Changing macroeconomic environment: Will guaranteed products come back?

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- Changing macroeconomic environment
  - Focus on higher interest rates
- ...Will guaranteed products come back?
  - How do rising rates impact the value added of guaranteed products?
  - Value added of guaranteed products: insurance against market risk

- Changing macroeconomic environment
  - Focus on higher interest rates
- . . . Will guaranteed products come back?
  - How do rising rates impact the value added of guaranteed products?
  - Value added of guaranteed products: insurance against market risk
- Guaranteed products embed two insurance mechanisms against market risk
  1. Return guarantees
  2. Return smoothing

Insurance mechanism 1: Return guarantees

- Insurance against market risk provided by the insurer
- Variation in the level of return guarantees

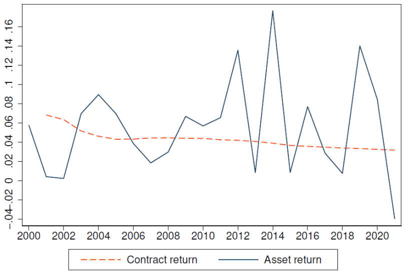
  . . . across countries

  . . . across time (more later)

Insurance mechanism 2: Return smoothing

- Return smoothing: contract return $\neq$ return of invested assets

Germany



France

! color code is different on each graph !

Insurance mechanism 2: Return smoothing

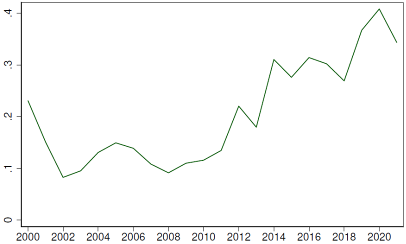
- Accounting identity:

  Asset return $=$ Contract return $+$ ΔReserves $+$ Insurer income

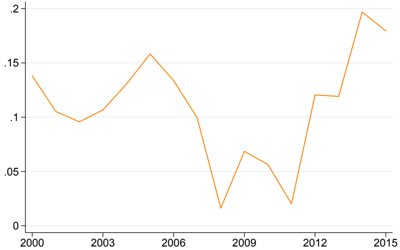
- Most of the difference between contract return and asset return is absorbed by reserves $\Rightarrow$ reserves fluctuate

Reserves (% of account value)

Germany



France



Insurance mechanism 2: Return smoothing

- Reserves are carried over across investor cohorts ⇒ wealth redistribution between investor cohorts
- Theoretically: risk sharing between investor cohorts
- Empirically over the period 2000–2020:

  interest rates ↓

  large bond returns

  . . . hoarded as reserves, to be distributed to future cohorts of investors

  ⇒ redistribution from early cohorts to late cohorts

- Quantitatively:

  France: 1.4% of account value is redistributed across investor cohorts every year (Hombert and Lyonnet, 2022)

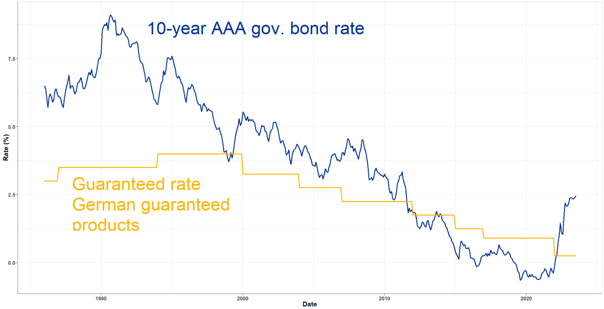
  Germany: between 0.8% and 1.5%/yr depending on product characteristics (Hombert, Mölmann and Weill, 2023)

Rising interest rates

- How do high interest rates affect both risk sharing mechanisms
- . . . and therefore the supply and demand for guaranteed products?

1. Impact of rising interest rates on return guarantees

- Guaranteed rates vary less than 1-for-1 with market rates



- Higher rates make guaranteed products more profitable for insurers

$\Longrightarrow$ Supply $\uparrow$

2. Impact of rising interest rates on return smoothing

- On impact (2021–?): reverses the direction of redistribution $\rightarrow$ towards current cohorts (use reserves and replenish later)
  - Back-of-the-envelop depletion of reserves: duration 8 years $\times$ interest rates rise 2.5 pp $\Rightarrow$ reserves drop by 20% of assets
- After impact (starting 2023?): redistribution away from current cohorts (replenish reserves)
  - Empirically: low reserves lead to lower future contract returns (Hombert and Lyonnet, 2022; Hombert, Möhlmann and Weiss, 2023)
- Implication: guaranteed products are becoming less attractive for investors

$\Longrightarrow$ Demand $\downarrow$

Wrap up

- Different implications of rising interest rates

  1. Wider wedge market rates v. guaranteed return
     $\Longrightarrow$ Supply $\uparrow$

  2. Low reserves
     $\Longrightarrow$ Demand $\downarrow$

- Other factors not covered in this impulse statement

  3. Inflation: return guarantees are a poor hedge against inflation risk
     $\Longrightarrow$ Demand $\downarrow$?

  4. Risk-based regulation: return guarantees consume regulatory capital
     $\Longrightarrow$ Supply $\downarrow$

References

Hombert & Lyonnet, 2022, "Can Risk be Shared Across Investor Cohorts? Evidence from a Popular Savings Product," *Review of Financial Studies* [pdf]

Hombert, Möhlmann & Weiss, 2023, "Inter-Cohort Risk Sharing with Long-Term Guarantees: Evidence from German Participating Contracts," *Bundesbank Discussion Paper* [pdf]