

To: Solvency II WG
From: Prudential Team
cc:
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Subject: Summary of EIOPA's Financial Stability Report

Comments

The secretariat has prepared a summary of EIOPA's Financial Stability Report, which EIOPA published on 11 December. Members can find further information [here](#).

Summary

The report highlights key developments and risks in the European insurance and pension sectors. It also includes four key typical focuses:

- Recent developments in the liquidity positions of insurers,
- Evolution of the asset allocation of insurers in an environment of rising interest rates,
- Increases in interest rates and the liquidity needs of IORPS on interest rate derivatives,
- Past recessions and insurance business.

Key developments and risks

The report identifies the following key developments and risks during 2023.

- **Interest Rates and Inflation:** Interest rates increased during 2023, continuing the trend of 2022. This increase has impacted the value of the insurer's technical provisions, own funds (increases in the EIOPA Risk-free rate curves) and the value of risky assets like equities, real estate, and corporate bonds. Inflation rates have continued in 2023, impacting claims ratios and operational costs.
- **Liquidity Risks:** EIOPA argues that there is increased liquidity risk due to the new market conditions (e.g. the UK Gilt crisis).
- **Investment behaviour:** EIOPA notes that insurers could shift from alternative investments to conventional investments, such as government bonds, due to the new interest rate environment.
- **The solvency position of insurers remains high.** The median SCR ratio moved:
 - For solo life undertakings; from 227 % at YE 2021 (228 % at YE 2022) to 243 % in Q2 2023.
 - For solo non-life undertaking; from 211% at YE 2021 (215 % at YE 2022) to 214 % in Q2 2023.
 - For solo reinsurers; from 234% at YE 2021 (223% at YE 2022) to 213% in Q2 2023.
- **Other key developments:** EIOPA highlights a number of other macroeconomic and geopolitical tensions which may impact the insurance industry

Recent developments in the liquidity positions of insurers

EIOPA has undertaken an analysis of the evolution of the liquidity positions of European insurance undertakings. This analysis is based on SII reporting templates and the data collected through an ad-hoc template. The scope of the analysis is a sample of 100 insurers selected by NCAs based on their potential high exposure to liquidity risk. Therefore, the results should not be generalised to the aggregate EEA insurance sector.

EIOPA's analysis focuses on some of the riskiest undertakings from a liquidity perspective and makes very strong assumptions about the liquidity of the liabilities (50% lapse rates). Therefore, it overstates the liquidity risks for the sector as a whole.

Nevertheless, **the analysis shows that liquidity risk is not a major concern for the insurance industry.** For 2022, after adjusting for asset haircuts, **the total aggregate assets of the sample were nearly 2.5 times the amount of "liquid" liabilities.**

EIOPA itself concluded that the aggregate liquidity position of the insurers in the sample does not give reasons for concern but considers that monitoring is still needed. There could be potential reasons for a future deterioration in net cash flows.

EIOPA's analysis contains the following key takeaways:

- The balance sheets of the sample deteriorated from a liquidity perspective but there remained very high levels of liquidity.
- Despite the material reduction in trading activities, life insurers remained net buyers of assets in 2022, and this was projected to continue in 2023.
- For the 25 insurers in the sample using derivatives, the net cash flows related to margin calls were, in aggregate, negligible but positive.
- Headline inflation affects insurers in their operational expenses and the cost of claims. However, the available data did not allow EIOPA to decide whether headline inflation increased the liquidity needs.
- Out of the 29 undertakings projecting negative total net cash flows for 2023, only 8 (5 composites, one life, two non-life) would not be able to make the payments by drawing down their holdings in cash and equivalents, i.e. would be required to sell assets.

Evolution of the asset allocation of insurers in an environment of rising interest rates

The interest rates in major economies have increased since 2022. In recent years, EIOPA reports that insurers have increased their allocations to alternative investments. The report points out:

- Insurers continue to increase their asset allocation to alternative investments despite the increase in interest rates.
- Non-life insurers and reinsurers continued to buy short-term bonds on a net basis, benefitting from high yields. On the other hand, life insurance companies paused their purchases.

Increases in interest rates and the liquidity needs of IORPS on interest rate derivatives

Increasing interest rates during 2022 resulted in many IORPs requiring to post margin on their interest rate derivative positions. Due to their small cash balances, European IORPS liquidated investments to meet these margin calls.

However, EIOPA found that these sales did not have the same impact on the financial markets as experienced in the UK during the Gilts crisis. This is because IORPS have greater investments in equities, more diversified fixed income and the EEA sovereign bond market being larger and deeper than the British one.

Past recessions and insurance business

EIOPA analysis focuses on the last three recessions: the global financial crisis, the European sovereign debt crisis, and the Covid crisis. EIOPA has identified the following possible lessons for the next recession:

- Financial market volatility (inflations, interest rates...) could pose a significant element in the next recession.
- There are factors mitigating the immediate effect of recession on insurers (limited exposure to non-unit-linked portfolios, increased exposure to non-listed equities, and SII countercyclical elements). Nevertheless, a widespread and protracted recession affecting corporate default rates could have a significant impact on investment portfolios.