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Nordic Insurance Sectors Are Healthy, But Exposed To Interest Rate Risk

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Nordic Insurance Sectors Are Healthy, But Exposed To Interest Rate Risk

Standard & Poor's Ratings Services' insurance industry and country risk assessments (IICRAs) for Nordic countries highlight features common to insurance sectors in the region. For example, apart from Iceland, we see country risk as low or very low and therefore a key strength. Denmark, Finland, Norway, and Sweden are all wealthy, supporting our IICRAs in those countries. Yet we see differences in the underlying economies, financial systems, and industries that could test insurance companies over the next two years.

Overview

- Seven of nine Nordic insurance sectors carry low-risk IICRAs, while just two carry intermediate or moderate risk, according to our assessment. But the sectors still face various risks, particularly from low interest rates.
- We believe the life insurance sectors are somewhat riskier than the property/casualty (P/C) sectors, mainly because of asset-liability mismatches amid continually low interest rates, which pose significant product risk.
- However, Nordic insurance markets are generally concentrated, with high operational barriers to entry, dissuading non-Nordic competition.
- We expect long-term interest rates to remain low, at least until year-end 2016, leading P/C insurers to keep focusing on underwriting profitability and life insurers to continue derisking the balance sheet and shifting toward less capital-intensive products.

We published nine IICRAs for the Nordic region in February this year: for the P/C and life insurance sectors in Denmark, Finland, Norway, and Sweden, and the P/C sector in Iceland (see table). Our IICRAs allow for a deeper evaluation of the industry and country risks insurers face, and are a part of our rating analysis. They also enable us to benchmark the 103 insurance sectors we review worldwide. At present, only three insurance sectors have stronger IICRAs than in most Nordic countries: Switzerland's P/C sector and the life sectors in Australia and Canada.

Nordic Insurance Industry And Country Risk Assessments (IICRAs)

Country/Sector	IICRA*	Country Risk	Industry Risk
Property/Casualty			
Denmark	Low risk	Very low risk	Low risk
Finland	Low risk	Low risk	Intermediate risk
Iceland	Moderate risk	Moderate risk	Moderate risk
Norway	Low risk	Very low risk	Low risk
Sweden	Low risk	Very low risk	Low risk
Life			
Denmark	Low risk	Very low risk	Intermediate risk
Finland	Intermediate risk	Low risk	Intermediate risk
Norway	Low risk	Very low risk	Intermediate risk
Sweden	Low risk	Very low risk	Intermediate risk

Nordic Insurance Industry And Country Risk Assessments (IICRAs) (cont.)

*Our IICRA results from combining the country risk and industry risk scores. The risk categories range from "very low," "low," and "intermediate," to "moderate," "high," and "very high."

Country Risk Is A Generally Favorable Factor

Apart from Iceland, country risk is a key strength in our Nordic IICRAs. The wealthy economies in Denmark, Finland, Norway, and Sweden sustain their insurance sectors' stability. Nevertheless, we see variances in the underlying economies and financial systems that could create challenges for insurers.

Economic prospects and insurance growth go hand in hand

We expect the demand for insurance protection to generally keep pace with overall economic growth in the region. This supports our forecast for the insurance sectors in Denmark, Finland, Norway, and Sweden, which have high GDP per capita. We estimate real GDP growth in these countries to average between 1% and 3% in 2015-2017 as consumer confidence strengthens, fostering demand and investment.

That said, high household debt remains a threat to economic growth. According to our estimates, household debt ranges from about 300% of gross disposable income in Denmark, to 215% in Norway, and about 175% in Sweden, and is significantly lower in Finland. Still-low interest rates are relieving some of the pressure on households. But a rise in interest rates could slow down consumption growth, including the demand for insurance protection.

We continue to see substantially higher risk for insurers in Iceland

Iceland's economy is small, concentrated on fishing and aluminum and, more recently, tourism, and highly leveraged. Following the collapse of the three major Icelandic banks in late 2008, the government's success in reining in its fiscal and external deficits saw GDP per capita start to recover, after contracting by more than 10% during 2009-2010. The 36% depreciation in Iceland's real effective exchange rate between 2007 and 2012 has also helped rebalance the economy.

We expect continued strong economic growth in Iceland averaging about 3% over 2015-2017. The export sector is flourishing, due to strong tourism and an increased fishing quota after years of conservation. However, we believe growth will likely shift toward domestic demand. In our view, consumption growth will be supported by increasing incomes, a continued reduction in unemployment, and government-initiated household debt relief, which is currently underway. Upcoming investments in the metals, energy, and tourism industries support favorable long-term growth prospects.

Financial systems are supportive, but depressed yields remain a challenge

The insurance sectors in Denmark, Norway, and Sweden benefit from stable financial systems, in our view. Combined with these countries' strong creditworthiness, this provides a solid platform for investment opportunities and growth. We believe Finnish insurance companies operate in a slightly weaker environment, mainly because the three largest banks account for more than 75% of the financial system and almost all of its external funding.

Overall, the low issuance levels of long-term bonds in Nordic markets (although less so in Denmark) means fewer domestic investment opportunities for insurers. It also limits options for asset-liability management (ALM), which is

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especially important for life insurance companies because of their need to meet guaranteed yields on long-term policies.

What's more, continuously low yields, which decreased significantly in 2014, have dampened insurers' earnings prospects and investment returns and reduced their solvency levels. Low yields are particularly challenging for life insurers because of the relatively high guarantees on inforce life insurance contracts. We believe long-term interest rates will remain low at least until the end of 2016, and therefore solvency and earnings will remain a key concern for insurers, in our opinion.

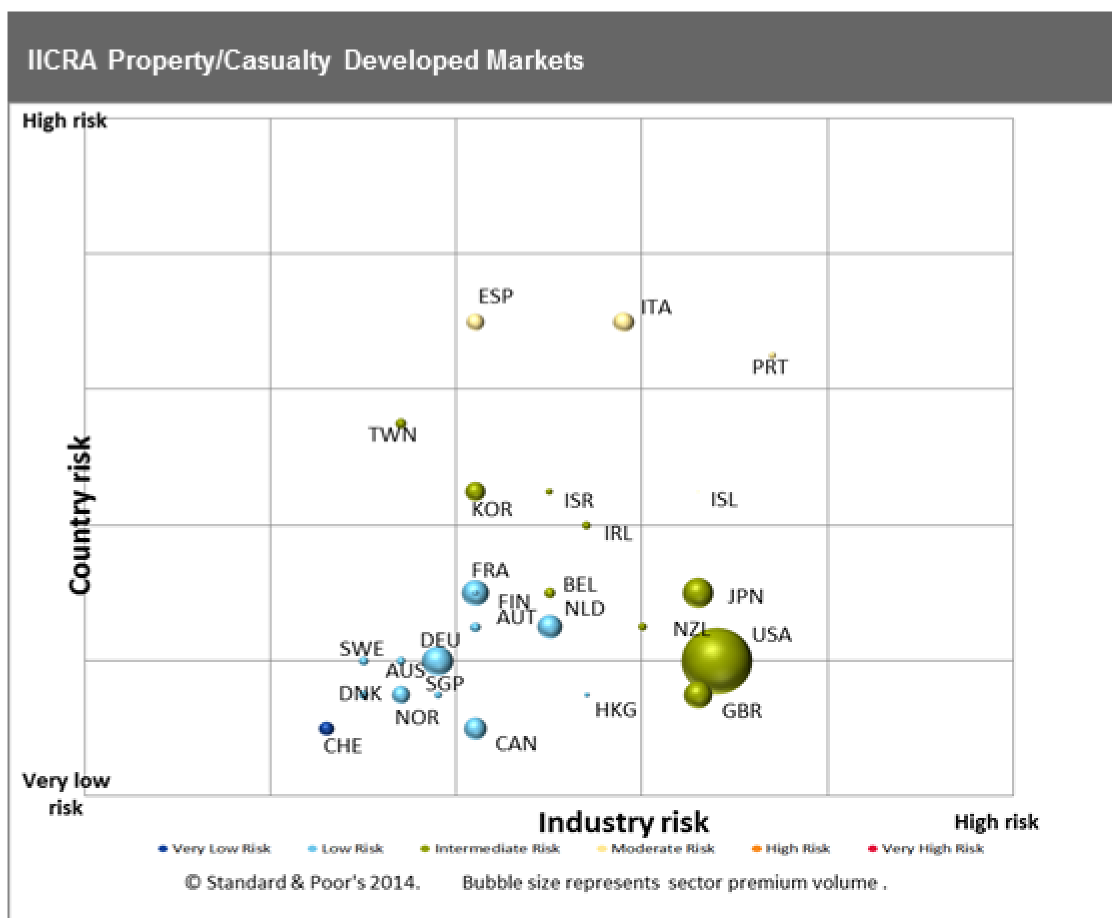
In Iceland, we consider that the financial system puts the insurance sectors at a disadvantage. Capital controls limit insurers' investment choices, as well as their access to external funding, in our view, mainly because they discourage investment. However, we recognize the risks associated with removing capital controls, such as significant capital outflows, the extent and speed of which are hard to predict. Combined with still-sluggish economic growth, this could hurt the debt-laden economy and expose insurance companies to significant balance-sheet volatility.

Property/Casualty IICRAs: Sectors Are Generally Strong

Overall, we see lower risk in Nordic P/C insurance sectors than in many other such sectors in Europe. Several larger players are focusing on profitability rather than growth, and we expect them to continue doing so during 2015 and 2016. We also see material entry barriers for new insurers, the main ones being the need for a strong brand and much lower expense ratios than in other markets. These positives are partly offset by moderate exposure to natural catastrophes and some long-tailed products.

Our IICRAs for the P/C sectors in Denmark, Finland, Norway, and Sweden are low risk (see chart 1). The only P/C sector we consider stronger is that in Switzerland, where we see an even steadier economy and a stronger institutional framework. Other countries where our P/C IICRA is moderate risk, as for Iceland, are Spain, Portugal, and Italy.

Chart 1



Healthy overall profits are set to continue

Profitability remains strong in Denmark, Norway, and Sweden, with the five-year average return on equity (ROE) at between 10% and 20%, benefitting from strong underwriting margins. Companies are focusing on profitability, mainly through price increases, enhanced risk selection, and cost efficiency.

We believe that, with low yields pushing investment income downward, insurers have increased their focus on improving underwriting results. This is evident in the five-year average net combined ratios in these countries, which are below 95%. The combined ratio is the industry's main profitability metric: 100% denotes breakeven, and below 100% the insurer is making an underwriting profit.

The lower profitability of Finland's P/C sector is partly due to the comparably weaker reported underwriting performance of several smaller mutual insurance companies, which are inherently less focused on profitability. The average net combined ratio was 96% in 2013, which means that only Iceland's profitability metric was lower in 2013, at 97% (see chart 2); the five-year average net combined ratio is 100%. Another key factor is that Finnish P/C insurers appear to have a higher appetite for equities than those in Denmark, Norway, or Sweden, which increases the volatility of their earnings.

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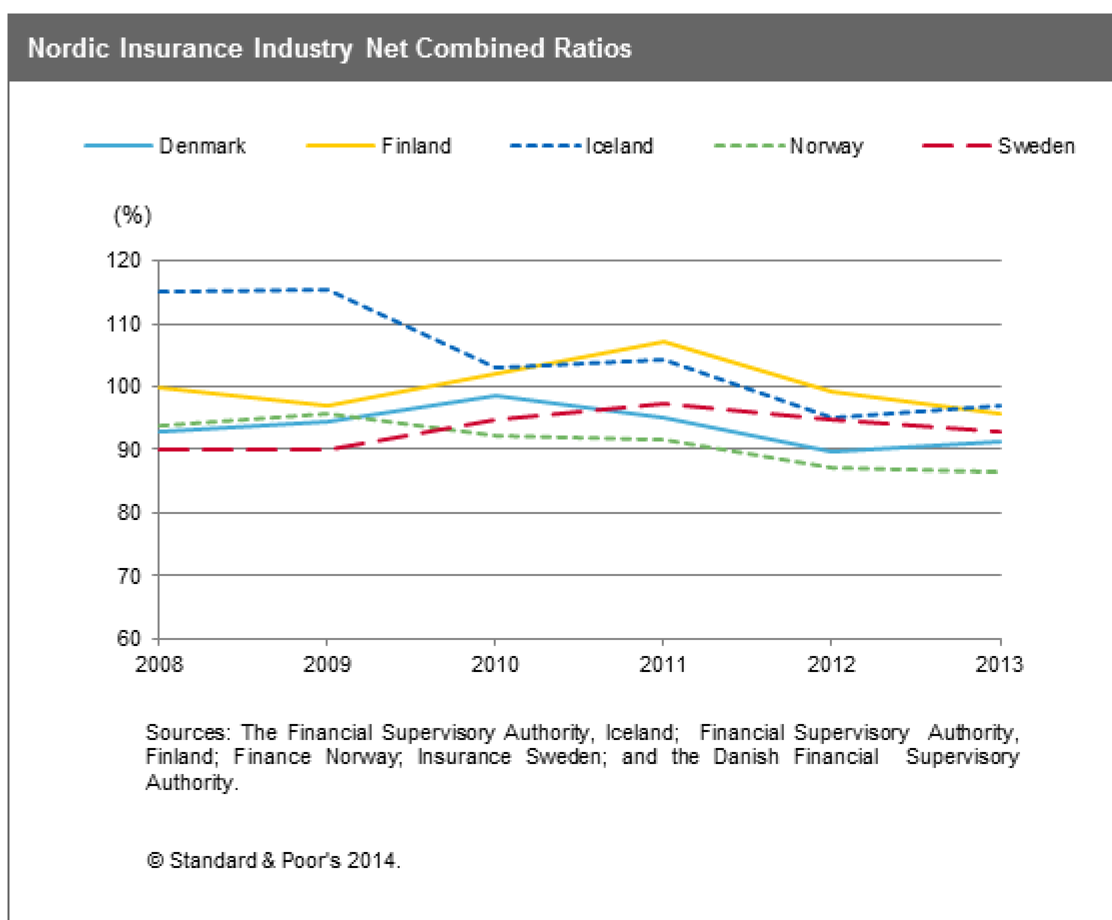
Chart 2



Profitability remains a negative factor in Iceland, but there are signs of recovery

Iceland's P/C sector continues to report losses, with the five-year average net combined ratio at 103%. However, the average ROE was 11% in 2009-2013, and we see a positive profitability trend that we expect will continue as companies remain focused on earnings. Consequently, the net combined ratio, which exceeded 100% for many years, improved to about 95% in 2012 and was 97% in 2013; we expect it to remain below 100% during 2014 and 2015. Consequently, if Iceland's P/C insurance sector stays profitable over the next few years, we could change our assessment of profitability to neutral from negative.

In our view, the financial hurdles for P/C insurers in Iceland vary considerably from those in other Nordic countries. We consider that the country's weakened financial system has put the sector at a disadvantage, mainly because capital controls limit insurers' investment choices and access to external funding. What's more, we consider the sector prone to earnings volatility because of the small and concentrated market, intense competition, and history of volatile returns.

Nordic P/C sectors appear less susceptible to major natural catastrophes

Overall, we consider exposure to natural disasters moderate in Denmark, Norway, and Sweden. Despite claims from weather-related events, such as storms, flooding, or landslides, the P/C sectors in these countries have remained

profitable over the past five years. Countrywide risk pooling and comprehensive reinsurance programs lessen the impact of natural catastrophes on insurers' earnings, in our view.

Although Iceland can experience earthquakes, volcanic eruptions, and mud slides, among other things, these are all covered by the Icelandic Catastrophe Fund, a public corporation functioning as an insurance company. In addition, all residential and commercial properties in Iceland are insured against natural disasters through obligatory fire insurance.

The risk of natural catastrophes in Finland is low, in our view. There's a lower impact from weather-related events than in other Nordic countries, which we view positively in our assessment of product-related risks in Finland.

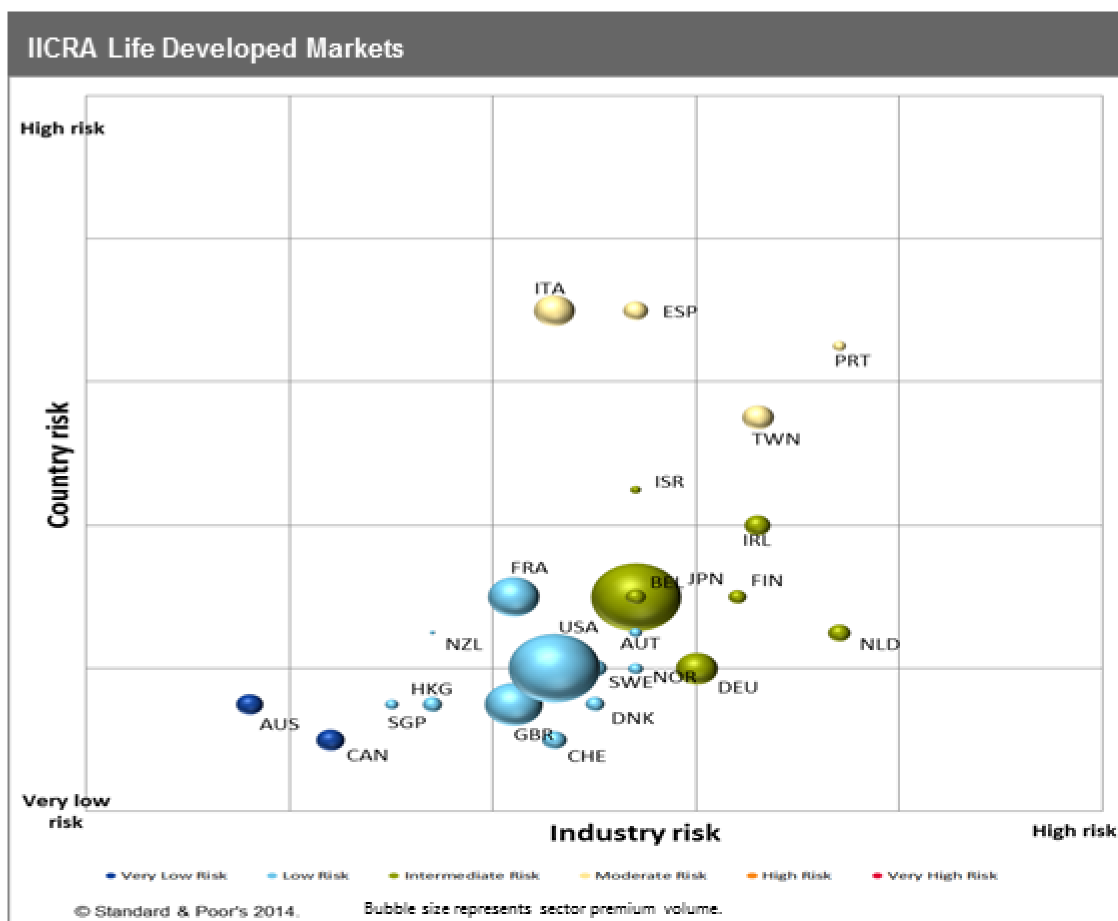
Insurers also face moderate exposure to long-tailed business. This exposure varies across the Nordic countries and relates mainly to annuity-based worker compensation and motor-related claims.

Life IICRAs: Low Interest Rates Are The Main Threat

Generally, we consider that the life insurance sectors in Denmark, Finland, Norway, and Sweden carry somewhat higher risk than the corresponding P/C sectors. The main reason is the mismatch between the amount and terms of insurers' assets and their long-term life insurance liabilities, including relatively high guarantees on inforce life insurance contracts. In our view, the low interest rates prevailing in the Nordics, and across Europe, heighten this risk by hampering investment income and consuming capital.

That said, the positive contribution of very low country risk has resulted in low-risk life IICRAs, except in Finland. Other countries where we assess the life insurance sector as low risk are the U.K., France, Switzerland, and Austria (see chart 3). Our IICRA for Finnish life insurers is intermediate risk mainly because country risk is higher and Finnish life insurers do not hedge interest rate risk to the same extent, and have a greater appetite for high-risk investments. Other countries where our IICRA for the life insurance sector is intermediate risk include Germany, Belgium, and The Netherlands.

Chart 3



Insurance policies with high guaranteed yields weigh on earnings and capital

Low interest rates have been making it harder for companies to meet guarantees on life insurance policies without taking on riskier investments. We expect long-term interest rates to remain low, at least until the end of 2016, and therefore guaranteed yields will remain a key concern, in our opinion. Continually low rates also heighten risk from life insurers' large asset-liability mismatches. In our view, this poses significant product risk, owing to the policy guarantees, and constrains our IICRAs for the sectors.

Most of the region's life insurers have taken measures over the past decade to reduce risk in their product portfolios. These measures include a general shift of new business toward unit-linked products without guarantees, or to products with different types of guarantees. Although we see some progress, we believe it will take time before the pressure on earnings and capital adequacy dissipates. Life insurance and pension policies vary, but the guaranteed interest rate on inforce policies averages 3.0%-3.5% in all Nordic countries except Denmark, where we estimate it at about 2.6%.

We believe the strategic move away from traditional guaranteed business to other product types will be positive for our assessment of product-related risks in the Nordic region in the longer term. However, guaranteed business still dominates many companies' inforce books; therefore, ALM risk is still high, in our view.

The degree of asset-liability mismatch also differs by country. In our view, there is better availability of long-term bonds in Denmark than in other Nordic countries, and Danish life insurers actively hedge interest rate risk. Finland's debt market is considerably smaller than the other Nordic markets, and the life insurers there hedge interest rate risk to a lower degree. In addition, Finnish life insurers have the highest proportion of equities in their investment portfolios, making their investment returns prone to volatility. According to our estimates, equities made up 30%-35% of the assets backing life insurance business with guarantees. Equivalent Swedish portfolios showed an equity share of just below 30% of total invested assets. Insurers' equity holdings are substantially lower in Denmark and Norway, but still higher than in many other European life sectors.

Lower profitability than in P/C sectors in the mature Nordic markets

Profitability (as measured by ROE) is a neutral factor for our life IICRAs in all four countries. The average ROE is lower than 8% in all four countries and considerably lower than the strong ROE of 10%-20% in the P/C sectors in Denmark, Norway, and Sweden. Companies' bottom-line earnings fluctuate, largely because of asset-liability mismatches and a relatively high proportion of equity investments. In addition, companies in Denmark and Sweden use a market-value approach to report assets and liabilities, which makes their balance sheets more volatile than in other jurisdictions.

In the long term, we expect the highly developed Nordic life insurance sectors to continue to expand roughly in line with GDP growth, but not without setbacks. Changes to regulations and the tax regime, for example, have led to a decline in business in the past.

Occupational pensions comprise a large share of the life insurance business in all countries except Finland, where dedicated pension insurance companies provide statutory employee pensions. We also anticipate some volatility in business volume growth from the transfer of traditional business with guarantees to other products.

High Entry Barriers Insulate Both P/C And Life Sectors From Competition

Operational barriers for entrants to Nordic insurance markets are high, in our view, dissuading foreign competitors, and we expect this will continue. We see high costs to enter the markets as the main impediment. Another important factor is the company's brand, which is crucial for market penetration. The barriers are somewhat lower in Iceland, where using an intermediary would allow a non-Nordic insurer access.

Market concentration is high in all Nordic countries, which strengthens the barriers to entry. The largest life insurance operations by gross premium income control between 56% of the market (in the case of Sweden's five largest companies) and 77% (for Norway's top three firms). In P/C, we see five companies together holding a 65% market share in Denmark and three with more than 80% in both Finland and Iceland. Most insurers are domestic companies, but there are pan-Nordic players.

In recent years, small companies have established a presence in their home bases or in other Nordic countries, but we don't expect big changes in the overall market composition. In the P/C sectors, cost efficiency is quite high, as indicated by the low average market expense ratios of 17%-21%. This adds to the difficulty in entering Nordic markets.

The typical distribution setup also supports the high barriers to entry. Nordic insurers sell most of their products

through their own sales teams, affiliated groups, trade unions, business partners, and banks. Broker distribution, an important channel in other parts of the world, plays a comparably small role in the Nordics. Therefore, gaining a foothold in the market would be tough for a nondomestic insurer without first building up distribution relationships.

The Institutional Framework Sets The Stage For Future Business Strategies

A strong institutional framework, as we believe exists in Denmark and Sweden, paves the way for insurance companies' future growth. Although we consider the frameworks moderately strong in Finland and Norway, and intermediate in Iceland, they play a pivotal role in the development of the insurance sectors, in our view.

Regulation and legislation are important elements we consider when assessing an insurance sector's vulnerability because they influence the type of business an insurer is willing or able to write. Policymakers also influence the actions insurers take in managing their investments, capital, and earnings. Nordic regulators have long used risk-based solvency models as supervisory tools, the first being Denmark's Finanstilsynet, which introduced such tools in 2001. Since then, we've seen companies we rate adapt the solvency models and use them to manage their business and financial risk profiles.

Recently, in response to continuously low yields, both the Danish and Swedish regulatory bodies have implemented forbearance measures, such as changes in the yield curves being used, that somewhat dilute the strict economic character of solvency measures. Although this has helped insurers, it has also created regulatory uncertainty for stakeholders.

We see continuing stability in the Nordic insurance sectors, supported by solid institutional frameworks and the strength of most economies. These factors, and the business strategies insurers adopt, will influence how well they cope with the effect of low interest rates and increasing demand for more transparent insurance products over the next few years.

Related Criteria And Research

Related Criteria

- Insurers: Rating Methodology, May 7, 2013

Related Research

- Denmark's Life Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Finland Life Insurance Sector Carries An Intermediate Industry And Country Risk Assessment, Feb. 28, 2014
- Norway Life Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Sweden's Life Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Denmark's Property/Casualty Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Finland's Property/Casualty Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Norway Property/Casualty Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Sweden's Property/Casualty Insurance Sector Carries A Low Industry And Country Risk Assessment, Feb. 28, 2014
- Iceland's Property/Casualty Insurance Sector Carries A Moderate Industry And Country Risk Assessment, Feb. 28,

2014

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