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Non-life insurers – Europe

# Lower for longer rates add to pressure on P&C insurers' profitability

Against the background of a coronavirus-induced slowdown in global growth, and with government bond yields falling further during 2020 from already very low levels in 2019, there is a material risk that interest rates will stay low for longer than previously expected. While Property & Casualty ("P&C") insurers are less sensitive to low rates than life insurers, persistently low yields will erode their investment returns, weighing on their profitability and, to a lesser extent, their solvency. At the same time, claims inflation has largely offset the sector's efforts to raise prices, casting doubt over the sustainability of current reserve releases, a key contributor to earnings.

**P&C sector profit to weaken in 2020 and beyond**. Falling bond yields force P&C insurers to reinvest maturing assets at rates below their current investment yield. This will pressure their investment income in 2020 and beyond. The impact of falling yields on investment income is more immediate for P&C insurers than for life insurers, as their assets are of shorter duration, and they are unable to share losses with policyholders. Investment returns account for about 50% of European P&C insurers' profits on average, down from a peak of 65%. The decline has put additional strain on profit, as underwriting income has also come under pressure. Reliance on investment income is highest in the Netherlands and France.

**Low yields push up liabilities**. Falling interest rates also lower the discount rate for reserves in long-tail lines of business such as motor annuities, thereby increasing the present value of insurers' future liabilities. Insurers in France and the Nordics are particularly affected, as are their counterparts in the UK, where low interest rates have also driven a reduction in the Ogden discount rate used to calculate lump sum payments to bodily injury victims.

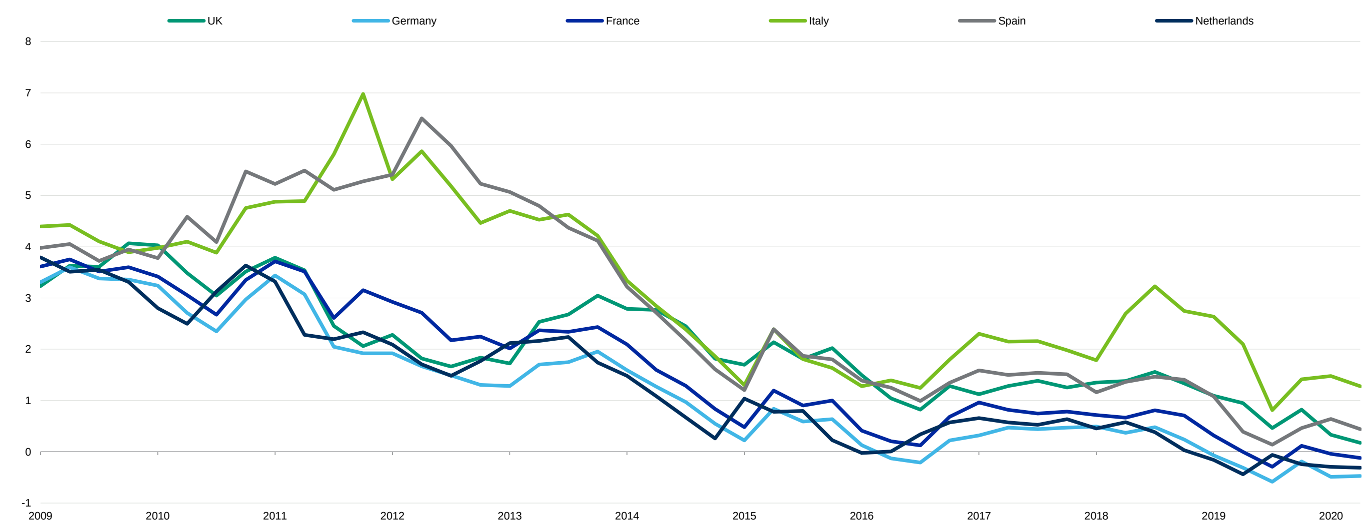
**Claims inflation is a headwind**. P&C insurers have responded to low rates by cutting costs and raising prices, but claims inflation is holding back earnings improvement. Raising prices further is difficult in mature, highly competitive western European markets. Moreover, reduced motor claims as a result of the coronavirus outbreak will make it harder to justify price increases. A combination of claims inflation and intense price competition casts doubt over the sustainability of current high reserve releases, a key earnings contributor.

**Insurers increase investment risk in search for yield**. European P&C insurers have also responded to low interest rates by assuming more investment risk. The quality of their corporate bond portfolios has deteriorated as the sector seeks out higher-yielding investment assets. While insurers are highly sensitive to fixed income downgrades and credit spread widening, we expect this trend to continue, albeit modestly as a result of Solvency II capital constraints.

## P&C sector profit to weaken in 2020 and beyond

Ten year government bond yields in Europe have continued to fall in 2020, reaching record lows in some countries. This is credit negative for European non-life insurers, as falling yields weigh on their investment income. This puts them under added pressure to raise prices to counter claims inflation, which is holding back their underwriting income.

Exhibit 1
**10-year government bond yields have fallen further during 2020**

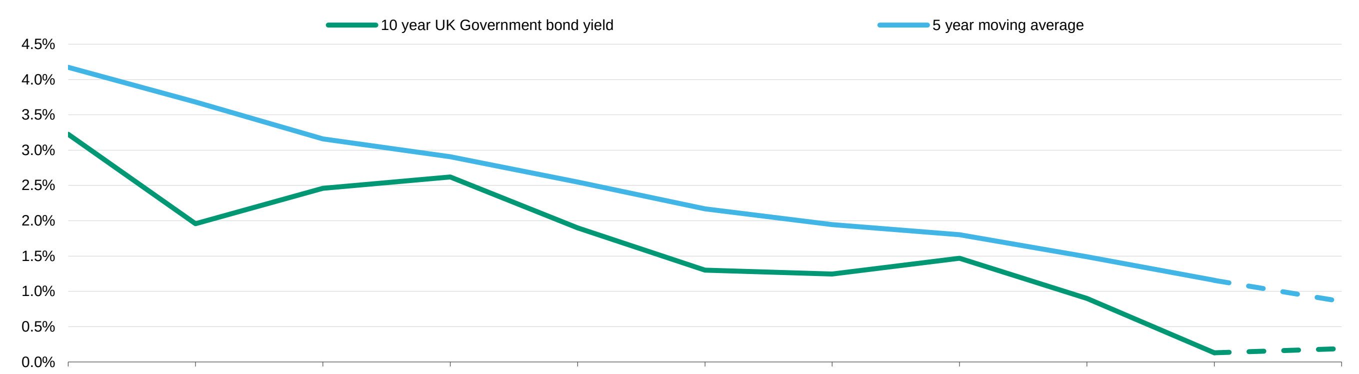



*Source: Moody's Investors Service, Facset*

In Germany, UK, France and the Netherlands – the largest European non-life insurance markets - 10 year government bond yields have fallen on average by around 35 basis points (bps) during 2020 from already historically low levels. The decline has been especially marked in the UK, where 10 year gilt yields have fallen by 65 bps during 2020 to a near record low of 0.17% as at 26 June, 2020.

This exacerbates a long-running decline in the yield's 5-year moving average, which is correlated with insurers' investment returns. The 10-year UK gilt yield has fallen so sharply in recent years that even if it were to rise, its moving average would continue to fall for some time (Exhibit 2). This would also be the case for other government bond yields.

Exhibit 2
**Decline in 10-year UK gilt yield will continue to erode investment results in 2020 and 2021**




*Source: Moody's Investors Service, Moody's Analytics*

Going forward, we expect rates to stay low for longer than previously expected as a result of the coronavirus. The gap between short and long term rates has narrowed, flattening yield curves, although the future trajectory of rates is highly uncertain due to the unprecedented monetary and fiscal stimulus launched in response to the coronavirus-induced economic contraction.

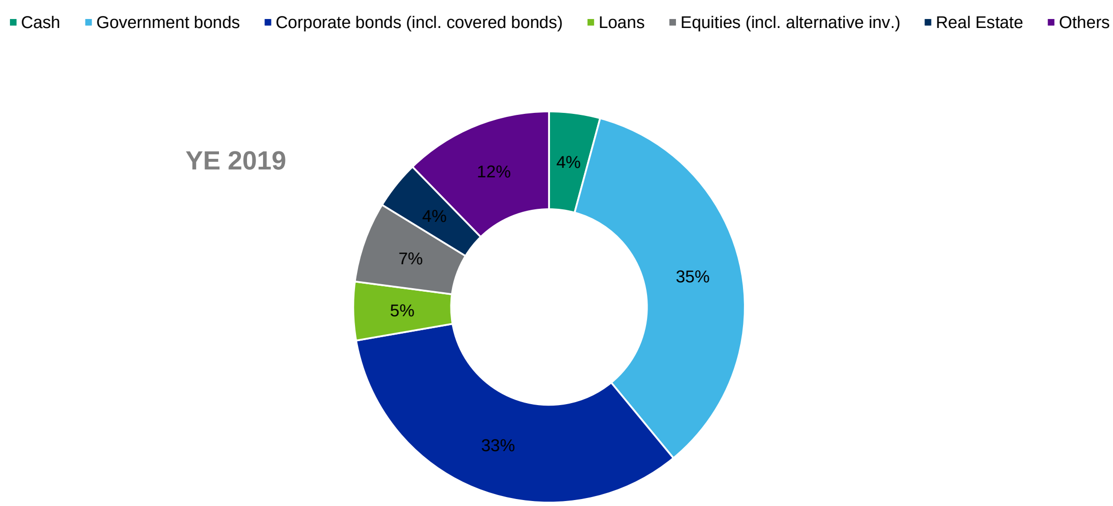
## Investment income is under pressure

Unlike many European life insurers, P&C companies do not underwrite products whose profitability depends on investment yields exceeding fixed payments to policyholders. They are therefore generally less exposed to interest rate risk. Furthermore, P&C insurers can reprice their products on an annual basis. This can allow them to compensate, subject to competitive pressure, for lower investment income.

Nevertheless, P&C insurers predominantly invest in fixed income securities, amplifying the pressure from lower underwriting returns, with government and corporate bonds typically accounting for around 70% of their investment portfolios (see Exhibit 3). Falling bond yields force P&C insurers to reinvest maturing assets at rates below their current investment yield, pressuring their investment income.

Exhibit 3

**Government and corporate bonds make up the majority of European insurers' investments**
**European insurers' investment portfolio composition**




*Source: Moody's Investors Service, Companies' reports*

Furthermore, the impact of falling rates on investment income is more immediate for P&C insurers as their fixed income assets are generally of shorter duration – typically 2-5 years compared to 7-10 for life insurers. They are also unable to share losses with policyholders, although life insurers' scope to do so is narrowing.

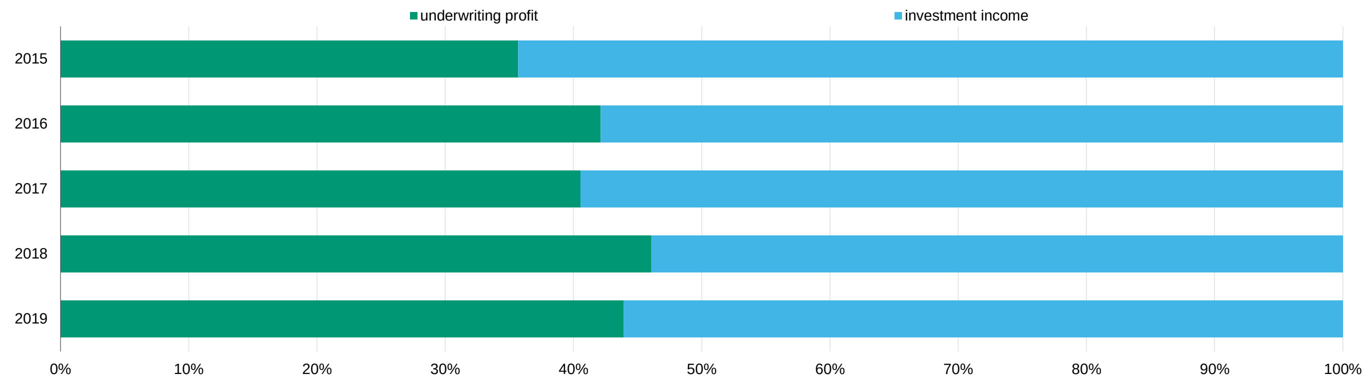
In 2019 and so far in 2020, falling rates have forced P&C insurers to invest new money or reinvest expiring assets at rates below current investment yields. With investment income accounting for over 50% of the industry's operating profit, this will translate into a decline in overall profits, all else being equal.

The proportional profit contribution from investment income was as high as 65% on average in 2015. However, it has fallen gradually due to a combination of lower interest rates and better underwriting performance, leading to more balanced contributions from underwriting and investment activities. Going forward, the proportion attributable to investment income will remain under pressure from falling interest rates, counterbalanced somewhat by pressure from claims inflation on underwriting profit.

Exhibit 4

**Investment income accounts for over 50% of P&C insurers' profits**

**Breakdown of European P&C insurers' results**



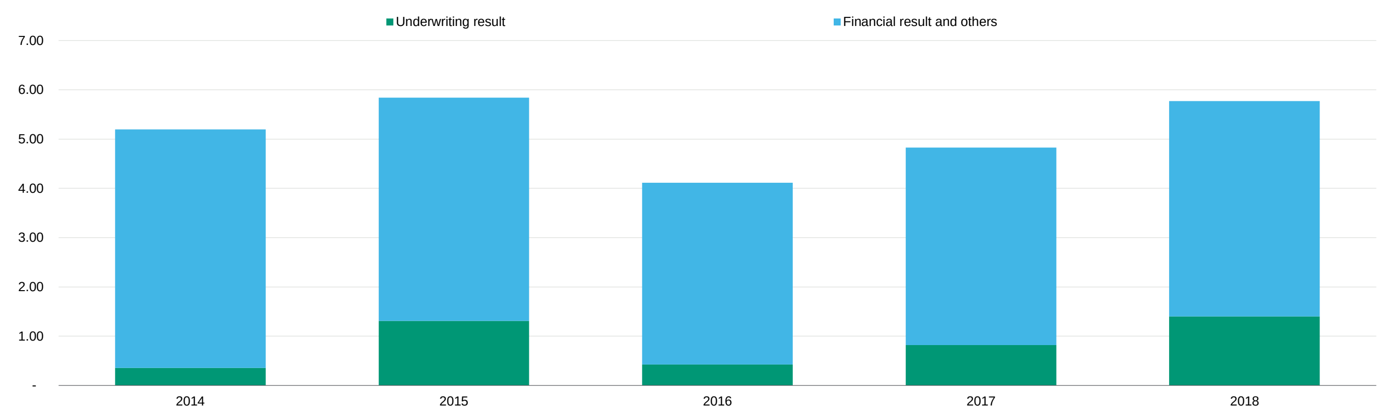

*Source: Moody's Investors Service, Companies' Reports*

P&C insurers' reliance on investment returns is greater in France (see Exhibit 5) than in all other European markets with the exception of the Netherlands. This is because the French P&C industry's underwriting profit, despite recent improvements, is weaker, as reflected in its high combined ratio (claims and costs as a percentage of premiums) of 98% in 2018. French P&C insurers face intense competition, exacerbated by the large market share of mutual insurers, which generally have lower profitability targets. The Dutch market's reliance on investment income reflects its even higher combined ratio of 100%.

Exhibit 5

**Investment results account for most of French non-life insurers' pre-tax profit**

**Breakdown of French non-life insurers' technical results before tax**




*Source: Fédération Française de l'Assurance and Moody's Investors Service estimates*

## Low yields push up liabilities

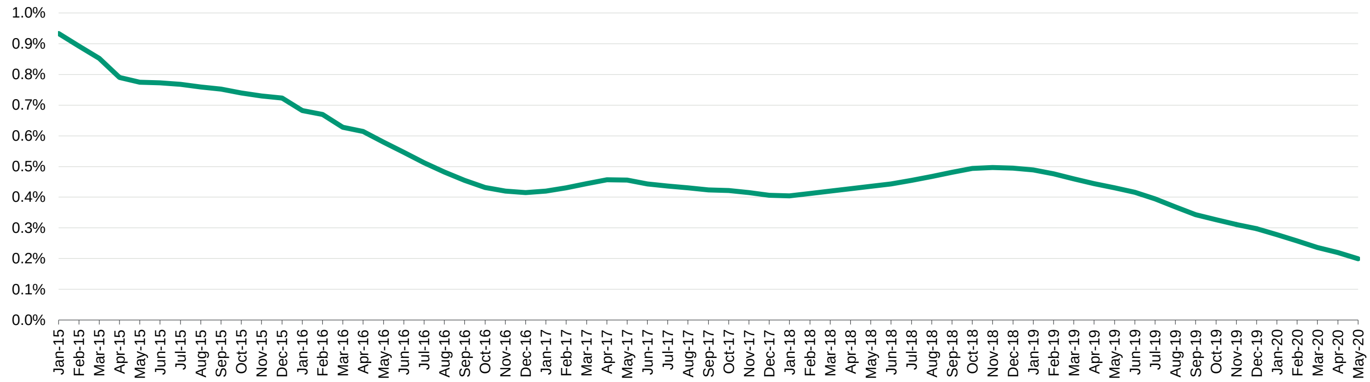
Falling interest rates also push down the discount rate used to calculate reserves in long-tail lines of business such as motor annuities, which provide a lifetime income to victims of serious bodily injury. A lower discount rate increases the present value of such future liabilities, leading to higher reserving requirements, which can recur if interest rates fall again. This is especially relevant for insurers in France, the Nordic region and the UK.

In France, insurers discount motor annuity liabilities using a rate equivalent to 60% of the 24 month moving average of the risk-free rate. After several years of decline, this discount rate gently increased in 2018, but fell back again in 2019, as shown in Exhibit 6. With the fall in rates during 2019 and 2020 to-date, the discount rate will continue to decline in 2020, further increasing the present value of French insurers' future liabilities.

Exhibit 6

**The discount rate for French motor annuity reserves is falling again**

**Discount rate used to calculate French motor annuity reserve**




*Source: Banque de France and Moody's Investors Service*

In the UK, motor insurers settle claims for lifetime care costs from serious bodily injury victims either through a series of regular payments, known as periodic payment orders ("PPOs"), or through lump sum payments. PPO reserves are discounted using real discount rates. With a significant fall in interest rates suppressing investment returns, there is a risk that UK motor insurers will need to revise their PPO discount rates at year end, with a negative impact on earnings and solvency.

Low interest rates have also driven a reduction in the Ogden rate, the discount rate used by UK courts use to calculate lump sum compensation payments to injury victims. The rate has fallen from 2.5% in 2017 to -0.25% in 2019, adding billions of pounds to the claims costs of UK motor insurers and their reinsurers. The rate will be reviewed again by 2024 at the latest, and may fall again unless interest rates pick up from current levels.

### Erosion of P&C insurers' economic solvency less significant than for life peers

Falling interest rates can also weigh on non-life insurers' economic solvency (see Exhibit 7), although they are less vulnerable than life insurers with high exposure to guaranteed savings policies and wide asset/liability duration gaps.

Falling interest rates in some cases have little to no adverse impact on non-life insurers' Solvency II ratios. As shown in Exhibit 7, Tryg's ratio would increase in response to a 100 bps decline in rates, in contrast to Admiral, If P&C and RSA. This is because Tryg hedges interest rate risk by means of its match portfolio, which corresponds to discounted claims reserves. Direct Line also has minimal interest rate sensitivity, provided there is no change in the PPO real discount rate. A 100 bps decline in the PPO rate would reduce the company's ratio by eight percentage points. The impact on RSA's solvency of a 100 bps fall in rates would be comparable to the effect of a 50 bps rate decline on EMEA life insurers.

Exhibit 7

**Some P&C insurers' Solvency II ratios are sensitive to falling interest rates**

| Group | Solvency II ratio | | YE 19 Solvency II ratio Sensitivities | |
|---|---|---|---|---|
| | YE 2019 | Q1 2020 | Ratio after Interest rate fall -100bps | Ratio after Interest rate rise -100bps |
| Direct Line | 165% | 174% | 166% / 157%[1] | NA |
| Admiral | 190% | NA | 185% (Interest Rates -50bps) | NA |
| Tryg | 162% | 159% | 163% | 161% |
| If P&C | 190% | 170% | 175% | 203% |
| RSA | 168% | 151% | 158%[2] | 174%[2] |

[1] Solvency II Ratio after change in reserving basis for PPOs to use a real discount rate of minus 1%
[2] Including pensions
*Source: Companies' Reports*

## Claims inflation is a headwind

P&C insurers have some capacity to counter the negative impact of low interest rates on earnings by raising the price of their policies when they come up for their annual renewal. This is in contrast to most guaranteed return savings products offered by life insurers, which do not have a repricing option. Insurers in most large European P&C markets have pushed through price increases in recent years.

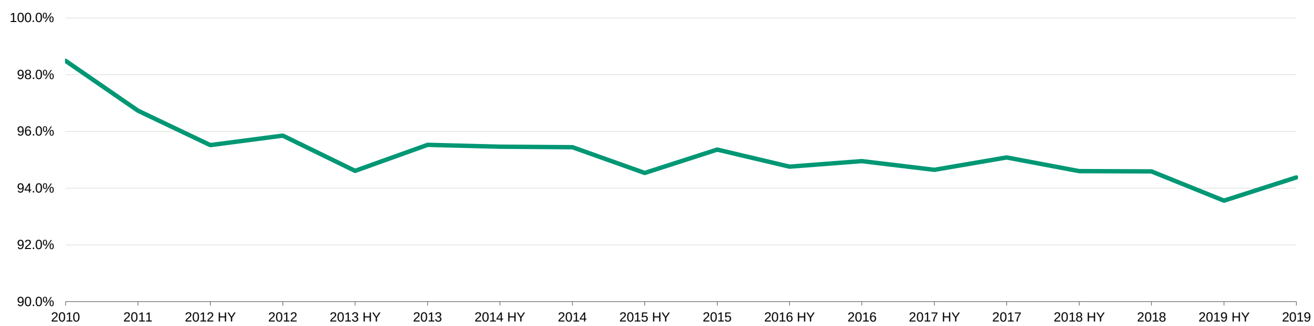
However, price rises in the motor sector – the largest insurance line in Europe at around 40% of total premium - have barely offset claims inflation. Intense competition in saturated western European markets, as well as a sharp contraction in motor claims during the coronavirus crisis, constrain the industry's ability to push through further increases in 2020 and into 2021.

Most European insurers also aim to cut their expense ratios in order to improve their underwriting results. However, sustained cost reductions beyond the "low hanging fruit" of savings via IT systems upgrades and more efficient procurement can be difficult to achieve. This, together with claims inflation headwinds, will pressure combined ratios going forward.

Exhibit 8

**Rising P&C prices have had limited impact on combined ratios**

**Average P&C combined ratio reported by selected large European insurers**




*Source: Moody's Investors Service, based on data disclosed by Ageas, Allianz, Aviva, AXA, Generali, If P&C, Mapfre, RSA, UnipolSai and Zurich Insurance*

Exhibit 9

**Pricing trends for the largest European P&C markets**

| | | | | | | |
|---|---|---|---|---|---|---|
| Pricing trends | > 0 | ~ 0 | <= 0 | < 0 | -1% to +1% | ~ 0 |

*Source: Moody's Investors Service*

Overall, as shown in Exhibit 9, we see subdued pricing trends in EMEA P&C markets, with the prospect of only limited or no rate increases in a number of countries.

Broadly, we foresee price pressures in the retail market, and more moderate pricing headwinds in the small business market. For larger commercial business, we expect price increases for the remainder of 2020 as major insurers reduce their risk appetites, and because of a combination of high accident year combined ratios in certain US casualty lines, rising litigation costs, low interest rates, economic uncertainty and coronavirus-related claims.

However, we expect the coronavirus outbreak and the economic shutdown measures designed to contain it to distort pricing trends and underlying earnings patterns, and there is a high degree of uncertainty over the ultimate impact. P&C insurers will face increased claims in travel insurance, business interruption (BI), and other commercial lines, partly offset by a sharp decline in motor claims during April and May 2020. Furthermore, pricing trends could be affected by lower revenue as a result of significant GDP contraction, which could also pressure insurers' expense ratios.

### Low claims will make it harder for French insurers to justify price increases in 2021

In France, we expect the coronavirus outbreak to reduce claims and drive exceptional profits for the retail P&C insurance industry in 2020, leading to political and social pressure on insurers to make ex gratia payments to their customers. The decline in French insurers' total claims expenses this year will also make it harder for them to justify price increases in 2021, despite a structural increase in the average cost of motor claims, and persistent pressure on investment income from low rates. Intense competition, one of the drivers of our negative outlook for the French P&C sector, is already hindering the industry's efforts to push through even moderate price increases. This challenge will become more acute in the next 12 months, particularly in the retail and small business segments.

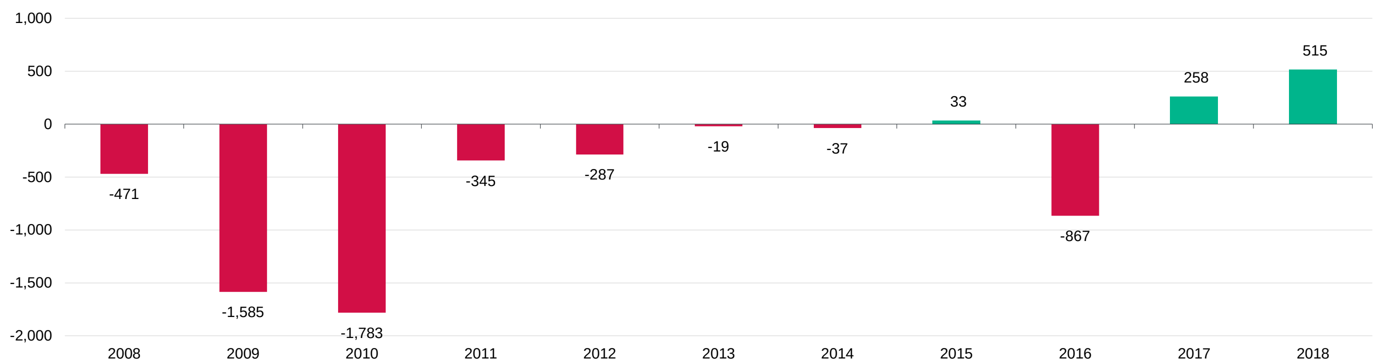
### Claims inflation challenges UK motor profitability

In the UK, motor claims inflation continues to outpace price increases. According to the Association of British Insurers (ABI), the average premium for 2019 as a whole fell 1% relative to 2018, compared with claims inflation estimated at 5-8%. More recently, the UK's Office for National Statistics (ONS) transport insurance index shows a price increase of around 4% in the year to May 2020, with intense competition and reforms of bodily injury compensation rules limiting the scope for more material rate rises.

A drop in motor claims as a result of the coronavirus-induced lockdown would make it harder for insurers to justify price increases in 2020 and 2021, despite underlying claims inflation as more expensive in-car technology pushes up repair costs. This will erode insurers' underwriting results, further challenging the sector's historically weak profitability (Exhibit 10), and putting insurers under pressure to reduce operating costs.

Exhibit 10

**UK motor insurers' underwriting results have historically been weak**
**Underwriting result for UK motor insurers since 2008 (£ million)**




Note: The underwriting result is the sum of both Domestic and Commercial business
*Source: Association of British Insurers (ABI)*

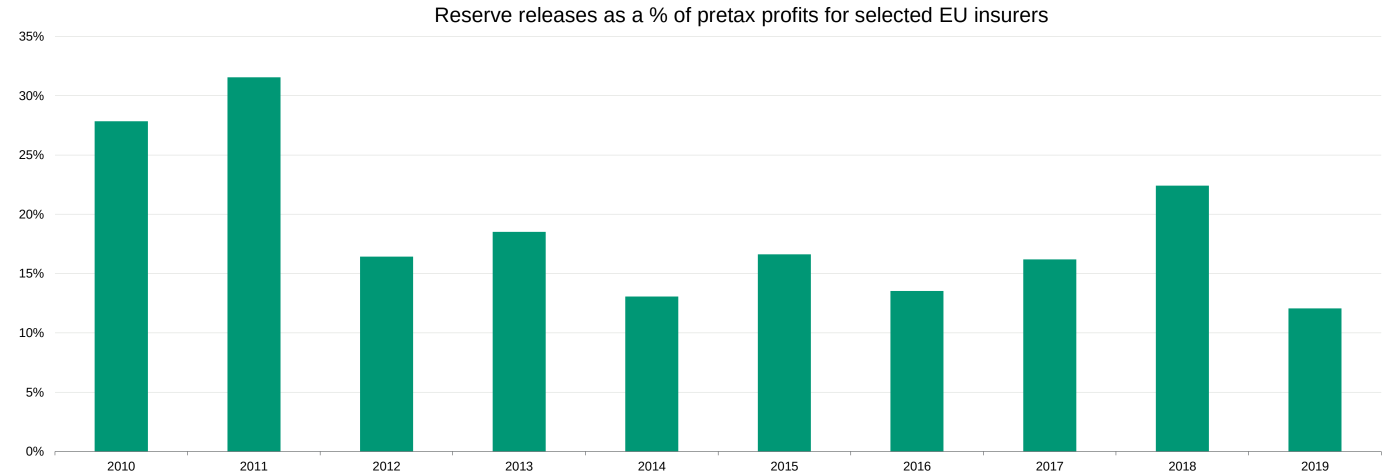
### Reserve releases fall significantly in 2019

Prior year reserve releases have been a meaningful contributor to European insurers' pre-tax profits, accounting for close to 20% of the total between 2010 and 2019 (see Exhibit 11). However, releases in 2019 were the lowest of the period, and we expect the impact of rising claims inflation and intense price competition to continue to curb the extent of reserve releases. Insurers have also used up some of the reserve buffers they hold over and above actuarial best estimates in older underwriting years.

Exhibit 11

**Reserve releases will remain a feature of the industry but are likely to fall**

**Reserve releases as a % of pretax profits for selected EU insurers**




Note: Profits include life and P&C profits
*Source: Moody's Investors Service based on data disclosed by Ageas, Allianz, Aviva, AXA, Direct Line, Generali, If P&C, Macif, Mapfre, RSA, Tryg AS, UnipolSai and Zurich Insurance*

As insurers have set prudent loss estimates, we expect them to continue to benefit from reserve releases. However, reserve releases will provide less support to combined ratios in future. This will provide a further incentive for insurers to improve their current year underwriting performance, especially in the low interest rate environment.

The European non-life insurance industry is inherently cyclical, with premium rate increases typically lagging periods of severe or persistent underwriting losses, or materially adverse claims trends. As part of this cycle, declining reserve releases should drive rate increases as the non-life insurance sector seeks to protect its underwriting performance.

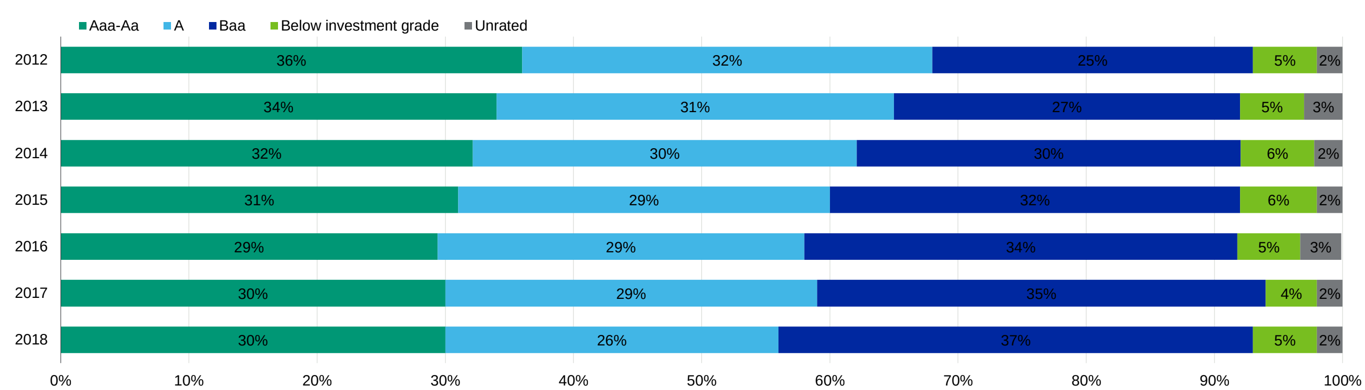
## Insurers increase investment risk in search for yield

European P&C insurers, like their life and non-life peers globally, have also responded to low interest rates by assuming more investment risk in order to enhance their investment returns. The quality of European insurers' corporate bond portfolios has deteriorated as the sector seeks out higher-yielding investment assets (see Exhibit 12). While insurers are highly sensitive to fixed income downgrades, we expect this trend to continue unless interest rates start to increase meaningfully.

Exhibit 12

**European insurers' search for yield has reduced the quality of their fixed income portfolios**

**Quality of European insurers' fixed income portfolio**




Note: Moody's estimate based on data disclosed by Aegon, Allianz, Aviva, AXA, Generali, Munich Reinsurance Company and Zurich Insurance
*Source: Companies' financial statements and Moody's Investors Service*

However, we believe the European P&C sector will maintain a relatively conservative stance, and that the uptick in asset risk to be relatively modest. This is because under Solvency II, insurers' capital burden increases the further they move down the credit curve. P&C insurers are also under less pressure to increase their investment income than life insurers with guaranteed investment returns to honour.

We also expect a further modest increase in P&C insurers' holdings of illiquid assets such as mortgages, commercial real estate loans, infrastructure debt and private placement bonds. Such assets are higher-yielding and offer good duration matching with long-dated liabilities associated with Motor Third Party Liability (MTPL) and workers' compensation business, as well as diversification benefits under the Solvency II capital regime. However, as illiquid assets tend to replace less risky sovereign or corporate bonds, they typically have a negative impact on overall asset quality.

## Moody's related publications

» Insurance - France: Pressure to contribute to pandemic costs,new long term challenges arise, 22 April 2020

» Insurance - Europe: 2020 Outlook update, 31 March 2020

» P&C Insurance – UK: 2020 Outlook, 26 February 2020

» Non-life insurers – United Kingdom: UK motor insurers' profit under pressure as higher claims outweigh price gains, 4 February 2020

» Insurance - France: Outlook negative as low rates create challenges for P&C and life insurers, 11 December 2019

» P&C Insurance – Global: 2020 Outlook, 5 December 2019

» Insurance – Europe: 2020 Outlook, 18 November 2019

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