2. The European insurance sector

2.1. Market Share and Growth

The insurance sector substantially differs among European countries (Figure 2.1). The penetration rate indicates the level of development of the insurance sector in a country. Measuring the size of the sector by total Gross Written Premiums (GWP) as a percentage of Gross Domestic Product (GDP), it ranks highest for Luxembourg for life business (41%), followed by Liechtenstein (37%) and Ireland (12%). For non-life business, Liechtenstein ranks highest (45%), followed by Malta and Luxembourg with 21% and 15% respectively.

Liechtenstein and Luxembourg are also the countries where GWP per capita is highest by country. In these two countries also a substantial amount of cross-border business is written (see Box 2).

Figure 2.1: GWP as a Share of GDP in % (LHS) and Total GWP per capita by country in EUR bn (RHS)

The level of insurers’ investment portfolio to GDP also varies widely among countries (Figure 2.2). In Q2 2017, the total insurers' investment portfolio to GDP was highest in Luxembourg and lowest in Romania.
Similarly, the share of GWP non-life business to GWP life business is also heterogeneous among countries (Figure 2.3). Contrary to life premiums, non-life premiums improved in many countries, as insurance companies focus increasingly on non-life products in the low yield environment. However, it should be noted that especially the Motor Third Party Liability (MTPL) segment saw premiums simply increasing as a result of price increases in previous years.

EIOPA will monitor the development of GWP for both life and non-life companies in the years ahead. Due to the low interest rate environment, especially life insurance companies are expected to further align their business operations in the future which might have an impact on overall premium volumes. Indeed, in some countries tax changes and a drop in single paid premiums already contribute to decreasing life insurance premiums. Lately, for instance, in order to remain profitable, reduced guaranteed rates or at least the announcement of further reductions have also been observed. In addition, other life insurance companies have recently put their new business into run-off.
However, significant changes in the business models and strategy will only evolve over time. Article 132 of the Solvency II Directive (Directive 2009/138/EC) introduces the "prudent person principle" which includes guidelines on how undertakings should invest their assets. The absence of regulatory limits on investments does not mean that undertakings can take investment decisions without any regard to prudence and to the interests of policyholders.

In times of low yields, however, the median value for unit-linked business at undertaking level has increased over one year (Figure 2.4). In Q2 2017 total unit-linked business as a percentage of GWP is 34% for the median company as opposed to 26% in Q2 2016. However, the dispersion has been relatively stable in Q2 2017. EIOPA will monitor the development of these products as the risk is shifted to policyholders which deserves further attention from a financial stability perspective.
**Lapses for life insurance companies are relatively stable over the last year as products benefit from relatively high guaranteed rates** (Figure 2.5). Insurance companies’ profits remain high when compared with EU banks. However, EIOPA will monitor the future development, especially in case of a sudden increase in interest rates. Surrender penalties that are in place are highly heterogeneous across countries. In some countries surrender penalties are e.g. limited by law, others have annuities that cannot be surrendered at all, some recently blocked surrenders in case of emergency (at least temporarily), whilst others enable policyholders to surrender policies relatively easy. If this is the case, often the products also lack differentiation with banking and asset management products. Additionally, lapses lead to the termination of insurance protection which only might be retrieved under conditions due to biometric reasons which are unfavourable in comparison with the terminated contract.

**Figure 2.5: Lapse rate (in %; median, interquartile range and 10th and 90th percentile)**
Box 2: Cross-border business in the European Economic Area (EEA)

Insurance undertakings authorised in an EEA country may carry out insurance activities in another EEA country (“host country”) via Freedom of Establishment (FoE) or via Freedom of Services (FoS). FoE requires the establishment of a branch, while FoS can be done without physical presence in the host country. Cross-border business is an established and material part of European insurance business. Business of insurance groups via a subsidiary established in another country is not classified as cross-border business.

In the EEA, EUR 59 bn gross written premiums (GWP) are reported via FoS and EUR 56 bn via FoE, accounting together for more than 8 % of all GWP in the EEA. The share of the cross-border business to the total EEA insurance market depends on the type of business. For direct business life, the share is 6 %. For direct business non-life and reinsurance the share is 9% and 12% respectively. Out of more than 2800 insurance and reinsurance undertakings under Solvency II, 750 reported cross-border business within the EEA in 2016.

The amount of cross-border business and the interconnectedness between countries depend not only on the line of business, but also on regional specificities. These factors are discussed below.

Line of Business

For direct business, i.e. insurance sold directly to customers, a clear distinction between the life and non-life segments can be seen (Figure B2.1). While cross-border life business is mainly written via FoS, cross-border non-life business is mainly written via FoE. Customers of non-life business are likely to prefer to have a local branch through which damage claims can be sent and settled. For reinsurance, where both counterparts are professionals, the need for a local branch seems less important (indeed, non-life reinsurance relies more on FoS than FoE most likely due to the relatively higher share of Business-to-Business).

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Note that the data used for this box is based on a reporting template that follows accounting recognition and valuation and that the data might not be fully comparable across companies or countries. In particular, in some countries following IFRS or local GAAP that recognise the difference between insurance and investment contracts, some insurance contracts may be recognised as investment contracts and be accounted as such, i.e. with no premiums reported in this box for those contracts. This issue has been addressed in Commission Implementing Regulation (EU) 2017/2189 of 24 November 2017 amending and correcting Implementing Regulation (EU) 2015/2450 laying down implementing technical standards with regard to the templates for the submission of information to the supervisory authorities according to Directive 2009/138/EC of the European Parliament and of the Council and for year end 2017 onwards both insurance and investment contracts will be reported.
Unit-lined or index-linked business accounts for more than EUR 25 bn cross-border GWP in EEA, about 25% of the total (Figure B2. 2). In line with the observation above, the vast majority of this life business is written via FoS, while all non-life business is dominated by business written via FoE.

Volume by country

The share of cross-border GWP within the top 5 countries (in terms of outgoing share), indicates the main host countries and the top line of business for each country. Off all written premiums issued by insurance undertakings authorised in Luxembourg, 59% reflect cross-border business in other EEA countries (Table B2.1). The top line of business that Luxembourg undertakings write in these countries is unit-linked or index-linked business. The main countries where Luxembourg undertakings write business to are France, Italy and the UK.
While cross-border business is mainly driven by unit-linked or index-linked business at EEA level, other lines of business can dominate bilateral cross border activity (Table B2.2). The Baltic countries (Estonia, Lithuania, Latvia) have a relatively open insurance market with a high share of incoming business. Moreover, the markets have a high level of interconnectedness among themselves relative to their national insurance market, with Estonia in particular exporting to its neighbours (Table B2.2). While highly relevant for the national markets, the cross-border business between the three Baltic countries accounts for only 0.5% of the total EEA cross-border business.

### 2.2. Profitability

Insurance companies have to deal with a challenging macroeconomic environment characterised by low interest rates. New technologies and the growing pace of digitalisation require them to continuously adapt their business models to remain profitable. In addition, the ageing population will eventually have a corrosive effect on the profitability of life insurance portfolios potentially leading to portfolio shifts in different asset classes or markets where growth potential is stronger, e.g. emerging markets.

In the last couple of years, especially life insurers have reduced and continue to reduce the guaranteed rate on new products in many countries as a result of the low interest rate environment. Others have completely stopped selling new business with guarantees. However, a high percentage of long-term commitments still consist on existing policies where high returns are guaranteed. It is interesting to see that products offering a zero per cent guarantee are on the rise in some countries. This shows that markets somehow adapted to the low interest rate environment for new products.

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### Table B2.1: Top 5 outgoing 23 (in percent of GWP of domestic undertakings)

<table>
<thead>
<tr>
<th></th>
<th>Outgoing (%)</th>
<th>Top line of business</th>
<th>Top 3 host countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Luxembourg</td>
<td>59%</td>
<td>Unit-linked or index-linked</td>
<td>France, Italy, United Kingdom</td>
</tr>
<tr>
<td>Ireland</td>
<td>54%</td>
<td>Unit-linked or index-linked</td>
<td>Italy, United Kingdom, Germany</td>
</tr>
<tr>
<td>Estonia</td>
<td>53%</td>
<td>Unit-linked or index-linked</td>
<td>Lithuania, Latvia</td>
</tr>
<tr>
<td>Malta</td>
<td>35%</td>
<td>Miscellaneous financial loss</td>
<td>United Kingdom, France, Spain</td>
</tr>
<tr>
<td>Lichtenstein</td>
<td>34%</td>
<td>Unit-linked or index-linked</td>
<td>Italy, Germany, Netherlands</td>
</tr>
</tbody>
</table>

23 Percentage outgoing is defined as: EEA Cross-border GWP by domestic undertakings/Total GWP of domestic undertakings and percentage incoming is defined as: Cross-border GWP by EEA undertakings in the country/(Total GWP of domestic undertakings – EEA Cross-border GWP by domestic undertakings).
**Profitability remains low but positive in 2016** (Figure 2.6). Based on annual data, return on assets (ROA) for the median insurance company is about 0.45%. For the 10th percentile and 90th percentile it amounts to 0.03% and 2.38% respectively. Return on excess of assets over liabilities is 6.1% in 2016.

**Figure 2.6: Return on Assets (ROA) and Return on Excess of Assets over Liabilities; (in %; median, interquartile range and 10th and 90th percentile)**

Insurers, especially life-insurers that have issued long-term interest guarantees to their policyholders, are sensitive to interest rate changes. Results of the EIOPA stress tests in 2014 and 2016 already showed that a prolonged low interest rate environment will make it increasingly difficult for insurance companies to meet their commitments long-term (see Chapter 5).\(^{24}\)

**In the current low yield environment maintaining profitability is getting more and more difficult as already reflected by market returns** (Figure 2.7 and Figure 2.8). The return on equity (ROE) has indeed substantially dropped compared to the pre-crisis period although is high overall.

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Based on market data, the return on assets on the other hand improved since the crisis. However, overall it remains low (Figure 2.8).

On the non-life side strong market competition leads to intense price pressures. Especially those insurance companies that lack size, international relations or a niche might eventually have difficulties maintaining their profitability in the long-run.

**Nevertheless, the gross Combined Ratio (CR) has been relatively stable across business lines** (Figure 2.9).\(^{25}\) In some countries, for example, negative price and volume effects can be seen for motor and credit insurance due to new quota share agreements where premiums earned are not sufficient to cover claims and costs. Also health costs are extremely high in some countries and disability covers are experiencing severe losses potentially increasing claims costs even more in the future. Claims to natural catastrophes might rise in Q3 following the Hurricanes and other events but the extent of the devastation is not fully clear yet (see Chapter 3).

\(^{25}\) Below 100% implies an underwriting profit, above 100% implies an underwriting loss.
2.3. Solvency

As of Q2 2017 the SCR ratio of the majority of solo insurance undertakings remains high (Figure 2.10). In fact, the SCR ratio for the median company is above 200% and hence twice as much as the regulatory requirement.

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

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26 SCR calculated using the Standard Formula.

27 Please note that the graph does not show any observation below the 10th percentile.
Transitional measures form an integral part of Solvency II and are intended to limit the procyclicality of the regulatory changes and to facilitate the entry into the new regime by giving companies the time needed to adapt to the new solvency requirements. Specific transition periods are used mostly by life insurance companies with long-term guarantees business (See also “Background information and Data description”). An analysis of the insurance companies illustrates the importance of these transitionals. Applying these measures has a major impact on the SCR ratio (see Chapter 5).

**When comparing the SCR ratio among EEA countries, a high heterogeneity remains in Q2 2017** (Figure 2.11). However, the SCR ratios are well above the prudential requirement of 100% for the median company in all countries, ranging from 154% in Cyprus to 304% in Denmark.

Based on Q2 2017, a total of eighteen insurers from ten different EEA-countries reported SCR ratios below 100%. Fifteen of the undertakings operate solely in the non-life segment, two in the life segment and one is a composite insurer and these companies hold EUR 17.4 bn in assets (or 0.2 per cent) and EUR 17 billion (or 0.2 per cent) in technical provisions in their respectable country.\(^{28}\) The gross combined ratio for these non-life entities exceeds 100% especially due to the low profitability in the motor insurance segment (Figure 2.9 in this report).

![Figure 2.11: SCR ratio by country (in %; median, interquartile range and 10th and 90th percentile)](image)

Source: EIOPA Quarterly Solo based on 2698 insurance companies  
Reporting reference data: 30/06/2017

**At the end of 2016 the SCR was EUR 417 bn, which is somewhat higher than last year** (Figure 2.12).\(^{29}\) The largest risk components for all insurers were market risk (53%), non-life underwriting risk (19%) and life underwriting risk (14%). Counterparty risk and health underwriting risk amounted for a relatively small proportion of the total risk, namely 6% and 9% respectively.

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\(^{28}\) Market share calculated as ratio of GWP, TA and TP (un-weighted).

\(^{29}\) SCR calculated using the Standard Formula.
Diversification effects reduced the sum of the partial capital requirement by 21% on average. The effect of the loss absorbing capacity of deferred taxes (LAC DT) amounted to 17% of SCR (see Chapter 5).

**Figure 2.12: SCR by main components in EUR bn**

Source: EIOPA Annual Solo based on 2637 insurance companies; excluding insurers with internal model (Article 112 (7) of Directive 2009/138/EC), (S.25.01 and S.25.02) Reporting reference date: 31/12/2016

### 2.4. Regulatory developments

On 5th of July 2017 EIOPA published an Opinion to institutions of the European Union on the harmonisation of recovery and resolution frameworks for (re)insurers across the Member States. The Opinion calls for a minimum harmonisation of national recovery and resolution frameworks for insurers and provides the main building blocks of a harmonised framework, including: preparation and planning; early intervention; resolution; and cross-border cooperation and coordination. The Opinion states that the scope of a harmonised recovery and resolution framework should in principle cover all (re)insurers within the scope of Solvency II. However, in accordance with the proportionality principle, Member States should be given the possibility to waive certain requirements of the framework for specific insurers; this applies, in particular, to the requirements to develop and maintain pre-emptive recovery and resolution plans. On 17th July 2017 EIOPA submitted to the European Commission draft amendments to the Implementing technical standards (ITS) on reporting and the ITS on public disclosure. The proposed amendments to specific templates are intended to facilitate consistent reporting and disclosure as well as to improve the quality of the information reported, including the correction of several minor drafting errors identified. After the adoption by the European Commission and publication in the Official Journal the amendments will enter into force and become applicable. It is expected that the ITS will be applicable for the submissions and disclosures at the end of 2017.

In light of the United Kingdom’s decision to withdraw from the European Union and the relocation of UK-based undertakings in the EU27, EIOPA issued in July 2017 an opinion addressed to the national competent authorities of the EU Member States in order to foster convergence and consistency of authorisation processes across Member States by setting out guidance on the application of the existing legal framework considering arrangements between EU and non-EU entities. EIOPA’s Opinion on supervisory convergence in light of the United Kingdom withdrawing from
the European Union emphasises the need for consistent supervisory approaches both on authorisation processes and on-going supervision of undertakings so as to avoid standards being lowered or prudential requirements disregarded. The Opinion also encourages communication between the UK and EU supervisors.

Following the proposal submitted by EIOPA in February 2017, the Commission Implementing Regulation laying down a standardised presentation format for the insurance product information document (IPID) was adopted on the 11th August 2017. The Regulation establishes the standardised presentation format to be completed by insurance providers that will be provided to customers prior to the sale of a non-life insurance product.

Following the Technical Advice provided by EIOPA in February 2017, two delegated regulations concerning the Insurance Distribution Directive (IDD) were adopted by the Commission and officially published on the 21st of September 2017. The Commission Delegated Regulation with regard to product oversight and governance (POG) requirements for insurance undertakings and insurance distributors specifies the criteria and practical details for the application of the POG rules in the IDD, which are intended to ensure that all insurance products for sale to customers meet the needs of their specific target market in order to avoid and reduce from an early stage risks of failure to comply with customer protection rules. The Commission Delegated Regulation with regard to information requirements and conduct of business rules applicable to the distribution of insurance-based investment products concerns information requirements and conduct of business rules applicable to the distribution of insurance-based investment products, specifying the criteria and practical details for the application of the rules on conflicts of interest, on inducements and on the assessment of suitability and appropriateness.

In April 2017 EIOPA published a methodology to derive the ultimate forward rate (UFR). By doing so EIOPA fulfilled its mandate according to Article 47 of the Delegated Regulation on Solvency II which requires that the methodology to derive the UFR shall be clearly specified (see Box 3).

In the context of the IDD, EIOPA published on the 11th of October 2017 Guidelines on Insurance based investment products that incorporate a structure which makes it difficult for the customer to understand the risks involved. The guidelines aim to facilitate the identification of types of products which are deemed complex and therefore not fit for distribution via execution-only (i.e. distribution without an assessment of the suitability or appropriateness of an insurance-based investment product for the customer by the insurance intermediary or insurance undertaking).

The Joint Committee of the three European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) approved on the 28th July 2017 its technical advice to assist the Commission on the possible content of the delegated acts on the procedures used to establish whether a Packaged Retail and Insurance-based Investment Product (PRIIP) targets specific environmental or social objectives. The Technical Advice addresses four areas of regulatory attention with regard to PRIIPs with environmental or social objectives: specific environmental or social objectives, disclosure of specific investment policy, governance procedures and controls and review of progress.

The Joint Committee of the three European Supervisory Authorities published on the 22nd September 2017 guidelines to prevent the abuse of funds transfers for terrorist financing and money laundering purposes. These guidelines are part of the ESAs' wider work on fostering a consistent approach to Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) and promote a common understanding of payment service providers' obligations in this area. In particular, the
guidelines set clear, common regulatory expectations of payment service providers’ policies and procedures to ensure the completeness of the information on payers and payees to be passed on along the payment chain.

The International Association of Insurance Supervisors (IAIS) announced in July 2017 the release of Insurance Capital Standard (ICS) Version 1.0 for extended field testing, which will be an important input into the future development of the ICS. The ICS is part of the Common Framework for the Supervision of Internationally Active Insurance Groups (IAIGs). Once finalised and agreed, the ICS will establish minimum standards for setting levels of capital for IAIGs, including methods of calculating the ICS capital requirement and ICS capital resources.

**Box 3: The methodology to derive the UFR**

Under Solvency II risk-free interest rates are used for the discounting of insurance and reinsurance liabilities. For that purpose, EIOPA is required to derive and publish risk-free interest rates. EIOPA is currently publishing risk-free interest rates for 33 currencies on a monthly basis.

The risk-free interest rates are derived from prices of financial instruments that are traded in deep, liquid and transparent markets. The financial instruments are interest rate swaps and, where swaps are not available, government bonds. For maturities where the markets for the relevant financial instruments or for government and corporate bonds are no longer deep, liquid and transparent the risk-free interest rates are derived by means of extrapolation towards an ultimate forward rate (UFR). For the euro the risk-free interest rates for maturities longer than 20 years are extrapolated. EIOPA is currently applying an UFR of 4.2% for most currencies, including for the euro.

In April 2017 EIOPA published a methodology to derive the UFR. By doing so EIOPA fulfilled its mandate according to Article 47 of the Delegated Regulation on Solvency II which requires that the methodology to derive the UFR shall be clearly specified.

In line with the relevant provisions of the Delegated Regulation the published methodology determines the UFR as the sum of an expected real rate and an expected inflation rate. The expected real rate is a long-term average of observed real rates since 1961. The expected inflation rate is based on the inflation targets of central banks. The annual changes to the UFR are limited to 15 basis points.

The methodology aims to strike the right balance between the legal requirements of stability of the UFR over time and reflecting changes in long term expectations.

The first application of the UFR methodology is set to the beginning of 2018. In line with the methodology, and reflecting the significant changes in the long-term expectations of interest rates in the recent years, the calculated value of the UFR for the euro is 3.65%. However, since annual changes will not be higher than 15 basis points, the current UFR of 4.2% will be lowered in January 2018 to 4.05%.

EIOPA has analysed the impact of changes to the UFR on the financial position of a representative sample of 336 insurance and reinsurance undertakings from 29
countries of the EEA (Figure B3.3). The impact varies across different markets and undertakings, but the results of the calculations show that at a European level the impact of the planned changes to the UFR is very small and manageable by insurance and reinsurance undertakings.

*Figure B3.3: Average impact of reducing the UFR by 20 bps (scenario 1) and 50 bps (scenario 2) on the solvency ratio of insurance and reinsurance undertakings*