1. Key developments

The overall macroeconomic environment remains very challenging for the European insurance and pension sector. The yields have been further compressed and are substantially below the tested levels of the EIOPA Insurance stress test 2014. This has been the consequence of the recent decision of the European Central Bank on the Quantitative Easing (QE) policy driven by deflationary pressures in Europe supported by the global oil prices drop. This environment might affect investment behaviour of insurers and pension funds to rebalance their portfolios towards more risky assets. At the same time macroeconomic imbalances remain as both private and public sectors are heavily indebted and unemployment and market fragmentations are high. Due to the current QE policy the potential risk for a reversal in the investment flows (that has been compressing spreads on higher yielding assets) has been slightly decreased, but remains high in the medium to long term. A re-aggravation of the sovereign debt crisis driven by the situation in Greece would trigger such a scenario with severe negative implications for the insurance and pension sector. Moreover, worsening geopolitical risks such as the situation in Ukraine or Middle East could also cause a risk reversal scenario.

Financial markets in the first quarter of 2015 showed a confirmation of the trends that had started in 2013 and 2014: a prolonged low yield environment (see 1.1), weak macroeconomic fundamentals (see 1.2.) and credit risk (see 1.3).

1.1. Low yield environment

The current QE policy in Europe together with sustained expectations of low inflation and moderate growth is moving yields further down and drives the expectations to a continued low yield environment. A substantial move of the yield swap curve down (Figure 1.1) and very low forward rates indicate this prolonged market trend (Figure 1.2).

Figure 1.1: EUR swap curve

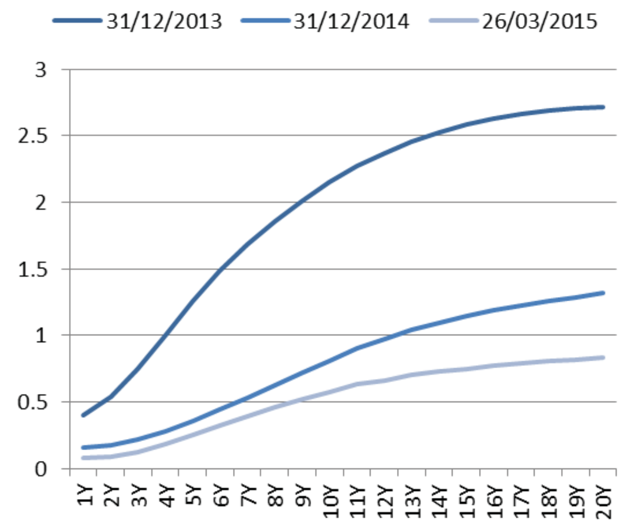
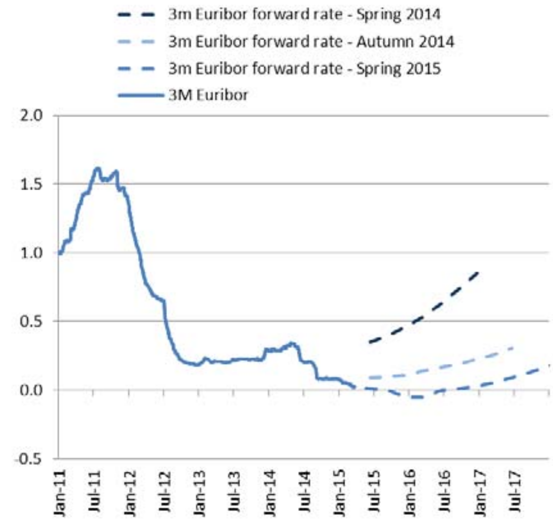


Figure 1.2: 3M EURIBOR



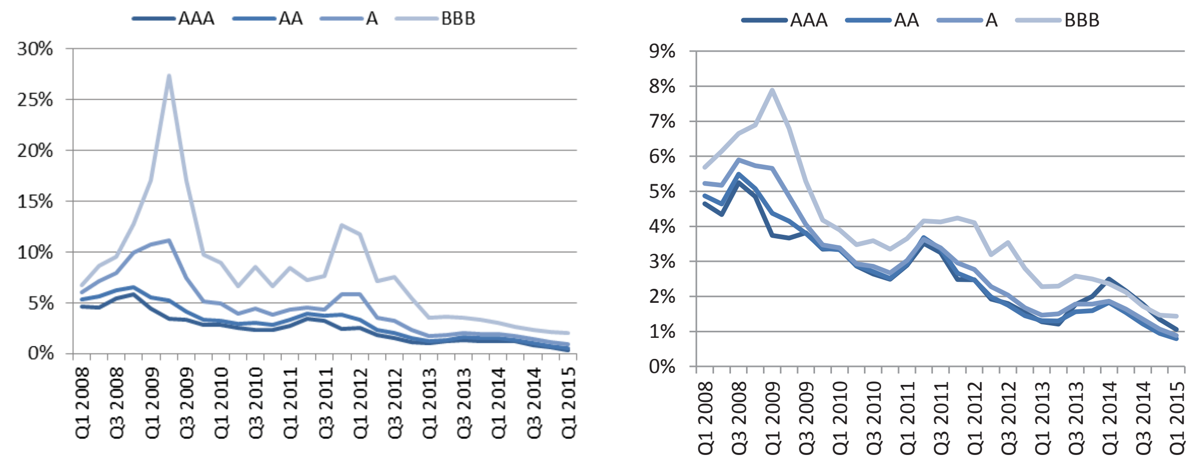
Source: Bloomberg - Final observation: 26 March 2015

A portfolio rebalancing is a key transmission channel of the QE policy that has direct implication on the insurance and pension sector. It lowers the risk-free rate (as shown above) as well as the funding costs. Furthermore, rebalancing from sovereign bonds into more risky asset classes should reduce lending spreads and also help to stimulate the economy. Finally, it could trigger a portfolio outflow from the economies who apply QE policies.

Declining risk free rates creates an enormous challenge for the profitability of insurance companies. It raises the question how insurers and pension funds can respond to this situation (Figure 1.3). As investors they have a natural appetite for assets that match their liability profiles and allow them to manage their duration and cash flow positions. The development of successful financial instruments with features attractive to both insurers and pension schemes is still an area for development (for example in relation to infrastructure investments). New asset classes, however, should be approached in a careful manner and should entail appropriate investment analysis and risk management skills within the organisation. Moreover, the treatment of these asset classes for solvency capital requirements needs to be properly calibrated, as evidenced by EIOPA's work in refining the capital treatment of securitised assets. At the same time, based on a survey conducted by EIOPA, large insurance groups have allocated a much shorter duration to their portfolio. The aim is to ensure that new investment opportunities are captured in the short run, whilst also becoming more resilient to a sharp rise in interest rates. Insurance companies should have appropriate expertise and resources to take advantage of the new investment opportunities. Apart from this, insurers increasingly offer new products, with varying degrees of guarantees. For example, some insurers have contracts with guarantees reset regularly, e.g. every 10 years, instead of being a lifetime guarantee. This increases investment flexibility. Other insurers have improved cost efficiency and invested in their asset liability management to offset lower investment result. On the pension front, low yields remain negatively impacting the performance and cover ratios of pension schemes and continue to be a point of concern.

Figure 1.3: Corporate bond yields in the euro area

EMU Financial *EMU Non-financial*

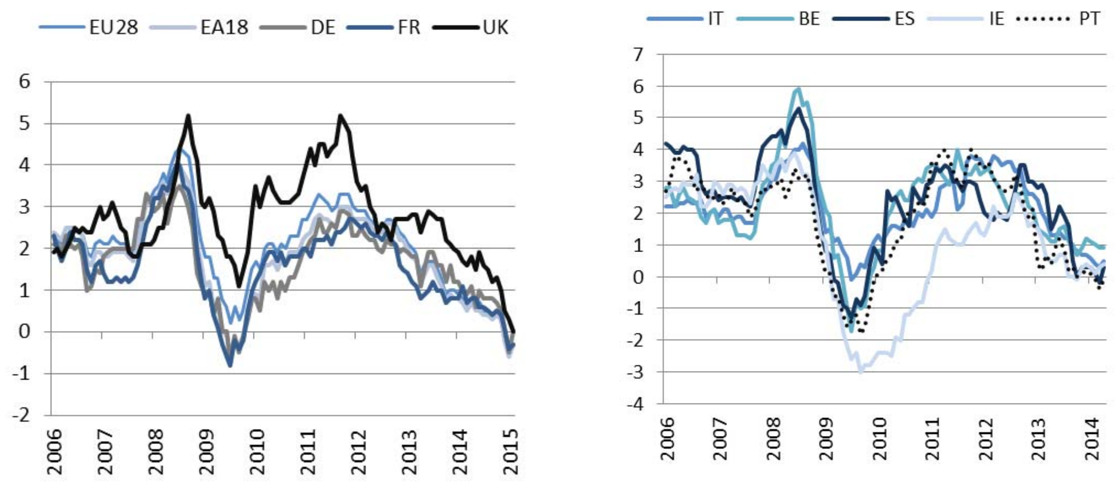


Source: BoA Merrill Lynch Global Research, used with permission

Last observation: 2015 Q1

A further increase in deflationary risk increases the likelihood that interest rates remain low (Figure 1.4). Despite the current QE policy, some countries still experience deflationary trends. Due to substantial lower inflation levels that are mostly below the ECB's mid-term goal (on the back of the steep fall in energy prices), monetary policy is expected to remain loose.

Figure 1.4: Inflation rate (in %)



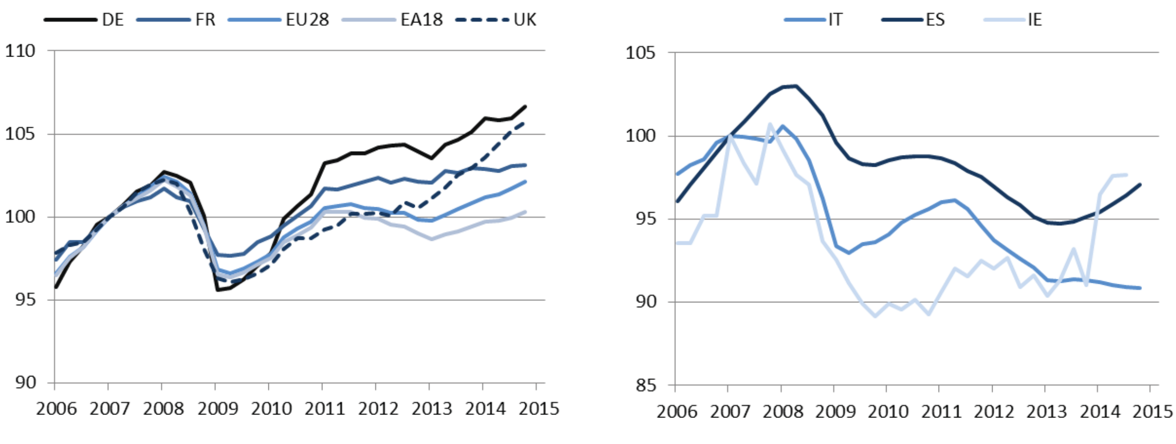
Note: Inflation rates refer to Harmonized Indices of Consumer Prices (HICP).

Source: ECB and Eurostat - Last observation: February 2015.

1.2. Weak macroeconomic environment

Economic growth in the euro area and in the EU is still positive in the majority of countries, although it remains very fragile (Figure 1.5). The recovery rate continues to be slow. Many countries, especially Southern European countries, have not caught up yet to pre-crisis GDP levels.

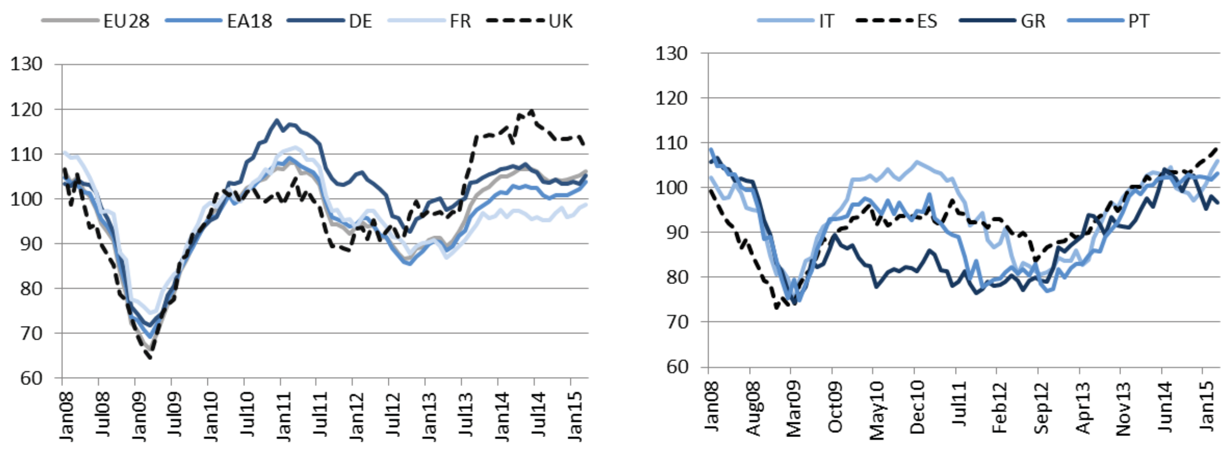
Figure 1.5: Real GDP development (index 2007Q1=100)



Source: Eurostat and EIOPA calculations - Last observation: 2014Q4 (2014Q3 for IE).

The Economic Sentiment Indicator (ESI) increased slightly in the euro area and the EU following a period of stagnation or decline. The improvement of the euro-area sentiment resulted from marked increases in consumer and retail trade confidence, only partly offset by declines in confidence in the services and construction sector. In February 2015, the European Commission Flash estimate of the consumer confidence indicator increased markedly in both the EU and the euro area compared to January 2015. The ESI is also expected to increase (Figure 1.6).

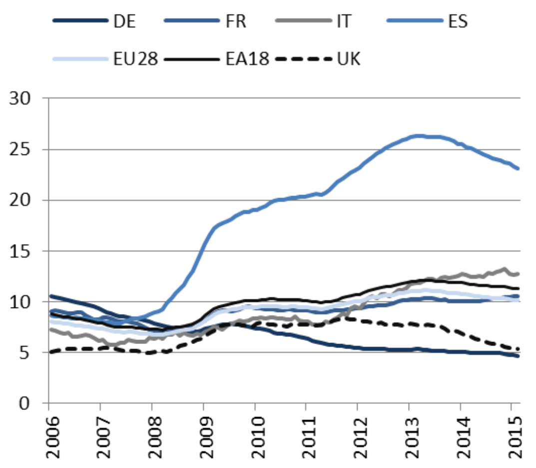
Figure 1.6: Economic Sentiment Indicator (ESI)



Source: European Commission - Last observation: March 2015

Despite prevailing macroeconomic imbalances, markets seem to be relatively optimistic on the future economic development. However, persistently high unemployment and market fragmentation is negatively impacting economic growth in some countries in the euro area (Figure 1.7). Market prices represented by the DJ STOXX Europe have recovered from sovereign crisis levels and are moving towards pre 2008 crisis levels. The DJ STOXX Insurance performance is in line with the positive development of the overall equity markets (Figure 1.8).). A sustainability of this good performance of (life) insurance stocks in the current low yield environment is questionable though.

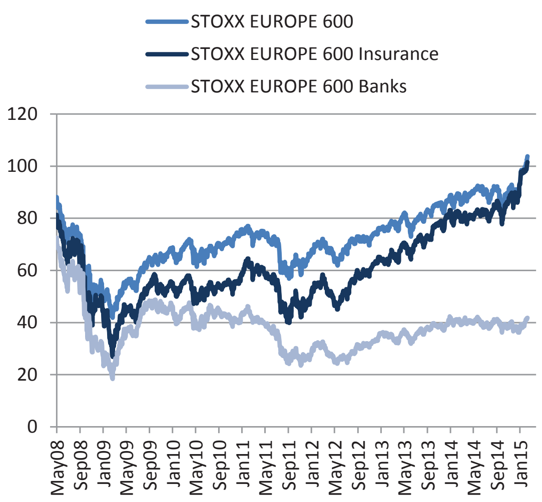
Figure 1.7: Unemployment rate - (in % of the labour force)



Source: Eurostat

Last observation: February 2015

Figure 1.8: Stock market developments (index:2007=100)



Source: Bloomberg

Last Observation: 13 April 2015

The appreciation of the US Dollar and the strengthening of the Swiss Franc following the removal of its minimum exchange rate ceiling to the Euro implies that profits of insurers and eventually their solvency might be affected. This especially applies to large insurance groups whose Swiss business is funded from the Euro area. Similar effects might be seen for the US Dollar, which heavily appreciated against the Euro over the last year. Appropriate hedging strategies, which need to be in place, especially for those insurers who anticipate future growth outside their national boundaries, might be quite costly and will also negatively impact the profitability. At the same time, those groups with a substantial exposure to Swiss assets and liabilities, in particular life insurance companies, additionally need to cope with the impact of zero risk free rates and decreasing Swiss equity markets.

1.3. Credit risk

As a consequence of the QE policy, rebalancing from sovereign bonds into more risky asset classes reduces credit spreads (Figure 1.9). This development applies to the insurance sector (Figure 1.10). Rebalancing of insurers' portfolios will most likely take place in sovereign and corporate bonds with an investment grade rating which will eventually result in higher credit risk and vulnerabilities towards a risk reversal scenario. Some rebalancing towards the US bonds on the expense of the

Euro area bonds might also be seen. Exposures towards emerging markets might also increase to maintain insurers and pension funds profitability.

Figure 1.9: 5-year Credit Default Swaps - Sovereigns

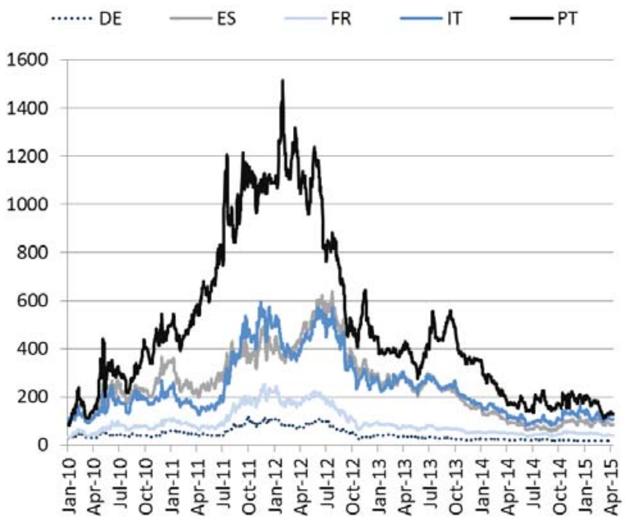
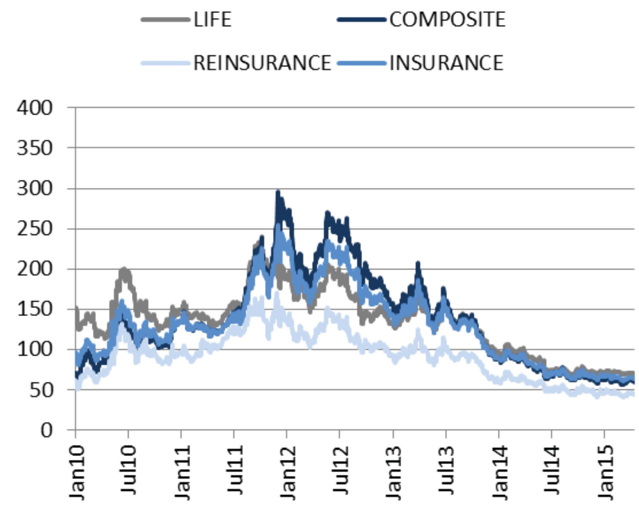


Figure 1.10: 5-year Credit Default Swaps - Insurance sector



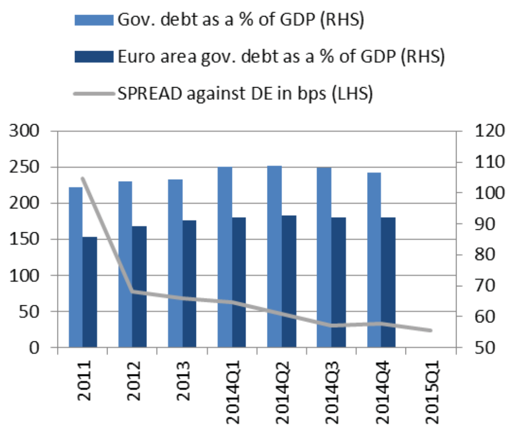
Source: Bloomberg

Last observation: 13 April 2015

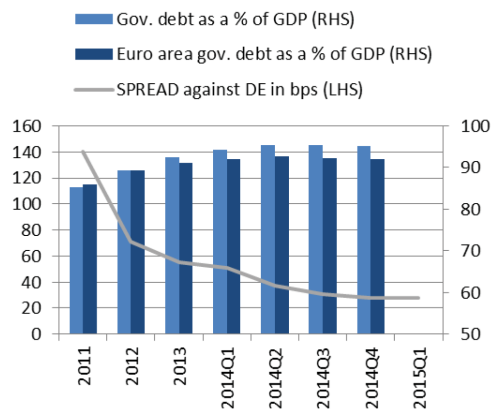
Tightened credit spreads reflecting market future expectations do not seem to be in line with the current economic conditions. A change in the positive market sentiment might be triggered by a re-emergence of concerns about sovereign debt sustainability reflecting high public sector indebtedness, large fiscal deficit and insufficient fiscal consolidation in some countries (Figure 1.11).

Figure 1.11: Government debt against 10-year sovereign bond spreads

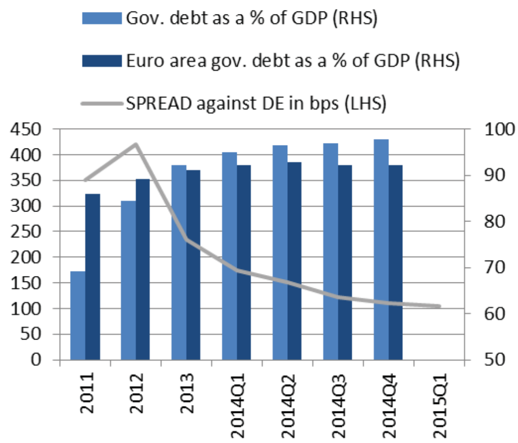
Belgium



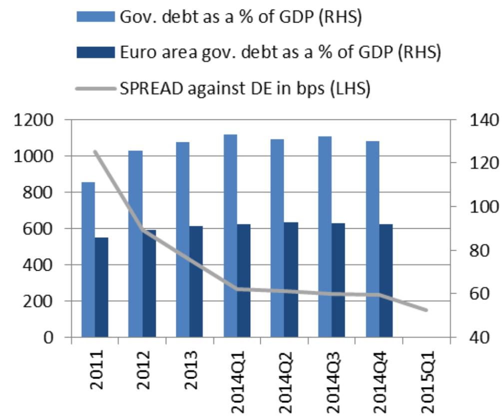
France



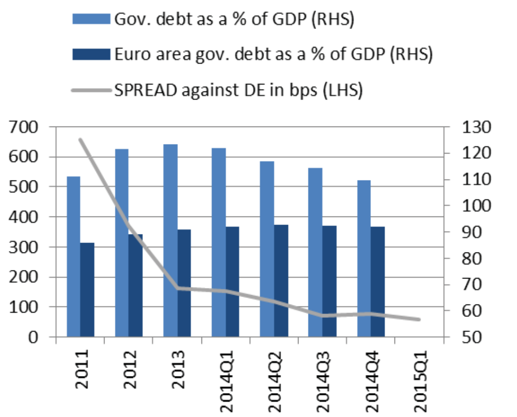
Spain



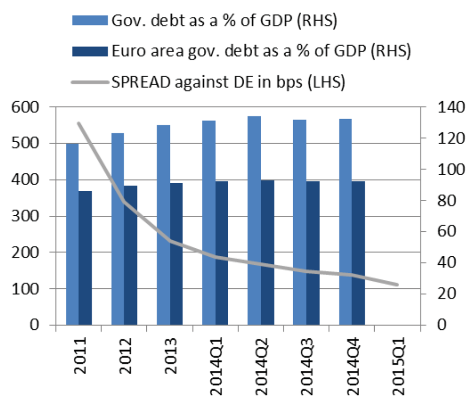
Portugal



Ireland



Italy

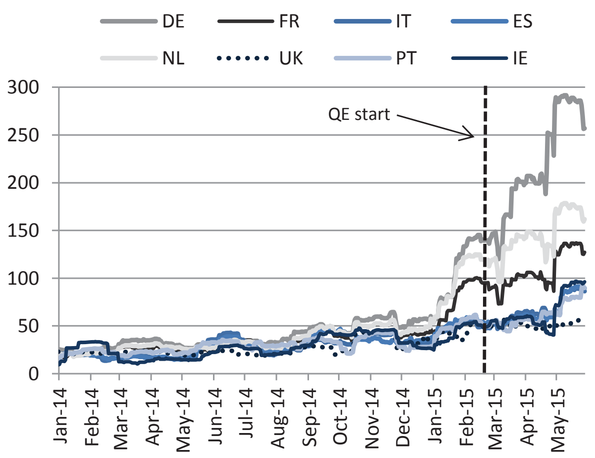


Source: Eurostat and Bloomberg

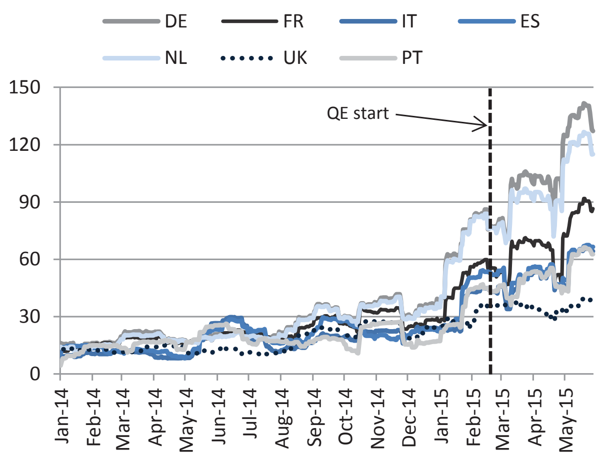
The QE programme substantially reduced market volume for some assets classes which significantly increased volatility of their daily returns. Hence, the liquidity of sovereign bonds used for the QE programme was dramatically reduced which in turn has caused an increase of volatility for their returns (Figure 1.12). In such an environment, a risk reversal scenario could be triggered by a relatively limited market move.

Figure 1.12: Sovereign bonds: 30-day volatility

10-year sovereign volatility



20-year sovereign volatility



Source: Bloomberg - Last observation: 28 May 2015

Increasing geopolitical risks could trigger a risk reversal scenario. The direct exposure of European insurers towards Russia and Ukraine seems to be very limited. Only about 0.2% and 0.05% of the total bank and sovereign exposure have Russian or Ukrainian sovereign and bank exposures respectively. The 90-percentiles, i.e. the decile of insurance groups with the highest exposure towards these two countries are 0.25% and 0.1% for Russia and Ukraine respectively. On the other hand, a further escalation of the conflict between Russia and Europe might have a destabilizing effect on the overall market sentiment. Also, the uncertainty about the situation in Greece might add to this. However, the direct exposure of the European non-Greek insurers towards Greek sovereign and bank bonds is also negligible (0.02% of total assets).