Political Instability and Financial Volatility Remain Key Headwinds For Italian Insurers

Italy’s volatile financial and political environment will pose challenges for the domestic insurance sector in 2017, principally due to the potential impact on investment portfolios. A.M. Best considers insurers’ exposure to the country’s troubled banking sector manageable. But any deterioration in Italy’s macroeconomic fundamentals, and subsequent pressure on its sovereign rating, will weaken the credit quality of balance sheets dominated by domestic government bonds. With difficult operating conditions likely to remain, A.M. Best is focused on how companies are managing their investment portfolios, as well as the appropriateness of risk management measures in place.

Profitability for Italian insurers has been resilient over the past few years, with the market as a whole reporting an average 6.8% Return on Equity (ROE) over the period 2011 to 2015, according to data from insurance trade association, the Associazione Nazionale fra le Imprese Assicuratrici (ANIA). In absolute terms, both life and non-life business have made a positive contribution to pre-tax profits.

Underwriting performance has been good, in spite of what A.M. Best considers to be a difficult operating environment due to the combination of political uncertainty and challenging financial market conditions. Results have been helped by the actions taken by Italian insurers to de-risk their life portfolios, principally by reducing the average guarantees to policyholders to offset the impact of the prevailing low interest rate environment. In the non-life sector, the five-year average combined ratio for the market between 2011 and 2015 was solid at 92.7%, supported by favourable claims experience, particularly in the motor sector. As political, economic and financial system risks heighten in Italy, A.M. Best has increased its focus on insurers’ ability to manage these risks.

Political and Economic Instability

In December 2016, Italy faced two substantial headwinds to its economy: increased political uncertainty and a looming crisis in its banking sector. On December 5, Prime Minister Matteo Renzi resigned from office following his defeat by a large margin (59% to 41%) in a flagship referendum to streamline Italy’s political system.

Following his resignation, the new prime minister, Paolo Gentiloni, faces the daunting task of stabilising Italy’s fragile banking sector in an environment of low growth and stagnant productivity, as well as increasing debt levels for the country and weak competitiveness. According to the International Monetary Fund (IMF), debt levels – defined as general government net debt as a percentage of gross domestic product (GDP) – will increase from 2016 to 2017. The current political situation will make it more difficult to implement reform measures, as the opposition has been demanding an early snap election.

Italy has also been plagued by financial concerns regarding non-performing loans (NPLs) crippling its banking sector. On December 23, the Italian parliament approved a EUR 20 billion bailout – equating to 1% of GDP – to help support the sector. A few days later, it was...
estimated that Italy’s third largest bank, Monte dei Paschi di Siena (MPS), had a capital shortfall of EUR 8.8 billion, much larger than the initial EUR 5.0 billion estimated in July following the European Central Bank’s banking stress test.

State support is expected at Italian banks due to the fragile condition of the sector. The Italian banking system has faced years of low growth, profitability challenges and a large stock of NPLs. According to the IMF, it is estimated that gross NPLs have equated to about 18% of total loans, totalling over EUR 360 billion in 2015 across the Italian banking sector. According to the Banca D’Italia, NPLs as a percentage of total loans in 2016 had decreased but still reached 17% in Italy, versus the European Union average of around 6%.

**Italian Insurers Heavily Exposed to Domestic Debt**

Political and financial market uncertainty, such as that observed in the build up to the December referendum, has implications for the Italian insurance sector, principally due its exposure to the country’s government bonds.

Exhibit 1

**Italy - 10-Year Italian Government Bond Yields**  
(Year-End 2015 to present)

Source: Bloomberg

A.M. Best notes that domestic insurers use Italian sovereign debt to back local liabilities and, as a whole, the sector is well matched so that the value of assets and liabilities move in tandem. However, significant exposure to this asset class—amounting to EUR 285 billion as at April 30, 2016—means that balance sheets are prone to potential volatility as any sudden increase in the yields of Italian bonds will directly impact investments and could weaken the capital base of insurers.

**Exposure to Banks is Deemed Manageable**

The industry is also exposed to Italy’s troubled banking sector through debt and equity holdings, as well as to the bank back-stop fund, Atlante. However, A.M. Best considers the risk to balance sheet strength to be manageable. According to the European Insurance and Occupational Pensions Authority’s (EIOPA) 2016 Financial Stability Report, banks represented approximately 33% of the European insurance sector’s investments, and domestic banks comprised only 32% of Italian insurers’ total bank investments as at June 30, 2016. Concentrations that favour individual entities tend to be limited.
Banks also play an important role in the distribution of insurance products in Italy, particularly in the life sector. While the financial difficulties of a particular bank may disrupt the distribution of some insurance products, this would not be expected to have a material impact on the insurance sector's overall performance.

There are examples of common ownership between banks and insurers in Italy. Furthermore, on January 24, 2016, Intesa Sanpaolo, Italy's largest bank by market value, stated that it was considering a bid for the country's largest insurer, Assicurazioni Generali SpA, with the aim to grow in the insurance and asset management sectors.

When an insurer rated by A.M. Best has a non-insurance owner, such as a bank, a two-step rating process is employed. The first step comprises a stand-alone assessment of the insurance company. The second step contemplates whether or not the insurer qualifies for enhancement or drag to its stand-alone assessment after incorporating information related to the non-insurance parent. The analysis of the parent will include an assessment of publicly available credit measures, market-based credit measures and independently performed financial analysis.

**No Rating Actions Anticipated in the Near Term**

Robust enterprise risk management, including monitoring of solvency positions, stress testing and reverse stress testing, is fundamental if insurers are to withstand the political and economic instability prevailing in Italy. A.M. Best tests the resilience of rated insurers against market fluctuations and throughout the rating process embeds an assessment of economic, political and financial system risk through its Country Risk methodology, together with an evaluation of companies' risk management capabilities.

As heightened levels of political and economic uncertainty are already factored into current ratings, A.M. Best does not expect to take any rating actions on Italian insurers in the near term. However, it will continue to monitor the exposure of domestic insurers' balance sheet strength to investment market volatility and scrutinise the measures they have in place to navigate this challenging environment.

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