2. The European insurance sector

The development of premiums written continued to be in line with EIOPA (see chapter 5) projections and expectations that anticipate a further improvement of premium growth in 2016 and 2017 (following negative premium growth in 2015 for life insurance). At the same time, long-term interest rates are expected to hover at low levels due to the additional QE.

2.1. Market growth

In the fourth quarter of 2014, some economies provide a positive environment to generate insurance growth, due to economic growth, low unemployment rates, and some increases in wage levels. European markets are in general highly developed, mature and very competitive but divergence in economic performance across the EU is expected to continue. Intense competition in this environment had driven the industry to considerably lower premium rates, particularly in motor insurance. This has resulted in meagre growth rates up until recently, from when the industry implemented premium rate increases in an attempt to avoid any further underwriting losses and to offset decreasing investment returns.

The UK has recently introduced major changes to the retirement market. These have removed the effective requirement for defined contribution pension savers to buy an annuity. Retirees now have the flexibility to take their pension pot as cash (subject to tax at their marginal rate), purchase an annuity or enter into drawdown. These changes are expected to result in a material reduction in the flow of new individual annuity business to life insurers and are likely to result in innovation in alternative products.

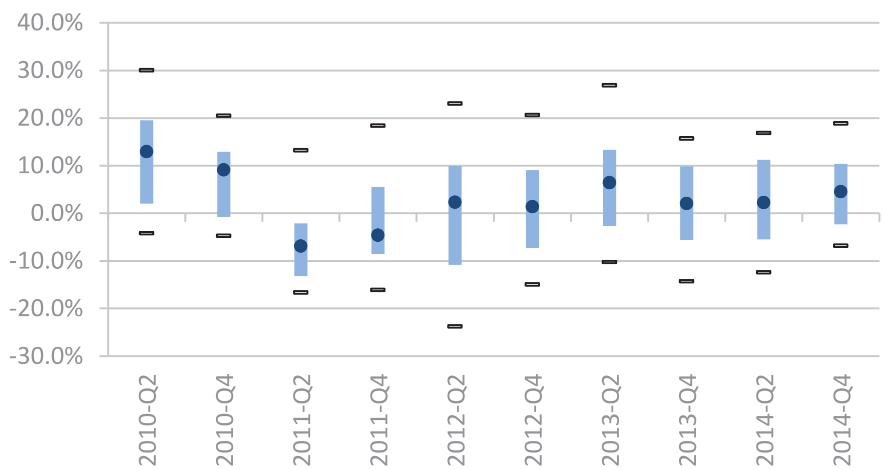
LIFE INSURERS

The life segment showed some recovery in premium income for the median company in 2014 (compared to 2013). Some member states reported growth figures prompted by regulatory changes that for example allow insurers to provide group health cover for employees. In many countries guaranteed products remained the main source for premium income. Moderate growth rates were reported in other countries reflecting disparate movements depending on the country considered, whilst others even reported negative growth rates mainly for investment life products due to changes in legal regulations.

On the one hand, unit-linked business is on average on the rise as in some countries traditional products are currently phased out. On the other hand, it is in decline for many countries as policyholders are simply not willing to carry the investment risk in times of low yields (see Figure 2.1).

Overall, growth in life premiums remains limited. In fact, the range of growth rates reported has tightened, and some firms are recording negative premium growth. In 2014, a negative 6.8% was reported for the 10th percentile (compared with minus 14.3% in 2013).

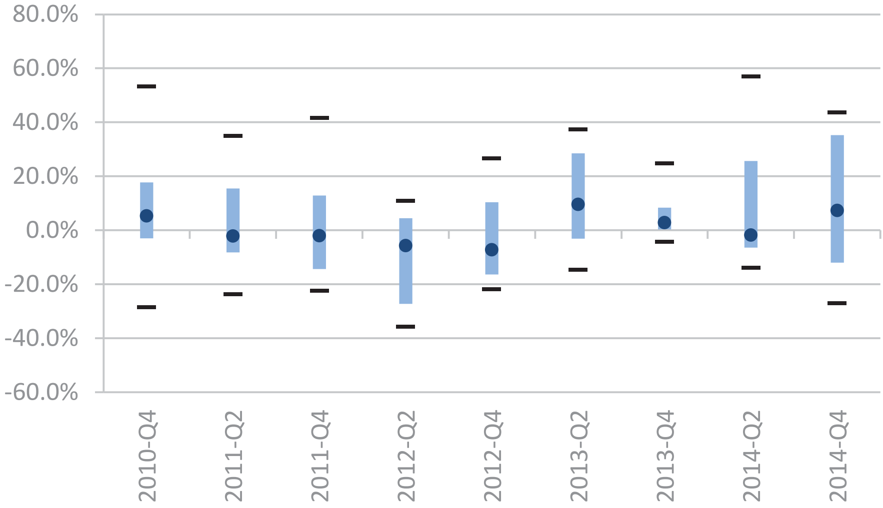
Figure 2.1: Year-on-year growth Gross written premiums - Life. Median, interquartile range and 10th and 90th percentile



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

Figure 2.2: Year-on-year growth in gross written premiums, unit-linked. Median, interquartile range and 10th and 90th percentile

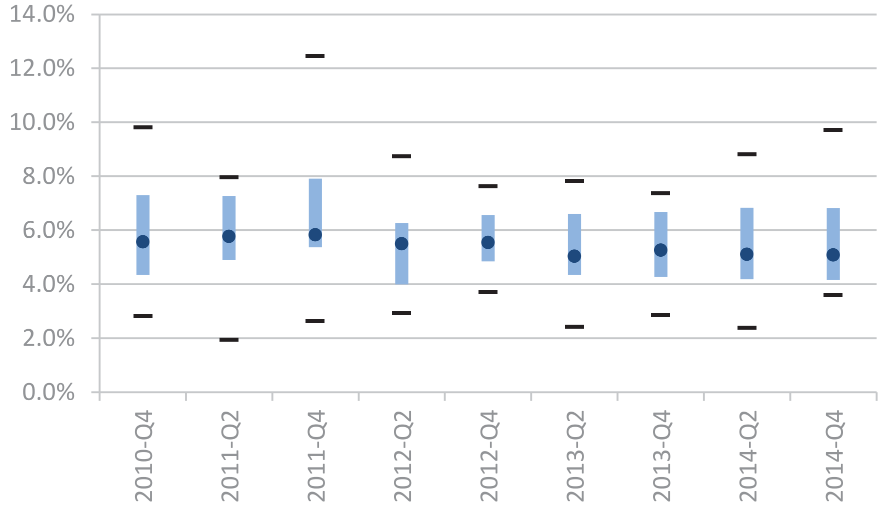
Life insurance – Unit-linked



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

Regarding cancellation of policies, some countries report easier cancellation clauses. Prevention against lapsation is the contractual penalty policy holders need to pay in case they lapse. The penalties are not always applied though. In some countries, insurers faced net cash outflows due to high lapse rates after the government had abolished certain tax advantages for life insurance policies. In other countries, the increase of an already existing tax further increased lapsation.

Figure 2.3: Lapse rates – Life. Median, interquartile range and 10th and 90th percentile



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

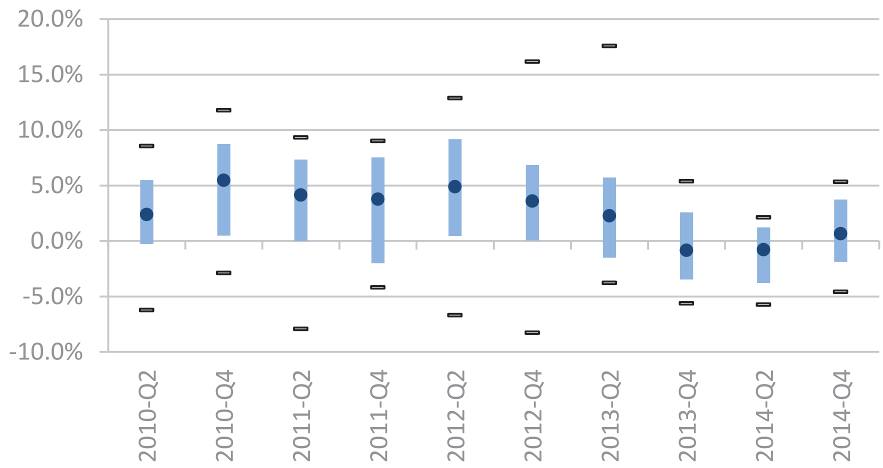
In addition, changes in legislation may also have an impact on life insurance premium growth. In the UK e.g. people will be in a position to take as much or as little as they want from their annuity when they reach the minimum retirement age. This could have far reaching implications for life insurers.

NON-LIFE INSURERS

Most countries indicate only minor growth in premiums in the non-life sector. This is due to compulsory business lines (Figure 2.4). Moreover, in the majority of countries, competition seems to increase. At the same time, claims remain under control as a result of the lower frequency of claims in motor insurance, which is in most countries the dominant class of property and casualty activity. Another factor that contributed to the favourable development of claims was the absence of major natural disasters in 2014.

For the median company, non-life insurance premiums stabilised in 2014 despite the low level. In some countries growth of premium income (Figure 2.4) is slowing due to lower economic growth or because of a very competitive non-life insurance market. The 10th percentile reports an improved but still high negative premium growth figure of minus 4.6% in 2014 (compared to minus 6.2% in 2013). The large drop is mostly due to shrinking demand for motor insurance, with car sales at multi-year lows in some countries. This will eventually put downward pressure on profits although underwriting results are still sound (see profitability section of this report).

Figure 2.4: Year-on-year growth Gross written premiums – Non-Life. Median, interquartile range and 10th and 90th percentile



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

2.2. Profitability

Profitability challenges remain. To remain competitive, insurers respond to the challenges of the low yield environment with various measures: a reduction of new and more flexible business guarantees and the development of new products with different guarantee structures can be seen. Also, further new guarantee concepts are being introduced, such as savings-type insurance products that guarantee a return only after the contract has been fulfilled rather than an annual return. This way, investment flexibility is increased and the capital costs are reduced as short-term market fluctuations can be absorbed over time.

Yields are at their lowest level ever and offering competitive rates that appeal to policyholders is getting increasingly difficult. Whether these new low guaranteed products will be a true competitor for asset managers or hedge funds in the long run remains to be seen. On the other hand, insurers are reacting by e.g. increasing their premiums or reallocating their portfolios towards more risky assets with higher expected rate of returns. Eventually this might make them even more vulnerable in the event of adverse market developments.

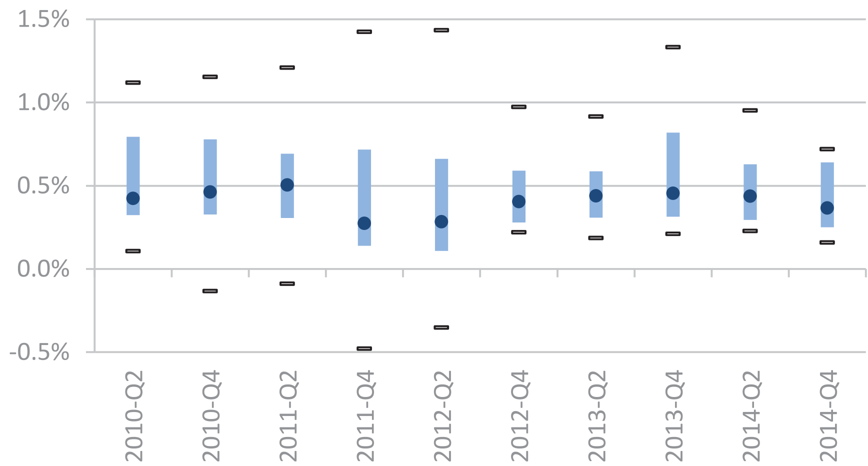
Insurers' earnings will continue to be challenged by the persistent low interest rate environment, which will adversely affect returns and pressure the profitability of products. In countries where life insurers have guaranteed returns, low interest rates reduce the margin between investment returns and the guaranteed rates, potentially opening a gap between the two. This issue has already prompted risk mitigation actions in many countries. Insurers are expected to continue to adapt business and investment strategies to meet the challenges of the current low interest rate environment.

A prolonged period of poor results will eventually affect insurers' strategies as already noticed through the increased M&A activity that was witnessed in 2014. Insurers will not only alter their product mix, but also their investment mix by taking on riskier or alternative activities or by international expansion in an attempt to maintain profits. The move into non-traditional bank-like activities through non-conventional lending arrangements can be the natural response in some cases.

LIFE INSURERS

Return on assets (ROA) continues to be low. Based on the reported data, the average return on assets (as a percentage of total assets) is relatively stable (Figure 2.5). The ROA for the median company was 0.4% in 2014. Low bond yields have not yet resulted in a sharply decreasing ROA in the past year. The main drivers for this trend have been positive stock market developments along with some gains from derivative positions in some countries.

Figure 2.5: ROA – Total. Median, interquartile range and 10th and 90th percentile



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

A clear message emerged from the 2014 EIOPA stress test (based on year-end data of 2013) showing that for most countries the duration of life insurers' liabilities is higher than that of assets. This message came together with the finding that the average return of the covering assets is also below the average level of the guarantees in many countries (Figure 2.6).

Given the still important stock of guaranteed return contracts in many member states, of which the duration is often longer than that of the covering assets, a renewed decline in long-term interest rates would further weaken insurance companies' capacities to repay relatively high rates of return, that were guaranteed when market rates were considerably higher. Business models are suffering from depressed interest rates as guarantees are in the money and insurance companies are required to match assets and liabilities, hence increasing the cost of managing their investments.

In the current low yield environment the situation described above puts a lot of pressure on the profitability of life insurance companies. As stated in the EIOPA stress test report, problems on sustainability will in general take more time to materialise depending on the current capitalisation level and the potential increased risk incurred due to the search for yield. These findings stand up despite the caveats already acknowledged in the stress test report regarding limitations on data quality and the comparatively lower coverage on the assets' than on the liabilities' side reported cash flows.

Figure 2.7 shows that for a number of jurisdictions the average durations are longer on the liabilities than on the assets side. Figure 2.6 also highlights that, for a number of jurisdictions, the internal rate of return is still higher on the assets than on the liabilities side providing a bit more time before capital might start eroding.

Figure 2.6: Duration mismatch

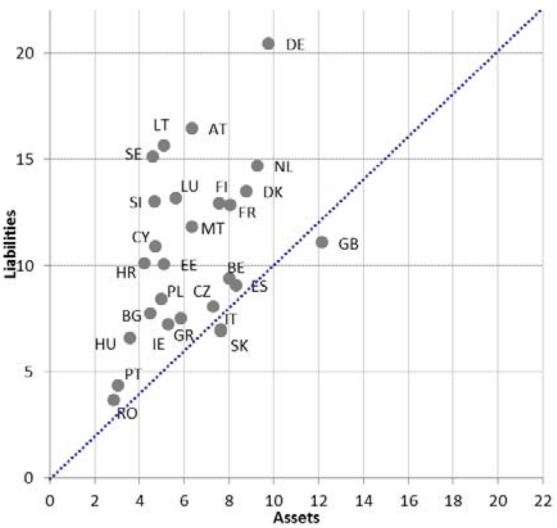
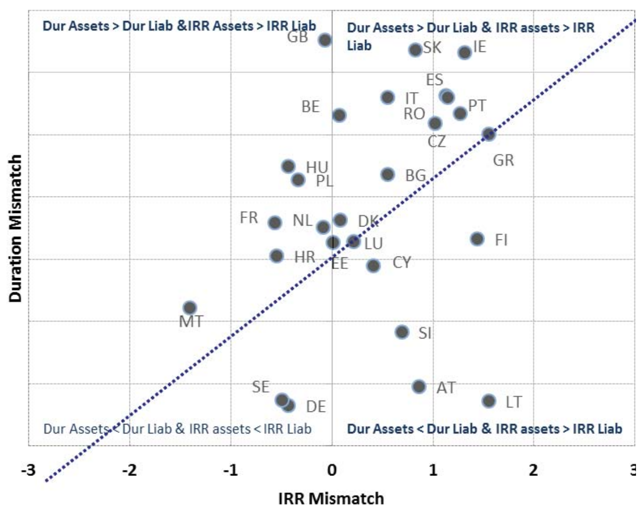


Figure 2.7: Joint mismatch of IRR and duration (assets minus liabilities)



Source: EIOPA Stress test report (2014)

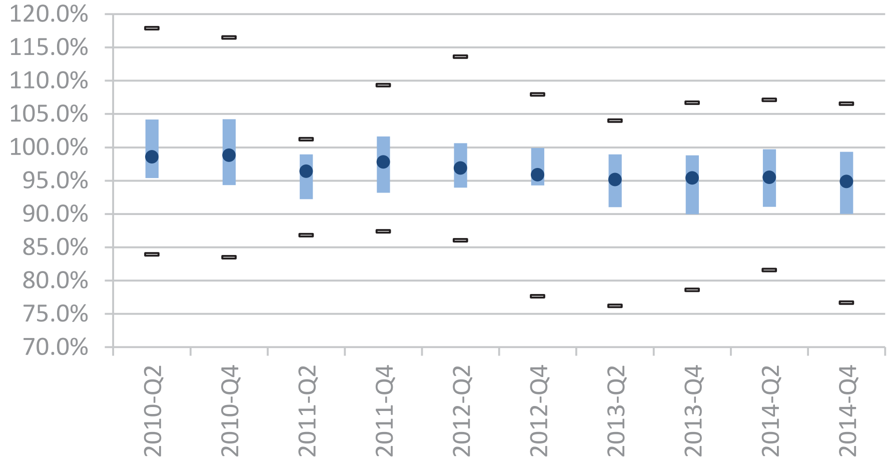
Whilst the upward movement in premium rates somewhat eased the burden on insurance companies, companies still gradually reinvest maturing bonds with higher coupons at the current lower market rates. Insurance companies can manage this risk by lowering the guaranteed returns and by lowering the duration of their contracts. For contracts with more flexible guaranteed returns, adjusting to market conditions for new premium periods, this significantly improves the resilience. However, for contracts with guaranteed returns fixed also for future premiums, the changes to the terms of these contracts only relate to new sales and the total effects will only be visible within a few years. Moreover, in some cases, these new contracts may contain embedded options. For instance, under certain circumstances, policyholders in some countries are now allowed to renew their contracts during the year.

As already pointed out, the duration of life insurers' liabilities is in many countries considerably longer than that of their assets, resulting in a significant asset-liability-mismatch risk. In Germany and Austria, e.g. maximum guaranteed interest rates were cut to 1.25% and 1.5% respectively (from 1.75%) as of January 2015. This should allow insurers to meet their inforce guarantee commitment, although only over the long term.

NON-LIFE INSURERS

For the median company, the Combined Ratio averaged about 95% in 2014 given the very limited frequency and severity of natural catastrophes over 2014. Pressure still arises in loss-making business lines such as motor insurance (Figure 2.8).

Figure 2.8: Combined Ratio – Non-Life. Median, interquartile range and 10th and 90th percentile

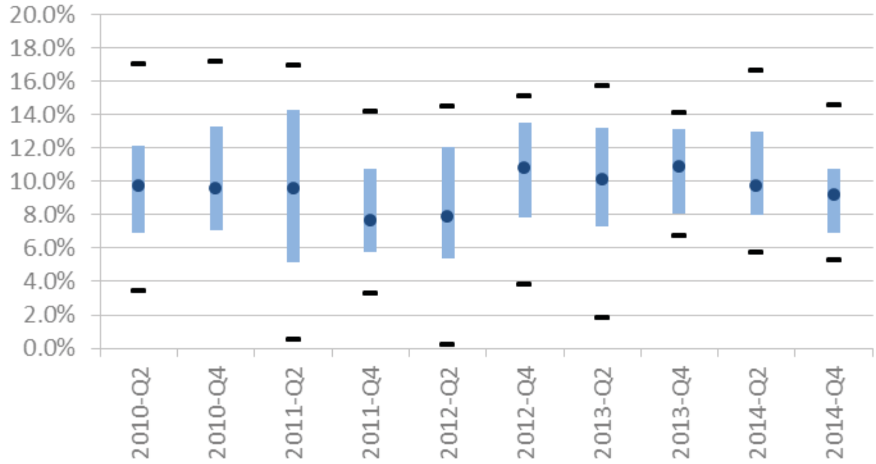


Source: EIOPA (sample based on large insurance groups in EU and Switzerland)

LIFE AND NON-LIFE INSURERS

The return on equity (ROE) has dropped in 2014. The ROE for the median company is 9.2% at the end of 2014. Due to competitive pricing and weak investment returns over the past year, ROE (Figure 2.9) has dropped by 1.7 percentage point in 2014 though (with ROE to be down from 10.9% in 2013). Non-life companies operate typically with lower fixed income asset durations than their life counterparts. Thus, their returns typically adjust more quickly to the current low yield environment. Claims growth has also remained benign.

Figure 2.9: ROE – Total, Median, interquartile range and 10th and 90th percentile

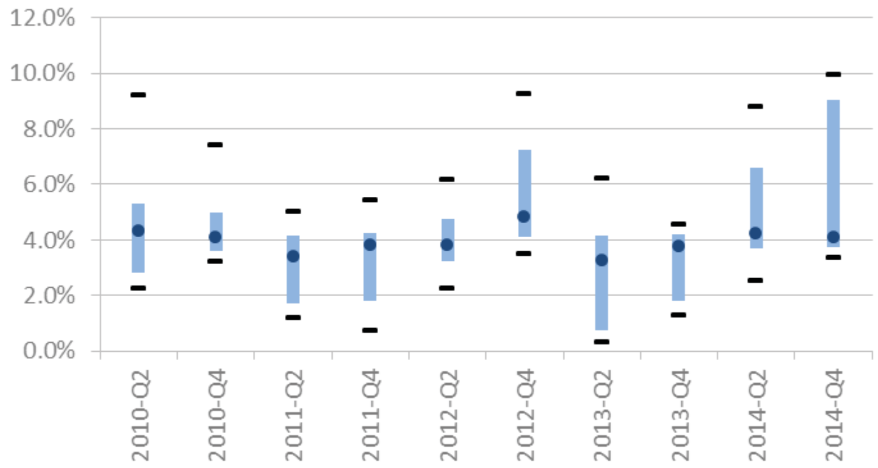


Source: EIOPA (sample based on large insurance groups in EU and Switzerland)

Also the investment returns weakened slightly in 2014, albeit to a much lesser extent. The median investment return (Figure 2.10) is still a strong 4.1% (compared with 4.2% in 2013) despite the fall in bond yields (after a short-lived recovery in 2013) and maturing investments being reinvested at lower yields.

The overall investment environment remains challenging and it is still far from certain that the investment return will remain at this level in the future. Over the course of 2014, risk free rates have decreased and credit spreads have tightened throughout the Eurozone. Bond yields will remain low until at least 2016, given that further monetary easing by the European Central Bank is expected. The fall in yields might eventually have a further negative impact on the ROE. At the same time, continuous losses in some business lines, especially motor, will decrease returns further, inevitably leading to increased rates for many insurance companies.

Figure 2.10: Return on Investment – Total. Median, interquartile range and 10th and 90th percentile



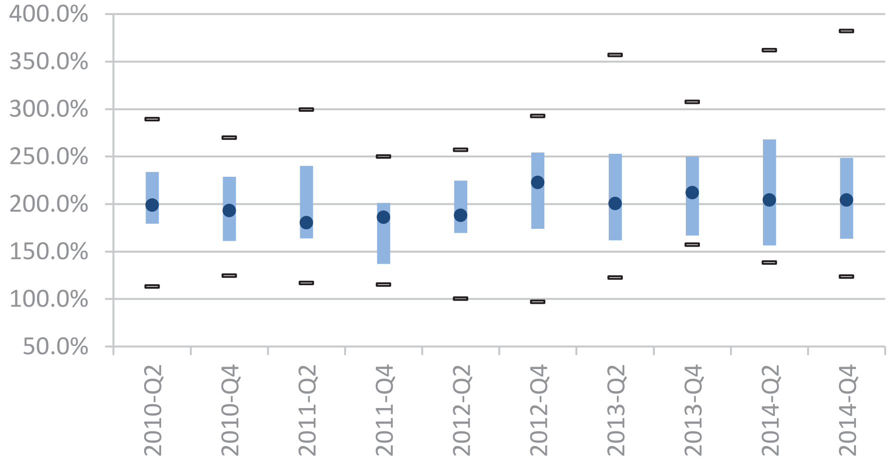
Source: EIOPA (sample based on large insurance groups in EU and Switzerland)

2.3. Solvency

The Solvency I ratio has remained adequate for the whole European insurance sector. For life insurers it has dropped slightly (due to the link between solvency margin and the life insurance liabilities, with the latter increased due to low interest rates in some jurisdictions), whilst it improved for non-life insurers. Figure 2.11 and Figure 2.12 show the required minimum margin for life and non-life companies.

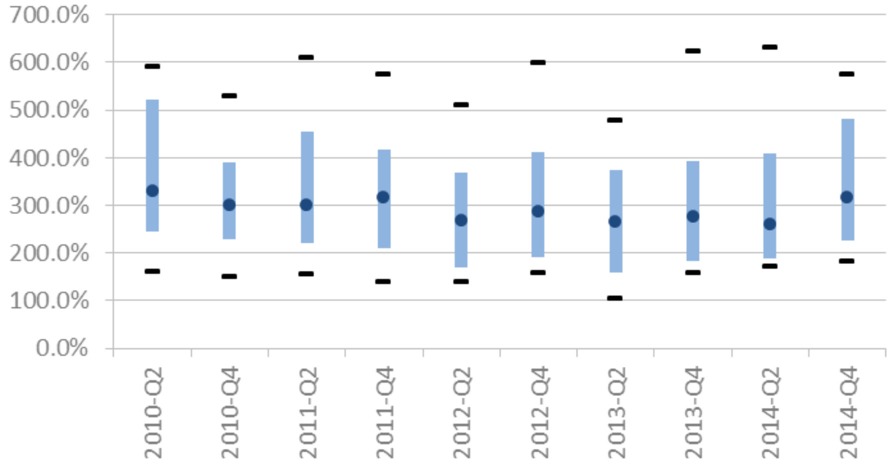
Significant changes lie ahead for Europe's insurers. The implementation of Solvency II is little more than 6 months away. For insurers, it is a critical period moving from Solvency I to Solvency II regulatory regimes.

Figure 2.11: Solvency I Ratio - Life. Median, interquartile range and 10th and 90th percentile



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

Figure 2.12: Solvency I Ratio, Non-Life. Median, interquartile range and 10th and 90th percentile



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

The start of Solvency II next year marks a major step forward in modernizing and harmonizing European insurance regulation. Solvency II applies a common risk-sensitive and market consistent regime to European insurers. It replaces Solvency I, a relatively risk-insensitive framework, under which a patchwork of different regulatory regimes has been developed. Given the micro- and macro-prudential benefits of a harmonized, market consistent and risk-sensitive regime, a quick and efficient implementation of Solvency II is essential.

With regards to Solvency II, the recent EIOPA stress test found that 14% of the core stress[1] participants (representing 3% of total assets in the sample) would have a Solvency Capital Requirement ratio below 100% (when calculated on a Solvency II basis using only the standard formula taking into account the optional use of long-term-guarantee measures and the impossibility of using undertaking-specific parameters). However, the use of internal (or partially internal) models and transitional measures might mitigate this impact.

The risk sensitiveness introduced in Solvency II capital requirements will increase undertaking's awareness on their exposure to products with long term guarantees, especially in low yield environments like the current one. As a response to that they will likely adapt their business models or their ALM strategies or both.

2.4. Regulatory developments

Following the publication of the Delegated Regulation by the EU Commission in January 2015, remarkable regulatory developments have been achieved for the completion of the Solvency II framework and relevant steps have been taken towards its effective implementation.

A first set of guidelines issued by EIOPA in order to ensure a consistent and uniform implementation of Solvency II was officially published in February 2015. These guidelines are aimed to provide the necessary level of detail for a consistent approach across the European insurance sector in areas such as the calculation of technical provisions, solvency capital requirements or own funds.

[1] The EIOPA stress test comprises two completely independent main blocks, based on different assumptions and sample of participants: a) core module assessing separately the impact of market and insurance stresses to the sample including Insurance Groups and Solos with a view to revealing the possible effects on the main sector vulnerabilities. For this purpose EIOPA developed two hypothetic market stress scenarios jointly with the ESRB and (separately) the participants who were also requested to test a set of single risk factor tests (i.e. life and non-life stresses) and b) low yield module investigating the size, timing and scope of the vulnerability implied by the current low interest rate environment to the most potentially exposed solo insurance undertakings by testing two hypothetical risk-free rate discount curves.

Based on the draft proposals submitted by EIOPA, the EU Commission published in March 2015 the implementing technical standards on the approval of the matching adjustment, ancillary own funds, undertaking-specific parameters, special purpose vehicles, internal models and joint decision processes for group internal models. From 1st April 2015 insurers can formally seek for the approval by their supervisors of the application of those particular and relevant elements of the new prudential framework.

Also in March 2015 EIOPA published a technical advice to the EU Commission on the recovery plans and finance schemes to be provided by insurers in case of non-compliance with the new capital requirements under Solvency II and the supervisory measures that can be taken by supervisors in case of deteriorating financial conditions, taking due care to avoid pro-cyclical effects.

The publication of a second set of guidelines and implementing technical standards, expected between June and October 2015, will be a further and ultimate step before the first day of enforcement of Solvency II.

Furthermore, during the first quarter of 2015 EIOPA started the regular publication of important inputs to be used by insurance companies for the Solvency II calculations. In particular, these are relevant risk free interest rate term structures for the calculation of technical provisions and the technical information on the symmetric adjustment of the equity capital charge under Solvency II. Both are key elements for the assessment of the insurance companies' solvency and financial position. The risk-free interest rate structure and its adjustments determine the value of the liabilities of the undertakings and, to a large degree, the amount of capital which European insurers need to hold against their liabilities. The symmetric adjustment of the equity capital charge (also referred as equity dampener) aims to mitigate undue potential pro-cyclical effects of the financial system and avoid a situation in which insurance companies are unduly forced to raise additional capital or sell their investments as a result of adverse movements in financial markets.

The technical information published by EIOPA mentioned in the paragraph above is instrumental for the annual reporting by undertakings under the Solvency II Preparatory Phase with reference to 31 December 2014 that is expected by the first week of June 2015 (mid-July for groups) and the quarterly reporting with reference to 30 September 2015 that is envisaged by the last week of November 2015 (first week of January 2016 for groups). For these purposes insurance undertakings will make use of harmonised EU-wide reporting formats which are crucial to ensure a consistent implementation of European regulatory and supervisory frameworks to support

EIOPA's goal to improve the efficiency and consistency of the supervision of financial institutions across Europe.

Insurance undertakings, national supervisory authorities and EIOPA are preparing for Solvency II implementation and complementary to these preparatory guidelines. EIOPA issued in December 2014 general recommendations for NSAs based on the findings of the last EU-wide insurance stress test. Among other, EIOPA recommended NSAs to engage in a rigorous assessment of the preparedness of insurance undertakings to implement Solvency II, to engage with troubled firms assessing their planning of capital, balance sheet management and their capacity to utilise all available features of the Solvency II framework and finally to report by September 30 on the number, size and market significance of those undertakings that are not expected to meet the capital requirements of Solvency II from 1 January 2016. Moreover, these recommendations should also be viewed as fulfilling the commitments set out in the EIOPA Opinion on the supervisory response to a prolonged period of low interest rates.