Memo for information

To: Solvency II WG, Long Term Investments & Sustainable Finance PG
From: Prudential Team
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Subject: EIOPA Financial Stability Report June 2022

The secretariat has prepared a high-level summary of EIOPA's June 2022 Financial Stability Report.
In the Report EIOPA examines the main trends for European (re)insurance and pensions sectors, as well as the macroeconomic landscape with its implications.

Summary

Macro and market risks

- Although the European insurance sector entered year 2022 in good financial conditions with a solid capital buffer and a median SCR ratio of 216%, European macroeconomic conditions have deteriorated due to the Russian invasion of Ukraine in first quarter of 2022.
- Several consequences of the Russian invasion and the introduced sanctions affect the European market:
  - The European economy faces a supply shock, which simultaneously pushes up inflation and reduces growth. It is also unclear whether Europe will fall back into a recession.
  - Europe has a sizeable trade link to Russia which can prove a transmission channel for spill-over effects.
  - Foreign exchange markets are volatile since the Russian invasion led to depreciation of the Euro against major currencies.
  - In financial markets, interest rates levels and volatility increased, bond and equity prices declined, equity markets are volatile and on a declining path, and the yields of sovereign bonds are volatile and increased in 2022.

Climate risk and sustainable finance

- Climate risk remains one of the focal points, with Environmental, Social and Governance (ESG) factors increasingly shaping investment decisions of insurers and pension funds. Extreme weather conditions may put a significant pressure on non-life insurers.
- 2021 proved to be the second costliest year ever for the insurance sector, with global losses from natural catastrophes and weather-related events amounted to $280 bn (of which $120 bn were insured).
- Weather-related disasters have increased by a factor of five over the past 50 years and extreme weather events are expected to become even more frequent and severe.
- The European Climate Law was adopted and entered into force on 29 July 2021. It writes into law the goal for EU to become climate-neutral by 2050 and sets the intermediate target of reducing net greenhouse gas (GHG) emissions by at least 55% by 2030. The preliminary data shows that in 2020 targets have been overachieved.
- With air pollution as the largest environmental health risk in Europe, the Zero Pollution Action Plan aims the reduction of the number of premature deaths due to exposure to fine particulate matter by 55% by 2030. Implications for the insurance sector could regard health and life product design, underwriting and pricing.

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- The recent developments regarding Russia's invasion could also have an impact on climate change policies, with energy, gas and oil prices already at extremely high levels and very volatile.
- The long-term impact of this invasion could be an increase in demand for renewable energy as a response to the need to find new energy supplies to replace Russia's fossil fuels. The consumption of energy from renewable sources in EU has been increasing in 2020 by 23.9% compared to 2015.

Cyber risk and the insurance sector

- Amid COVID-19 and Russia's invasion, cyber-risk incidents have increased further. Supervisors expect a rise in the materiality of risks related to digitalisation over 2022.
- EIOPA's Spring 2022 survey shows digitalisation and cyber risks ranking in the third place in terms of materiality, after market and macro risks and above credit, profitability, and solvency risks.
- Russia's invasion of Ukraine raises concerns of a potential increase in cyber risk.
- The results of the EIOPA Risk Dashboard in April 2022 show an increase of digitalisation and cyber risks from medium to high level since January.
- European Commission, EIOPA and other relevant bodies (eg ESRB) are taking active actions to better cover digitalisation and cyber risks (in relation to - for example - stress tests, supervisory procedures, SII reporting templates, DORA, MICA).

Risk Assessment

- The results of EIOPA's survey indicate that market and macro risks remain key risks: among market risks, equity and interest rate risks are the main concerns.
- Insurers' major exposure is towards fixed income assets and equities (government and corporate bonds), and this makes portfolios sensitive to interest rate risk, credit risk and equity risk.
- The concentration in lower quality bonds could potentially be a risk transmission channel for insurers, with the level of exposure that differs greatly between countries.
- Another source of concentration risk comes from the sizeable proportion of government bonds held by undertakings issued by counterparties in their home country.
- The EEA insurance sector direct exposure to Russia and Ukraine is limited but the risk of second and third round effects via spill overs might be more substantial and challenging.
- Impact of the Russia's invasion of Ukraine on insurers:
    - In terms of asset exposure, insurers hold only limited assets issued in Russia, Ukraine and Belarus (less than 0.1% of their total investments), with a large share of these composed by index and unit-linked products.
    - EU insurers exposures in terms of both subsidiaries and liability portfolios are limited.
    - One of the major concerns is therefore related to second-round effects, that could emerge via exposures to sectors that are highly exposed to the current crisis (eg the banking sector and the sectors that are more sensitive to energy and gas prices).

Thematic Article: Do EU-wide stress tests affect insurers' dividend policies?

- The article aims to identify whether the EIOPA's EU-wide insurance stress test results of 2018 and 2021, and pre-existing vulnerabilities as a weaker capital position or profitability can explain the changes in dividend pay-out ratio of European insurers.
- Results show that insurers' dividend policy is not impacted by stress test results, and undertakings are resilient and well capitalised against adverse scenarios.
- There is evidence that insurers act prudently by reducing their pay-outs when in weak capital position, while they seem to prefer to build up capital during good times instead of increasing their pay-out ratios.
- EIOPA suggests that restrictions of dividend distributions could be used as a macroprudential tool to reduce uncertainty during crisis.