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Financial Stability Report 2012

Second half-year report

EIOPA – Westhafenplatz 1 - 60327 Frankfurt – Germany – Tel. + 49 69-951119-20
Fax. + 49 69-951119-19 email: eiopa@eiopa.europa.eu; Website: <https://eiopa.europa.eu/>

Financial Stability Report 2012

Second half-year report

About EIOPA Financial Stability Reports

Under Article 8 of Regulation 1094/2010, EIOPA is, inter alia, mandated to monitor and assess market developments as well as to undertake economic analyses of markets. To fulfill its mandate under this regulation EIOPA performs market intelligence functions regarding its supervisory universe, develops a market surveillance framework to monitor, and reports on market trends and financial stability related issues. The findings of EIOPA's market development and economic analyses are published in the Financial Stability Report on a semi-annual basis.

(Re)insurance undertakings and occupational pension funds are important investors in the financial market and provide risk sharing services to private households and corporates. In the financial markets, they act as investors, mostly with a long-term focus. Their invested assets aim to cover liabilities towards policyholders or members of pension fund schemes to which long-term savings products are offered, e.g. in the form of life assurance or pension fund schemes. Besides from offering savings products, (re)insurance undertakings provide risk sharing facilities, covering biometric risks as well as risks of damage, costs, and liability.

Financial stability, in the field of insurance and pension funds, can be seen as the absence of major disruptions in the financial markets, which could negatively impact insurance undertakings or pension funds. Such disruptions could, for example, result in fire sales or malfunctioning markets for hedging instruments. In addition, market participants could be less resilient to external shocks, and this could also affect the proper supply of insurance products or long-term savings products at adequate, risk-sensitive prices.

However, the insurance and pension fund sectors can also influence the financial stability of markets in general. Procyclical pricing or reserving patterns, and potential contagion risk stemming from interlinkages with other financial sectors, could potentially make the financial system, as a whole, less capable of absorbing (financial) shocks. Finally, (re)insurance undertakings might engage in non-traditional business such as the provision of financial guarantees or alternative risk transfer, which also needs to be duly reflected in any financial stability analysis.

The Financial Stability Report draws on information from EIOPA's member authorities which is both of a quantitative and a qualitative nature. Supervisory risk assessments as well as market data are further core building blocks of the analysis.

Second half-year report 2012

EIOPA's Financial Stability Committee (FSC) has updated its report on financial stability in relation to the insurance, reinsurance and occupational pension fund sectors in the EU/EEA. The current report covers developments in financial markets, the macroeconomic environment, and the insurance, reinsurance and occupational pension fund sectors as of 29 October 2012 unless otherwise indicated.

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1. Summary of main issues and conclusions

At present, the macroeconomic uncertainties constitute the main challenges for the European insurance and occupational pensions industries. Risks to financial stability remain high despite recent positive developments in financial market prices and coordinated political initiatives. Actions by the European Central Bank (ECB) have helped ease the pressure on banks and the Euro. However, macroeconomic and financial market fragilities remain, and the financial soundness of the European insurance and occupational pensions sectors could be materially and adversely affected over the medium term, unless the current uncertain macroeconomic environment is reversed into a stable moderate-growth equilibrium. This is particularly pertinent when considering that the likelihood of a prolonged period of low interest rates in a number of global economies, and volatile capital markets in general, are increasing, and that the macroeconomic scene in Europe is severely bifurcated; with some jurisdictions having negative real interest rates, and others having positive and somewhat elevated real interest rate curves.

In the insurance sector, this report documents an overall premium growth, although the variation between companies is large. Profitability levels remain relatively stable and Solvency I ratios are still at comfortable levels. However, the lack of market and credit risk sensitivities in Solvency I is a clear drawback of the current regulatory framework. An urgent and much needed contribution to assisting financial stability work in Europe is therefore a clear and realistic timetable for the implementation of Solvency II.

Reinsurers' near-term profitability will likely remain under pressure due to structural over-capacity in the sector, combined with weak global macroeconomic environment. In contrast to 2011, natural catastrophe losses have been relatively moderate in the first six months of 2012.

Data for 2011 documents a significant change in the funding positions of IORPs, especially for the larger defined benefit (DB) systems such as UK and the Netherlands. In the UK data show funding levels below 80%. The low yield environment is a key driver behind this development, since low discount rates increase the current market value of the liabilities. At the longer time-horizon, improved longevity of pensioners will also weigh negatively on funding levels. Supervisors are taking actions to address the low funding levels and are preparing recovery programs, usually allowing pension funds additional time to reach target funding ratios. These actions, combined with the longer term investment horizons adopted by pension funds, will work to reduce financial instability by acting as shock absorbers.

2. Recent developments

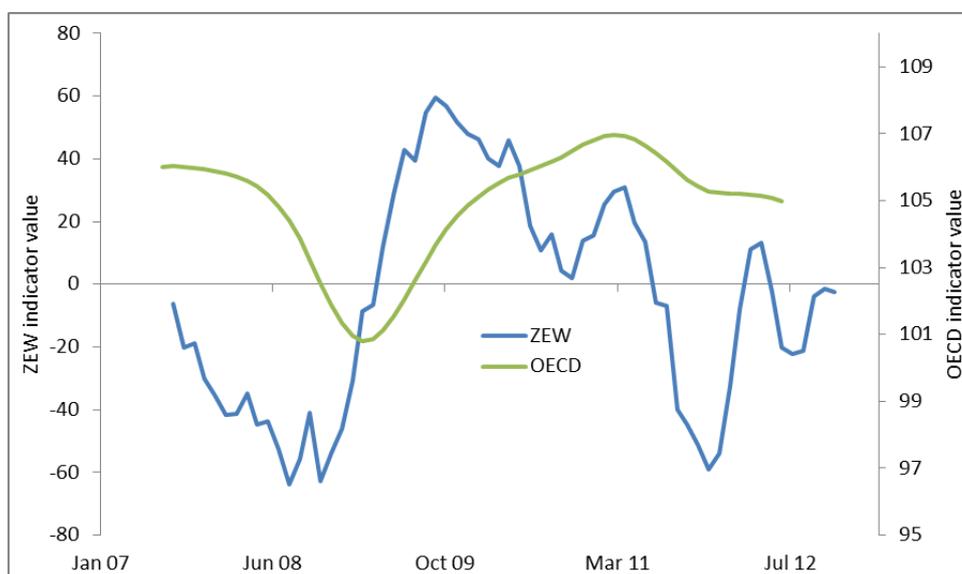
MARKET DEVELOPMENTS

Despite the recent favourable developments in financial markets, risks to financial stability remain high, in Europe and globally. Although very significant progress has been made by European policymakers with the proposal of a banking union, political uncertainty persists and there is a risk of fragmentation of the internal market. The actions of the European Central Bank (ECB), including the exceptional liquidity operations in the beginning of 2012 and the announcement of the Outright Monetary Transactions (OMTs) has eased the pressure both on banks and the common currency, but uncertainty remains in financial markets and may still lead to a stressed situation for the European insurance and occupational pensions sectors. In particular, the likelihood of a prolonged period of low interest rates is increasing, which challenges the profitability and capital position of the industry.

Economic growth required to ensure financial stability

Improved growth prospects in Europe would be a key contributor to financial stability. However, the main leading European indicators for the economic cycles six months ahead continue to predict a decline in macroeconomic trends, although possibly at a slower pace than in previous months. The ZEW Eurozone (see Figure 1) indicator has improved since the middle of 2012, especially when compared to end 2011-levels, but it is still showing an overweight of negative sentiment. The OECD indicator in the same figure draws a similar picture.

Figure 1: Business cycle leading indicators



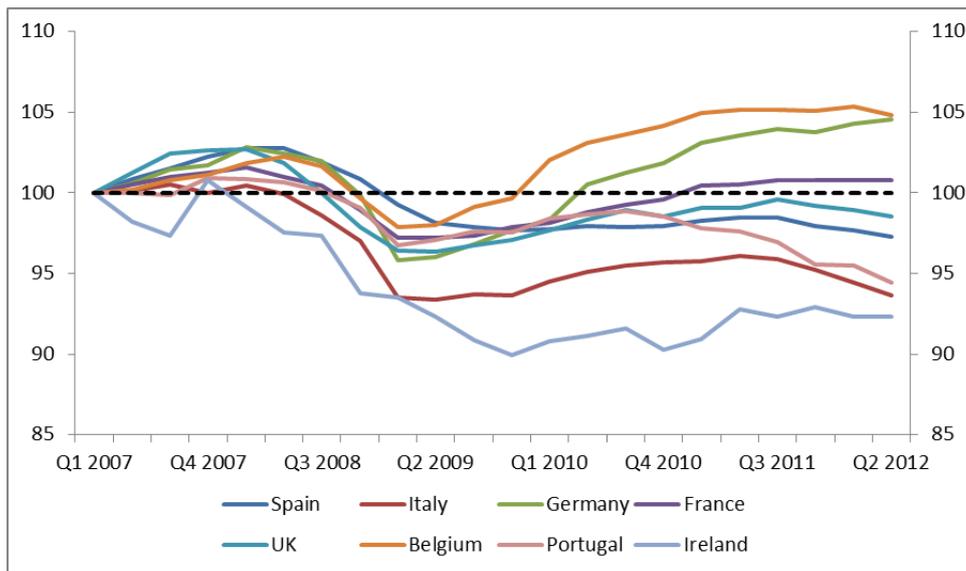
Source: Bloomberg

Note: The figure shows leading indicators for the economic cycle six months ahead. Two indicators are depicted. One derives from the ZEW (Zentrum für Europäische Wirtschaftsforschung) Eurozone expectation of economic growth and the other from OECD. The former is plotted in blue on the left-hand axis and the latter is plotted in green on the right-hand axis. The OECD updated its methodology for the calculation of the indicator in April 2012 to use GDP as a reference series.

Current economic downturn reinforces asymmetric situation

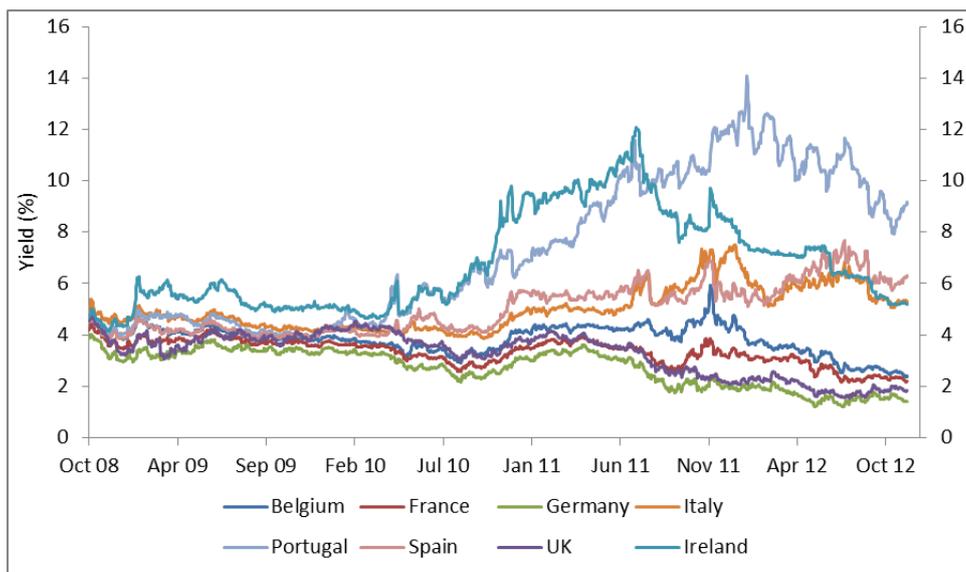
Several European countries are facing a continued economic downturn, amid deleveraging by the banking sector and fiscal consolidation. Figure 2 shows the development in real GDP in several large European countries. Only in a few countries the real GDP is on pre-crisis levels, and several countries are still experiencing downward-trending GDP levels. Combined with high government bond yields for several countries shown in Figure 3, the current economic downturn reinforces the current asymmetry in Europe as the countries which would most benefit from lower interest rates are the ones where borrowing costs are the highest. Concern over government debt levels also rules out any large scale fiscal stimuli in the countries mostly affected.

Figure 2: Development in real GDP in 8 selected European countries



Source: Bloomberg. Fixed prices indexed to 100 in Q1 2007

Figure 3: European government bond yields for 8 selected countries – 10 years segment



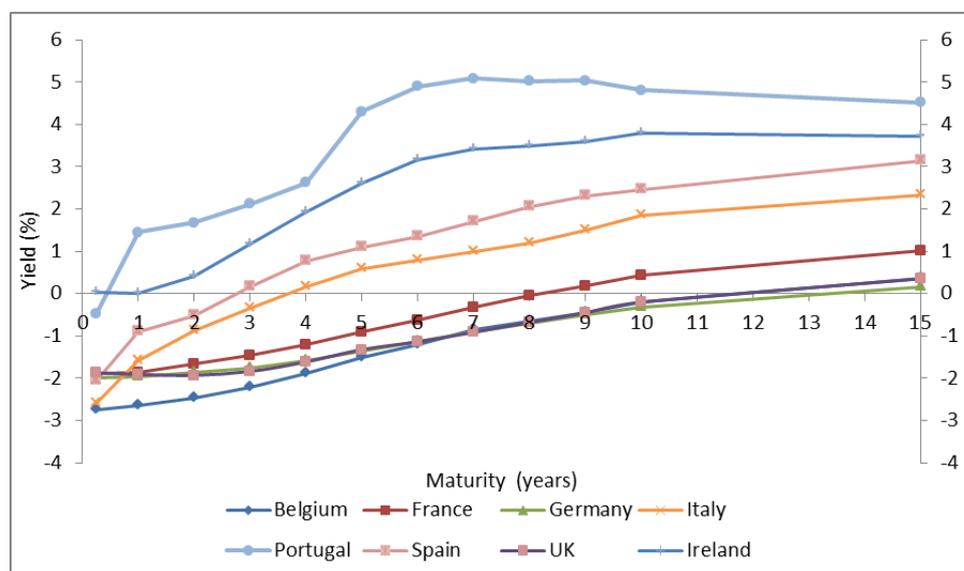
Source: Bloomberg

Note: The figure shows the evolution of 10 year government bond yields for selected countries.

**Diverging
real govern-
ment bond
yields and
increased
imbalances**

The asymmetry also manifests itself in the real yield curves shown in Figure 4 as observed by end-October 2012. At 5-year maturity, Belgium, Germany, UK and France are all experiencing negative real interest rates for government bonds, whereas the real interest rates for Italy, Spain, Ireland and Portugal are substantially higher despite the sharp decrease that sovereign credit spreads have experienced since the beginning of the year in some of these economies. As a result, financing costs for investment projects in these countries are relatively low, while other countries benefit less from the expansionary monetary policies currently pursued. Unless there is a large degree of spill-over between countries (e.g. foreign direct investment or subcontracting for production in other countries), there is a risk that European-wide imbalances will continue to grow. For this reason, signs of fragmentation of the internal market are particularly worrying as such imbalances would depend on a fully functioning internal market to level out.

Figure 4: European government bond yields curves for 8 selected countries corrected for inflation rates



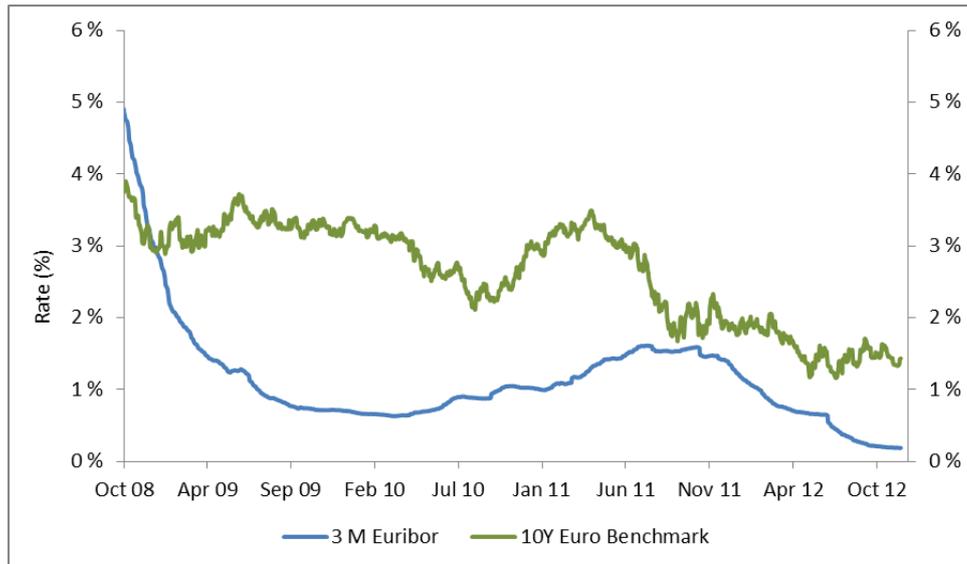
Source: Bloomberg

Note: The figure shows yield curves for selected countries, observed in October 2012.

**Increase
likelihood of
a prolonged
period of low
interest
rates**

The likelihood of a prolonged period of low euro interest rates has increased with the continued economic downturn. Both short-term and long-term European benchmark rates have decreased since the beginning of 2012 (see Figure 5). Clearly, long-term rates are of critical importance to life insurers and pension funds, as the net present value of their long-run obligations to policyholders and pensioners increase when interest rates are low. Therefore, the financial position of these institutions typically suffers under such circumstances, in particular where the duration of liabilities exceeds the duration of the corresponding assets. For life insurers, this problem can be even more significant if guaranteed minimal rates of return have been offered to policyholders. Although there is a move by the sector to reduce or adjust the offering of guaranteed returns, many contracts cannot be renegotiated and the sector remains vulnerable to a prolonged period of low interest rates.

Figure 5: European short- and long-term benchmark nominal interest rates

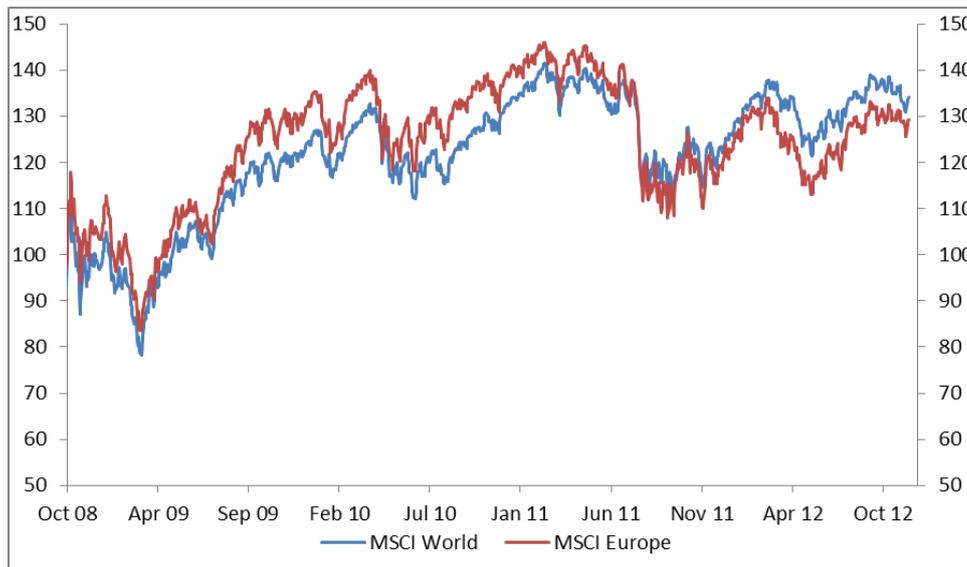


Source: Bloomberg (GECU10YR and EUR003M)

Soft rebound in equity prices in the second half of 2012

The soft rebound in equity prices experienced since the middle of 2012 (see Figure 6) seem to reflect somewhat improved market sentiment following relatively strong policy responses at the level of the European Union. Indeed significant progress has been made with the proposal of a banking union, and the actions of the ECB have eased some of the most immediate pressure on the financial system. Naturally, increased equity prices help improve the capital position of insurance companies and occupational pension funds, to the extent to which they hold sizeable equity positions in their portfolios.

Figure 6: European and world equity price indices



Source: Bloomberg. Indexed to 100 on 28 October 2008

In line with the general market sentiment, equity prices of listed European insurance undertakings also increased over the last few months (Figure 7). The equity prices of insurers continue to outperform those of banks and the gap has widened substantially since the middle of 2010.

Figure 7: Stoxx Europe Equity Indices

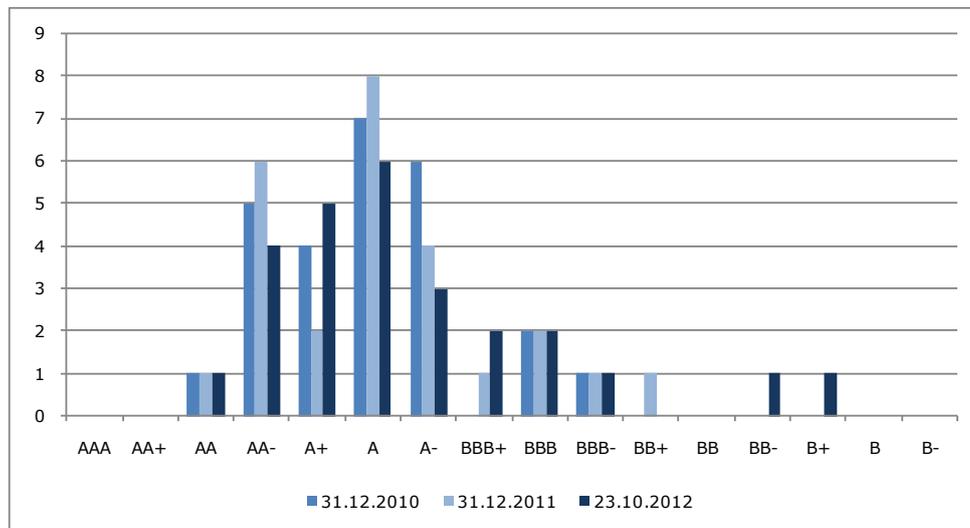


Source: Bloomberg. Indexed to 100 on 28 October 2008

Mixed rating outlook

The credit ratings of European insurers experienced more downgrades than upgrades following the financial crisis in 2008 (Figure 8). Following the recent developments, a higher number of the leading European insurance groups are now rated BBB+ or lower than at the end of 2010.

Figure 8: Development of leading European insurance groups' credit ratings

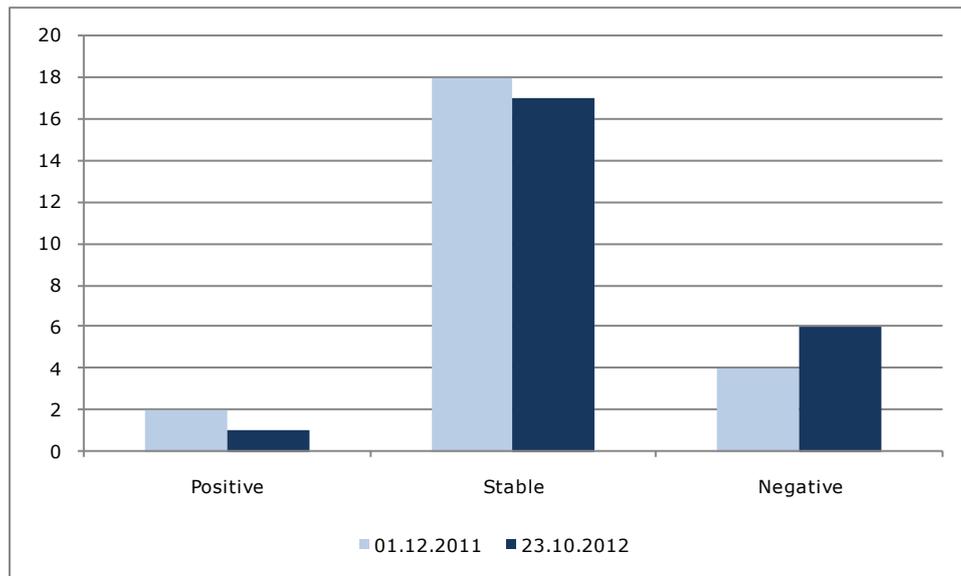


Sample of 26 large European insurance groups

Source: Standard & Poor's

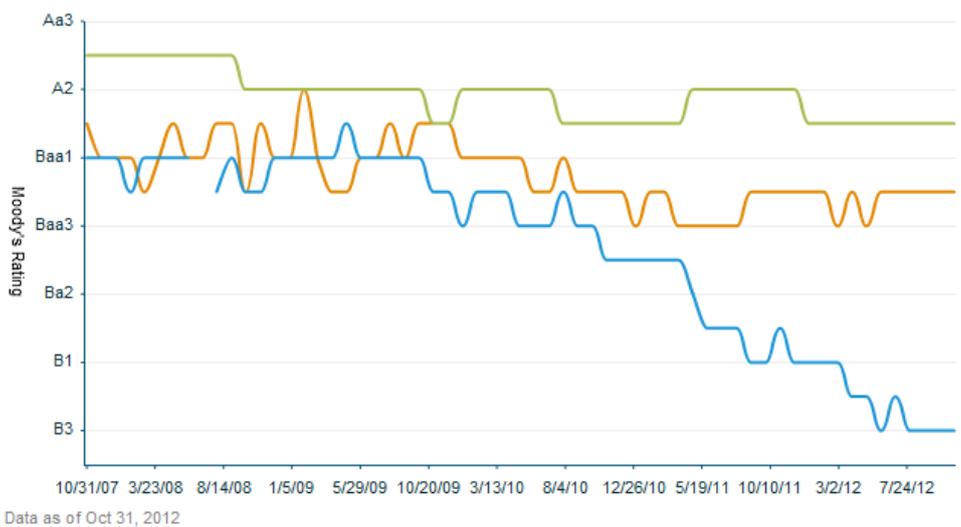
In addition, several companies have a negative outlook (Figure 9). This development is also mirrored in long-term ratings from Moody's and implied ratings based on CDS and equity data (Figure 10). The latter has shown a relatively sharp decline since 2009.

Figure 9: Development of European insurance groups' ratings outlooks/credit watches



Sample of 24 large European insurance groups
Source: Standard & Poor's

Figure 10: Moody's ratings



Insurance

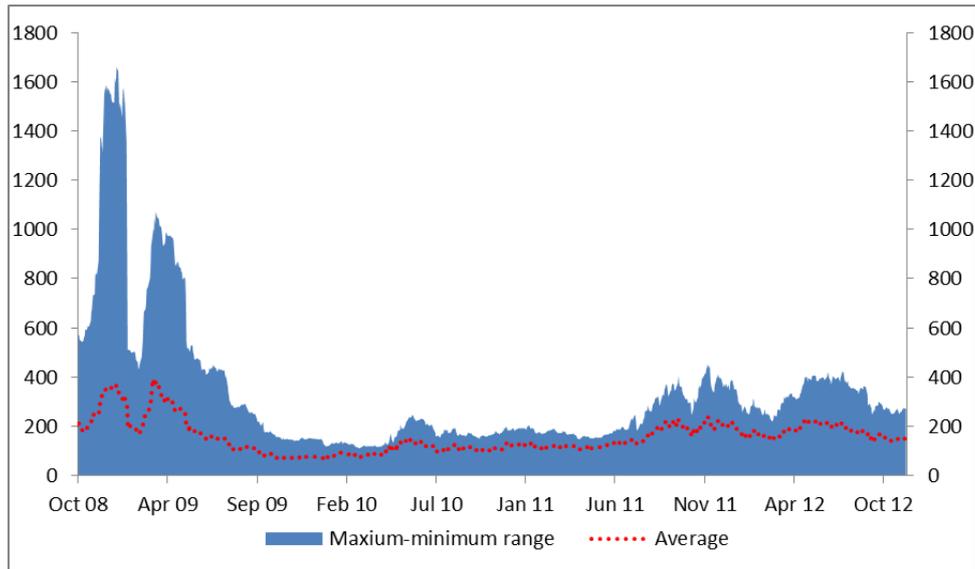
- Credit Default Swap-Implied - AVG
- EDF-Implied - AVG
- Moody's Senior Unsecured or Equivalent Rating - AVG

Source: Moody's

Note: The figure shows weekly observations on Moody's long term rating (light green line) and implied ratings extracted from equity data (blue line) and CDS data (orange line).

The sharp widening of Credit Default Swap (CDS) spreads for European insurance groups during the market turbulence of 2008 and the start of 2009 was possibly a reflection of the concerns about the sustainability of the global financial system and the sector's investment exposure to large European sovereigns and banks. Credit spreads did come down substantially after mid-2009 for a broad set of insurance companies, but were seen to rise again (see Figure 11) at the end of 2011 and middle of 2012. These evolutions at the level of individual insurance companies coincide with the observed increase in sovereign CDS spreads. Sovereign CDS spreads have fallen dramatically following the recent policy responses.

Figure 11: Development of CDS



Source: Bloomberg

Overall impact on insurers

It is difficult to quantify the overall detrimental impact the on-going macroeconomic and financial market turbulence will have on the European insurance and occupational pension fund sectors. However, it is clear that with the deteriorating macroeconomic environment the likelihood of a prolonged period of low interest rates has increased. This will certainly put capital positions of life insurers and pension funds in particular under pressure. Indeed, an EIOPA low interest rate stress test carried out in conjunction with the 2011 insurance stress test showed that between 5% and 10% of the companies surveyed would face severe problems in the sense that their MCR solvency ratio would fall below 100% in a scenario where interest rates would remain low for a prolonged period of time. In addition, several other companies would observe a deteriorating capital position with solvency rates falling only slightly above the 100% threshold, whereby they potentially would become vulnerable to other external shocks.

3. Developments in the European insurance sector

RECENT INSURANCE SECTOR DEVELOPMENTS AND RISK OUTLOOK

Macro, credit and market risks remain high

As presented in the EIOPA Risk Dashboard published in October 2012 (see excerpt of the risk dashboard in Figure 12), recent developments have contributed to a slight improvement in credit risk on the asset side of insurer's balance sheet and CDS spreads have been decreasing. However, still high sovereign bond yields and high spreads on financial and non-financial bond holdings make the capital position of insurers challenging. This is exacerbated by high market risks stemming from low interest rates in a number of economies. The financial sector is highly interlinked, and there is a risk that the banking sector problems could spill over to insurance companies. For instance, in some jurisdictions, life insurers are experiencing increased competition from banks due to the banks' aim to strengthen the deposit base. However, the declining trend in life gross written premiums has been reversed and lapse rates stabilised in comparison to the fourth quarter of 2011.

Figure 12: Excerpt from the EIOPA September 2012 Risk Dashboard

Risk	Assessment as of September 2012	Qualification
Macro		<ul style="list-style-type: none"> Political risk with regard to sovereigns and Eurozone Weak worldwide growth outlook with a significant dispersion in outlook within Eurozone
Credit		<ul style="list-style-type: none"> High spreads for sovereigns and financials Substantial banking exposures
Market		<ul style="list-style-type: none"> Investing when markets are imbalanced Low yield environment increases re-investment risk
Liquidity/funding		<ul style="list-style-type: none"> Lapse rates stabilised Ratio of liquid over illiquid investments rising Funding via cat bonds intact
Profitability/Solvency		<ul style="list-style-type: none"> Combined ratio stabilised since Q2/2011 Solvency ratios are stable
Interlinkages/Imbalances		<ul style="list-style-type: none"> Interbank market tensions are of concern Risk of banking crisis spillovers Increased exposures to financials in some jurisdictions
Insurance		<ul style="list-style-type: none"> Slight increases in life and non-life premiums, but uncertainty about medium-term sustainability of growth Fewer natural catastrophes than in 2011

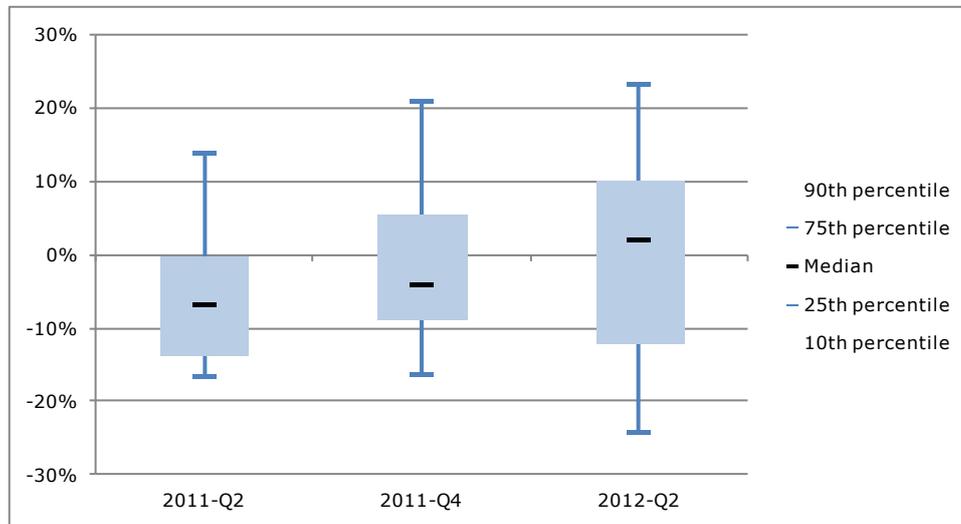
Source: EIOPA, assessment based on worldwide-consolidated financial information received from a sample of large European insurance groups and publicly available market data. The full dashboard is available on the EIOPA website. The colours represent the assessment of the relevance of a particular risk; red implies very high relevance, orange implies high relevance, yellow implies medium relevance and green implies low relevance. The direction of the arrow indicates the change in the assessment over the previous three months.

Overall increase in premium growth

Year-on-year growth in premiums in life insurance remained negative throughout 2011, but turned positive in 2012. Reported premiums in Q2 2012 were 2% higher than one year ago. However, many groups still report negative premiums growth (see Figure 13 and Figure 14). Unit-linked life insurance companies reported a decline in premiums of around 15%, a much worse performance than that reported by traditional life insurance (often with a guarantee element) which reported premiums growth around 1%. Most national supervisors expect a stabilisation in premiums both in life and non-life over the next 6 to 12 months. The highest increases in

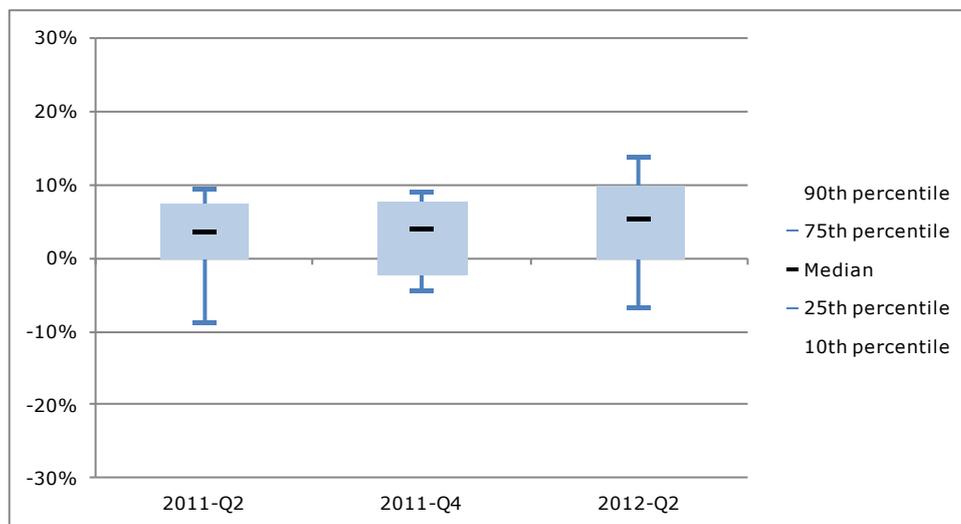
premiums have been seen in the non-life segments fire and damage to property (+6%) and general liability (+6%). Credit and suretyship continues to decline reflecting the general weak macroeconomic conditions.

Figure 13: Year on year growth rates in gross written premiums – life insurance (in %)



Source: EIOPA, based on worldwide-consolidated financial information received from a sample of large European insurance groups from AT, CH, DE, ES, FR, IT, NL, SE and UK (25 groups for 2012, 24 groups for 2011 data).

Figure 14: Year on year growth in gross written premiums – non-life insurance (in %)

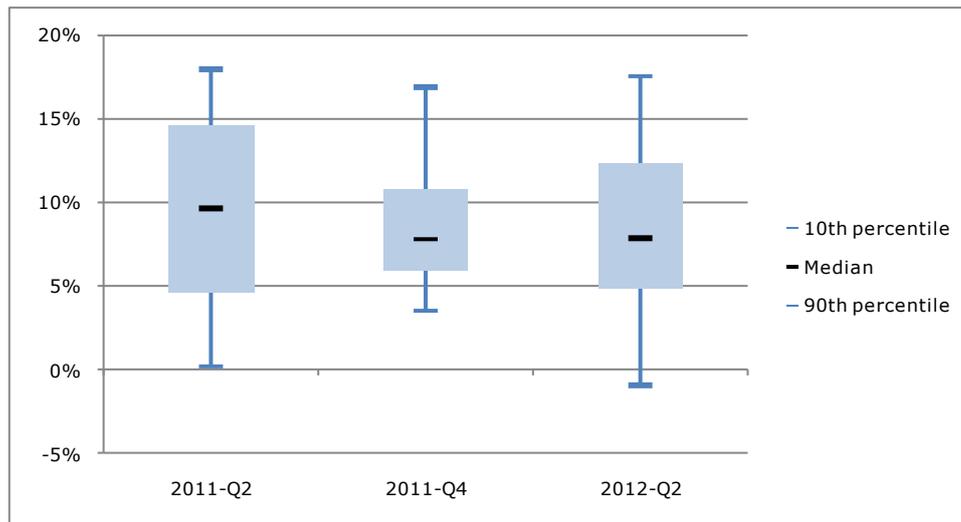


Source: EIOPA, based on worldwide-consolidated financial information received from a sample of large European insurance groups from AT, CH, DE, ES, FR, IT, NL, SE and UK (24 groups for 2012, 23 groups for 2011 data).

Profitability remains stable

Overall profitability figures signal some resilience of the insurance sector. Non-life underwriting performance remained positive despite competitive pressure as this was offset by fewer catastrophic events in Q2 2011. However, both the life and the non-life sector reported positive year on year growth rates in Q2 2012 (the median group in the two sectors reported negative growth of 0.3% (life) and 9.7% (non-life) in profitability). Return on equity is relatively stable with a downward trend compared to the same quarter one year ago (see Figure 15).

Figure 15: Return on equity – life and non-life insurance (in %)

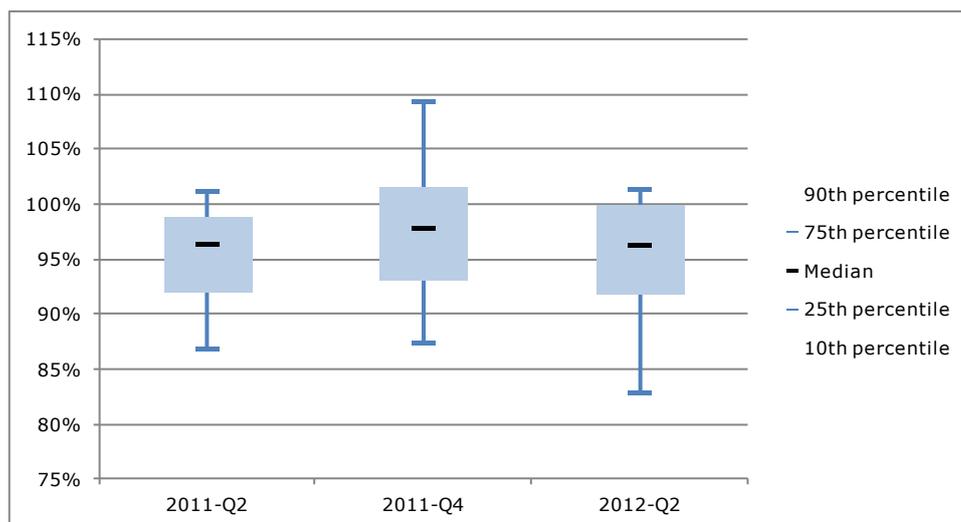


Source: EIOPA, based on worldwide-consolidated financial information received from a sample of large European insurance groups from AT, CH, DE, ES, FR, IT, NL, SE and UK (29 groups in Q2-2011, 28 in Q4-2011 and 27 in Q2-2012).

Relatively stable combined ratios

Combined ratios in the non-life sector have been relatively stable, even through 2011 which was characterised by a large number of unusually costly natural catastrophes. Overall, from Q4 2011 to Q2 2012, net claims continued to grow less than net premiums. Hence combined ratios slightly improved from 98% to 96% for the median group, with some groups reporting even better improvements as indicated by the 10th percentile in Figure 16. About 1/3 of the national supervisors report increasing claims over the past year, but most expect claims to be more stable over the next 12 months period.

Figure 16: Combined ratios – non-life insurance (in %)

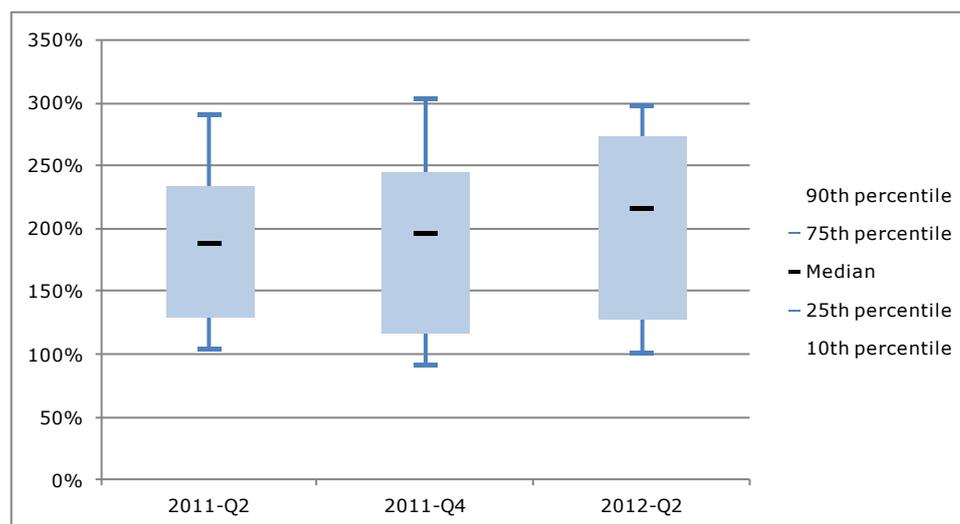


Source: EIOPA, based on worldwide-consolidated financial information received from a sample of large European insurance groups from AT, CH, DE, ES, FR, IT, NL, SE and UK (22 groups in Q2-2011, 21 in Q4-2011 and 19 in Q2-2012).

Solvency ratings in a challenging environment

Solvency ratios in both life and non-life have slightly improved over the previous quarters (see Figure 17), aided by somewhat declining sovereign bond spreads and less volatile capital markets. However, the current macroeconomic situation is likely to result in a deterioration of solvency margins, especially in the life sector. Non-life solvency margins remain strong due to continued underwriting profitability and lower susceptibility to the macroeconomic environment. A strong majority of national supervisors report that they expect solvency ratios to remain stable over the next 6 to 12 months.

Figure 17: Solvency ratios – life and non-life insurance (in %)



Source: EIOPA, based on worldwide-consolidated financial information received from a sample of large European insurance groups from AT, CH, DE, ES, FR, IT, NL, SE and UK (24 groups in Q2-2011, 25 in Q4-2011 and 26 in Q2-2012).

STRUCTURE OF THE EUROPEAN INSURANCE MARKET

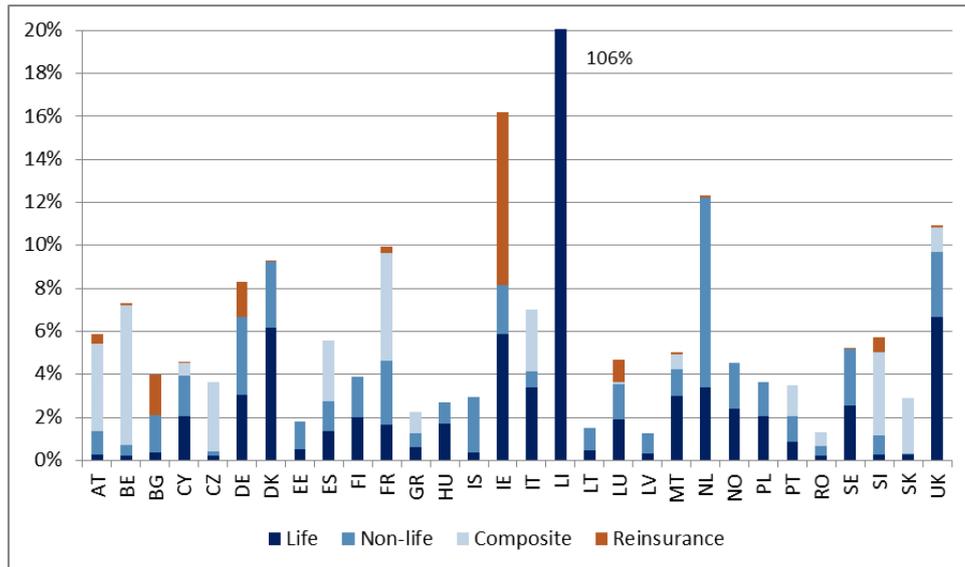
In addition to the data collected quarterly on the largest European insurance groups employed above to assess the recent developments and risk outlook of the industry, EIOPA also collects and publishes statistics annually for the European insurance sector broken down by country. This data sheds light on the structure of the European market and country-specific differences.

Insurance penetration vary across

The ratio of gross written premiums in percentage to gross domestic product is an indicator of insurance penetration. It generally develops very gradually overtime, but is of a very different size across Europe (Figure 18).

In IE the penetration ratio is one of the highest behind LI. In the non-life business penetration is highest in NL (due to the privatization of health insurance in 2006).

Figure 18: Insurance penetration: Gross Written Premiums in percentage of GDP 2011

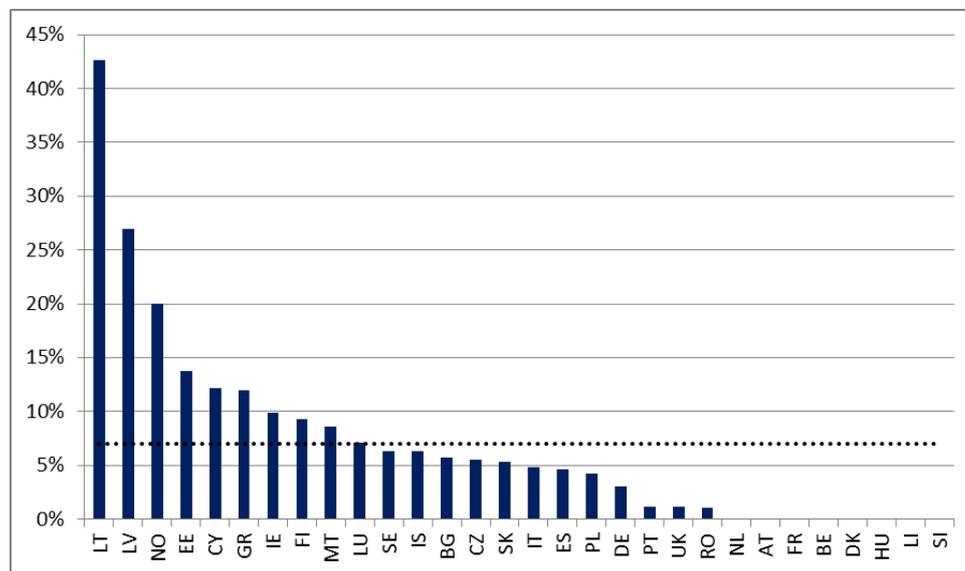


Source: EIOPA.

Limited direct role of foreign companies

Although a large number of companies have asked for authorisations to enter foreign markets, the actual market share of these activities is almost negligible. Most of the international business is still done through subsidiaries and branches. However, the data shows an increasing trend; in 2011, the average share of foreign branches measured in terms of gross premiums written in the reporting Member States was 7%, compared to 2% in 2010. Figure 19 shows the share exceeds the average (marked with dotted line) in LT, LV, NO, EE, CY, GR, IE, FI and MT.

Figure 19: GPW by foreign branches as percentage total activity in the country 2011



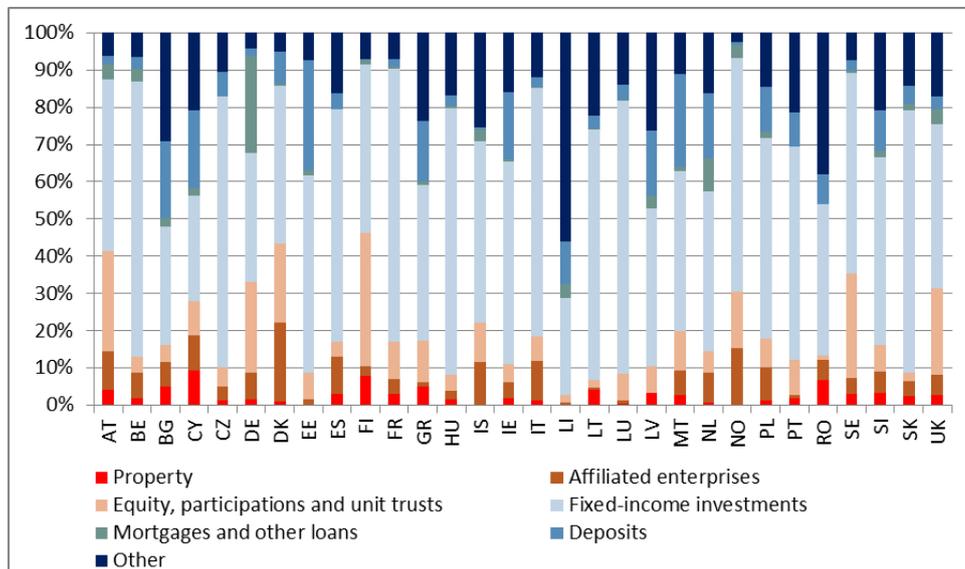
Source: EIOPA.

Investments vary, but fixed-income dominates

EIOPA monitors the current asset allocation of European insurance companies closely, especially with regard to sovereign and banking exposures. In general, insurance companies report a fairly diversified sovereign bond portfolio across EEA countries, Japan, Switzerland and the United States. However, investment strategies in many cases exhibit a certain level of home bias, which to some extent could be due to asset-liability matching. Although investments vary by country, as seen in Figure 20, asset allocations are generally dominated by fixed income assets. On average across

European countries (unweighted), fixed income instruments made up 52% of total assets by the end of 2011, compared to only 11% for equity. A gradual shift towards lower holdings of equity has been observed in recent years; whether this change is a result of deliberate asset allocation decisions or a result of market value changes cannot be determined on the basis of the collected data.

Figure 20: Asset allocation 2011

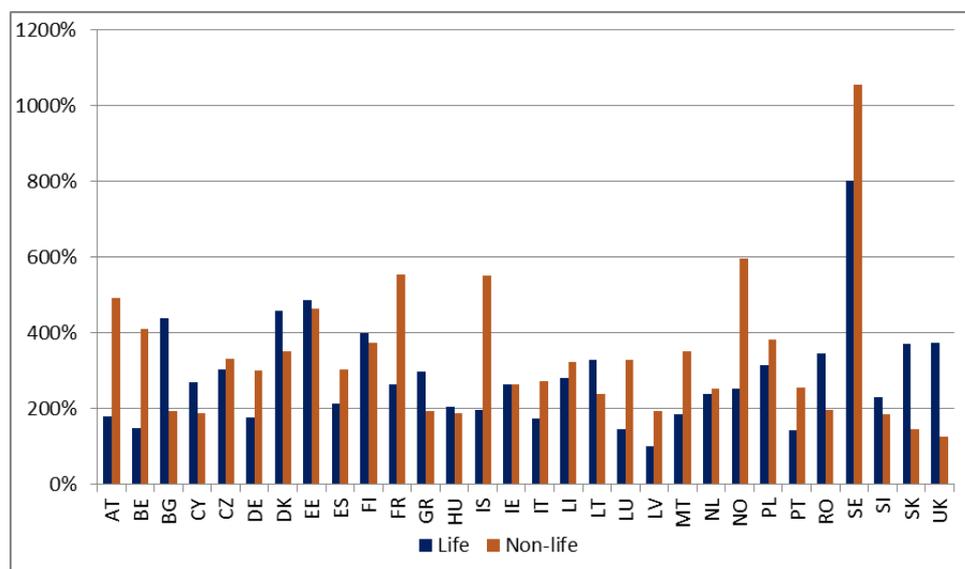


Source: EIOPA. Note: Investments for the benefit of policyholders who bear the investment risk are excluded. Equity, participations and unit trusts covers shares and other variable-yield securities and units in unit trusts for which no look-through has been applied. Data includes composite insurance undertakings, but excludes reinsurance undertakings.

Solvency ratios at comfortable levels across Europe

As seen above in Figure 17, solvency ratios have improved slightly among the largest insurers in Europe. Figure 21 adds to this picture by showing that solvency ratios across the European market remain at comfortable levels in most countries. In several large countries, such as Germany, France, Italy and Spain, non-life solvency ratios are higher than in life, but this is far from a uniform picture, UK being an example of the opposite.

Figure 21: Solvency ratios, life and non-life 2011



Source: EIOPA.

SOLVENCY II IMPLEMENTATION

Long-term guarantee impact assessment

It is foreseen that various counter-cyclical mechanisms will be embedded in the final Solvency II framework. In principle, these measures are intended to mitigate potential procyclical dynamics in the insurance sector and should contribute to financial stability. However, the impact of these measures, in particular in combination, need to be assessed in order to avoid negative and unintended consequences for both insurers and the system as a whole. An impact and sensitivity study (the long term guarantee impact assessment) will therefore be launched to assess in detail the impact of these measures and how they may interact with each other.

Commitment to a realistic timetable essential

This impact study will provide critical input into the legislative process and should aid in overcoming some of the remaining obstacles to the Trilogue negotiations. In the meantime, a clear commitment to a realistic timetable which takes into account the time required to deliver the different milestones is essential to secure the credibility of the project.

LOCAL MARKET DEVELOPMENTS

Qualitative assessment

In addition to the quantitative answers reported above, members¹ have provided qualitative assessments of market conditions, key aspects of the life and non-life insurance sectors, and the main risk factors as they are observed in local markets. A summary of this input is provided below.

Business activities and risk profile

Compared to the previous year, in 2012 no significant changes in the business model and strategy of insurance undertakings or in their overall risk profile have been observed. There is a general convergence in the European countries to intensify the credit assessment of counterparties and to reduce the exposures, in particular to market and liquidity risks. Due to the competitive environment, there is still a trend to revised corporate structures through mergers, to transfer portfolios (four countries) including cross border business of branches, or outsource activities (three countries) and differentiating distribution channels. In three cases an expansion of the business in Latin America and Asia (three countries) was reported.

In detail, investment programs have been somehow revised, diversification policies have been broadly adopted to reduce concentration risk and the insurance business has been intensified by selling bundled or supplementary contracts to those offered.

The life business composition shows a further shift in 2012 from guarantees/traditional products to investment contracts (funds or bank deposits-like) and even more to unit-linked products, both pure and with limited or optional guarantee components equally provided by the insurance undertaking or third parties. Other products have been redesigned or repriced to be aligned with the gender directive introducing unisex tariffs (DE, HU).

Almost all countries reported that insurers have adopted measures to strongly reduce expenses by increasing the efficiency of resources and operations management and by applying cost-cutting programmes which downsized administrative, structural and operational expenses. The cost reduction policy in three countries also included a downsizing of the workforce.

¹ AT, BE, BG, CY, CZ, DE, DK, EE, ES, FI, FR, GR, HU, IE, IS, IT, LI, LT, LU, LV, MT, NL, NO, PL, PT, RO, SE, SI, SK, UK.

Financial position

On a sample of 30 responding countries, 80% reported sufficient capitalisation as of the end of 2011. Just in four cases reserving needs were detected due to longevity, discounting rate, reserve strengthening in some lines of non-life business and asset repricing following the financial crisis.

Solvency and capital positions of undertakings have been monitored constantly during the regular supervisory activities. Less than half of the countries reported the necessity to implement additional supervisory measures to prevent or solve solvency strains. These were primarily caused by difficulties in insurance business (four countries), losses on financial asset (three countries), inability to raise capital (one country), and underestimation of technical reserves (two countries) or set up of new business (two countries). The supervisory actions in these cases required more frequent reporting obligations to support off-site activities. Individual cases warranted an immediate increase in capital, supported by further capital projections and recovery plans, in one case an undercapitalized undertaking was successfully sold, as a result of supervisory action, to a bank, its new shareholder, which will fully capitalize the undertaking.

The solvency position of the few non-EEA subsidiaries operating in European domestic markets was considered stable and the conditions appropriate. These entities do not seem to have a high impact on domestic markets.

Interest rate environment

The financial crisis in Europe led undertakings to face new performance challenges in an environment of low interest rates.

Fourteen countries noted that the impact of the interest rate environment on companies was limited or minimal, depending , on local GAAP regulation and the matching programs in force as well as on adequate ALM strategies.

In the remaining cases, persistent low interest rates have had a significant impact on the economic situation (e.g. profitability of the assets) and the risk-taking capability (e.g. revaluation reserves) of the insurance companies but the interest environment did not seem to affect, at this stage, the liabilities side. Nevertheless, in a few countries it was stressed that a long period of low interest rates could potentially harm the insurance sector as they would threaten fulfilment of guarantees for old traditional products and especially on paid-up policies.

As a consequence of the crisis, most of the European insurers lowered the duration of their asset portfolios, but in general the asset-liability matching does not give rise to concerns in most countries. In a few cases, the lack of long-term fixed-income instruments (maturity over ten years) has been mentioned as a potential source of risk from an asset-liability matching point of view for life insurance undertakings.

Additionally, reinvestment risk in the short/medium term is considered high for one third of the surveyed countries, which pointed to the low interest rate environment as the main potential source of reinvestment risk.

Market stress in sovereign debt

Regarding the effect of market stress in sovereign debt, 70% of the countries highlighted that exposures to what is currently perceived as being "distressed sovereigns", are relatively limited, 30% of the respondents reported that their local industries are resilient towards sovereign stresses, despite relative high sovereign bond exposures and that their industry has capital buffers that would sustain most adverse sovereign bond scenarios. In these countries additional supervisory measures have been taken to follow the capital situation of the companies more closely. The remaining countries did not provide specific information on the impact of market stresses over sovereign debt but highlighted that a close monitoring and

assessment on the investment policies and the solvency margin position following the government bond market turbulences is carried out.

A large majority of respondents saw no impact of potential rating changes, since external ratings do not serve as an eligibility criterion under the current regulation. Nevertheless, the value of assets in countries where assets are valued at market value are affected by ratings. For instance, if some government bonds are further downgraded a significant sell off in sovereign debt by other financial institutions could be the cause which would eventually affect the balance sheet of undertakings. Finally, in three countries ratings are used to limit the market and credit risk. Therefore downgrades in these two countries could lead to sales by undertakings because of their internal risk management process.

Changes in national regulation

The major regulatory change reported by two countries allowed undertakings to value government bonds at cost (or some form thereof) rather than at market value. The government bond valuation at acquisition cost has been implemented to cope with artificial volatility caused by the financial crisis. However, permanent losses are in any case written in profits and loss. Thirteen countries reported minor or no regulatory changes. Two countries also mentioned amendments to the national regulation in order to strengthen the requirements to enter the insurance business, to coverage of technical provisions and to the reporting disclosure. Nevertheless, in some countries there are currently on-going assessments on different issues, which could have a potential impact on regulatory changes, such as, impact of Solvency II, decision of the European Court on mandatory unisex products (affecting mainly life insurance), and imposing limits to guaranteed interest rates.

Exposure to credit risk

Low exposures of portfolios to credit risk, in particular through corporate bonds and securitised assets (the latter showing very low amounts, and in some countries investments in securitised assets are not allowed), and low possible impacts are reported by most countries. Moreover, in a large majority of countries portfolios are made up by an ample majority of securities with 'investment-grade' ratings. In one country the share in corporate bonds shows an increasing trend at the expense of sovereign debt and equities.

Lapse rate developments

The picture emerging from the survey with regard to lapse rate developments is almost homogenous. Just in six cases it was mentioned that lapse rates have increased (in one case the increase was seasonal), but for almost all the respondents these currently remained unchanged. Nevertheless, the risk associated with such increased lapse rates are watched carefully.

Liquidity and funding conditions

No specific vulnerabilities regarding intra-group funding flows were identified and in general the liquidity and the funding conditions seem to be appropriate.

Only one country reported that dividend pay-out is the primary source for demand of additional funding in the companies operating in groups. Intra-group funding flows are observed and monitored directly by the supervisors or by external auditors. In one country it was mentioned that due to the reduction in life premiums written and increases on lapse and surrender rates the liquidity condition of life insurers is now one of the main priorities of the supervisor.

Liquidity swaps and other instruments with potential impact on liquidity

Liquidity swaps which take place between a bank and an insurance company may expose insurance companies acting as lenders of liquid assets to additional risk and may increase interconnectedness between the banking and insurance sector. EIOPA therefore launched a survey to assess the extent of such transactions undertaken by insurers and the risks they may pose. The survey was designed to cover not only liquidity swaps as such but also a wider range of transactions and programs that may have a liquidity impact. A main finding was that liquidity swap activity was carried out only by a small number of institutions, and often to a limited extent.

In particular, the survey revealed that in some countries there are no significant (or inexistent) positions related to liquidity swaps and liquidity programs. Indeed, the total notional amount of liquidity swaps and liquidity programs represents a mere 3% of total balance sheet assets with a variation by jurisdiction from 0% to 14%. This is most likely due to legal restrictions in some countries and Solvency I requirements that place eligibility criteria on assets (both quantitative and qualitative).

The main motivation behind liquidity swaps and related activity was revenue generation, portfolio optimisation and hedging. Risk control measures were generally in place and maturities were mainly short-term. Counterparties were mainly external, although some countries did report instances of repos and reverse repos performed by insurance undertakings originating from bank funding needs within the same group/conglomerate. It is possible that some of the securities lent by insurance undertakings are sovereign debt instruments which are then pledged as collateral for central bank operations. Thus, in these instances insurance undertakings may be using these transactions as a way to facilitate access to liquidity to a bank within the same group/conglomerate. Such activity needs to be carefully considered as it is not motivated by the business needs of the insurer, and may expose it to additional risk.

Market volatility

40% of the respondents consider the exposure to market volatility as moderate and 20% as low. Ten countries reported high exposure in equity and fixed income.

It is considered important to regularly monitor and timely perform an assessment on the exposures to the undertaking's assets, on a potential widening of spreads, their evolution and consequent impact, as well as on the related credit and counterparty risks.

The widening of spreads on sovereigns and corporates doesn't seem to be perceived to materialize by most of the responding countries.

Counterparty risk

No concerns are reported on the counterparty risk regarding reinsurers whose financial position has remained strong in spite of the financial markets turbulence.

Most of the counterparty reinsurance undertakings are of high credit quality, and/or belong to the same insurer's group and are subject to monitored reinsurance programs.

Contagion risk

Half of the sample reported not to have a significant number of subsidiaries in other financial sectors or considered this risk to be limited.

A general view is that the contagion risk is mainly stemming from any contractual obligations linking the insurance sector to other financial institutions, and primarily banks within bancassurance relationships and financial conglomerates. Partnerships and intra-group transactions (e.g. liquidity swaps transactions) with banks might lead to potential liquidity problems,

concentration and reputational risks and might considerably affect the optimisation of capital and liquidity and the adequacy of internal policies and infrastructures.

Vulnerabilities in the banking and financial system is considered the main source of risk potentially affecting the insurance sector. This may directly or indirectly hit insurance undertakings through the composition of their assets portfolio (e.g. bank exposure, shareholding, complex or structured financial products, sovereign risk, and concentration risk). Potential channel for spill-over effects are the holdings of financial institutions' bonds as part of their insurers' corporate bond book. In this case problems at the issuing institution might affect the valuation of the bonds and thus the credit portfolio of the insurers.

Annual reports on intra-group transactions, vulnerability and liquidity risk questionnaire and common supervision with the banking supervisory authority are the monitoring instruments used at a national level to directly assess the contagion risk.

**Supervisory
assessments**

Solvency, capital positions and the asset profile of undertakings are monitored constantly in order to evaluate how the financial market developments may affect insurers' financial conditions and strategies.

In 2012 internal stress tests were run in several countries.

The local markets showed a good resilience to liquidity and market stresses, proving to be able to absorb the impacts of relatively large movements in risk factors. The results also showed an improved solvency position when compared with previous year results. Just one country reported that one undertaking did not pass the most adverse scenario.

Further stress test exercises will be carried out in 2013 in several countries.

In this context, low-yield valuation exercises were also performed in some countries. The outcome has been overall positive although results differed depending on the methods applied. In one country the results of the low interest rate environment led to a change in the discount curve which improved solvency and loss absorption possibilities.

A large majority of the respondents reported that risk analysis on a national level across the financial sectors was developed to monitor current and emerging risks that may have an industry-wide relevance. Reporting requests and ad-hoc surveys were launched during 2012 to investigate the structure of investment portfolios, in terms of liquidity and asset profile (including details on ratings, country of issue, type of asset), reserving policies, potential mismatch risk, and capital-liability adequacy tests. In one country thorough investigations currently focus on complex valuation techniques for financial instruments and real estate investments made directly or through subsidiaries.

Two countries also reported that particular attention was addressed to the unit-linked business and to the procedures followed to place unit-linked life insurance products on the market.

On-site examinations (nine countries), off-site inspections (five countries) and meetings with the undertaking's management (two countries) were also conducted on a regular basis or on a targeted approach according to the ad-hoc survey results and the supervisory reporting. As a result of such examinations some undertakings were asked to reduce intra-group trans-

actions and reduce the assets values or to perform recalculations of the bonds categories portfolio at the market value.

In one country, following the on-site visits, the supervisors strengthened in some cases the on-going monthly monitoring on the solvency ratio and reduced the exposure to vulnerable assets, asking for a capital increase where needed.

Similar actions were also carried out in another country where additionally undertakings were imposed to revise their investment policy and to improve the ALM analysis and the liquidity risk assessment as well as the information disclosed to the market.

**Further actions
for the future**

The surveys and investigations conducted at national level were complemented by EIOPA's surveys with the aim of mapping the European risk profile of the insurance sector and providing a European view on impact and implications of stressed risk factors. EIOPA has already taken many initiatives on the issues mentioned above. Nevertheless, further suggestions were mainly addressed to strengthen the EIOPA's role as a catalyst for:

- gathering information, highlighting and tackling risks for the insurance sector in order to foster a level playing field and a higher consistency between the NSAs on different procedures. This may avoid possible arbitrage behaviours among member states and ensures a uniform approach in NSAs reviews and a common risk assessment framework under Solvency II regime;
- identifying whether key risks are widespread across the EU supporting this activity by detailed investigations and information sharing on cross border business;
- improving quality and quantity of information exchanged between NSAs on cross border business;
- developing guidelines and standards, like best practices;
- spreading among national supervisors best practices and actions taken in different jurisdictions and financial sectors.

SUPERVISORY RISK ASSESSMENT FOR THE INSURANCE SECTOR

**Qualitative
assessment**

With regard to the risk themes highlighted by Members, the main risk, which can be associated to the implementation of Solvency II, is the regulatory and reporting change². In addition, risk factors which are affected more for adverse financial markets conditions and a weaker economic environment are also seen to be more relevant (see Table 1).

The risks expected to increase: economic downturn, prolonged period of low interest rates, property and credit to corporates and households emerge simultaneously in a sluggish economic environment such as Europe experienced in the past months. Moreover, in an environment where government yields are located at low levels, interest rate guarantees become hard to fulfil. Furthermore, as a result of a weak economic recovery, the

² See summary in this report for the insurance sector: 'Solvency I lack risk sensitivity and does not capture key risks such as market and credit risks. The EIOPA Risk Dashboard presented in this report shows that these particular risks are currently at an elevated level, while the Solvency I regime does not allow a complete assessment of these risks and therefore cannot guarantee appropriate supervisory action in time. An urgent contribution to financial stability is therefore a clear and realistic timetable for the implementation of Solvency II.'

remaining economy and industrial enterprises face difficulties, and the average credit rating of governments and industrial corporations would therefore deteriorate. Hence, investment opportunities in lower rated investment vehicles, such as, for example, sub-investment grade bonds, increases in supply, make it relatively easier for insurance companies to engage in such investments.

As highlighted by several Members, it is important to be vigilant and to contain and monitor these risks described above. Otherwise, it can be envisaged that weaker capitalised insurance companies could suffer unsustainable losses from their investment activities. Indeed, macroeconomic conditions indicate that 2012 will likely be another year in Europe of low GDP growth, low interest rates and moderate equity market performance. Even if the economic recovery continues, insurers may find that the assets underpinning their balance sheets have decreased in value.

Quantitative assessment

EIOPA Members and Observers have been asked to assess risks and challenges according to the probability of a materialisation and the impact on the national insurance markets. A comprehensive list of 45 risks and challenges is used as the basis for the risk assessment, many of them being of a structural nature. The list used in the Spring Report, however, is primarily focussed on market and credit risks.

Based on the responses from 23 Member States³, the following risks and challenges are classified as the most imminent, ranked by the product of the scores for probability and potential impact (see Table 1).

Main risks

Regulatory and reporting changes, low interest rates, equity risks, economic downturn as well as sovereign risk are the risks with highest overall rankings. Especially the first of these items is considered to have an increased probability of materialisation. It should be stressed that sovereign risk, if realised, would have a significant impact. However, its development over the next 12 months is expected to decrease slightly.

³ AT, BE, BG, CY, CZ, DE, ES, FI, FR, GR, IE, IT, LT, LU, LV, NL, NO, PL, PT, SE, SI, SK and UK.

Table 1: Classification of the most imminent risks for the insurance sector

INSURANCE (based on 23 replies)	Average probability of risk	Average impact of risk	Development over the last 12 months	Expected development over the next 12 months
	1 = low 2 = medium-low 3 = medium-high 4 = high	1 = low 2 = medium-low 3 = medium-high 4 = high	-2 = cons. decrease +2 = cons. increase	-2 = cons. decrease +2 = cons. increase
Regulatory & reporting changes	3.25	2.50	0.4	0.4
Interest rate risk 1 - prolonged period of low interest rates	2.95	2.77	0.6	0.1
Equity risk	2.90	2.65	0.3	0.1
Economic downturn	2.84	2.95	0.7	0.4
Credit risk 2 - Sovereigns	2.80	3.05	0.2	-0.1
Competition within the insurance sector	2.75	2.50	0.6	0.4
Tax and pension reforms	2.75	2.58	0.8	0.8
Credit risk 1 - Corporates and private households	2.67	2.33	0.5	0.4
Credit risk 3 - Banks	2.58	2.79	0.3	-0.1
Lapse risk	2.53	2.42	0.4	0.1
Competition from banks and other financial services providers (substitution)	2.45	2.00	0.5	0.4
Liquidity risk	2.42	2.25	0.4	0.1
Property risk	2.36	2.07	0.7	0.4
Longevity risk	2.23	2.46	0.0	0.0
Premium risk	2.23	2.54	0.1	-0.1
Consumer confidence	2.22	2.33	0.1	0.1
Reserve risk	2.17	2.75	0.0	-0.1
Expense risk	2.00	2.22	-0.2	-0.1
Claims inflation	2.00	2.44	0.2	0.3
Concentration	2.00	1.57	0.2	0.3
Availability of market funding	2.00	1.83	0.2	0.0

Source: EIOPA members, data collected until end-October 2012.

... over the past months

Over the last six months nineteen of the 21 risks mentioned above have increased according to the feedback of national supervisors. The highest increases are reported with regard to tax and pension reforms, economic downturn, property risk, prolonged periods of low interest rates, and, competition within the insurance sector. On the contrary, longevity risk and reserve risks are considered to be stabilised while expense risk decreased compared with data from twelve months ago.

... for the next months

For the next twelve months the risks which are expected to increase more are those related to tax and pension reforms, regulatory and reporting changes, credit risk related to corporates and households, economic downturn, property risk and increased competition in the insurance sector. Conversely, sovereign, credit risks related to banks, premium, reserve and expense risks are expected to decrease slightly.

Based on observations over the last 12 months, Members were also asked to report their opinion on behavioural changes observed in their jurisdiction. The results are shown in Table 2.

Table 2: Behavioural changes observed in the insurance sector

Total number of replies is indicated in the last column.	Based on observations over the last 12 months in your jurisdiction, do you agree with the following statements?					
	agree	somew hat agree	somew hat disagree	disagree	no opinion	Total
Undertakings reduce their exposure towards sovereigns with higher credit spreads.	10	7	2	2	0	21
Undertakings increasingly substitute fixed income exposure for equity exposure.	1	6	4	11	0	22
Undertakings increasingly substitute corporate bonds for government bonds.	5	7	4	4	1	21
In reaction to the low-yield environment, undertakings increasingly engage in a search for yield behaviour.	0	10	4	3	5	22
Undertakings increasingly engage in asset classes which have been off limits in the past due to unavailable risk models (e.g. infrastructure investments, other alternative assets).	0	3	3	9	7	22
Undertakings increasingly provide direct credit to the real economy, e.g. via mortgage loans or financing of commercial real estate projects.	0	5	4	11	2	22
Undertakings increase the relative share of liquid investments while reducing the relative share of illiquid investments.	4	4	6	2	6	22
In reaction to low premium growth and reduced new business, undertakings currently have to cope with negative net cash flows which subsequently triggers asset sell-offs.	1	7	3	7	4	22
In acquiring new business, life undertakings increasingly offer products without guarantees.	6	4	2	5	5	22
In acquiring new business, life undertakings increasingly offer unit-linked products.	7	3	6	2	4	22
Credit insurers have been restrictive in prolonging existing business and/or writing new business.	3	5	1	2	10	21
Undertakings have increased their prices in non-life casualty business by a higher percentage than in previous years.	3	3	4	4	7	21
Undertakings increasingly make use of reinsurance and alternative risk transfer for hedging purposes.	2	4	6	3	7	22
Undertakings have reduced their strategic profit targets as compared to previous years.	1	5	3	0	11	20

4. Developments in the European reinsurance sector

GENERAL COMMENT

In terms of natural catastrophes the first nine months of 2012 were benign for the reinsurance industry. Therefore, the technical results of reinsurance companies have risen after one of the costliest disaster-loss years on record. Despite record low interest rates, investment results improved in many cases due to a better overall balance of write-ups and write-downs. Overall, the companies' total net profit including underwriting income jumped upwards too along with the technical results.

The catastrophe activity in the first nine months of 2012 allowed reinsurers to rebuild capital quickly and at half year of 2012 global reinsurance capital stood at a record USD 480bn representing a 5% increase when compared with 2011. Reinsurance demand is still subdued though. As a consequence, the observed modest premium rate increased in the first half year, which was mainly driven by marked premium increases in areas that had been hit hard last year. Therefore renewals reinsurance prices are expected to remain stable or to increase slightly in 2013. The reinsurance industry remains under pressure to achieve rate increases and to improve underwriting results in order to compensate for increasingly low investment returns due to the challenging economic environment. Against this background getting risk-adequate prices at the January 2013 renewals is crucial for the reinsurance companies.

MAJOR LOSS EVENTS IN THE FIRST 10 MONTHS OF 2012⁴

Following unusually low claims costs for natural catastrophes in the first nine months of 2012, a serious natural catastrophe occurred in the fourth quarter in the form of the exceptionally wide-ranging Hurricane Sandy. While overall losses for the first half year of 2012 amounted to USD 26bn, compared with a ten-year average of USD 75.6bn and a previous year record of USD 302bn for the corresponding period, the disaster gave rise to substantial insured losses of a still unquantifiable amount. Based on a provisional estimate, losses are anticipated to cost a staggering USD 52bn with as many as 200,000 claims for wind damage and 20,000 claims for flood damages filed by the consumer. Modelling firm Eqecat⁵ estimated insured losses between US 10bn and USD 20bn with total projected economic damages in the USD 30bn and USD 50bn range. A comparison with insured losses for the first six months in the region of USD 12bn shows the severity of this event. The ten-year average of USD 19.2bn also underlines Hurricane Sandy's extreme extent of damage. However, European reinsurers don't expect the storm to have a material impact on their financial results.

**85% of 2012
insured
losses in
America**

The first half year of 2012 differs from the corresponding previous period not only in terms of absolute values, but also in respect to the distribution of the losses to the different regions and perils. In 2011 economic and insured losses came mainly from Asia-Pacific and stemmed predominantly from geophysical events like earthquakes, which was quite untypical. This year the losses were dominated by extreme weather event losses in Amer-

⁴ See Munich Re: NatCatSERVICE.

⁵ See EQECAT, <http://www.eqecat.com/catwatch/post-landfall-loss-estimates-superstorm-sandy-released-2012-11-01/>

ica, especially in the USA. Some 61% of overall losses and 85% of world-wide insured losses were incurred in America, compared with a long-term annual average of 40% and 65% respectively (see Table 3).

Table 3: The five largest natural catastrophes from January - October 2012, ranked by insured losses

Date	Event	Region	Fatalities	Overall losses USD bn	Insured losses USD bn
22-31.10.2012	Hurricane Sandy	USA	More than 100	Up to 50	up to 20 ⁶
2-4.3.2012	Severe storm, tornadoes	USA	41	4.0	2.3
24-31.8.2012	Hurricane Isaac	USA	n.a.	n.a.	Up to 2 ⁷
28-19.4.2012	Severe storm, tornadoes	USA	1	2.0	1.0
13-15.4.2012	Severe storm, tornadoes	USA	6	1.8	0.9
25-30.5.2012	Severe storms, tornadoes	USA	0	1.6	0.85

Source: Munich Re, NatCatSERVICE; EQECAT. Hurricane Sandy is explicitly named because of the severity of the event.

Further catastrophe losses occurred in the third quarter of 2012.⁸ Most prominently was Hurricane Isaac which became the first land-falling hurricane along the US Gulf Coast region since 2008. The insured losses are estimated to reach USD 2bn. In addition, a number of typhoons and significant flood events were recorded in Asia causing overall losses in the double-digit billions of USD.

MARKET TRENDS⁹

Despite the heavy losses of 2011, broad-based "hard-market" premium rate increases are yet to be awaited. There were, of course, some marked increases in reinsurance prices in the regions and segments affected by losses, especially regarding the Asia-Pacific region. But overall, the rates have gone up only modestly, last but not least due to the extensive absence of major loss events in Europe and North America. In addition the modest increase in reinsurance prices appears to have peaked, largely because of excess supply due to the benign catastrophe activity in the first

⁶ See EQECAT, <http://www.eqecat.com/catwatch/post-landfall-loss-estimates-superstorm-sandy-released-2012-11-01/>

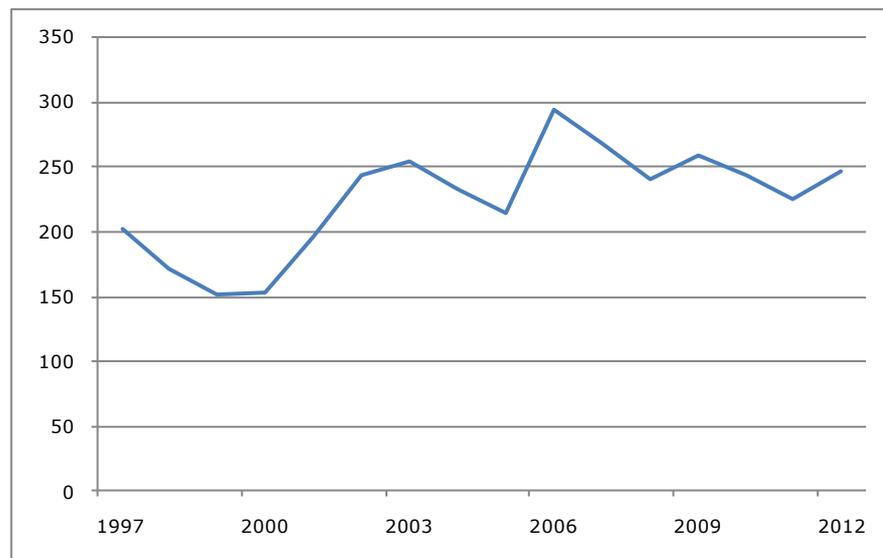
⁷ See AIR Worldwide, <http://www.air-worldwide.com/Press-Releases/AIR-Estimates-Insured-Losses-in-the-U-S--from-Hurricane-Isaac-of-between--USD-700-Million-and-USD-2-Billion/>

⁸ See AON Benfield: Global Catastrophe Recap July, August and September 2012.

⁹ See AON Benfield: Reinsurance Market Outlook September 2012.

nine months of 2012. It is to be seen whether Sandy will have an impact for the next renewal season of North American hurricane coverage.

Figure 22: Guy Carpenter Global Property Catastrophe Index (1990=100)



Source: Guy Carpenter

In the reinsurance market, it is all about the supply and demand of capacity. At the end of the first half of 2012 the reinsurer capital has reached a new all-time high of USD 480bn. This corresponds with an increase of 5 percent within the first half of 2012. Reinsurance supply remains higher than demand in all global regions.

Increased capital and capacity

The supply of reinsurance capacity has risen significantly over the twenty years since Hurricane Andrew in 1992. The ability of the insurance and reinsurance industry to raise capacity to sustain multiple events the size of Hurricane Andrew today is noteworthy. This is also highlighted by the heavy disasters of 2011, which led to a reinsurance capacity only three percent under the level of 2010.

There is also an enhanced capital-flow into the reinsurance market. Against the background of the on-going finance and debt crisis the diversifying nature of catastrophe-exposed business attracts investors who are searching for safe investments. Low corporate and sovereign debt yields are likely to continue to produce more capacity for catastrophe and other reinsured risks with a depressing effect on the rates.

Moreover, the reinsurance market has become increasingly property catastrophe-centric with its peak insured risk — US hurricane. Since the hurricane seasons in previous years were relatively harmless the demand for reinsurance in the US, where reinsurance demand far exceeds that of any other region, continues to be very sensitive to price. Only substantial losses caused by US hurricanes would result in a broader market turn.

The reinsurance market is largely US dollar denominated, last but not least due to the importance of US hurricanes. Against this background exchange rate movements could have a significant impact on reinsurance pricing. Due to the dramatic rise of the Japanese Yen perils like Japanese typhoon or earthquake have a less diversifying effect for reinsurers than they have been in the past. Bearing that in mind the considerable rate increases in Asia-Pacific appear in a different light.

The reinsurance demand is still subdued

Whereas the reinsurance capacity continues to increase the reinsurance demand is still subdued. As a long-term trend insurers tend to raise the retention as insurers have increased their risk management. Furthermore, the competitive markets as well as low investment returns force the insurers to be increasingly price sensitive, whereas the insurers' capital basis rose along with the reinsurers' due to the benign catastrophe activity in 2012 so far. Especially the demand for reinsurance for non-catastrophe perils continues to decrease as the loss frequency declined. The need to transfer risk that seems to not be occurring decreased. As a consequence the reinsurance prices continue to be subdued.

Only slight price increases at the beginning of 2013

Altogether, there is an expectation that supply of reinsurance capacity will continue to exceed the demand of insurers for upcoming January 2013 renewals in most global regions resulting in a stable or slightly increasing reinsurance price level. For that reason reinsurers' profitability will remain under pressure, because they have to improve underwriting results in order to compensate increasingly low investment returns due to the challenging economic environment (euro-zone crisis, uncertainties in the capital markets, sustained low interest rates). Moreover, the ability to release reserve from previous years appears to have been diminished.¹⁰ Against this background getting risk-adequate prices at the January 2013 renewal is crucial for the reinsurance companies.

INSURANCE LINKED SECURITIES

Increased activity and resilience of ILS market

The increased capital-flow into the reinsurance market can also be observed by looking on the Insurance-Linked Securities (ILS) market. The market reached its highest levels for both new issuance and outstanding volumes in four years.

Given the first total loss of three ILS within the year 2011 the increased issuance volume is astonishing. The primary issuance of catastrophe bonds and life-risk securitisations totalled to USD 4.3bn within the first nine months of 2012, more than the full year total of USD 4.28bn in 2011.¹¹ Thus the ILS market has clearly demonstrated its resilience. Total bonds on risk as of 30 June 2012, finished at USD 14.9bn compared to USD 11.5bn at half year 2011.¹²

US hurricane risk continued to dominate the market, comprising over 50 percent of natural catastrophe issuance. US earthquake risk and Europe windstorm risk accounted each for approximately 20 percent. Life and health issuance represents only 5 percent of all issuance activity.¹³ A novelty in the first half of 2012 was the first catastrophe bond combining the risk of two reinsured parties into a single transaction. Through Combine Re, Swiss Re securitized USD 200m of risk based on the aggregate ultimate net loss of the two reinsured parties (Country Mutual Insurance Company and North Carolina Farm Bureau Mutual Insurance Company)

¹⁰ See Standard & Poor's: "Breaking Out Of The Holding Pattern: Which Way Now For Global Reinsurance?"

<http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245340108431#ContactInfo>.

¹¹ See Artemis: <http://www.artemis.bm/blog/2012/10/09/2012-a-remarkable-year-for-catastrophe-bonds-a-m-best/>.

¹² See AON Benfield: Reinsurance Market Outlook September 2012, Page 12.

¹³ See AON Benfield: Reinsurance Market Outlook September 2012, Page 13.

**Demand for
CAT bond
will remain
strong**

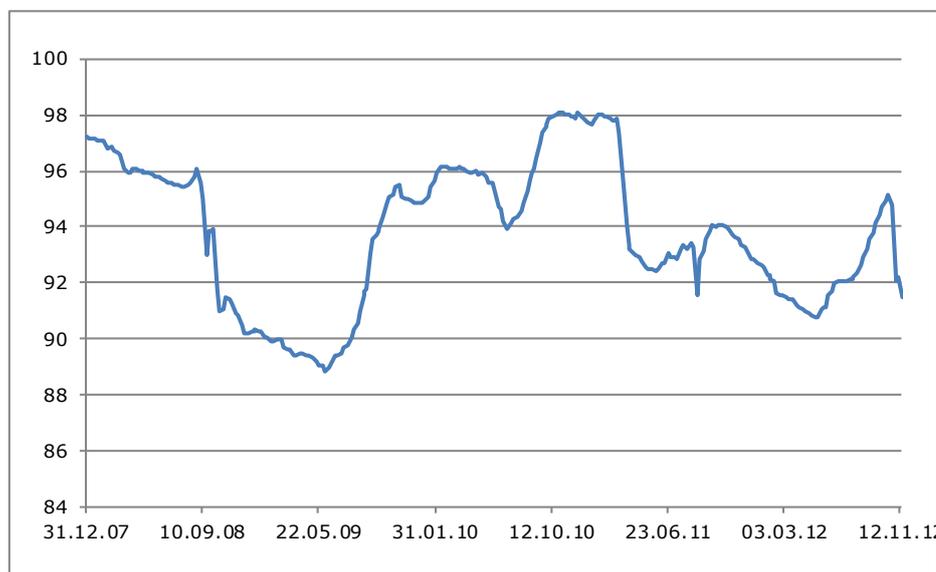
from the US perils of severe thunderstorm, hurricane, and earthquake and winter storm.¹⁴ In another transaction, Swiss Re for the first time combined life risks and non-life risks in one transaction: Mythen Re, which came to the market in October with a volume of USD 115m, covers US hurricane risks and the risk of extreme mortality in the United Kingdom.¹⁵

Due to the persistent low interest rate environment and the uncertainties in the capital markets investors' demand for catastrophe bonds will remain strong, which will depress the bonds' interests. This will raise the attractiveness of ILS further for sponsors both new and repeat sponsors, which are expected to issue into the ILS market for diversification and to complement overall reinsurance purchases. Thus the conditions are positive for annual primary ILS issuance to reach USD 7.0bn this year.

Although the ILS market is a niche in comparison with the overall securities market and small in comparison with the overall reinsurance market, it is of significant size in comparison with the property-catastrophe reinsurance market. Munich Re estimates that the ILS market amounts to 4% of the overall reinsurance market, whereas Guy Carpenter reckons the proportion of the ILS market to the property-catastrophe reinsurance market to be nearly 15%.¹⁶

Hurricane Sandy had a significant impact on the catastrophe bond market: Although no confirmation on defaults following this event is available at the time of writing, two deals have been placed on credit watch negative by a rating agency. Further, most deals with an exposure towards US hurricane risk have experienced lower market prices which can be clearly be identified in the downturn of the Swiss Re Cat Bond Price Index.

Figure 23: Swiss Re Cat Bond Index (Price Index) (2002=100)



Source: Bloomberg

¹⁴ See Swiss Re: News release 26 March 2012.

¹⁵ See Artemis: <http://www.artemis.bm/blog/2012/10/29/mythen-re-cat-bond-gets-its-preliminary-ratings-from-sp/>

¹⁶ See Munich Re: Topics Magazine 2/2012, Page 25.

See Artemis: <http://www.artemis.bm/blog/2012/09/10/the-reinsurance-market-has-converged-guy-carpenter/>.

COMPANY INFORMATION¹⁷

The following section presents the performance of selected European reinsurers in the third quarter of 2012.

Munich Re

The world's biggest reinsurer **Munich Re** concluded the first three quarters in 2012 with a net profit of EUR 1,434m. This is roughly 40% higher when compared with the same period in 2011. The combined ratio dropped further to 93.6% for the first nine months of the year and 89.4% for the third quarter. The investment result improved to EUR 1,646m for January to September compared to EUR 590m for July to September. The increase is mainly attributable to higher capital gains on the restructuring of fixed-interest securities and on the disposal of equities. The operating result also improved to EUR 2,395m for the first nine months of the year and EUR 1,031m for the third quarter. Overall, the gross written premiums (GWP) including the primary insurance increased in the first three quarters from EUR 12,217m in 2011 to EUR 13,236m in 2012.

Swiss Re

The group net income of the world's second biggest reinsurer **Swiss Re** improved by 62% to USD 2,182m (USD 1,348m in three quarters in 2011). The combined ratio improved to 69.3% from 81.5% in the same period in 2011. This improvement was largely driven by the very benign natural catastrophe experience in the third quarter of 2012, as well as by favourable claims development from prior accident years, and due to lower claims and administrative expenses. The GWP increased by 11% to USD 6,388m in the first three quarters 2012 when compared with the same period in 2011.

Hannover Re

The group net income of **Hannover Re** grew from EUR 381.7m in the first three quarters of 2011 to EUR 670.8m by 13.6%. The major loss situation was in the first three quarters very moderate and below the loss expectancy resulting in a further improved Combined Ratio of 96.5% (105%) for the non-life reinsurance segment. The group's investment income rose to EUR 1,208.8m (EUR 950.8m), while the operating profit (EBIT) increased significantly to EUR 1,016.8m (EUR 490.8m). The GWP also rose by 13.6% to EUR 10.296.

SCOR

French biggest reinsurer **SCOR** concluded the first half-year 2012 with a consolidated net income of EUR 206m, compared to EUR 40m at half year 2011. However the comparison with the previous year is given to misunderstanding since the 2011 figures do not include Transamerica Re, which was acquired in August 2011. Again, the non-life reinsurance segment incurred only moderate losses due to a catastrophe activity below average. The CR improved considerably from 113.1% in the previous year to 93.8% in 2012. The total investment income showed a year-on-year deterioration of 14.5% to EUR 306m. The GWP increased appreciably by 36.3% to EUR 4.6bn due to the acquisition of Transamerica Re.

Lloyd's

After the costliest year for natural disasters in its long history, the insurance market **Lloyd's** of London showed a swung to a pre-tax profit of EUR

¹⁷ Data from published annual and interim reports. Please note that Q3 data for the above mentioned reinsurance companies was not fully available at the time of report publishing.

1,897m (EUR -774m at half year 2011) for the six-month period ending 30 June 2012. Lloyd's incurred total net claims dropped nearly by a third to EUR 5,592m. As a consequence the CR strengthened significantly from 113.3% at half year 2011 to 88.6% in 2012. Despite record low interest rates, Lloyd's investment return rose 13% to EUR 755m.

5. Developments in the European occupational pension fund sector

This section highlights the main developments that occurred in the European occupational pension fund sector, based on feedback provided by EIOPA Members. Not all EU countries are covered, in some of them IORPs (i.e. occupational pension funds falling under the scope of the EU IORPs Directive) are still non-existent or are just starting to be established (e.g. CZ, HU, MT and RO). Furthermore, in other countries such as DK, FI, and FR the main part of occupational retirement provisions is treated as a line of insurance business respectively held by life insurers, and is therefore also not covered in this section. The country coverage in this section is 67% (20 out of 30 countries)¹⁸.

Data sources

Please note that data collected for 2010-2011 was provided to EIOPA with an approximate view of the financial position of occupational pension funds during 2011. Data is not definite and is subject to revisions. Therefore, this chapter should not be read as a definite summary of the current conditions but more as an indicator of the situation.

All following graphs will use the country order by total assets of occupational pension funds as displayed in figure 24.

RECENT DEVELOPMENTS – MAJOR POLICY REFORMS

The entire occupational pensions sector in Europe is experiencing a large number of regulatory changes. Recent highlights include NL having introduced a new regulatory framework which has been under discussion with the social partners in the summer of 2012. The government aims to send the new framework to the parliament for approval in 2013.

In the last months of 2011, and as a result of the financial crisis, a comprehensive package of measures has been decided by the new IT government. The main aim was to lower the cost of borrowing and to restore public finances. Changes were focused on to the extension of the notional defined contribution (NDC) system to all the workers, as well as changes to retirement age linked to higher life expectancy.

In AT a new regulation was introduced that defines more frequent reporting requirements for occupational pension funds. As of 2012, funds would be required to report breakdown of their portfolios by asset classes in a quarterly frequency.

The UK has introduced legislation in which employers have legal duties to automatically enrol certain workers into a qualifying workplace pension scheme and make contributions towards it. These duties are being staged in over six years, starting with large employers in October 2012.

Several reforms and related initiatives have also been reported by BG, ES, IS, LV, NO, PL, RO and SE, SI.

¹⁸ AT, BE, BG, DE, EE, ES, GR, HU, IS, IT, LU, LV, NL, NO, PL, PT, SE, SI, SK, UK.

STRUCTURAL DEVELOPMENTS – ASSETS AND CONTRIBUTIONS

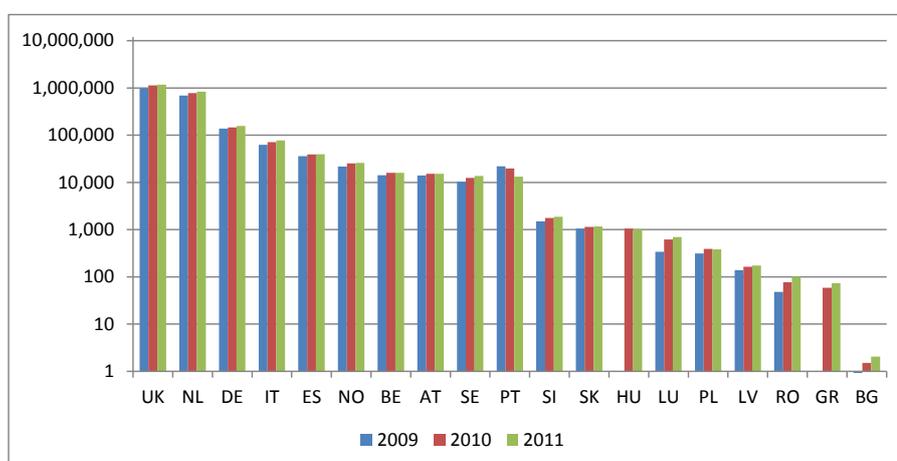
ACCUMULATED ASSETS

Total assets

Measured by absolute size, the European occupational pension fund sector is very concentrated around the UK and NL which together are making up for the vast majority of the overall assets. This has not changed significantly since the previous reports (Figure 24).

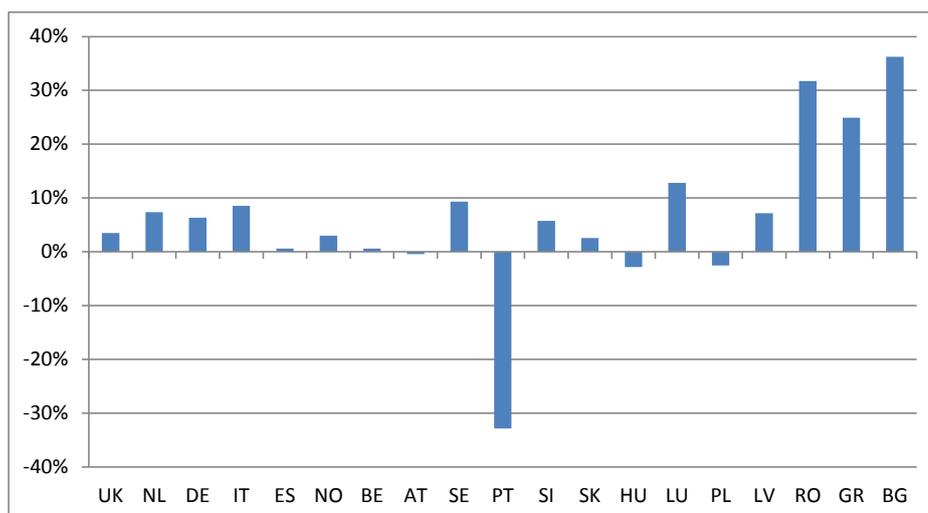
However, from 2010 to 2011, asset levels have experienced significant changes in many countries. Out of 19 respondents, 14 reported that total assets held by occupational pension funds have significantly increased since 2010 (average increase of +11.2%). AT, HU and PL reported minor decreases (<3%) whereas in PT has seen a significant drop due to the transfer of responsibilities from private pension funds to Social Security (Figure 25).

Figure 24: Total occupational pension assets (in EUR million, logarithmic scale)



Note: For the UK figures relate to DB schemes only.

Figure 25: Total occupational pension assets – All schemes - 2010-2011 (% difference)



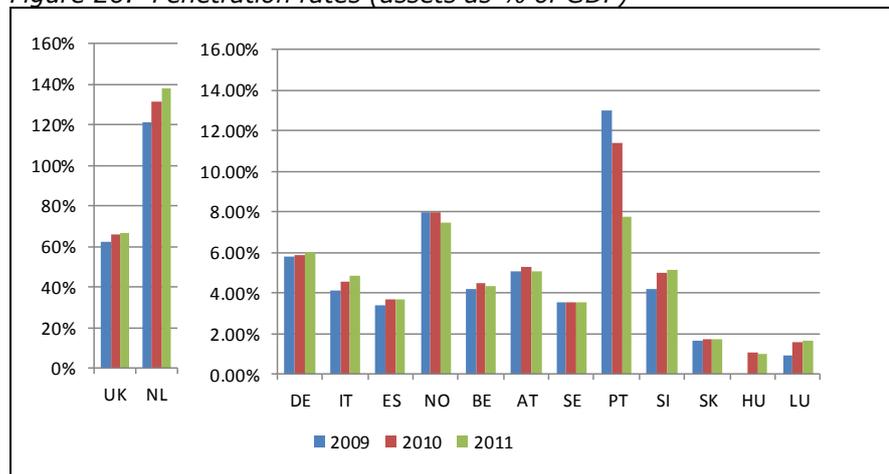
Note: For the UK figures relate to DB schemes only.

Source: EIOPA

Penetration highest in UK, NL

The penetration rate being the total size of assets as a percentage of GDP gives an indication of the relative wealth accumulated by sector. Figure 26 shows that for the 14 countries covered here, penetration rates have mostly remained at the same levels between 2010 and 2011. More specifically except for the cases of NL (+6.5 percentage points) and PT (-3.7 percentage points, mainly influenced by the abovementioned transfer of responsibilities to Social Security) changes in all of the other countries were within the range of -1 to +1 percentage points.

Figure 26: Penetration rates (assets as % of GDP)



Note: For LV, PL, RO, BG and GR figures are less than 1%. For the UK figures relate to DB schemes only.
Source: EIOPA

The size of occupational pension funds is related to their time of operation as well as to the coverage of the labour force. Countries such as the UK and NL have a long history of occupational pension provision and relatively low public pension replacement rates. This is why total assets are representing a very high portion of GDP.

In other countries, occupational pension funds are a rather new concept since the pension sector is dominated by traditional public pension funds or direct benefits by employers. Some of these countries have been placing reforms in order to have more occupational pension funds in the future but volumes still remain very small compared to NL and the UK.

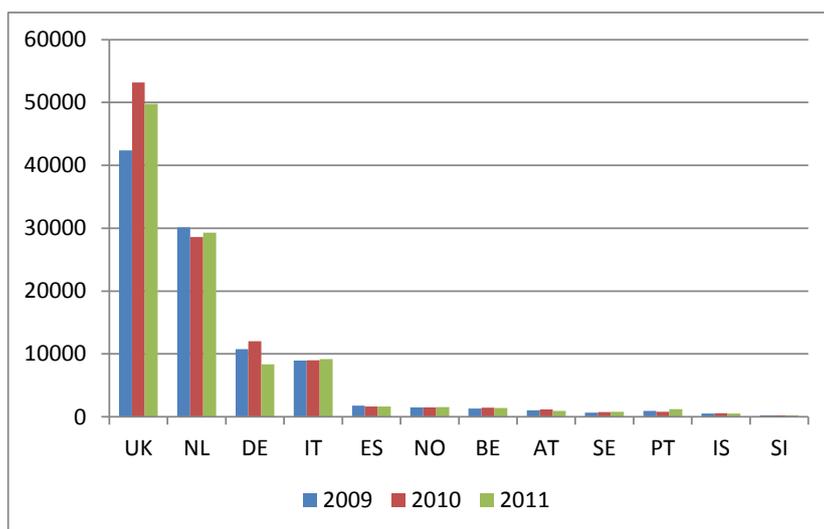
CONTRIBUTIONS RECEIVED

Mixed picture on development of contributions

The main source of funding for pension schemes results from the contributions payable by both employers and members. Figure 27 shows the total estimated absolute contributions for 2009 to 2011. Percentage changes in gross contributions are depicted in Figure 28.

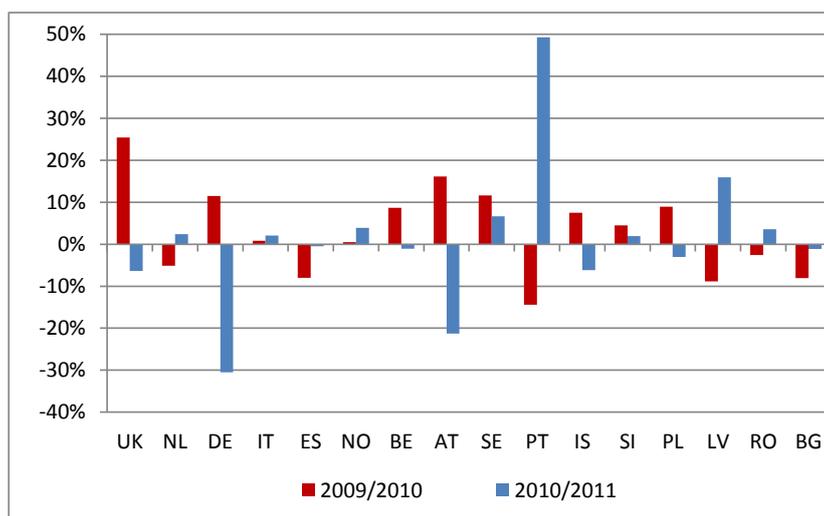
Countries that have seen falling contribution in 2011 are AT, DE, UK, BE, IS, PL and BG. Increases are observed in NL, IT, NO, SE, PT (mainly justified by the funding of pension funds transferred to Social Security, whose responsibilities were recalculated), SI, LV and RO.

Figure 27: Gross contributions 2009-2011 (in Million EUR)



(Note: For LV, SK, HU, LU, PL, RO, BG, and GR figures are below 200 million for 2011)
Source: EIOPA

Figure 28: Percentage change in contributions for the years: 2009-2010 and 2010-2011

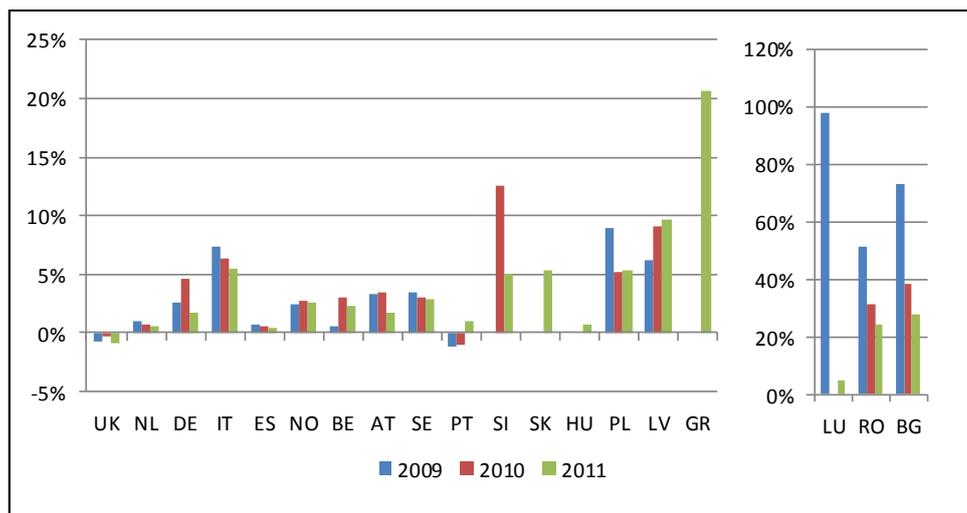


(Note: For HU, LU and GR data is not available for 2009 and 2010. Movements in DE in 2009 are due to a shift from a few large industrial companies to IORP schemes. In 2010 similar shifts turned out to be smaller).
Source: EIOPA

Net cash flows declined in 2011

Occupational pension schemes in Europe experienced a relative growth measured as net cash flow over total assets (Figure 29). However, as one can see by the figure for most of the countries, a declining trend can be clearly observed for 2011.

Figure 29: Net cash flows over total assets 2009-2011



(Note: For the UK, the figures could not be computed exactly as contributions and assets were not available on the same base, however, net cash flows over total assets are slightly negative there for the entire market including DB and DC.)

Source: EIOPA

DEFINED BENEFIT VS. DEFINED CONTRIBUTION SCHEMES

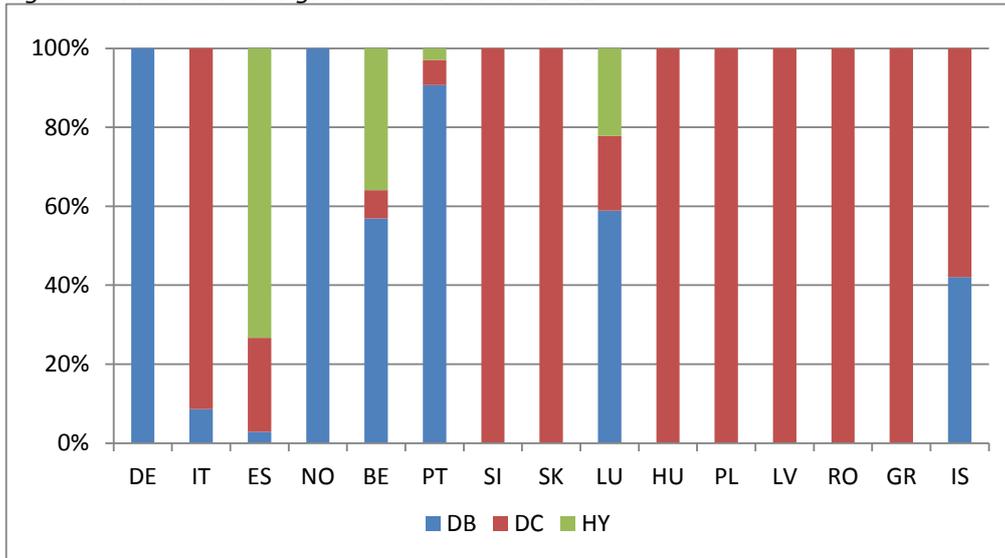
DB schemes still dominating in larger markets

Figure 30 demonstrates the allocation of contributions against DB, DC or Hybrid schemes for 2011. In the majority of the countries with large occupational pension sectors, DB schemes still dominate the occupational pension’s landscape.

For most of the countries, asset allocation by pension funds has not significantly changed compared to 2010. The strategy of the funds is characterised by many members as very conservative where the biggest part of the assets is invested in fixed-income securities (BG, DE, HU, IS, IT, NL, NO). In ES, pension funds are increasing their positions in Spanish debt mostly due to its high yield. In 2012 Spanish public debt is expected to represent approximately 35% of the total assets. In the NL, most of the pension funds have also changed their investments to home government debt which is considered safer.

In some countries a shift away from traditional DB schemes has already started or is expected to start as sponsors are increasingly choosing to replace these and share a number of the risks with members or to set up DC plans instead. This trend started in many countries two years ago and is continuing also in 2012. In the smaller IORP markets in CEE, DC schemes are the most common.

Figure 30: Allocation of gross contributions 2011



Source: EIOPA

Note: UK would be 100% DB as DC or HY figures were not reported.

Moving from DB to DC will reduce the vulnerability of sponsors and the pension fund sector as a whole to funding risks that are traditionally related to DB plans. On the other hand the shift to DC plans moves the risk more to the individual members.

IORP MEMBERSHIP

In general across Europe, EIOPA see the membership of IORPs as relatively stable.

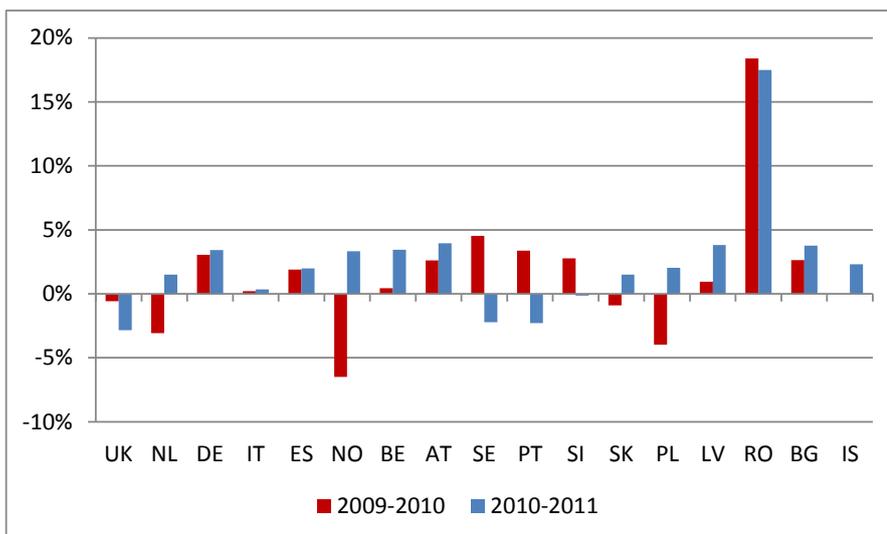
Figure 31 shows the change in membership numbers from 2009 to 2011 where a small upward trend can be seen. For the periods 2009/2010 and 2010/2011, the average growth in the membership rates among the respondents was 1.6% and 2.4% respectively.

According to a few respondents membership rates are mostly affected by normal labour market dynamics, such as unemployment, shifts from wage-employment to self-employment, and wage growth. In one case the supervisor observed the move of customers to small but highly specialised pension funds.

Finally, a consolidation process of the occupational pension fund sector is underway. Some countries have reported a declining number of IORPs. Other countries experienced IORPs closures and mergers in the past two years (NL and NO).

Membership of IORPs continues to grow

Figure 31: Percentage change in membership levels 2009 – 2011



(Note: For GR, HU and LU data was not available. UK figures only relate to trust-based occupational pension schemes).

Source: EIOPA

FINANCIAL DEVELOPMENTS – FUNDING LEVELS, ASSET ALLOCATION AND RETURNS

AVERAGE FUNDING LEVELS

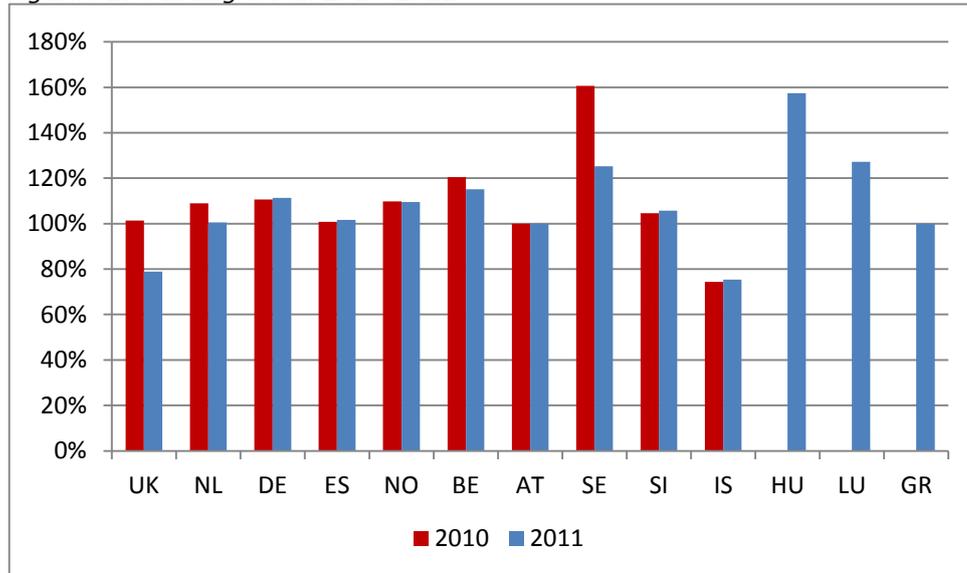
Funding levels in key markets fell below 100%

The recent low yields in a number of European countries, have put significant pressure on DB liabilities valued to market and as a result funding levels have suffered in the past months. Average cover ratios in NL, SE and UK are estimated to have fallen significantly in 2011.

A number of respondents (LV, NL, NO, SE) reported that various evaluation studies, scenario analysis and stress-testing have been performed in order to closely monitor the effects of the low-yield environment.

In practice, since Member States use different methods and assumptions to determine inputs into the funding levels, i.e. caution is required when making comparisons across countries and different kinds of pension schemes (DC with guarantees and DB schemes). See Figure 32.

Figure 32: Funding levels 2010-2011



Source: EIOPA

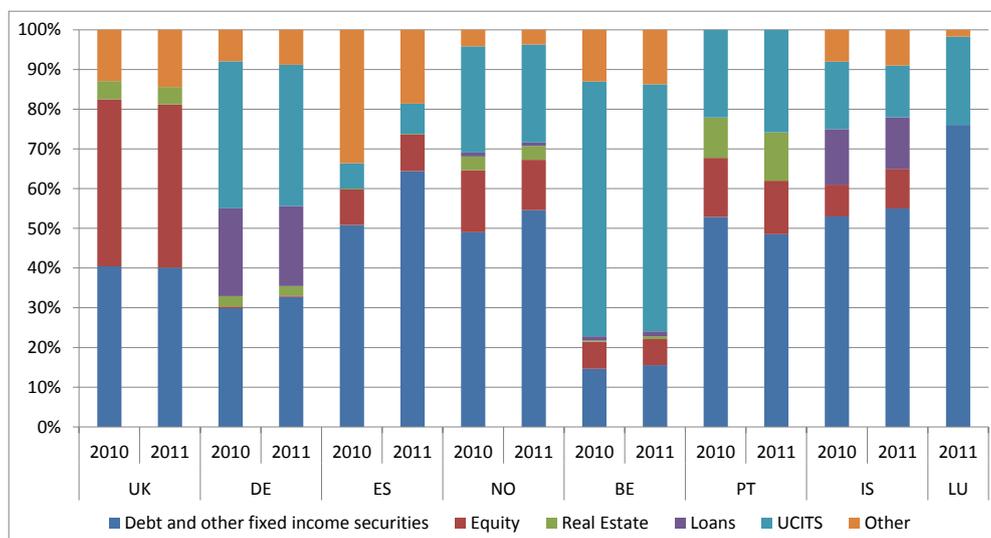
In situations where funding levels fall below 100%, national supervisors' recovery plans have come into action in order to get the levels back up. For instance in NL pension funds were allowed one or two additional years to reach the target of a funding ratio of at least 105%. This 2-year period has been used by most of the funds and it is not planned to be prolonged. As a consequence, several funds may have to cut pension benefits next year but these cuts will be spread over multiple years.

ASSET ALLOCATION

Dominance of debt and fixed income in DB

Figure 33 to Figure 35 show the aggregate asset allocations across countries for 2010 and 2011 for DB, DC and Hybrid schemes separately. Figure 33 indicates that asset allocation strategies for DB schemes have been relatively stable in recent years in each of the different countries. Debt and fixed income investments remain the dominating asset class in most countries.

Figure 33: Asset allocations for DB 2010-2011

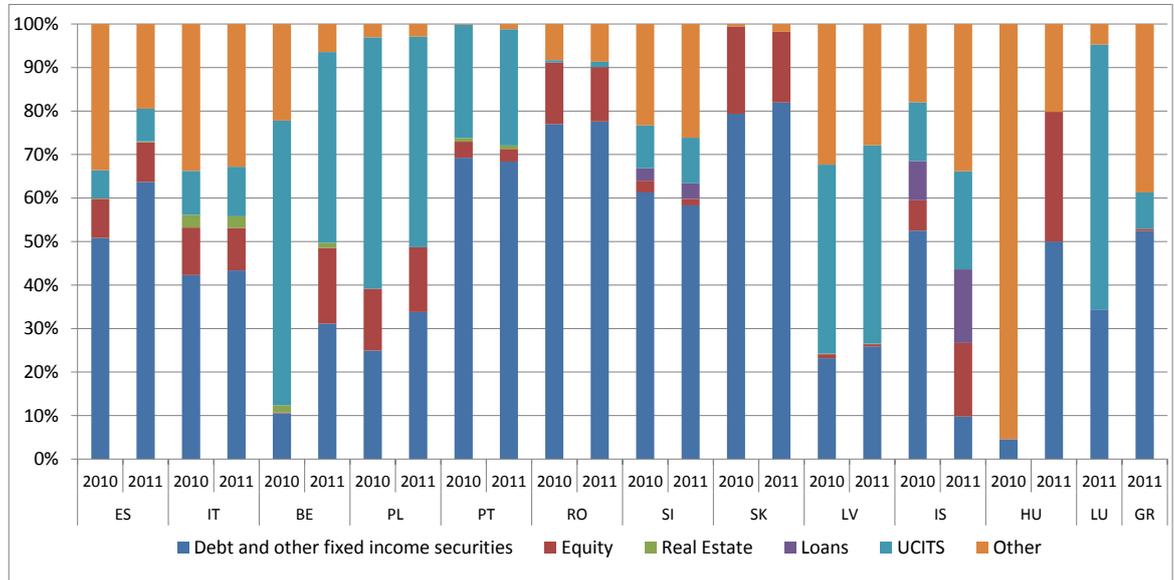


Source: EIOPA

...and DC...

For DC schemes there is a significant variety in the preferred asset allocations. In ES, IT, PT, RO, SI and SK there is a very heavy bias towards debt and fixed income securities. In some cases, equity exposures seem to have increased rather than declined in a number of countries in recent years.

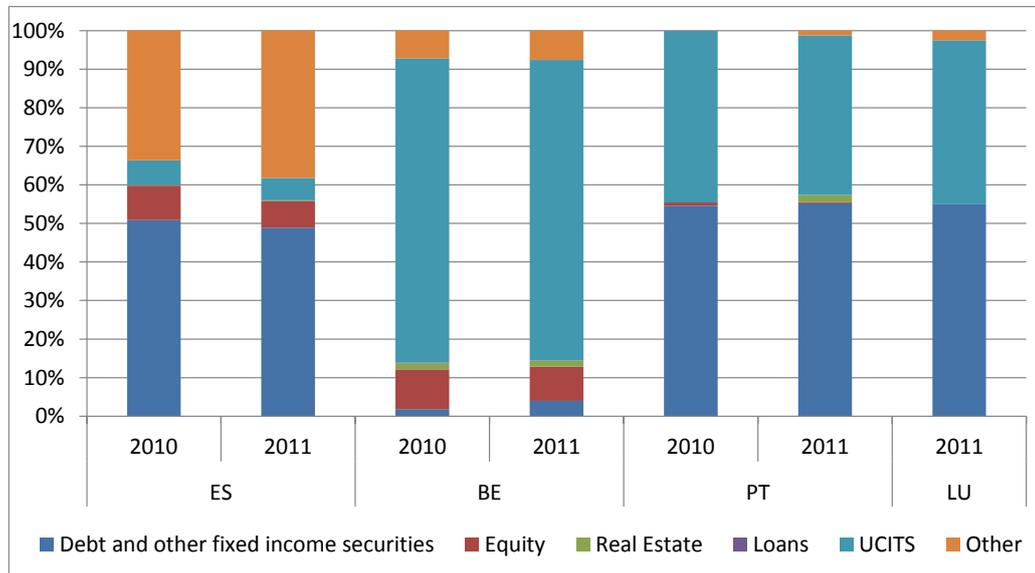
Figure 34: Asset allocations for DC 2010-2011



(Note: For GR and LU data was not available for 2010).

Source: EIOPA

Figure 35: Asset allocations for Hybrid 2010-2011



(Note: For ES "Other" includes insured technical provisions).

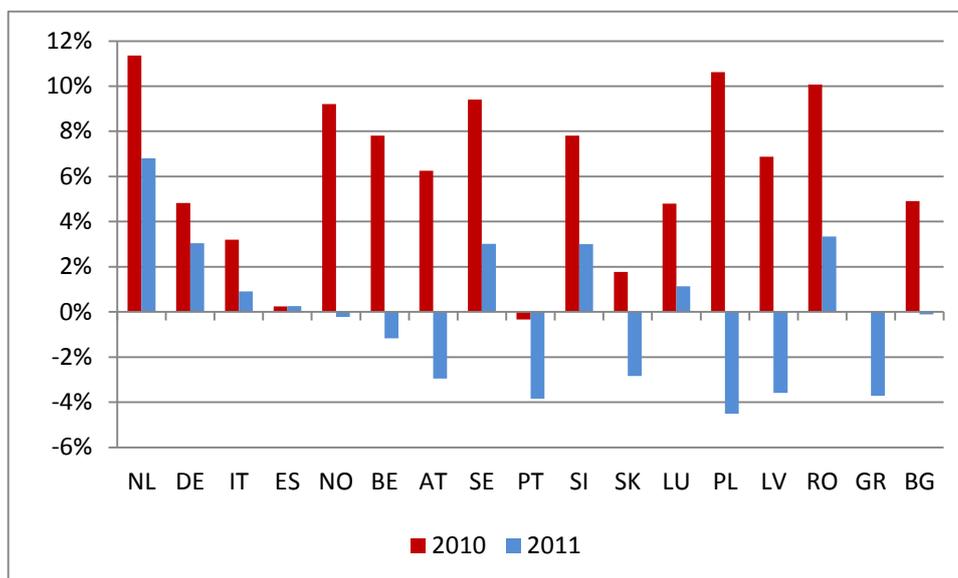
Source: EIOPA

ASSET RETURNS

Negative asset returns in 2011 ...but in 2012 some recovery is taking place

Figure 36 gives an estimate of the rate of return on assets for all schemes from 2010-2011. After the decline of the financial markets in August 2011, investment returns for that year have been particularly low. Increased market volatility, low yields and increased uncertainty are some of the reasons that justify this performance.

Figure 36: Percentage return on assets 2010 – 2011



Source: EIOPA

With the relative increase of the markets during 2012, BG, IT, NL and NO have reported that the value of assets held by OPFs has partly recovered.

In many countries, institutions are very cautious towards investment activities mainly due to low confidence levels in some countries. The volatility of the markets has also a direct impact on investments.

SUPERVISORY RISK ASSESSMENT FOR THE OCCUPATIONAL PENSION FUND SECTOR

EIOPA Members and Observers have been asked to assess risks and challenges according to the probability of a materialisation and the impact on the national occupational pension funds sector. Based on the responses from 17 national supervisory authorities¹⁹, the following risks and challenges are classified as the most important.

Main risks are interest rate and equity risks

Interest rate (due to prolonged period of low interest rates) and equity risks are the ones with the highest overall ranking. Given the on-going review process on the IORP Regulation, the risk factors connected to regulatory and reporting changes and tax and pension reforms are also reported to be significant (see Table 4).

¹⁹ AT, BG, DE, ES, GR, IT, LU, LV, NL, NO, PL, PT, RO, SE, SI, SK, UK.

Table 4: Classification of the most imminent risks for the occupational pension fund sector

PENSION FUNDS (based on 17 replies)	Average probability of risk	Average impact of risk	Development over the last 12 months	Expected development over the next 12 months
	1 = low 2 = medium-low 3 = medium-high 4 = high	1 = low 2 = medium-low 3 = medium-high 4 = high	-2 = cons. decrease +2 = cons. increase	-2 = cons. decrease +2 = cons. increase
Interest rate risk 1 - prolonged period of low interest rates	2,9	2,9	0,4	0,1
Equity risk	2,9	3,0	0,4	0,3
Regulatory & reporting changes	2,8	2,8	0,5	0,8
Tax and pension reforms	2,8	3,3	0,4	1,0
Longevity risk	2,5	2,6	-0,2	0,0
Credit risk 2 - Sovereigns	2,5	2,8	0,0	-0,3
Economic downturn	2,4	2,6	0,4	0,1
Credit risk 1 - Corporates and private households	2,4	2,3	0,4	0,3
Property risk	2,3	1,5	0,4	0,3
Credit risk 3 - Banks	2,3	2,8	0,0	-0,2
Currency risk	2,1	1,5	0,2	0,4
Interest rate risk 2 - sharp increase with a resulting fall in bond prices	1,9	2,8	-0,1	0,1
Consumer confidence	1,9	2,3	-0,2	0,3
Inflation	1,5	2,2	0,4	0,4
Internal control	1,4	2,0	0,2	0,2
Social changes	1,3	2,2	0,2	0,4

Note: where the average probability of risk is more than 2 (i.e. medium-low) the risk is reported. Where average probability is below 2 but the average impact is more than 2 the risk is also reported.

Source: EIOPA

Based on observations over the last 12 months, Members were also asked to report their opinion on behavioural changes observed in their jurisdiction. The results are shown in Table 5.

Table 5: Behavioural changes observed in the pension sector

PENSION FUNDS (based on 17 replies)	Based on observations over the last 12 months in your jurisdiction, do you agree with the following statements?					
	agree	somew hat agree	somew hat disagree	disagree	no opinion	Total
Undertakings reduce their exposure towards sovereigns with higher credit spreads.	5	5	1	3	3	17
Undertakings increasingly substitute equity exposure with fixed income exposure.	3	5	3	5	1	17
In reaction to the low-yield environment, undertakings increasingly engage in a search for yield behaviour.	2	5	2	1	7	17
Undertakings increase the relative share of liquid investments while reducing the relative share of illiquid investments.	3	6	3	0	5	17

MARKET AND CREDIT RISKS: ADDITIONAL FINDINGS

Low interest rates

The data reported in the table above is supported by the main findings of the qualitative assessment. Many members are concerned about the potential effects of an extended low interest rate period. AT, LV, NL, NO and SE reported that evaluation studies have been performed. These mainly involve extended stress testing and scenario analysis.

In some countries such an evaluation is not taking place due to the fact that they are either not affected (pension system is mainly based on DC schemes) or there is simply no legislation in place (BG, EE, ES, HU, PL, SI, SK).

Rate down-grades

According to existing legislation rating downgrades are not affecting the eligibility of sovereign debt in BG, DE, HU, LV, NL and PT. DE is still accepting low rated bonds as long as they are guaranteed by the ESM (until end of 2013). In ES there is a legal framework but it is not binding to be applied. For the remaining members, exposure to such investments is very small and hence not significant anymore (NO, SE, SI, SK).

Credit Risk

Most of the respondents characterised credit risk to corporate bonds as acceptable.

Members described the exposure of credit risk to covered bonds as low and moderate. In NO and SE exposures to covered bonds are relatively high but the portfolios are of prime quality (currently rated as AAA).

Securitisation exposure is very low among the members. In most of the cases volumes are an insignificant part of the OPFs' portfolios. None of the respondents mentioned any increased credit risk coming from investments in such securities.

Contagion risk

Most of the respondents see as a main risk for the sector, contagion coming from other financial sectors such as banks. The increasing need of financing by the banks can potentially lead to interconnections between banks and occupational pension funds. Increased attention should be therefore given to pension funds having a high buffer capital in order to be able to handle risks in their portfolios.

In addition to that, another important issue stressed by a few respondents including ES and IT was the need for increased financial education. Members need to be aware of the suitability of investment products and the risks attached to them. The quality of pre-contractual information has to be improved and the selling practices of these products need to be further reviewed.

Annex 1: Country abbreviations

AT	Austria
BE	Belgium
BG	Bulgaria
CY	Cyprus
CZ	Czech Republic
DE	Germany
DK	Denmark
EE	Estonia
ES	Spain
FI	Finland
FR	France
GR	Greece
HU	Hungary
HR	Croatia
IE	Ireland
IS	Iceland
IT	Italy
LI	Liechtenstein
LT	Lithuania
LU	Luxembourg
LV	Latvia
MT	Malta
NL	Netherlands
NO	Norway
PL	Poland
PT	Portugal
RO	Romania
SE	Sweden
SI	Slovenia
SK	Slovakia
UK	United Kingdom
CH	Switzerland