Reform of insurance sector regulation

7 Jun 2016 – Analysis – Financial stability

 Pertti Pylkkönen  Eero Savolainen

At the beginning of 2016, a new life and non-life insurance company solvency regulation was launched in EU, the so-called Solvency II regime. In the new regulation, both assets and liabilities of insurance companies are valued at market terms. The timing of the reform is awkward for the companies, as low interest rates and economic uncertainty burden company solvency.

New regulation launched at a difficult point of time

The insurance sector's importance as a potential cause of systemic risk is due to the scale of the sector's investment activity. In addition, monitoring the insurance sector is important, because insurance companies are to a large extent connected with both domestic banks and Nordic actors.

The Solvency II regime[1] for insurance companies entered into force at the beginning of 2016 after lengthy preparations. As regards the operating environment, the timing of the new regulation was not the best possible. Slow economic growth and uncertainty have been reflected in volatility in the financial markets. Low interest rates have in particular burdened insurance companies. The running yield from low-risk fixed income investments has decreased, and the interest paid on life insurance policies with a guaranteed return is higher than the return on new investments. This may increase the emphasis on the return on investments and encourage excessive risk-taking. In Finland, on the other hand, policies with a guaranteed return now represent only one third of all life insurance policies, and new life insurance business is almost entirely unit-linked, which eases the situation.

In the wake of the entry into force of the new risk-based solvency regulation, not only the assets of insurance companies but now also the liabilities are valued at market terms. Valuation of technical provisions at market terms weakens solvency at the current very low interest rates. For this reason, the insurance companies, also the Finnish ones, have been permitted by supervisors to apply long-term transitional provisions for technical provisions in solvency calculation. The main purpose of these transitional provisions is to ensure a smooth transition to solvency calculation in accordance with the new regulation and avoid possible market disruptions due to low interest rates, such as fire sales of security holdings that could be caused by adjustment of insurance company investments to the new regulation.

The last Solvency I data were reported as at the end of 2015. The average solvency of Finnish insurance companies had deteriorated but still remained at a good level (Chart 1).

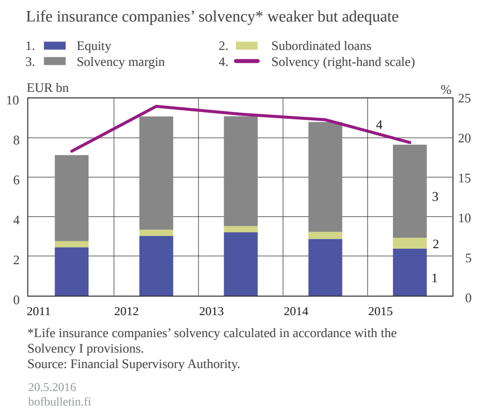

Chart 1

Insurance sector increasingly concentrated

The Finnish insurance sector, like the banking sector, is concentrated and it will become even more concentrated as a result of the winding up of the insurance company Suomi. Assets and liabilities of the three largest life and non-life insurance companies form more

1. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II). See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32009L0138.

than 75% of the aggregate assets and liabilities of the whole sector.

Banks and insurance companies, in turn, are connected through their holdings. The largest banks and banking groups have their own insurance companies, and insurance business can be of great importance to the income and profitability of financial and insurance conglomerates. In 2015, insurance operations supported the profitability of banking groups. Insurance companies and banks are also connected to the other Nordic countries via fixed income investments and holdings.

Insurance sector a possible source of systemic risk

In recent years, increasing attention has been paid to possible systemic risks caused by insurance operations.[2] In particular, insurance companies' role as large-scale investors may lead to procyclical market disruptions, such as fire sales of securities.

The investments of Finnish insurance companies are largely diversified but, due to the large size of the investments, changes in them may have material effects in Finland. For example, domestic earnings-related pension providers and insurance companies hold nearly one third of Finnish corporate debt securities.[3] Domestic ownership is positive for corporate funding, but a possible change in insurance companies' investment allocation could hamper market-term financing of Finnish companies. However, the corporate sector's diversified funding structure decreases the consequences of this risk.

In 2016, Europe-wide stress tests of the insurance sector will be carried out under the management of the European Insurance and Occupational Pensions Authority (EIOPA). The tests will help to assess the vulnerability of the sector to adverse market risk scenarios. The core of the tests is a so-called double hit scenario where, in addition to low interest rates, asset prices are also stressed. EIOPA will disclose the stress test results in December 2016.

Earnings-related pension assets nearly 90% of GDP

The growth of earnings-related pension assets has continued, primarily due to the good return on investments. At the end of 2015, the earnings-related pension assets of the private and public sectors, EUR 180 billion, represented about 87% of GDP.

The framework for investments by private sector earnings-related pension providers was revised in 1997, after which the weight of equity investments has increased. As a result of increased equity investments, the volatility of the return on investments has increased, but over the longer term equity investments have raised the return on investments. The average real return on private sector earnings-related pension investments has been 4.1% in 1997–2015. The return on public sector earnings-related pension investments has been a little higher. However, the returns are not fully comparable, because public sector

---

2. In 2015, the European Systemic Risk Board published a Report on systemic risks in the EU insurance sector. See https://www.esrb.europa.eu/pub/pdf/other/2015-12-16-esrb_report_systemic_risks_EU_insurance_sector.en.pdf.

3. Insurance companies owned 16% and earnings-related pension providers 13% of Finnish corporate debt securities in 2015.

pension providers are not governed by the same solvency provisions as the private sector.

In addition to national diversification, pension assets have also largely been diversified to international investment objects. Half of the investments have been made in countries outside the euro area, more than a quarter in Finland and the rest in other euro area countries. Almost half of all the investments had been made in the stock market or in investment objects involving equity risk. The proportion of different fixed income investments was 42% at the end of 2015. The relative share of stable property investments has remained at about 10% of all investments.

The return on fixed income investments of earnings-related pension providers' capital employed has already decreased to close to zero, and the return on all investments increasingly relies on investments involving property and equity risk. In line with the negative change in value of equity investments, the nominal return on investments fell to –0.1% in the first quarter of 2016.

As a result of low interest rates and increased stock market volatility, the risk-based solvency position of earnings-related pension providers deteriorated during 2015, and the trend has continued in the first quarter of 2016.[4] In spite of the deterioration, the performance ratios have still remained at quite a good level, if the changes in the investment environment are taken into account. The key objective of earnings-related pension providers' investments is productive and prudent investment of assets covering the pensions. This emphasises the importance of on going assessment of the interaction between earnings-related pension providers' investments and solvency.

Tags

insurance, Solvency II, systemic risks

---

4. Financial Supervisory Authority (2016) Financial position and risks of supervised entities, and interim reports of earnings-related pension providers.