2. The European insurance sector

The current low interest rate environment suggests that profitability and sustainability of insurers holding high portions of guaranteed products are under severe pressure. Historically, insurance companies were in a position to buy long-duration bonds offering yields sufficiently high to cover their guaranteed rates to policyholders. In an attempt to meet these guaranteed rates, some insurers will be more inclined to some "search for yield" via riskier investments. Such behaviour is more likely to affect insurers offering high guaranteed returns. The problem is not the search for yield per se, but that insurance companies could take on too much risk, beyond their risk-bearing capacity ("excessive search for yield behaviour"). Being locked into unprofitable long-term contracts and promising to pay high rates of return, far above what insurers can earn at a time of very low and close-to-zero interest rates, might lead to such search for yield or search for duration behaviour, for example via investments in infrastructure or new energies. Hence, national supervisors need to closely monitor these cases to ensure that all risks are properly managed.

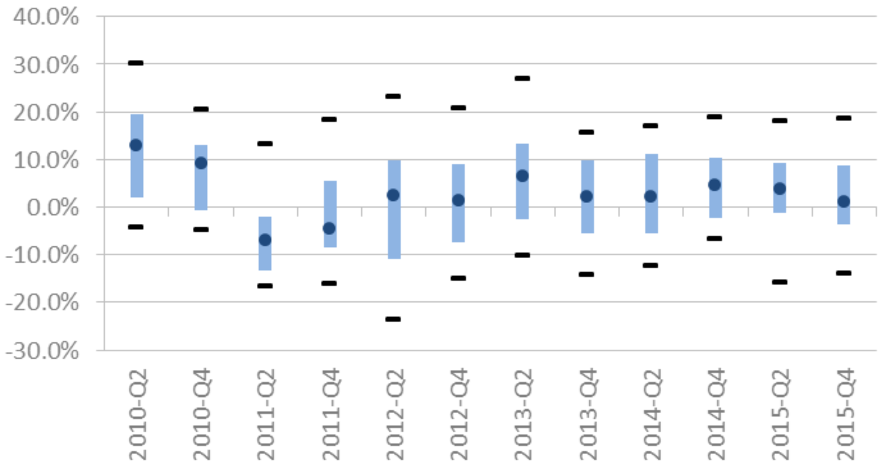
2.1. Market growth

Premium growth continues to be very heterogeneous and stronger for non-life insurance in Q4 2015. In times of low yields, slacking life premium volumes prove to remain a big challenge for the business models of some insurance undertakings.

LIFE INSURERS

The overall growth rate of gross written premiums (GWP) continues to be positive for the median company **of the sample** (Figure 2.1). A lot of dispersion can be observed though: whilst the 90th percentile reported strong growth, with premiums growing by 18.5 per cent in Q4 2015, the 10th percentile continued to be negative, with a negative growth rate of 13.9 per cent in Q4 2015 (compared with 15.9 per cent in Q2 2015).

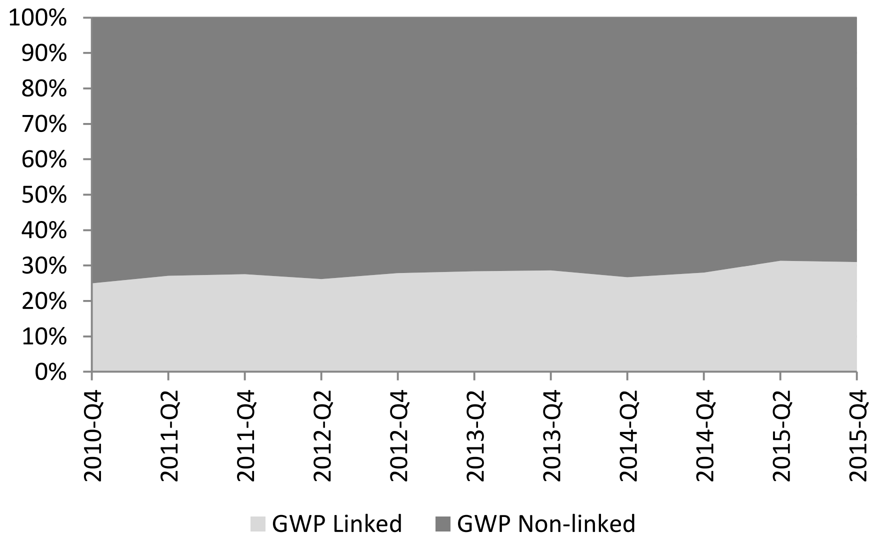
Figure 2.1: Gross written premiums - Life (year-on-year growth in per cent; median, interquartile range and 10th and 90th percentile)



Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

For life business, premium growth was highest for unit-linked products (Figure 2.2). This trend has confirmed more recently. A couple of new developments can be seen: for example, single premiums (that were eventually transferred into pension products) contributed to premium growth on the life insurance side. The deteriorating market environment and a high unemployment rate had on the other hand also a negative impact on life insurance products' demand.

Figure 2.2: Gross written premium, share of linked vs. non-linked products (in per cent)



Source: EIOPA (sample based on 15 large insurance groups from AT, FR, DE, IT, NL and UK)

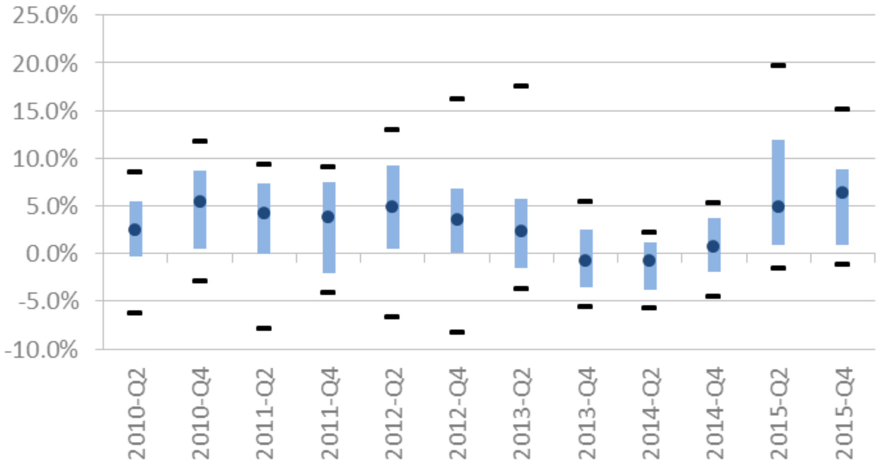
Efforts are already made to limit the impact of low rates. For example, biometrical products such as term life insurance or disability insurance are increasingly sold within many European countries in Q4 2015. Also, products with more flexible guarantees that are lower and often not "fixed for life" are on the rise. A shift of commercial activities from the traditional long-term life savings business to the more short-term life protection business or the non-life business altogether can also be seen. It was already witnessed that life insurance premiums decreased for some countries due to increased premium taxes and the non-renewals of contracts which reached the end of their beneficial fiscal treatment. More recently, also group life contracts seem to be impacted and showed some decline in premium growth.

These trends are an indicator that insurers try thoroughly to strengthen their risk profile. Insurers have demonstrated their willingness and ability to share adverse experiences with policyholders in spite of the potential commercial consequences. Consequently, insurers are more inclined to move to more risky assets such as stocks and investment funds, which could lead to an increase in the supply of risk-bearing capital for the real economy on the one hand. On the other hand this behaviour is often accompanied by additional challenges for insurers' risk management capacities. Overall, it should be mentioned that all efforts observed are characterised by "slow adaptations" rather than "drastic movements".

NON-LIFE INSURERS

The overall growth, previously observed, in premiums continued in Q4 2015 (Figure 2.3). This is also due to mandatory, but often very competitive business lines such as motor third party liability business.

Figure 2.3: Gross written premiums – Non-Life (year-on-year growth in per cent; median, interquartile range and 10th and 90th percentile)



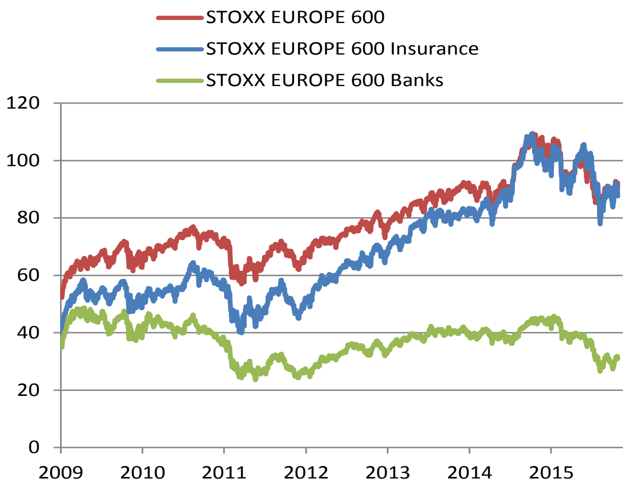
Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

If low interest rates persist long enough, certain types of insurance products may experience profound changes, possibly leading to sector consolidation. Cost cutting in turn may lead to a wave of consolidation to achieve economies of scale. As increased price competition, and stagnant organic growth continue to dampen insurance company returns, more mergers and acquisitions might be expected to build up capabilities and markets (see thematic article at the end of this report).

2.2. Profitability

In the current low yield environment maintaining profitability is getting more and more difficult as confirmed by market returns (Figure 2.4).

Figure 2.4: Market Returns (Index: 2007=100)



Source: Bloomberg; as of 29/04/2016

Despite some measures to limit guarantees for new products in the last couple of years, the legacy portfolio still represents a substantial amount of liabilities. Life insurers carry in general a somewhat higher risk than the corresponding non-life sectors due to the mismatch between assets and long-term life insurance liabilities, including guarantees on inforce life insurance contracts. Hence, an appropriate asset liability management is needed. Especially, life insurers with high guarantees to policyholders that reside in countries where these guarantees are rigid (and sometimes even valid for future premiums), are at particular risk. This is amplified for contracts that have a long time to maturity embedded within them. These contracts are often also highly exposed to longevity risk.

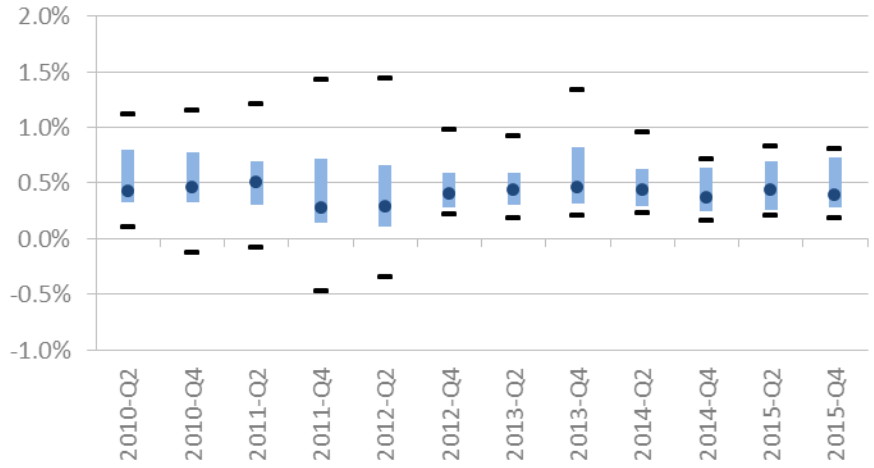
Both return on equity (ROE) and investment returns dropped in Q4 2015. Furthermore, additional monitoring is warranted to check whether the risk profile of investment portfolios will change and if, to which degree and at what pace. After all, the long-term sustainability of high-yield investments in such a market environment is questionable as long-term investors such as (re)insurers have difficulties in reinvesting assets at a reasonable level. Also, non-life insurers' business models might be impacted in this low-yield environment when lower investment returns cannot counter-balance potential underwriting losses as was often observed in the past. Pressure on motor insurance profitability is currently reported in a number of countries as the cost-competitive nature of motor insurance makes it challenging to generate substantial profits.

Further changes in product portfolios and business models may lead to a shifting of risks towards policyholders. In some countries , for example, a new generation of products with changed guarantees such as reduced or zero guarantees provides an innovative and forward-looking answer to the challenges posed by the low interest rates.

LIFE INSURERS

Return on assets (ROA) continues to be low (Figure 2.5). The average return on assets remained 0.4 per cent in the life business.

Figure 2.5: ROA – Life (in per cent; median, interquartile range and 10th and 90th percentile)

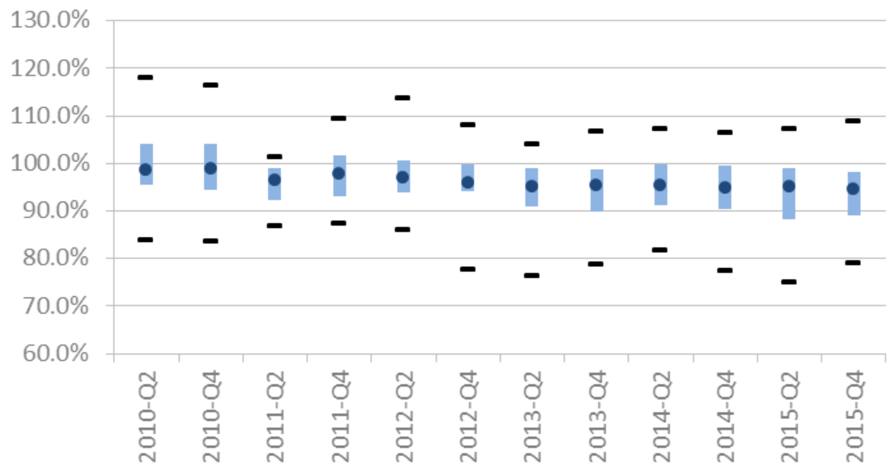


Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

NON-LIFE INSURERS

In the non-life business the combined ratio (CR) remained broadly unchanged (Figure 2.6). It was 94.6 per cent for the median company in Q4 2015, compared to 95.0 per cent in Q2 2015. Pressure is currently arising from motor insurance business which is highly competitive. It remains challenging to generate profits on this book, as a CR of over 100 per cent in some countries suggests. Hence, rate increases can be seen in some cases. However, increased claims provisions due to deteriorating claims experience are often offsetting the positive impact of these rate increases.

Figure 2.6: Combined Ratio – Non-Life (in per cent; median, interquartile range and 10th and 90th percentile)

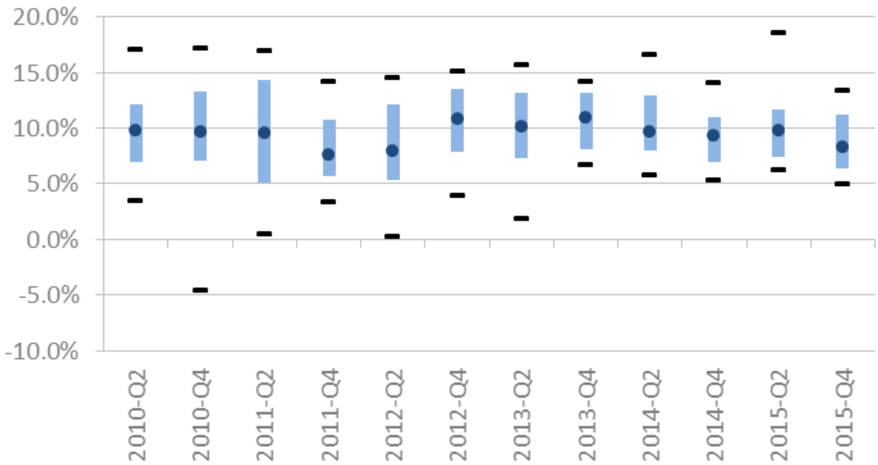


Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

LIFE AND NON-LIFE INSURERS

The ROE has deteriorated in Q4 2015 (Figure 2.7). The distribution shown reveals a broad-based deterioration in profitability. For the median company, it dropped to 8.3 per cent in Q4 2015 (from 9.8 per cent in Q2 2015), while for the 10th percentile it fell to 5.0 per cent from 6.3 per cent during the same time. For the 90th percentile on the other hand, the ROE is still a high 13.4 per cent although it has also fallen from 18.4 per cent in the same period.

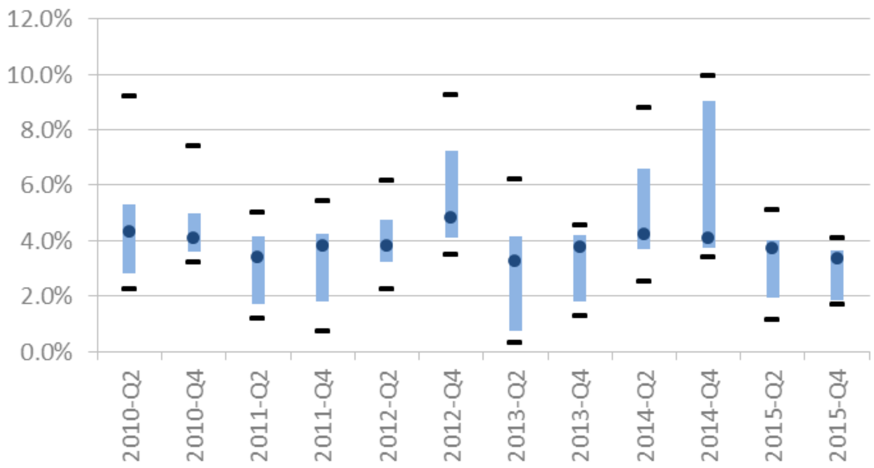
Figure 2.7: ROE – Life and Non-Life (in per cent; median, interquartile range and 10th and 90th percentile)



Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

Investment returns also experienced markedly lower returns for the median company during the last half of 2015 (Figure 2.8). The return on the investment portfolio has suffered from high volatility and lower prices on the worldwide stock markets. Following the uncertain and difficult market environment, some companies already implemented and continued to focus on efficiency management and cost-cutting schemes. These measures aim mostly to modernise the overall infrastructure (also to comply with Solvency II requirements) or to realise lower costs in the future through benefits of digitalisation. Still, it remains to be seen, whether these efforts are sufficient to offset the lower investment returns. Under continuing similar circumstances, it can be expected that more companies will have to follow this trend in the near future.

Figure 2.8: Investment Returns - Life and Non-Life (in per cent; median, interquartile range and 10th and 90th percentile)

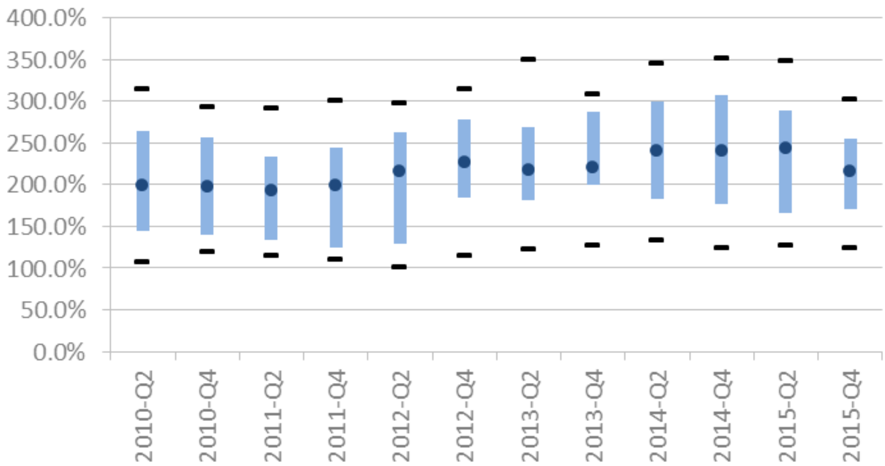


Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

2.3 Solvency

Under the Solvency I framework, that was in place until the end of 2015, total solvency ratios have declined for the whole European insurance sector (Figure 2.9). Solvency I did not fully take into account the importance of the evolution of interest rates in determining the overall financial soundness of an insurance company. Furthermore, the Solvency I ratio is characterised by shortcomings in directly translating financial market movements. The Solvency I ratio has declined from 244.2 per cent in Q2 2015 to 215.5 per cent for the median company in Q4 2015. The decline is partly due to a decreased dispersion within the sample.

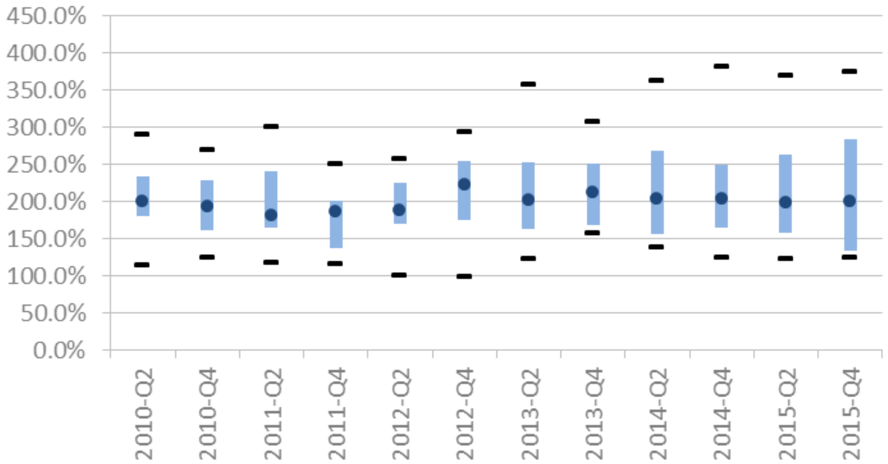
Figure 2.9: Solvency I ratio - Life and Non-Life (in per cent; median, interquartile range and 10th and 90th percentile)



Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

For life insurers, the Solvency I ratio dropped to just below 200 per cent for the median company in Q4 2015 (Figure 2.10). On the other hand, the Solvency I ratio is far higher for the 90th percentile.

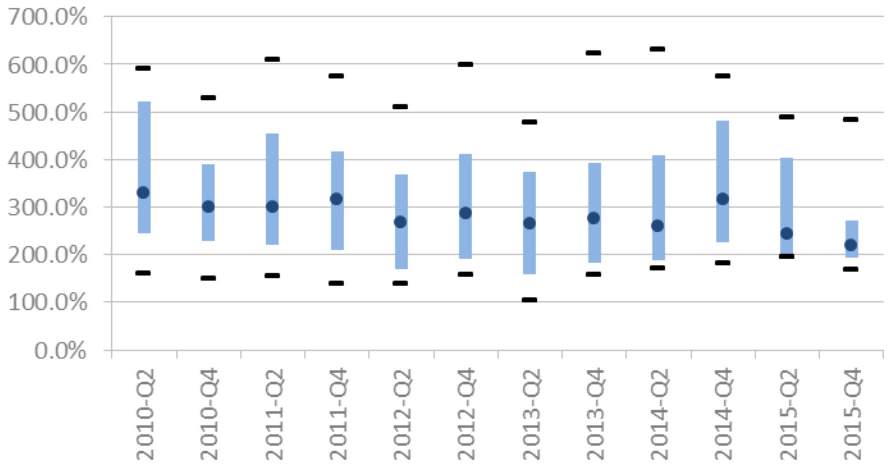
Figure 2.10: Solvency I ratio - Life (in per cent; median, interquartile range and 10th and 90th percentile)



Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

For non-life insurers, the Solvency I ratio for the median company also dropped to 220 per cent in Q4 2015 (Figure 2.11). Solvency I ratios for non-life insurers are in general higher than for life insurers.

Figure 2.11: Solvency I ratio, Non-Life (in per cent; median, interquartile range and 10th and 90th percentile)



Source: EIOPA (sample based on 32 large insurance groups in EU and Switzerland)

In preparation of Solvency II, some companies have taken measures to underpin their capital position. Solvency II, a more fair-value based, risk-sensitive solvency regime, will reflect the impact of the low yield environment more accurately. It will hence contribute to better risk management practices with a positive impact on the resilience of the European insurance sector in the medium to long-term. Solvency II takes a forward looking approach and requires companies to take remedial action if their business model is becoming unsustainable by, for example, increasing provisioning and avoiding dividend payments.

2.4 Regulatory developments

The new Solvency II regime came into force on 1st January 2016. Insurance and reinsurance undertakings across the EU are now subject to a harmonised, sound, robust and proportionate prudential supervisory regime, for which they have been preparing the implementation during the last years.

Under the new regime EIOPA plays an important role in monitoring and ensuring the consistent and convergent application of Solvency II. EIOPA's opinion on the application of a combination of the methods to the group solvency calculation, which has been issued as of 27th January 2016, could be referred to as a concrete example of this new role. The opinion intends to ensure convergent supervisory practices with respect to insurance groups allowed to calculate the group solvency with a combination of method 1 (consolidation method) and method 2 (deduction and aggregation method), in particular regarding the application of the tier limits to own funds.

On 1st April 2016 the amendment of the Solvency II Delegated Regulation with respect to the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings has been officially published. The amendment introduces a differentiated treatment (i.e. a lower risk calibration) for investments in infrastructure projects that meet a series of qualifying criteria designed to identify safer, higher quality investments. Subsequent changes will be adopted with respect to the Implementing Technical Standards on the templates for the submission of information to the supervisory authorities, in order to ensure that supervisors collect all the relevant information concerning these assets. Further amendments are envisaged in order to adopt a similar approach regarding the treatment of infrastructure corporates. For that purpose, the European Commission has requested EIOPA to define criteria or classifications to identify safer debt or equity investments in infrastructure corporates, to advise on appropriate calibrations for such investments and to provide a rigorous framework for insurers performing due diligence.

On 8th January 2016 EIOPA has released the first official monthly publication of the risk free interest rate term structures to be applied by all insurance and reinsurance companies in the calculation of their technical provisions. EIOPA already began with the publication of the risk-free interest rate curves in 2015 during a preparatory phase, intended to test the methodology applied and identify the necessary refinements before the full implementation of Solvency II.

The Insurance Distribution Directive (IDD) was adopted on 20th January 2016. This new directive updates the previous legislation in the area (Insurance Mediation Directive, 2002) and complements other rules on the sale of investment products (MiFID II) and packaged retail and insurance-based investment products (PRIIPS), taking into account the importance of ensuring effective consumer protection across all financial sectors as underlined by recent financial turbulence. It aims to strengthen policyholder protection (and the confidence of consumers) and to create a level playing field between insurance distributors across the EU.