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Box 13

THE INSURANCE UNDERWRITING CYCLE IN THE EURO AREA

The amount of insurance premiums written and insurance premium rates typically move in cycles that have in the past lasted between six and ten years. Insurance underwriting cycles can be divided into "hard market" periods, in which insurance rates are at levels that correspond to a return on capital that equals or exceeds the cost of capital, and "soft market" periods, in which underwriting returns are low or even negative (see Figure A).¹ This box examines how the insurance underwriting cycle can shape the financial performance of insurers, and thus financial stability.

During a hard market period, the insurance sector accumulates capital via new inflows and retained profits. However, this capital expansion usually leads to higher competition in the sector, which ultimately results in reduced premium rates and diminishes opportunities for profits and

1 See, for example, Fitch Ratings, "The Property/Casualty Underwriting Cycle", April 2008.

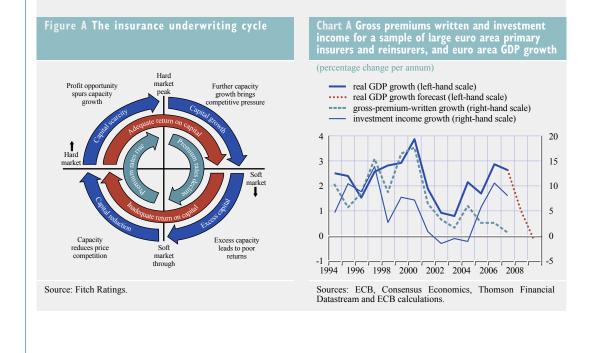


brings the market into a soft market period. During a soft market period, underwriting capacity declines on account of lower returns and competition among insurers is reduced, which leads to increases in premium rates and, eventually, to a return of adequate underwriting profitability for insurers.

The insurance underwriting cycle is important from a financial stability perspective as insurers are more prone to face underwriting losses during a soft market. In addition, when underwriting performance is poor, insurers have to rely more on investment income to achieve positive financial results, which might make them lean towards increased risk-taking in their investments.

The assessment is that the euro area insurance underwriting cycle is currently in a soft market period – mainly due to the competitive environment in some segments – and can be seen to be in the bottom right quadrant of Figure A, and possibly close to the trough of the cycle. It should be noted, however, that different insurance segments (such as life or non-life) and regional markets sometimes have their own distinctive underwriting cycles.

The insurance underwriting cycle is closely linked with the business cycle (see Chart A). This is because the economic environment affects the demand of both households and firms for insurance products. A deteriorating economic environment has the potential to reduce earnings for insurers. Other factors, such as disaster-related losses or unexpected changes in claim trends can, however, also affect the insurance underwriting cycle. Furthermore, periods in which the investment income of insurers is high can weigh on the underwriting cycle as insurers may engage in cash-flow underwriting, whereby premiums are written not with the aim of increasing technical profits, but to increase investment income when investing the new funds. This seems to have been the case in recent years when the growth of premiums written did not follow the relatively strong GDP growth in the euro area and insurers had to rely to a greater extent on investment income (see Chart A).



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Looking ahead, the prospects for a deteriorating economic environment in the euro area – where GDP growth is expected to slow down in 2008 and 2009 (see Chart A) – are likely to have a negative effect on many insurers' underwriting performances. This is contributing to a less favourable and more uncertain outlook for the euro area insurance sector at present.