RESEARCH:

EUROPEAN INSURANCE INDUSTRY: CHALLENGES AHEAD FOR 2022

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KEY CONSIDERATIONS

- ✓ Challenges to the European Insurance sector are largely related to persistent low interest rate scenario and high inflation. After more than 18 months from the start of the Covid pandemic, the global macroeconomic environment is still under pressure and uncertainty about the recovery remains very high. In addition, the implementation of IFRS 17 adds pressure to companies on IT and operational set up to comply with the regulatory deadline of 2023.

- ✓ Environmental, Social and Governance (ESG) factors are increasingly becoming the main driver for investment decisions for EU insurers, specifically Climate risk as a key point affecting underwriting strategies. Natural disasters recorded in 2020 generated losses higher than in previous years, and extreme weather events are becoming much more common adding significant pressure on non-life insurers.

- ✓ Digitalization and innovation, that were not previously a driving force to improve customers' experience and retention, have now become a must to allow insurers to get closer to customers and be able to provide customized insurance solutions. Insurers are now facing the challenges of redefining their strategies to adjust to new customers' demands in service and product offering, topics that before the Covid pandemic were not considered a priority.

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I. PRESSURE ON PROFITABILITY: LOW INTEREST RATES, HIGHER INFLATION AND IFRS 17

The European Insurance industry faces the challenge of achieving positive investment profitability balancing a scenario of persistently low interest rates and higher inflation

The European insurance industry faces the bottom-line challenge of achieving positive investment profitability under a scenario of persistent low interest rates and high inflation. After more than 18 months from the start of the Covid pandemic, the global macroeconomic environment is still under pressure and the uncertainty about the recovery is still very high. However, the increase in prices coming from a strong demand for goods and disruptions in the supply chain has caused increase in costs leading to higher inflation in most of the countries that are already starting to recover GDP growth.

This could affect the ability of insurance companies to improve investment profitability under a persistently low interest scenario, as well as an increase in costs from all aspects of the supply chain, starting from labour costs up to regulatory costs related to the introduction of International Financial Reporting Standard 17 (IFRS 17)[1], the new standard for accounting insurance contracts. Aside from IFRS not becoming effective until January 2023, companies are already setting up all operational changes to be able to comply accordingly. It is worth mentioning that IFRS 17 is mainly related to a comprehensive accounting for insurance contracts. The main aspects covered by IFRS 17 are:

- Recognition of profit over the period that services are provided under the insurance contract.
- Detail of insurance service results (including presentation of insurance revenue) separately from insurance finance income or expenses.
- Decision to be taken for accounting policy between (i) Recognising all insurance finance income or expenses in P&L or (ii) Recognising some of that income or expense in other comprehensive income.

For 2022 the insurance industry is expected to continue to face a persistent low interest rate environment, with most of EU member states government bond yields being negative for a significant set of maturities.

In addition, uncertainty related to the successful implementation of the vaccination campaign across EU countries, as well as the possibility of a prolonged scenario of Covid related restrictions, pose material difficulties to insurance companies, in particular life insurers, to plan for steady medium-term growth and therefore add pressure to solvency positions, to keep capital available in case of need.

[1] IFRS 17: https://www.ifrs.org/issued-standards/list-of-standards/ifrs-17-insurance-contracts/

II. CLIMATE CHANGE RISK: DRIVER FOR UPDATES IN UNDERWRITING STRATEGIES

Economic losses due to natural disasters reached an estimated EUR 223Bn in 2020, of which only 36% was covered by insurance. The so called 'protection gap' is a concern for governments and regulators, both now pushing for the development of insurance products that cover climate change related risks

In 2020, economic losses from natural disasters were estimated at EUR 223bn, of which only 36% (EUR 81bn) were insured. The EU Commission is encouraging the industry towards a better awareness and use of insurance protection for climate related risks. The EU Strategy on Adaptation to Climate Change published in February 2021 outlines the long-term vision of the EU to adapt to the impacts of climate change and become climate resilient by 2050.

The strategy adopted by the EU relies on the ability of the insurance industry to become a key player in the development of climate-related insurance tools, helping economies and *the population to reduce the potential of large economic losses that could result from natural disasters. The emphasis on the development of adequate insurance products to cover climate change related risks follows the need to avoid unnecessary economic burden for governments and individual citizens when facing natural disasters. It is well known that insurance coverage allows those affected to recover their activities.

However, the current challenge for the EU is the existing 'protection gap' between member states. Based on a recent study published by EIOPA[2], in 2019 only 35% of the total losses caused by extreme weather and climate-related events across Europe were insured. The uninsured part, around 65%, is therefore not covered, creating the 'protection gap.' To actively address this issue, increasing insurance penetration is not enough as the increasing frequency/intensity of some events make some risks uninsurable. However, the EU is promoting a cross sector approach with the implementation of pro-active measures on buildings' vulnerability, localisation of exposure and optimised insurance coverages.

For now, the evidence is clear and shows that insurance related to extreme weather events due to climate change risks is very limited. The five most expensive climate extreme events in EU Member States (as disclosed by EIOPA in its dashboard report) were the following:

- 1999: Winter storm Lothar, caused EUR 13bn in losses.
- 2000: Flood in Italy and France, caused EUR 13bn in losses.
- 2002: Flood in Central Europe caused EUR 221bn in losses.
- 2003: Drought and heat wave caused EUR 15bn in losses.
- 2013: Floods in central Europe caused EUR 11bn in losses.

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[2] EIOPA's pilot dashboard addresses the natural catastrophe protection gap https://www.eiopa.europa.eu/content/eiopa-pilot-dashboard-addresses-natural-catastrophe-protection-gap

III. DIGITALIZATION AND INNOVATION: IMPROVING THE ENGAGEMENT WITH CUSTOMERS

During the beginning of the Covid pandemic, Insurance companies needed to speed up digitalization and their capabilities to virtually engage with customers; the adaptation to a more digital environment to develop their businesses is now becoming the leading strategy

Before the Covid pandemic, the Insurance industry was aware that the future of business interactions was quickly moving to a virtual and digital environment, more so if the strategies were to engage with younger customers. The shift to digital technologies because of the limitations of in-person interactions with customers was inevitable and insurance players needed to quickly embrace digital and virtual tools to continue serving them and not losing market share.

One of the main solutions implemented to better engage with customers were related to claims settlement and wider payment methods including pre-paid cards, direct deposits, and allowing non-banking alternatives. Moreover, what before was a traditional process of signing documents in person, became now a fully digital experience with the implementation of electronic signature solutions that include, among others, SMS as a tool for authorising and certifying payments.

An interesting way in which insurance companies were able to continue engaging with their customers was through the offering of telemedicine platforms, using digital technologies to help their policyholders to have access to 'online consultations' enabling patient monitoring and support in a way that was not even considered before.

In addition, the use of advanced analytics and artificial intelligence is now showing the strengths of assessing risks with wider information, harvesting data from mobile apps and other IT devices to better price-in insurance solutions. This is also allowing the entry of new players, Insuretech[3] start-ups, that have a faster ability to engage with new technology solutions and enter markets with innovative products. As an example, travel insurance is becoming a completely different product as the travel industry is heavily affected by the decision of countries to open and close borders with almost immediate effect. This generates a large level of cancellations that need to be managed and eventually reimbursed by companies/travel agencies/airlines, among others.

[3] Five Themes from InsureTech Connect 2021: www.mckinsey.com/industries/financial-services/our-insights/insurance-blog/five-themes-from-insuretech-connect-2021

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