Standard & Poor’s perspective on Swedish insurance sector risks

Summary

In May 2013, Standard & Poor's published new insurance criteria. Our objective with the new criteria is to improve the transparency of our criteria and provide the market with greater insight about how we rate insurers through a globally consistent criteria framework.

The criteria include a new factor, the insurance industry and country risk assessment (IICRA). Our IICRAs allow a deeper evaluation of the industry and country risks insurers face, which we assess for almost 100 insurance markets across the globe on a consistent basis. The Swedish Life and Property/Casualty (P/C) insurance sectors carry low risk IICRAs, in our view. Nevertheless, the sectors still face various risks, particularly from low interest rates. We believe the life insurance sector is somewhat riskier than the P/C sector, mainly because of asset-liability mismatches that could trigger volatile returns. We anticipate interest rates to gradually improve, but to remain low, leading P/C insurers to keep focusing on underwriting profitability and life insurers to continue de-risking the balance sheet and shifting focus towards less capital-intensive products.

Why did Standard & Poor's publish new insurance criteria in 2013?

This series represents the insurance part of our commitment to the market, undertaken in 2008, to enhance the transparency, rigor, and specificity of our criteria across sectors and asset classes. Our objective is to provide the market with greater insight about how we rate insurers and to enhance the global comparability of our ratings through a clear, coherent, and globally consistent criteria framework.

For example, we have introduced a matrix that shows in a very transparent manner how we derive the anchor, a key subcomponent of the rating analysis, based on the combination of the business and financial risk profiles. In addition, we are much more specific as to how the macroeconomic and industry environment affects the creditworthiness of an insurer, having introduced the assessment of industry and country risk as an explicit rating factor.

What are the key changes in these criteria?

The changes are more evolution than revolution. In the sectors covered by the new criteria framework, ratings performance (defaults and transitions) has in our view been very satisfactory during the past decade. We would highlight three key changes:

- The introduction of a business risk/financial risk matrix framework to anchor our insurer ratings;
- The formalization of our insurance industry country risk assessment (IICRA); and
- Specification of the combined impact of ERM and Management & Governance on our insurer ratings.

How have the final criteria changed since the request for comment?

We solicited feedback from the market during the comment period and considered that feedback carefully. We believe we have responded to market perceptions that analytical judgment was under-represented and that too many features could cap ratings. In part to address these concerns, but also because of our own criteria-development thought process, we adjusted various scoring elements in the framework to be less formulaic and more judgmental.

Our discussions with the industry and the market as well as many comments we received were helpful in adjusting our communication about our new ratings framework.

How has the performance of insurance ratings in the past affected the criteria?

The main sources that we used to review the history of insurance-company defaults are our default studies. Creditworthiness in this heavily regulated sector appears to be sustainable during periods of economic stress. Default rates have increased during periods of stress, such as economic downturns or following major catastrophes, but have remained relatively low and are among the lowest of any sector.

The global financial crisis did not trigger a wave of life or P/C insurance defaults. In fact, no significant insurer that we rated at the time has defaulted due to the financial crisis. Insurers defaulted in the bond insurance and mortgage insurance sectors, but those are outside the scope of these criteria.

The criteria globally address issues that could cause failures, specifically through:

- New liquidity metrics;
- Capital metrics that focus more on asset-liability risks;
- IICRA metrics that take into account industry-wide pricing adequacy; and
- A larger role for ERM for insurers with complex risks.

How does Standard & Poor's determine the rating?

Two factors--the new IICRA assessment and the company-specific competitive position--determine the insurer's business-risk profile. The financial risk profile has three components--capital and earnings, risk position, and financial flexibility. We take the anchor, resulting from the BRP and FRP matrix, and the combined impact of ERM and management and governance into account to generate the indicative stand-alone credit profile or group credit profile.

We then add two more factors: the insurer's liquidity and an evaluation of sovereign risk, which most of the time would be neutral, and in rare cases cap ratings. We assess each of these eight factors in an explicitly forward-looking approach. For example, capital and earnings, which anchors the financial risk profile, is projecting capital and earnings two to three years out.

We expect to publish our assessments of these factors regularly for each insurance group we rate globally to allow transparent comparison to rating users.

How does the insurance industry country risk assessment (IICRA) work?

Our previous criteria included industry- and country-related risks. These are not risks that we are considering for the first time. However, we have now added a transparent, robust, and specific framework for analysing these risks systematically. We analyse four specifically identified features of country risk and five similarly specified aspects of industry risk--together nine "sub-factors." We aggregate them in a specified way to generate IICRA assessments. For example, we will publish one each for Canada's life insurance sector, the U.S. health insurance sector, and Russia's P/C sector. We expect to publish these assessments regularly for the countries and insurance sectors where we rate companies.

Regarding country risks specifically, the framework intends to ensure consistency with our views in other asset classes. For example the economic, political, and financial-system factors underlying country risk analysis draw on our sovereign and banking criteria (see "Insurers: Rating Methodology," published May 7, 2013, for more detail).

What is your view on the country risk in Sweden and how does that affect the IICRA?

We see country risk as very low and therefore as a key strength to the overall Life and P/C IICRAs. We believe the insurance sectors benefits from the country's wealthy economy. We expect the demand for insurance protection to generally keep pace with overall economic growth in Sweden. That said high household debt remains a threat to economic growth. In Sweden, we estimate that debt is close to 170% of household gross disposable income. Still-low interest rates are relieving some of the pressure on households. However, a rise in interest rates could slow down consumption growth, including the demand for insurance protection.

We regard Sweden's financial system as stable. The diversified economy provides a good basis for investments, despite a lack of liquidity for long-term fixed-income investments. Although, the low issuance levels of long-term bonds in Sweden means fewer domestic investment opportunities for insurers. It also limits options for asset-liability management (ALM), which is especially important for life insurance companies because of their need to meet guaranteed yields on policies. What's more, continuously low yields have dampened insurers' earnings prospects and investment returns and reduced their solvency levels. We believe this reflects the financial markets' general perception of Sweden as a "safe haven." The result is depressed yields on government and covered bonds. Low yields are particularly challenging for life insurers because of the relatively high guarantees on in-force life insurance contracts. We believe the modest pickup in interest rates in 2013, which we expect will continue in 2014 and 2015, should relieve some of the pressure on solvency and earnings.

What is Standard and Poor’s view on the Swedish Life and Property/Casualty sectors?

We published one insurance industry and country risk assessments (IICRA) for the Swedish P/C and one for the life insurance sector in February this year. More details are available in "Sweden's Life Insurance Sector Carries A Low Industry And Country Risk Assessment," and "Sweden's Property/Casualty Insurance Sector Carries A Low Industry And Country Risk Assessment," published February 28, 2014, on RatingsDirect. We assess both sectors as carrying low risk. This is a relatively favorable assessment. At present, only three insurance sectors globally have stronger IICRAs than in Sweden: Switzerland's P/C sector and the life sectors in Australia and Canada. 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 99 insurance sectors we review worldwide.

What is your view on the main industry risk drivers for the P/C insurance sector in Sweden?

We base our assessment of industry risk on our view of five industry-related factors: profitability (measured by return on equity), product risk, barriers to entry, market growth prospects and the institutional framework.

Overall, we see lower risk in the Swedish P/C insurance sector than in many other such sectors in Europe. Larger players are focusing on profitability rather than growth, and we expect them to continue doing so during 2014-2015. We also see material entry barriers for new insurers in the highly concentrated sector, 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.

Profitability remains strong in Sweden, with a five-year average return on equity (ROE) about 13% according to our estimate, benefitting from strong underwriting margins. Companies are focusing on profitability, mainly through price increases, enhanced risk selection, and cost efficiency. With low yields pushing investment income downward, insurers have increased their focus on improving underwriting results. However, we believe that low interest rates could strain earnings over 2014-2015.

By global standards, the Swedish P/C sector is moderately exposed to natural catastrophes, in our view. Storms, floods, and harsh winters have resulted in large claims in recent years. But their impact has been confined to earnings, as evidenced by the five-year weighted-average net combined ratios of about 93%. In our view, there is also intermediate risk in the Swedish P/C sector related to the long tail in motor-related claims. We also think some insurers have a high appetite for equity investments. However, this is more common at well-capitalized mutual companies.

What is your view on the main industry risk drivers for the life insurance sector in Sweden?

Overall, we believe the Swedish life insurance sector is somewhat riskier than the P/C sector, mainly because of asset-liability mismatches that could trigger volatile returns. This is partly offset by high operational barriers to entry in the life insurance sector.

Low interest rates have been making it harder for companies to meet guarantees on life insurance policies without taking on riskier investments. We expect gradually increasing interest rates to provide some relief. But since interest rates will likely stay low in our forecast at least until the end of 2015, 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 IICRA for the sector.

Most of the Swedish 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. We believe policyholder demand is high for the guaranteed business in Sweden.

In the long term, we expect the highly developed and concentrated life insurance sector 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 and is a threat to growth also going forward.

How does the IICRA for the life sector compare to the IICRA for the P/C sector in Sweden?

We consider that the life insurance sector in Sweden carries somewhat higher risk than the P/C sector. The main reason is the mismatch between the amount and term of insurers' assets and their long-term life insurance liabilities. In our view, the low interest rates prevailing in Sweden and across other European countries heighten this risk by hampering investment income and consuming capital. That said the positive contribution of our country risk assessment for Sweden still has resulted in low-risk life IICRA. Another key difference is our view on profitability. In our view, profitability is stronger in the P/C sector than in the life insurance sector. Underwriting profitability in the P/C sector is strong in our view, and P/C earnings are less volatile than earnings in the life insurance sector.