Challenges and opportunities for the insurance sector in Europe

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The insurance sector is facing many challenges while the rapidly changing business environment also give rise to a number of opportunities. As insurers adapt to the new landscape, insurance regulators and supervisors must also evolve.

As insurers, regulators and supervisors navigate the digital revolution, the challenges of cyber risk and corresponding opportunities of cyber insurance, the risks associated with a prolonged low yield environment and the opportunities of taking a stewardship approach in relation to sustainable finance, it is essential that policyholders' interests remain a priority.

Since its inception, the European Insurance and Occupational Pensions Authority (EIOPA) has worked with supervisors across Europe to foster a common approach to supervision to ensure that consumers remain protected no matter where they live or from where they bought their policy.

As a European supervisor, EIOPA will continue to work with consumers, industry and supervisors to make sure that Europe is resilient in the face of challenges and open to the opportunities that the next decade will bring.

Introduction

Disruption – Change – Transformation – Upheaval: These words characterise the insurance sector as we start the 2020s, and indeed the sector is facing many challenges. At the same time, it can take advantage of the rapidly changing business environment to seize a number of opportunities.

New developments in technology have resulted in new business models, new ways of doing business and new types of insurance. At the same time, changes in the financial and economic environment, coupled with environmental changes are all having an impact on the role of insurance and insurers in society.

Arguably, the insurance sector will change more in the coming 10 years than it has in the past 50 years and all these changes represent both challenges and opportunities for insurers. They also present challenges and opportunities for insurance regulators and supervisors, who must also adapt to an evolving landscape. In this process, it is important that insurance regulators and supervisors do not lose sight of their policyholders' interests. In seizing opportunities and overcoming challenges, positive consumer outcomes will always be the most fundamental measure of success.

Protecting consumers is central to the mission of the European Insurance and Occupational Pensions Authority (EIOPA). In maintaining a forward-looking perspective to regulation and supervision, EIOPA can identify at an early stage significant trends that can affect the market and consumers. This means that EIOPA can support supervisors to address the risks facing the insurance sector, whether they stem from challenges or opportunities.

Embracing the digital revolution

Fast-paced digital technology is one of the most important drivers of change. The digital transformation of how people work, live and do business has created huge opportunities for innovation and efficiency and without question digital technology is rapidly transforming the industry, bringing with it benefits for insurers and consumers alike.

Many benefits are driven by the greater availability of data and an improved capacity for processing it. Better analytics mean companies can better profile customers to personalise products and services and enhance their own internal processes and reduce costs.

In recent years, EIOPA has further investigated the growing use of Big Data analytics and related risks. As a result of this work, EIOPA concluded a thematic review on the use of Big Data analytics and associated benefits and risks focusing on motor and health insurance business lines. The review found that traditional data sources such as demographic data or exposure data are increasingly combined with new sources such as online or telematics data, to provide greater granularity and frequency of information about consumer's characteristics, behaviour and lifestyles. However, this granularity can lead to consumers being excluded from certain products, and errors in data analytics may lead to incorrect decisions by financial services providers. Biases can also be reinforced through machine learning algorithms if firms do not have adequate governance arrangements in place.

The challenge then is how to ensure that consumers can take advantage of benefits of digitalisation and improved data analytics while continuing to remain protected. This becomes a challenge for supervisors: how to regulate the growing use of digital technology without stifling innovation?

Two factors determining the answer are a technology neutral approach and finding the right balance between enabling financial innovation and safeguarding consumer protection. Part of the answer will also be determined by a European approach that place European values at the core of the discussion. Fundamental rights like privacy, fairness and non-discrimination should be the basis for a trustful innovation framework. This is a societal issue, as well as a technical and supervisory issue.

This is one of the reasons why EIOPA has set up a consultative expert group on digital ethics in insurance. This group will assist the Authority in the development of principles of digital responsibility in insurance, which should have European values at their core. The principles should also recognise the important role that insurance plays in the economy and society, reflected by the principle of risk mutualisation that characterises the insurance sector.

Cyber risk: a challenge and an opportunity

The growth in digital technology and use of big data is also leaving people and companies vulnerable to cyber attacks. This is both a challenge and an opportunity for the insurance sector: a challenge because insurers must protect themselves against cyber threats, and an opportunity as a result of the growing cyber insurance market.

Cyber attacks against financial institutions are increasing in frequency, complexity and sophistication. While these attacks have tended to focus on financial gain, they are now moving towards critical infrastructure disruption, which can undermine confidence in the financial system and financial stability itself.

As part of its work to monitor threats to financial stability, EIOPA conducts a structured dialogue with European insurance groups of the topic of cyber risk and cyber insurance.

The most recent information available has shown that the most common cyber incidents affecting insurers are phishing mail, malware infections (ransomware) data theft and denial of service. The main consequences suffered by insurers are business interruption and material costs for policyholders and third parties. However, beyond direct financial loss, there is also the risk that insurers could find themselves facing severe – and possibly irreversible – reputational damage.

Most insurers also keep track of both cyber events and cyber incidents (with cyber incidents being the more severe) and the dynamic nature of these attacks is reflected in the growth rates of both. There was a 300% increase in cyber events in 2018 compared to 2017 and a 43% increase in cyber incidents.

Good monitoring and a better understanding of the nature of cyber threats, cyber events and cyber incidents are the first steps to building resilience. An effective cyber insurance market is also an essential component of a sound cyber resilience framework.

While the European cyber insurance industry remains small compared to the US, it is growing rapidly, with an increase in 2018 of 72% in terms of gross written premium for affirmative insurance compared to 2017. The upward trend in cyber insurance is not only due to the overall increase in written contracts offered by insurers – which grew by 36% in 2018 compared to 2017 – but also due to the growing number of insurers providing cyber insurance.

There is also the need for policy holders and insurers to share the same understanding of contract definitions and terms. Clear and transparent cyber coverage is essential from a consumer protection perspective. Therefore, industry and representatives from small and medium-sized enterprises and consumer associations must work together to provide clarity and facilitate a shared understanding.

While there is a growing awareness of and preparedness for cyber risk among insurers and a growth in the availability of cyber insurance, it is clear that more needs to be done. Increasingly, cyber risk is seen as a potentially systemic risk for the financial system and the real economy. Perpetrators of cyber attacks pay no attention to borders. The targets of an attack may be located in one single country, but the victims (end users, consumers) can be located in many different countries.

Lack of data is one of the biggest obstacles to a detailed understanding of fundamental aspects of cyber risk and to the provision of proper coverage. The scarcity and heterogeneity of quantitative information on incidents makes it difficult to properly price risk and estimate the liability exposures. A lack of data also hampers cyber risk measurement and management for insurers. Therefore, a standardised cyber incident reporting framework should be developed at European level to allow the sharing of aggregated data, anonymised of course, so that insurers and reinsurers can develop adequate pricing and risk management models. This would avoid some risks becoming uninsurable to the detriment of the economy, business and people.

The challenge of the current economic environment

Technological advances have had a huge impact on society in recent years. At the same time, the economic environment has become more challenging for European insurers, and the low for long environment has significant consequences for the business models of insurers, putting pressure on both the capital position and long-term profitability.

On the one hand, the low long-term interest rates directly affect the capital position of insurers with nominally guaranteed liabilities and the low yield environment making it increasingly challenging for insurers to meet the promises and guarantees made in the past. In this regard, Solvency II, as the market-consistent and risk-based regulatory framework has helped price in the risk, build resilience and enhance the risk management practices of insurers. At the same time, it is important that the regulatory framework continues to remain robust in the future and adequately reflects the risks faced by insurers in a low for long environment. It is therefore important that these elements are addressed in the 2020 review of Solvency II to ensure that promises can continue to be met in the future.

The low yield environment also has important implications for the business model of insurers, as there is a gradual shift away from guaranteed products towards unit-linked products, where the investment risks are borne by the policyholder. While this shift may reduce direct financial risks for insurers, it requires increased supervisory attention for potential conduct issues in the provisions of these products, which may carry significant reputational risks for the insurance sector.

For this reason, EIOPA is strengthening its approach to conduct of business supervision within its overall supervisory convergence agenda. This is an area where strong leadership is needed, both from insurance companies and from supervisors. Insurance company leaders are well placed to implement proper product oversight and governance to ensure elimination of bad practices, while supervisory authorities must give due attention to conduct supervision, including to market monitoring, conduct risk assessment and, eventually, product intervention.

Driving a sustainable agenda

Like conduct of business, sustainability, sustainable finance and climate change are not new ideas, but are issues that have become all the more important in recent years.

The success of the sustainability agenda will depend to a great extent on the capacity of financial market participants, including insurers, to incorporate into today's risk measurement and decision making processes the expected long-term consequences of climate change, resource depletion, environmental degradation as well as social and governance issues.

This will be certainly challenging for all market players but for insurers, it is critical to their own business.

As institutional long-term investors, it is essential that insurers take a sustainable approach in their investment behaviour, as this will underpin their long-term commitments to policyholders and members. Insurers can also play a stewardship role through engaging with business and industry on risk mitigation and adaptation measures, thereby supporting the transition to a more sustainable investment environment and a more resilient capital market.

Insurers also contribute to adaptation to climate change by providing cover for climate-related risks. Insurers put a price on natural catastrophe risks and these are likely to occur with increasing frequency and severity due to climate change. The assessment of insurers contributes to identifying the underlying risk drivers, and through their expertise, insurers can further contribute in their underwriting capacity to promoting loss prevention and mitigation.

Such 'impact underwriting', can be implemented by being selective on the risk quality, by applying forward-looking pricing, imposing higher protection and claims fulfilment standards with a view to eventually achieving, in the long term, behavioural shifts among their clients through product design.

EIOPA has taken several initiatives to pro-actively tackle the climate challenge. As part of the 2020 review of Solvency II, EIOPA has issued an Opinion addressing the integration of climate-related risk in Solvency II. EIOPA is also analysing potential climate-sensitive exposures in investment portfolios as part of its regular financial stability reporting. In addition, the 2019 occupational pension stress test included an assessment of potential transition risks for pensions funds and EIOPA will continue to work on methodologies for climate change stress testing to be used in future exercises.

EIOPA is also paying close attention to the widening protection gap regarding natural catastrophes. Currently, only 35% of the losses arising from natural catastrophes are insured. Admittedly, there is only so much the insurance industry can do: where risks become too high, they become uninsurable. This may have systemic repercussions on the financial sector, but also on the public finances of Member States. To address this, there is the need for a greater understanding of the underlying causes of the protection gap across Europe. This is an area where it is important to build capacity at European level, for example in the form of a risk dashboard on natural catastrophes that could inform the necessary measures at European level. Like cyber risk, climate change and weather do not stop at borders and again a common European approach will ensure a more effective response to this threat.

Analysing the potential impact of climate change on insurers and policyholders is challenging and require close cooperation between different stakeholders including industry and supervisors, and EIOPA will continue its constructive dialogue to ensure that these emerging risks continue to be incorporated into supervisory frameworks.

The opportunity for EIOPA: Fostering a European approach

Economic and environmental factors coupled with technological advances are fundamentally changing the nature of insurance and the insurance business itself. Supervisors must also adapt to make sure that business is conducted fairly and customers are treated with respect.

Since its inception, EIOPA has worked closely with supervisors across the European Economic Area to foster a common approach to supervision and the result is a stronger supervisory culture that ensures that consumers are protected no matter where they live or from where they bought their policy.

This common European approach can also be applied to the challenges and opportunities facing insurers and supervisors today. Risks today have the potential to become systemic and are therefore too big to be tackled by one company or one country alone. A common approach to sharing knowledge and best practice will help create more effective solutions to risk, resulting in a more resilient society.

As a European supervisor, EIOPA will continue to work with consumers, industry and supervisors to make sure that Europe is resilient in the face of challenges and open to the opportunities that the next decade will bring.