Investment Managers

For professional clients only

Investment Institute *Sustainability*

The Ukraine crisis and its impact on insurers

30 May 2022

Arnaud Lebreton
Insurance Investment Solutions

Yolande Poulou
RI Solutions, Core Investments

Key points

- The Ukraine crisis has significantly impacted the financial and macroeconomic backdrop and adds to the already heavy burden on insurers
- Inflationary pressures are a drag on profitability and disturb balance sheets. Inflation risk should be factored into asset liability management and investment strategies. Close attention should be paid to duration gaps
- Insurance losses related to the war should be manageable for insurers, but the general uncertainty, volatility and risks tilted to the downside call for more insurance and agility in asset portfolios
- The war's interference with climate action plans does not mitigate against physical and transitional risks. This calls for an acceleration in climate risk integration, both in liabilities and assets. The crisis will likely not slow the regulatory process underway, and insurers must be ready to manage these risks

War in Ukraine is adding to the burden

Insurers already had a heavy agenda to contend with at the start of 2022 – not least an expected change in economic and financial regimes and some significant regulatory developments underway.

Lingering COVID-19-related supply-side disruptions, alongside a significant rebound in consumer demand, were already producing supply bottlenecks and an inflation rate not seen for decades. At that time our central scenario was for a gradual absorption of the pandemic shock and of a normalisation of global supply chains, allowing for sustained growth, a slowdown in inflation and a digestible pace of monetary policy normalisation.

That said, the uncertainty around inflation, interest rates and the potential for more volatility already called for more prudence and for bringing more resilience in insurance balance sheets and asset portfolios.[1]

The Ukraine crisis jolted investors and continues to have major implications for the global economy and financial markets, especially in Europe. Volatility has surged, equity markets have sold off and credit spreads have widened especially for corporates with direct or indirect exposure to Russia. Europe is heavily dependent on Russia for its oil and gas which has further fuelled the environment of rising inflation. Exhibit 1 shows that rising pressures have pushed up inflation expectations further.

Exhibit 1: 5 year / 5 year forward inflation swaps – Euro vs. US

Source: Bloomberg – AXA IM

When the war broke out, the flight to quality was brief, and market participants quickly priced in further significant interest rates hikes, comforted by a more hawkish stance from central banks, which significantly impacted bond portfolios. High inflation hurts real incomes, dampens consumers' confidence, and continues to feed concerns about the extent of monetary tightening and growth implications.

The job market is in good shape, corporate financing conditions remain affordable, and we continue to see earnings growth, but uncertainty is increasing. Supply chain disruptions, especially with new restrictions in China as a response to a resurgence of COVID-19, and geopolitics should impact GDP growth. This, combined with a high degree of uncertainty on the inflation trend and the pace of monetary tightening, should also translate into more frequent episodes of volatility in financial markets.

There is much talk around 'stagflation' – when slowing economies see rising prices – and while we do not see any market crash or credit crunch for now, our call to strengthen asset and liability management and build insurance portfolio resilience is even more valid than three months ago.

Inflation impacts balance sheets and profitability

Inflation had already been on the rise, but Russia's invasion of Ukraine has pushed it even higher, leading to steeper energy and food prices. Both Russia and Ukraine are major commodity exporters and global prices have skyrocketed in response to the war and sanctions from NATO. The contribution of oil and gas to inflation is significant but so too is that of food prices.

Central banks' hawkish stances indicate their determination to fight inflation, but some argue that they remain behind the curve of what is required to reach their targets. In a recent paper, the International Monetary Fund (IMF) questioned the persistence of inflation and suggests that *"the duration of the current inflation episode will depend on i) the interplay between the persistence of labour market tightness and supply chain bottlenecks and the central bank response and ii) the duration of the War in Ukraine and its impact on energy prices, food prices, and global growth."*[2]

Russia has recently suspended gas supplies to Poland and Bulgaria for refusing to pay in roubles which could make inflation much stickier than expected. If we add to that the talks around potential inflation related to deglobalisation and

[1] No immediate storm ahead but insurers should use the lull to build portfolio resilience – AXA IM – January 2022

[2] Will inflation remain high? - IMF Research Department, April 7th, 2022.

climate action, the bottom line is that inflation is running high and there is a high degree of uncertainty on its future path.

Inflation puts particular pressure on property and casualty (P&C) and health insurance companies, as it can impact both assets and liabilities and ultimately the profitability and solvency of insurers. High inflation can translate into higher claim costs and has already hurt margins in business areas with typically short turnarounds from claim to pay-out.[3] Should inflation be more persistent it could also pressurise long-term liabilities.

P&C insurers tend to have positive duration gaps – where the duration of assets exceeds that of liabilities – and inflation can also hurt via the impact of higher interest rates. Although increasing interest rates can be a positive for life insurers, they are not immune. Sudden changes in interest rates and interest rate curves can also make it more complex for them to manage their net duration exposure.

Regulatory capital regimes such as Solvency II do not explicitly require inflation risk to be quantified and as such, some insurers may not have paid it the attention it deserves.

In the current environment – and given the high level of uncertainty around future prices – we believe that inflation risk should be factored into the asset and liability management framework and lead to potential adjustments of strategic and/or tactical asset allocations.

Greater agility is required in asset portfolios

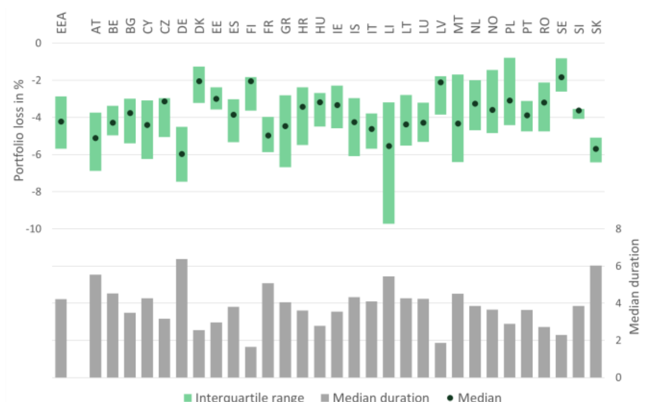
A report from the joint committee of the European Supervisory Authorities – including the European Insurance and Occupational Pensions Authority (EIOPA) – published in March[4] indicates that *"the direct exposures of insurers… towards Russia are contained, but second round effects… can potentially prove relevant. In terms of direct impact (i.e. assets and liabilities), preliminary analysis suggests that exposures are relatively contained on aggregate for the sector. Nevertheless, for some undertakings the exposures seem to be relatively more material."*

In another report published end of March[5], S&P Global said the war would lead to major claims in 2022 with specialty lines such as aviation, trade credit, political and cyber risks being the most impacted. S&P estimated that global insurance losses from the conflict could range from $16bn to $35bn, with 50% of those claims impacting reinsurers.

But Fitch Ratings, in a note also published in March,[6] corroborates the European supervisors' view that European insurers and reinsurers' direct exposure to Russia and Ukraine is limited. It estimated that global reinsurers' exposure is less than 2% of their gross written premiums (GWP). Fitch also recognised that indirect exposures could hurt the profitability of certain insurers but not to an extent that would put their capital positions at risk.

A bigger threat comes from potential changes in the macroeconomic regime and further market turbulence, which the Ukraine war is exacerbating. We have discussed the impact of inflation, rising interest rates and the duration gap, but volatile equity and credit markets can also significantly hurt insurers' capital positions, and a sustained downturn could erode their solvency.

Exhibit 2: EIOPA credit risk stress scenario applied to European insurers' corporate bond portfolios.



Source: Financial Stability Report – EIOPA – December 2021

European insurers have a robust solvency position – at 226% as of the third quarter (Q3) 2021 – and the insurance stress test conducted by EIOPA in 2021 has shown that, on average, European insurers are equipped to navigate through harsh economic conditions. But the test also confirmed that the main vulnerabilities for the sector stem from financial market risks and that certain insurers still heavily rely on transitional measures.

Leveraging the 2021 stress test exercise, EIOPA also published a scenario analysis[7] of increased credit risk with rating downgrades. It shows that European insurers' corporate bond portfolios are resilient with overall losses amounting to 5.6% of a corporate bond portfolio's value or 7% of total excess of assets over liabilities. Exhibit 2 illustrates that results are uneven across countries and insurance

[3] Market Volatility Is Ukraine War's Main Risk for European Insurers – Fitch Ratings – March 17th, 2022.

[4] Joint committee report on risks and vulnerabilities in the EU financial systems – March 17th, 2022.

[5] Russia-Ukraine Conflict Adds to a Bumpy Start to 2022 for Global Reinsurers – S&P Global – March 22nd, 2022.

[6] Market Volatility Is Ukraine War's Main Risk for European Insurers – Fitch Ratings – March 17th, 2022.

[7] Financial Stability Report – EIOPA – December 2021

companies. In the analysis, a number of insurers incur losses above 10% of the portfolio and for a smaller number of companies, losses exceed 50% of their surplus. Corporate bond portfolios with long durations are particularly sensitive.

Since the invasion, global financial markets have become highly volatile, spreads have widened across rating categories and European equity markets have experienced significant price fluctuations and bouts of volatility.

In a note published in March[8], Moody's estimated that the market drawdown which followed Russia's invasion only slightly impacted European insurers' solvency ratios, by two percentage points. But it also highlighted that lower equity and credit valuations contributed to a decrease by eight percentage points, mitigated by a positive impact related to higher interest rates, illustrating the 'average' negative duration gap of the sector.

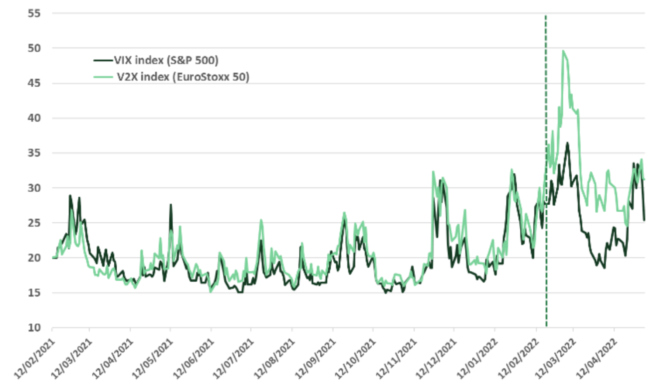
A toxic combination of factors has driven the IMF to downgrade its global growth forecasts to 3.6% for this year and next – respectively 0.8 and 0.2 percentage points lower than its January forecast. Our own outlook is for an even weaker 3% and 2.9% respectively – and risks are tilted to the downside for both equity and credit markets. In the last report from the joint committee of the European Supervisory Authorities (including EIOPA) published in March,[9] supervisors warned that *"financial institutions… should continue to be prepared for a possible deterioration of asset quality in the financial sector"* and that *"credit risks related to the corporate and banking sector remain a main concern… for insurers."* Uncertainties could amplify corporate vulnerabilities and lead to a possible scenario of repricing and downgrades.

In another recent S&P Global Ratings' report[10], it indicated that *"the 14-month improving trend in credit quality is likely to reverse, with cost input pressures to increasingly weigh on corporate margins through the year".* It expects default rates to move higher, toward 2.5% by year end in Europe.

With potential storms ahead we reiterate our view that insurers should increase resilience in asset portfolios. Diversification remains key to mitigate against market risks but also to exploit relative value opportunities and enhance risk-adjusted returns, especially in a context where European insurers have a very strong domestic bias in their credit portfolios.

As of end-2020, insurers had more than 82% of their aggregate corporate bonds' portfolio invested in EEA/EU countries.[11] This is an average and several insurers have a much stronger domestic tilt. The market drawdown that followed Ukraine's invasion in February did not have the same magnitude across countries and regions. Exhibit 3 shows that volatility has picked up more dramatically in the Eurozone compared to the US – and their respective equity and credit markets' valuations were not impacted in tandem.

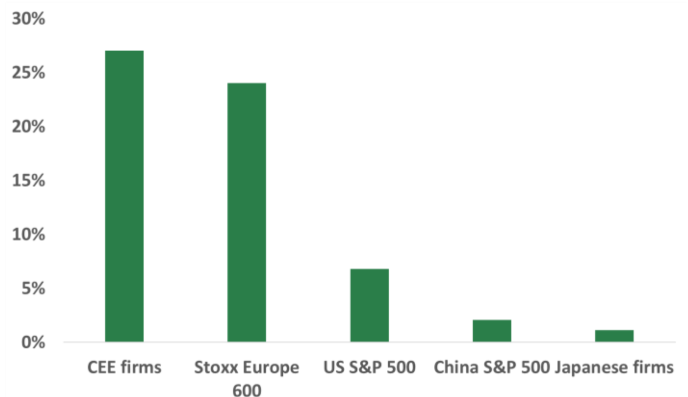
Exhibit 3: Implied volatility of EuroStoxx 50 (V2X) and S&P 500 (VIX) equity indices



Source: Bloomberg – AXA IM

European sovereigns and companies are much more exposed to the impacts of the Ukraine crisis than sovereigns and corporates in other regions, as illustrated by Exhibit 4, reinforcing the case for further diversification, and also to mitigate against geopolitical risks.

Exhibit 4: Percent of firms with exposures to Russia and Ukraine



Source: Global Financial Stability Report – IMF – April 2022
Foreign exposures are defined as revenues derived from abroad in percent of total revenues. Percent of firms with >2 percent exposures. The sample includes 529 CEE firms and 2,079 Japanese firms. CEE = central and eastern Europe and includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, and Turkey; EMEA = emerging Europe, Middle East, and Africa.

[8] Reinsurance News - Moody's says Russian invasion has done little to impact insurer solvency ratios – March 17th, 2022.

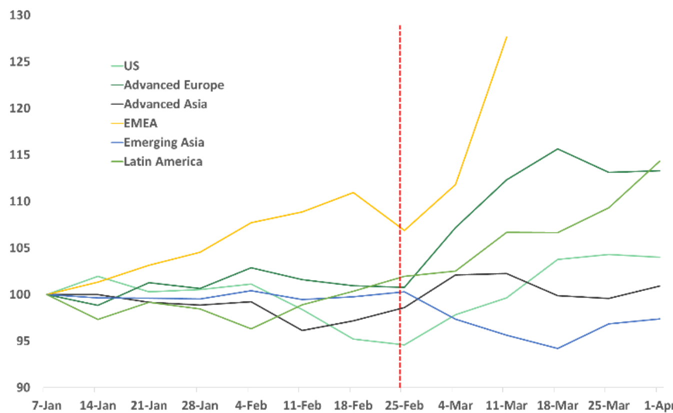
[9] Joint committee report on risks and vulnerabilities in the EU financial systems – March 17th, 2022.

[10] Credit Conditions Europe Q2 2022: Seismic Shocks, Security & Supply – S&P Global Ratings – March 29th, 2022.

[11] Financial Stability Report July 2021 - EIOPA

This higher direct exposure to Russia and Ukraine combined with Europe's dependency on Russian oil and gas certainly helps explain the far greater uncertainty about the European corporate outlook. Exhibit 5 shows a high dispersion of earnings forecasts across geographical areas. Diversifying corporate bond portfolios across regions would allow a reduction in the impact of potential negative outcomes, including on capital ratios. From a regulatory standpoint it is worth remembering that under IFRS 9 the impairment model will now be forward-looking (Expected Credit Loss model), with credit downgrades directly translating into P&L records, further supporting the idea of diversification.

Exhibit 5: Dispersion in Earnings Forecasts (Index, January 1, 2022 = 100)



Source: Global Financial Stability Report – IMF – April 2022
Presents standard deviations in analyst forecasts of earnings per share over the next 18 months

Building resilience does not only rely on diversification. Implementing interest rate derivatives overlays to manage asset and liability matching and the duration gap can also provide much more flexibility to optimise corporate bond portfolios, for instance, potentially reducing the portfolio's spread duration and enhancing credit risk-adjusted return and return on capital.

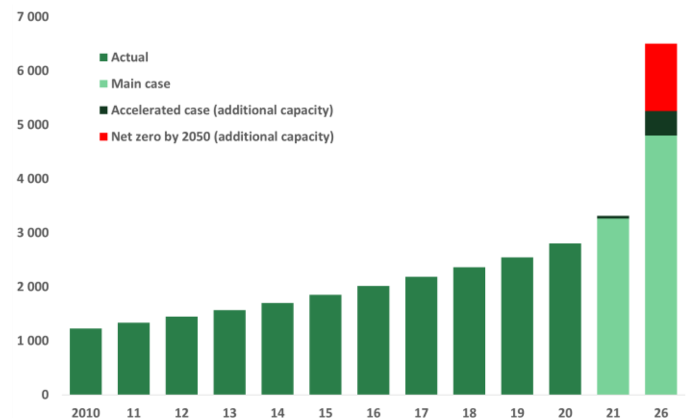
Crisis calls for accelerated climate risk integration

The Ukraine crisis has prompted a more ambitious European Union (EU) plan to diversify energy sources (the REPowerEU plan reinforces the existing Fit for 55 plan) so as to reduce its dependence on Russia's exports of oil and gas – it suggests a reduction of gas imports by almost 70% by the end of 2022 and a potential total stop by 2027.[12] The plan encompasses an acceleration in the switch from fossil fuels to renewable energy generation (in particular solar and wind) but the ambition appears challenging and the feasibility questionable.

In the shorter term the plan also envisages diversifying the EU's gas imports – including Liquefied Natural Gas (LNG) – but on that front too, it may be difficult to fully substitute Russian imports, especially if stronger sanctions are applied. AXA IM research estimates that EU countries will likely have to temporarily increase reliance on coal-based generation which would increase carbon emissions in the short- to medium-term (well above the pre-war EU projections), until the switch into renewables is sufficiently and up and running and allows for a downward trend to materialise.[13]

This temporary greater use of coal-based energy will likely slow the already insufficient pace of execution of climate action plans and delay the achievement of net-zero targets, while the Intergovernmental Panel on Climate Change (IPCC) has recently warned that it is "now or never" and that emissions must peak by 2025 to avoid dramatic climate change.

Exhibit 6: Evolution in renewable energy capacity and forecasts in a net-zero scenario (Total capacity in gigawatt)



Source: Global Financial Stability Report – IMF – April 2022
IEA's forecasts are shown for 2026, where main case is the base case scenario, accelerated case is a more optimistic scenario, and net-zero by 2050 case estimates capacity needed to transition to a net-zero energy system by 2050.

[12] Global Financial Stability Report – IMF – April 2022

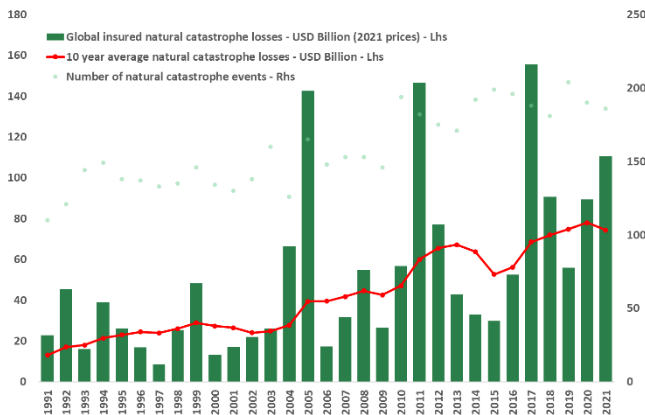
[13] The Russia Ukraine impact on Climate Change – Considering the impact of the war on the prospects for emissions – AXA IM Macro Research team – May 2022

The IMF corroborated this view in its latest Global Financial Stability Report,[14] stating that *"the geopolitics of energy security may put climate transition at risk"*. It emphasised the trade-off between energy security and energy transition, with some countries having indicated their intention to rely on domestic coal-based energy generation, and that the buildup of the renewable energy infrastructure is likely to be delayed given the headwinds related to rising prices and supply disruptions. Exhibit 6 shows that investments aimed at increasing renewable energy supplies are insufficient given the net zero target.

Bottom line – in its report the IMF warned that *"given that climate change poses a threat to financial stability, a delayed and disorderly climate transition may magnify risks to the financial system"*.

The insurance sector is particularly concerned by climate change as insurers are exposed on both sides of the balance sheet. P&C insurers are particularly exposed as they cover homes and properties, infrastructure, businesses, and goods that can be damaged or destroyed by extreme weather events, which have intensified over the last years.

Exhibit 7: Global insured natural catastrophe losses



Source: Swiss Re - Sigma 1/2022 - Natural catastrophes in 2021. Focus flood: building resilience against a rapidly growing risk.

A March report from Swiss Re Institute,[15] noted that natural and man-made disasters resulted in global economic losses of $280bn in 2021, of which $270bn was attributable to natural catastrophes. As shown in exhibit 7, insurers covered $119bn of last year's economic losses, of which $111bn related to natural catastrophes – the fourth highest since 1970. The growing impact of climate change on insurers appears incontestable.

A November 2020 report from McKinsey & Company indicated that insurers have underestimated the immediacy of physical and systemic effects from climate change.[16] P&C insurers can reprice risks and adjust policies on a regular basis and the widening protection gap could also be considered as an opportunity. But McKinsey highlighted that climate risks are systemic and non-stationary, meaning that *"further warming is locked in for the next decade because of inertia in the geophysical system"*.

The systemic and irreversible effects of climate change were again recently reaffirmed by the IPCC as part of its Sixth Assessment Report (AR6) published earlier this year: *"The world faces unavoidable multiple climate hazards over the next two decades with global warming of 1.5°C (2.7°F). Even temporarily exceeding this warming level will result in additional severe impacts, some of which will be irreversible."*[17]

So standard actuarial models based on historical data are likely to underestimate forward risks and insurers should leverage climate science to properly assess their exposure and the rise of aggregation risk (one single event leading to multiple damages across geographies).

The implications of the Ukraine crisis should lead to higher greenhouse gas (GHG) emissions for longer and exacerbate physical risks related to climate change. Whatever its magnitude, the contribution of the expected spike in GHG emissions to global warming will also be 'locked in' for the future. The frequency of occurrence and severity of physical risks is likely to continue to increase and to materialise into growing insurance losses. Insurers should certainly consider strengthening their assessment of climate risk when defining and implementing their underwriting strategies, especially when considering the combination of higher number of claims with higher inflation.

Climate risks can be physical, but they can also be transitional as governments, regulators and market participants work to reduce the world's reliance on carbon and get organised to redirect capital allocation toward sustainable businesses. The REPowerEU plan and the general political will to reduce the EU's dependence on Russia's oil and gas could potentially increase transitional risks.

[14] International Monetary Fund. April 2022. Global Financial Stability Report—Shockwaves from the War in Ukraine Test the Financial System's Resilience

[15] Swiss Re - Sigma 1/2022 - Natural catastrophes in 2021. Focus flood: building resilience against a rapidly growing risk.

[16] Climate change and P&C insurance: The threat and opportunity – McKinsey & Company – November 2020

[17] Sixth Assessment Report — IPCC

Insurers have a strong incentive to integrate environmental, social and governance (ESG) into both their liabilities and asset portfolios. It is not only about reducing risks, it's about building a more resilient and sustainable world. A lot of insurers have already committed to fighting against climate change and are very active actors of sustainable finance. Many have joined the Net-Zero Asset Owner Alliance (NZAOA) and have formulated concrete objectives in terms of reduction of carbon emissions to contribute to achieving the goal set by the Paris Agreement to limit the rise in global warming to +1.5°c versus pre-industrial levels. An increasing number of insurers have also joined the Net-Zero Insurance Alliance (NZIA) which expands carbon neutrality commitments to their insurance activities. Several have already committed to the fight against climate change, but the implications of the Ukraine war should certainly be a wake-up call. Those who are late need to catch up and those who are already well engaged should accelerate their journey to decarbonisation.

Regulatory pressure also requires the integration of sustainability risks into insurers' risk management under Solvency II. Climate risks are significant in insurers' balance sheets and policy makers are expecting these risks to be integrated in risk management frameworks. Insurers are clearly centre stage in ensuring the stability and effectiveness of the financial systems in the long term. With this objective in mind, EIOPA has already engaged in the process of integrating climate but more broadly ESG risks in the Solvency II framework.

An opinion on Sustainability within Solvency II was first published in 2019 and EIOPA launched a consultation on climate scenarios in ORSA (Own Risk and Solvency Assessment) in 2020. There are still challenging methodological questions around climate risk quantification and stress testing, but discussions on the definition of climate risk scenarios and their impact on capital positions are moving forward.
Insurers have already been asked to perform climate stress tests in certain countries, notably in the UK with the Climate Biennial Exploratory Scenario (CBES) exercise launched by the Bank of England in June 2021.

During its 5th Sustainable Finance Roundtable which took place on 7 December 2021, EIOPA announced its sustainable finance agenda for the next three years – and it is certainly ambitious. It notably reaffirmed its objective to ensure the integration of sustainability in all pillars of the prudential frameworks.

More recently, in January 2022, EIOPA published a new paper on the methodological principles of insurance stress testing. It sets out methodological principles that can be used to design bottom-up stress test exercises that aim to assess the vulnerability of insurers to climate risks. There is a lot of regulatory activity around climate which clearly shows that it is a priority for policymakers and supervisors.

The implications of the Ukraine crisis on carbon emissions and climate action plans will certainly not slow this regulatory process and we believe insurers should get equipped to perform climate stress tests or partner with investment managers who can support them in complying with this mounting regulatory pressure.

Our Research is available online: http://www.axa-im.com/en/insights

Insights Hub
The latest market and investment insights, research and expert views at your fingertips
www.axa-im.com/insights

Ref-25460

For professional clients only

DISCLAIMER

This document is for informational purposes only and does not constitute investment research or financial analysis relating to transactions in financial instruments as per MIF Directive (2014/65/EU), nor does it constitute on the part of AXA Investment Managers or its affiliated companies an offer to buy or sell any investments, products or services, and should not be considered as solicitation or investment, legal or tax advice, a recommendation for an investment strategy or a personalized recommendation to buy or sell securities.

It has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. Its analysis and conclusions are the expression of an opinion, based on available data at a specific date.

All information in this document is established on data made public by official providers of economic and market statistics. AXA Investment Managers disclaims any and all liability relating to a decision based on or for reliance on this document. All exhibits included in this document, unless stated otherwise, are as of the publication date of this document.

Furthermore, due to the subjective nature of these opinions and analysis, these data, projections, forecasts, anticipations, hypothesis, etc. are not necessary used or followed by AXA IM's portfolio management teams or its affiliates, who may act based on their own opinions. Any reproduction of this information, in whole or in part is, unless otherwise authorised by AXA IM, prohibited.

Issued in the UK by AXA Investment Managers UK Limited, which is authorised and regulated by the Financial Conduct Authority in the UK. Registered in England and Wales No: 01431068. Registered Office: 22 Bishopsgate London EC2N 4BQ

In other jurisdictions, this document is issued by AXA Investment Managers SA's affiliates in those countries.

AXA Investment Managers SA
Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
Registered with the Nanterre Trade and Companies Register under number 393 051 826