MOVING OUT OF THE PANDEMIC CRISIS: KEY FINANCIAL STABILITY RISKS

Insurance Market Trends Conference
Bucharest, 23 May 2022

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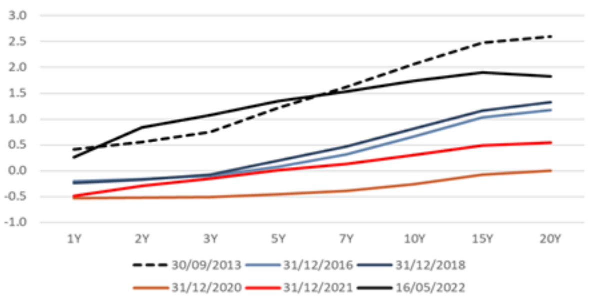
PANDEMIC CRISIS AND ITS CONSEQUENCES

- Extensive fiscal measures and accommodative monetary policy constrained the economic impact of COVID-19
- Fiscal and monetary space has been substantially reduced
- Reducing the economic resilience and room for manoeuvre for a future crisis
- Significant market losses in March 2020 were broadly recovered even within the year
- A clear trend toward digitalisation intensified by the crisis highlighted the importance of cyber risk with a negative effect on financial firms’ operational risk
- The Covid-19 crisis caused more extensive work from home, the question is to which extend this this trend will revert back to pre-pandemic situation with implications to commercial real estate prices

FROM CRISIS TO CRISIS

- Getting out of the pandemic crisis in early 2022, Russian invaded Ukraine on 24 February 2022
- Inflation that has been elevated driven by energy prices before the war has been further pushed up
- Accommodative monetary policy is phasing out to control inflation
- The yield curve has been moved up from ultra low to 2013 levels
- All developments on the back of green and digital transformations and demographic trends with population ageing

EUR Swaps

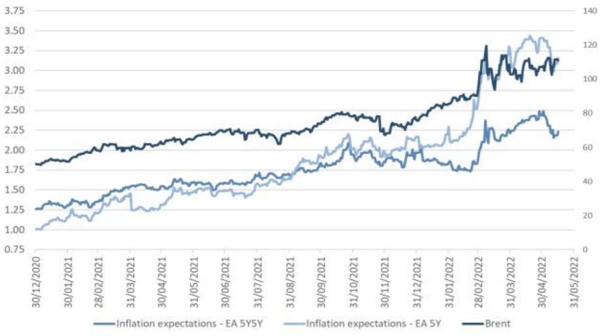


Source: Refinitiv
Last observation: 16 May 2022

UNCERTAIN MACROECONOMIC OUTLOOK

- **Lower growth prospects and higher inflation**
  - April EA (EU) inflation 7.4% (8.1%) with core 3.5% (4.1%) → energy and food (not incl. in core) dominant parts
  - Latest EC forecasts for 2022 : growth from 4% revised down to 2.7% & inflation from 3.5% revised up to 6.1%
  - EC projections assuming severe disruption to natural gas imports → 0.2% growth and 9.1% inflation for 2022
- **Valuations corrections in the risky assets**
  - Market corrections could materialised given the war consequences and tighter monetary policy that central banks are implementing
  - More severe impact with double digit inflation figures can be triggered by cut-off of gas supplies from Russia and further intensification of the supply bottlenecks due to China's Covid-zero policy and subsequent substantial increase of risk premia

Inflation expectations



Source: Bloomberg, 13/05/2022

EIOPA INSURANCE RISK DASHBOARD APRIL 2022

Risks	Level	Trend (Past 3 months)	Outlook (Next 12 months)
1. Macro risks	high	↘	↗
2. Credit risks	medium	→	↗
3. Market risks	medium	→	↗
4. Liquidity and funding risks	medium	↗	→
5. Profitability and solvency	medium	→	↗
6. Interlinkages and imbalances	medium	→	→
7. Insurance (underwriting) risks	medium	→	→
8. Market perceptions	medium	↘	→
9. ESG related risks	medium	→	↗
10. Digitalization & Cyber risks	high	↑	↗

Reference date for company data is Q4-2021 for quarterly indicators and 2020-YE for annual indicators. The cut-off date for most market indicators is end of March 2022.

IMPACT OF THE RUSSIAN INVASION OF UKRAINE ON EUROPEAN INSURERS

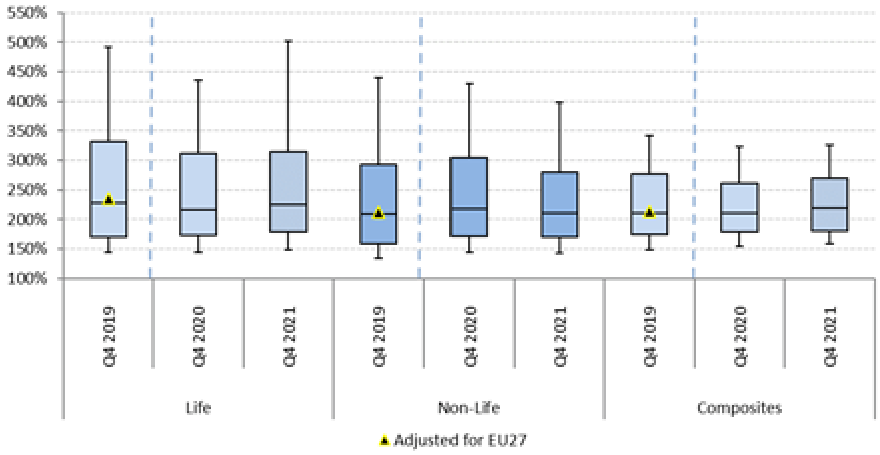
- **Direct exposure**
  - EU insurers hold only limited assets issued in Russia, Ukraine and Belarus mostly through investment funds
    - Russia: EUR 6.3 bn, 0.066% of total investments
    - Belarus: EUR 0.2 bn, 0.002% of total investments
    - Ukraine: EUR 1.8 bn, 0.019% of total investments
  - European insurers have limited activities in the Russian, Ukrainian and Belarusian markets; a low number of EEA groups are active in those countries through subsidiaries, whose size are small compared to the groups
  - Major movements where observed on derivatives linked to commodities and energy related commodities, but very limited exposures for insurers
- **Second round effects**
  - With regards to assets, two areas are most relevant: the exposures to the banking sector and the exposure to sectors of the economy that are more sensitive to energy and gas prices; losses in those sectors could have spill-over effects to insurers through losses on investments; furthermore, lower economic growth could significantly affect new as well as existing businesses

ROBUST SOLVENCY POSITIONS OF EUROPEAN INSURERS

- **The insurance sector entered 2022 with solid capital buffers, an improvement is observed for life and composite insurers while a slight decline for non-life insurers**
  - An improvement is observed for life and composite insurers while a slight decline for non-life insurers
  - The median SCR ratio for life solo undertakings went from 216% in Q4-2020 to 225% in Q4-2021
  - The median SCR ratio for non-life insurers slightly decreased from 218% towards 211%, probably due to the increase in interest rates

SCR ratio by type of undertaking

(in %; median, interquartile range and 10th and 90th percentile)



Note: For comparison purposes, the figures prior to 2020 do not include United Kingdom (UK), additionally the median values before 2020 are also reported adjusted for EU27 (excludes UK).
Source: EIOPA Financial Stability Groups, EIOPA Financial Stability Report June 2022

INSURANCE AND INFLATION

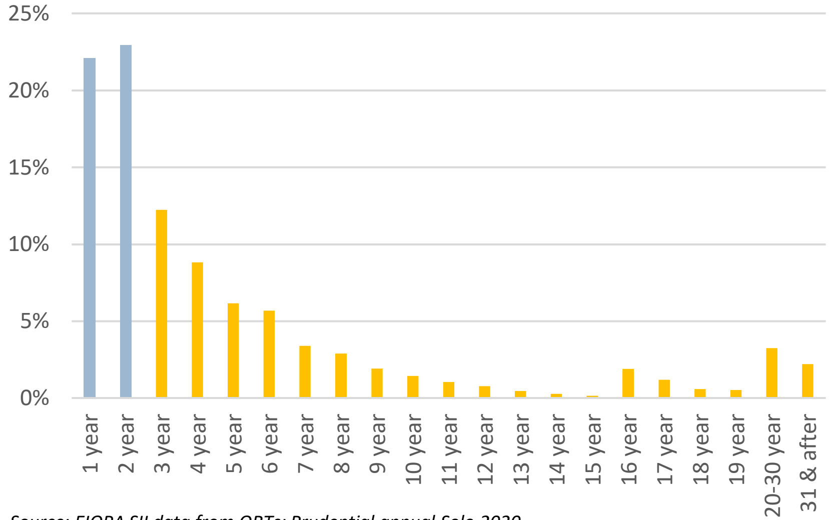
IMPACT ON BALANCE SHEET AND CLAIMS INFLATION

Balance sheet	▪ **Asset side**: Insurers investment portfolios whose market prices are sensitive to inflation ▪ **Liability side:** Inflation affects insurers through higher cost of claims • This is relevant mostly for **non-life** lines of business, because non-life guarantees are in nominal terms; crucially, insurers build-up provisions for future claims payments and in doing so they must make today assumptions about **future price developments** • Life insurers typically have liabilities in nominal terms, i.e. claims do not increase with the price development; this is because potential **future benefits are often stipulated at inception** ▪ Increasing interest rates (inflation is typically associated with higher interest rates) lead to net capital gain in case of **negative duration gap**; the net effect depends on the relationship between the inflation sensitivity to both sides of the balance sheet
Claims inflation	▪ In insurance, what tends to be more relevant is **claims inflation**, which is the price development relevant for claims expenses ▪ Claims cost depend only to a lesser extent on inflation as it is typically measured by the Harmonized Index of Consumer Prices (**HICP**); the reason is that the goods for which insurers pay are significantly different from those that consumers buy; moreover, **claims of insurers encompass various costs**, not just costs of goods and services ▪ **Claims inflation tends to outpace the general inflation rate**; for Europe, there are no time series available on estimates of future claims inflations;* each insurer makes its own business line specific forecast; data in Solvency II QRTs on inflation assumption is incomplete

* For the U.S there is an estimate of a commercial provider available, the Willis Towers Watson Claim Cost Index; the data indicates that claims inflation outpaces the general inflation rate and that there is a large heterogeneity between business lines

NON-LIFE – LONG PERIODS OF CLAIMS SETTLEMENT

EEA insurers' non-life technical provisions (% to total): Year - projection of undiscounted expected cash out-flows

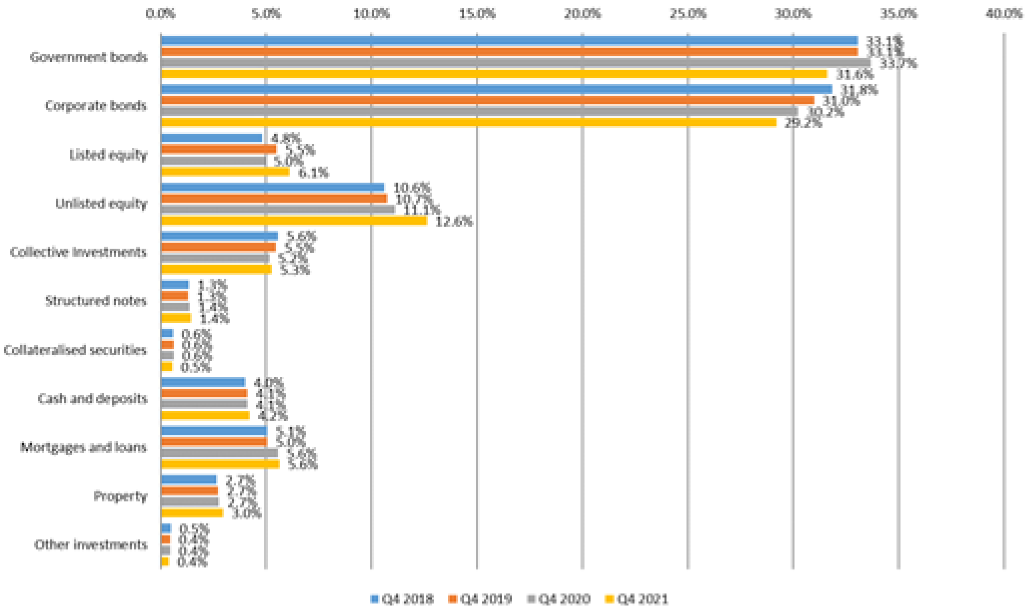


Source: EIOPA SII data from QRTs: Prudential annual Solo 2020.

- Non-life claims and expenses reserved by insurers might need to be adjusted to reflect the increase in inflation; insurers usually set aside technical provisions whose calculation uses an assumption about inflation development
- An important dimension is the length of the settlement period; longer duration cumulates an unexpected one-off increase in inflation over more years
- Non-life liabilities typically have a duration of several years in fact **55% of technical provisions have duration longer than 2 years**
- Duration of non-life technical provisions depends on business lines

ASSET ALLOCATION FOR INSURERS: INCREASED SHARE FOR ALTERNATIVE INVESTMENTS AND EQUITY

Investment split

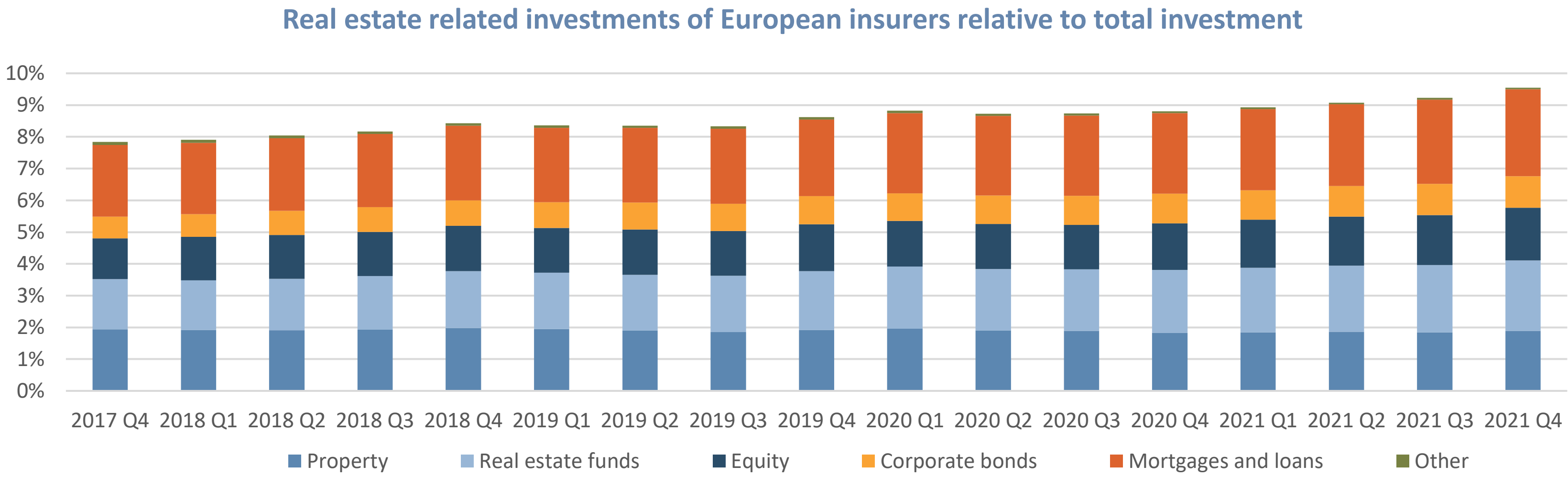


- The share of **government and corporate bonds decreased** by 3 p.p. Instead, the shares of **listed and unlisted equity increases**.
- In principle, these changes are driven by the combination of price and quantity effects; during the last year, there have been strong market movements; Increasing bond yields reduced bond prices while equity prices increased over the course of the year

Note: Look-through approach applied; assets held for unit-linked business are excluded. Equities include holdings in related undertakings.
Source: EIOPA quarterly solo, EIOPA Financial Stability Report June 2022.

REAL ESTATE HOLDINGS OF INSURERS GROW OVER TIME

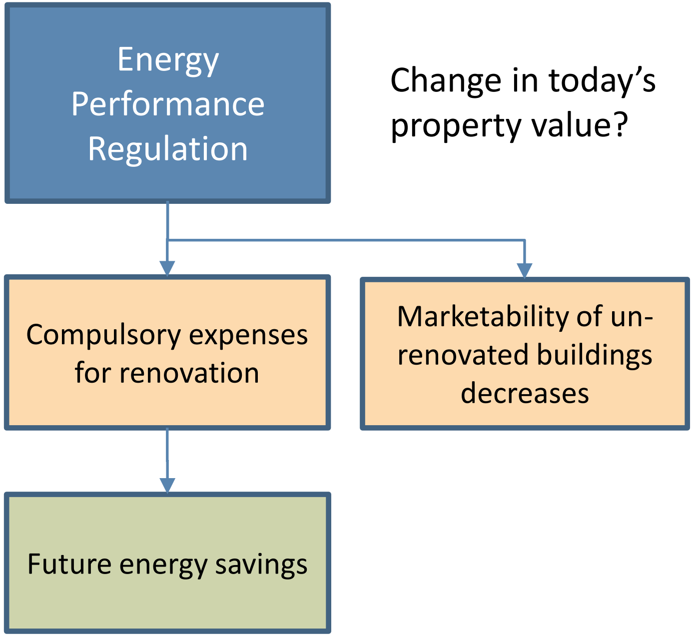
- EEA insurers' real estate related investments account for 9.4 % of total investments in Q4 2021, up from 7.8% in Q4 2017



Source: EIOPA Insurance Statistics (public data); unit-linked excluded.

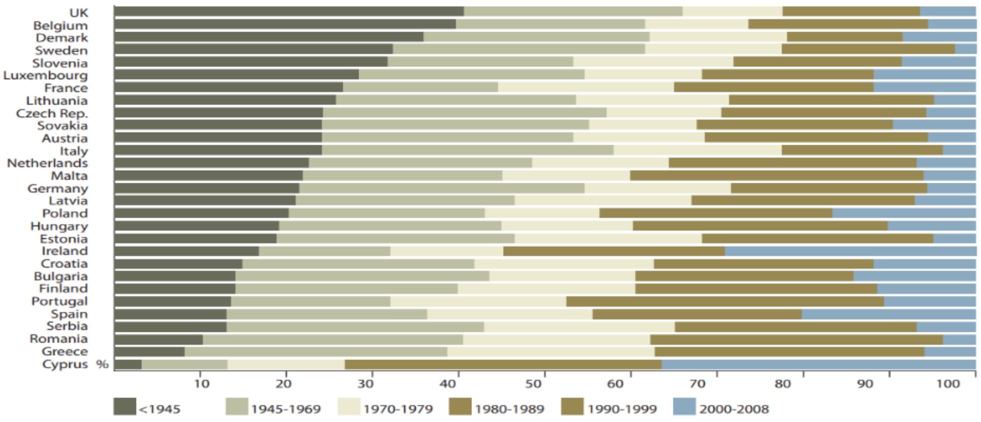
REAL ESTATE VALUES ARE SENSITIVE TO ENERGY PERFORMANCE REGULATION

- 15 Dec 2021 Commission proposal of revision of the Energy Performance of Buildings Directive
  - sets a direct obligation for businesses to renovate properties
  - EU–wide minimum energy performance standards: Worst-performing 15% of the building stock to be upgraded by 2027 for non-residential buildings and 2030 for residential buildings
- Short time frame in light of the high number of affected properties and the currently observed shortage of construction workers and price increases in building materials
- The proposal will now follow the ordinary legislative procedure, where it will be considered and negotiated by the Council (i.e. the Member States) and the European Parliament



ADJUSTMENT OF HOUSE PRICES TO CLIMATE POLICIES

EU Member states building stock varies by age



Source: ENTRANZE Project

Research focuses on how energy performance regulation could affect real estate values

- BoE Staff Paper 2021: England and Wales introduced 2018 Minimum Energy Efficiency Standard (MEES), which limited renting of energy-inefficient residential real estate; prices of properties affected by the MEES decreased by about £5,000 to £9,000 relative to unaffected ones
- Bundesbank paper 2021: Simulation of house prices changes for Germany with changes in CO2 taxation; RRE valuations could decrease by about 10% for Germany as a whole
- DNB paper 2022: estimated costs to make existing NL building stock zero-emission: building owners will need to invest between EUR 75 and 200 billion

THANK YOU!

For more information visit:
https://www.eiopa.europa.eu

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