2025 European Insurance Outlook:

Opportunities Amid Subdued Growth

BOB SHARMA
Head—EMEA & APAC Insurance

INIGO FRASER JENKINS
Co-Head—Institutional Solutions

JOHN TAYLOR
Head—European Fixed Income and Director of Global Multisector

The backdrop as European insurers kick off 2025 is one of a likely soft economic landing globally, with subdued growth in Europe. Solvency has declined but is still in good shape. This could usher in greater focus on asset-liability management, hedging programs and the solvency efficiency of investments. The regulatory front is rather quiet now.

Executive Summary

Rates are likely to fall a little further in the medium term, with greater divergence among the easing paths of major central banks, which would have implications for hedging costs. Strategic forces will likely lead to higher structural inflation over the long run.

Credit spreads remain tight, though they've shown the ability to stay tight for a while, supporting credit exposure—particularly short-term credit, and even more so when factoring in required solvency capital. Opportunities in many private-credit segments, which tend to be short duration, also seem compelling. High-yield credit remains an important consideration for insurers, even with tight spreads. A barbell exposure seems sensible, leaning more into spread risk at shorter maturities.

Stocks largely go unmentioned in the insurance arena, but they may be worth revisiting in light of our outlook for higher long-run inflation—they offer an implicit cushion against the erosion of portfolio buying power. Allocation changes of any kind, however, require an intensive focus on liquidity risk.

The Macroeconomic Backdrop: Subdued Growth for Europe

As 2025 gets under way, the global economy is still broadly on track for a soft landing—as long as inflation remains subdued. Energy prices are stable, making us more confident that inflation will gradually slow in the short to medium term, though a confluence of forces suggests that it will be above central bank targets. We expect central banks to continue easing at their individual paces.

While the US economy looks set for an even softer landing, euro-area growth risks remain tilted to the downside, picking up but remaining subdued and below potential. However, recession risks are likely contained. Inflation should decline to target in 2025, enabling the European Central Bank (ECB) to cut rates to a neutral level.

As inflation reaches the ECB's 2% target in 2025 and monetary policy becomes less restrictive, consumption should slowly rebound, especially in the second half of the year. Investment should also recover, albeit more slowly than consumption. Fiscal policy won't remain as supportive, which could be a drag in countries with stricter consolidation requirements, such as France and Italy.

Downside growth risks have been building lately as private demand struggles to recover, monetary policy remains restrictive, manufacturing is in recession and labor markets loosen. We see Europe's periphery continuing to outpace core economies. Germany's growth, for example, stalled in 2024. All told, the euro area starts 2025 with weak momentum and the balance of risks tilted to the downside.

The UK's recent budget is both expansionary and inflationary. We expect stronger growth in that country, and therefore a slower inflation decline. These changes will likely make the Bank of England more cautious and prone to cut rates more gradually.

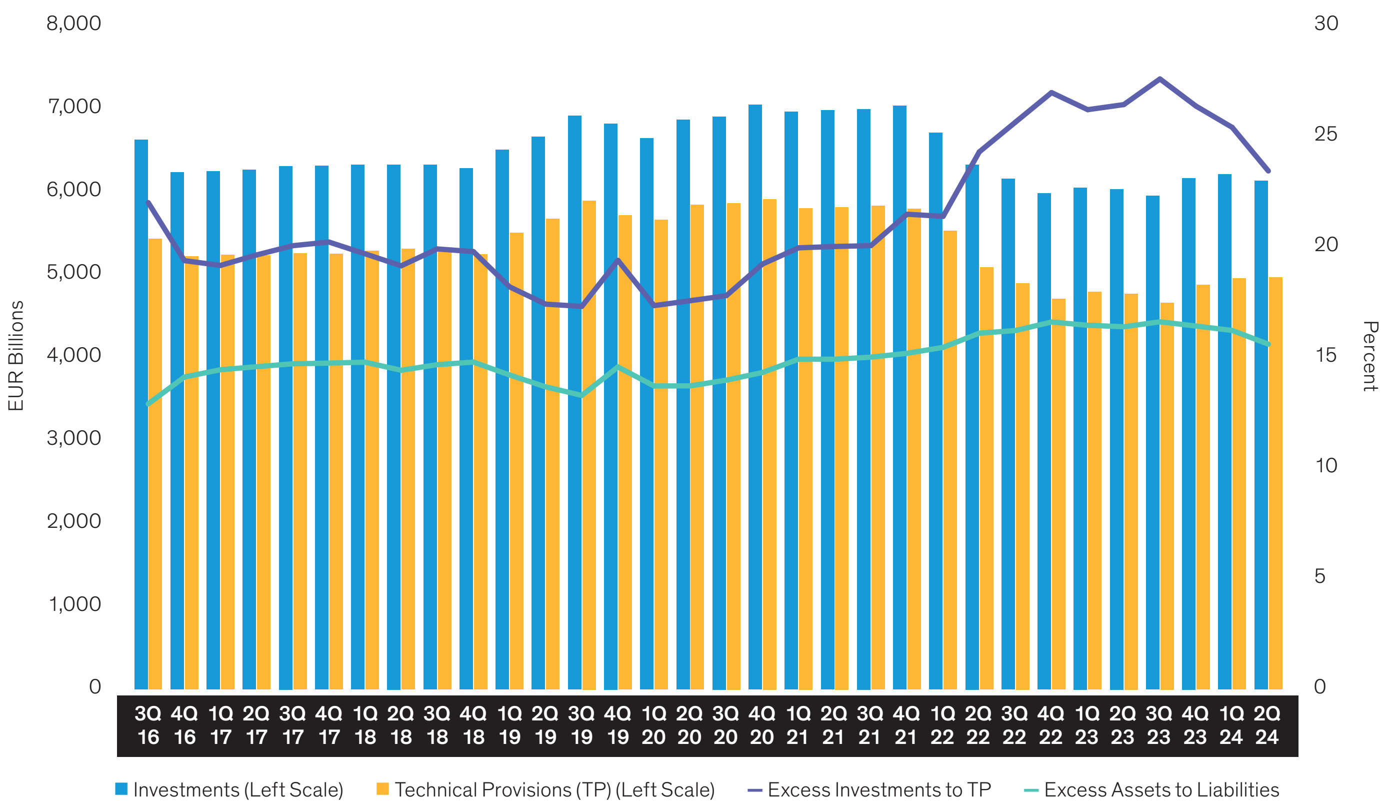
Solvency Positions Have Tapered Off but Are Still Healthy

Insurers enter 2025 with solvency near its 2022 level (*Display 1*). After a period of heightened strength, due to assets falling less than liabilities as rates rose, excess has declined but is still healthy.

The decline suggests to us that insurers—broadly speaking—didn't seek to lock in the solvency benefits of rising rates in a significant way. This isn't surprising: Closing a long-held duration gap holds challenges for insurers, as long-term assets are in high demand. Hedging with swaps poses collateral considerations. And insurers' balance sheets are large, so any move would be sizable.

DISPLAY 1: EUROPEAN BALANCE SHEET STRENGTH HAS DECLINED, BUT IS STILL HEALTHY

Investments, Technical Provisions, Assets and Liabilities

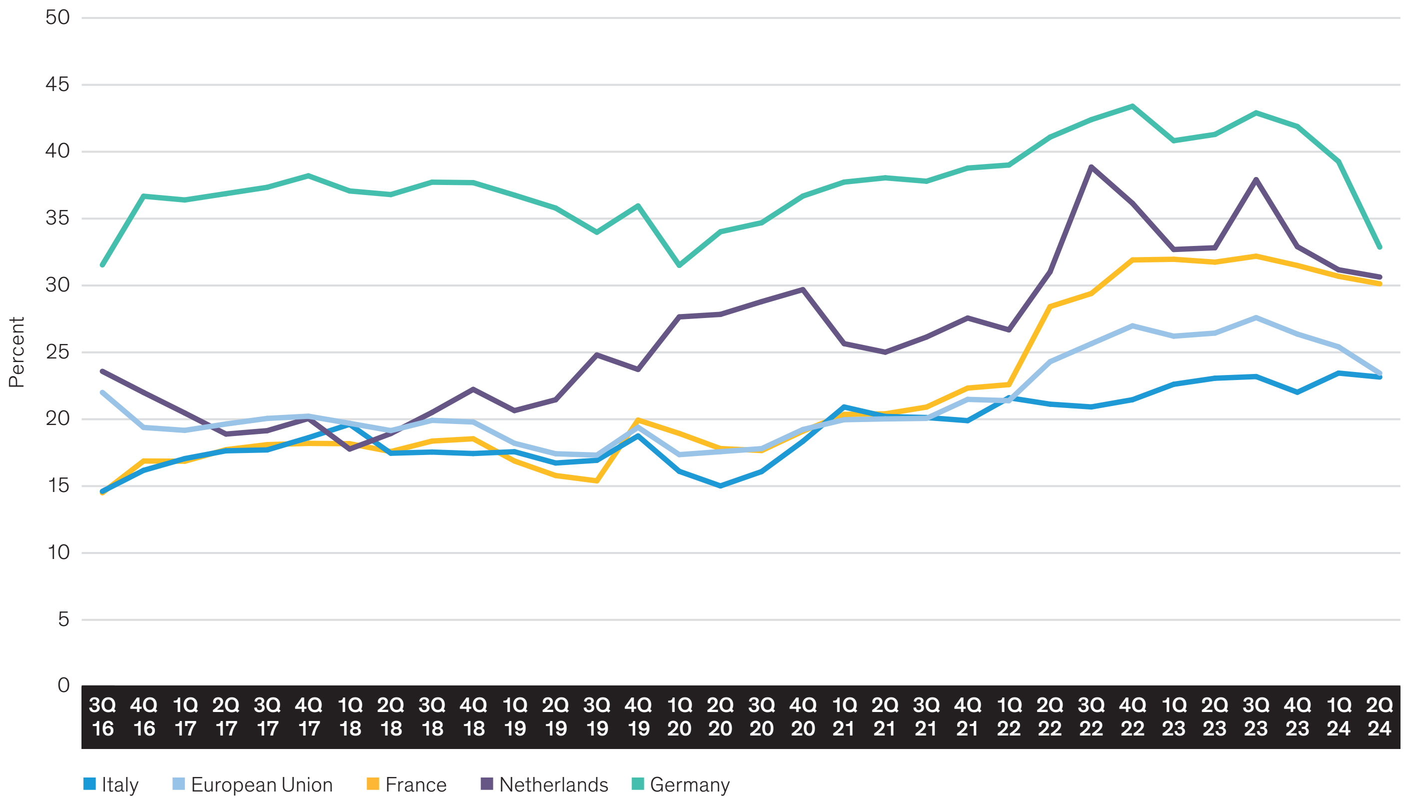


Past performance does not guarantee future results.

Through June 30, 2024 | **Source:** European Insurance and Occupational Pensions Authority (EIOPA) and AllianceBernstein (AB)

DISPLAY 2: DIVERGENCE IN INVESTMENTS EXCESS WITHIN THE EURO AREA

Excess of Investments over Technical Provisions by Country



Past performance does not guarantee future results.

Through June 30, 2024 | **Source:** EIOPA and AB

Assessing the excess of investments over technical provisions at the country level (*Display 2*), Italy has strengthened slightly from its weaker position in recent years versus the European Union (EU) average. Italy saw greater lapses than most countries as rates rose, but our conversations with insurers suggests that lapses have subsided—though they're still an area of careful consideration for asset management. In the Netherlands and Germany, meanwhile, investments have declined relative to technical provisions—we think largely rate driven—but are still strong within the region.

With solvency down versus recent years, insurers seem keen to stave off further declines given the erosion of the beneficial headroom they've operated with the last couple of years. This situation could bring an increased focus on asset-liability management (ALM), hedging programs and the solvency efficiency of investments.

The Regulatory Front: No Major Changes in Motion

Recent regulatory changes have been marginal, with tweaks to solvency rules in both Europe and the UK. Adjustments to Solvency II in the EU are in progress, including an effort to make the long-term-equities category more accessible. Solvency UK efforts are introducing changes focused on bulk-purchase annuity players, with incremental altering of rules on the matching adjustment. Both initiatives seek to reduce the cost of capital for the risk margin to boost solvency positions.

It's still early days, but solvency-capital increases on fossil-fuel-related investments are something for insurers to keep a close eye on. The latest recommendations from the European Insurance and Occupational Pensions Authority (EIOPA) point in that direction, although a long review, approval and legislative process stands between recommendation and reality.

Further afield, Asian insurers continue to transition toward regimes similar to Solvency II and to implement International Financial Reporting Standards 17. While Asia will see a significant impact, the short-run implications for European insurers are likely to be small. In the longer run, a greater focus on ALM considerations over return alone could accelerate the maturity of the Asian private-debt market. This may broaden the opportunity set for Europeans.

In the US, noninsurance regulation could have more of an impact, as a change in the government balance of power could roll back support for green initiatives enacted by the previous administration. Such a course change could affect the investment opportunity set—and have consequences for the pace of transition to a greener economy.

Investment Views: Establishing the Landscape

Rates are down from their highs of the last couple of years, reducing solvency buffers—which remain broadly satisfactory and close to insurers' own targets.

Rates are likely to fall a little further in the medium term, with greater divergence among major central banks, which have shifted into easing mode. The chances seem promising for a global soft landing, though with sizable downside risks that make for an unpredictable backdrop: geopolitical conflicts, record peacetime debt burdens and the lingering aftermath of COVID-19. Also, the challenges facing the world's three biggest economic drivers—the US, Europe and China—have become more diverse, so we expect rate paths and risk-asset valuations to follow that lead.

Divergence would affect hedging costs. A higher nominal US rate suggests a slightly higher cost for euro investors to hedge out currency risk; our base case is for a stronger US dollar under President Trump. But we think the benefit of geographic diversification and the relative outlooks for the US and European economies make this a cost worth stomaching. Insurance investors might consider adjusting hedging ratios to create tactical dollar exposure, though this entails a 25% cost of capital under the Solvency II standard formula (assuming an insurer has no US dollar liabilities to offset against).

DISPLAY 3: DEFLATIONARY AND INFLATIONARY FORCES AT WORK OVER STRATEGIC HORIZONS

Deflationary Forces	Inflationary Forces
• Lower long-term growth expectations imply lower inflation • Technology and automation have been deflationary for years. Does AI revolutionize this and undercut the case for inflation? • Customers' realization, once pent-up spending ebbs, that nominal savings returns are down and inflation is up. This implies the need to save more, which lowers money's long-term velocity	• Deglobalization (supply/labor cost impact) • Demographics (shrinking labor force and higher care costs) • Labor bargaining power (smaller supply of labor versus AI benefit) • Energy transition and climate: Is the transition inflationary or deflationary? What's the impact of severe weather on inflation volatility? • Debt monetization. Debt/GDP is at it highest since WWII: Is inflation the only way out?

Current analysis does not guarantee future results.

As of November 30, 2024 | **Source:** AB

Strategic Forces Will Likely Lead to Higher Structural Inflation

The case for higher long-run structural inflation argues against rates returning to a "lower for longer" environment. The cooling of cyclical inflation has led some investors to believe that inflation will return to "normal," as in the very special conditions of 10 to15 years before COVID-19. We think this conflates cyclical and structural inflation, and the different powers central banks may have for each.

We see very different forces at work that are set to drive inflation higher over strategic horizons, though deflationary forces are present, too (*Display 3*). So, we don't see unanchored inflation in the future; instead, we think elevated inflation hovering around 3% is more likely.

Credit Spreads Are Tight—but Opportunity Remains

What are the implications of the landscape for credit markets, especially with spreads priced fairly reasonably without much to suggest further tightening?

Historically, credit spreads have shown the ability to stay tight for quite a while, supporting credit exposure in insurance portfolios. This makes a particular case for short-term credit, where spreads would need to widen much more than those of longer-term credit to offset carry and drive underperformance versus government bonds. Pent-up cash balances could also find their way back into the bond market as cash rates decline, offering further support, with a particular benefit to shorter maturity investment-grade credit that represents a step back into the market.

From a longer historical view, corporate spreads are tighter than their 10-year averages, but the shorter the duration cohort, the tighter the spread relative to the average. This hints at better value for taking credit risk in short-duration segments (*Display 4, page 5*). The same holds true over a 20-year history that includes the global financial crisis.

Factoring in required solvency capital against each duration cohort (assuming 50% A / 50% BBB credit quality and focused on spread risk only), the picture becomes more compelling. Relative to the 10+-year bucket, 1–3-year credit offers more than double the spread per percent of solvency capital. Lower duration credit offering a better return on solvency has held true over the long run, but the dispersion among duration buckets is particularly pronounced today. The shortest duration offers better value than average, and the longest duration offers worse value than average.

DISPLAY 4: BETTER VALUE FOR CREDIT RISK IN SHORTER SEGMENTS

	Global Aggregate Corporate	Global Aggregate Corporate 1-3 Yr	Global Aggregate Corporate 3-5 Yr	Global Aggregate Corporate 5-7 Yr	Global Aggregate Corporate 7-10 Yr	Global Aggregate Corporate 10+ Yr
Current Spread (bps)	86.70	62.34	82.12	93.64	101.89	103.09
Average Spread (bps)	126.16	84.08	109.93	128.93	144.68	163.00
Standard Deviation (ratio)	28.56	28.01	30.39	31.71	31.70	32.14
Z Score (ratio)	–1.38	–0.78	–0.92	–1.11	–1.35	–1.86
Duration (years)	5.99	1.87	3.58	5.25	6.83	12.45
Solvency Capital Requirement (SCR) (%)	10.85	3.90	7.80	9.75	11.95	16.75
Current Spread/ SCR (%)	7.99	15.99	10.53	9.60	8.53	6.15

Current analysis does not guarantee future results.

As of November 30, 2024 | **Source**: Bloomberg Global Indices and AB

Private Credit: Floating Rate and Broader Opportunities

Our conviction in shorter-duration credit value is strengthened by looking beyond public fixed income to private markets benefiting from banks pulling back from lending in certain segments. Direct lending, asset-based finance and net-asset-value lending are floating-rate assets that expand the opportunity set for insurers.

Asset-based lending represents a strong diversification opportunity for European insurers, in our view. Many insurance investors held this type of risk before Solvency II, then reduced it because exposures were typically available in the asset-backed security format when not held on a bank balance sheet. This made the solvency capital charge unpalatable.

Increasingly, strategies are being developed to aggregate these exposures in a nonsecuritized format, enabling insurers to diversify corporate credit risk on their balance sheets without picking up a material change in solvency capital usage. Corporate risk accounts for 41% of all fixed-income risk in European balance sheets (*Display 5, page 6*); using structured notes, collateralized securities, and mortgages and loans as a proxy, asset-based lending is only 14% (the mortgage allocation is significantly skewed by Dutch insurers). We think this leaves much room for diversification.

Insurance balance sheets seem a sensible home for this kind of risk. As regulatory changes spur banks to pare back lending, insurance balance sheets offer a home within a model that could make more sense. Whereas banks focus on maturity transformation in borrowing short and lending longer, insurers simply seek to balance assets and liabilities, making insurance portfolios a potentially more stable home, especially when rates are volatile.

High-Yield Bonds Still an Important Consideration

Staying on the shorter duration theme, we believe investment-grade credit spreads look attractive relative to high-yield spreads. However, high-yield credit remains an important consideration for insurers even with spreads tight.

The attractions high yield offers include compellingly high yields and robust fundamentals. But they also include structural performance benefits stemming from the mechanics of upgrades to investment-grade ratings and downgrades from that space.

Within high yield, we think insurers should stay up in quality, where the incremental spread pick up versus BBB-rated credit is attractive relative to the additional expected loss investors must take on. As of November 18, 2024, the global high-yield market's duration was 3.6 years, based on the Bloomberg Global High Yield Index.

A Barbell Approach to Taking Spread Risk

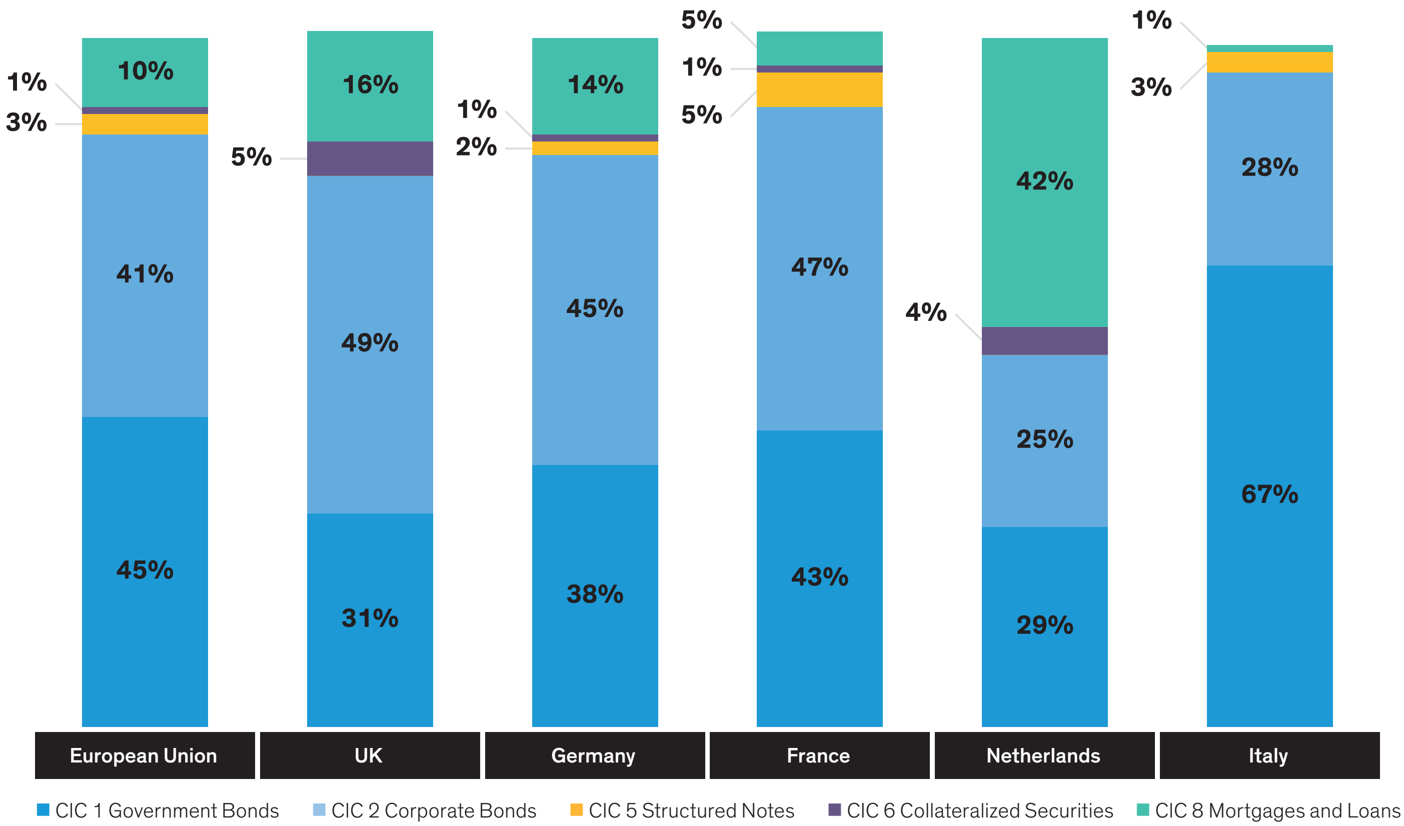
Given the state of credit opportunities, we think it makes sense for insurers to barbell exposure to spread risk. Spending more of a spread-risk budget in shorter-duration segments while leaning away from investment-grade corporates in longer-duration exposure may enable insurers to exploit better relative value and expand balance sheet risk exposures to aid diversification.

Rising government debt levels and fiscal largesse are a counter to this approach over the longer term. This trend could boost the term premium over time, increasing rates available on longer-term bonds. However, this process is very hard to time, and extra return would be viewed as a requirement in light of the added risk.

Ultimately, it's critical to achieve the right aggregate duration positioning—including key rate durations. Leaning toward shorter-term spread risk doesn't mean spread risk should be absent at the longer end. Insurers must simply ensure that they're compensated appropriately from a relative-value perspective. Longer-duration private investments, such as infrastructure or private placements, are

DISPLAY 5: MUCH ROOM FOR DIVERSIFICATION IN INSURANCE PORTFOLIOS

European Insurance Allocation by Credit Investment Classification



Past performance does not guarantee future results. Numbers may not sum due to rounding.

CIC: credit investment classification

As of June 30, 2024 | **Source:** EIOPA and AB

likely to produce attractive opportunities, but on the whole, we see more relative value in the shorter end of the market.

Given the varied and evolving opportunity set across fixed-income segments, it would seem sensible for insurance investors to consider a dynamic approach across sectors, including investment-grade debt, higher yielding credit and securitized assets. This approach would allow leaning into areas of opportunity in a flexible way, whole adhering to investment limits and constraints.

Equity Exposure Might Be Worth Another Look

Stocks largely go unmentioned in the insurance arena, but they may be worth revisiting given our outlook for higher long-run inflation. Equities' implicit link to inflation could cushion against the erosion of portfolio buying power. We're not arguing for a major allocation, but equity can be accessed flexibly: passive or active, public or private. Passive public equities are among the cheapest, most-liquid asset classes and may be a viable option for some insurers—though they leave little control for leaning into areas where the opportunity may be more compelling.

The range of capital charges for equities is growing. We're all very familiar with the 39% and 49% charges for type I and II equities, but the evolution of the seldom-used Long-Term Equities Investments (LTEI) classification could mean easier access to a 22% charge for equities that align. Previously, insurers seeking to use LTEI would have to ring-fence the assets, identify and assign them to a corresponding pool of insurance obligations (requiring the restructuring of insurance liabilities), and face challenges in defining and testing LTEI under a "no forced sale" requirement.

The new criteria offer insurers a lower hurdle.

They include requirements such as implementing a policy to reflect the insurer's intention to hold the assets long term for a period beyond five years on average. Insurers must also demonstrate the ability to continue holding the assets under stressed condition (finding liquidity from other areas of the investment book as needed), and that the equity portfolio is appropriately diversified. With a capital requirement of 22% as opposed to 39% or 49%, the appeal of the LTEI category is clear.

Additionally, the latest EIOPA recommendations following its report on the prudential treatment of sustainability risks proposes a supplementary capital charge for fossil-fuel-related equities. It's just a recommendation now but does point to a potential increase in equity risk charges of 17%, with type I fossil-fuel-related equities, for example, seeing their charge rise from 39% to 56%.

Looking at these two regulatory elements together, it's possible to conclude that insurance investors who've considered equities to support additional objectives, such as climate or societal benefit, and who'll take an active long-term approach should be in good stead. We believe that a number of insurers are doing just that—in Europe at least. Considering all these factors together, it seems worthwhile to reassess the desired level of equities in general accounts over the strategic horizon.

Exploring the Liquidity Dimension of Opportunities

Whether involving equities, short-duration credit or private markets, allocation changes demand a focus on liquidity risk. The insurance industry maintains robust practices to manage it, so we see no imminent concern of large liquidity calls. But it makes sense to factor in the potential implications of our views.

Insurers considering changing their allocations to equity risk should consider the liquidity of those holdings. On the one hand, equity is viewed as one of the most liquid asset classes. On the other hand, Solvency II reforms for long-term equity offer a clue within the initiative's name. The criteria focus on ensuring that insurance investors can access liquidity from any source other than those stocks. This may seem obvious, but it's an important element in the approach to liquidity.

If tapping the opportunity in the shorter-duration spectrum causes an insurer to increase interest-rate hedging to achieve duration in the longer end, it's key to factor in collateral considerations. A combination of further rate hedging coupled with more long-duration government bonds could complement each other, with the bonds being the first port of call for liquidity and collateral.

The market still draws a line between public and private investments—as we do in this paper. But we see this line blurring over time, giving way to a more granular assessment of liquidity for each opportunity—especially as private opportunities continue expanding. This would be a good thing. The EIOPA recently published a consultation paper on enhancing liquidity risk management, so it seems sensible for insurers to consider evolving the consideration of their investment book liquidity alongside their capacity to take more illiquidity risk.

Bringing It All Together

With 2025 likely to usher in divergent economic expectations and downside risks in Europe, insurers will be looking to make balance sheets more resilient and portfolios more diversified. Couple that with some weakening in still-robust solvency positions, and insurance investors will clearly be keen to find the most bang for their solvency buck.

Marry that quest with our assessment of the opportunity set, and we believe insurers should be considering allocating more of their risk budgets to the shorter duration end of the market. While inflation is coming under control, we see it settling above central bank targets in the long run. This should prompt insurers to consider the impact on their balance sheets—whether their liabilities are in nominal terms or not.

Equities won't become a core insurance holding for many reasons, but inflation, regulatory change and the potential to pursue environmental or societal objectives in addition to return present a few reasons why we think it would be worth assessing appropriate equity exposure.

Nashville

501 Commerce Street
Nashville, TN 37203
United States
(212) 969 1000

New York

66 Hudson Boulevard East
New York, NY 10001
United States
(212) 969 1000

Milan

Piazza Gae Aulenti 1 Torre B
20124 Milan
Italy
+39 02 0062 1325

Tokyo

Hibiya Parkfront 14F
2-1-6 Uchisaiwaicho,
Chiyoda-ku
Tokyo, 100-0011
Japan
+81 3 5962 9000

Toronto

200 Bay Street, North Tower
Suite 1203
Toronto, Ontario M5J 2J2
Canada
(647) 375 2803

London

60 London Wall
London EC2M 5SJ
United Kingdom
+44 20 7470 0100

Sydney

Level 32, Aurora Place
88 Phillip Street
Sydney NSW 2000
Australia
+61 02 9255 1200

Singapore

One Raffles Quay
#27-11 South Tower
Singapore 048583
+65 6230 4600

Hong Kong

39th Floor, One Island East,
Taikoo Place
18 Westlands Road
Quarry Bay, Hong Kong
+852 2918 7888

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EIO–8375–0125
alliancebernstein.com