What's next for the insurance sector in 2022

Climate change and sustainability are at the heart of the insurance sector, impacting both the asset and liability side of the balance sheet, and as such, these will be key themes to watch in 2022. Also in focus: the re-risking of portfolios with alternative asset classes and post-Covid-19 shocks in the Non-Life segment.

The bank of the river Rhine is seen flooded in Cologne, western Germany, on July 15, 2021. Flooding in the western German states of Rhineland-Palatinate and North Rhine-Westphalia due to persistent rainfall has left at least 58 people dead and dozens missing, local media reported.

Source: Shutterstock

Re-risking of portfolios amid market volatility and low interest rates

The ongoing environment of low rates has been weighing heavily on insurers' profitability, especially life insurers, with guarantee products suffering the most. But under the Solvency II framework, return on capital is not the only consideration. In portfolio allocation strategies, insurance companies have to find a balance between higher returns on capital, lower solvency capital requirement (SCR) and longer duration.

In order to boost returns, insurers have been vocal about their ongoing shift towards higher risk and less liquid assets, while at the same time being conscious of the capital charges these investments attract. We predict that the following alternative asset classes will be insurers' top picks for the purpose of optimising their investment portfolio:

- Mortgages – without attracting a penalising duration factor, these limited risk investments attract relatively low capital charges, providing insurers with an opportunity to invest in an amortising asset class with a natural interest rate hedge.
- Private placements – tailor-made products that match the exact needs of both issuer and investor are relatively low risk and can provide insurers with a perfect match for their portfolio on relatively attractive terms.
- Infrastructure debt – an asset class that is characterised by a very long duration, the favourable SCR treatment compensates investors for the absence of a secondary market with a hefty illiquidity premium, and it can also offer something of a sustainability factor.

Some companies will also choose to cautiously expand a more capital costly equity portfolio and invest in lower rated corporates. The initial capital market shock triggered by the Covid-19 pandemic revealed that insurers' asset portfolios are exposed to such drastic fluctuations, however, they managed to withstand it and quickly bounce back. Equity risk, spread movements and rating changes were amongst the main factors that led to a significant drop in asset value at the beginning of the pandemic. Despite this, insurers are still looking to re-risk their portfolios.

Resilience in the face of Covid-19 and post-crisis shocks

Insurers have shown remarkable resilience in the face of the Covid-19 pandemic, in our view. The Life segment struggled the most due to adverse mortality results. The non-Life business has shown a strong performance.

The results of Life were more significantly impacted due to the following factors:

- Insurers have reported losses in this segment on the back of mortality results;
- The pandemic has had a significant impact on the value of new business;
- Low interest rates and volatile markets have led to a negative impact on investment results in the Life segment.

Non-Life business has shown better results, despite additional pressure on the Health sector. This was largely due to factors such as:

- Lower claims (for instance, given that people were working from home and travelling less, there have been fewer claims in P&C (property insurance and casualty insurance));
- Lower demand for elective health care (due to the postponement of non-emergency medical treatment);
- In some countries, like in the Netherlands, injections from the government.

Overall, insurers quickly adapted to the new operating environment and we have seen the impact of Covid-19 become less significant over time. The crisis had a minimal impact on the capitalisation of insurers, as the European Insurance and Occupational Pensions Authority (EIOPA) reported an average Solvency II ratio of 235% for the end of 2020, only seven percentage points lower than in 2019.

The health segment is well positioned to absorb the post-crisis shock

Going forward, with all the measures taken to combat the pandemic and ongoing vaccinations, we expect the performance of the Life segment to improve. In Non-Life, we are going to see some catch-up over the coming months as demand will increase for non-Covid-19 related medical care which was postponed, but we believe that insurers have sufficient reserves to absorb that shock.

Sale of closed life books to continue

Insurance companies are dealing with numerous market challenges (such as low interest rates, Solvency II capital charges, an ever changing regulatory framework, etc) and are seeking to create value through both new business as well as through the optimisation of already existing books. Closed books can be managed in several different ways, be it through internal optimisation within the insurer, putting it in run down internally or outsourcing some lines of business to an external company, or completely offloading balance sheet exposure. In order to release capital and shift the focus onto new business, a lot of insurance companies have been vocal about their intention to sell closed life books which pose a significant profitability challenge.

The sale of closed life books allows insurers to efficiently manage capital and shift the focus onto new business

Capital efficiency came into focus since the introduction of Solvency II in 2016 and put under pressure the strategies of legacy portfolio management. These portfolios are mostly composed of capital dense, high guarantee policies, with are costly to hold from an SCR perspective. With no new policies being added to the portfolio, the number of outstanding policies gradually decreases, pushing fixed costs per policy higher and therefore reducing returns. The size of closed books varies by country, but can be rather substantial. According to McKinsey 2018 data, closed books accounted for 35% of premiums in the life insurance market in Germany.

Such portfolios are being sold to run off players, which can be either large specialised consolidators which normally belong to PE and are fully dedicated to managing closed books, or other independent insurers. Some of them are based in Solvency II equivalence regimes and can benefit from more favourable regulatory treatment, but mostly they are looking for various optimisation solutions such as, for instance, merging portfolios in order to achieve economies of scale and decrease expenses per policy, optimising operations and IT to maintain legacy systems, digitalising processes, alternative investments especially in the case of Private Equity owned consolidators, etc.

While the market for closed books in the US and the UK is booming, the activity in the EU has not yet reached the same levels. However, the number of deals in the market across Europe continues to grow, with the Dutch insurers playing an active role. In spring 2021, Allianz sold 90,000 policies to Monument Assurance Belgium NV. The latest to announce was Athora Belgium seeking to acquire closed life book of NN Insurance Belgium with €3.3bn of assets under management. The deal is expected to close in mid-2022.

UFR to remain stable

Changes to the Ultimate Forward Rate continue to have an impact of insurers' Solvency II ratio. The UFR, being higher than rates observed in the financial markets, has a positive impact on insurers' solvency position. For 2022, the UFR was fixed at 3.45%, reflecting the expected real rate and expected inflation. The UFR is based on an average of past real rates observed since 1961. With the new (negative) rates being added to the calculations, the resulting expected real rate is continuously decreasing. Despite the slight increase in rates in 2021, no upward revision to it is expected short term. Should the trend continue over the coming years, we could see a slight increase in the rate in the coming years. The annual change in the UFR is capped at 15bp, and therefore any upward revision would be limited.

Premiums and demand are set to grow

Higher claims during Covid-19 could lead to higher premiums. This is especially important for the health segment, as it would have the greatest impact on consumers across Europe. Insurers are conscious of this fact and are trying to minimise the impact. As such, a lot of them are planning to use built-up reserves to curb premium increases. Increased risk-awareness during the pandemic pushed demand for insurance products higher. We can expect to see growth in sales of life insurance policies, in particular. It is expected that this product will be used more widely, for instance as part of employee benefit packages.

Climate change and sustainability are key topics

Climate change is at the heart of the insurance sector for many reasons, having a profound impact on both the liability and the asset side of insurers' balance sheets.

The number of natural disasters, such as floods, wildfires, droughts, storms and earthquakes has been steadily increasing over the last decades. Climate change has exposed vulnerabilities of P&C insurers and reinsurers in the wake of rising catastrophe claims through natural disasters' impact on businesses (business interruptions) and homes (property damage and destruction).

> *We observe systemic and aggregation risks*

One of the challenges of climate change is the systemic nature of the risk. For instance, rising global temperatures lead to an increased number of wildfires, impact crops, can kill livestock, etc. The interconnected nature of the world means that the consequences of natural catastrophes are spreading far and wide, and multiple claims can be submitted relating to one event, so called aggregation risk.

Drastic weather conditions stemming from climate change are spreading. It's no longer only about droughts in Africa, but recent floods in Germany, Belgium and the Netherlands showed us the local nature of climate change here in Europe. Insurers underwriting policy is always based off past claims experience, therefore it's important for them to proactively re-evaluate the risks to be mirrored in their premiums. It is possible that new products will have to appear to reflect the complex nature of new risks, and insurers have to remain flexible in providing new underwriting solutions to maintain coverage ability. Insurers are also taking active climate conscious actions by offering new innovative products to their customers. Be it a discount on motor insurance of electric vehicles or providing protection on wind and solar energy, insurers are participating in actions targeted at combatting climate change. The systemic nature of climate risk makes the need for global collaboration among insurers indispensable. Insurers need to study climate risks together to better understand them and provide customers with the best solutions. In September 2021, it was announced that EIOPA is set to conduct climate stress tests. The European Commission also disclosed that a review of the Solvency II framework will comprise a new requirement for a long-term climate change analysis as well as potential changes to the standard formula catastrophe risk module.

Another way in which climate change is increasingly important for insurers is the environmental impact of their investments. More and more financial institutions, including insurers, are looking to align growing parts of their asset portfolio with ESG goals through responsible investments. Across Europe, insurers have over €10t invested in assets, and changes in their investment behaviour can have a major impact on the market. As discussed above, insurers are looking to re-risk their portfolio, which is a perfect opportunity to take environmental considerations into account. Opportunities in sustainable investments are endless and any insurer can find a good fit. ESG-related infrastructure debt investment would be our top pick for insurers' growing risk appetite, offering portfolio diversification, attractive return on capital, much needed duration and, at the same time, a positive environmental impact. Another good alternative could be real estate investment, either direct or through mortgages, namely social and student housing. EIOPA has been authorised by the European Commission to draw up a report by 2023 on potentially environmentally and socially harmful investments of insurers with a view to revising the standard formula.

Climate change can also ultimately have a negative impact on the catastrophe bond market. Offering investors attractive yields and an opportunity to diversify their portfolios with instruments that are generally not correlated with economic and market conditions, CAT bonds allow insurers to transfer some of the risk to investors, decreasing their expenses in case of a natural disaster. If the number of natural catastrophes continues to rise, the perceived risk of CAT bond investments will also increase, leading to more challenging conditions in raising funding via CAT bonds and pushing spreads on insurance-linked securities wider.

Solvency II framework to be amended

On 22 September 2021, the European Commission adopted a comprehensive review of Solvency II. The review is centred around two main areas. First, the revision of the Solvency II Directive (Directive 2009/138/EC) and a proposal to introduce a new Recovery and Resolution Directive, establishing proper resolution procedures. The aim of the review is to strengthen European insurers' contributions to the financing of the recovery, with many aspects of the framework coming into focus. The Covid-19 crisis highlighted the vulnerabilities of insurers in an environment of prolonged low interest rates and also showed that there is room to further strengthen crisis management tools amid great economic and market shocks, which could potentially lead to instability in the whole financial sector. The revision is set to release as much as €90bn of funds to contribute to the post Covid-19 recovery. The Recovery and Resolution of insurers is set to be strengthened based on the experiences of the Bank Recovery and Resolution Directive (BRRD) and regulation for the recovery and resolution of central counterparties (CCPRRR) but will take into account the specific nature of risks in the insurance sector and the primary need to protect policyholders.

Author

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Disclaimer