



# **European Insurance Industry**

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**EFRAG Supervisory Board**  
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# AGENDA : Presentation Outline

**1** Overview of the European insurance industry

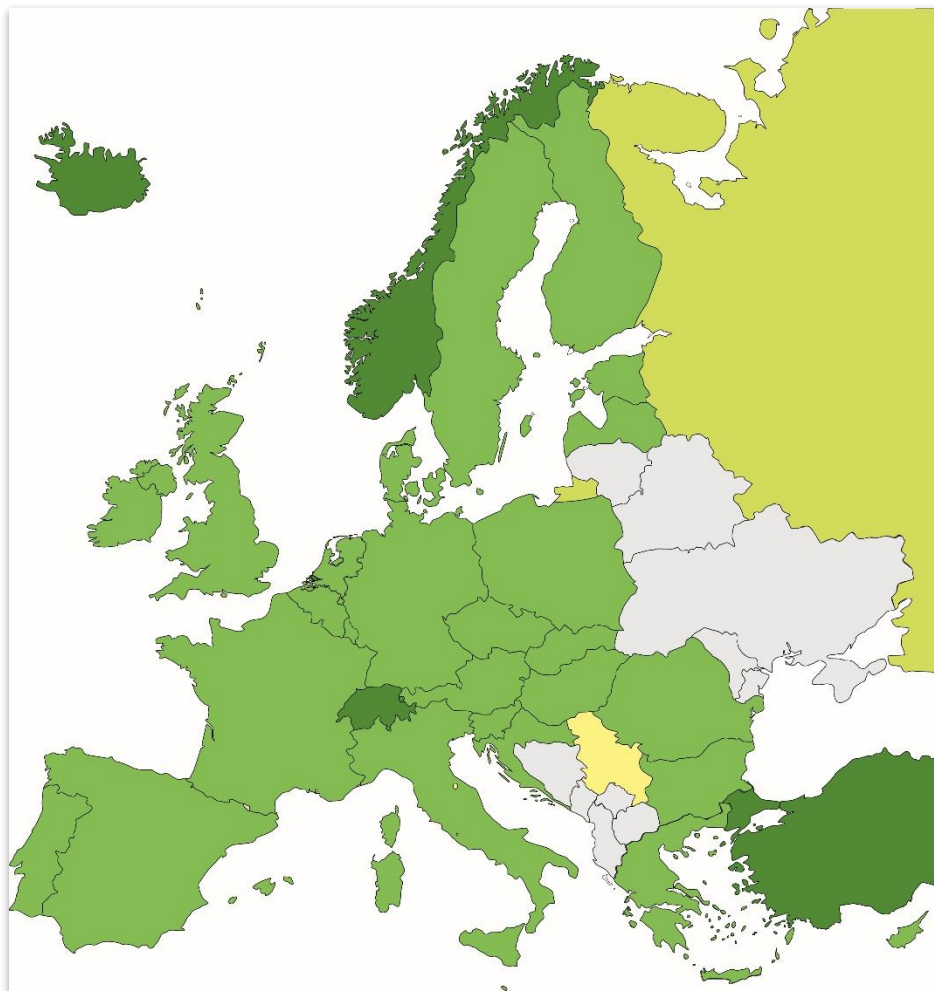
**2** The role of insurance in society and the economy

**3** Key things to know about the insurance business model

**4** Solvency II

**5** Summary and Q&A

# Insurance Europe



- Insurance Europe represents around 95% of European insurance market by premium income
- All types of insurers
  - Life, Non-Life, Reinsurers
  - Shareholder, Mutual
  - Large, Small
- 34 members (national associations)
  - **27 EU member states**
  - **5 non-EU markets** (*Switzerland, Iceland, Norway, Turkey, Liechtenstein*)
  - **2 associate members** (*Serbia, San Marino*)
  - **1 partner** (*Russia*)

# What is insurance?

- ❖ **What:** insurance is about protection against risks
- ❖ **How:**
  - ❖ The risk of financial losses is transferred in exchange of a fee or premium
  - ❖ The premiums are invested in function of the characteristics of the risks covered
- ❖ Main **categories** of insurance:
  - ❖ General (non-life) insurance
  - ❖ Life insurance
  - ❖ Reinsurance

# What is General / non-life insurance?

- ❖ **What:** Protection is provided against:
  - ❖ First-party damage or loss sustained by the insured policyholder (**property lines**)
  - ❖ Third-party liability for damage or loss caused to a third party's person or property (**casualty lines**)
- ❖ **Main non-life areas:**
  - ❖ Motor insurance
  - ❖ Property insurance: including fire, flood, earthquakes, windstorms
  - ❖ Health insurance: protection against the risk of medical expenses
  - ❖ Accident insurance: protection against bodily accidents of the insured
  - ❖ General liability insurance
  - ❖ Professional indemnity insurance: e.g. legal, medical
  - ❖ Other: nuclear, environmental, product liability...

# What is Personal / Life insurance?

- ❖ Life insurance products are typically made up of **2 components**:
- ❖ **A life component**: protection against the financial consequences of death or disability for policyholders and beneficiaries. Risks covered:
  - ❖ Biometric risks (death and morbidity)
  - ❖ Longevity risks
- ❖ An **investment component**: typically, either the policyholder retains the full investment risk or the insurer assumes part of it. Various types of guarantees are offered (e.g. capital protection, minimum yield).

# What is Personal / Life insurance? A focus on retirement products

## ❖ 2 phases:

- ❖ An « accumulation » phase
- ❖ A « pay-out » phase

## ❖ At pay-out: either a **lump sum** or **annuities**

## ❖ Possible characteristics of **annuities**:

- ❖ Number of beneficiaries (single or joint annuities)
- ❖ Indexation to inflation (escalating annuities)
- ❖ Medical conditions (enhanced or impaired annuities)
- ❖ Share of savings which remain invested (flexible or investment annuities)

# What is re-insurance?

- ❖ Reinsurance is insurance for insurance companies
- ❖ Risks are transferred from insurance companies to the reinsurer allowing insurers to reduce their risk exposure and capital requirements.
- ❖ Freeing capital for insurers enable them to write more business and stabilise their financial results
- ❖ By taking on a wide range of rare and extreme risks, re-insurers can diversify them
- ❖ Re-insurers invest significant amounts in specialist skills, data and modelling needed to allow them to understand and manage more extreme risks



# Companies and employees

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3 700

insurance companies  
in Europe



975 000

direct employees in  
Europe

- Different structures
  - Private ownership/Mutual/Listed
  - Monoline, Life, Non-Life, Re-insurer, Composite, Conglomerate
  - National companies, European Groups, International Groups
- Wide range of sizes

# European claims and benefits paid

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€976bn

Total benefits and  
claims paid



€649bn

Life benefits paid



€222bn

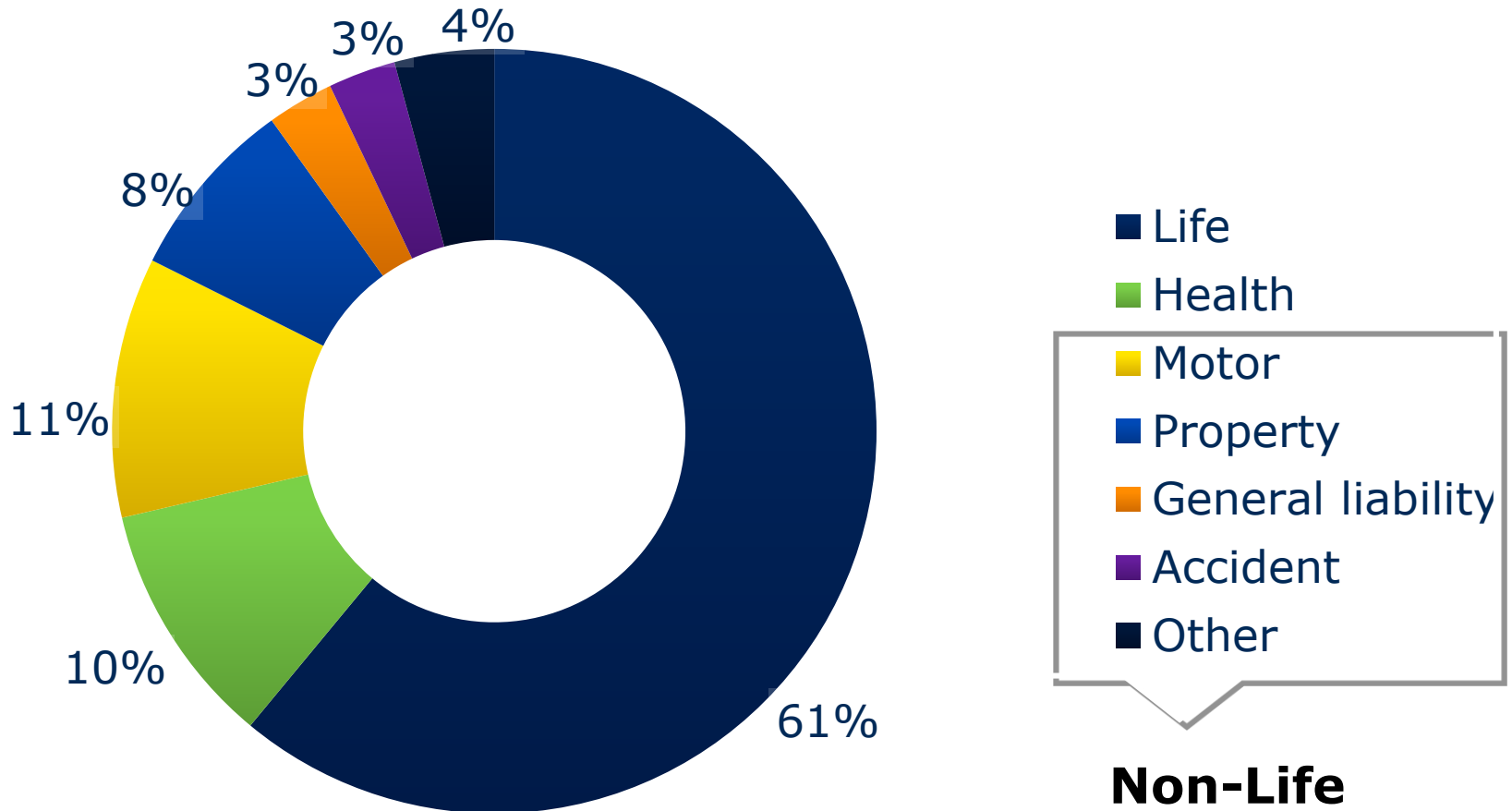
Non-life claims paid



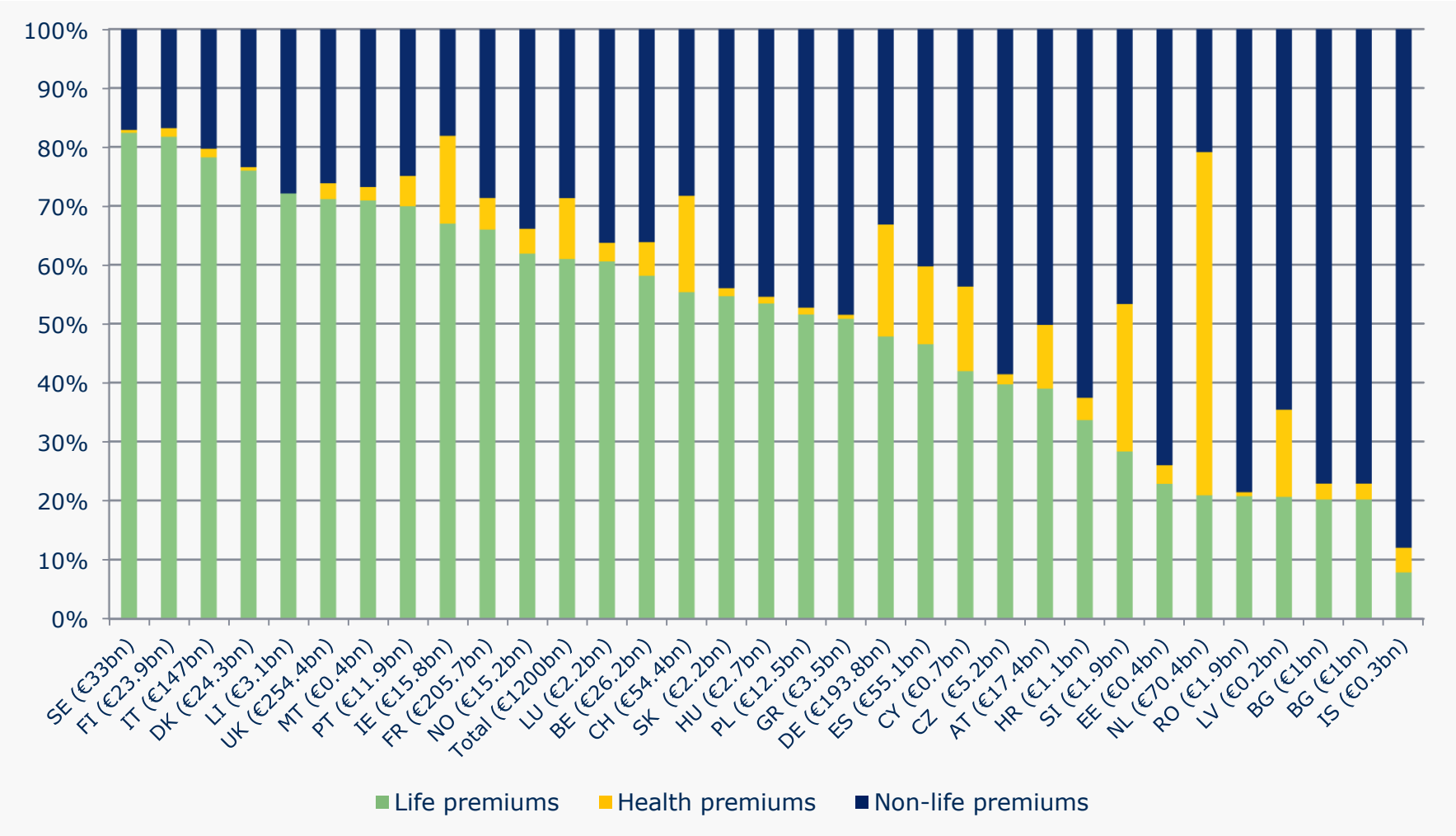
€101bn

Health claims paid

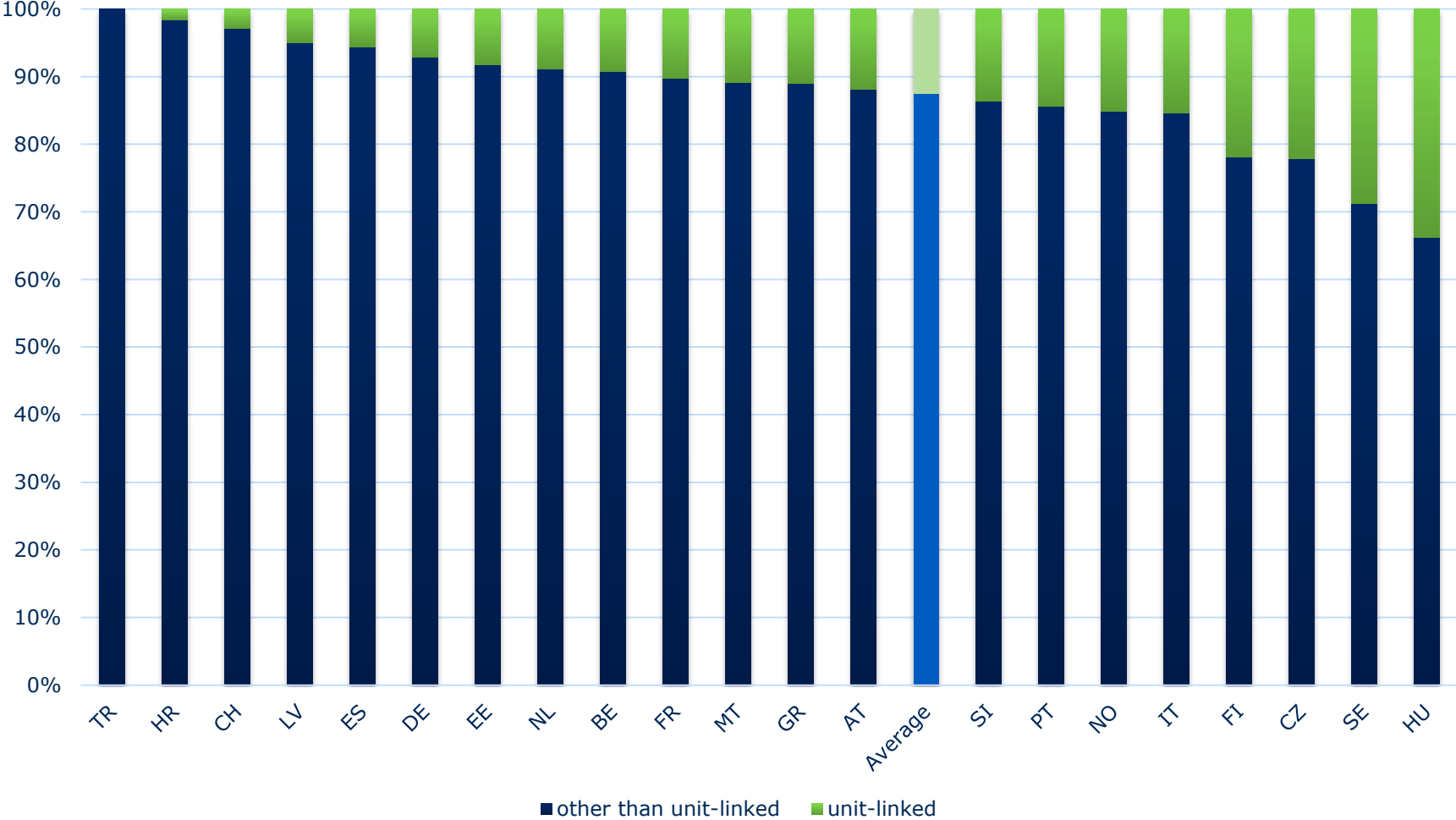
# Overall product mix - Premiums - 2015



# Product mix varies greatly by country



# Unit linked life products sales have grown but remain relatively small overall as % premiums



# Distribution

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## ❖ Diversity of distribution channels

- Types, size and methods
- Across markets and business lines



Bancassurance

is the main life distribution channel

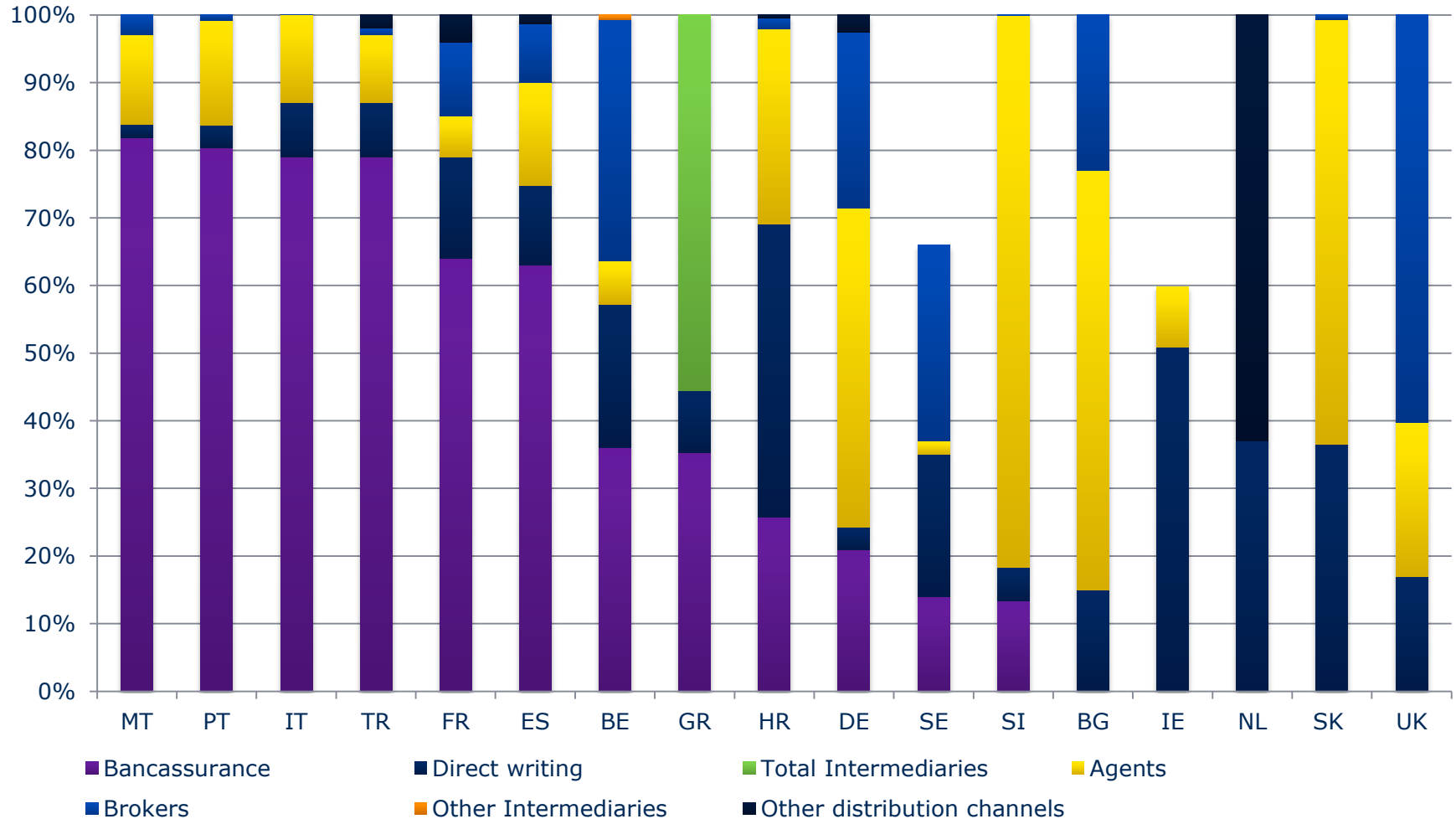


Agents and brokers

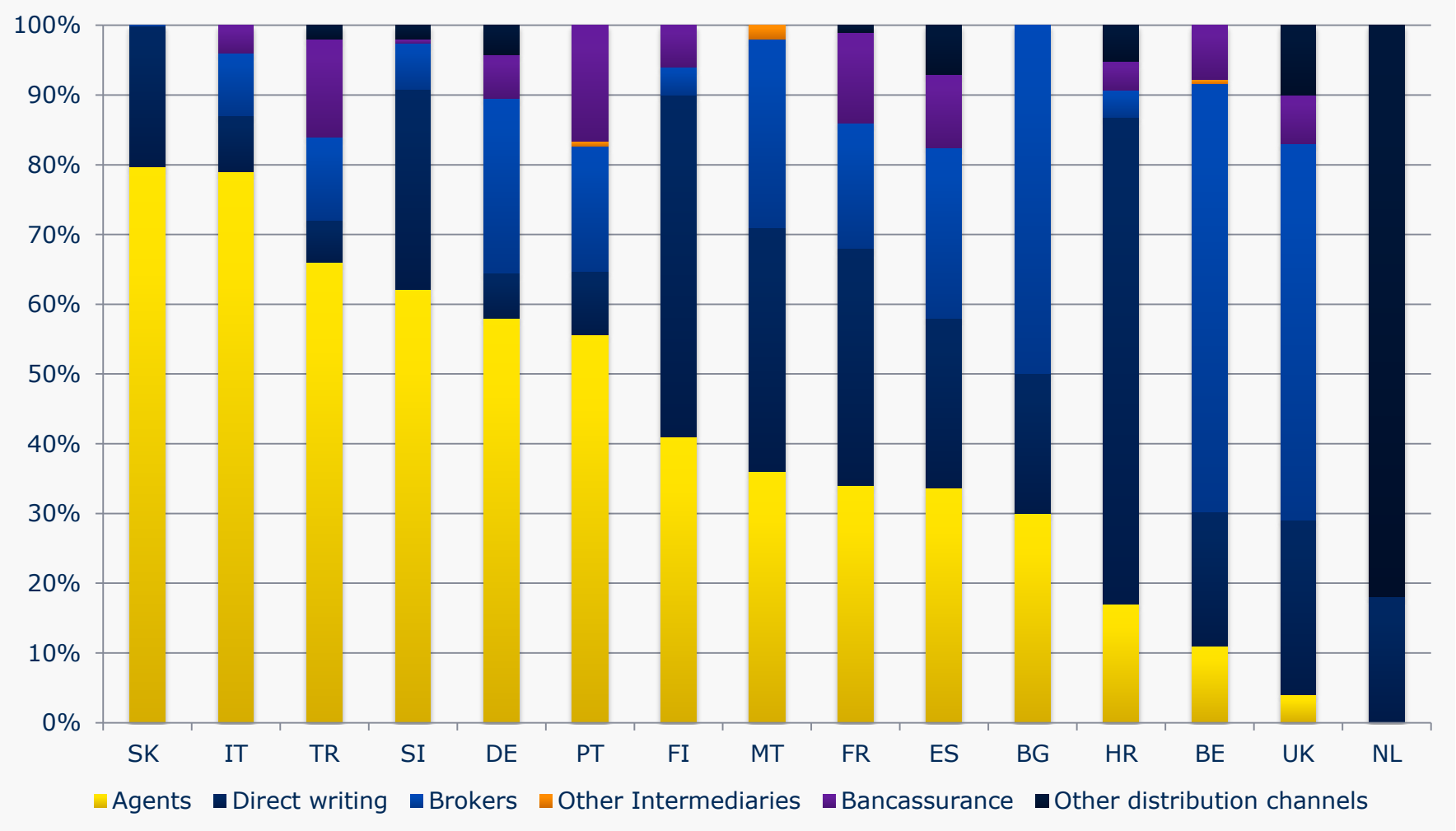
are the main non-life  
distribution channel

# Distribution varies greatly

## - Life distribution channels (% of GWP) - 2014

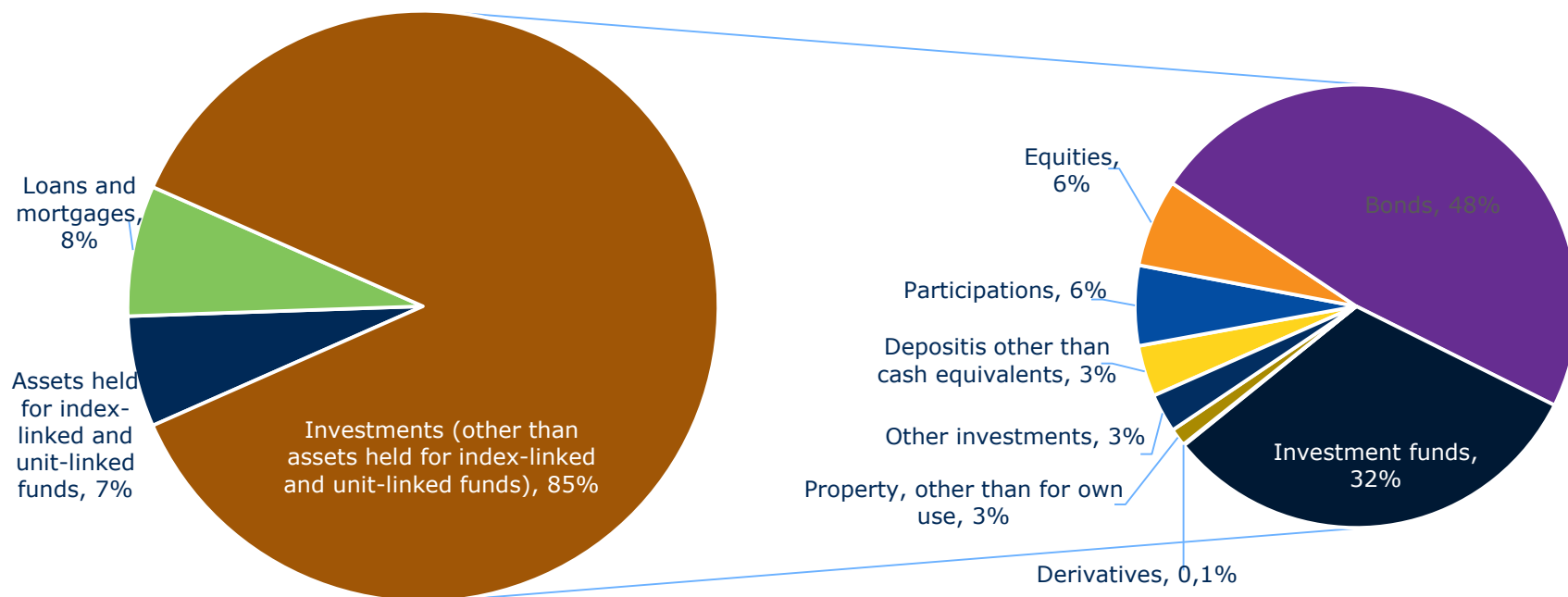


# With significant differences between Life & Non-life



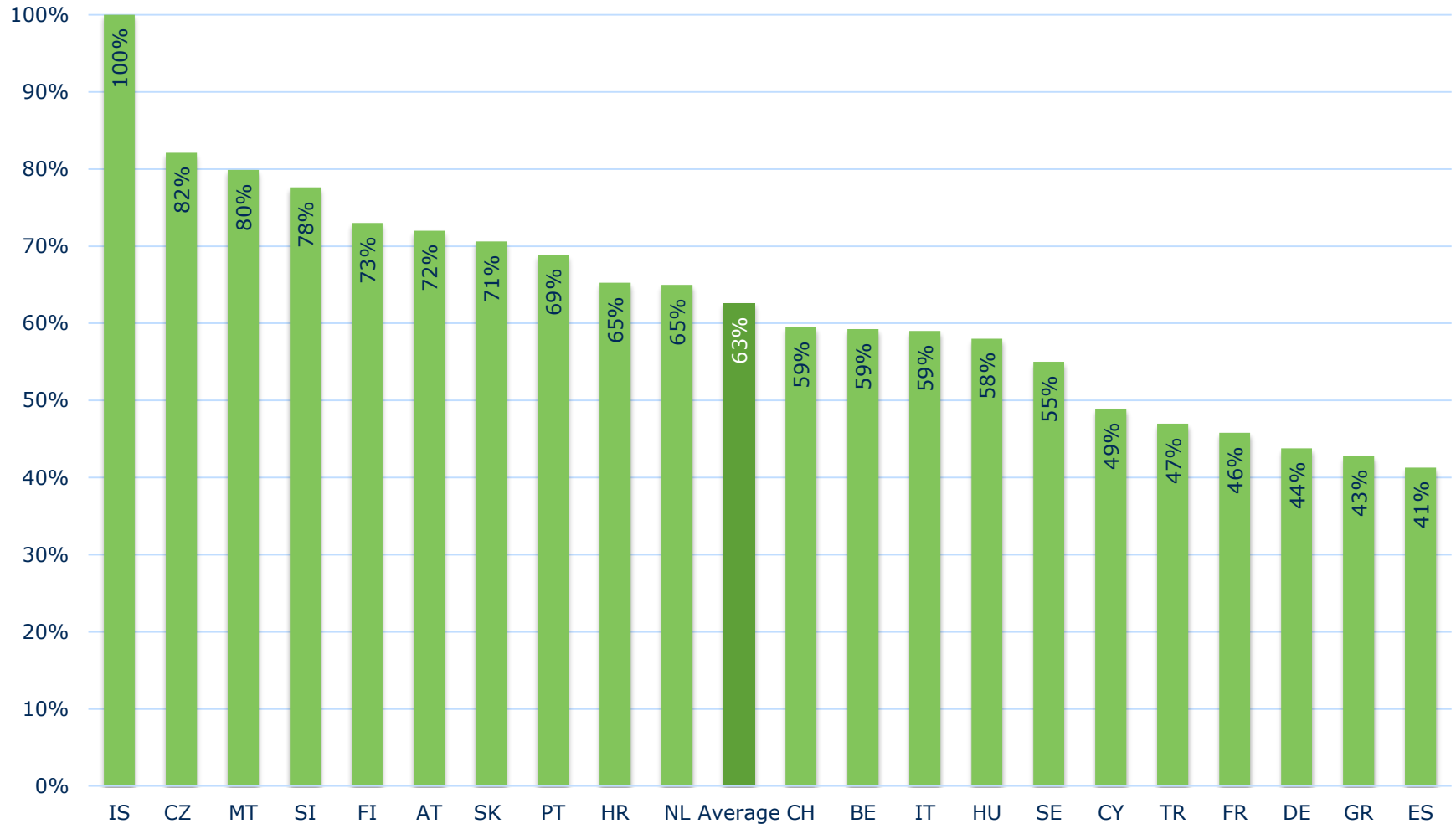


# Structure of the European Investment portfolio - 2014 (%)

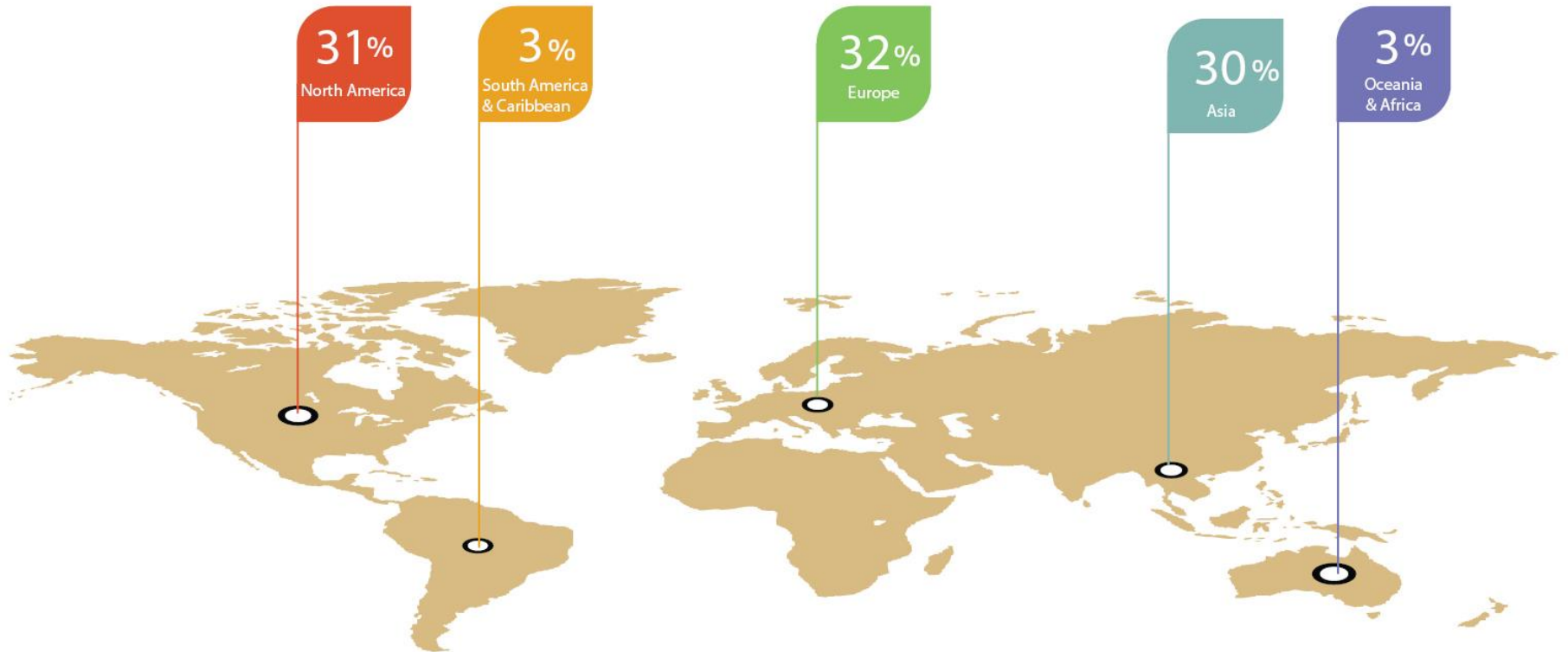


As with other areas, investment mix can vary significantly across countries and companies

# Provider concentration: Top 5 companies % of GWP - 2014



# European industry is the largest globally - and also the most active internationally



**Distribution of insurance premiums 2015**

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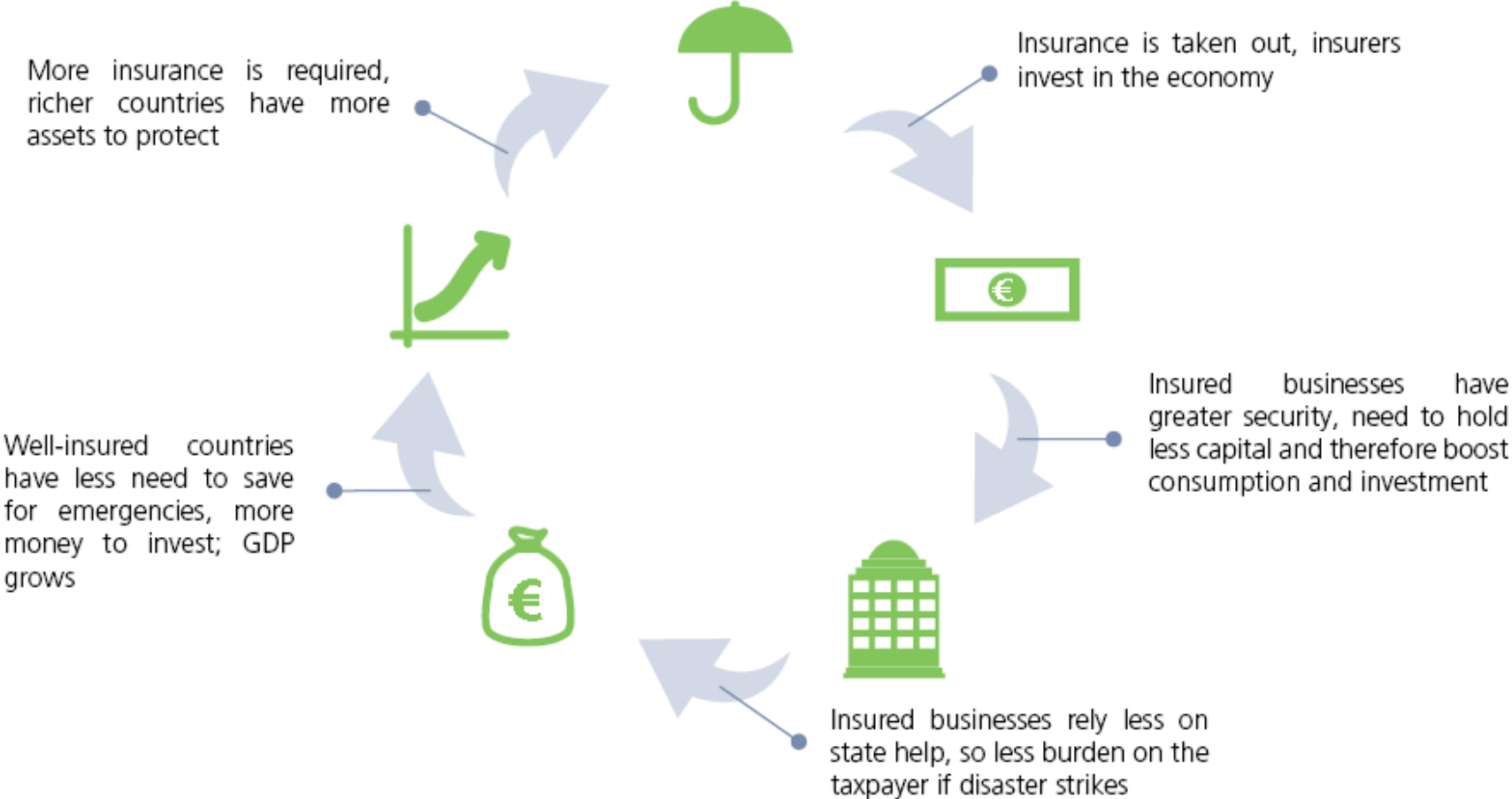
**2** **The role of insurance in society and the economy**

**3** Key things to know about the insurance business model

**4** Solvency II

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# The insurance industry plays a fundamental role for customers and the economy ...



Source: "Lloyd's global underinsurance report", Lloyd's, 2012

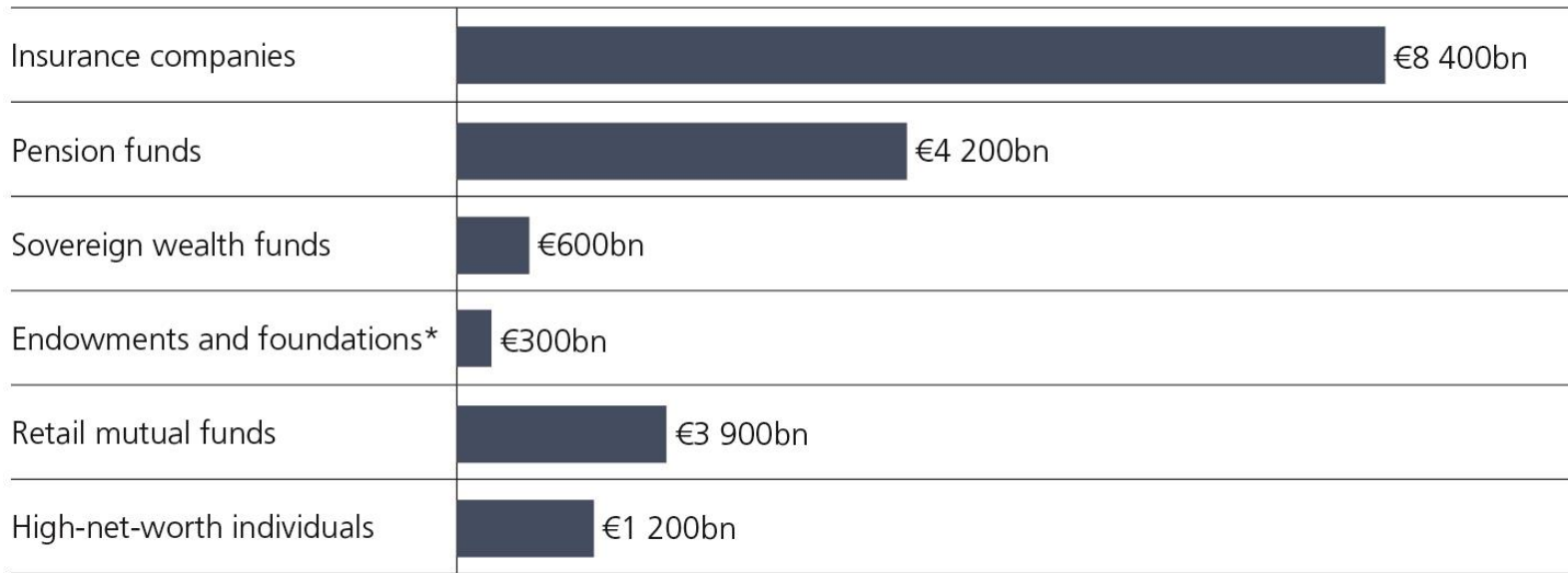
# The insurance industry plays a fundamental role for customers and the economy...

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- Our retail protection and savings products helps individuals to cope with adverse events and have sufficient income and savings during retirement
- Our corporate insurance products facilitate economic activity and resilience
- Significant work is also done on prevention (e.g better flood defences, building planning and regulations; better car and road design as well as driver safety (“Bob”))
- Through the premiums we receive in advance and invest we are Europe’s largest institutional investor and able to take a long-term view including investing in illiquid assets such as infrastructure
- Regular premium inflow, long-term perspective and low exposure to forced selling allows us to avoid pro-cyclicality and act as a stabilising force during market turmoil rather than contribute to it

# Insurers are the largest institutional investor in Europe

## European assets under management — 31 December 2012



Sources: Insurance Europe, OECD, EFAMA, SWF Institute, Forbes

\*2011 data, Oliver Wyman analysis

- Insurers' assets represent more than 55% of European GDP

## ... and results in benefits for more than just policyholders

- ❖ Long-term investment is beneficial:
  - ❖ For policyholders
  - ❖ In terms of long-term growth
  - ❖ In terms of financial stability





# Benefits for policyholders (1/2)

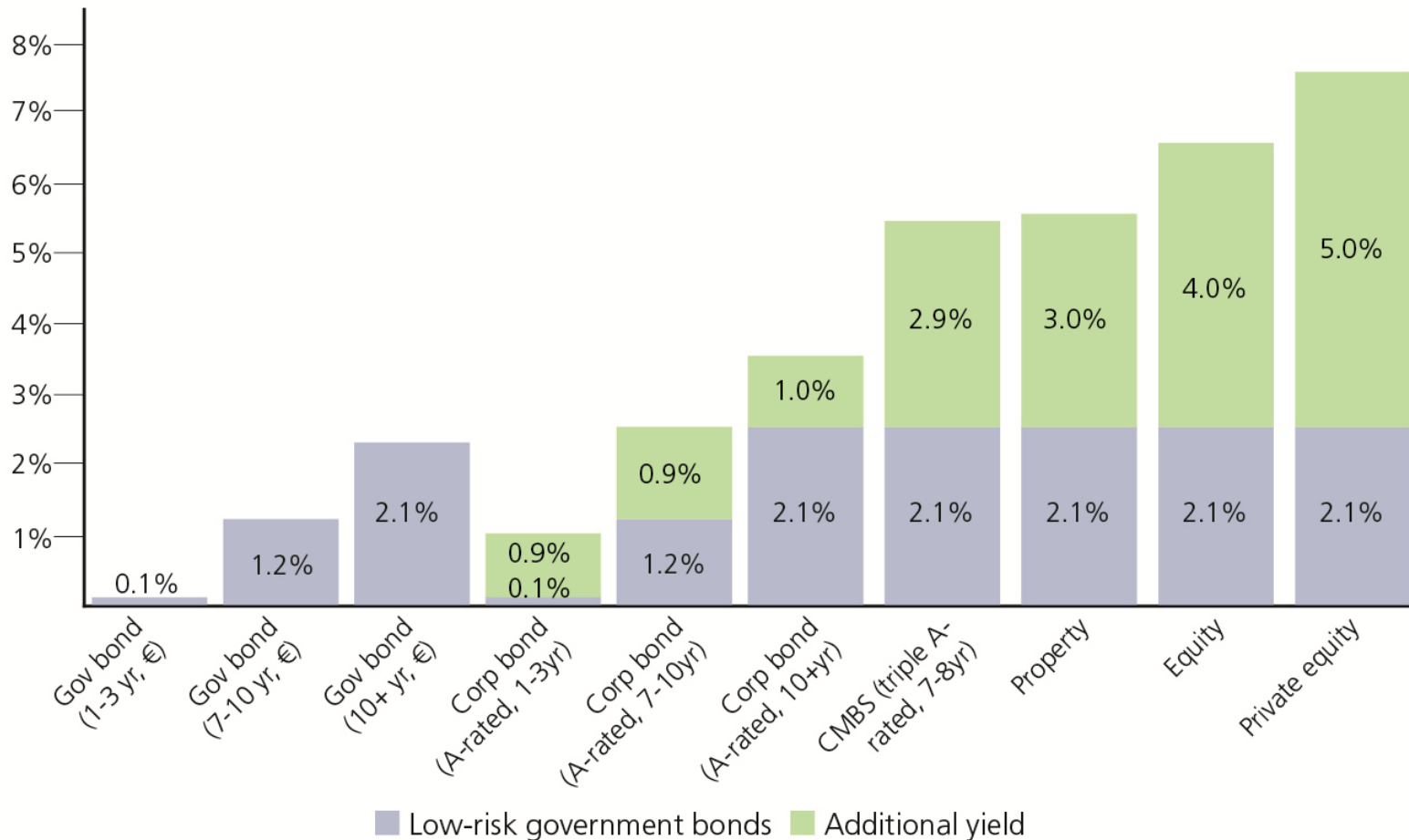
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- ❖ Pooling of risks can provide structural investment advantages
  - ❖ Diversification across time and asset classes
  - ❖ Great flexibility over which assets to sell and when
  - ❖ Ability to avoid “forced sales” during market stress and to buy when prices are low
- ❖ Access to investment expertise
- ❖ Cost reduction
  - ❖ Pooling of assets can allow for greater scale
  - ❖ Pooling and long-term approach can result in lower transaction costs
- ❖ Choice of investment risk for policyholders
  - ❖ From unit-linked to participating products (profit-sharing) to fully guaranteed

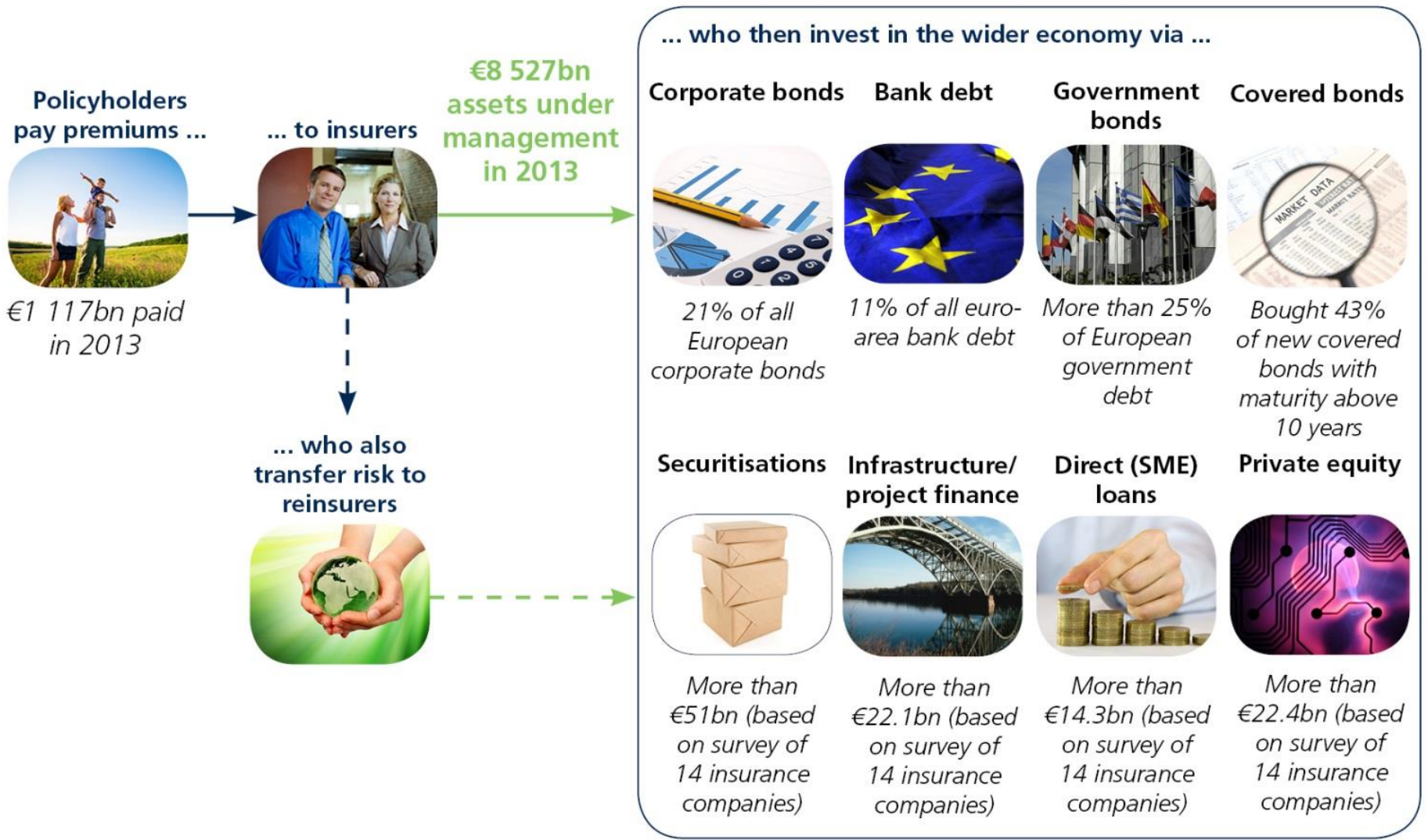
# Benefits for policyholders: access to additional yield (2/2)

- Access to higher yielding investments: illiquid assets, “big ticket” investments, etc

Illustrative comparison of expected returns on long-term assets v. returns on low-risk government bonds



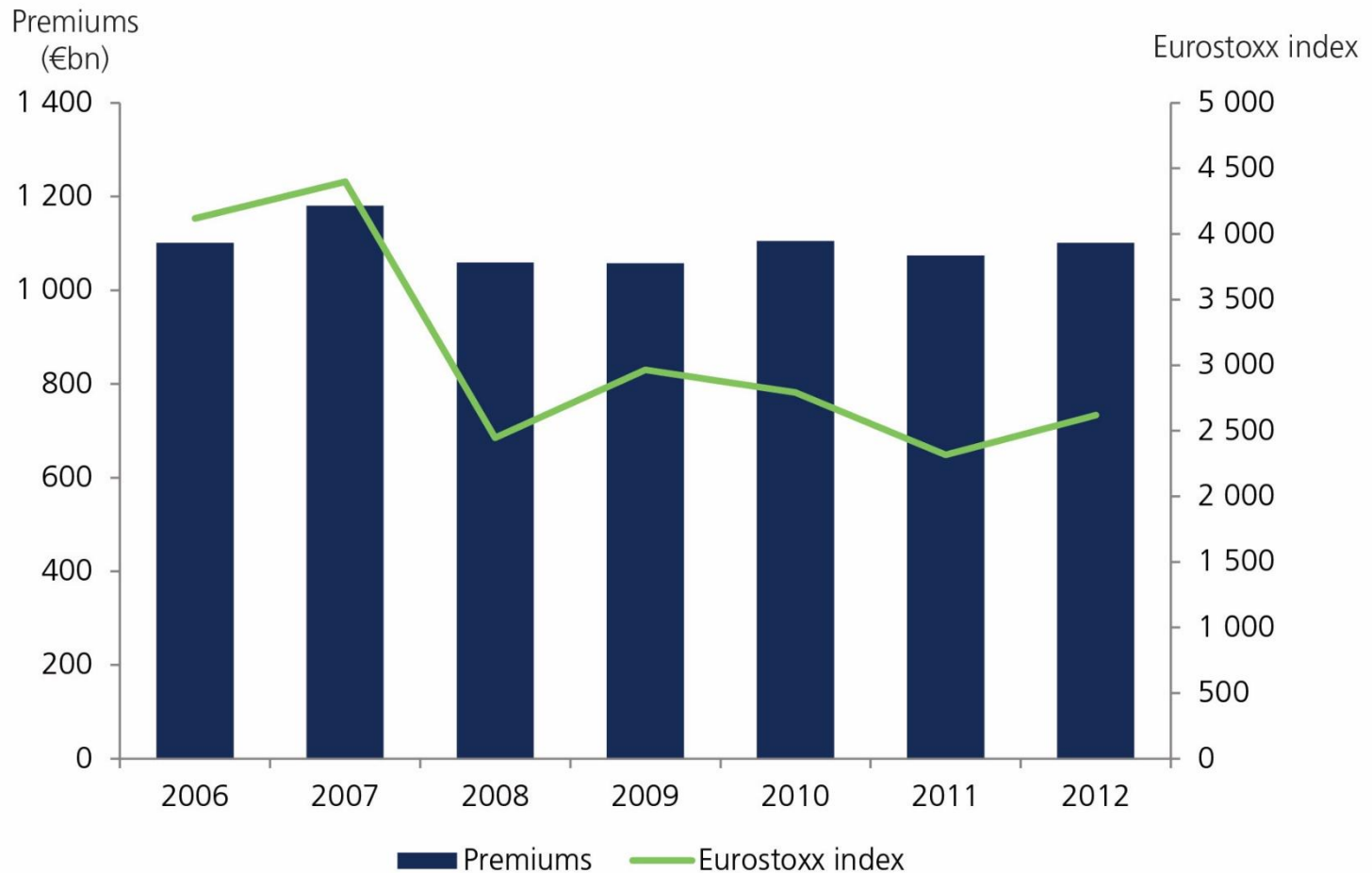
# Benefits for investment and growth in the economy



Source: Insurance Europe analysis. The 14 insurance companies that participated in Insurance Europe's survey represent €3.8trn in assets under management.

# Benefits for financial stability: Stable funding and ability to avoid pro-cyclical investment approach

- Premiums provide stable source of funding even during market downturns – allows insurers to be stable patient long-term investors



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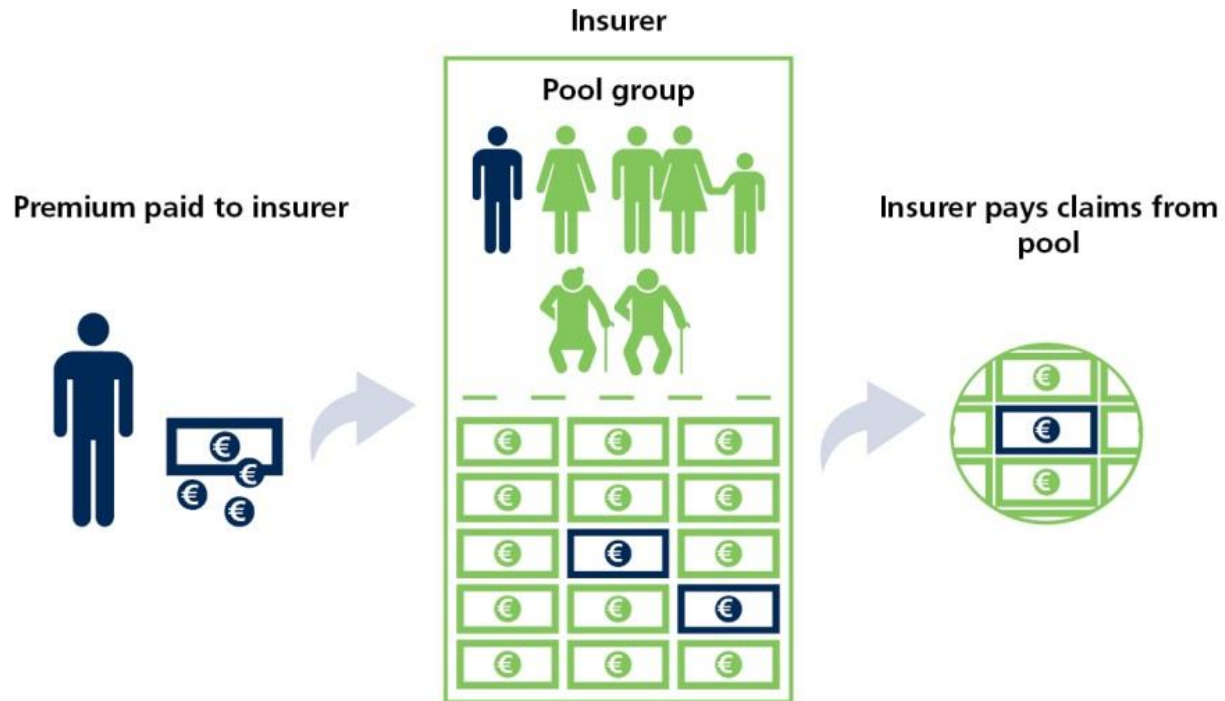
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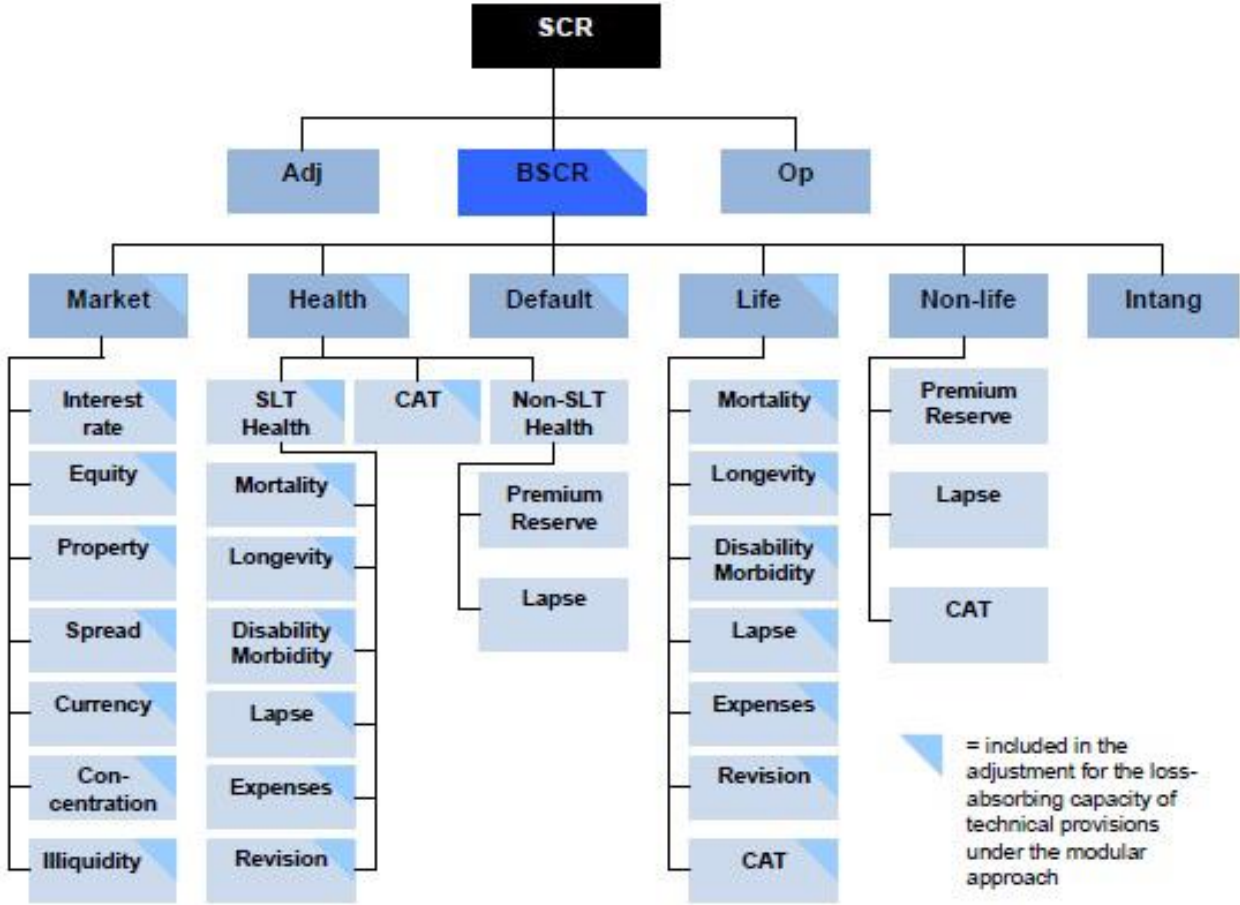
# Insurance – the transfer and reduction of risk for the customer



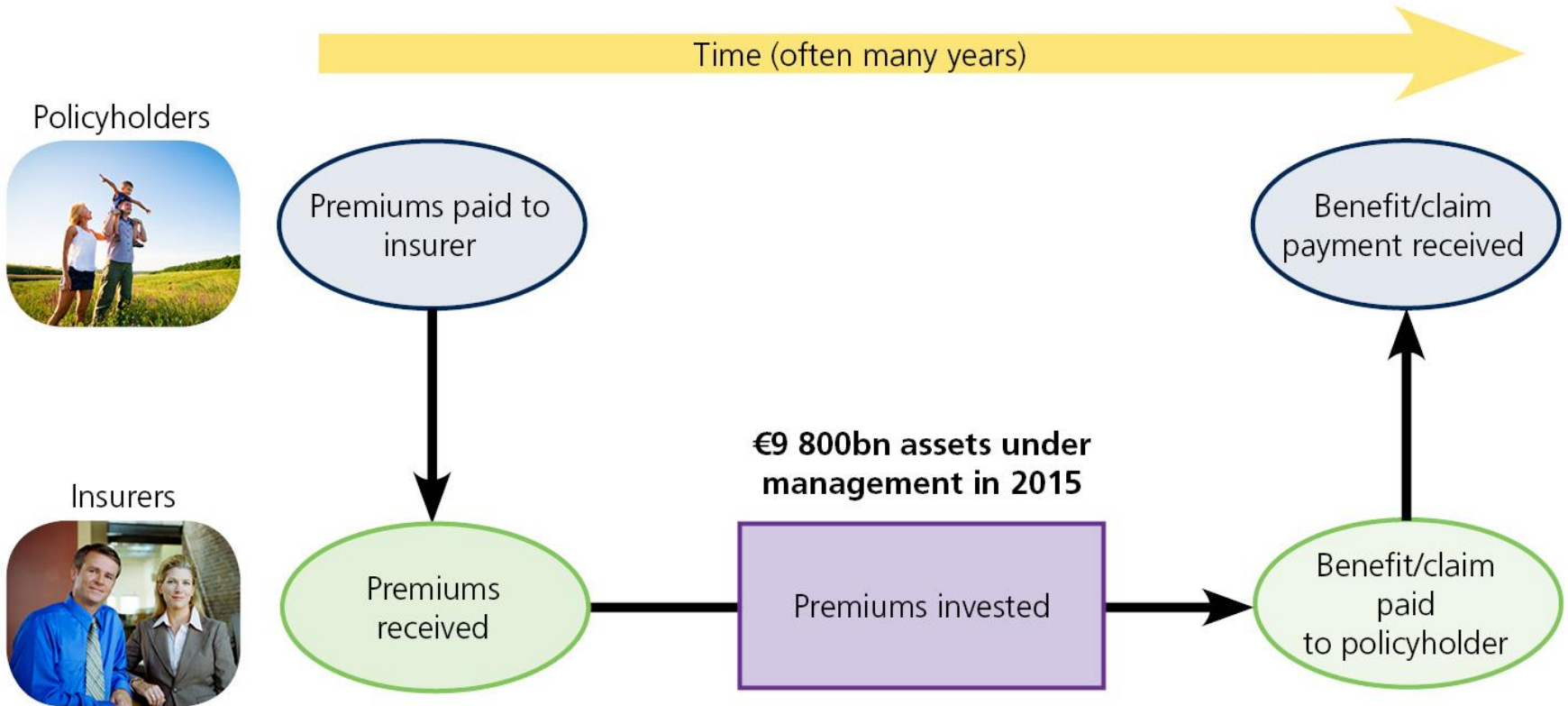
# For insurers, taking and managing risks is not a side product of doing business – it is our business

Very wide range of risks - actual nature and size can vary greatly across companies

Solvency II Standard Formula Model for Capital Calculations



# Receiving premiums before the services are provided and long-term business are key elements





# Mutualisation and other key elements

- ❖ **Risk mutualisation/pooling:** cost of losses spread between a number of policyholders
- ❖ **Risk assessment (underwriting), risk-based pricing:** premium and terms of the insurance contract based on the insurer's assessment of the level of risk
- ❖ **Important to avoid:**
  - ❖ **Moral hazard:** Risk of change of behaviour once a contract is signed (e.g. less careful driving). → terms and conditions are important
  - ❖ **Adverse selection:** Situation in which higher risk individuals take out insurance (e.g. smokers vs. non-smokers) → identify the relevant risk factors
- ❖ **Reinsurance:** “insurance for insurers“

# Focus on: insurability – basic criteria



# Focus on: Main risks facing insurers

- ❖ **Market risk:** Risks related to the level or volatility of market prices of financial instruments. For example, the exposure to movements in equity prices, interest rates, yield spreads, property prices, and exchange rates.
- ❖ **Default:** Risks related to an unexpected default or deterioration in the credit standing of independent counterparties and debtors. (Applies to reinsurance arrangements, mortgage assets, derivatives, deposits)
- ❖ **Health:** Risk that the claims made for illness, disability or medical treatment expenses is higher than expected claims
- ❖ **Life:** Risks that the actual claims for life insurance (due to death, disability or critical illness, or surrenders) are higher than expected claims
- ❖ **Non-Life:** Risks that the actual claims for non-life insurance (e.g property, motor, liability) are higher than the expected claims
- ❖ **Operational:** Risks related to inadequate or failed internal processes, people and systems, or external events (e.g legal risks)
- ❖ **Intangible Asset Risk:** Risk in the change of value of intangible assets (goodwill, incorporation fees)

# Focus on: Solvency Capital

- ❖ Solvency Capital is crucial to ensure insurers can meet their promises to a high degree of certainty (at least 99.5% under SII)
- ❖ The industry has from the beginning supported Solvency II because it moves the industry to a risk based system and so should allow alignment between internal company best practice and regulatory requirements
- ❖ However, capital is relatively expensive resource to find and so as well as a strong focus on ensuring enough – there needs to be a focus on ensuring not excessive amounts
- ❖ Zero risk of default will lead to zero activity
- ❖ Excessive and/or poorly designed capital requirements have consequences for consumer and economy
  - ❖ Products more expensive than necessary
  - ❖ Less provision of product
  - ❖ More risk passed on to customer
  - ❖ Impact on investment (especially long-term investment)

# Focus on: Insurance Pricing ... driven by a range of factors

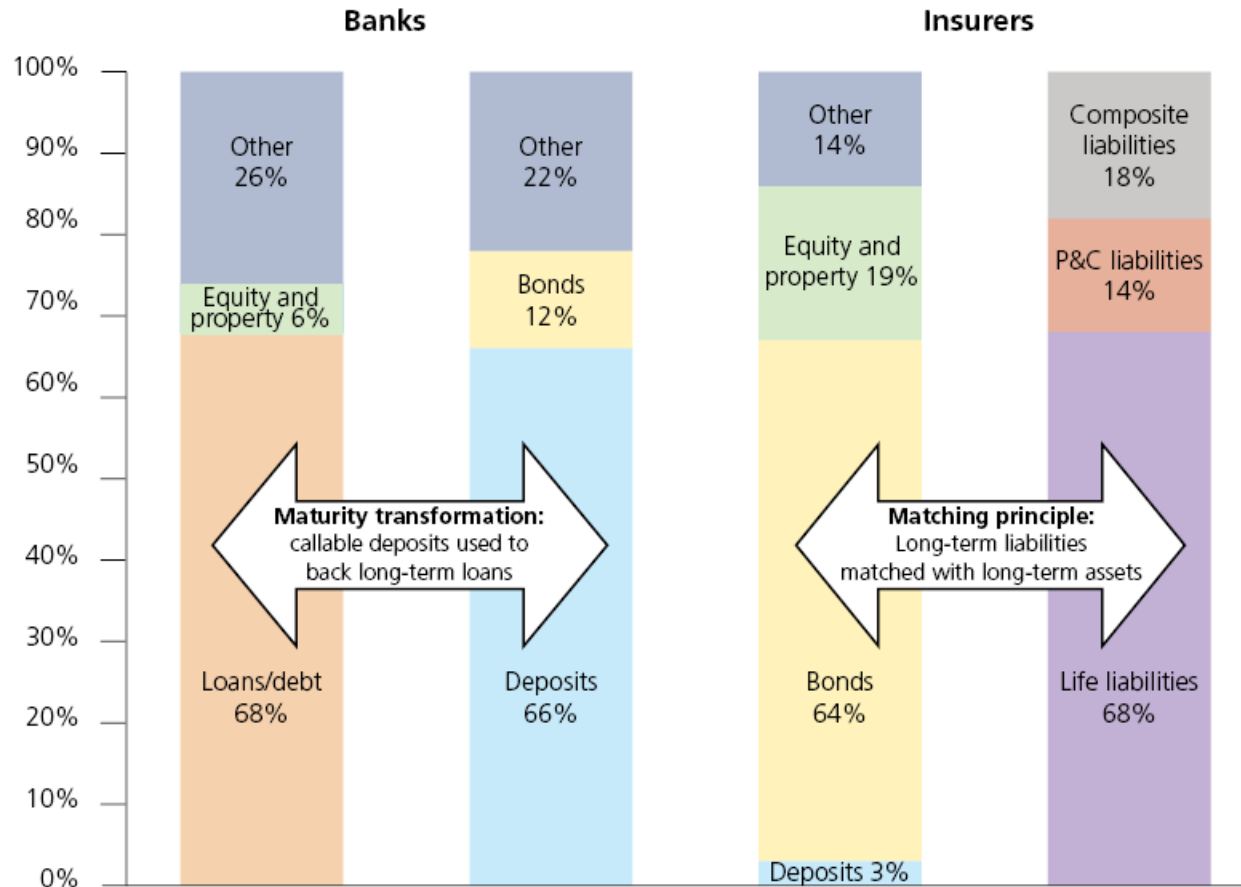
- ❖ The expected claims (sometimes requires sophisticated modelling to project over life time)
- ❖ Other costs
  - ❖ Distribution
  - ❖ Administration
  - ❖ Regulatory compliance
  - ❖ Risk mitigation
- ❖ Capital investment required
  - ❖ Solvency Capital (sometimes requires sophisticated modelling to understand extreme risks – and must meet regulatory rules)
  - ❖ Product development
- ❖ Profit margin
  - ❖ How much uncertainty is there around the assumptions
  - ❖ How much capital
  - ❖ Demands from investors in return for supplying capital
  - ❖ Competition

# Focus on: Product differences

- ❖ Products such as profit sharing (participating) savings products vary greatly in design and specification across Europe
- ❖ Some of these difference impact risk, some profitability
  - ❖ Guarantee per year or at maturity
  - ❖ Type of investments
  - ❖ Level of gurantee
  - ❖ Nature of guarantee (legal obligation or not)
  - ❖ Guarantee linked to underlying assets or not
  - ❖ Surrender options
  - ❖ Hedges in place

# Focus on: Insurers are not the same as banks – fundamentally different business models

Banks: Maturity transformation, have «*trading*» and «*banking*» books  
Insurers: Matching assets & liabilities and have only *insurance* book



Sources: ECB; Bank of England; Oliver Wyman analysis

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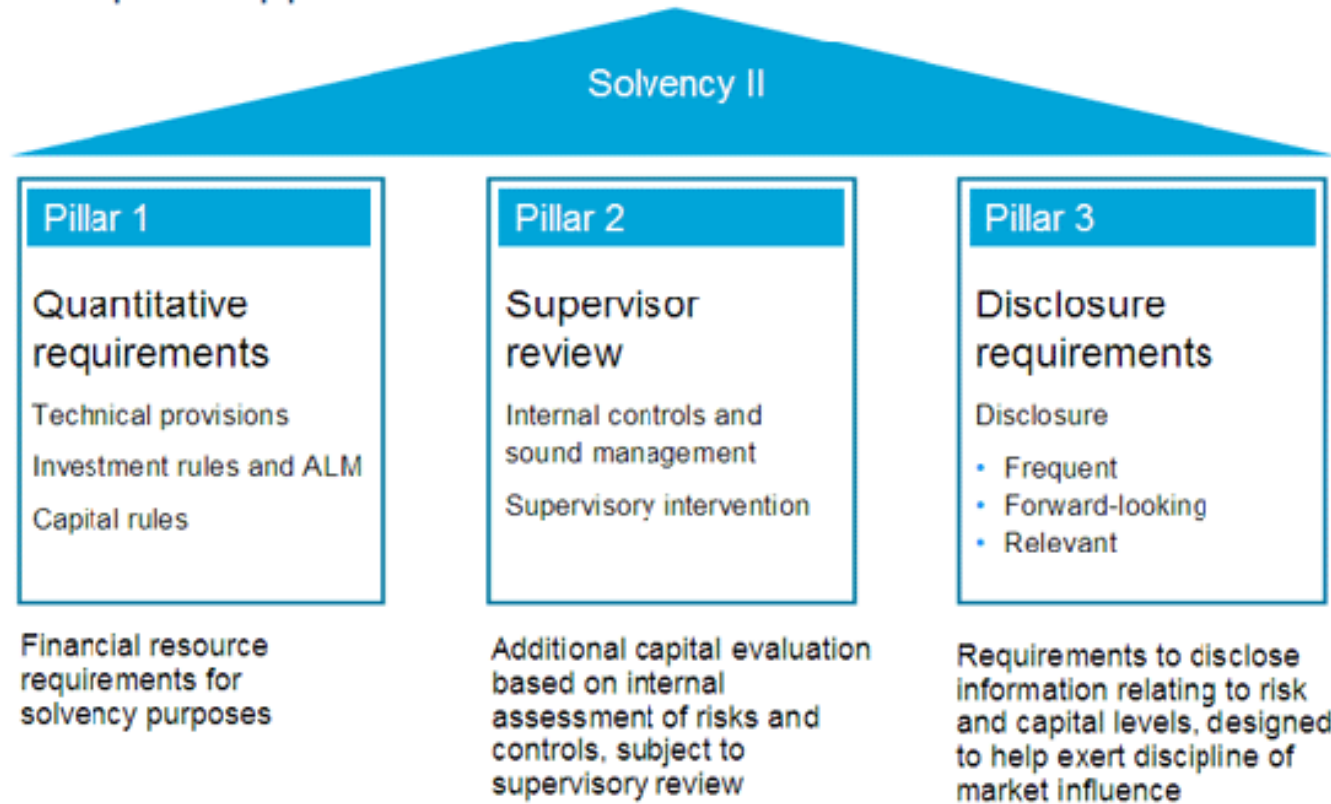
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# Solvency II – a quick overview

## The 3 pillar approach



Source: PricewaterhouseCoopers

# Solvency II: huge change and improvement...

## ... huge cost too

### Solvency I

- Cost accounting valuation, limited rules on assumptions for liabilities
- Very simple factor-based approach for measuring risks
- Solo-based regime
- Relatively low minimum solvency requirements
- Little governance and risk-management requirements
- Limited reporting requirements
- Limited powers to intervene before failure
- 199 pages covering 14 directives

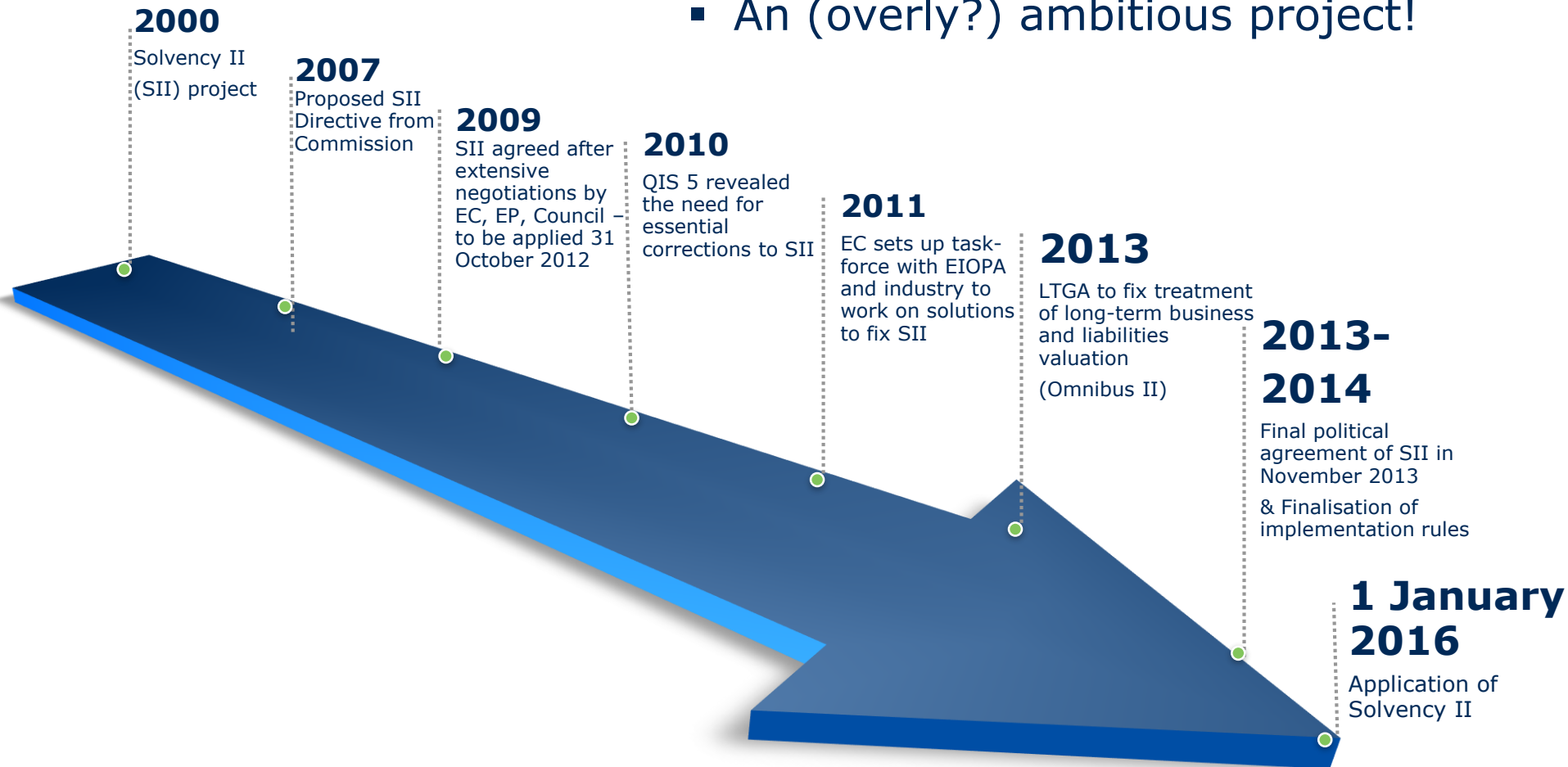


### Solvency II

- Market valuation of assets and best-estimates liabilities
- Risks measured by standard formula with 28 risk types or sophisticated approved internal models
- Solo and group based regime
- Minimum capital (MCR) & much higher Solvency Capital Requirements (SCR)
- Very extensive governance and RM
- Massive reporting: >150 templates
- Ladder of intervention: before actual failure
- >3000 pages

# Solvency II took a long-time to develop

- An (overly?) ambitious project!



# Strong support for SII but also strong concerns

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- Good regulation is essential for a healthy industry
- The industry has supported from the beginning the key objectives of Solvency II:
  - Very high policyholder protection
  - Transparency and high standards of risk management
  - Harmonised regulations
  - A strong and efficient European insurance industry
- A great deal of effort, time and money was dedicated by the industry during the development of the framework
- However, there were significant concerns about capturing the risks and long-term nature of the industry correctly – finding solutions caused delays
- Review processes have been built in to make sure SII is working as intended

# Solvency II: The long term issue

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The insurance industry was far from alone in voicing concerns...

**Bank of International Settlements<sup>(1)</sup>:** *"A related concern is whether life insurers and pension funds can maintain a long-term investor perspective ... could alter the traditional role of life insurance companies and pension funds as global providers of long-term risk capital ... could reduce the private and social benefits the sector generates through long-term investing, and the extent to which it mitigates the procyclicality of the financial system."*

**OECD<sup>(2)</sup>** *"Care must be taken in the design and implementation of mark-to-market valuation principles and risk-based funding rules as they could incentivise pro-cyclical investment behaviour such as the fire-sale of assets in market downturns."*

**IMF<sup>(3)</sup>:** *"Initiatives like Solvency II for European insurance companies may push these institutions away from their traditional role of taking on longer-term risky assets, potentially dampening the positive impact of one class of "deep pocket" investors."*

**Group of 30<sup>(4)</sup>:** *"Furthermore, some form of countercyclical measures should be incorporated within the capital framework for insurance companies to avoid any unintended consequences that a market-consistent valuation approach might bring in times of distressed market conditions, such as worsening solvency positions triggering higher surrenders by policyholders or the forced sale of assets by insurers."*

(1) Fixed income strategies of insurance companies and pension funds, July 2011

(2) The effect of solvency regulations and accounting on long-term investing, December 2012

(3) Global Financial Stability Report, September 2011

(4) Long-term Finance and Economic Growth, February 2013

# Solvency II was failing to recognise how long-term investment can change the nature of risk

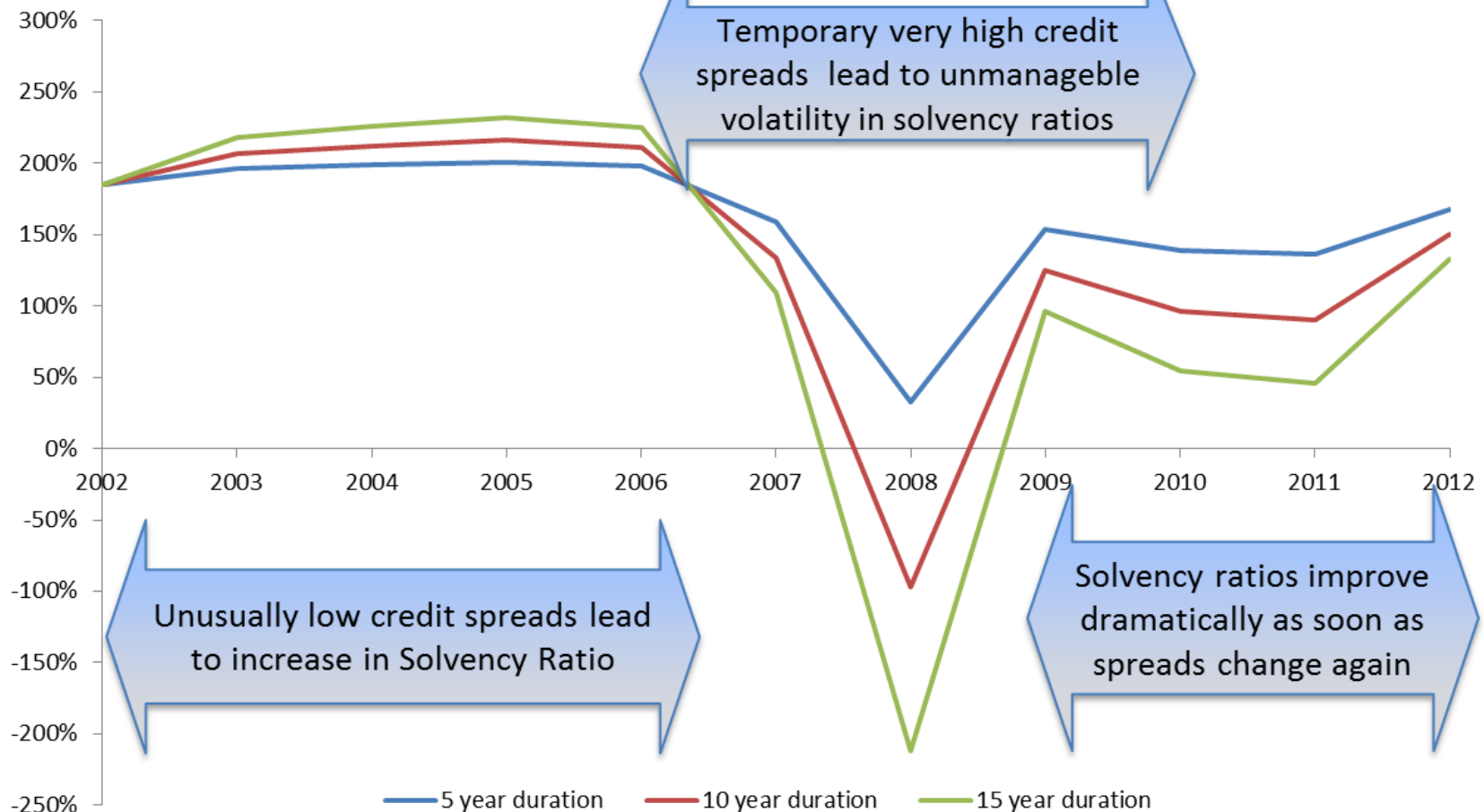
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- Long-term investors very different from traders
  - NOT exposed to forced sales and therefore interim changes in market value of the bonds are not of main interest
  - ARE exposed to actual bond defaults
  - These are very different: eg for portfolio of 20yr AA bonds:
    - Value loss from 2007 to 2008 > **30%**
    - Actual defaults only < **0.4%**
- This can affect Solvency measurement in two ways:
  1. Solvency Capital Requirement (SCR) set unnecessarily high
  2. Available Capital will be very volatile due to market movements to which the company is not exposed – this will force companies to hold unnecessary and very large capital buffers

# Adjustments were vital because without them the SII measures would not work as intended...

- 3 simplified insurance companies – with fully cashflow matched “AA” assets backing 5, 10 & 15 year liabilities
- No long-term measures have been included

## Solvency ratio



# A range of measures were developed for SII to recognise the long-term nature of the business

Measure	What it is meant to achieve
Matching Adjustment	Recognise that in certain cases insurers can eliminate exposure to asset price volatility (and are exposed to risk of actual default)
Volatility Adjustment	Recognise that even where conditions for Matching Adjustment are not met, companies are not fully exposed to asset volatility
Extrapolation	Recognise that risk free curve needs to be extended because liabilities can be longer than available market data
Transitional measures	Recognise that long-term nature of business means that insurance companies both need and have time to adapt from previous regime, products and market situations to new one
Extension of recovery period	Give more time to deal with exceptional situations, such as falls in financial markets



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# Summary

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- European Insurance industry is very large and diverse
- Insurance plays a major role in society and the economy
  - Regulations and measures it is required to work under can impact this role
- Solvency II and IFRS developments have shown that it is very challenging to develop measures that work as intended across the wide range of products, companies, markets and market conditions
  - The challenge of capturing the long-term nature of the business and interaction between liabilities and assets are common to both projects
  - IFRS has the additional challenge of dealing with both P&L as well as balance sheet
  - While perfect solutions are not possible, must seek to avoid unintended consequences unnecessary excessive expense
  - Recognise once the best solution has been found that should in principle work as intended – we will only know once it is implemented



**Thank you**

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