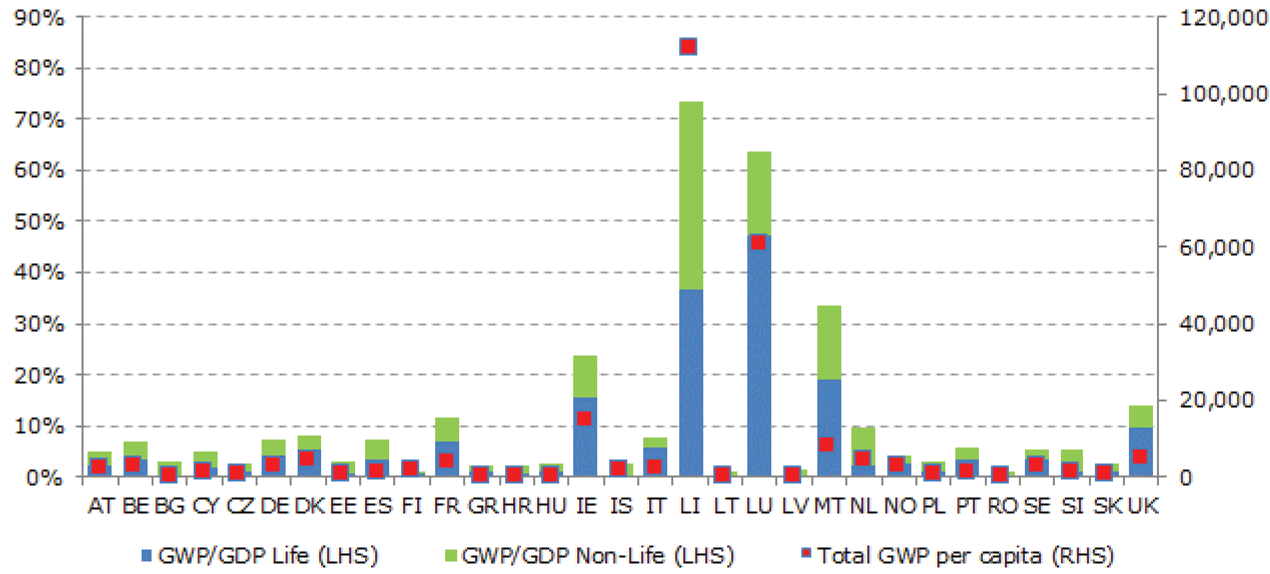
2. The European insurance sector

2.1. Market share and growth

The relative size of the insurance sector differs substantially among European countries (Figure 2.1).[18] [19] As a share of the economy, Luxembourg has the largest life insurance sector, followed by Liechtenstein and Ireland, as measured by the penetration rate.[20] Concerning non-life business, Liechtenstein and Malta have the highest volume of GWP relative to their GDP. A similar picture emerges when looking at insurance density, which gives insights into the total GWP over the population. Overall, the total GWP as a percentage of total GDP declined slightly from 10 percent to 9 percent in 2017.

Figure 2.1: GWP as a Share of GDP in % (LHS) and Total GWP per capita by country in EUR bn (RHS)in Q4 2017



Source: EIOPA Quarterly Solo

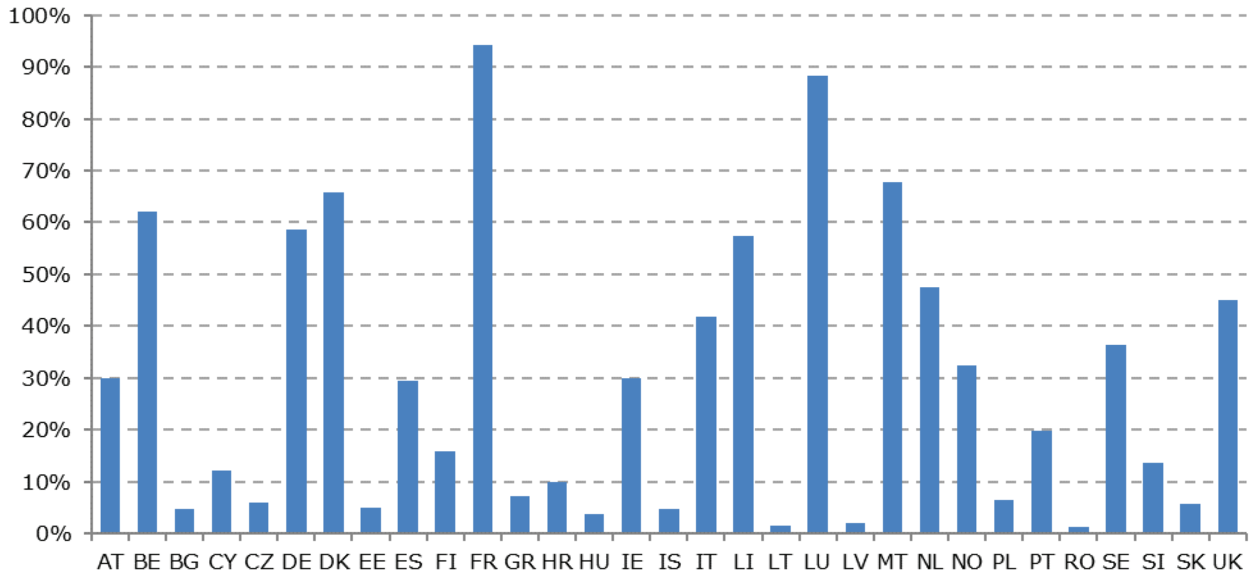
When considering the relative size of the insurers' investment portfolio to GDP among countries, a different picture emerges (Figure 2.2). This indicator provides insight into the role of insurers as institutional investors and, while again substantial differences can be observed, it shows that the investment activities of insurers play an important role in the economy of many different countries.

18 Chapter 6 of this report gives an overview of Solvency II data sources that were used in the entire FSR.

19 Liechtenstein GDP calculated by applying the Swiss quarterly growth rate; 2015 is the last publicly available GDP measurement.

20 The penetration rate is defined as the percentage share of Gross Written Premiums (GWP) over Gross Domestic Product (GDP) and gives an indication of the size of insurance sector relative to the economy of the country.

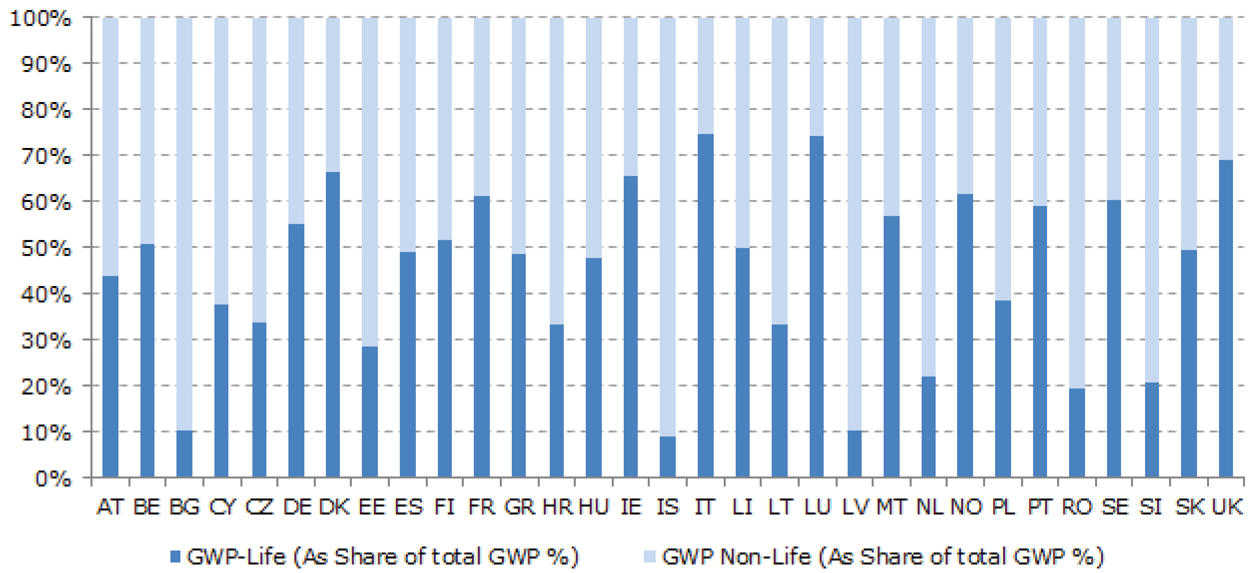
Figure 2.2: Insurers' investment portfolio to GDP in % in Q4 2017



Source: EIOPA Quarterly Solo
Note: Insurers' investments exclude index-linked and unit-linked business

The share of non-life business to life business also differs considerably among countries (Figure 2.3). Non-life business remains predominant in Iceland (91% of GWP), Bulgaria (88%) and Latvia (87%), whereas in countries such as Italy (75%) and Denmark (69%) the proportion of life premiums is higher. However, the share of life premiums has been decreasing in these countries, as insurance companies seem to increasingly focus on non-life products in the current low-yield environment. These results should be interpreted with care, however, as especially the Motor Third Party Liability segment saw premiums simply increasing as a result of price increases.

Figure 2.3: GWP Non-life as a Share of Total GWP (in %) and GWP Life as a Share of Total GWP in Q4 2017 (in %)

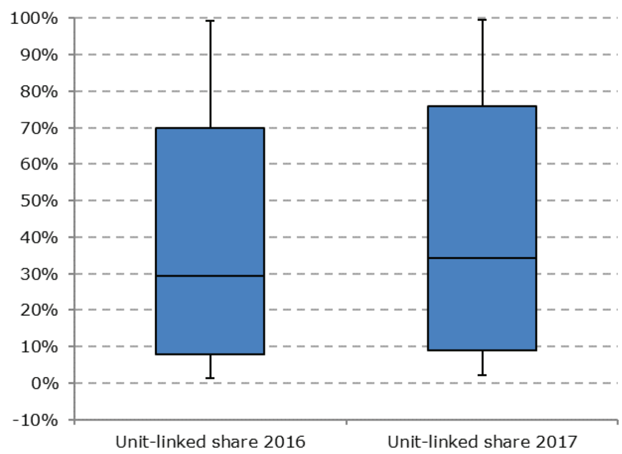


Source: EIOPA Quarterly Solo

The share of unit-linked business has increased further over 2017. The total share of unit-linked business in life GWP has increased from 28% in Q4 2016 to 41% in Q4 2017, while the share for the median insurance company has increased to 35% in 2017 compared to 30% in 2016 (Figure 2.4). In most countries, insurers increasingly focus on 'capital light' unit-linked products with few financial guarantees in response to the current low yield environment. EIOPA will monitor this trend as it increasingly shifts the financial risks to policyholders. However, considerable differences remain across countries. Close monitoring of the trend towards unit-linked business is therefore warranted, to prevent potential future misselling problems where products do not live up to policyholders' expectations, which eventually could undermine confidence in the sector as a whole.

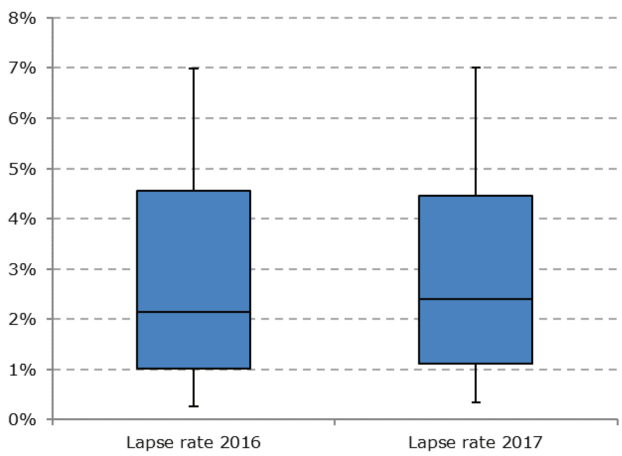
In 2017, lapse rates increased slightly for all percentiles but remained low overall (Figure 2.5). However, a sharp increase in yields combined with lower economic welfare of households could potentially lead to a sudden increase in the lapse rate for insurers (Chapter 1).

Figure 2.4: GWP-Life business: Unit-linked share (in %; median, interquartile range and 10th and 90th percentile)



Source: EIOPA Quarterly Solo
Note: Sample sized on insurance companies which have reported unit-linked business (life and life part of composite insurance companies)

Figure 2.5: Lapse rate (in %; median, interquartile range and 10th and 90th percentile)

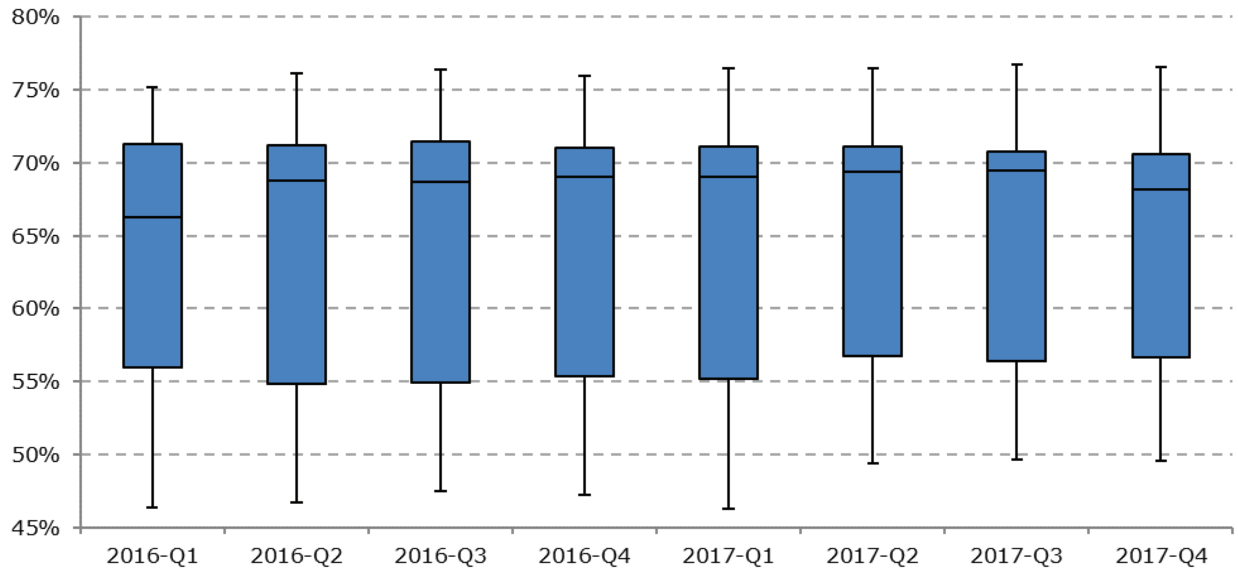


Source: EIOPA QFG

Sufficient liquidity should ensure that an insurance company is always able to meet payment obligations, even under adverse conditions. However, in case of mass lapses or surrenders if yields go up, insurance companies may suffer liquidity risk.[21] In Q4 2017, the median share of liquid assets declined slightly, but remains at a reasonable level (Figure 2.6). Still, the follow-up of liquidity risk continues to require supervisory attention.

[21] It should be noted that funding risk for insurers is generally limited compared to banks, due to the specific liability structure of insurance companies.

Figure 2.6: Liquid assets ratio (in %)[22]



Source: EIOPA QFG
Note: The liquid assets ratio shows the proportion of liquid assets on total assets (excluding assets held for unit-linked). The ratio is calculated by applying different weights (ranging from 100% for cash to 0% for intangible assets) to different assets, according to their liquidity profile).

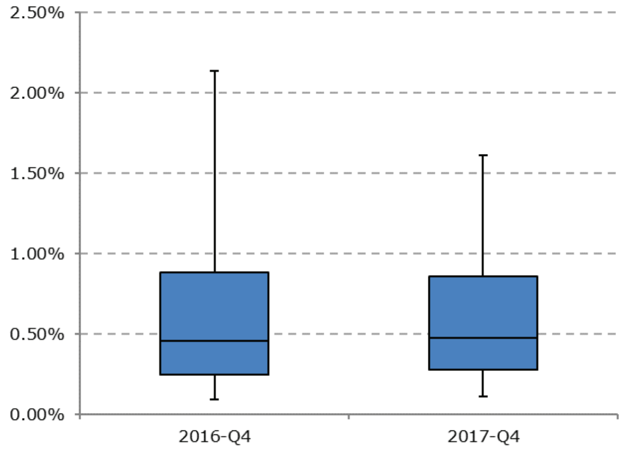
2.2. Profitability

Insurance undertakings are responsible for fulfilling their insurance obligations, as part of the round and prudent management of their business. In order to remain profitable in the long run, insurance companies need sufficient investment returns and also increasingly need to focus on strong claims and expense management in the current low-yield environment. With interest rates only slowly rising again especially countries with high guaranteed insurance contracts are facing material risks in the long-term. The use of cash-flow matching by insurance undertakings may mitigate this risk.

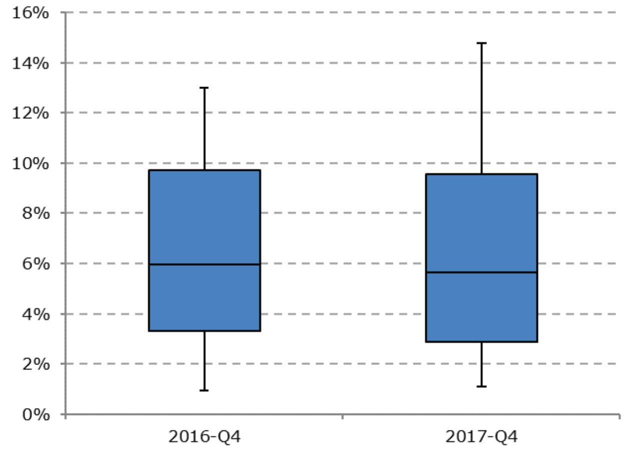
ROA remained at the same low level over 2017 (Figure 2.7 and Figure 2.8). The median ROA accounts for a low 0.48% in 2017. For the same sample, return on excess of assets over liabilities (used as a proxy of return on equity) had a median of 5.6% in Q4 2017 (slightly lower than in Q4 2016 at 5.9%). Discrepancies are significant within percentiles.

[22] Template used S.02.01.02

Figure 2.8: Return on Assets (in %; median, interquartile range and 10th and 90th percentile)	*Figure 2.9: Return on Excess of Assets over Liabilities (in %; median, interquartile range and 10th and 90th percentile)*



Source: EIOPA QFG (templates S.39.01.11 and S.02.01.02)
Note: Data is cumulative (Q4 is annual)



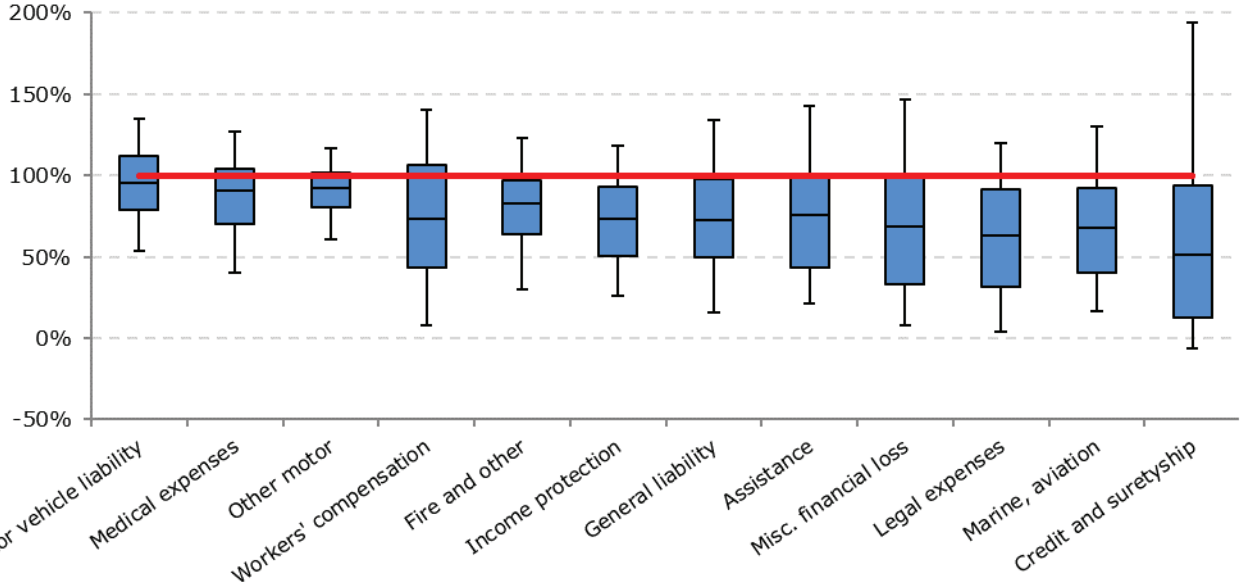
Source: EIOPA QFG (templates S.39.01.11 and S.02.01.02)
Note: Data is cumulative (Q4 is annual)

Going forward, robust economic growth is likely to support ongoing insurance demand, while rising interest rates could alleviate the current strain on (life) insurers' performance. However, increased competition and the rising frequency of natural catastrophes will undoubtedly affect the profitability of insurance companies in years to come. Especially increased competition might weigh on the results of insurance companies, but also well-established insurers face increasing competition from other sectors, such as hedge funds, investment funds and InsurTech players.

For the median company, the Gross Combined Ratio remained stable and below 100% in 2017 (Figure 2.10).[23] This means roughly that all business lines generate underwriting profits. However, intense price pressures are experienced in the highly competitive motor insurance markets but also in the credit and suretyship market. An adequate pricing of risk is key to optimise costs. Furthermore, some undertakings in the non-life market experienced huge losses until Q3 2017 from natural catastrophes, and their frequency will undoubtedly affect the development of the combined ratio in years to come. In fact, 2017 is the first year to be comparable with 2005 in terms of insured losses, a season that was also characterized by multiple storms and devastating losses. Finally, some undertakings may also have cyber insurance coverage in their portfolio, potentially covering client losses due to cyber attacks. To date, however, no statistics are available for this type of coverage.

[23] The Gross Combined Ratio is the gross loss ratio plus the gross expense ratio.

Figure 2.10: Gross Combined Ratio across business lines (in %; median, interquartile range and 10th and 90th percentile) as of Q4 2017



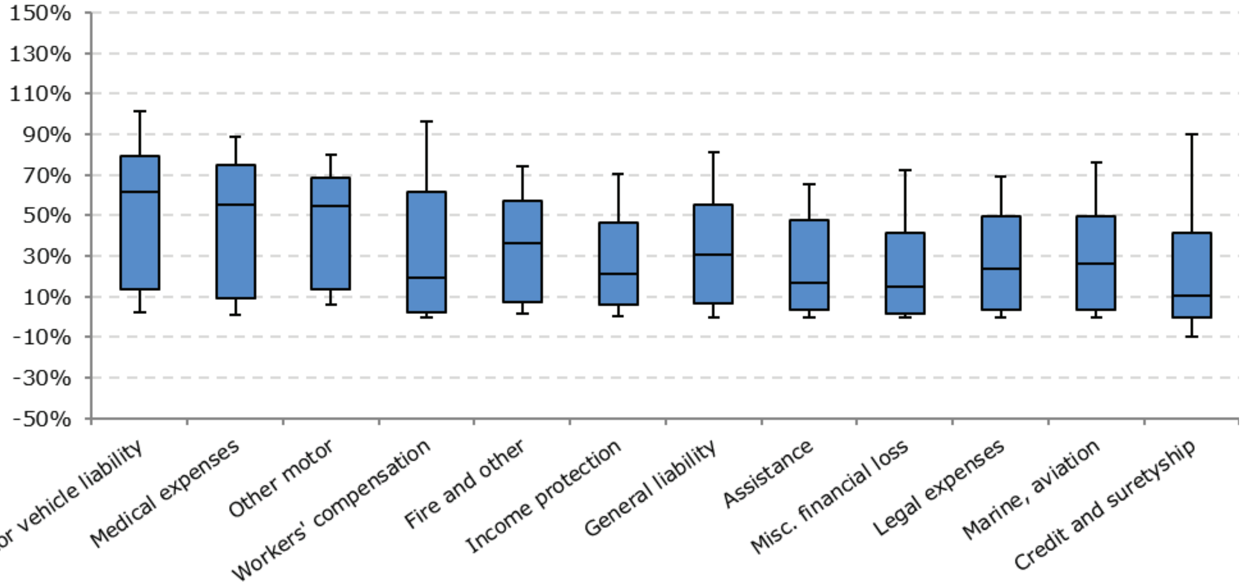
Source: EIOPA Quarterly Solo
Note: Premiums, claims and expenses by line of business (Claims Incurred *Gross Direct Business + Expenses incurred by line of business divided by Premiums)*[24]
Reference date: 31/12/2017

On average, the median gross loss ratio was stable in 2017 (Figure 2.11). When lines of business are taken individually, an increase in the median gross loss ratio is observed in six out of the twelve business lines. Legal expenses show the highest increase, namely 2 percentage points. In addition, the loss ratio of fire and other damage increased due to the natural catastrophes. On the contrary, a decrease is observed in the gross loss ratios for motor vehicle liability insurance (-3 percentage points), other motor insurance (-1 percentage points) and miscellaneous financial loss (-4 percentage points). In terms of gross earned premiums (GEP), motor insurance[25] is the most important line of business, representing 28% of total GEP. Fire and other damage to property is the second most important line of business (23%), followed medical expense insurance (21%).

24 Nominator S.05.01.02 ([R0310+ R0550, C0010-C0160]); Denominator S.05.01.02 [R0210, C0010-C0160]

25 Motor vehicle liability and other motor insurance taken together.

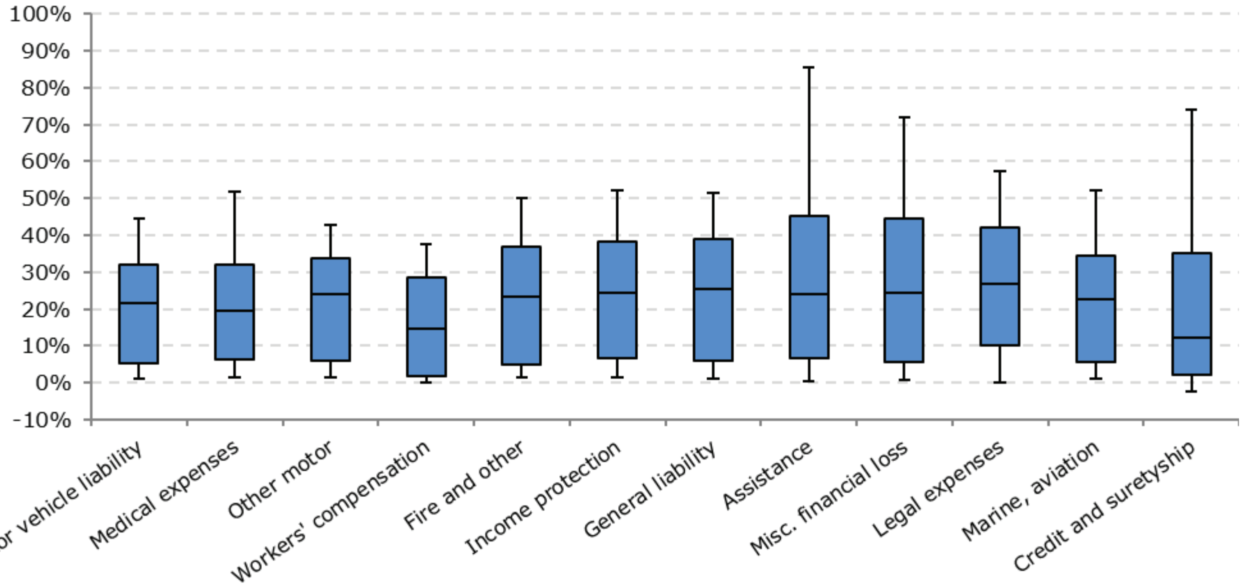
Figure 2.11: Gross Loss Ratio across business lines (in %; median, interquartile range and 10th and 90th percentile) as of Q4 2017



Source: EIOPA Quarterly Solo

The median gross expense ratio slightly increased for most lines of businesses in 2017, with the exception of workers' compensation insurance, credit and suretyship, and assistance. The overall median expense ratio increased by 1 percentage point to 21 percent (Figure 2.12).

Figure 2.12: Gross expense ratio across business lines (in %; median, interquartile range and 10th and 90th percentile) in Q4 2017



Source: EIOPA Quarterly Solo

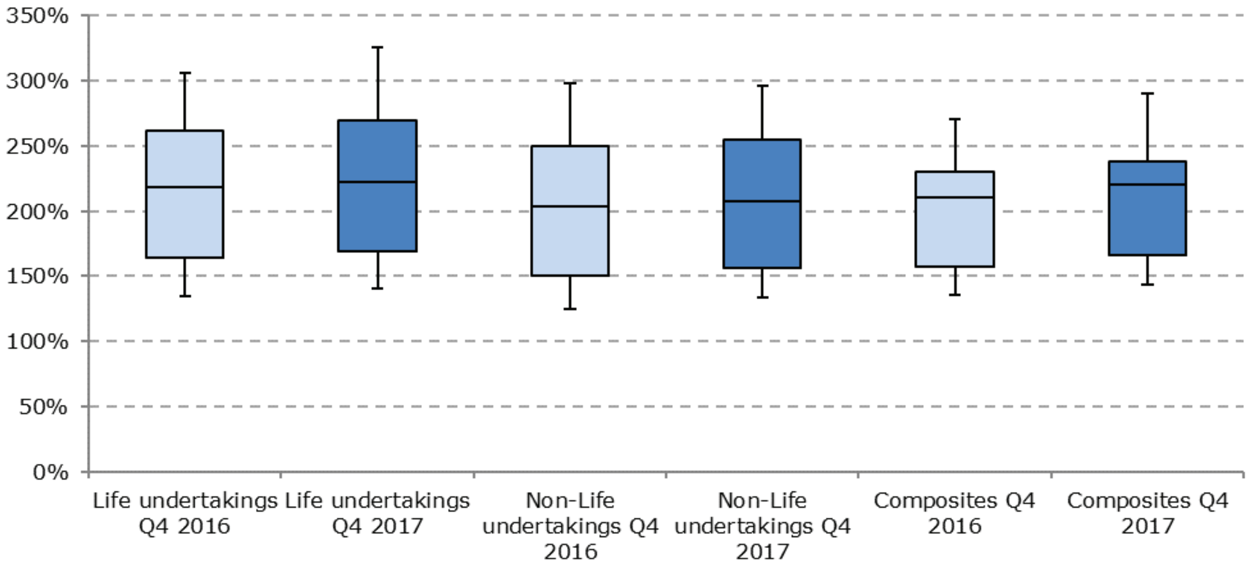
2.3. Solvency

Insurers have to establish technical provisions (TPs) to cover expected future claims from policyholders. Under the Solvency II framework, these TPs should correspond to the amount another insurer would be expected to pay in order to take over and meet the insurer's obligations to policyholders. In addition, insurers must have available resources sufficient to cover both the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR) to be able to withstand unexpected losses.

The overall solvency position of solo insurance undertakings improved in 2017 and remains high, although significant disparities can be observed across undertakings and EEA countries (Figure 2.13 and Figure 2.14). In fact, the SCR ratio for the median company increased for all life, non-life and composite insurance undertakings in Q4 2017. It ranks highest for Germany (293%) and lowest for Latvia (154%) in Q4 2017.

The use of transitional measures and the long-term guarantee measures can have a major impact on the SCR ratio.[26] However, information on the impact of these measures on the Solvency position of undertakings is only available on an annual basis, to be reported in June 2018. Hence, no recent information is available at the time of writing on the impact of these measures (Chapter 6).[27]

Figure 2.13: SCR ratio (in %; median, interquartile range and 10th and 90th percentile)[28] in Q4 2017



Source: EIOPA Quarterly Solo

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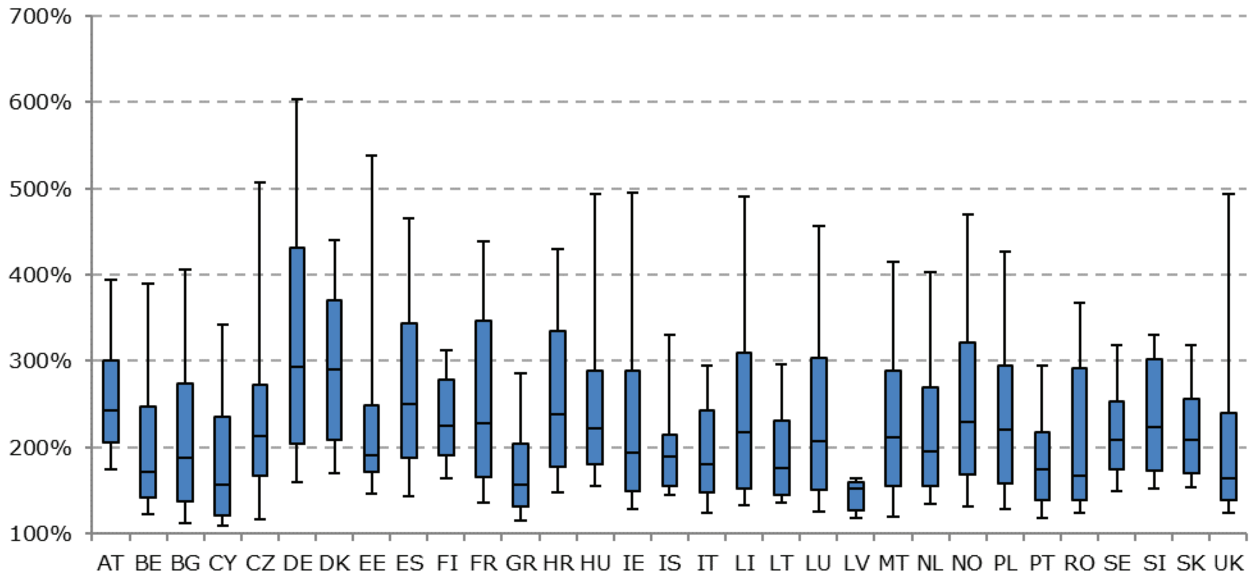
[26] The transitional measures are intended to smooth the transition to the new Solvency II regime, whereas the long-term guarantee measures are intended to limit the procyclicality of the regulatory framework and ensure an appropriate treatment of insurance products with long-term guarantees.

[27] Please refer to the EIOPA Report on long-term guarantee measures and measures on equity risk (2017) for the latest figures on the use and impact of transitional and long-term guarantee measures.

[28] SCR calculated using the Standard Formula.

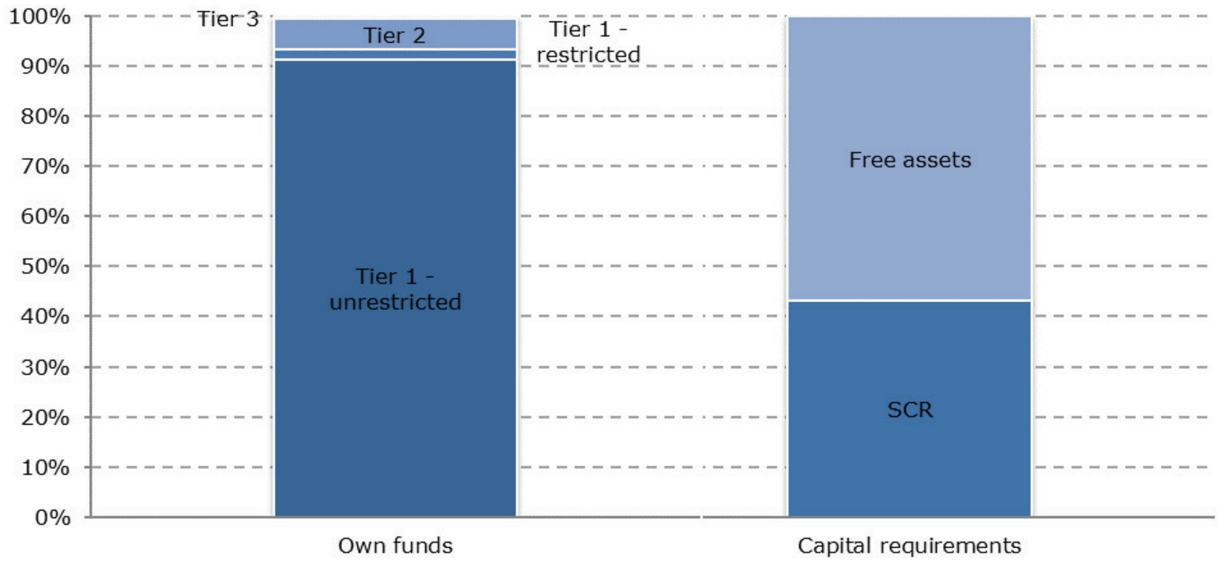
Figure 2.14: SCR ratio by country (in %; median, interquartile range and 10th and 90th percentile)



Source: EIOPA Quarterly Solo

On aggregate, Tier 1 capital amounts to more than twice the amount of the SCR in Q4 2017 (Figure 2.15). Tier 1 unrestricted accounts for 91% of own funds, while restricted Tier 1 equals 1.9%. As of Q4 2017, the eligible amount of Tier 3 items is equal to a mere 0.5%. The sum of the eligible amount of Tier 2 and Tier 3 items is equal to 6.7% and hence well below the restriction that it shall not exceed 50% of the SCR. All own funds held in excess of the SCR consists of "free assets".

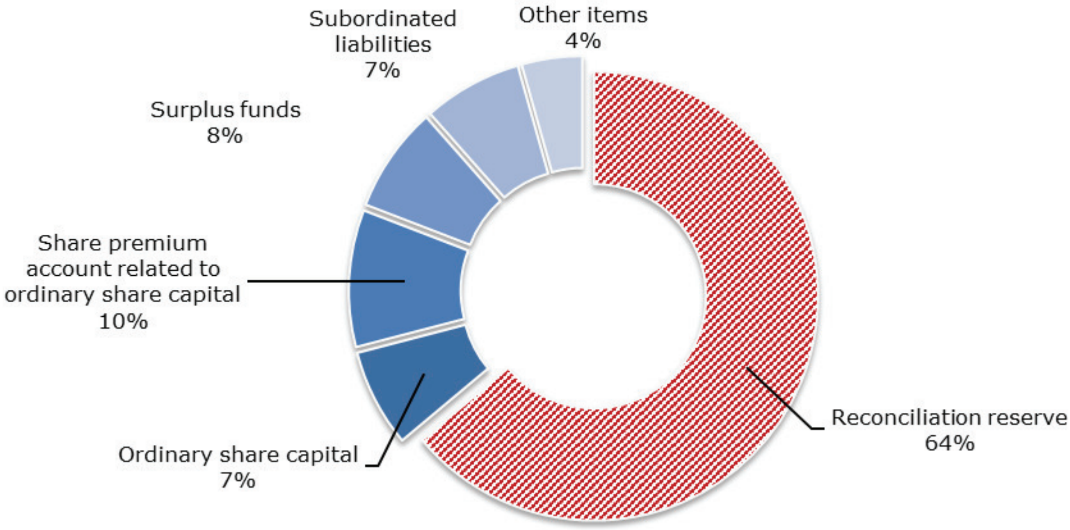
Figure 2.15: Quality of Own Funds (in %) in Q4 2017



Source: EIOPA Quarterly Solo

Own funds consists of basic own funds and ancillary own funds. Basic own funds are composed of excess of assets over liabilities and subordinated liabilities. Ancillary own funds are committed but unpaid types of capital where undertakings must apply for approval from the supervisory authority (Further description on Solvency II insurers' own funds is included in Chapter 6).[29] The reconciliation reserve makes up a large part of own funds (Figure 2.16). It is derived by taking the excess of assets over liabilities from the balance sheet and reducing it by basic own fund items (other than subordinated liabilities) and other adjustments to prevent double-counting of capital. As the reconciliation reserve is derived from the market valuation of assets and liabilities, it might be volatile. Compared to year-end 2016, the reconciliation reserve (64%) is unchanged.

Figure 2.16: Split of Own Funds (in %) in Q4 2017



Source: EIOPA Quarterly Solo

2.4. Regulatory developments

Two years after the implementation of the Solvency II framework, EIOPA must ensure that the regime remains fit for purpose, works for insurance companies of all sizes and types to continue to preserve regulatory certainty in order to maintain the stability of the insurance sector.

The first phase of preserving and continuously improving the existing regulation was the completion of the Solvency Capital Requirement (SCR) standard formula review. In February this year, *a technical advice for the SCR review* was submitted to the European Commission. EIOPA recommends a mixture of revised calibrations, simplifications and, where needed, proposals to achieve greater supervisory convergence. In particular, the first set of advice that EIOPA covers are topics such as simplified calculations, reducing reliance on external credit ratings, treatment of guarantees and exposures to regional governments and local authorities, risk-mitigation techniques, look-through approach for investment related vehicles and undertaking specific parameters, reflecting developments in the insurance sector and in the wider environment.

In the area of the calculation of *interest rate risks*, the current capital requirements are calibrated with data up to 2008. This approach does not cater for negative interest rates and is not effective in the current low yield environment.

[29] Please refer to Commission Delegated Regulation (EU) 2015/35 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=EN for the further description on Solvency II insurers' own funds

For this reason, EIOPA recommends to implement new calibrations that take recent evidence such as negative rates into account.

EIOPA also carried out an analysis of the *loss-absorbing capacity of deferred taxes* (LAC DT) across the European Economic Area including supervisory and industry practices. The results of the analysis showed that similar practices are applied with respect to 75% of the approximately EUR 100 billion of LAC DT. But for the remaining 25%, insurers' and supervisors' practices were divergent. In order to strike a reasonable balance between flexibility and to foster greater supervisory convergence, EIOPA developed a set of key principles, consistent with the Solvency II framework, that allow proportionality and flexibility in the calculation while increasing the comparability of outcomes. For example, they refer to projections of future fiscal results that should be consistent with the business plan or to the projection of future return on assets where assumptions on such returns are equal to the forward rates derived from the relevant interest rate term structure, and where returns in excess of the risk-free rates are only allowed where an undertaking is able to provide credible evidence.

In addition, several new initiatives have recently been announced by the European Commission that are relevant for the insurance and pension sector. First, the *EU Action Plan on Sustainable Finance* announced in March 2018 aims to develop an EU classification system for sustainable activities, labels for green financial products and enhanced ESG requirements and disclosures. The Action Plan would also require insurance and investment firms to advise clients on the basis of their preferences on sustainability. Second, the *EU Action Plan on FinTech*, also announced in March, sets out 19 steps to promote technologically enabled innovation in financial services, increase cyber security and the integrity of the financial system. In this regard, the new *EU General Data Protection Regulation*, which came into force on May 25th and strengthens rules on the way personal data on EU residents is collected, stored and processed/handled by undertakings, is also relevant, as it tightens the rules on data protection for all types of companies including financial undertakings.

In the end of last year, EIOPA issued an *Opinion on the supervisory assessment of internal models including a dynamic volatility adjustment (DVA)* in order to reinforce supervisory convergence in this area. When using the DVA, undertakings should ensure a prudency principle, meaning that the internal model should produce a solvency capital requirement guaranteeing a level of policyholder protection that is at least as high as if replicating the "EIOPA VA Methodology". The Opinion asks supervisors to take a holistic view in their assessment of modelling and risk-management aspects. This means that all tests and standards on internal models apply and no undesirable risk management incentives should be allowed. Finally, EIOPA reminds that undertakings have to provide the explanation of the DVA methodology in the Solvency and Financial Condition Report in order to fulfil the Solvency II disclosure requirements.

Insurance regulation on investment risks should promote an accurate reflection of risks and ensure alignment with policyholder interests. Especially under the current low interest rate environment, there is an increased focus on the institutional investor role of insurers and pension funds. Towards the end of 2017, EIOPA published an *Opinion on monetary incentives and remuneration between providers of asset management services and insurance undertakings*. The opinion relates to the risk of consumer detriment in case insurance undertakings choose underlying investment vehicles of unit-linked policies on the basis of those which provide the highest level of monetary incentives and remuneration from insurance undertakings. EIOPA aims to promote consistent supervisory practices covering how existing and upcoming EU law applies to conflicts of interest arising from the monetary practices and the practical application of the principles set out in the IDD and Solvency II Directive in managing assets of unit-linked policies.

Following EIOPA's Opinion on supervisory convergence in light of the Brexit dated July 2017, EIOPA issued in 2017 an *Opinion on service continuity in insurance in light of the withdrawal of the United Kingdom from the European Union*. The aim of this Opinion is to remind supervisory authorities and insurance undertakings to take the necessary steps in order to prevent insurance activities without authorisation and ensure service continuity with regard to insurance contracts concluded before the withdrawal date by way of freedom of establishment or freedom to provide services from/into the UK. In particular, insurance undertakings with such cross-border insurance contracts should develop realistic contingency plans and implement the measures necessary to ensure service continuity.

The withdrawal of the UK from the EU might have an impact on the solvency position of insurers. Technical provisions, own funds and capital requirements of insurance and reinsurance undertakings in Member States other than the UK can change when the UK becomes a third country due to changed regulatory requirements. In particular, Solvency II and other financial regulation distinguish between activities in and outside of the EU. EIOPA has therefore issued an Opinion on the solvency position of insurers in May 2018 in light of the withdrawal of the UK from the EU. The objective of this Opinion is to call upon national supervisory authorities to ensure that all risks to the solvency position of insurers arising from the UK becoming a third country are properly addressed.

With regard to proportionality, the Joint Committee of the ESAs also published in December 2017 the *Draft implementing technical standards (ITS) amending the Commission Implementing Regulation (EU) 2016/1800 on the allocation of credit assessments of external credit assessment institutions (ECAIs) to an objective scale of credit quality steps* in accordance with the Solvency II Directive. The amendment reflects the currently registered/certified ECAIs and, consequently, the draft ITS establish external credit assessment allocations for five new ECAIs and remove the reference to one de-registered ECAI.

Finally, the new methodology for deriving the *Ultimate Forward Rates (UFR)* used in the risk-free interest rates calculations came into force in January 2018. For the first time the risk-free interest rates were calculated with UFRs derived in accordance with the UFR methodology published by EIOPA in April 2017. The UFR applied to the euro decreased from 4.2% to 4.05%.