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Key lessons learnt from recent crises for long term investors

Over the last years the economy, the financial sector and insurance and pension industries have faced several unforeseen exogenous economic shocks such as the pandemic, supply chain disruptions, war in Europe and the energy crisis. Although European insurers and pension funds have successfully navigated the challenges, it is important to distil the key lessons to further improve the sectors' resilience.

At the outbreak of Covid-19, the main concern for the insurance sector was short-term financial market volatility, which has been well absorbed thanks to comfortable capital buffers. While the whole non-life sector with health, business continuity and worker compensation business lines came under scrutiny, it was the high uncertainty surrounding trade credit insurance claims and the risk of insurance coverage withdrawals that prompted a focused government intervention. The broader fiscal response also supported the economy and helped mitigate many potential negative effects.

Russia's invasion of Ukraine ended decades of geopolitical and security assumptions in Europe. While insurers' direct exposures were limited, the subsequent inflationary shock continues to pose serious challenges. For non-life insurers, the unexpected increase in the cost of claims has a negative effect on profitability with limited room for price adjustment due to competition while rising interest rates reduce the value of fixed income investments. Life insurers, which pay guaranteed returns in nominal terms, are less affected by inflation. Nevertheless, lapses may occur as investors seek higher returns elsewhere. Also, potential mid-term implications to the profitability and solvency amid reduction in underwriting and future profits might materialise. Here, supervisors and insurers must closely monitor developments together with potential mid-term implications on profitability and solvency and be ready to take appropriate measures to manage the risks.

Turmoil in the UK gilt market highlighted that if market movements are intense and fast enough, liquidity can be a risk for long-term liability driven investors like pension funds and insurers, where investments are concentrated in shallower markets. The ESRB highlighted liquidity risks in its September 2022 warning on vulnerabilities in the EU's financial system, suggesting that liquidity may be a wider concern. Although such a scenario cannot be ruled out entirely in the EU, the bloc seems less vulnerable to such risks as markets are deeper and derivative-using long-term investors tend to be well diversified in their holdings of fixed income investments so better positioned to cope with potential margin calls.

In March, several regional banks in the United States faced massive withdrawals of deposits, which ultimately led to the collapse of two of them. While triggered by bank-runs, one of the underlying causes relates to the sharp increase of interest rates in 2022 whose impact was not reflected into bank balance sheets due to the enforced book-value based regulatory regime. In the current situation, the risk of contagion through softer channels, such as reputation and fear, seems very high with the less robust banks being the first potentially facing severe consequences. European insurers have significant interlinkages with banks, particularly through investments in bonds. As a result, market corrections would lead to mark-to-market losses for insurers depending on individual exposures. That said, Europe's banking and insurance sectors seem well-capitalized to face current headwinds.

Insurers and pension funds have successfully navigated recent stress events but still headwind ahead.

From the crises shown above, a few valuable lessons can be learnt. First, as shown by the gilt crisis, long-term investors can both be subject to and generate liquidity shocks. Second, due to lack of substitutability, insurance activity can be potentially systemic, as demonstrated by the public interventions on trade credit insurance during the pandemic. Third, inflation is currently a material risk for insurers and assumptions used in the modelling are highly relevant to determine the value of Technical Provisions and capital levels. Fourth, when interest rates rise too quickly this can pose risks. It remains to be seen whether and to what extent the combination of inflation, which reduces consumer purchasing power, and higher interest rates will increase lapses on life policies in search for higher yields, putting insurers' solvency and profitability under pressure.

Bottom line: a robust supervisory framework based on a mark-to-market full balance sheet approach covering the whole risk profile of an industry is not a guarantee against crises, but it is key to containing the impact of adverse economic and market developments.