How life insurance companies can affect financial stability

Through their significant holdings of financial assets, insurance companies, particularly life insurance companies, form an important part of the financial system. If life insurance companies rapidly sell their assets on markets in which they have significant interests, this may have consequences for financial stability. At present, life insurance companies are facing two situations that could unleash a wave of sales. The first of these is related to the historically low interest rates, and the second to the new solvency regulations for insurance companies, Solvency II, which will enter into force in the autumn of 2012.

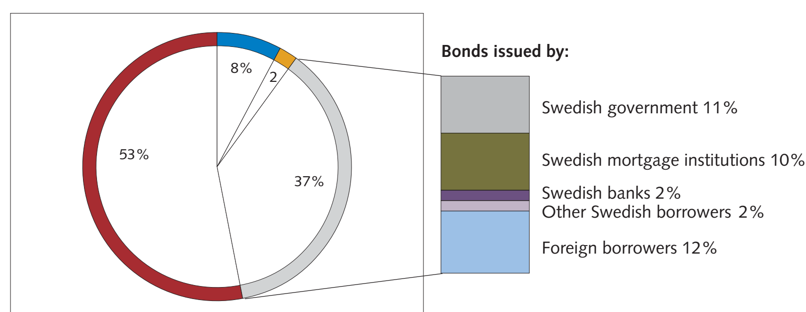
The Swedish insurance companies' holdings of financial assets amount to just above SEK 2 800 billion, with life insurance companies standing for almost 85 per cent of this figure. Life insurance companies' large holdings of financial assets (see Chart B5) make them significant from the perspective of financial stability. As an example, Swedish life insurance companies hold around a quarter of the bonds issued by Swedish mortgage institutions, i.e. Swedish covered bonds (see Chart 3:21). If the holdings of foreign life insurance companies are included, this proportion increases further. These companies thus form an important source of funding for the major Swedish banks, which largely obtain funding through covered bonds. They also contribute liquidity to markets where these assets are traded. If the life insurance companies were to sell off their assets rapidly on those markets in which they own major interests, this would have an impact on the way these markets function and also, in the end, on the banks' funding.

Low long-term interest rates and the life insurance companies

During 2010, long-term interest rates reached historically low levels (see Chart B6). If interest rates fall further, a vicious circle may arise among life insurance companies. This is because, as interest rates fall, the size of the life insurance companies' debts increases. A life insurance company's debt consists primarily of the present value of the commitments it has undertaken. In order to calculate this present value, a discount rate is used. This is determined on the basis of the yield on Swedish government bonds, Swedish interest rate swaps and covered bonds issued by Swedish mortgage institutions. When the discount rate falls, the present value of commitments rises. Above all, this takes place when long-term interest rates fall because life insurance companies have commitments that sometimes extend more than 50 years in the future.

The solvency of life insurance companies must exceed a certain level prescribed by law. This means that as a minimum requirement, they must have a capital base (i.e. assets minus liabilities) above or equal to the solvency margin. When the solvency of life insurance companies decreases to the statutory level, they buy bonds whose value follows the discount rate and sell other assets, including their holdings of shares.[B8] However, when life insurance companies buy these bonds, the price rises and the discount rate falls accordingly.

Chart B5. The Swedish life insurance companies' holdings of various financial assets, including property, in relation to their total holdings for Q2 2010
Per cent



Note. Shares and holdings in funds also include funds in unit-linked insurances and bond funds and money market funds.
Source: Statistics Sweden

B8 By increasing their holdings of assets that increase in value when the discount rate decreases, the solvency of the life insurance companies is affected to a lesser extent than it would be were the discount rate to change.

And when life insurance companies sell shares, the prices of these shares fall. The life insurance companies thus enter a vicious circle with falling interest rates and share prices, which, in turn, results in that the solvency falls further and the life insurance companies selling even more shares.

As life insurance companies are among the largest investors on the Swedish stock market, such a vicious circle may lead to a fall on this market. In turn, a major fall on the stock market may result in a decrease in risk-taking among other financial market participants, or that other financial institutions must redistribute their holdings of financial assets, among other reasons to comply with statutory requirements. In this way, the vicious circle spreads to other financial markets, with the consequence of falling prices and reduced liquidity in assets that are important to the funding of the banks.

As well as the risk of vicious circles among life insurance companies, the low long-term interest rates and expectations of continued low interest rates may lead to a search for yield, as described in Chapter 1, among Swedish and foreign life insurance companies. In particular, it is the willingness of life insurance companies with large guaranteed commitments to invest in alternative and higher-risk interest-bearing investments that is increasing. This search for yield is taking place because, if these life insurance companies cannot receive a higher return than at present from more traditional investments, they will not be able to meet their future guaranteed commitments to their policyholders.

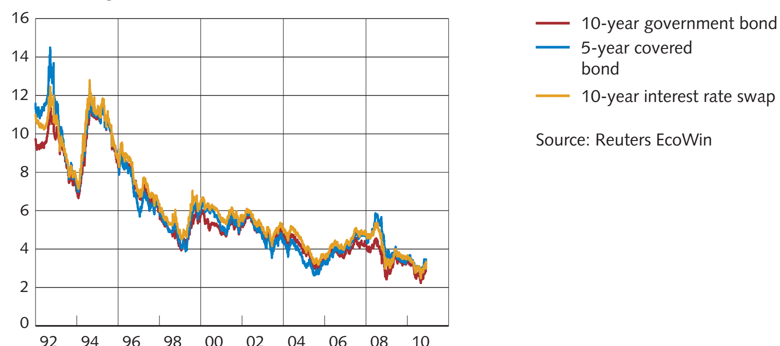
Solvency II and the life insurance companies

In the autumn of 2012, the new EU solvency regulations for insurance companies, Solvency II, will enter into force.[B9] Under Solvency II, life insurance companies must have a capital base exceeding the solvency capital requirement, just as in current legislation. However, in the current regulations, the solvency capital requirement (that is the solvency margin) for life insurance companies is largely based solely on the size of the companies' commitments.

Under Solvency II, the solvency capital requirement is based on the insurance risks existing in the life insurance companies' operations and on the risks arising when the companies invest in financial assets, such as covered bonds.

It is presently unclear how large the solvency capital requirement will be for life insurance companies under Solvency II. If the life insurance companies' capital base is less than the new solvency capital requirement, the life insurance companies will have to reduce their risks, thus decreasing their solvency capital requirements. The life insurance companies can do this by increasing investments in those financial assets with the lowest capital requirements (which are government bonds), and at the same time reducing their holdings of other financial assets. The introduction of Solvency II may thus result in that life insurance companies adjust their holdings in financial assets, among other means by reducing their holdings in covered bonds. If this happens, an important source of financing for the Swedish banks will disappear.

Chart B6. The yield on 10-year Swedish government bond, 10-year Swedish interest rate swap, and 5-year Swedish covered bond
Percentage



Source: Reuters EcoWin

B9 Originally, Solvency II should have entered into effect on 31 October 2012, but it now seems as though it will be 31 December 2012.