Executive Summary

In the first quarter of 2015 a confirmation of the trends that had started in 2013 and 2014 can be seen: the weak macroeconomic environment, a continuation of the low yield environment and credit risk. Although the current QE policy decreases the potential risk for a reversal in the investment flows (that has been compressing spreads on higher yielding assets) slightly, the risk remains high in the medium to long term. A re-aggravation of the sovereign debt crisis driven by the situation in Greece and increasing geopolitical risks would trigger such a scenario with severe negative implications for the insurance and pension sector. 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. Declining risk free rates create an enormous challenge for the profitability of insurance companies, especially for life insurance companies. Overall, the Eurozone prospects remain weak. As a consequence of the QE policy, rebalancing from sovereign bonds into more risky asset classes reduces credit spreads. Tightened credit spreads reflecting market future expectations do not seem to be in line with the current economic conditions. The QE programme substantially reduced the market volume for some assets classes which significantly increased volatility of their daily returns. In such an environment, a risk reversal scenario could be triggered by a relatively limited market move.

All in all, growth in insurance premiums remains limited although the life segment showed some recovery in premium income for the median company in 2014 (compared to 2013), whilst only a minor growth in premiums in the non-life sector was reported. Profitability challenges remain. Yields are at their lowest level ever and offering competitive rates that appeal to policyholders is getting increasingly difficult. 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. The Solvency I ratio has remained adequate for the whole European insurance sector; the start of Solvency II next year marks a major step forward in modernizing and harmonizing European insurance regulation. As stated in the EIOPA stress test report, problems on the sustainability of the capital level will in general take more time to materialise. However, some time has passed and interest rates have fallen further since the stress test has been carried out.

The reinsurance premiums have been pressurised because reinsurers face continuing competition from non-traditional resources. 2014 was very benign in terms of losses and fatalities. The pressure related to the risks arising from the low yield environment foreseen in the coming years may lead the reinsurance industry to consolidate. Alternative sources of capital push the sector's capitalization levels higher and pressure pricing. The rise of alternative capital (AC) is a key risk for the traditional reinsurance market, as it has contributed to lower rates and increased competition.

The ongoing macroeconomic environment continues to generate increasing challenges to the European occupational pension fund sector. Defined Benefit (DB) plans are directly adversely affected by declining interest rates given the asset-liability mismatch on their balance sheets. New types of hybrid (HY) schemes have emerged to deal with the current challenging conditions. Furthermore, in Defined Contribution plans (DC), future benefits driven by lower long-term expected returns are under pressure.

The low interest rate environment continues to impact both the pension and the insurance sector alike. Market growth for both life and non-life insurers is expected to be positive in 2016 and 2017. However, as a consequence of the current QE policy in Europe, their investment portfolios might be rebalanced towards more risky asset classes, whilst also further new growth opportunities in emerging markets are expected. The current 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. A holistic view of recovery options (complexity and interrelations between groups, assessment of potential herding behaviour) for the European insurance sector should not be forgotten to avoid further negative implications for the insurance sector.

The report consists of two parts – the standard part and the thematic article section. The standard part is structured as follows: the first chapter discusses the key risks identified for insurance and occupational pension sectors. The second, third and fourth chapter elaborates on these risks covering all sectors (insurance, reinsurance and pension). The fifth chapter provides the final qualitative and quantitative assessment of the risks identified and monitored in previous chapters. This assessment is done in terms of the scope as well as the probability of their materialization using econometric techniques and questionnaires.

The thematic articles section elaborates on two specific topics in more detail and underpins the analysis and discussions provided in the standard part. The first article deals with profitability issues and the macroeconomic environment, whilst the second one focuses on macroprudential objectives and instruments for insurance.