Memo for information

To: Solvency II WG, International Affairs & Reinsurance WG
From: Prudential Team
cc:
Date: 21-12-2022
Reference: ECO-SLV-22-422

Subject: Summary of EIOPA's Financial Stability Report

Comments

The secretariat has prepared a summary of EIOPA's Financial Stability Report, which was published by EIOPA on 15 December. Further information can be found here.

Summary

The report highlights key developments and risks in the European insurance and pension sectors. Additionally, the report presents four topical focuses, notably on the impact of rising inflation and interest rates on insurers' financial position, insurers' use of derivates and related liquidity needs, the growing relevance of life portfolio transfers as well as non-life insurers' underwriting exposure to physical climate change risk.

Key developments and risk

EIOPA has identified the following critical developments and risks during 2022 for the insurance and pension sectors. The war has triggered multiple other consequences, such as inflation, lower growth, and increased interest rates. On the other hand, other relevant topics include climate change, private equity, digitalisation, and cyber risk.

- **War in Europe.** Although the tragic human consequences of the Russian invasion of Ukraine, the effect on insurers and pension funds is limited. The European insurers and pension funds have little direct exposure to Russia, Belarus, and Ukraine.
- **Inflation.** The inflation in Europe marked 10% in September 2022. This increase is a consequence of the rise in energy prices (linked with the war)**.** The inflation increase and the strong labour market intensify the possibility of de-anchored inflation expectations and a wage-price spiral.
- **Lower growth in Eurozone.** The prospects for economic growth in the EU have deteriorated significantly. The international monetary fund forecasts a growth of 0.5% in the Eurozone for 2023, with negative estimations for countries like Germany or Italy.
- **Discount rates moved to positive territory.** Government bond yields rose significantly during 2022. E.g., the 10-year German government bond yield rose from -0.18% (January) to 2.11% (September).
- **Spreads on EU sovereign bonds remained stable** but are still considerably higher than at the beginning of the year.
- **The solvency position of insurers remains high**.
- **European insurers' stocks suffered less than the broad European market.** The loss of Stoxx 600 Insurance was 12% (January- September) compared with 18% in the broad Stoxx 600.
- **Impact of climate change.** EIOPA will publish the data collected regarding the resilience of pension funds in a climate change scenario in December. Another area of work has been the development of risk indicators to assess the potential impact of physical climate change risk on different non-life Lines of Business in several countries.

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- **Insurers and pension funds have increased the share of private equity in their portfolios**. EIOPA has looked at the possible risks the increasing interlinkage can produce.
- **Increase in digitalisation and cyber risk**, especially in the current geopolitical context. Supervisors continue to assess the materiality of these risks.

TOPICAL FOCUSES 1 IMPACT OF CHANGES IN INFLATION AND INTEREST RATES AND VULNERABILITY TO POTENTIAL HIGHER RISK PREMIA: EVIDENCE FROM A TOP DOWN APPROACH

EIOPA has divided the impact of inflation in insurance into three steps (increase of inflation, increase in discount rates, and increase in risk premia).

- Step 1: The increase in inflation causes a drop in the excess of assets over liabilities (eAoL).
- Step 2: The following discount rate increase overcompensates for the initial drop in the eAoL.
- Step 3: The final increase in the risk premia combined with an estimated drop in the equity market makes the eAoL drop again below the initial value of the eAoL.

This impact is more significant in non-life undertakings due to the nature of their business.

TOPICAL FOCUSES 2 EU INSURERS DERIVATIVES POSITIONS: HEDGING INTEREST RATE RISK AND LIQUIDITY NEEDS

Insurers are successful in hedging interest rate risk with derivatives. More importantly, the rising risk-free rate created a situation where they had to pay large variation margins, which mirrored their mkt-to-mkt losses on interest rate swaps.

The analysis of reporting data shows that insurers sold bonds when prices were declining in order to cover the variation margins. This forced selling could threaten financial stability (UK example). Another analysis showed that the insurers' cash positions at the beginning of the year were not enough to cover the margins, and insurers with significant margin calls sold investments for a value similar to the margin calls.

EIOPA refers to the UK pension case, but it also highlights that insurers that are derivative users are most likely increasing their presence in repo and secured lending markets to borrow cash collateralised with liquid bonds, which can be used to post cash collateral.

TOPICAL FOCUSES 3 LIFE PORTFOLIO TRANSFERS AND THE ROLE OF PRIVATE EQUITY IN THE EU INSURANCE SECTOR

The data collected showed that life insurers offloaded liability portfolios with higher guaranteed rates to improve capital efficiency, as profitability was challenged during the persistently low-interest rate environment. Portfolio buyers, sometimes backed by private equity funds, benefitted from low funding costs and saw the opportunity for generating returns by acquiring life liability portfolios.

The business model adopted by the portfolio buyers has inherent risks resulting from concentration, capital arbitrage, and complex/less transparent governance structures. These business models also rely on a high cession of risk to re-insurance.

These practices are focused on a reduced number of markets and a low volume of transactions; therefore, they do not represent a threat to the financial system but raise concerns about policyholder protection.

TOPICAL FOCUSES 4 RISK INDICATORS FOR PHYSICAL CLIMATE CHANGE RISK FOR THE EUROPEAN NON-LIFE UNDERWRITING BUSINESS

This chapter uses an alternative quantitative approach to assess the current and the potential change in risk for non-life and composite undertakings in light of physical climate change risk.

The study shows that changes in the climate will have a significant impact on the non-life insurance business. The "Fire and other damages to property" Line of Business (LoB) has the highest weather-related disaster risk, and the Southern and Eastern European countries have the highest temperature and solid mass-related risk scores. Other LOBs and regions will also be impacted to a lesser extent.

Climate change risks will increase the protection gaps and insurability issues of weather-related risks with negative consequences for economic growth and economic recovery following extreme climate events. EIOPA recognised that more granular data might be used to enhance this methodology and provide more solid ground for interpretations and further developments.

APPENDIX

EIOPA publishes in the appendix the results of the survey done to national competent authorities on risk assessments in terms of materiality for insurance and IORP sectors. The survey shows that the top five risks for insurers and pensions are the same (Macro risk, Market risk, Profitability &solvency risk, Risk related to digitalization, and credit risk).

Figure A.1.1: Risk assessment in terms of materiality for the insurance sector

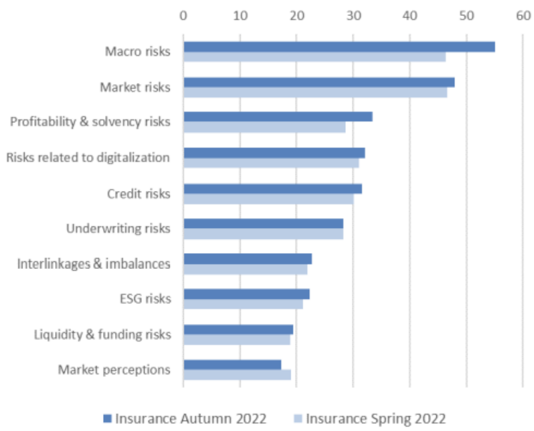

Figure A.1.2: Risk assessment in terms of materiality for the IORP sector