: Switzerland (FINMA) as per 2016; other countries (EIOPA) as per Q2 2017. In all markets except Switzerland the split is derived from Solvency II values and may deviate for some markets to ratios based on local accounting regimes due to valuation differences.

Product Risk Remains A Critical Factor In Our Ratings

In a number of Western European life insurance sectors, the market environment is negatively influenced by product risk.

While some insurers will likely reap benefits from their new capital-light course further down the road, for others the alleviation might come too late. We consider that product risk, in its different forms, remains a key factor in our overall assessment of many European life insurers' creditworthiness. That said, we don't expect any immediate impact on our ratings for European life insurers from mounting product risk.

We note that changes to a life insurer's product portfolio can influence how we assess product risk in our ratings in several ways, for example: Reducing ALM or longevity risk would likely lead us to strengthen our view of the company's risk position and be a rating positive. At the same time, if an insurer made themselves attractive to customers and achieved an efficient cost structure, this could lead us to consider that they have a competitive advantage.

For instance, we consider that Zurich's early adoption of a clear focus on capital-light products, such as UL and protection, has given it a competitive advantage. We also consider life insurers with a competitive asset-management subsidiary as better off, since they capture margins both on product and on structuring. For instance, our ratings on Allianz take into account our view that its business risk is strengthened by the material earnings diversification provided by its asset manager.

For a more in-depth analysis of how we assess the creditworthiness of individual life insurers, how they have adapted to current market conditions, and how we expect they will fare over the next two to three years, see our ongoing surveillance reports on specific entities.

Country Spotlight

U.K.: Business Is Diversifying, But Longevity Risk Remains Significant

U.K. life insurers have recently been through a period of major change due to government reforms, with more likely to follow in light of Brexit. Recent reforms include:

- A ban on commissions for retail investment sales. From this, we have seen a big drop in commissions paid by life insurers, and a significant change in the assets advisers are recommending to clients (for e.g., the sale of UL bonds has slowed). The biggest winners of the reform have been investment platforms that allow customers to hold several types of investment products on the same system. Assets held on such platforms have increased, and this trend is not necessarily bad for life insurers, as many own platforms themselves.
- The Pension Schemes Act 2015 (so-called "pension freedom" act), which has given people significantly more control over their pension savings. The most dramatic change is that people can now access their defined contribution pension as they wish from the point of retirement, and use it as they wish. Traditionally, people were forced to buy annuity with their pension savings, and accordingly we've seen a material drop in individual annuity sales since its

implementation.

- Auto pension enrollment, which provides employees with an easy way to save toward retirement and has driven growth in group pension plans.

For the most part, insurers have successfully adapted to these changes. We believe their business models are now more diversified, and consider that fee-based business accounts for a higher portion of earnings and exposure to interest rate risk is lower than before. In our view, insurers have been responding to consumer demand and leveraging new opportunities by offering flexible savings products. Having a greater array of product options has increased the need for advising consumers, and retirement planning is receiving greater political attention.

Products in the U.K. are now mostly UL and sold without guarantees. In fact, more than 60% of the sector's reserves are UL, one of the highest rates in Europe, which we view as a positive (see chart 1).

Consequently, we regard the sector's ALM risk as low. U.K. life insurers have a strong track record of minimizing ALM on nonprofit business, which has clear solvency capital benefits. Low ALM risk is also greatly supported by the wide availability of fixed-income instruments with sufficient duration to match insurance liabilities in the U.K. In addition, insurers have taken significant risk-management actions in the with-profits business over the past decade aimed at reducing risk in portfolios and increasing the use of hedging.

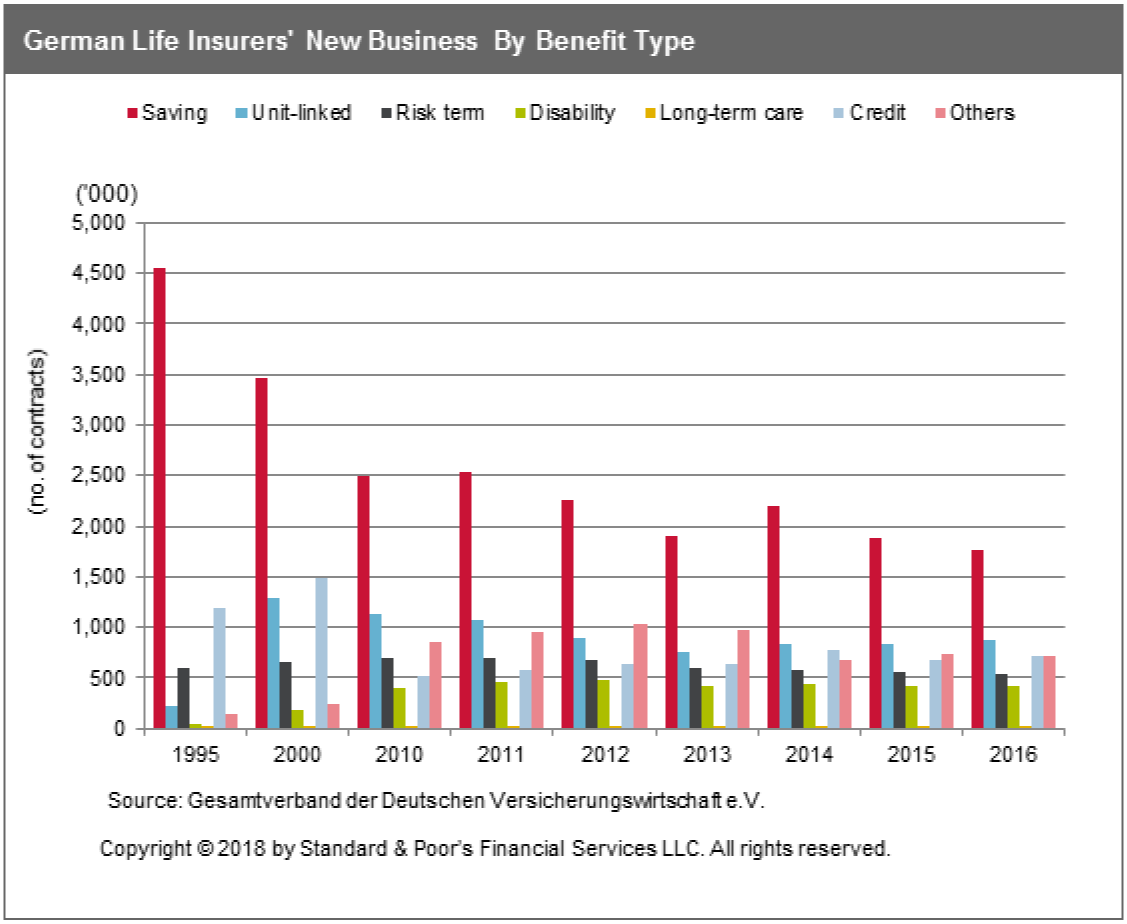
Offsetting this, we regard longevity risks as material, given the historical importance of annuity products in the U.K. We also consider that insurers are exposed to persistency risk, namely the risk of customers lapsing or surrendering their policies. Historical sales of individual annuities mean that longevity risk will still be material in the future. However, we see longevity risk being increasingly transferred to the reinsurance market, although the total amount ceded (while increasing) remains a small proportion.

We expect that the U.K. product universe will continue to change over the medium term. Due to increased pension freedom and customers' increased awareness of savings and retirement planning, we are seeing a sustainable reduction in the sale of individual annuities and greater emphasis on more flexible options, such as income drawdown, together with equity release policies (i.e., allowing borrowers to release some equity tax in their property without sell it and moving house). That said, we don't believe these changes will alleviate U.K. life insurers' longevity risk in the next few years, and expect to only see a gradually decline in this risk, due for example to a trend reversal in life expectancy, indicated by the U.K. actuarial association's recent update of their actuarial assumptions and longevity tables in 2017.

Germany: Measures Against Heavy Guarantee Books Have Side Effects

In German life insurance market, we have seen a significant shift in new business toward capital-light products in recent years (see chart 2). However, insurers' technical liabilities are still dominated by traditional savings products with guarantees. UL products, for example, contributed merely about 8% to overall technical provision, and have only increased slightly in recent years. This is rather low compared to the U.K. life market for instance (see chart 1).

Chart 2



Furthermore, the average guarantee in German life insurers' books--which stood at about 2.5%-2.9% at year-end 2017--has only slightly decreased in recent years (about 0.05%-0.15% per year based on our estimates). Moreover, guarantees are usually life-long, do not have repricing options in the accumulation phase, and have to be provided on a yearly basis (and not only at the maturity of the contract, as is the case in the Spanish life insurance market). Combined with the long maturity of insurance contracts relative to the maturity of available fixed-income instruments, most German life insurers face significant interest rate risk.

We note that the German regulator introduced additional reserving requirements in 2010, the so-called "Zinszusatzreserve" (ZZR), with the idea that German life insurers would build additional buffers to better enable them to meet future guarantee requirements stemming from their traditional guaranteed endowment and annuities products. While we estimate that the ZZR reduces the average guarantee rate in the back book by about 25-35 basis points annually (average guarantee rate after ZZR was about 2.1% as of year-end 2017), we think that these requirements might be overburdening the German life insurance industry (see "Could Germany's Additional Reserving Requirement Be The Cure That Kills The Patient?," published Dec. 5, 2017, on RatingsDirect). This is because insurers typically finance the ZZR predominately through recognizing unrealized gains on fixed-income investments. This ultimately constrains future earnings, since older bonds with higher coupons are replaced by new investments with lower coupons. The German insurance association estimates that the ZZR for the market increased in 2017 by €16 billion to about €60 billion at year-end.

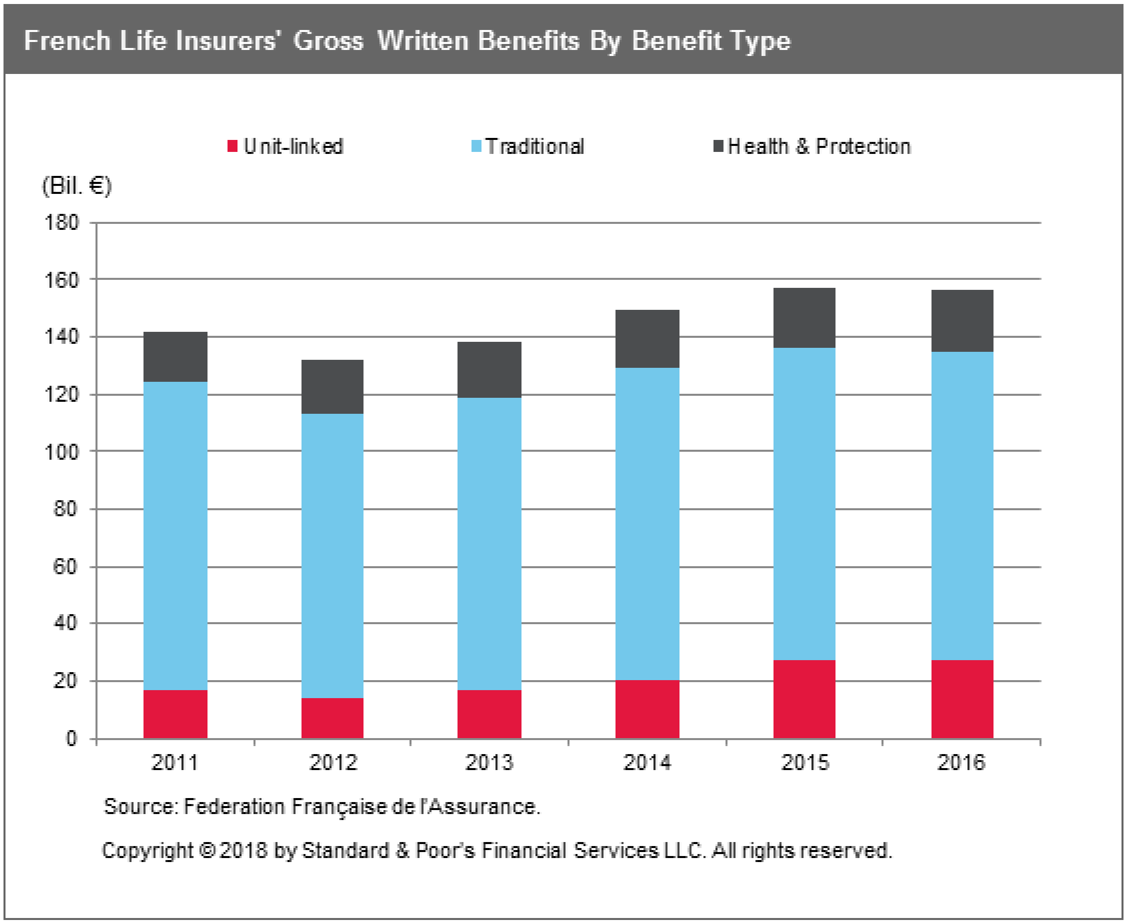
While risk from guarantees is high, we regard longevity risk for German life insurers as rather limited. We believe the actuarial assumptions underlying life insurers' premium calculations are usually prudent, and life insurers usually benefit from a positive risk result--stemming from the difference between actuarial assumptions and actual values on longevity, mortality, morbidity. Nonetheless, if longevity risk materializes, it can have a significant negative impact on insurers' back books and ultimately capital strength, particularly in combination with the life-long guarantees. From our perspective, it is therefore particularly important to monitor the trend risk within longevity assumptions.

Another reform impacting German life insurance is the "Betriebsrentenstärkungsgesetz" pension reform, which was passed in 2017 and took effect this year. The reform allows for capital-light products for group life business, which so far has been dominated by traditional guaranteed products. Having said that, we also do not expect a massive product shift within the occupational pension business in the short to medium term, and note that its ultimate success will depend on the acceptance of customers. Furthermore, it will take time until a shift to capital-light products has a material impact on pension back books.

France: Back Books Remain Heavy, But Average Guarantees Low

In France, we have also seen a material shift in new business toward capital-light products in recent years (see chart 3). This is due to a higher share of new premiums being allocated to UL investment vehicles as well as to the migration of part of funds invested on existing policies with traditional guarantees to UL investment vehicles. For 2017, almost 30% of premiums from savings products were put toward UL investment vehicles, compared with 20% in 2016.

Chart 3



However, French insurers' technical liabilities are still dominated by traditional products; UL products, for example, contributed about 16% to overall technical provisions at end-2016, and have only gradually increased in recent years. That said, the average guarantee rate in the book has continued to decrease in recent years to reach a market average of about 0.8% based on our estimates. Some of the guarantees may be life-long without any repricing option, but others end after a fixed number of years. French insurers have taken measures to avoid new premiums being invested on old policies with high guarantees. Consequently, the French life insurers faces less significant interest rate risk than German or Nordic peers, despite the relatively long duration of insurance contracts (11 years on average according to the French Insurance Federation).

At the same time, French insurers have increasingly invested in shorter-term corporate bonds in recent years. This move was a reaction to the Southern European sovereign debt crisis, and French insurers' significant investments in Southern European sovereign bonds. Consequently, the duration of their fixed-income portfolio has reduced, and symmetrically their ALM has increased. This exposes French insurers' profitability to the negative consequences of prolonged low interest rates.

We regard longevity risk for French life insurers as relatively limited. This is because very few policyholders convert their life insurance policy into annuity when they retire, and because annuities in payment make up a rather limited amount of insurers' overall reserves. Instead, policyholders organize regular partial withdrawals to leverage favorable tax treatment applied to policies aged eight or more years.

French insurers' group life business conversely is more exposed to interest rate and longevity risk (due to regular premiums, guaranteed rates, and use of annuity options, and contract boundaries preventing insurers from benefiting from future premiums), making its contribution to Solvency II ratios a negative one, despite its relative size (less than 15% of the total life and protection French market). The new "Fonds de Retraite Professionnelle Supplementaire" (FRPS) regulation adopted by France carves out group policies from Solvency II regulation and aligns them with a regime more akin to that of occupational pension regulation. We expect that, despite this move, insurers will continue to manage their group policies on a risk-adjusted basis and keep their risk exposure growth in check.

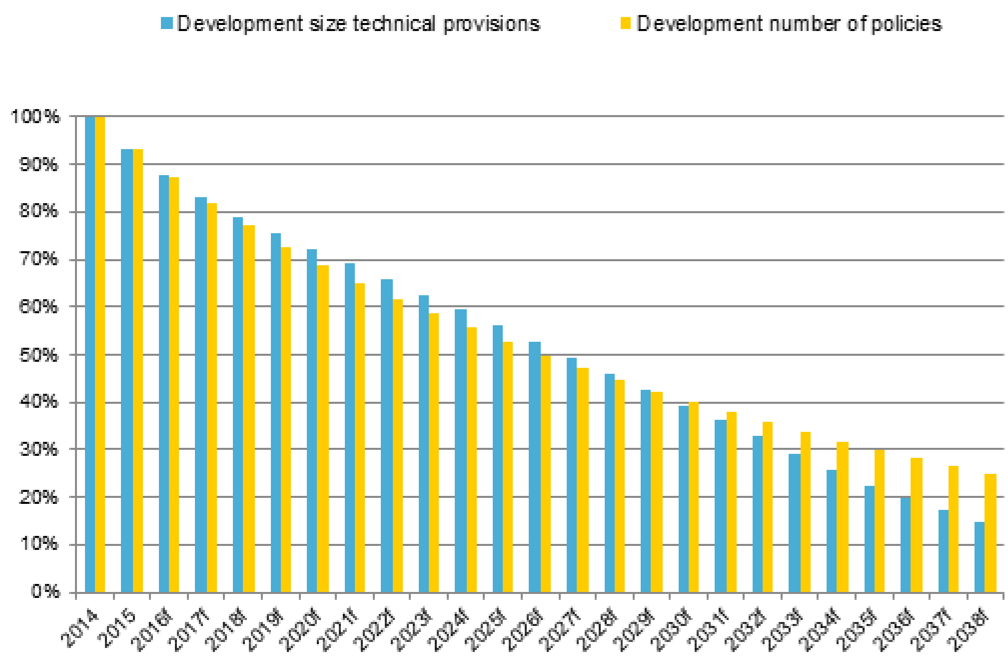
The Netherlands: High Guarantees Persist And Appetite For Unit-Link Is Muted

Similar to the German life insurance market, the Dutch life insurance market is characterized by high guarantees, long liability duration, and consequently high interest rate risk. Historically, life insurers in the Netherlands generally wrote traditional savings products, representing 76% of gross premium income (€10 billion) and approximately 75% of technical provisions (€115 billion) in 1995. From 2006 the insurance market started to change and by 2015, traditional products in the Dutch life sector had reduced to 62% of gross premium income (€9 billion) and approximately 66% of technical provisions (€338 billion).

We regard the average guarantee level in the life insurers' book backs as high at about 3.5%, although the level has slightly decreased in recent years. We anticipate it will continue to reduce over time, because many Dutch players have closed their books to new business (see chart 4).

Chart 4

Dutch Life Insurers' Development Of Individual Life Insurance Policies, Closed Book

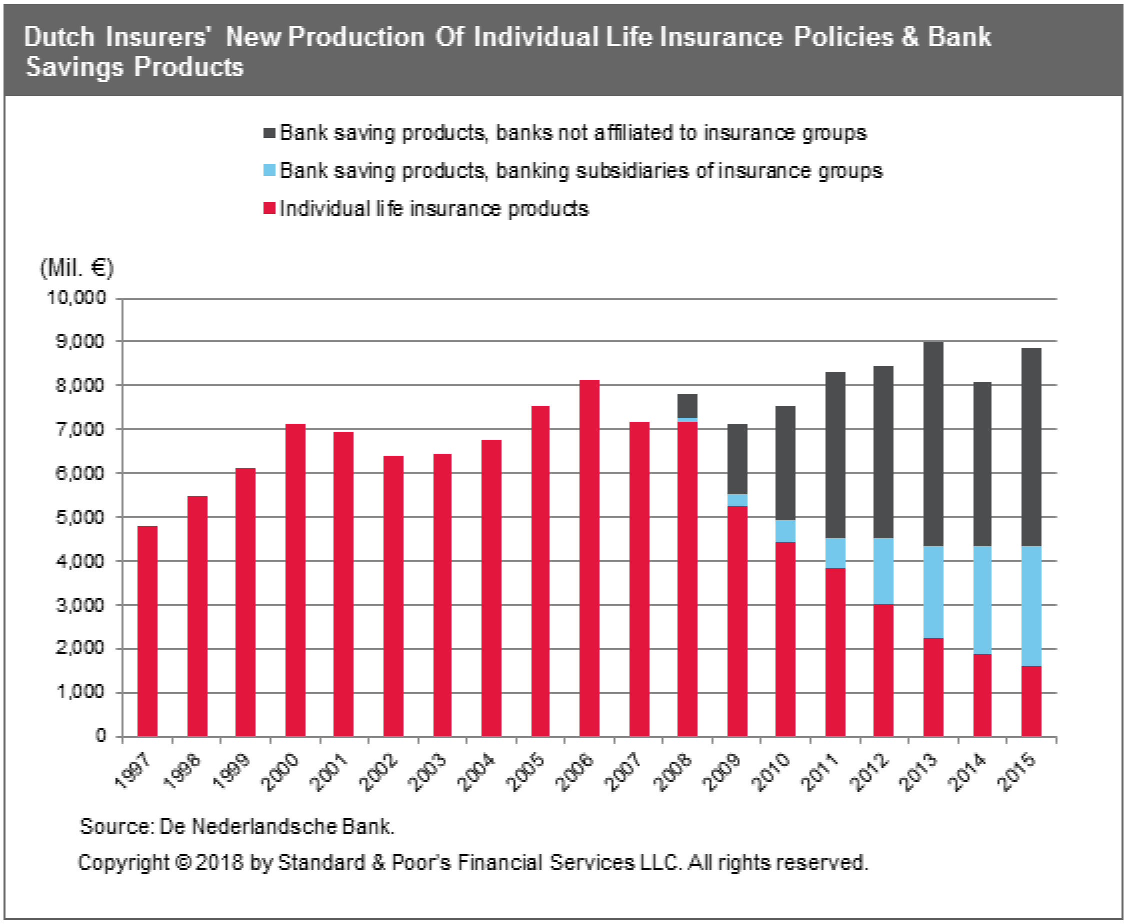


Source: De Nederlandsche Bank. f--Forecast.

However, we believe the exposure to the guaranteed business is still significant, and will only slowly abate. Consequently, we believe interest rate risk will remain high and dominate the Dutch life market over the next years.

To mitigate exposure to interest rate risk, Dutch companies have been shifting their business toward less capital-intensive products, such as banking savings products, and away from individual life products (see chart 5).

Chart 5



We also are observing a shift toward defined contribution pension schemes. The introduction of pension platforms, namely facitlities that provide services associated with managing and administering pension schemes, is taking place, and new opportunities are arising for insurance companies to administer defined contribution schemes for companies and pension funds for a fee income.

Furthermore, some Dutch insurers like Achmea, Aegon, NN are diversifying into asset-management activities to acquire additional fee income and reduce their capital requirements. However, the margins on fee-based business are usually low, meaning insurers would need to build up significant scale over time in order to generate meaningful profit contributions from these products.

In the Netherlands, contrary to other European markets, UL products are rather unpopular due to historical issues, and product and UL sales are being replaced with banking products. However, most of the large insurers have a bank within their group structure, and aim to retain former UL customers by offering banking products through their banking distribution channel.

Longevity risk also remains significant in the Netherlands. However, with the introduction of Solvency II, select insurers, such as Aegon, entered into longevity swaps or diversified their business books to reduce this risk.

The Nordics: Converting In-Force Business Is Alleviating Heavy Back Books

For the purpose of this report, the Nordic life insurance markets comprise the markets in Denmark, Finland, Norway, and Sweden. In our view, all Nordic markets are exposed to material interest rate risk due to significant guarantees in the back book, although the amount of guarantees varies from 2.5% to 3.5% (see table 1). Like in the rest of Europe, we are seeing a clear move toward capital-light products, such as UL products or products with lower or no guarantees. In Sweden, for example, it is becoming more popular to have only about 80% of paid premiums guaranteed.

We note, however, that insurers are restructuring their portfolios faster in the Nordics than in other European markets. For instance, in Norway the amount of UL business in terms of premiums increased to 35% in 2016 from 21% in 2012, and to about 18% from 12% in terms of reserves. We consider that this is in part because local regulators support the conversion of life insurers' traditional in-force business into UL products. This isn't the case in other countries, such as Germany where the regulator is more hesitant toward restructuring.

Some years before the introduction of Solvency II, the life insurance sectors in Denmark and Sweden introduced balance sheets based on a market value approach. This means that the value of both assets and liabilities change when market interest moves, which results in higher balance sheet volatility than in other European markets. Besides the focus on the restructuring of the product portfolio, many Nordic life insurers, particular in Denmark, have implemented hedging techniques to manage interest rate risk. We believe that Danish and Swedish life insurers' experience dealing with interest rate risk and having a market valued-based balance sheet supports them in coping with the Solvency II requirements.

In this context, we see the life insurance market in Finland in a somewhat different light. In the Finnish life market, guaranteed liabilities have a relative long duration, and insurers have not used interest-rate-hedging strategies to match assets and liabilities to the same extent as their Nordic peers. Moreover, the average guarantee in the back book is relatively high. We estimate the average at about 3.0%-3.5%, with some insurers having guarantees of about 4.5%. What's more, at year-end 2016, about 30% of invested assets for the guaranteed life insurance business were held in equities, which is one of the highest levels in the Nordics, leading to potential volatility in the results of Finnish life insurers.

We regard longevity risk in general as well controlled in the Nordics. In Norway, for example, the regulator in 2013 changed the actuarial assumptions for longevity. This led to material reserving requirements of about Norwegian krona (NOK) 40 billion (about €4 billion) that Norwegian life insurer have to fulfill by 2021. However, in the meantime the Norwegian life insurers have almost completed the longevity reserve strengthening. Furthermore, we have no indications that the improved reserves are insufficient. Nonetheless, similar to the German life insurance market, longevity risk can become material in combination with life-long guarantees; therefore it is important to monitor the trend risk within longevity assumptions.

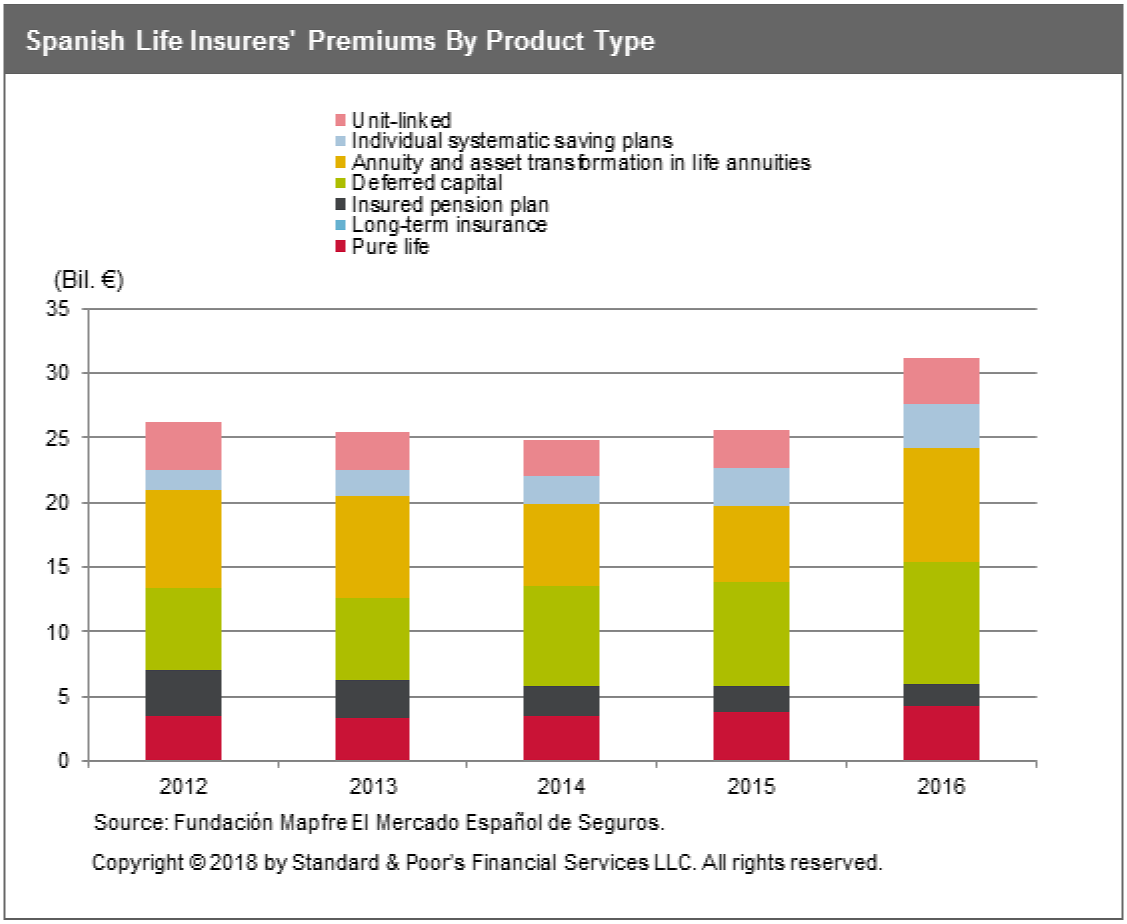
Spain: Strict Regulatory Requirements Are Reducing High Interest Rate Risk

Guarantees on the back book of Spanish life insurers, although reducing, remain relatively high compared with other European peers at between 2.5% and 3.0%, according to our estimates (see table 1). However, life insurance products in Spain have a shorter duration than the rest of Europe, and Spanish insurers have historically mitigated much of the reinvestment risk by closely matching assets and liabilities, as well as applying market-value adjusters in case of early redemptions. This approach has been supported by strict regulatory requirements to minimize the ALM.

Most life insurance policies offer guarantees only at maturity, which means that in the event of early redemption by the policyholder, they would only pay the market value of the liability if lower (a concept similar to the market-value adjustment). This helps insurers to safeguard their asset-liability monitoring, passing the risk of negative movements in the market onto the policyholders.

Spanish insurers have been disciplined in reflecting the decline of long-term yields in their commitments to policyholders. We estimate that new products offer guarantees of 1% or below, on average. Notwithstanding the weakened appeal of these products, in 2016 the market posted exceptional growth above 20% in terms of premiums (5% in terms of reserves), followed by flat growth in 2017. Banks, which are the main life insurance distributors in Spain, diverted part of their customers' savings from unattractive term deposits to annuities and other categories of savings products (see chart 6).

Chart 6



Insurers have packed bonds, mostly Spanish government bonds, into life insurance policies that offer lower (guaranteed) returns with similar maturity features. While benefiting in terms of matching adjustment and capital absorption under Solvency II, Spanish life insurers have however further increased their already high exposure to domestic government bonds. The latter accounted for more than 40% of their investments at year-end 2016, according to our estimates. This represents the second-highest level of concentration in domestic sovereign bonds within Western Europe, after Italy.

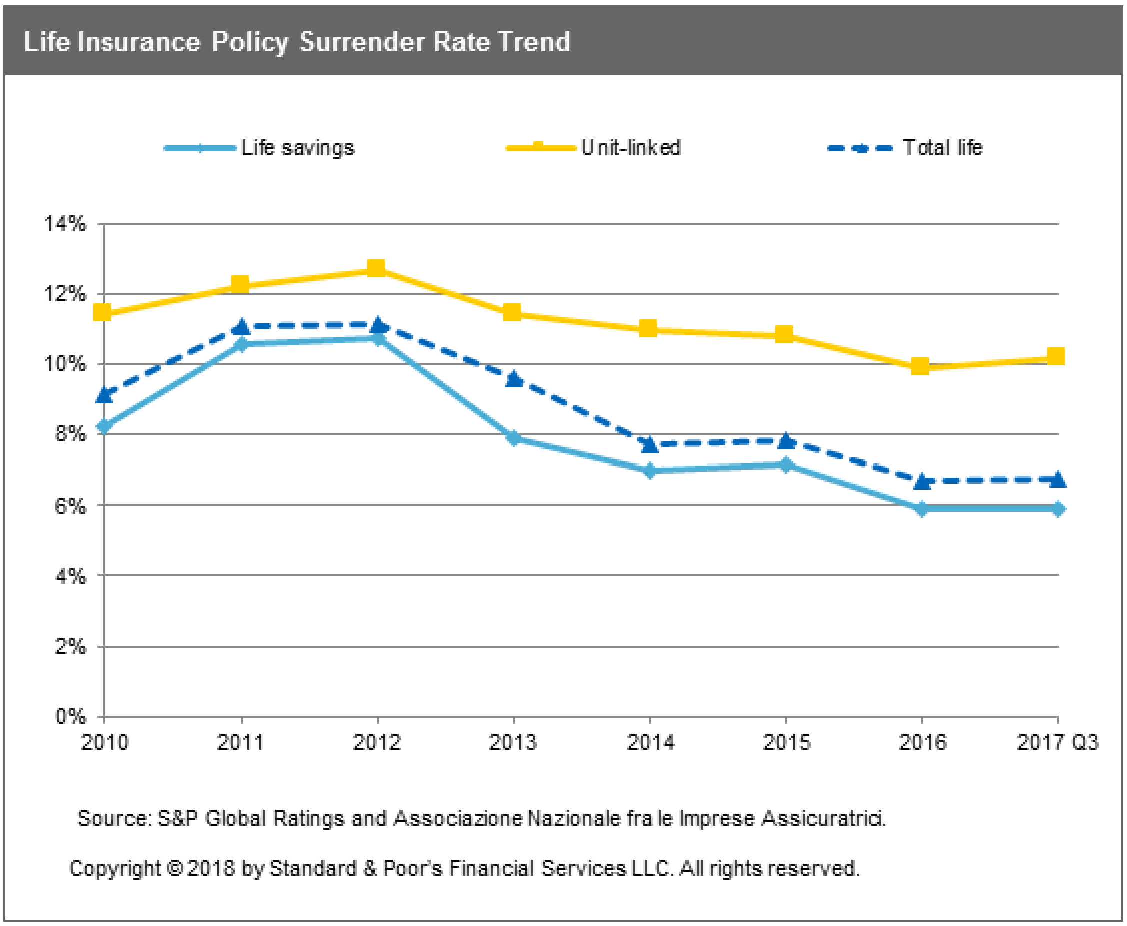
We regard other product risk, such as underwriting risk for traditional life products, as limited. This is mostly based on our view of the sector's prudent pricing and conservative mortality tables, which are not dissimilar to those of other European markets.

Italy: Surrender Risk Remains Prominent

Italian life insurers' back book of guaranteed interest policies, which accounted for about 75% of their total technical reserves at end-2016, are generally well-matched in the duration of assets and liabilities, in our view. We consider that the market average guaranteed interest rate on participating life reserves has declined by about 20-30 basis points since end-2015 to below 1.3% at year end-2017, because Italian insurers have mostly eliminated guarantees on new life insurance contracts. The guaranteed rates are sufficiently covered by returns on segregated funds (over 3% on average over the past five years).

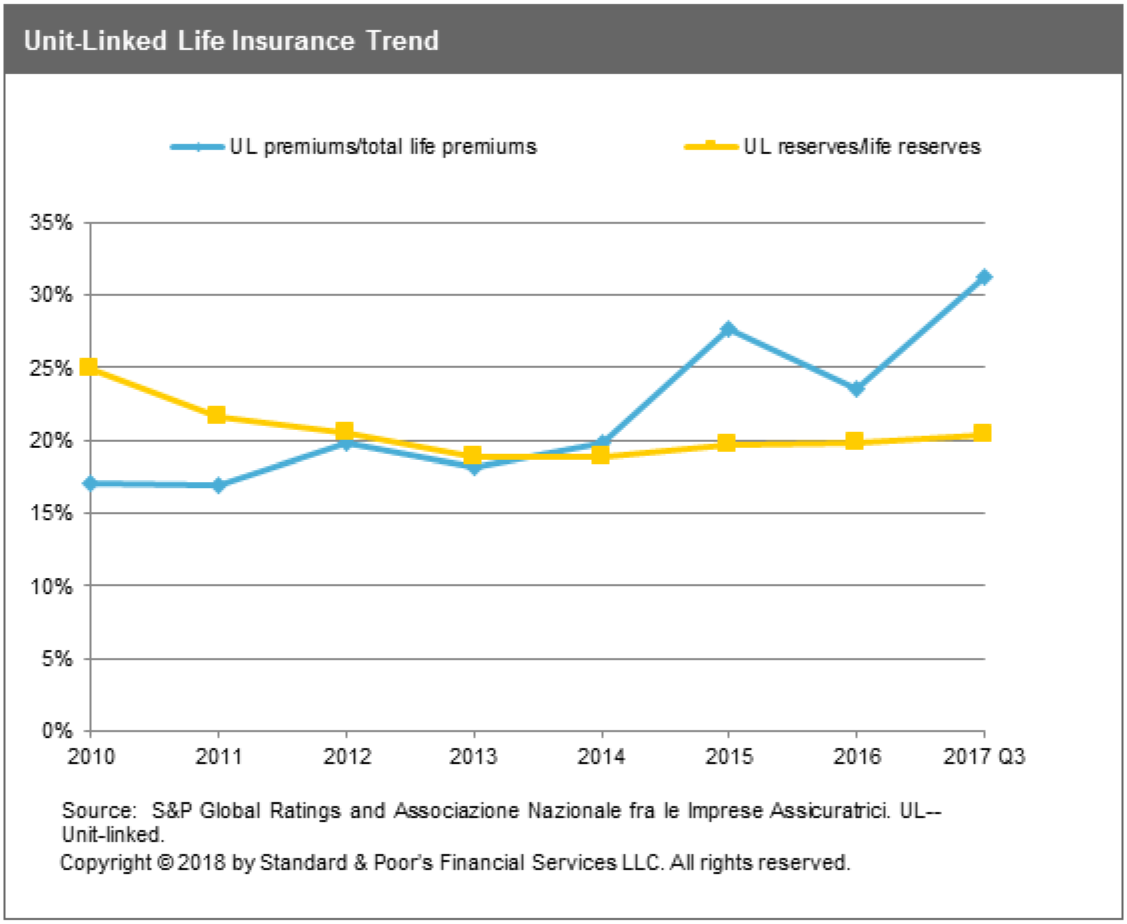
The average effective maturity of Italian life insurers' policies is generally between five and seven years, with combined surrenders and lapses of about 10%. We expect the average guaranteed rate on in-force life policies will decline steadily over the next few years, given that new policies will largely not include guarantees and our expectation that the average surrender rate on guaranteed life policies will remain above 6%, in line with recent years (see chart 7).

Chart 7



In Italy we are seeing Solvency II and low interest rates push insurers toward capital-light products, and we expect UL sales will keep rising, sustained by the sale of hybrid life policies, which mix guaranteed savings policies with a share of UL policies (usually between 30% and 40%). The shift of product sales to UL policies continued in 2017 after a temporary slowdown in 2016 linked to turbulence from the Brexit vote and financial difficulties of a number of regional Italian banks (see chart 8).

Chart 8



We consider that Italian insurers remain vulnerable to a potential sudden rise in surrenders (see chart 7). Product structures in Italy exacerbate potential losses when lapses spike, because most savings products guarantee accumulated capital and return, and offer a guaranteed surrender value if redeemed early. Furthermore, surrender penalties and tax disincentives do not appear to act as a strong impediment to surrenders, exposing Italian life insurers to the risk of losses on their bond portfolios when yields and surrenders spike.

In our view, Italian life insurers are particularly sensitive to domestic country risk because they hold a larger share of their investments in domestic governments bonds than insurers of other developed European insurance markets. The sovereign bond concentration is gradually declining, however: At the end of 2016, Italian life insurers' investments in Italian sovereign bonds had declined to below 50% of total investments backing life insurance reserves, from 55% in 2014. We expect further gradual declines in sovereign bond concentration.

Switzerland: Significant Exposure To Interest Rate Risk, But Extensive Experience In Managing It

Swiss life insurers started to steer their product portfolios and asset allocation toward less capital-intensive products earlier than most European peers. This was motivated by Switzerland's ultralow interest rate environment, which is one of the lowest globally, and by a very strict regulatory regime, which adopted the risk-based Swiss Solvency Test early on (came into force Jan. 1, 2011). Nevertheless, insurers' back books are dominated by traditional products with guarantees (about 95% of total reserves; see chart 1). This is despite guarantee products making up less than 20% of new business premiums. For market leader Swiss Life AG, guaranteed products made up even less at 9% of new business premiums in 2016. We expect it will take time until the positive effects of the capital-light products will be visible in the back book. The remainder of guaranteed products is almost fully driven by group life business.

Another very country-specific feature in Switzerland is that the regulator sets the guaranteed rates for the mandatory group life business for new business and the back book on an annual basis, which protects interest margins to some extent. Current guaranteed interest rates for the mandatory part of group life business stand at 1%. This compares with negative risk-free rates for 10-year Swiss government bonds. Rates for the non-mandatory part are even lower (0.25%, based on our estimate). The average guarantee in the back book stood at about 1.8-1.9% in 2016 based on our estimates.

ALM risks remain high in Swiss life insurers' portfolios and will only gradually reduce over time given the long-term character of the in-force business. Nonetheless, due to a strict regulatory regime, Swiss life insurers have a strong track record of controlling ALM risk. Availability of fixed-income instruments with sufficient duration to match insurance liabilities in the European capital markets, which Swiss insurers tap as the Swiss bond markets only offer limited volume, support this ALM capability. We believe that most of Swiss insurers' foreign exchange risk is adequately hedged. Overall, life insurers' investment portfolios consist of large, diversified pools of high-quality, long-dated, fixed-income assets, alongside other material chunks of real estate investments that offer higher investment yields than Swiss bond investments.

With regards to annuity products, although limited, longevity risk remains. Actuarial assumptions underlying life insurers' premium calculations are usually prudent, and life insurers benefit from a positive risk result. Nevertheless, we consider it is important to monitor the trend risk within longevity risk, especially for the mandatory group life business where the regulator sets a conversion rate into annuitized products, which determines the annual payout over the policyholder's lifetime. This conversion rate remained unchanged at 6.8% (that is 6.8% of savings are paid out to customers), following a referendum in September 2017 in which Swiss voters rejected the proposal to lower the rate to 6.0% as part of the Swiss Pension Reform 2020. The 6.8% conversion rate does not fully reflect the underlying risk, in our view. We note that in the non-mandatory part of group life business, insurers can set the conversion rate following actuarial expectations generally leading to lower rates.

Related Criteria And Research

Related Criteria

- Insurers: Rating Methodology, May 7, 2013

Related Research

- German Insurers See No Short-Term Relief From Gradually Rising Yields, Feb. 12, 2018
- A Ray of Sunshine For Dutch Insurers May Not Last, Dec. 14, 2017

- EMEA Insurance Outlook 2018: Managing Legacy Issues Should Not Distract From Adjusting To Demanding New Trends, Dec. 12, 2017
- Could Germany's Additional Reserving Requirement Be The Cure That Kills The Patient?, Dec. 5, 2017
- Nordic Insurers: Property/Casualty Earnings Stay Strong, While Life Insurers Are In Transition, Nov. 22, 2017
- U.K. Life Insurance Industry And Country Risk Overall Remains Low, Despite Brexit Outcome, July 12, 2016
- Lower-For-Longer Interest Rates: Assessing The Risk To Europe's Life Insurers, Oct. 26, 2015
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- Insurance Industry And Country Risk Assessment: France Life, Dec. 28, 2017
- Insurance Industry And Country Risk Assessment: Spain Life, Dec. 13, 2017
- Insurance Industry And Country Risk Assessment: The Netherlands Life, May 2, 2017

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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