Challenges facing insurers

1. The challenges of the insurance sector at the global level

The Chair detailed that the insurance sector is a particularly globally interconnected industry, given the nature of the business model of diversification, and many of the challenges facing the insurance sector demand global solutions.

1.1 EU insurance sector resilience despite a challenging global economic environment

The Chair noted that despite its resilience, the insurance sector is not without its challenges. In the short term, there are the macroeconomic environment and liquidity risk, credit risk and structural shifts in the life insurance sector. In the longer term there are climate and sustainability risks, which nonetheless demand immediate action.

An industry representative added that the challenges include economic growth, inflation, interest rates and the volatility of investments. However, the resilience of the insurance sector is striking. It has fared the challenges well, and is still weathering many risks. It has shown its ability to adapt through management actions, and there are still strong capital surpluses within insurance undertakings, particularly in Europe. Some elements, like the duration gaps in balance sheets, have been key, given the interest-rate changes. The low and negative interest rate environment had motivated insurers to reduce their fixed income asset durations which translated in increased negative duration gaps while both decreasing asset sensitivity to upwards movements in interest rates and allowing fast paced reinvestment once in higher rates environment. More than 300 basis points was the shock to absorb.

During the low interest rate period, long-term investments were not remunerated correctly and therefore discouraged. It was not worth investing long-term, and this hit investment in the productive economy. Furthermore, the spreads were not remunerating risks well. Long-term investments are equal to savings in the long run, which require an economic return over time capable of compensating for the risk taken and rewarding the patience needed for value creation. Positive interest rates were sought, so the interest rate increase is welcome for relaunching the financing of the economy and restoring a more appropriate level of risk remuneration. It is difficult to remunerate any life insurance and any savings without minimal financial returns. The positive interest rates were also welcome for non-life because any financial remuneration helps dampen premium increases and cost of covers.

A flip side of the increase in interest rates was the soaring inflation, which came in the wake of the low for too long interest rates era which created massive liquidity in the markets. Inflation is particularly costly for non-life insurers. It primarily hurts claims but also operating costs. In life insurance, liquidity has been abundant both in the market and in insurers balance sheets as underlined by rating agencies. This was due to the positioning of the fixed income assets on shorter durations. This has not served the productive economy and growth has stagnated, leading to increased uncertainty and vulnerabilities. Consequently, there is a great deal of volatility in the financial markets, which requires closely monitoring each asset, especially real estate, private debt, and equity ones.

In the meantime, on the prudential side the review of Solvency II, which is at an advanced stage, is expected to bring about approaches better adapted to the features of the long term, and for accurately capturing long-term risk profile specificities. Prudential tools must not distort the economic reality or amplify phenomena. They are helpful only when they do not blur the decisions that insurers have to take. Long-term investments in equities, the volatility adjustment and the risk margin were important for unleashing a better capacity for investing. Another consequence of the recent economic and financial environment has been challenges triggered by certain correlations with interest rate evolutions, observed in the standard formula market risk. However, with very few exceptions, there have been no widespread mass lapses observed.

A regulator remarked that the shift in the financial market changed the investment conditions and insurers' investment behaviour. In Germany, the increase in interest rates was welcomed. The solvency situation is now much improved. On the prudential side, Solvency II has been a constraint in the past but no longer is. For German life insurers with their long-term guarantees, higher interest rates are a release.

1.2 Lasting issues and the status of insurance companies in Japan

An industry representative detailed that the environment surrounding Japan's life insurance faces structural factors, most importantly the declining and ageing population. There is also a problem of sluggish growth in households' real income.

Companies are generating strong profits, but whether wages will strongly increase or not is yet to be determined. There is also a low insurance penetration rate, especially among young people. With the ageing population, the low participation rate and the weak household real income, the value of new life insurance contracts has been on a gradual downward trend for the past 15 years. There have been various negative factors in recent years, such as a decline in sales due to the Covid-19 pandemic, a large amount of repayment because of natural-disaster-related deaths and conduct risk for sales staff of companies, which is not necessarily easy to completely eradicate.

Against this backdrop, life insurance has a huge stock of long-term insurance contracts from the past. There are stable, long-term investments, mainly in government bonds but also in other conservative investments. There are no acute solvency issues in the sector. There is a growing possibility that Japan will be lifted from the zero-interest rate environment. However, the rate rise will be limited in scope in the near term, and most insurance contracts in Japan come with a protection feature. So, given the difficulty of re-enrolling to a similar contract, rising interest rates will not cause an extreme increase in contract cancellations, though there should be vigilance on the potential liquidity risk.

Listed insurance companies are pursuing capital efficiency and governance reforms. The investment capacity is increasing, and capital is being invested in new areas, such as IT. That has the potential to dramatically transform business efficiency. There is also investment in a service platform to expand the business into areas adjacent to insurance, so as to become lifelong partners for customers. Additionally, overseas markets that are expected to grow in the future are being invested in.

1.3 The financial strength of the sector in the US

A regulator remarked that despite the ups and downs due to Covid, the 2023 banking crisis, and ongoing inflationary pressures, the U.S. insurance sector remains resilient and financially In the early 1980s, the US saw a string of insurer insolvencies, which prompted state insurance supervisors to adopt a risk-based capital regime in the 1990s. Supervisors review that regime on an ongoing basis in an effort to capture new and evolving risks and maintain a strong market.

2. Structural shifts from the low for long environment

A regulator noted that in the past the insurance sector invested in highly illiquid assets in order to have higher yields, and now there are some insurers with quite a high share of illiquid investments on their balance sheets. This could lead to problems in the statutory profit and loss account. There is no liquidity problem overall, but there is a question about the price of liquidity. There are many hidden losses in the balance sheets, which is something that has to be managed properly.

A regulator noted some structural shifts, also highlighted in the IAIS's Global Monitoring Exercise (GME), are increased investment in alternative assets and the use of asset-intensive insurance.

These shifts could be a source of risks, but they are also a direct reaction to the economic environment. That should be considered when thinking about the supervisory or regulatory response.

Alternative assets could hide the actual exposure of insurers to market, credit, and liquidity risks, and could entails asset valuation issues. Asset intensive reinsurance, if not well implemented, could unduly decrease the level of protection of policyholder and create hidden accumulation of risks at global level. As highlighted in the GME, alternative assets and asset-intensive insurance could be concerning under both micro and macro perspectives. However, if those perspectives are addressed within appropriate internal risk governance systems, with insurance companies able to understand the consequential risk exposure, and within appropriate oversight by supervisors, these practices could be useful and should not necessarily be blocked.

Alternative assets could help by increasing the risk diversification of the asset portfolio without resulting in exaggerated exposures. They could also help to match assets and liquidity in terms of duration. Asset-intensive reinsurance is preferable to the actual transfer of life insurance portfolios from one company to another, which obviously has consequences for policyholders.

Overall, supervisors and regulators should take a selective approach. Regulatory adjustment is not needed in Europe or the US. Their frameworks already include principles that should lead to an appropriate use of these instruments. However, supervision should be enhanced in order to understand what the right exposures are, and when a company is not appropriately valuing the assets or is not aware of risk exposures.

In Italy we have checked, for example, several non-traditional reinsurance treaties that cover the mass lapse risk, which is the loss that a company could have in case of massive surrender. Some of these treaties actually transfer the risks and represent a genuine risk mitigation. Overall, there should be a bespoke approach, and innovation coming from the market should be looked at with both openness and a critical eye.

2.1 Monitoring actual emerging risks

A regulator indicated that with Solvency II, market valuation, explicit recognition of risks and co-operation with EIOPA work. While the industry was working on this, it was also implementing International Financial Reporting Standard (IFRS) 17. 75% of the industry uses Solvency II valuation curves there.

There should not be complacency. The industry and supervisors can help each other. There are more positives on sustainability risk. There will be work on macro risk. From a supervisory perspective, there will be a great deal of easing. The industry is above a 200% solvency ratio and is robust, but after the implementation of the SII Revie that same number will mean something different. There will be billions of euros less behind the number. That is the reality of the change, and it means that supervisors need to focus on risk management and what is happening in the companies. That is part of the framework. There is no need for any change for that to occur.

2.2 The US market taking advantage of structural shifts

A regulator stated that some of what is seen in the US market is in response to structural shifts and changing business practices, such as a focus on complex ownership structures, like private equity and complex investments. The private equity piece was one of the driving forces for some of the enhancements and review assessments that were undertaken in the US in recent years. Through the National Association of Insurance Commissioners (NAIC) a list of 13 considerations were developed to formalise a review of insurer activities, look at existing guidance and consider appropriate updates, such as to the holding company system, cross-border reinsurance, and investment management agreements.

The American Academy of Actuaries released a paper that talked about a number of these matters. This was a good reminder of how work is co-ordinated among the states in the US, and the importance of stakeholders' engagement. Participation in meetings like Eurofi allows for further engagement, which is important because the sector is global.

Through the relevant NAIC groups, there is ongoing work on the list of 13 regulatory considerations, which are intended to address a variety of insurer practices. For example, Consideration 13 related specifically to offshore reinsurance vehicles, and indicates that, 'Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximise capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.'

As illustrations of work, after the issuance of those 13 considerations, the NAIC Life Actuarial Task Force (LATF) adopted an actuarial guideline known as AG53. This went into effect at the end of 2022 and included a range of requirements related to the considerations, including increased disclosures. In early 2023, the NAIC Macroprudential Working Group (MWG) held various meetings with stakeholders, including insurance industry representatives and international regulators. As a result, a worksheet was developed that state insurance supervisors could use to evaluate reinsurance transactions involving offshore jurisdictions. After receiving comments, the MWG adopted that worksheet, and it now serves as an additional tool that supervisors can use when reviewing such transactions.

3. Integration of the industry in the EU

The Chair remarked that there are developing issues that need to be better understood. Their impact on supervisory practices also needs to be understood. That is the journey that the IAIS is taking with its work on its global monitoring exercise.

A regulator added that further supervisory integration should occur alongside the integration and concentration of the insurance industry in the EU. in the insurance industry, over 12% is cross-border in Europe, and over 50% of what is written is done by 20 companies. In contrast to banks, it is already quite an integrated European market. With one licence, an entity can sell throughout Europe. However, that is not the reality of the insurance supervisors in Europe. For supervision, there is national competence with maximum harmonisation on the prudential side, but minimum harmonisation on the conduct side. There is a need to talk about that, particularly if there are cross-border issues to solve.

Questions can be asked about how much knowledge and understanding there is of the insurance market in the horizontal legislation that is coming out. A mechanism is needed so that there is a role for insurance knowledge when legislation or regulations come into being.

4. Climate risk in the EU insurance market

A regulator detailed, regarding a prudential treatment of sustainability risks, that EIOPA had a discussion with many stakeholders including the European Systemic Risk Board (ESRB). There is consultation on a dedicated treatment. Sustainability risks will be considered. There are risks with climate change, and quantifying will be done in Pillar 1 under Solvency II. Rather than talking about green or brown, there is just talk of risks.

The methodology and data set were already consulted on, which provided good feedback. The data was put into the methodology and there was an outcome, which is very balanced. For many categories, a differentiated treatment is not seen to be necessary. One exception is fossil fuel stocks and bonds. It is not huge, and through the risk modules it is diversified, but ultimately this is an area where it would be appropriate to have a differentiated treatment.

There is a need to be risk managers and to recognise that being in certain categories of assets means having an impact in terms of climate change. There is a risk, and it needs to be measured and included in the overall risk calibration.

A regulator reported that Italy is working to fill the protection gap. A legislative intervention introduced compulsory insurance for commercial industrial enterprises, and the insurer is obliged to accept the request for coverage together with the possibility to reinsure part of the risk to a state-owned entity, within certain limits.

Building this system presents many challenges. One of them is the need to combine the benefits of mutualisation, which requires a large base of policyholders, with risk-based incentives, which reduces the base of policyholders but lead to the introduction of preventative measures.

The supervisor will also have to define the prudential consequences for the companies that underwrite those risks. There are also market conduct issues related to the definition of what is covered and what is not covered.

If all these problems are addressed, however, the system will introduce incentives for preventative measures and the possibility to leverage the operational capability of insurers to speed up the liquidation of the claims. This goes in the good direction.

5. Finalisation of the Insurance Capital Standard (ICS)

The Chair highlighted that there was recent endorsement by the Financial Stability Board (FSB) of the IAIS's holistic framework for assessing and mitigating systemic risk in the insurance sector and that the finalisation of the ICS by the end of the year is well on track.

A regulator emphasised that it was positive to see the ICS enters its final year. Adoption by the IAIS can be achieved at its meetings in South Africa in December once some final issues are cleared up. It is also very positive that Solvency II can be an implementation of the ICS in Europe without adjustments, including the changes that come with the Solvency II review.

Currently, the IAIS and the US are putting tremendous effort into the comparability assessment of the Aggregation Method, including delivering data in order for there to be a technical assessment. A regulator added that there has been a great deal of work on the comparability piece and ongoing collaboration and communication among IAIS members in order to reach a successful conclusion of the whole ICS project.

The Chair welcomed these messages of harmony, the commitment to finalisation in December in Cape Town, and the shift to future discussions on ICS implementation.