EIOPA outlines key financial stability risks of the European insurance and pensions sector

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Today, the European Insurance and Occupational Pensions Authority (EIOPA) published its June 2019 Financial Stability Report of the (re)insurance and occupational pensions sectors in the European Economic Area.

The risk of a prolonged low yield environment has become more prominent in recent months, as central banks have put the process of monetary policy normalisation on hold amid concerns over economic growth following growing trade tensions and political uncertainty. The low yield environment remains the key risk for both, the insurance and pension fund sector, and continues to put pressure on profitability and solvency positions. This could trigger further search for yield behaviour by insurers and pension funds, which is slowly becoming visible in the investment portfolio of insurers. EIOPA will therefore continue to monitor closely this risk to identify at an early stage any potential vulnerabilities.

At the same time, valuations remain stretched across financial markets and a sudden re-assessment of risk premia cannot be ruled out, which could be exacerbated during a period of economic slowdown with concerns over debt sustainability. A sudden increase in yields driven by risk premia rather than an upward move of the risk free rate curve could significantly affect the financial and solvency position of insurers and pension funds in the short run, as the investment portfolios could suffer large losses, which may only be partly offset by lower liabilities. In this regard, the high degree of interconnectedness with banks and domestic sovereigns of insurers could lead to potential spillovers should a sudden reassessment of risk premia materialize. Relatively high exposures towards real estate can also be observed for insurers in certain countries, making them as well vulnerable to a potential downturn in real estate markets.

Furthermore, new types of risks are emerging with the onset of climate change and cyber risk. The climate related risks pose threats in particular for the insurance industry, as insurers act simultaneously as investors and underwriters, while the digital transformation makes insurers and pension funds increasingly exposed to cyber-attacks. In this respect, the 2019 EIOPA stress test exercise for occupational pension funds also incorporates Environmental, Social and Governance (ESG), while the results from the questionnaire on cyber risk included in the 2018 Insurance Stress Test exercise will be used to analyse the exposures of insurers towards cyber risk in more detail in the course of 2019.

This Financial Stability Report shows that while overall the insurance sector remains adequately capitalized, profitability is under increased pressure in the current low yield environment. The Solvency Capital Requirement ratio for the median company is 223% for life and 207% for non-life insurance sector, although significant disparities remain across undertakings and countries.

The reinsurance industry has proven resilient despite again suffering significant catastrophe losses in 2018, which ended up as the fourth costliest year in terms of insured catastrophe losses. In general, natural catastrophe losses are showing an upward trend, with the 10 costliest years in terms of overall losses all occurring after 2004. The price renewals continue to show only moderate price increases, indicating potential excess capacity in the reinsurance market, with the alternative reinsurance capital market in particular showing a strong appetite for insurance risks.

In the European occupational pension fund sector, total assets and cover ratios remained broadly stable. However, the current macroeconomic environment and ongoing low interest rates continue to pose significant challenges to the European occupational pension fund sector, in particular for the Defined Benefit (DB) pension schemes. The sector has also come under increased pressure in 2018 by the fall in stock values towards the end of the year, pertaining to significant losses in IORPs' equity investments.

Gabriel Bernardino, Chairman of EIOPA said: *"The economic environment has become more challenging for European insurers and pension funds in recent months. The risk of a prolonged low yield environment has become more prominent again, as central banks have become more cautious about monetary tightening amid concerns over economic growth. This is particularly challenging for life insurers and pension funds with long-term liabilities and could trigger further search for yield behavior. At the same time, we continue to observe high valuations in certain equity, real estate and bond markets and a sudden reassessment of risk premia could potentially lead to significant losses in the investment portfolios of insurers, which could be exacerbated during a period of economic slowdown. EIOPA will continue to closely monitor these developments by assessing vulnerabilities at both, the macro- and micro-level and deliver its mandate of supporting the stability of the European financial system."*

This Financial Stability Report also includes a thematic article assessing the impact of green bond policies on insurers. This study employs an empirical analysis based on the European equity market.