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With European Insurers Well Positioned For Economic Uncertainty, Focus Shifts To Future

February 12, 2019

Key Takeaways

- The biggest risk to European insurers' balance sheets in 2019 is the potential for economic disruption. Brexit will be manageable, but any wider global downturn will bring volatility, and likely cause low interest rates to persist.
- That said, 80% of our outlooks are stable and most rated insurers have a track record of coping with difficult conditions.
- Technology will force a change to the traditional business model. Insurers need to respond now or be left behind.

PRIMARY CREDIT ANALYSTS

Volker Kudszus
Frankfurt
(49) 69-33-999-192
volker.kudszus@spglobal.com

Dennis P Sugrue
London
(44) 20-7176-7056
dennis.sugrue@spglobal.com

SECONDARY CONTACT

Simon Ashworth
London
(44) 20-7176-7243
simon.ashworth@spglobal.com

RESEARCH CONTRIBUTOR

Ami M Shah
Mumbai
(91) 22-4040-8340
ami.shah@spglobal.com

ADDITIONAL CONTACT

Insurance Ratings Europe
insurance_interactive_europe@spglobal.com

It is now more than 10 years since the global financial crisis began and the risk landscape is changing again. Key central banks have entered a phase of quantitative tightening--raising rates or ending asset purchase programs. Geopolitical uncertainties such as Brexit present potential risks and technological advancements present a threat to the traditional business model for insurance.

However, S&P Global Ratings considers that insurers' management teams have steered companies through a difficult period of recession and low interest rates by enhancing their understanding and measurement of risk and building strong balance sheets and capital positions. European insurers today are better prepared to face challenging economic conditions than they were in 2008/2009.

Insurers Will Adapt, Even To Brexit

We anticipate that ratings in the sector will remain strong, stable, and resilient to the top risks we've identified for Europe's economy and credit markets (see table 1).

Table 1

Top Risks To European Credit Conditions

Risk	Risk Level	Risk Trend
Global trade	High	Worsening

Table 1

Top Risks To European Credit Conditions (cont.)

Risk	Risk Level	Risk Trend
Disruptive Brexit	High	Worsening
Tighter credit conditions	Elevated	Unchanged
Weakening European political cohesion	Elevated	Worsening

Brexit is our key concern for European credit markets in the near term. However, we currently anticipate that, in the event of a no-deal Brexit, we would see outlook revisions, rather than widespread rating downgrades, within the U.K. insurance sector.

The key findings from our previous analysis, "Countdown to Brexit: No Deal Moving Into Sight," published on Oct. 30, 2018, remain largely unchanged as of the date of this report.

At this stage, we do not believe that the risk of business interruption, particularly regarding the supply chain for non-life insurance business and claims-paying ability, presents a material risk for our ratings on U.K. insurers. Furthermore, and as we noted in our earlier commentary, insurers continue to make their preparations for a potential no-deal Brexit.

Customers Demand Innovation

The increasing sophistication and demands of a rapidly changing customer base are threatening the traditional insurance business model. The successful insurers of tomorrow have begun to address these issues today, but those that are slow to react risk being left behind.

So far, InsurTech has proved more complementary to the insurance business model than disruptive, as most of the developments we observe are helping insurers to increase efficiency and lower expenses, particularly in claims management and processing. Insurers are also using technology to improve their responsiveness to regulators, which helps to reduce the expense and capacity burdens associated with regulatory compliance.

Consumer preferences regarding the type of insurance products they want to buy, and the way they want to interact with their service providers are changing rapidly. For example, consumers are increasingly used to interacting with banks, utilities providers, retailers, and other service providers online or through a mobile phone. Insurers have generally proved to be less technically-minded and more difficult to interact with digitally than other industries.

Offering a means of interacting virtually with policyholders, from binding a policy through to paying the claim, will carry a distinct advantage in the digital era. Any entity--whether it is an insurer or a technology company--that provides such a service will find obtaining and retaining customers far easier. Similarly, consumers may be more attracted to entities that can prove smart services such as:

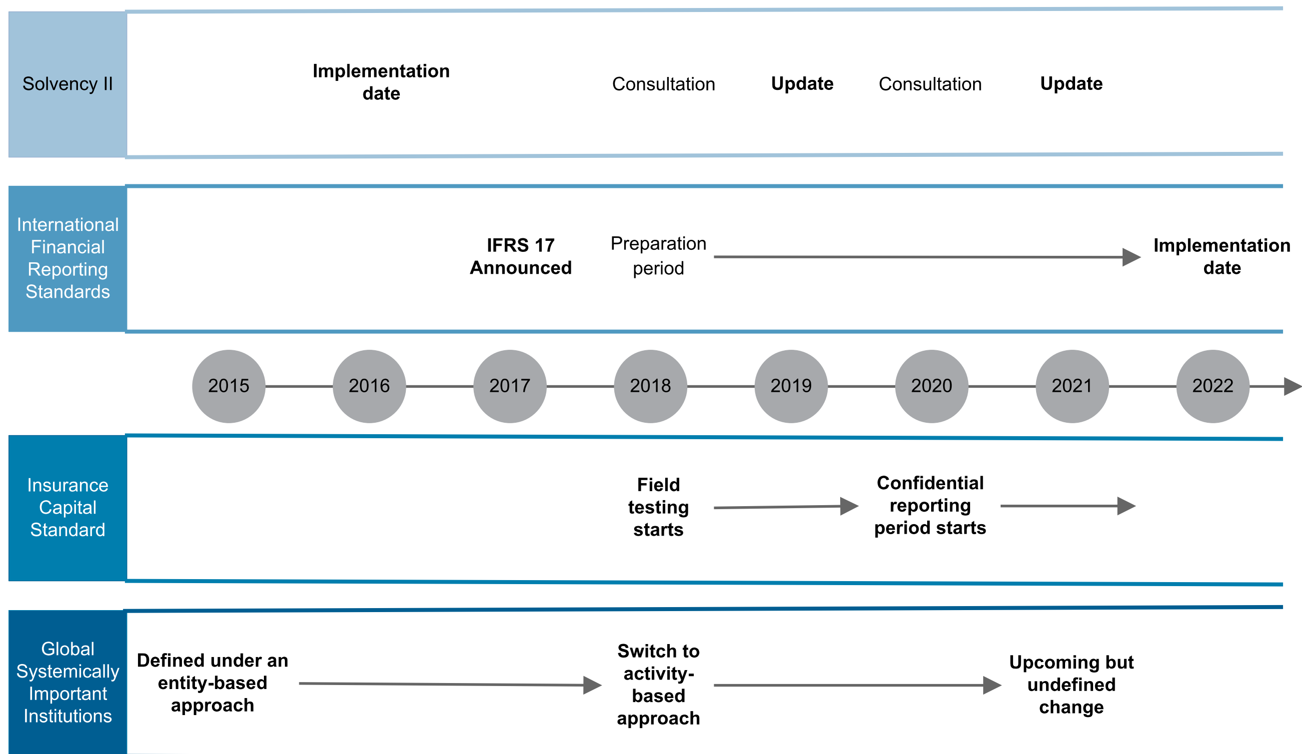
- Online or automated advice on policy options; or
- Coverage on demand, for example, tacking on extra coverage on jewelry while the policyholder is travelling or increasing liability coverage for a taxi driver only when passengers are in the car.

Insurers that hope to remain competitive in the market of the future need to look for solutions today to gain advantages tomorrow.

Regulatory Evolution, Accounting Revolution

Standard setters have also prepared a challenging pipeline for insurers in the coming years (see chart 1)

- Just three years after they implemented the EU's Solvency II Directive, European Economic Area (EEA) insurers face material updates to the guidelines, scheduled to come into effect in 2019 and 2021.
- At the same time, insurers that report under International Financial Reporting Standards (IFRS) are preparing for the adoption of IFRS 17 in 2022, which will bring a radical change to accounting and reporting standards.
- A group of internationally active insurance groups has embarked on field testing of the Insurance Capital Standard, which will run in parallel with Solvency II and the Swiss Solvency Test (SST).
- Finally, the International Association of Insurance Supervisors (IAIS) is reconsidering the way it assesses systemic risk in the insurance industry.



IFRS--International Financial Reporting Standards.
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The IAIS has historically focused on assessing whether individual insurance groups are considered

to be systemically important. It developed a list of nine globally systemically important insurers (G-SIIs). This entities-based approach (EBA) resulted in increased supervision of the G-SIIs and the imposition of additional capital and reporting requirements on them.

The IAIS is now shifting its approach. It will consider which of the activities insurers engage in could pose or contribute to systemic risk in the financial system. This activities-based approach (ABA) could be applied to a wider group of insurers, creating some uncertainty regarding the future of the G-SII list. It is not yet clear whether a broader group of insurers could face heightened regulatory scrutiny or capital requirements.

We do not anticipate that the industry will see higher capital requirements as a result of these developments. That said, the continuous change and various workstreams will require significant capacity and management attention, and will clearly come at a material cost.

We also expect that as technology alters how insurance and advice are distributed to policyholders, regulators will place conduct and mis-selling risk in sharper focus. The additional scrutiny we anticipate for insurers in this area will add to already-full regulatory workloads.

The Turning Credit Cycle Offers Hope, And New Risks

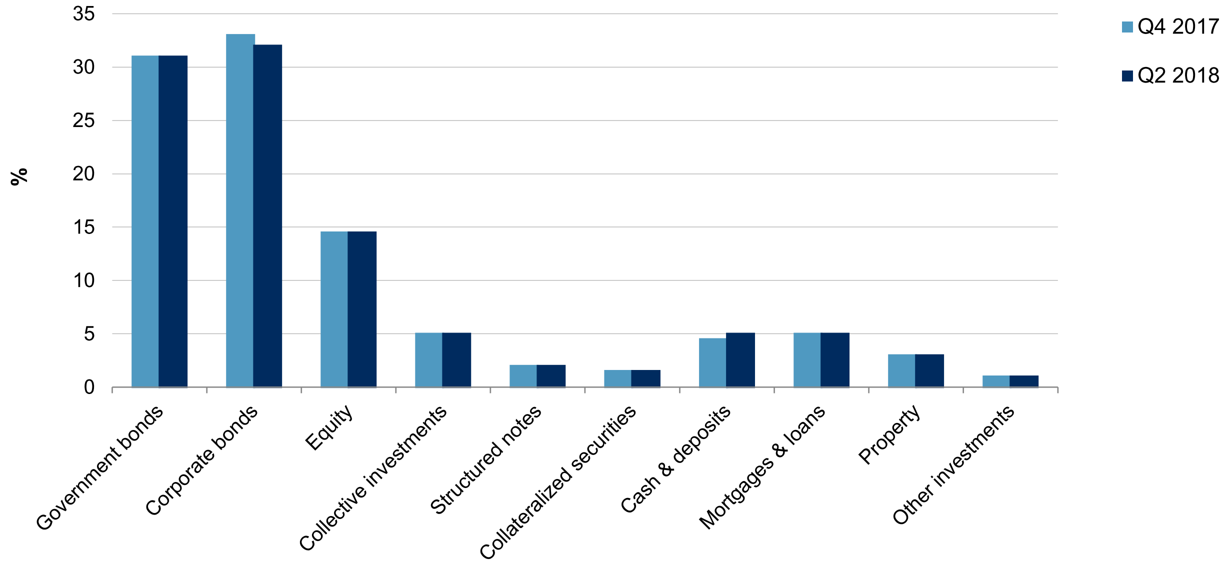
As the global credit cycle nears the later stages, financing conditions are becoming more restrictive. The wider spreads and higher yields that will result could offer insurers' beleaguered earnings profiles a respite. However, the later stages of the credit cycle also bring a heightened risk of corporate defaults and slower growth. If the underlying credit quality of riskier, credit-sensitive asset classes--such as real estate and leveraged finance--deteriorates, they may experience greater price volatility. The resulting financial market dislocations could affect insurers.

In our view, the situation is more advanced in the U.S., where issuers face the prospect of slower growth, higher recession risk, more volatile financial market conditions, rising input costs, and increasing trade concerns. Arguably, the European credit cycle has not yet reached the top. The European Central Bank (ECB) has only just stopped its bond-buying program and isn't expected to raise rates until 2020 at the earliest.

European insurers' asset portfolios tend to focus on government bonds, higher-rated corporate bonds, and cash and deposits. Together, these typically account for over half of the average portfolio. However, credit-sensitive asset classes make up a significant share of the average book, so balance sheets and solvency ratios could experience some volatility in a credit cycle turn.

In December 2018, the European Insurance and Occupational Pensions Authority (EIOPA) published the results of a stress test exercise which indicated that an upward shock to the yield curve, coupled with increases in lapses and claims inflation, would cut the average solvency ratio to 145.2% from 202.4%. We anticipate that the same scenario would have a less severe impact on our assessment of insurers' capital and earnings, but this will be an important focus area for our European insurance ratings in 2019.

Chart 2



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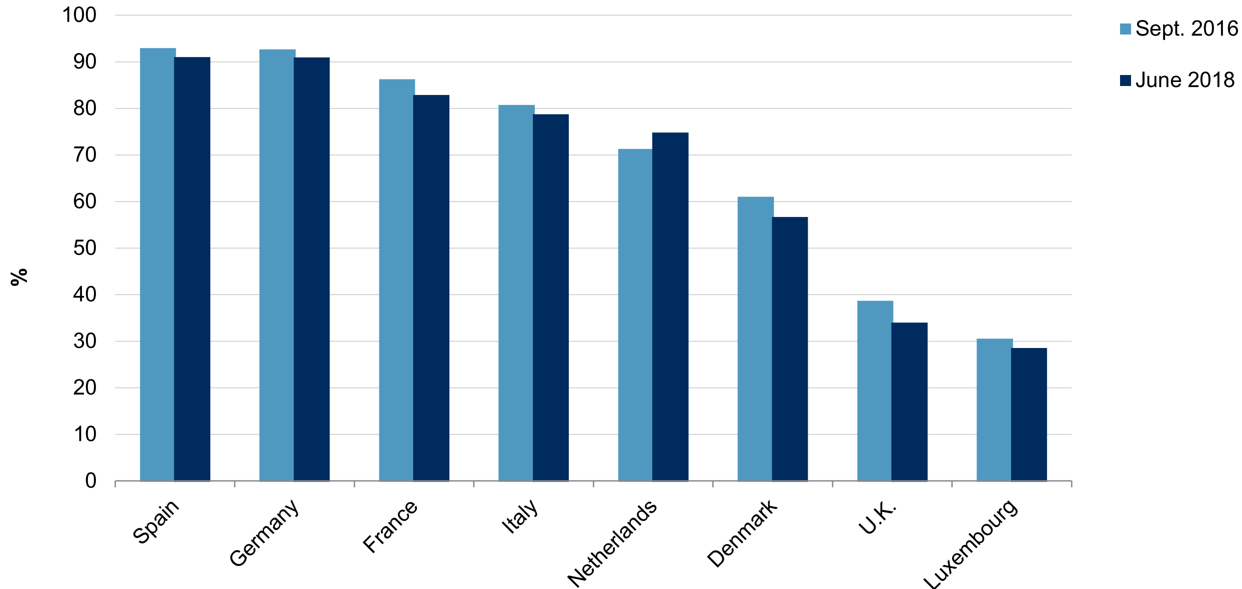
Life Insurers Would Suffer If Interest Rates Remain Low

If a turn in the credit cycle disrupts global growth, central bankers in the U.S., U.K., and EU could revert to accommodative monetary policy. Keeping interest rates low has depressed insurers' earnings, particularly those of life insurers that provide guaranteed investment returns to policyholders. In this scenario, ratings on some insurers that offer such products could come under pressure.

The liability profiles of life insurers in Germany, Spain, and France are heavily weighted toward these traditional savings products with guaranteed returns (see chart 3). In some markets--including Germany, Spain, the Netherlands and many of the Nordic markets--the average guarantee rate is still about 2.5%-3.5%. This is high compared with current returns on investment.

Chart 3

Shift Away From Traditional Life Business Is A Slow Process



Note: Traditional liabilities are here defined as those that carry a guarantee. Source: S&P Global Ratings and European Insurance and Occupational Pensions Authority.

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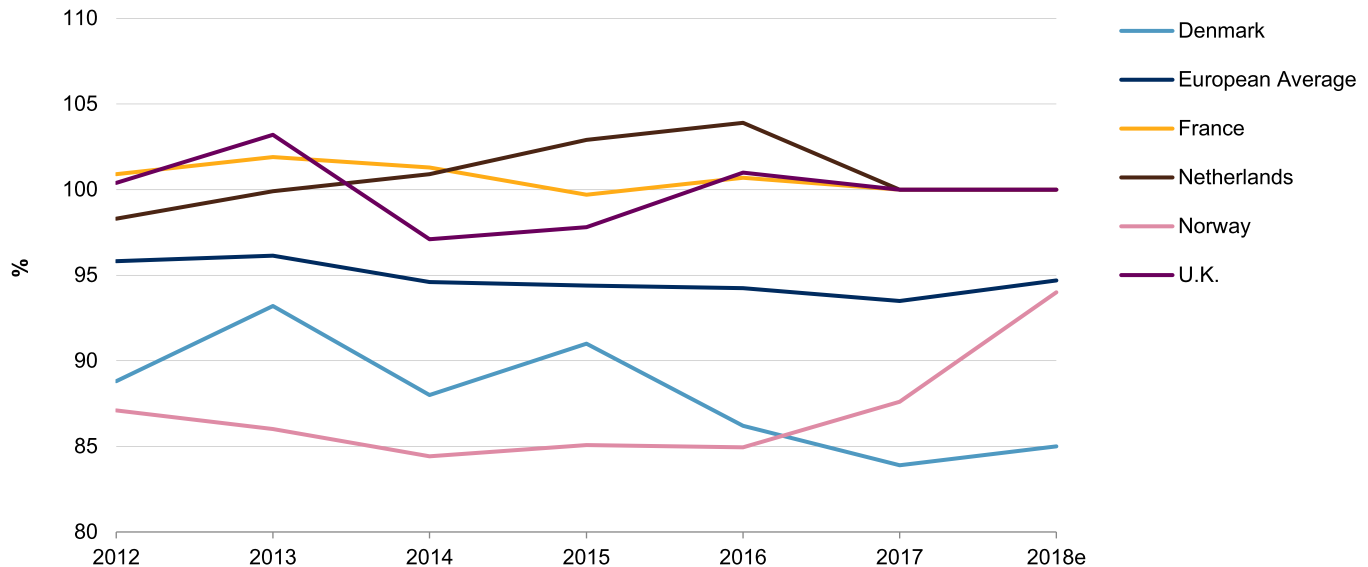
In recent years, Europe's life insurers have responded to low interest rates by adjusting product features, including guarantee rates, on their traditional savings business. In addition, they have shifted new business toward unit-linked products where policyholders bear some of the investment and interest rate risk. A culture of skepticism toward equity markets in some countries makes it unlikely that we would see a rapid shift into the unit-linked space in those markets. Consumers also remain unwilling to accept products that do not carry guarantees.

Investment returns for non-life insurers have also suffered from the prevailing low interest rates and tight spreads over the past decade. As a result, non-life insurers have focused on generating an underwriting profit, and have achieved strong combined ratios in recent years.

Chart 4



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The Nordic insurance markets and Switzerland have recently outperformed the European average, while the U.K., France, and the Netherlands have underperformed. Provided that interest rates increase only gradually, we expect technical margins to remain profitable on average in Europe, and largely unchanged over 2019.

Rising Interest Rates Will Close The Door To Easy Money

Insurers unearthed some opportunities from the low interest rate environment. We have already mentioned their sharper focus on achieving technical profit on underwriting business. Debt issuers also benefitted from cheaper financing in the capital markets.

Compared with the corporate credit market, we see Europe's insurers as relatively measured in terms of capital issuance. Most issuers filled their capital coffers in 2014, to take advantage of Solvency II grandfathering rules. Debt issuance by European insurers has since declined, and we expect this to continue through 2020.

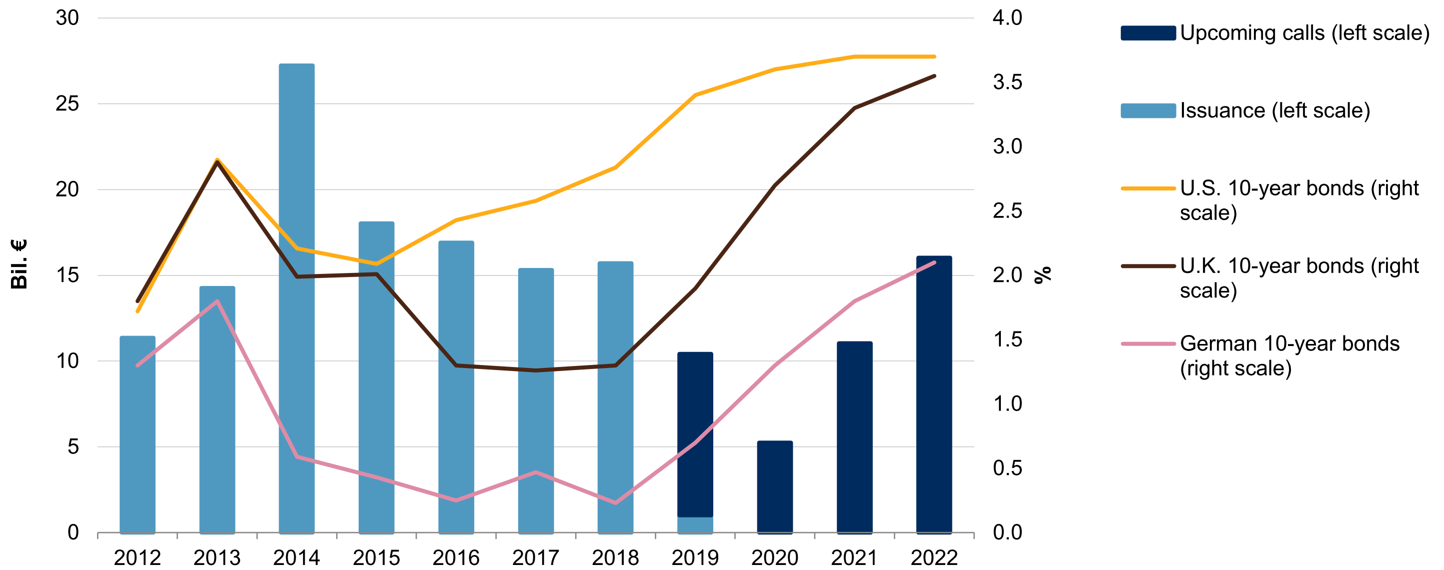
However, we forecast that rising rates and widening spreads will be in full swing precisely when the industry's refinancing burden picks up. Upcoming call dates for refinancing capital instruments will see a spike from 2022 through 2025. This could further increase insurers' financing costs, which are currently rising from the lows they hit in recent years.

In our view, this won't present a material problem for the sector's financial flexibility. However, it may be more difficult for some issuers to access the market at attractive terms in the coming years. Some issuers could then face a dilemma: does it makes more economic sense to exercise

call options on their hybrids and refinance at higher rates, or should they forego the call and keep these instruments outstanding?

If some insurers decide not to call their hybrids at the first call date, we expect borrowing costs for the sector to increase. Investors will price in a higher premium to compensate for extension risk.

Chart 5



Source: S&P Global Ratings.

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Primed For Any Ordeal

In our opinion, European insurers today are more resilient to a financial market or economic downturn than in 2008. Management teams have spent the past decade building strong capital bases, improving their understanding and measurement of risk exposures and steering asset portfolios to more conservative, albeit less profitable, allocations. Insurers' strong positions in their markets and close relationships with customers help them generate profit and capital. Practice has even made them more-proficient at preparing for regulatory and accounting changes.

What will distinguish the strongest insurers in future, in our view, will be their readiness to keep up with the rapid pace of technological advancement and the changes in customers' expectations and buying habits. Insurers now have the financial ballast to invest in new technology. Those that embrace the changes that could disrupt their industry will be better placed for the future. Those who wait too long risk being left behind.

Rating Distributions Reveal Few Surprises

Chart 6

EMEA Insurers' Ratings Are Strong...

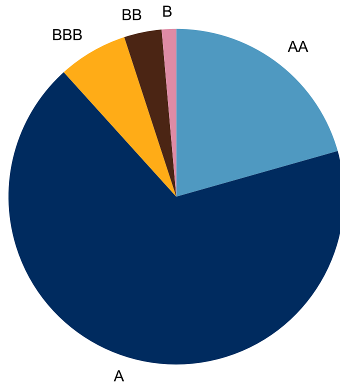

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Chart 7

...And Stable

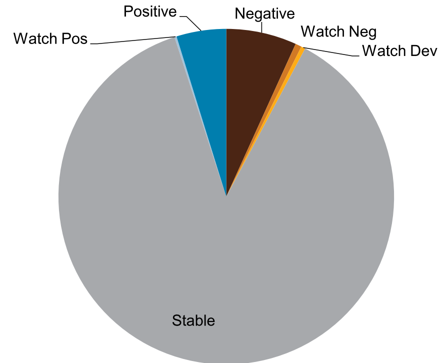

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Table 2

Regional Average Rating Compositions

	Western Europe	Russia/CIS	GCC	South Africa	Eastern Europe
Business risk profile	Strong	Vulnerable	Satisfactory	Fair	Satisfactory
IICRA	Intermediate risk	High risk	Intermediate risk	Moderate risk	Moderate risk
Competitive position	Strong	Adequate	Adequate	Adequate	Adequate
Financial risk profile	Strong	Less than adequate	Upper adequate	Less than adequate	Strong
Capital & earnings	Strong	Upper adequate	Moderately strong	Moderately strong	Very strong
Risk position	Intermediate risk	High risk	Moderate risk	Moderate risk	Intermediate risk
Financial flexibility	Adequate	Adequate	Adequate	Adequate	Adequate
Liquidity	Exceptional	Strong	Strong	Strong	Exceptional
Management and governance	Satisfactory	Fair	Fair	Fair	Satisfactory
ERM	Adequate, with strong risk controls	Adequate	Adequate	Adequate	Adequate
SACP	a	bb	bbb+	bb+	a-

CIS--Commonwealth of Independent States. GCC--Gulf Cooperation Council. IICRA--Insurance industry and country risk assessment. ERM--Enterprise risk management. SACP--Stand-alone credit profile.

On average, ratings in the 'A' range are supported by 'A' range capital adequacy and business line diversification; similarly, 'AA' range ratings are mostly supported by 'AA' capital adequacy and

accompanied by international diversification. The Solvency II ratios reported by insurers in EEA indicate a similar picture--most markets' average solvency ratios comfortably exceed 100% of the standard capital requirement (SCR) at about 150%-330%.

Insurers in the Middle East and Africa are generally weaker than those of their counterparts in Europe. Typically, ratings fall in the 'BBB' range and have stable outlooks.

Although in markets like Russia and South Africa we see sovereign risks weighing on the ratings on many insurers, we also see weaker fundamentals underlying many of these ratings. Although rated insurers generally demonstrate strong local relationships, expertise, and reputations which help to support their positions domestically, these strengths are often offset by structural differences. For example, many are exposed to heightened political and country risk and operate within weaker regulatory frameworks.

Many insurers in the Middle East and Africa have strong capital adequacy. This is undermined by their material exposure to higher risk, lower credit quality investments that tend to be concentrated by sector and counterparty. Balance sheet volatility may also be increased by higher levels of foreign exchange risk.

Governance of insurance companies in the emerging EMEA regions also tends to lag European peers. We have identified a number of governance deficiencies, some of which have caused us to take rating actions on individual companies.

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