German Life Insurance Outlook

Maintaining Capital in Turbulent Times

Outlook Report

Rating Outlook

STABLE

Rating Outlook

Stable Ratings Outlook Maintained: Fitch Ratings considers the German life companies well prepared to meet the current challenges of the sector, and does not foresee a significant number of rating changes over the next 12-24 months.

Interest Rates, Market Volatility: Fitch views the low interest rate environment and the pronounced volatility of the capital markets as the main challenges for the German life insurers. There is considerable pressure on the ability of the insurance companies to earn a decent return on their investments, although companies appear better positioned to surmount these challenges than during 2000-2003.

Meeting Guarantees not Threatened: Although the average guarantee on German life insurance contracts is above the current running yields on ten-year German government bonds, German life companies rated by Fitch are expected by the agency to meet the guarantees. Fitch considers current investment portfolios to be well balanced and able to generate sufficient investment yield for existing life insurance portfolios.

Guarantee Reduction From 2012: There are also additional sources of income that can be drawn to support the obligations, and some relief will come from the reduction of the maximum guarantees for business written from 2012.

Sovereign Debt Crisis: German life insurance companies have only a small direct exposure to peripheral euro-zone (GIIPS) bonds and even larger losses in their market values could be digested. Overall, investment portfolios have been derisked over the last few years, which has also reduced the equity investment ratios.

Premium Income: During 2009 and 2010 the German life market grew only because of the strong growth of single premium business. For 2011 Fitch expects this trend to reverse and premium income to decline overall. Before year-end, however, the agency expects some stimulus for new business, as clients will take advantage of the fact that the current maximum guaranteed rate will be reduced at the beginning of 2012.

Diminishing State Pension: Over the medium to longer term, Fitch expects the German life market to grow faster than GDP. The reform of the state pension system will gradually show its effects on the demand for private old-age provision.

What Could Change the Outlook

Negative: The main threats to the German life insurers' ratings are a prolonged period with low interest rates and a broadening of the sovereign debt crisis. Furthermore, a substantial decline in GDP growth or a recession could have a negative impact. The current outlook assumes low economic growth for 2012 and 2013.

Positive: Fitch does not expect positive factors to emerge that could lead to an upgrade of a significant number of ratings over the next 12-24 months. However, a recovery in the financial markets would stabilise the earnings outlook for German life insurers and improve the general sentiment for life insurance.

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Global Economic Outlook (June 2011)

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The German Life Insurance Market

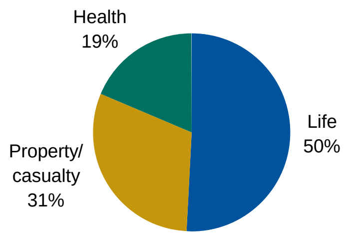
- The German life sector appears underdeveloped versus the non-life sector.

The German life insurance market has been growing consistently over the last few years and generated insurance premiums of EUR179.5bn in 2010. About half of the premium income is generated by life insurance (EUR90.4bn).

Figure 1

German Primary Insurance Market 2010

EUR179.5bn total premiums

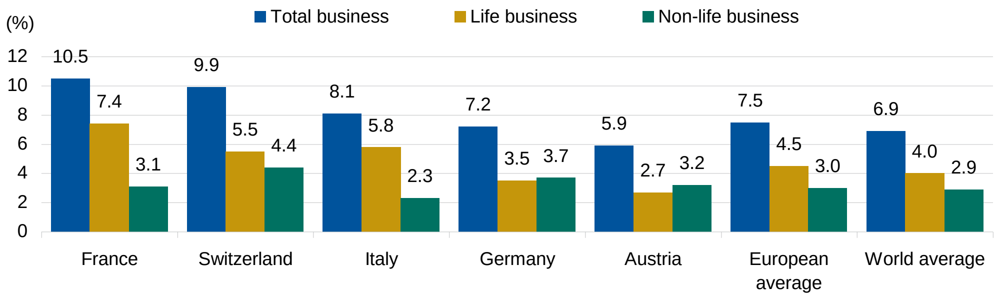


Source: GDV

Compared to other western European countries, the German life sector is relatively small versus the non-life sector. The insurance density in the German life business stands only at 3.5% of GDP, compared to 3.7% in non-life insurance. The life insurance penetration is below the European average (4.5%), while the non-life insurance density is above (3.0%). Germany is one of the few exceptions where life insurance penetration is below non-life insurance penetration.

Figure 2

Insurance Penetration: Premiums as % of GDP (2010)



Source: Swiss Re, sigma No 2/2011

- Reliance on state-funded pensions expected to decline over time.

Fitch believes that the main reason for the low life insurance penetration in Germany is the perceived still strong state pension system. While reforms of the system were implemented a few years ago with the effect of a gradual increase in the retirement age to 67, and lower benefits for future pensioners, these changes appear not to have been fully digested by the German public. This is also reflected in the fact that the newer tax-supported private pension products, Riester and Basic Pension, grew less fast than expected. However, at the end of 2010 out of the 90.5m contracts, about 10m were Riester contracts and 1.3m Basic Pensions, reflecting a combined share of 13%.

Fitch expects that not only will the general perception of what to expect from the state pension system become increasingly realistic over time, but also that there will be more government action to inform the people of their situation, possibly supported by new incentives to purchase private protection.

Premium Growth From 2009 and 2010 Not Sustainable in 2011

New business in 2010 was again driven by a further increase in single premium business which reached a share of 30% of gross premium income. Gross premiums increased by 6% to EUR90.4bn (EUR82.2bn), excluding premiums from premium refunds, of which single premium business contributed EUR26.4bn (+29%). Regular premium business was flat (+0.4%), measured in current premiums. Unit-linked contracts in both categories contributed together about EUR11.8bn (13.5% of the total). The number of new insurance contracts was flat, at around 6.1m.

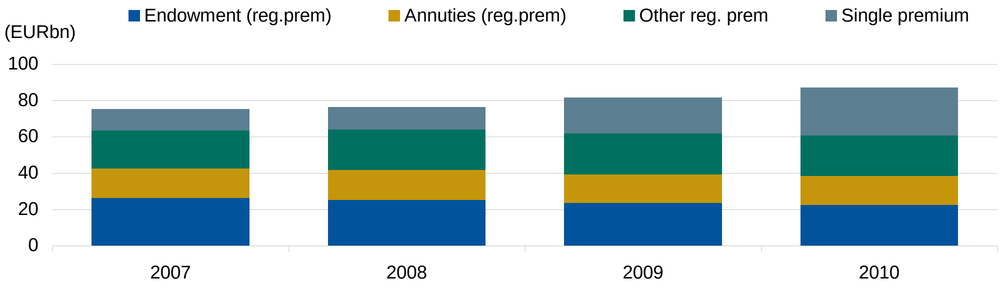
Related Criteria

Insurance Rating Methodology (September 2011)

Figure 3

Life Gross Premiums Written

(Without premiums resulting from bonus and rebate provisions)



Source: GDV

The positive trend in single premium turned negative during the first half of 2011 with gross premiums from single premium contracts declining by 27% to EUR10.6bn (EUR14.5bn). Fitch expects this trend to continue for the full year, as most life insurers no longer offer single premium products. In the current low interest environment these products provide only very low margins and do not lead to a sustained inflow of premiums.

The small increase in regular premium business (+0.8% at EUR29.5bn) was not sufficient to compensate for the decline in single premium business - total gross premium income during H111 declined by 8.3% to EUR40.1bn (43.8bn).

Figure 4

Business Development of German Life Insurers

	2007	2008	2009	2010	H111	Change vs. H1/2010 (%)
New business						
Number of policies (m)	7.6	6.7	6.1	6.1	2.8	-2.0
New business premiums (EURbn)	18.3	19.3	25.4	32.1	13.3	-22.9
- Of which regular premiums (for 1 year)	6.4	6.9	5.7	5.7	2.8	2.4
- Of which single premiums	11.9	12.4	19.7	26.4	10.5	-26.9
Sum insured (EURbn)	243.1	249.3	241.8	256.6	123.3	5.6
Portfolio						
Number of policies (m)	93.9	92.8	95.1	94.2	n.a.	n.a.
Gross written premiums (EURbn)	75.4	76.3	81.4	87.2	40.1	-8.3

Source: GDV, Versicherungswirtschaft

Fitch expects that the downward trend in new business premiums will continue for the full year, although there is a good chance that sales will pick up by year-end. Fitch expects there will be stimulus to demand from the upcoming reduction of the maximum guaranteed interest rate. The maximum guaranteed rate will be reduced from 2.25% to 1.75% on 1 January 2012, and all life insurance contracts sold before that date still benefit from the current guaranteed rate.

- Fitch expects German life insurance to be a growth business only in the longer term.

For the next two to three years Fitch expects sales of regular premium business to stabilise and to regain market share versus the single premium business. There is a considerable underlying need for private provision for old age, which offers a huge potential for life insurers to expand their business in the coming years, if they offer the right products. In the shorter term, however, the recently reduced economic growth outlook for Germany and the volatility of the financial markets have deterred people from buying long-term financial products such as life insurance policies.

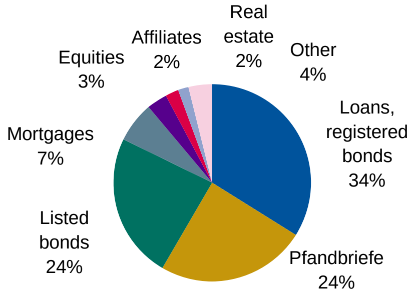
Investment Structure and Capitalisation

Conservative Investment Portfolios

German life insurance companies have derisked their investment portfolios and reduced their exposure to equities and other assets considered high risk, partly driven by federal regulation, but also because of lessons learned from their experiences with the capital markets. As a consequence, equity investment ratios are just over 3% and investments in private equity and hedge funds are below 1% each. At the end of 2010 the German life insurance sector held investments of EUR734bn.

Figure 5

Split of Investments of German Life Insurers 2010



Source: GDV

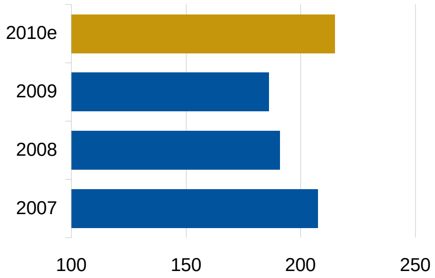
The main part of the investment portfolios (87%) is invested in fixed-income assets, with about one-third each in loans/registered bonds, Pfandbriefe, and listed bonds. This distribution has been kept relatively stable over the past few years, optimising the target risk and return, as well as liquidity. For the entire investment portfolio, the sector generated a net return of 4.3% in 2010 (2009: 4.2%).

Little Exposure to Greece and Other Countries Currently Under Stress

Due to their conservative investment policy, German life companies hold only 11.5% (2010) of their investments in "risky assets", as defined by the BaFin, much less than what is legally allowed (ie, 35%). The "risky asset" category includes several categories, such as equities, hedge fund investments, private equity, and high-yield bonds. Greek government bonds fall into the last category, which in total accounted for only 1.3% of the total investments of the German life sector. In total, however, German life companies hold 8.9% of their investments in GIIPS countries, according to a survey undertaken by the BaFin in October 2010.

Figure 6

German Life Insurance Solvency I Ratios



Source: BaFin

Adequate Capitalisation

Fitch views the capitalisation of the German life insurance industry as adequate. According to an estimate by the BaFin, the solvency ratio increased again during 2010, exceeding the pre-crisis level from 2007 (207%).

Sufficient Profitability to Meet Obligations

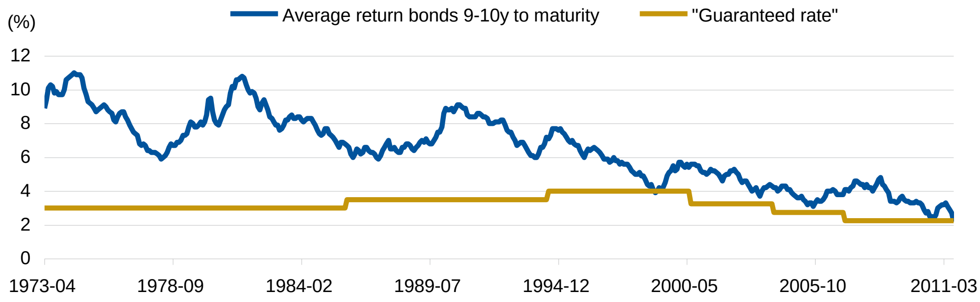
Given the importance of guaranteed crediting rates on policies in Germany, the low interest rate environment and the volatility of the financial markets are the biggest challenges for the German life insurance sector. However, this is not new and companies have reacted to this mainly by optimising investment portfolios to cope with the situation.

- Average guaranteed crediting rate of 3.3% constitutes a challenge.

Currently the running yield on 10-year German government bonds (1.9%) is below the current guaranteed crediting rate for newly sold life insurance policies (2.25%). The yield difference appears even more severe, relative to the average guaranteed crediting rate of a life insurance portfolio of an average company, which is around 3.3% At first sight this appears like a negative margin on the life insurance business, suggesting that companies might not be able to meet the guarantees of their policyholders at current market yield levels. However, companies can in fact still meet their guarantees at current market interest rate levels.

Figure 7

German Government Bond Yields vs. the "Guaranteed Rates"



Source: Deutsche Bundesbank, BaFin

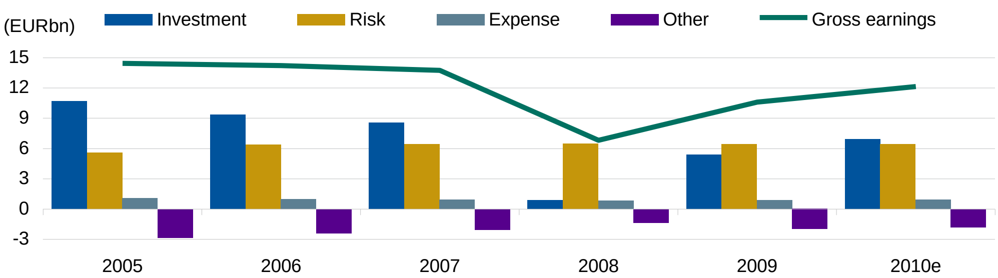
The existing life insurance books are currently matched with investment portfolios that can easily generate the average guaranteed crediting rate. There is only a small part of the bonds maturing each year, requiring reinvestments, most likely at lower running yields. New investments may water down the average yield of the portfolios, but so does the new insurance business. For new contracts with a guaranteed crediting rate of 2.25% (1.75% from January 2012) a life insurance company could today invest in a pure fixed-income portfolio and still meet the guarantee. Only a new portfolio with a strong focus on German government bonds would have a lower yield, but this not required from a risk point of view.

An important factor to meet the guarantees in each single year is the free part of funds for future appropriation (free RfB) which smooths the profit sharing with policyholders over time. In addition, since 2011 companies have been required to build up an additional reserve buffer, the so-called additional interest reserves (Zinszusatzreserve) in order to cope with a potential longer-lasting low interest rate scenario.

Besides the actual yield of the investment portfolio one should consider that the market value of investments on which the investment result is earned is always higher than the amount of mathematical reserves on which the policyholders' guarantees are granted. On the asset side there are typically off-balance sheet unrealised capital gains that imply that the market value of the investment portfolio is larger than the "investments" figure on the balance sheet. On the liability side there is the "equity" and other liabilities, including the free RfB, which are not subject to receiving a guaranteed rate of return.

Figure 8

Development and Split of Gross Earnings



Figures for 2010 estimated by Fitch
Source: BaFin

Furthermore, besides investment income, there are other substantial sources of income (underwriting result, cost result) that constitute an important part of the profits and can be used to meet the guarantees, if investment income is not sufficient. Profit sharing with clients is regulated too for those income components, but with a lower share for the policyholders. While the net investment income needs to be shared with policyholders with a quota of at least 90%, the underwriting result and other income have quotas of only 75% and 50%, respectively. There is therefore scope for these revenue sources to compensate policyholders in the unlikely event of a shortfall in investment income.

- Strong QIS5 results.

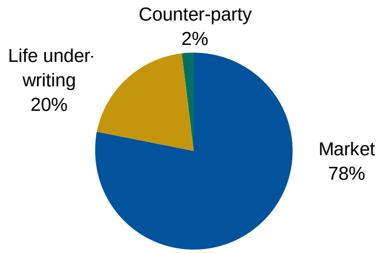
Results From QIS 5 and the Expected Impact of Solvency II

Among the German life insurance companies 78% (75 companies) participated in QIS 5, representing 92% of the market by premiums. On average the 75 participating companies showed a strong Solvency ratio of 158%, which is, however, below the 174% under Solvency I. Among the participants 13 companies (17%) did not reach the required solvency levels.

The focus of the risk exposure of German life companies is market risks, which account for almost 80% of total exposure, compared to only 20% for underwriting risk. Within market risks, 60% come from interest rate risk, leaving diversification effects aside. This is linked to the long duration of the liability side and its correlation to changes in interest rates.

Figure 9

German Life: What Drives Capital Requirements under Solvency II
QIS 5 results based on 2009 data



Source: EIOPA, Fitch

- Fitch expects product innovation and shifts in the product mix.

As higher capital requirements are driven by the character of the German market, with most products combining guarantees with long durations, Fitch expects the market to shift towards products with lower capital requirements. In addition, the agency believes that there will probably be adjustments in the standard formula that will bring additional capital relief.

Appendix

Figure 10

Insurer Financial Strength Ratings of German Life Insurers

Issuer name	IFS rating	Outlook
AachenMuenchener Lebensversicherung AG	AA-	Stable
Allianz Lebensversicherungs-Ag[a]	AA	Stable
Alte Leipziger Lebensversicherung auf Gegenseitigkeit	A+	Stable
Atlanticlux Lebensversicherung S.A.[b]	BBB	Stable
AXA Lebensversicherung AG	AA-	Stable
Condor Lebensversicherungs AG	A+	Stable
Cosmos Lebensversicherungs-AG	AA-	Stable
DBV Deutsche Beamtenversicherung Lebensversicherung AG	AA-	Stable
DEVK Allgemeine Lebensversicherungs-AG	A+	Stable
DEVK Deutsche Eisenbahn Versicherung Lebensversicherungsverein AG	A+	Stable
Dialog Lebensversicherungs-AG	A+	Stable
ERGO Lebensversicherung AG	AA-	Stable
Generali Deutschland Pensionskasse AG	AA-	Stable
Generali Lebensversicherung AG	AA-	Stable
Gothaer Lebensversicherung AG	A	Stable
Lebensversicherung von 1871 a. G. Muenchen	A+	Stable
Nuernberger Lebensversicherung AG	A	Stable
PrismaLife AG[b]	BBB+	Stable
Provinzial NordWest Lebensversicherung AG	A+	Stable
Stuttgarter Lebensversicherung AG.	A	Stable
Volkswohl Bund Lebensversicherung AG.	AA-	Stable
Vorsorge Lebensversicherung AG	A+	Stable
Wuerttembergische Lebensversicherung AG	A-	Stable

[a] The issuer died not participate in the rating process other than through the medium of its public disclosure
[b] Atlanticlux Lebensversicherung S.A. is situated in Luxembourg and PrismaLife AG is situated in Liechtenstein, but both operate mainly in Germany
Source: Fitch