## 2. The European insurance sector

The sector has continued to adjust to the new Solvency II (SII) regime, which entered into force in January 2016. The Solvency II Directive introduced significant changes and specific requirements related (among others) to different reporting formats, the best estimate of technical reserves, more stringent capital adequacy requirements, specific measurement and presentation requirements.

In 2016, the first year of the application of Solvency II, the reporting of insurance and reinsurance undertakings to National Supervisory Authorities (NSAs) is limited. In particular, according to the Solvency II reporting the impact of the LTG (long term guarantees) measures on the financial position have been reported to NSAs for the first time in 2017. Therefore, also the information available to EIOPA about the impact of these measures on undertakings is limited. While the 2016 stress test already provided some information on the impact of LTG measures, its full potential will only be reached during the course of 2017 (Box 3).

### *Box 3: Impact of the LTG (long term guarantees) measures*

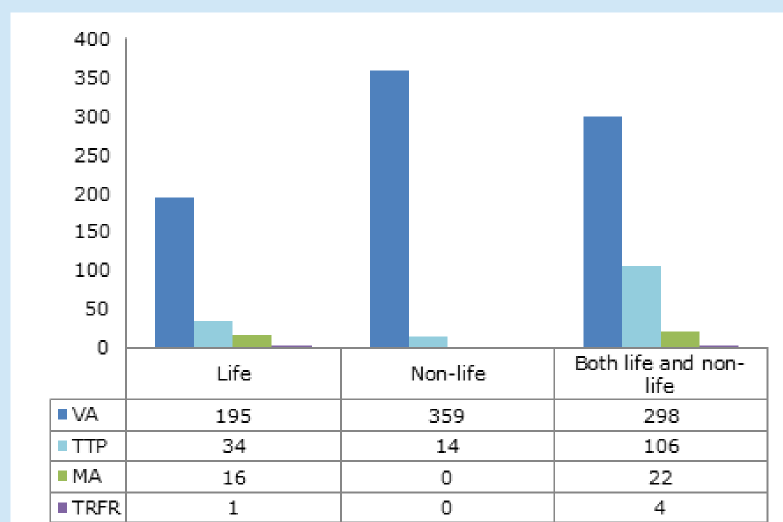
The Solvency II Directive (Art.77(f)) requires EIOPA on an annual basis until 2020 to report to the European Parliament, the Council and the Commission about the impact of the application of the so called long term guarantees (LTG) measures. The findings will form the basis for the review of the Solvency II Directive in this respect.

LTG measures are a series of measures amending the Solvency II Directive through the Omnibus II Directive  in order to ensure an appropriate treatment of insurance products that include long term guarantees. The LTG measures include: extrapolation of the risk-free interest rates; matching adjustment (MA), volatility adjustment (VA), extension of the recovery period (ERP), transitional on the risk free rate (TRFR), transitional on technical provisions (TTP). The application of the MA, VA, TRFR and TTP is optional for undertakings. These measures are intended to limit procyclicality and to enable a smooth transition to the new regulatory framework of Solvency II providing companies with the necessary time to adapt, in particular in a challenging macroeconomic environment.

In December 2016 EIOPA published the first Annual Report on LTG measures in particular on their use and impact on the financial position of insurers in terms

both of solvency capital requirement ratio and technical reserves.[17] Insurance companies covered in the LTG report and using at least one of the measures amount to 69% of the technical provisions (901 insurance undertakings) of the EEA insurance and reinsurance market, representing together 24 different countries. The application of the MA, VA, TRFR and TTP is optional for undertakings. The remaining 31% did not make use of any of these optional measures. The results of the LTG report show that the most used measure is the VA while the least used is the TRFR.

*Figure B3.1: Number of undertakings using the LTG measures*




| | Life | Non-life | Both life and non-life |
|---|---|---|---|
| VA | 195 | 359 | 298 |
| TTP | 34 | 14 | 106 |
| MA | 16 | 0 | 22 |
| TRFR | 1 | 0 | 4 |

*Source: EIOPA LTG Report*

The impact of the measures were calculated for the representative smaple of life insurers applying the measures. The most pronounced impact was attributed to the MA measure while the least one could be observed for the VA measure.

*Table B3.1: Impact of the LTG measures*

| | Initial SCR ratio | SCR ratio without the measure |
|---|---|---|
| MA | 144% | 75% |
| VA | 206% | 172% |
| TRFR | 154% | 102% |
| TTP | 183% | 115% |

*Source: EIOPA Insurance Stress Test 2016*

*Note: Each category refers to undertakings applying the respective measure.*

[17] https://eiopa.europa.eu/Publications/Press Releases/2016-12-16 LTG Report_final.pdf

## 2.1. Overview and data

This Financial Stability Report presents EIOPA's risk analysis and assessment of the European insurance industry. With the implementation of the Solvency II regime in January 2016 substantial improvements as regards the risks' quantification and the reporting standards were introduced. Despite the regime implying a major change in the way insurance companies have to set up their balance sheet and calculate their solvency capital requirements, the initial transition has been rather smooth resulting in a relatively stable profitability and solvency position (section 2.2 and 2.3 in this chapter for further details).

EIOPA bases the analysis for this report on Quarterly Financial Stability Reporting Group (QFG), Quarterly Financial Stability Reporting Solo (QFS)[18] and Quarterly Prudential Reporting Solo.[19] [20]

The summary statistics of the amount of total assets, technical provisions (TP) and gross written premiums (GWP) for all insurance and reinsurance undertakings is shown below (Table 2.1). Total assets are on average EUR 100,071 mn in Q4 2016. Also, for the average company, EUR 81,322mn of insurers' liabilities are TPs, i.e. contractual obligations to policyholders. The average company wrote EUR 11,466mn GWP in 2016.[21]

*Table 2.1: Summary statistics in EUR mn*

| Percentile | average | min | 10th | 25th | median | 75th | 90th | max | total |
|---|---|---|---|---|---|---|---|---|---|
| Total assets | 100,071 | 12,334 | 15,862 | 23,567 | 50,943 | 105,593 | 269,926 | 688,888 | 8,606,153 |
| TP | 81,322 | 5,991 | 12,372 | 16,504 | 38,861 | 84,978 | 189,534 | 548,029 | 6,820,489 |
| GWP | 11,466 | 0 | 1,166 | 2,494 | 4,131 | 12,059 | 29,716 | 119,916 | 965,105 |

*Source: EIOPA (sample based on 104 insurance groups in EEA)*

*Reporting reference date 31/12/2016*

**TPs are the largest item on the balance sheet (BS)** (Figure 2.1). They are hence a key input into the Solvency Capital Requirement (SCR) calculation, which models

[18] It covers 94 groups and 24 solos.

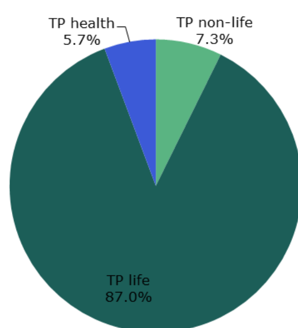
[19] It is based on 3076 solo insurance undertakings.

[20] The last available data for both groups and solos was 31/12/2016 (Q4) at the time of writing this report. The reference date for all indicators used in this report is hence Q4, unless otherwise indicated. The sample size for the different indicators may vary according to availability and consistency of the reported information.

[21] Note that not all companies report under financial stability reporting. For the full sample of 2640 solo undertakings subject to prudential reporting total assets are EUR 11trn, TPs EUR 8.7 trn and GWP EUR 3.8 trn.

the potential movement in the SII balance sheet over a one year time. Insurance companies' liabilities are mainly technical reserves for which market value is not available and the value is calculated as the expected value of all discounted cash flows. In terms of technical provisions, life insurance is by far the largest item per business line.

*Figure 2.1: Technical Provisions (TP) - by type of business in %*

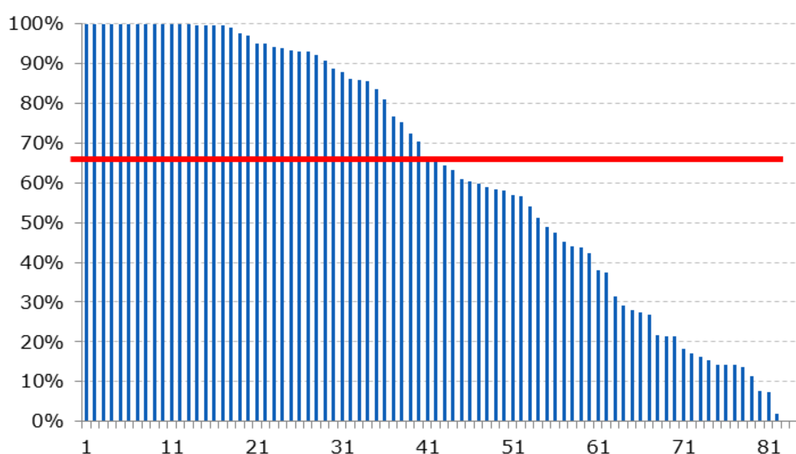



*Source: EIOPA (sample based on 2640 solo undertakings in EEA)*

*Reporting reference date: 31/12/2016*

The share of life business for each individual undertaking is shown in the data reported (Figure 2.2). Most insurance groups offer both life and non-life products. The business mix is slightly unbalanced towards life insurance business (with the median having a share of life business of 65% in Q4).

*Figure 2.2: Gross Written Premiums (GWP) - Share life business in %*

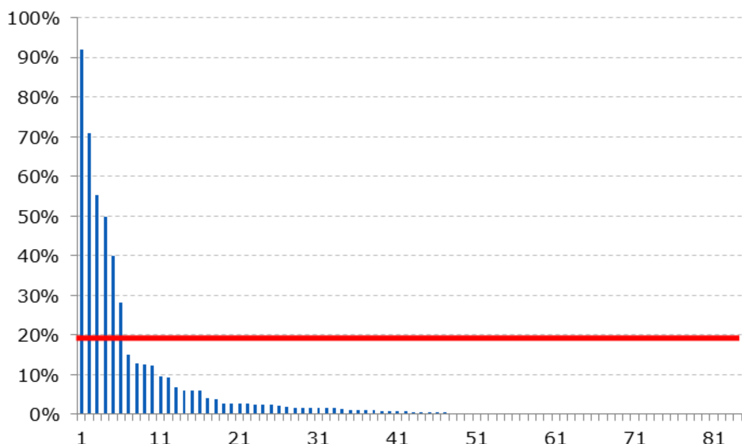



*Source: EIOPA (sample based on 104 insurance groups in EEA)*

*Reporting reference date: 31/12/2016*

The share of reinsurance business (in terms of gross written premium) for each individual undertaking can be calculated (Figure 2.3). Only six insurance groups have more than 20% of the share of GWP reinsured.

*Figure 2.3: Gross Written Premiums (GWP) - Share reinsurance business in %*

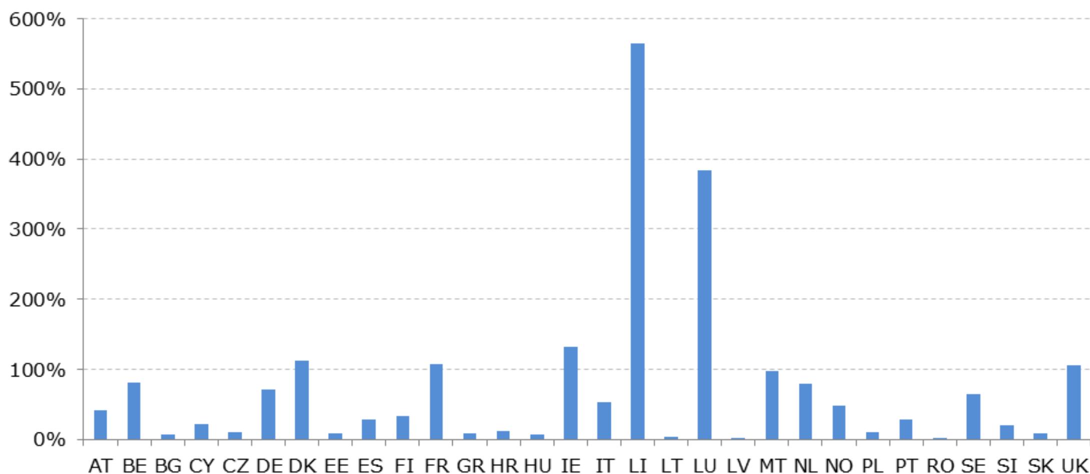



*Source: EIOPA (sample based on 104 insurance groups in EEA)*

*Reporting reference date: 31/12/2016*

The importance of insurance sectors substantially differs among European countries (Figure 2.4). Measuring the size of the sector by total assets as a percentage of GDP, it ranges from 2% in Latvia to very high ratios in Liechtenstein and Luxembourg where a lot of cross-border life business is written.

*Figure 2.4: Total Assets (TA) - Share of GDP in %*

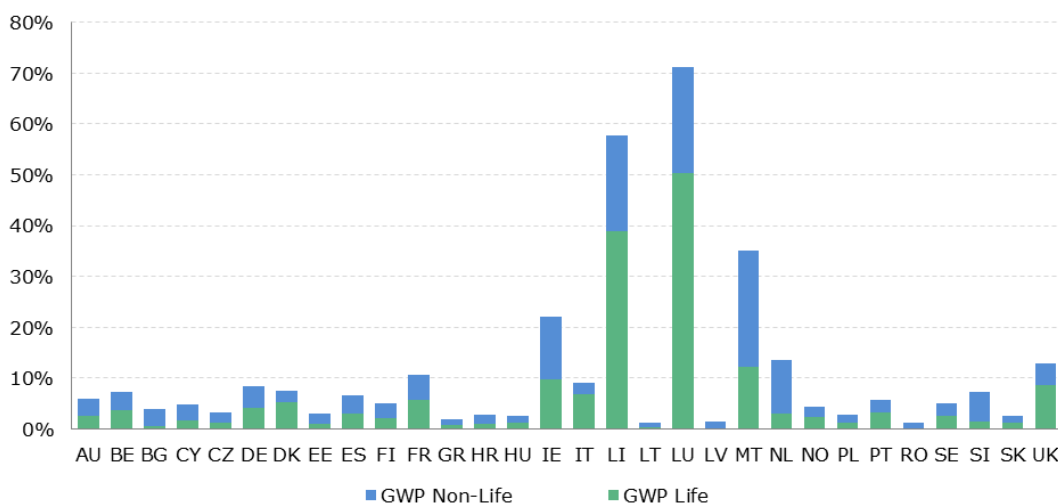



*Source: EIOPA (sample based on 2640 solo undertakings in EEA) and ECB for GDP*

*Reporting reference date: 31/12/2016*

Similarly, insurance penetration is a commonly recognised indicator of insurance activity, defined as gross written premium (GWP) as a percentage of GDP (Figure 2.5). Significant disparities are observed within European countries. Liechtenstein also ranks highest in terms of the penetration rates, both for life and non-life business. For non-life business Malta and Luxembourg are countries with high penetration levels (22.8% and 20.9% respectively). For life business, Luxembourg ranks highest (50.3%), while Latvia and Romania rank lowest (0.1% and 0.2%).

*Figure 2.5: Gross Written Premiums (GWP) - Share of GDP in %*




*Source: EIOPA (sample based on 2640 solo undertakings in EEA) annualised GWP and ECB for GDP*

*Reporting reference date: 31/12/2016*

**Capital requirements for unit-linked products are less stringent but the higher risk for policyholders has to entail a closer supervision of the duty to provide proper advice** (Table 2.2). There seems to be a general weakening of demand for life insurance products in the recent past, in line with the persistence of low interest rates which already weighs on new volumes of products.[22] In this perspective, the introduction of new products such as index-linked products needs to be monitored. [23]

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[22] Note that Solvency II data needs to be developed over time.

[23] Index-linked policies should not be confused with unit-linked policies. For index-linked policies the greater part of the money is invested in zero coupon bonds and the remainder is invested in structured products linked to the indices that are therefore more risky.

*Table 2.2: GWP-Life business: Unit-linked share in %*

| Percentile | 31/12/2016 |
|---|---|
| 10th | 0 |
| 25th | 1 |
| Median | 18.6 |
| 75th | 57.2 |
| 90th | 93.1 |
| Average | 26.2 |

*Source: EIOPA (sample based on 2640 solo undertakings in EEA),*

*Reporting reference date: 31/12/2016*

*Note: this average is obtained by the mean of the ratio where the numerator is gross written premium unit-linked (summed up across all insurers) and the denominator is gross written premium life (summed up across all insurers)*

**Compared to the previous year, no significant changes in the business model and strategy of insurance undertakings or in their overall risk profile have been observed**. Elements of strategies continue to be - amongst others - the development of new products with no long-term engagement and low(er) guaranteed interest rates that are often no longer "fixed for life", and the application of cost cutting plans that allow a positive technical result to regain profitability. Many companies have also e.g. put (a part of) their business into run-off, whilst others have switched their internal structure from a subsidiary to a branch. Others also focused on capital strengthening exercises. These changes focus almost exclusively on the life insurance business that suffers increasingly from the ever-increasing difficult environment. Indeed, some insurance groups nowadays show a growing tendency to mainly focus on non-life products and some companies have recently also decided to no longer commercialise classic individual life contracts. Lately however, more drastically measures have been observed with some companies cutting certain high fixed guarantees by setting-up “new” contracts with the insured, and companies offering advantageous conditions for clients to buy back or surrender their hard-guaranteed products. In fact, the maximum guaranteed interest rate which can be offered on insurance products was lowered in many countries once more at the beginning of 2016. In addition, sometimes unsustainable profit participations could be reduced if the legal framework allows. This also applies to business models when dividend distributions can be cancelled entirely or deferred.

**The lapse rate for life insurance companies is 2.11% for the median company in 2016** (Table 2.3). The current annual value demonstrates an overall low level of

lapses in the life sector for the median company. However, as the 90th percentile shows, in some countries people lapse their life insurance contracts. This is e.g. the case when the period of preferential fiscal treatment ends and guaranteed certain interest rates are no longer available. Also, the cancellation via the internet for term life insurance products is very easy and has an effect on lapse rates as well albeit it should be mentioned that this business line is usually a minor line of business. Annual solvency returns and/or quarterly return submissions should help to measure lapse rates adequately. Some countries already measure this risk on an on-going basis through different models such as traffic lights or quarterly stress tests which should facilitate to monitor the evolution of lapses in the future.

*Table 2.3: Lapse rate in %*

| Percentile | 31/12/2016 |
| --- | --- |
| 10th | 0.27% |
| 25th | 0.97% |
| Median | 2.11% |
| 75th | 4.55% |
| 90th | 6.98% |

*Source: EIOPA (sample based on 104 solo and group undertakings),*

*Reporting reference date: 31/12/2016*

## *2.2. Profitability*

Profitability results provide a quantified estimation of the insurance sector's vulnerability to the low interest rate environment and to a pronounced reassessment of risk premia.[24] The industry registered an almost unchanged profitability level. Yields in Europe, although improving slightly in the recent quarter, remain near historical lows and risks concerning the low profitability of financial entities pose key concerns to the financial system. Low yields have more seriously affected the profitability of life insurers, especially in some countries where there is a large stock of contracts with high guarantees. Hence, the development of business models guaranteeing lasting profitability for insurers, even in less favourable economic circumstances, is required.

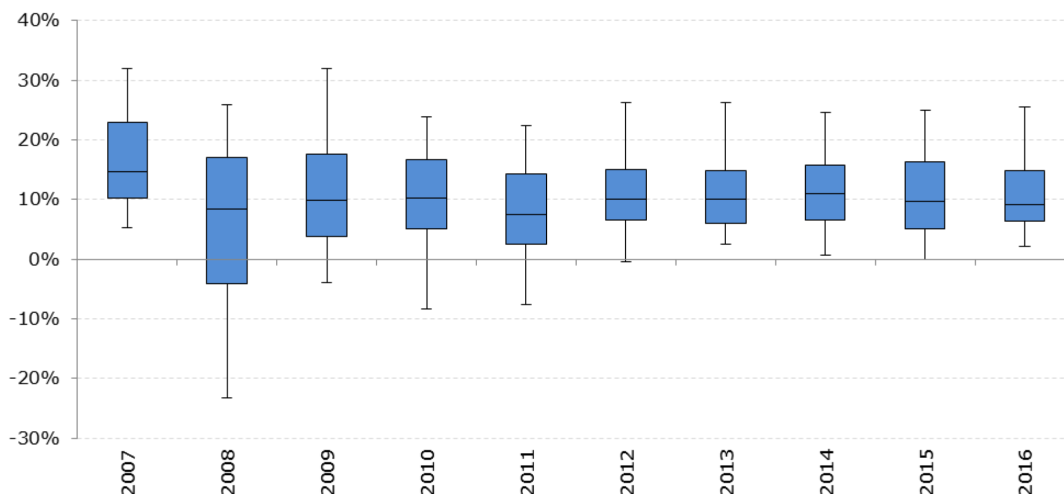
**The Return on Equity (ROE) for the median company is 9.1% in 2016, against 9.7% in 2015 and 11% in 2014** (Figure 2.6).[25] As the low interest rate

[24] Profitability refers to ROA and ROE and not to fiscal profits or fiscal losses.

[25] Note that results for year-end 2016 are preliminary.

environment is ongoing, these good results should gradually dampen further in the future.

*Figure 2.6: Return on Equity (ROE) in %*

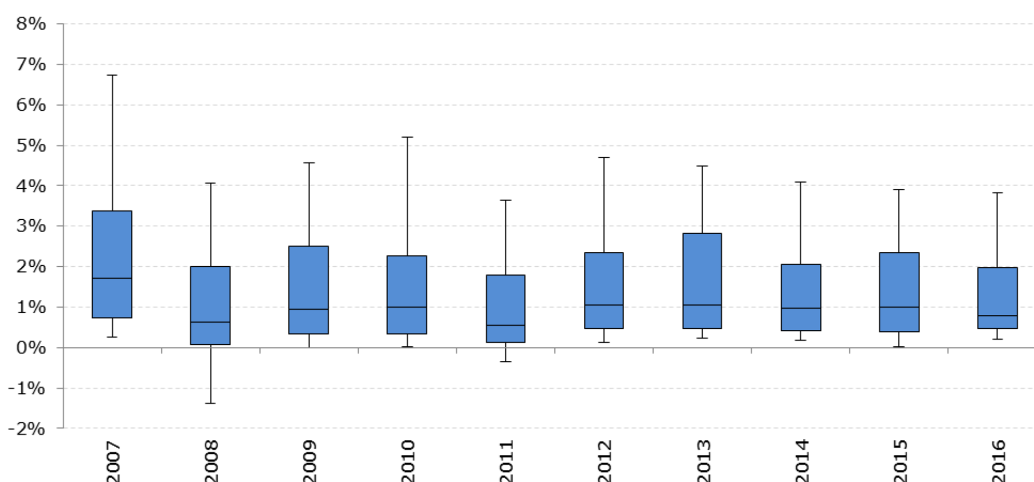



*Source: S&P Capital IQ, 114 insurance undertakings and brokers from 23 EEA countries*

*Reporting reference date: 31/12/2016*

**The Return on Assets (ROA) for the median company continues to be stable** (Figure 2.7). Based on our data, it is about 1% in 2016. However, insurers whose business models depend heavily on interest-rate-sensitive product lines such as traditional long-term savings products with fixed guarantees already see declining ROA.

*Figure 2.7: Return on Assets (ROA) in %*

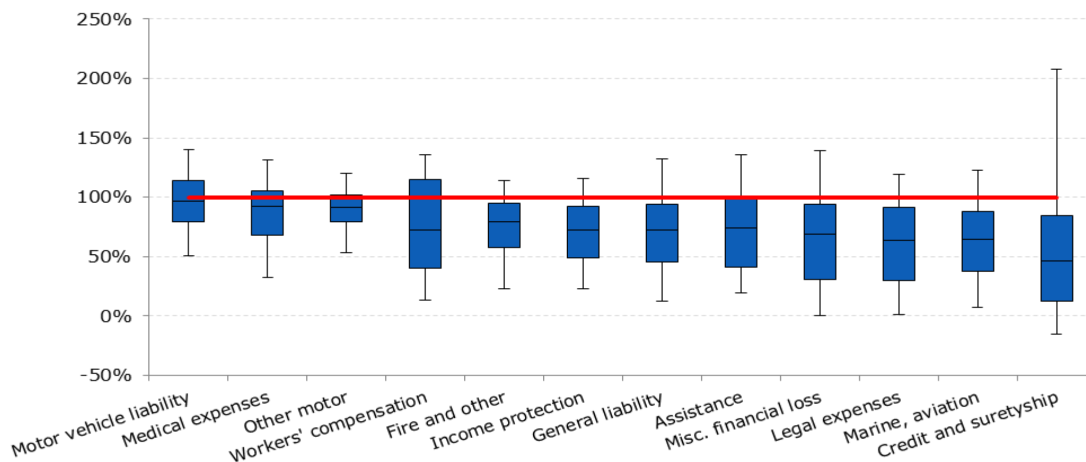



*Source: S&P Capital IQ, 114 insurance undertakings and brokers from 23 EEA countries*

*Reporting reference date: 31/12/2016*

**The net Combined Ratio (CR) in the non-life sector has been relatively stable across business lines** (Figure 2.8). Overall, the sector hence currently benefits from low underwriting risks, reflected by a median net Combined Ratio of below 100%. Whether the natural catastrophes claims in 2016 and early 2017 will have an impact on the Combined Ratio remains to be seen. With regards to the 90th percentile, the net CR averages more than 100% in Q4 2016. Especially the motor sector faces on-going high competitive pressures. As such, prices are suppressed, and the range of products available within this line is broad. It needs to be watched if national supervisors report increasing claims in the future. So far no increase in claims has been observed.

*Figure 2.8: Net Combined Ratio across business lines (in %; median, interquartile range and 10th and 90th percentile)*




*Source: EIOPA (sample based on 1608 solo non-life undertakings in EEA)*

*Reporting reference data: 31/12/2016*

## 2.3. Solvency

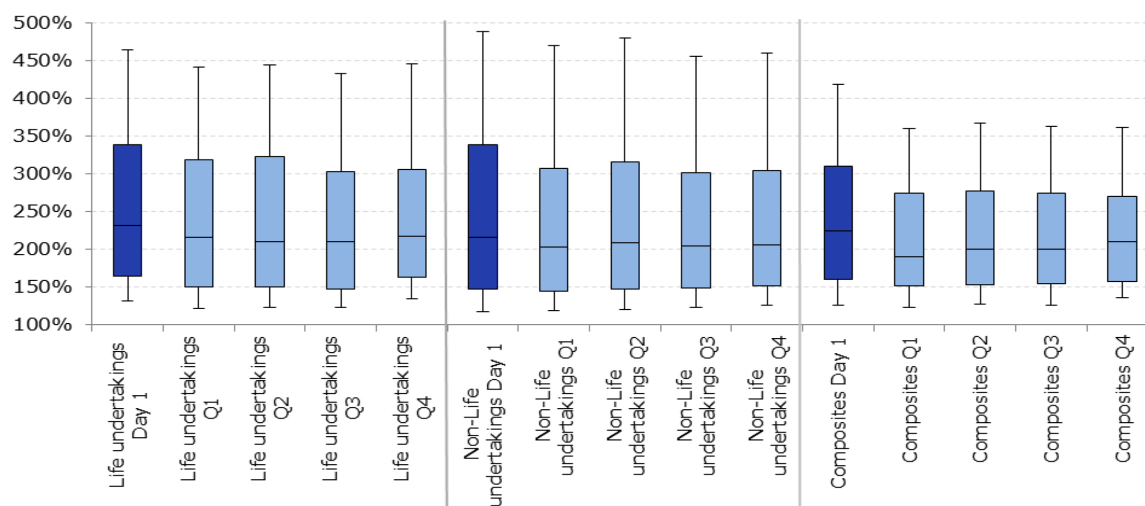
The Solvency Capital Requirement (SCR) can be calculated with a standard formula that is specified in the regulation or with an internal model that was approved by the NSA. It is also possible to calculate a part of the SCR with an internal model (partial internal model) and the remaining part with the standard formula. The SCR standard formula consists of modules for the different risks that an insurance and reinsurance undertaking is exposed to (in particular market risks, underwriting risks, counterparty default risks, operational risks). The risk that relates to the change of equity prices is captured in the equity risk sub-module of the standard formula. The MCR is usually lower than the SCR. It corresponds to the minimum level of security that is required under Solvency II. An insurance or reinsurance undertaking not complying with the

MCR would expose policyholders and beneficiaries to an unacceptable level of risk. If an insurer does not cover the MCR with own funds, its authorisation will be withdrawn unless the MCR is covered again within 3 months. The MCR is usually between 25% and 45% of the SCR.

The SCR ratio is the ratio of eligible own funds and SCR. Insurers have to maintain the SCR ratio of 100% or higher to comply with regulatory requirements. The MCR ratio is the ratio of eligible own funds and MCR. The MCR ratio needs to be 100% or higher to comply with regulatory requirements.

**As of December 2016, the majority of solo insurance undertakings show a SCR ratio above 100%** (Figure 2.9). The SCR ratio for the median insurance company is 209% in Q4. It corresponds to 217% for life insurance companies, 207% for non-life insurance companies and 210% for undertakings pursuing both life and non-life business at the same time. Solvency II levels for all insurance undertakings marginally improved in Q4 when compared with Q3 for the median company. This is mainly due to the increase in own funds.

*Figure 2.9: SCR ratio (in %; median, interquartile range and 10th and 90th percentile)*[26]




*Source: EIOPA (sample based on 2640 solo insurance undertakings in EEA)*

*Reporting reference data: 31/12/2016*

**The same conclusion for the SCR ratio could be made at country level as well** (Figure 2.10). The figures show that the SCR ratios are well above the prudential

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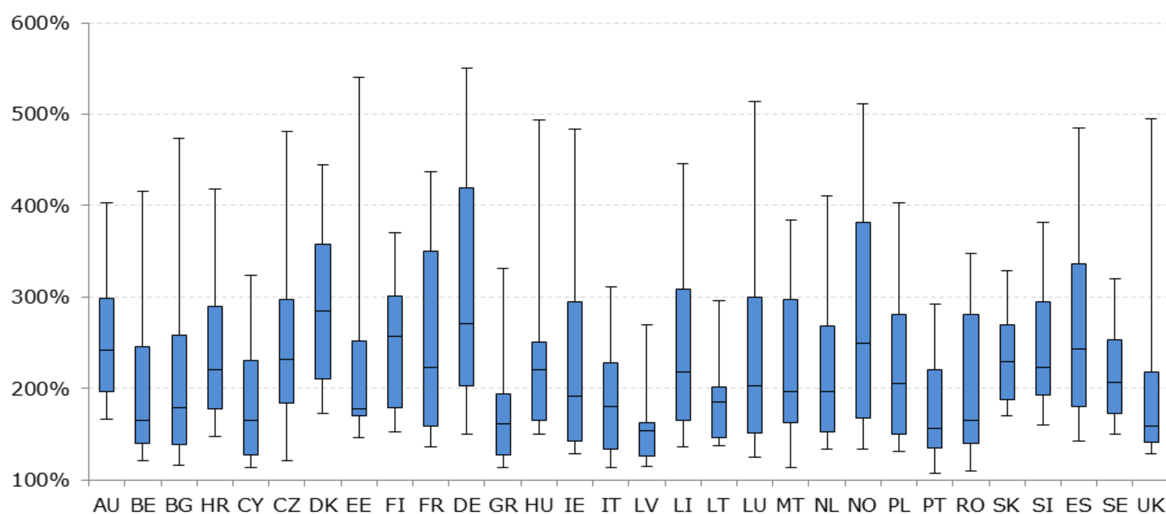
[26] Please note that the graph does not show any observation below the 10th percentile.

requirement of 100% for the median company in all countries, ranging from 153% to 285% in Q4 2016.

*Figure 2.10: SCR ratio by country (in %; median, interquartile range and 10th and 90th percentile)*




*Source: EIOPA (sample based on 2640 solo insurance undertakings in EEA)*

*Reporting reference data: 31/12/2016*

## *2.4. Regulatory developments*

In January 2017 the European Commission and the US Department of the Treasury and Office of the Trade Representative jointly announced the successful conclusion of negotiations of an Agreement between the EU and the USA on insurance and reinsurance. The Agreement covers three key areas of prudential insurance oversight: reinsurance, group supervision and exchange of insurance information between supervisors. Through this Agreement, collateral and local presence requirements for reinsurers operating on a cross-border basis between the EU and the USA will be removed, under certain conditions. Furthermore EU and US (re)insurance groups active in both jurisdictions will not be subject to certain requirements with respect to group supervision for their worldwide activities, but supervisors retain the ability to request and obtain information about worldwide activities which could harm policyholders' interests or financial stability. The Agreement also contains model provisions for the exchange of information between supervisors, which supervisors on both sides of the Atlantic are encouraged to follow. It is being notified to Congress in the USA and will be submitted to the EU Member States in Council in view of its formal

signature. The European Parliament's consent will also be needed for the conclusion of this Agreement.

**In February 2017, EIOPA forwarded to the Commission its technical advice on possible delegated acts concerning the IDD Insurance Distribution Directive (IDD)**. The technical advice covers the following aspects: product oversight and governance; conflicts of interest; inducements; and assessment of suitability and appropriateness and reporting. In particular, the policy proposals on product oversight and governance arrangements aim to ensure that the interests of the customers are taken into consideration throughout the life cycle of a product, namely the process of designing and manufacturing the product, bringing it to the market and monitoring the product once it has been distributed. Moreover, the policy proposals on conflicts of interest, inducements as well as suitability/appropriateness aim to ensure that distribution activities are carried out in accordance with the best interests of customers and to ensure that customers buy insurance-based investment products which are suitable and appropriate for them.

**As part of the IDD development, EIOPA submitted also to the Commission in February 2017 the draft Implementing Technical Standards (ITS) for the Insurance Product Information Document (IPID)**. These include the proposal of a standardised presentation format to be completed by insurance providers that will be given to customers prior to the sale of a non-life insurance product. The objective of the IPID is to ensure that the customer has the relevant pre-sales information about products to allow him to easily compare between different product offerings and to make an informed decision about whether to purchase a product.

**As part of the process of the Capital Market Union initiative of the European Commission, EIOPA has received on 22nd February 2017 a call for technical advice as regards unjustified constraints to financing, in view of removing barriers to investments in unrated bonds and loans and in unlisted equity**. Separately, this call for advice asks for information on the current application of the provisions related to strategic equity investments. EIOPA will base both of its advice on evidence and has engaged on discussions with stakeholders. The advices should be provided by February 2018.

**According to the EU Audit Regulation**[27]**, EIOPA issued in February 2017 guidelines addressed to insurance supervisory authorities for the purpose of facilitating the establishment and the maintenance of effective dialogue with statutory auditor(s) and audit firm(s) carrying out the statutory audit of insurance undertakings**. The Solvency II Directive provides legal requirements on statutory auditors to report promptly any facts which are likely to have a serious effect on the financial situation or the administrative organisation of a (re)insurance undertaking. However, in addition to that duty, supervisory tasks can be supported by effective dialogue between supervisors and statutory auditors and audit firms. EIOPA's Guidelines are aimed to support a consistent, appropriate and proportionate supervisory approach in aspects such as the objectives of the dialogue with statutory auditors and audit firms, nature of the information to be exchanged, means and channels for communication as well as frequency and timing of the dialogue, among others.

**On the 21st February 2017 the three European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) published a joint Opinion addressed to the European Commission on the risks of money laundering (ML) and terrorist financing (TF) affecting the European Union's financial sector**. The Joint Opinion finds that problems exist in relation to firms' understanding and management of the ML/TF risk they are exposed to. The Opinion also highlights difficulties associated with the lack of timely access to intelligence that might help firms identify and prevent terrorist financing, and considerable differences in the way national competent authorities discharge their functions. These issues, if not addressed, risk diminishing the robustness of the EU's AML/CFT defences and more action is needed to ensure their effectiveness. This is particularly important as Member States move towards a more risk-based AML/CFT regime that requires a level of ML/TF risk awareness and management expertise, which not all firms and all sectors currently have.

**In the wake of the global financial crisis the G20 summit in Pittsburgh agreed on a stricter regulation of derivatives transactions**. After in-depth discussions both on the international and European level the Delegated Regulation (EU) 2016/2251 on OTC derivatives, central counterparties and trade repositories with

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[27] Article 12(2) of Regulation (EU) No 537/2014 of 16 April 2014 of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities.

regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty entered into force in January 2017. It includes provisions for the exchange of initial and variation margin for non-centrally cleared OTC derivatives. While most pension funds and insurers will not be in the scope of the initial margin requirements, they will have to exchange variation margin.