5. Risk assessment

This chapter assesses the risks that were identified and elaborated in the earlier chapters of this report.

5.1. Qualitative risk assessment

Qualitative risk assessment is an important part of the overall financial stability framework. EIOPA conducts regular bottom-up surveys among national supervisors to rank the key risks to financial stability for the insurance, as well as for the occupational pension sector. This chapter summarizes the main findings revealed from the survey.

Figure 5.1: Risk assessment for the insurance sector

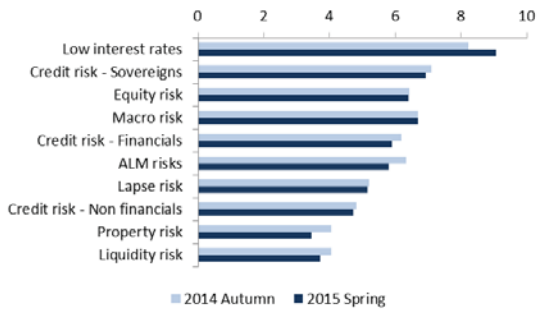
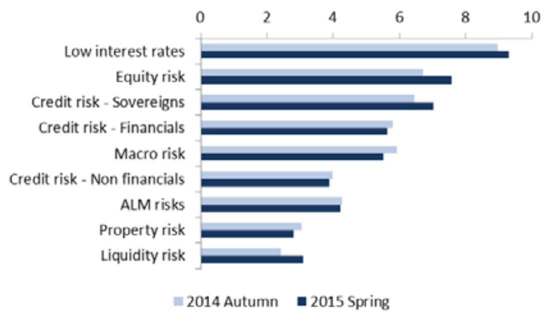


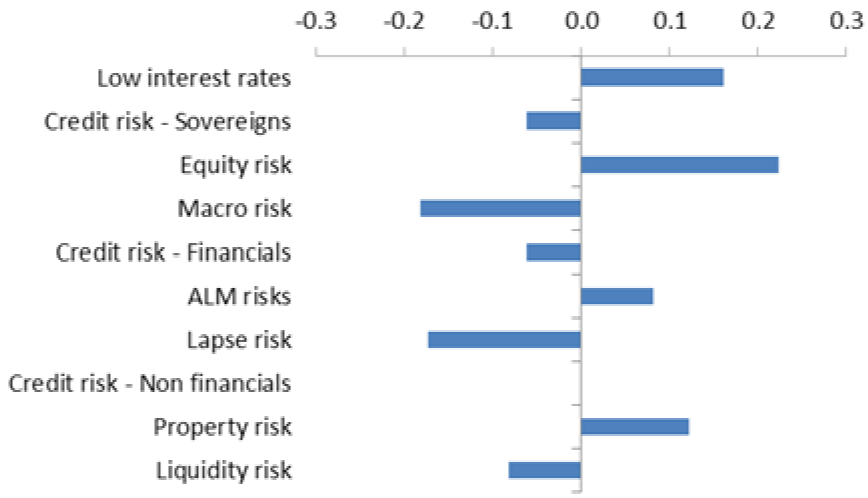
Figure 5.2: Risk assessment for the pension funds sector



Source: EIOPA

Note: Risks are ranked according to probability of materialisation (from 1 indicating low probability to 4 indicating high probability) and the impact (1 indicating low impact and 4 indicating high impact). The figure shows the aggregation (i.e. probability times impact) of the average scores assigned to each risk.

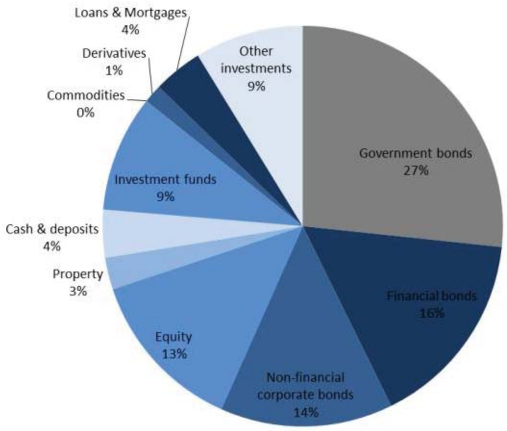
Figure 5.3. Supervisory risk assessment for insurance and pension funds - expected future development



Note: EIOPA members indicated their expectation for the future development of these risks. Scores were provided in the range -2 indicating considerable decrease and +2 indicating considerable increase.

In particular, the low interest rate environment continues to impact both the pension and the insurance sector alike. This is likely to continue to put pressure on earnings, especially for contracts promising guarantees. As a result, evolving investment strategies seeking higher returns are likely to lead to increased capital requirements for asset risks. Hence, common vulnerabilities to the low interest rates may eventually also lead to solvency problems with potential financial stability implications. The EIOPA insurance stress test report 2014 reveals indeed that the low interest rate environment will become an urgent problem for life insurers. Liquidity pressure due to lapses could increase the scale of disruption. Asset allocation in risky investments could also add to this. Investments in equity continue to increase. Although on average this increase is still small and there is no clear trend yet of an investment shift, equity markets in Europe might come under pressure given the overall macro-economic situation causing an adverse impact for insurers invested in this asset category.

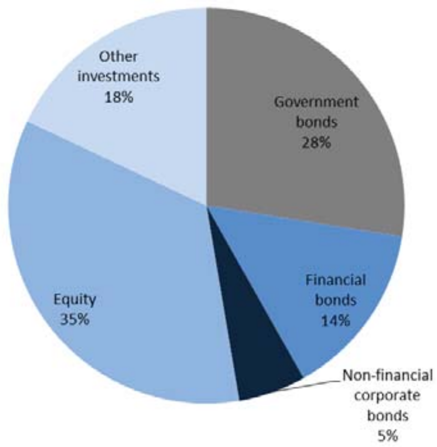
Figure 5.4: Average composition of the investment portfolio of the insurance sector 2014



Source: EIOPA

Note: Estimation based on a sample of 32 large insurers

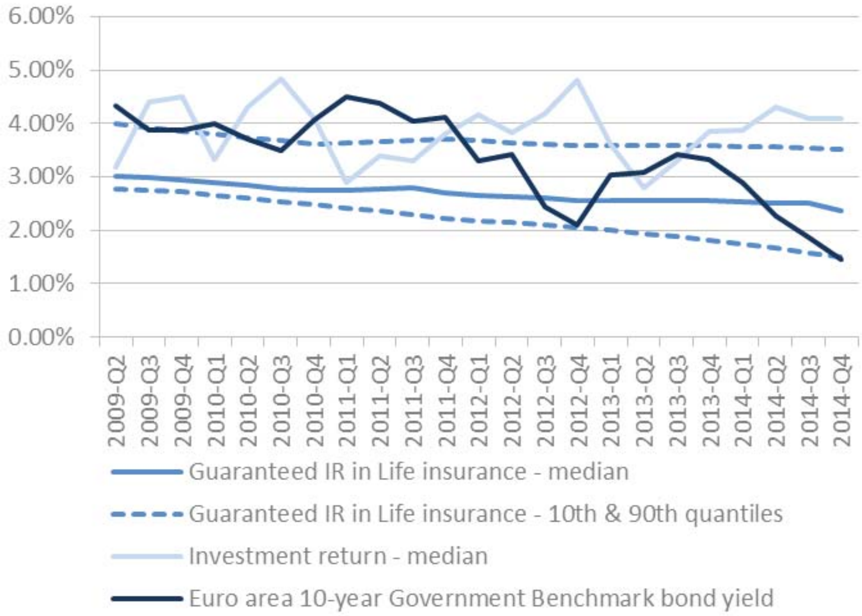
Figure 5.5: Average composition of the investment portfolio of the pension sector 2014



Note: Estimation based on a sample of 21 pension companies. For a few countries 2014 figures are preliminary and subject to major revisions

Now that average interest rate guarantees have been reduced again (but still account for 2.7% for the median company), life insurance might become even more attractive compared to other savings products that offer much lower returns in comparison. For new business, however, these high rates cannot be achieved anymore. Sovereign bond yields have fallen significantly in recent times. In fact they have been below the average interest rate guarantee.

Figure 5.6: Guaranteed interest rate in life insurance vs. investment return, Euro area 10-year government bond:



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

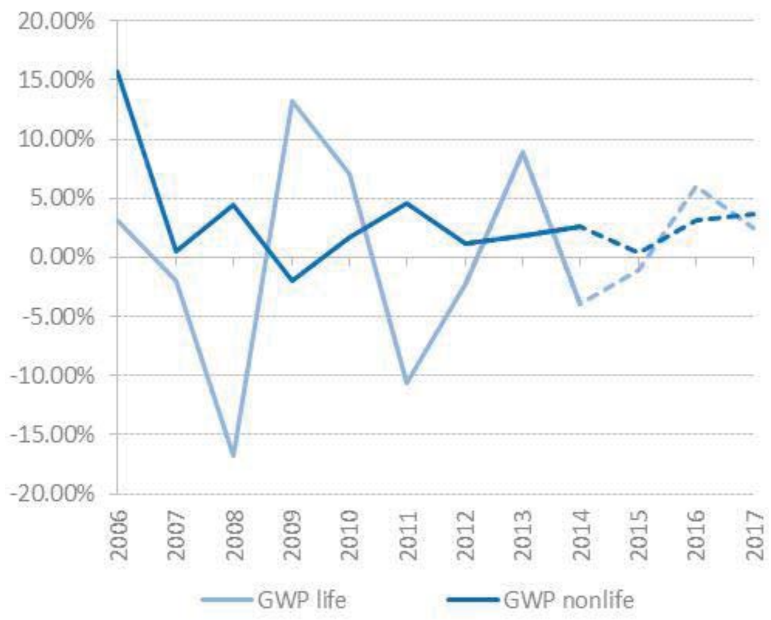
Note: the figures represent annual guaranteed rates for businesses where such guarantees are applied

5.2. Quantitative risk assessment

The key risks identified in the previous chapters are assessed in more detail in the following sections as part of a quantitative financial stability framework that EIOPA is developing for the insurance sector. First, growth in written premiums – a key insurance variable – is projected. Second, the scale and the drivers behind the expansion of insurers in emerging markets are tested empirically. Finally, some results from the recent stress test are used to assess risks mentioned earlier in the report.

Market growth for both life and non-life insurers is expected to be positive in 2016 and 2017. The latest EIOPA estimates suggest some slowdown for non-life growth in 2015 reflecting a current difficult market environment. Life insurance growth is still expected to be marginally negative in 2015 due to the persistently high level of unemployment as well as outstanding guarantees. However, market growth is projected to be positive for both life and non-life insurance in 2016 and 2017 benefitting from an expected economic recovery. Moreover, non-life insurance is less volatile because of compulsory business lines (Figure 5.7).

Figure 5.7: Gross Written premiums (GWP) projection for the Eurozone

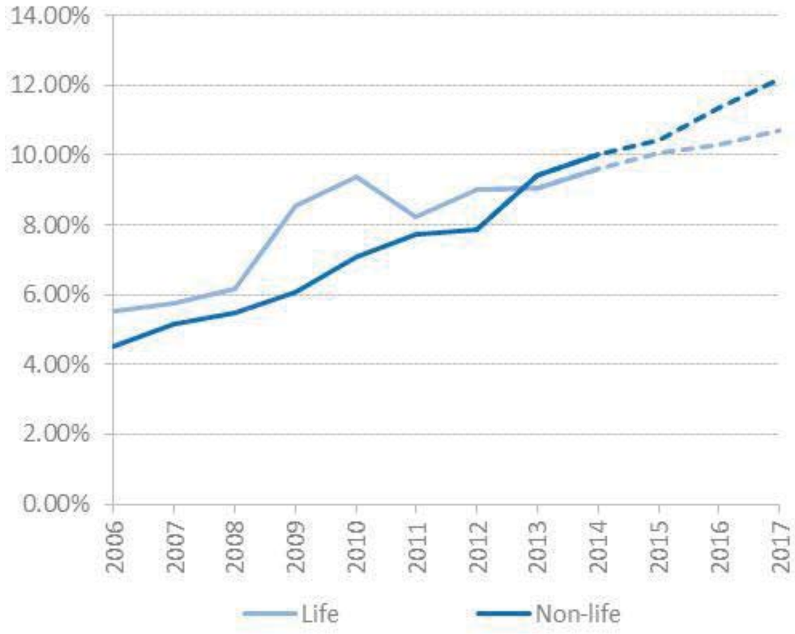


Source: EIOPA and ECB Survey of Professional Forecasters (SPF)

Note: Data corresponds to aggregates for the Eurozone, dashed lines represent the EIOPA projection using macro scenarios based on ECB SPF.

Insurance companies continue to expand outside their national boundaries in a search for new growth opportunities. The low yield environment and relatively limited growth opportunities in saturated European markets contribute to this trend. EIOPA data confirms the continuous expansion of insurers into new markets. Indeed, the latest projection suggests that insurers' cross-border activities will expand further as economic development and living standards in emerging markets increase (Figure 5.8). However, main risks in these countries remain on the geopolitical side.

Figure 5.8: Share of Gross Written Premium (GWP) abroad



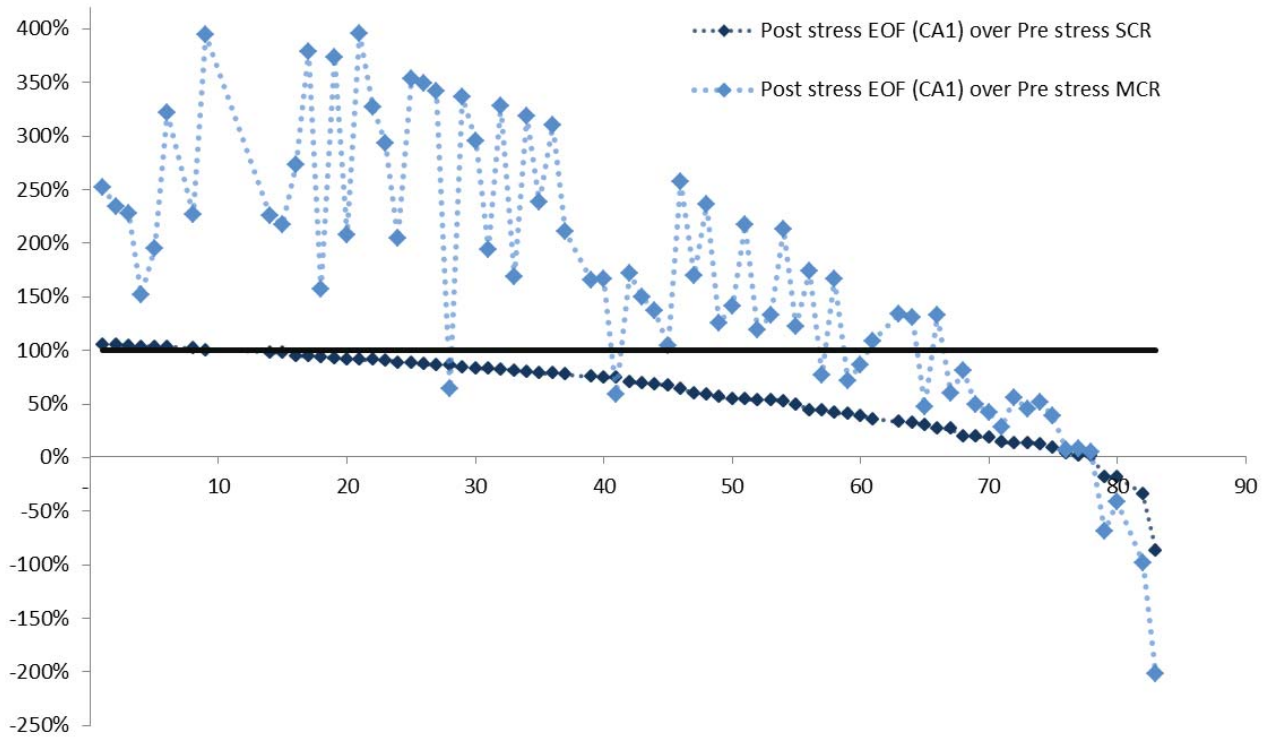
Source: EIOPA

Note: Data corresponds to aggregates for EU/EEA countries, dashed lines represent the EIOPA projection using a macro scenario based on the IMF World Economic Outlook, October 2014.

The EIOPA insurance stress test 2014 revealed that a double hit scenario would have a harmful impact on the insurance sector. Based on the current macroeconomic conditions, the risk reversal scenario cannot be ruled out. Although the gradual increase of interest rate might have a positive impact on the stability of the insurance and pension sector, increasing risk premiums whilst simultaneously keeping risk free rates low would create a completely different picture: this so-called double hit scenario was tested by the EIOPA insurance stress test 2014. It clearly showed that about half of the insurance groups that participated in the stress test core module would have a SCR ratio below or very close to 100% (Figure 5.9).

Figure 5.9: Impact of the double hit scenario

Y-axis: Solvency ratios in %, X-axis: Number of insurance groups

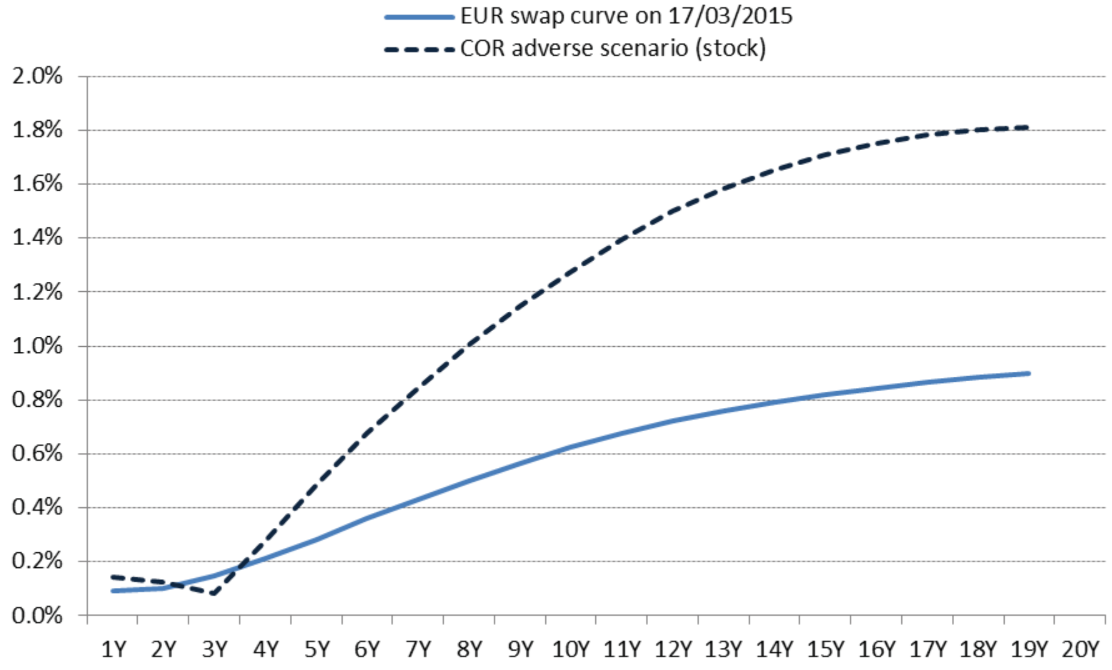


Source: EIOPA Insurance Stress Test 2014

Note: Subsample was selected from the core participants of the EIOPA Insurance Stress Test 2014 which had a SCR ratio <=105% after the CA1 scenario. Eligible own funds (EOF) to cover SCR is taken for both the SCR and MCR Ratio, participants which did not report MCR figures were deleted from the sample.

The yields are compressed to historical minimums negatively impacting the solvency positions of insurers. Interest rates are substantially lower compared to the time when the insurance stress test 2014 was conducted; the stressed interest rate curve in the most severe scenario conducted for insurance groups' balance sheets data assuming a further decline in interest rates is still more favourable compared to the current reality (see Figure 5.10).

Figure 5.10: EUR swap curves vs. adverse scenario curve



Note: The adverse scenario does not include adjustments of the Long term guarantee package. No credit adjustment has been applied to the EUR swap curve.

A holistic view of recovery options needs to be prepared. Complexity and interrelations between insurance groups need to be assessed to avoid a potential herding behaviour with negative destabilizing implications for the whole sector. The commonalities in recovery options considered, although relevant for a firm specific event, pose doubts whether their implementation is feasible by all firms at the same time in case of a systemic event. Hence, a harmonised approach for the European insurance sector needs to be in place.

5.3. Conclusion

Despite a challenging macro-economic environment and persistently low interest rates, insurance premium growth is expected to be positive in 2016 and 2017. However, the current QE policy in Europe compressing yields further down puts significant pressure on insurance and pension funds profitability. As a consequence, their investment portfolios might be rebalanced towards more risky asset classes, whilst also further new growth opportunities in emerging markets are expected. The ongoing difficult environment deteriorates the solvency position of insurers. This was confirmed by the EIOPA Insurance Stress Test 2014 that revealed substantial vulnerabilities for some insurance companies. The risk reversal scenario that was tested in this context also supports this view. Yields are at their lowest level ever reflecting the growing concern for the maintenance of the solvency position. A harmonised approach for recovery options for the European insurance sector should not be forgotten to avoid negative implications for the sector.