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Insurance

Germany
Special Report

German Non-Life Insurance

Storm, Capacity Flood and the Softening Market

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Contents

Summary..1
Market Overview 3
Private Insurance - Motor 6
Private Insurance - Legal.................. 13
Private Insurance - Home and Contents .. 15
Commercial and Industrial Insurance 17
Special Focus - Reserve release and profitability 26
Appendix 30

Summary

The German non-life industry is currently in the midst of a softening market in both private and industrial insurance, with declining premiums and increasing loss ratios in the major insurance lines. While the current insurance cycle is similar to its historic predecessors, the industry is additionally subject to underlying structural changes which in Fitch's view will suppress future profitability when the cycle reverses.

Fitch Ratings believes that the likelihood of defaults among German non-life insurers is currently low. Nevertheless, the agency has assigned a Negative Outlook in October 2007 due to the structurally declining profitability and increased competition in the non-life sector. A Negative Outlook means that, while there may be individual rating upgrades and downgrades, the number of rating downgrades is expected to be higher than upgrades. A review of the Negative outlook is possible following hard evidence of a shortening and shallower cycle, although the agency currently has no indication of this happening in 2008.

The German non-life industry is the major source of revenue for the insurance sector, generating EUR1.3bn of earnings after tax in 2006 (2.4% of non-life gross written premium ("GWP")). Compared to the life insurance industries' c. EUR1.0bn (1.3% of life insurance GWP), this equals 45% of the total German insurance industry's earnings after tax. Therefore any decreasing profitability in the non-life sector will have a strong impact on the market as a whole.

Winter storm Kyrill has heavily influenced the 2007 results of the German non-life industry, with the insured loss over EUR2.4bn. While most of the cost has been passed to the reinsurance sector, making this storm more a profitability than a capital event, the home, commercial property and motor insurance lines have been significantly affected. The overall gross combined ratio is expected to increase to c. 98% in 2007, which equals a gross underwriting profit (before equalisation reserve) of c. EUR800m. This follows underwriting profits of EUR4.6bn in 2006. Assuming a normal natural hazard development in 2008 without large-scale flooding, hail or storms, Fitch does not expect the gross underwriting profit to return to the 2004-2006 levels due to declining premiums as well as increasing claim ratios.

In motor insurance, the industry has benefited greatly from very favourable claims development over the last years. The savings in this area have fuelled the price competition in motor by reducing the impact on the loss ratios. A further material decline is however unlikely. The competition in motor insurance has also led to innovations like the motor repair shop network or the no-claims discount preserver. However, Fitch views both innovations as being potentially damaging in terms of profitability. The market development in motor insurance comes in light of a structurally declining premium level due to German demographic development. The overall profitability of motor insurance is still sound, however it is based on investment income (i.e. technical interest) generated by the relatively high technical and equalization reserves rather than underwriting profits. Fitch points out that the concept of technical interest is artificial to a degree, as it matches a part of the investment income to liabilities. The concept however allows a more detailed profitability analysis.

In legal insurance, the expected large-scale claims increase due to solicitors' fee reform has only partly materialized, and has further been checked by more prudent

underwriting of the participants. As in the previous years, the combined ratio remains close to 100% showing relatively low volatility. The technical interest generated in this line is relatively high, as only 52% of reserves are paid out in year one.

Home insurance remains unprofitable on average. Since 2001, gross combined ratios have been above 100% in years with low natural hazard claims, and in the 140s in years with large storms or floods (2007 estimate 144%). The technical interest generated in this line is relatively low, with 83% of reserves paid out in year one. Contrary to the home insurance line, the contents insurance remains very profitable with an expected gross combined ratio of 79% in 2007.

Fitch's definition of the industrial insurance market includes industrial property, engineering, motor fleet, transport and industrial liability insurance and estimates the market's GWP at c. EUR10bn. This definition excludes credit insurance (GWP EUR1.4bn in 2007) and company pension business. The industrial insurance market is experiencing strongly declining rates following the 2003 / 2004 hard market. Fitch believes the rate decline of 10%-20% continued in the 2008 renewals. The decline, which is sometimes masked by the expansion of cover, is mostly driven by the competition of established industrial insurers and only to a lesser degree by new market entrants. Market participants point to ample capacity amounting to a "capacity flood" in almost all areas. The merger of HDI and Gerling has enabled numerous new competitors to enter the market, utilizing the experienced and well connected personnel released in the merger to expand their operations. This will transform the German industrial insurance market in the long-term.

The extent of the soft market can be observed in the gross loss ratio development of the industrial property line, with an increase from 65.7% in 2005 to an estimated 85.0% in 2007. This is in spite of benign large claim developments in 2007, and minor claims resulting from Kyrill. While the prices in 2003 and 2004 were unsustainably high, the market still seems to have been marginally profitable with a combined ratio of 97% in 2007, but above 100% in the industrial fire line. However, Fitch expects normal large claim experience in 2008 in combination with lower rates and expanded cover to result in underwriting losses.

The profitability arising from the claim and equalisation reserves (2006 total EUR108.6bn) differs markedly between lines, as reserves have differing run-off periods. Some lines have very long run-off periods, in which the insurers can generate interest on the remaining reserves for a multiple of years, while other lines have very short periods as claims are paid out immediately.

Equalisation reserves have increased strongly since 2002 to c. 30.4% of total net written premiums in 2006. Assuming a risk-free interest of about 4.0% at year-end 2006, the total equalisation reserves generated about EUR560m in interest.

German statutory (HGB) non-life reserves are typically more conservative than the "best estimate" reserves in international accounts. Therefore, reserve redundancies are generally higher and result in larger run-off results. Total releases were about 7.9% of prior year reserves in 2006, with the motor insurance reserve release increased from 4.64% in 2005 to 6.02% in 2006. This equals about EUR477m.

In this report, Fitch provides a detailed analysis of the major insurance lines of the German non-life insurance market, and covers private, industrial and commercial insurance, as well as a special focus on reserve releases and profitability. [1] A section on analyzing German non-life underwriting performance is in the appendix.

[1] For full details on the Prism results of German primary insurers please see the special report "2006 Prism and "Beta" Aggregated Capital Scores for German Life and Non-Life Insurers" available at www.fitchratings.com.

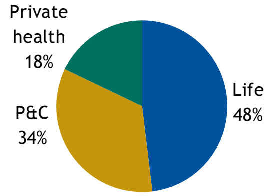
Market Overview

German Insurance Market

The German insurance market is one of the largest in Europe, with gross written premiums of EUR161.7bn in 2006 (2005: 157.8bn). Life insurance is the largest segment, generating premiums of EUR78.3bn in 2006 (2005: EUR75.2bn), while private health insurance has GWP of EUR28.5bn in 2006 (2005: EUR27.3bn). Unlike many other countries in Europe, private health insurance in Germany is not considered to be part of the non-life sector, as health insurance products are calculated using life insurance actuarial and accounting methods. For an overview about the private health insurance market in Germany, please refer to the Fitch special report *"German private health insurance: Much ado about nothing"*, published on April 3rd, 2007, and available in English and German on www.fitchratings.com.

Split of German Primary Insurance Market 2007

EUR162bn total



Source: GDV estimate November 2007. Excludes aircraft, nuclear and economic loss liability. Direct business only

The German non-life insurance industry generated GWP of EUR55.0bn in 2006, with a total insurance market share of about 34%. This is a decline versus 2005, both in terms of GWP (EUR55.3bn) and market share (about 35%).

Preliminary data for 2007 show GWP for the market virtually unchanged, with total premiums increasing from EUR161.8bn in 2006 by 0.2% to EUR162.1bn. While German non-life GWP is expected to further decline in line with expectations by about 0.4% to EUR54.8bn, the life insurance GWP growth is stagnating, after years of growth. Life insurance GWP increased by an average of 3.7% between 2000 and 2005, and following below-average growth of 2.3% in 2006, has come to a halt in 2007. For details on the development of the life insurance sector, please refer to the upcoming special report "German Life Insurers – in Search of Lost Time". In private health insurance, GWP growth was positive, with premiums increasing by 2.5% to EUR29.2bn.

Number and Legal Form

The German insurance market has historically had a very high number of insurance companies relative to similar markets, due to its decentralised structure. The total number of companies under supervision in 2004 was a very high 1,669 individual entities. However, over 1,000 of these are very small regional or inactive insurance companies, therefore only 622 insurance and 24 pension funds are under Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin") and state supervision. The number of insurance companies has declined over the last years due to the continuing consolidation in the German insurance industry, from 642 insurance companies in 2004 to 622 insurance companies in 2006. While the market still seems highly fragmented, this can be partly attributed to the regulatory principle of segmentation ("Spartentrennung"), which dictates that insurance companies are not allowed to write life, non-life, health and reinsurance business in the same legal entity. Therefore the actual number of insurance groups is much smaller, and it is widely expected that even without consolidation, the number of legal entities will decline in the future due to the impact of Solvency II. Under this future regulatory regime, it is generally more efficient to have a smaller number of entities in an insurance group, as capital requirements reflect the fungibility of capital and the potential support of subsidiaries. Cost and efficiency gains may also be realized by reducing the number of directors and audited accounts.

Of the 622 insurance companies, the majority (324 companies) are listed companies. These listed companies are quite frequently majority-owned by mutual insurance companies ("Versicherungsverein auf Gegenseitigkeit", "VVaG"). This structure can be found for larger as well as for smaller insurance groups.

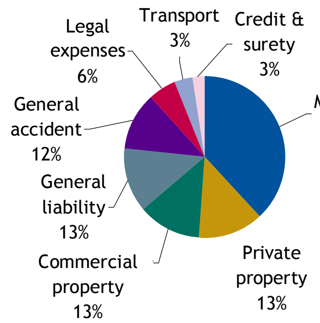
There are a total of 227 non-life companies in Germany, of which about 67% are (partly unlisted) stock companies, and about 26% are VVaGs (mutual companies). In addition, there are 10 public sector insurers ("Öffentliche Versicherer"), insurers owned by the state or municipalities, operating in the market.

The German non-life industry has historically operated in a very tightly regulated market. Pre-1994 the industry was required to have every individual insurance tariff signed off by the German financial supervision authority Bundesanstalt für Finanzdienstleistungsaufsicht's (BaFin) predecessor Bundesaufsichtsamt für das Versicherungswesen (BAV), which as a consequence led to a less competitive environment overall. The German insurance industry thus experienced almost 50 years of continued growth in a stable environment, which however did include underwriting cycles. Following the liberalisation of the market in 1994, competition increased strongly. Initially, the industry was able to benefit from the ample prior year reserves and the positive capital market environment, which resulted in large-scale cash flow underwriting (writing business at not risk-adequate rates in order to generate funds for investment) in important private and commercial insurance lines. This first soft cycle ended with the capital market turmoil of 2001, which forced insurers to increase rates and focus on the technical profitability of their business. Following years of prudent underwriting standards and high technical earnings between 2003 and 2005, the German non-life industry is currently in the second (post-liberalisation) soft underwriting cycle. While some market participants voice the opinion that the current soft cycle is a continuation of normal business practices, Fitch believes that underlying structural trends are transforming the industry, with increased competition and changes in customer preferences challenging the current business model.

Non-Life Insurance Lines

Motor is the dominant class in the non-life segment, generating about 38% of total estimated gross written premiums, or EUR20.8bn, in 2007. Due to competitive pressure, the motor insurance share has declined versus 2006 and 2005, both in absolute and relative terms: GWP declined from EUR22.0bn (non-life market share: 39.7%) in 2005 to EUR21.2bn (market share: 38.5%) in 2006. Private property insurance consists mainly of contents insurance, with EUR2.6bn estimated GWP in 2007 and building insurance with EUR4.1bn estimated GWP in 2007.

Premium 2007 by Class

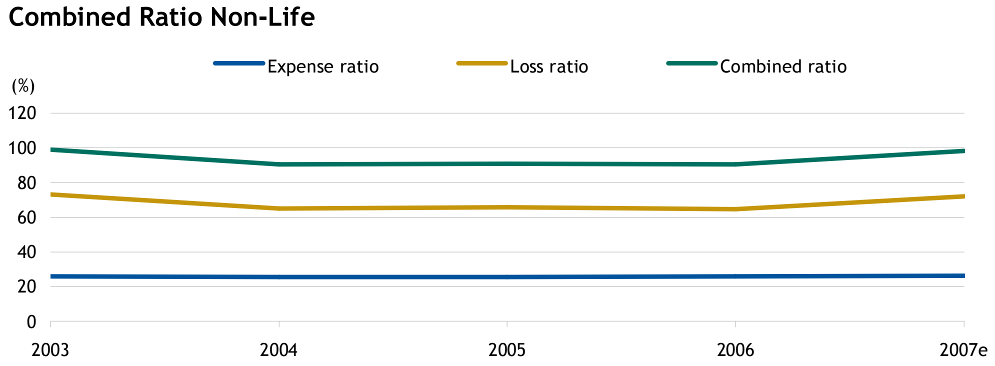


Source: GDV estimate November 2007. Excludes aircraft, nuclear and economic loss liability. Direct business

Fitch defines industrial insurance as industrial non-life and engineering, commercial liability, transport, and motor fleets

Industrial insurance is more a collective term used for insurance linked to industrial and commercial enterprises than a clearly defined segment, although the term is widely used. Many definitions are possible, including some definitions which include company pension business ("Betriebliche Altersversorgung", "bAV"). Insurance lines normally classified as industrial insurance are the industrial non-life and engineering lines, commercial liability (accounted for as part of the general liability line), transport, and fleet motor cover not excluding credit insurance. Due to the inclusion of lines over different segments, the general size of the market can only be estimated, but the above definition (excluding company pension business) is estimated at about EUR10bn.[2]

Underwriting Performance



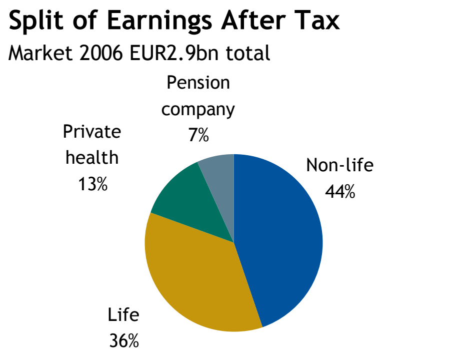
Source: GDV. 2007 estimate. Gross after reserves

Combined ratio of 98% expected for 2007 - EUR800m underwriting profit

The development and profitability of the overall German non-life market has been noticeably cyclical since the liberalisation of 1994. The market is highly profitable during the harder periods of the cycle. The market is estimated to have generated profits from the technical result (defined by the GDV as loss ratio plus expense ratio in relation to premium after reserve development but before reinsurance and equalisation reserve) of about EUR4.7bn in 2004 and EUR4.4bn in 2005. The development of the technical result in 2006 came as somewhat of a surprise, with the consensus among market participants expecting a firmly negative trend due to rising claims and lower premiums. However, GWP only declined from EUR55.3bn to EUR55.0bn, and not to EUR54.4bn as expected, and more slowly rising claims resulted in an increase of the claims ratio (without reserve development) to 73.9% and not 75.0%. Thus, the overall further declining combined ratio increased technical profits to EUR4.6bn in 2006 — about EUR1.3bn above estimates. The 2007 estimate of EUR800m (or a combined ratio of about 98%) should however be more robust, but is heavily influenced by the insured damages caused by winter storm Kyrill. The storm had a heavy impact on the technical result of motor insurance and home insurance lines, and, as a consequence, is driving up the market combined ratio. However, while winter storm Kyrill was a singular event (hopefully) not to be experienced again in 2008, the underlying trend in the industry is negative — as reflected in Fitch's assignment of a Negative Outlook for the German non-life insurance market.

Earnings after Tax

While life insurance is the largest segment in the German insurance market, the largest share of the market's earnings after tax are generated by the non-life insurance segment. In 2006, about 45% of all earnings after tax were generated by the non-life insurance segment. While life insurance generated about EUR78bn of GWP in 2006, earnings after tax only made up about EUR1.0bn, or 1.3% of life insurance GWP. In comparison, non-life insurance, with GWP of EUR55bn, generated more than EUR1.3bn, or 2.4% of GWP. The German non-life insurance



Source: BaFin. Excludes pension funds (-EUR6m)

[2] Joint estimate, Handelsblatt industrial insurance conference, November 2007, Cologne

industry is therefore a major source of revenue for the insurance sector. Therefore, any decreasing profitability in non-life insurance will have a strong impact on the market as a whole.

Corporate tax rate expected to decline long-term

Tax Effect

The revision of the accounting rules for corporate tax assets forced insurers to mandatorily account for the net present value of the tax assets ("Körperschaftssteuererstattungsguthaben") in 2006. A material share of this tax credit can be generally attributed to non-life insurers, which in turn has resulted in strongly declining effective tax rates and, in some cases, tax refunds for certain insurers. Based on selected market data, Fitch quantifies this tax effect at between 8% and 55% of net earnings in 2006, with many insurers showing a ratio of 25%. For example, the effect totals EUR878m for the three leading German insurance groups. It must be noted that not all insurers in Germany benefited from this effect, as both mutual insurance companies ("VVaGs") and relatively young insurers did not have these tax assets and could not benefit from the reform. In general, the tax effect is a one-off and has to be factored into the analysis of the 2006 results. However, due to other changes of the German corporate tax code, average future tax expenditure should be lower in the future, with insurers expecting a reduction from the current 40% to about 30%.

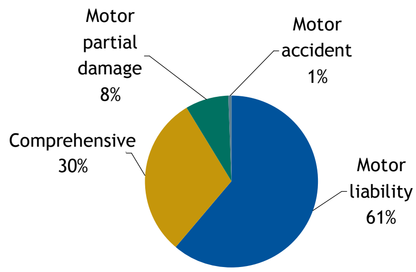
Fitch points out that some insurers have higher tax rates than others, reflecting business structure and historical tax optimisation. There is also the possibility of some insurers realising historic tax loss assets ("Verlustvortrag"), which (if accepted by fiscal authorities) would provide additional tax relief.

Private Insurance - Motor

Overview

Motor by Sub-Class

2007 total GWP EUR20.8bn



Source: GDV estimate

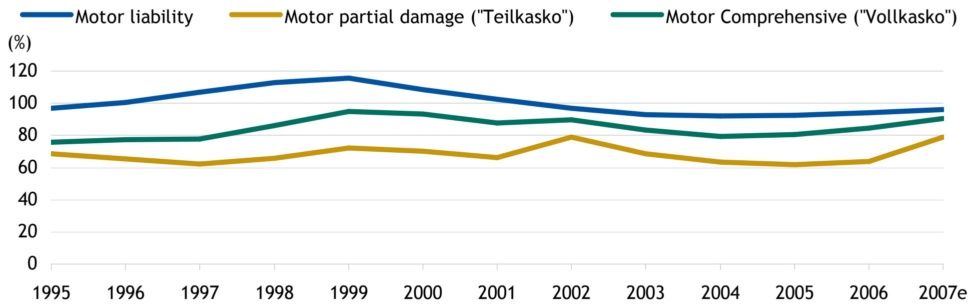
The motor lines include private and commercial (i.e. motor fleets) clients, which are estimated by the GDV for 2007 at a total gross premium level of about EUR20.8m (EUR21.2bn in 2006). The motor class can be split into three separate lines; mandatory third-party liability (TPL/"Kraftfahrzeughaftpflicht") with GWP of EUR12.8bn in 2007 (EUR13.6bn of GWP 2006), Motor partial damage insurance ("Teilkasko") / motor personal accident insurance with GWP of EUR1.7bn in 2007 (EUR1.6bn in 2006) and the comprehensive motor insurance cover ("Vollkasko") at EUR6.3bn in 2007 (EUR6.7bn in 2005). The total amount of vehicles in Germany is still increasing: The total amount of cars has increased to 46.5m in 2007 (from 46.1m in 2006), while the number of trucks has increased slightly to 2.6 million in 2007 (2005: 2.6 million). This is reflected by the increase in insurance policies, with 53.6 million motor third-party liability policies in 2006, 22 million comprehensive motor policies and 17.6 million TPL fire and theft insurance policies.

Please note that commercial and private motor insurance is not separated in available statistics, also due to the fact that differing definition exist about the minimum size of a "motor fleet".

Underwriting Performance Motor

As motor is one of the non-life lines with the highest premium volume due to its partly mandatory character, as well as being the traditional "door-opener" (i.e. with cross-selling potential) for other private insurance products, it has been one of the first lines to experience the intensifying competitive environment. While underwriting cycles were common even in the regulated market pre-liberalisation of 1994, a prolonged period of loss ratios in the high 90s was a rather uncommon market experience. However, following the liberalisation of 1994, the intensifying competitive struggle, supported by strong capital market returns, resulted in rising loss ratios and strongly declining profitability. The gross loss ratio in motor liability increased strongly from 96.0% in 1995 and peaked at 115.8% in 1999. This development was also reflected in the motor comprehensive insurance line, which increased from 75.6% in 1995 to 94.9% in 1999. The adverse capital market environment of 2001/2002 prompted enhanced awareness of the need for profitable underwriting for the industry, and consequently the trend of declining loss ratios accelerated. In 2004, gross loss ratios reached their trough, with 91.9% in motor liability and 79.4% in motor comprehensive insurance. The much smaller motor partial damage insurance line showed a similar, but not fully correlated loss ratio development: Beginning in 1995, loss ratios increased to 72.3% in 1999, but after declining for two consecutive two years peaked in 2002 with a gross loss ratio of 78.8%. The loss ratios of this line reached their trough in 2005, with a loss ratio of 61.7%.

Loss Ratios Motor



Source: GDV. 2007 estimate

Loss ratios have been increasing since 2005 in motor liability and motor comprehensive, and since 2006 also in motor partial damage insurance. This development reflects the increasing competition in the German motor insurance market. The increase has however been more benign than expected by market observers due to claims and reserve development discussed further below. For 2007, an increase to 96% is estimated in motor liability due to lower premiums, which could not be compensated by the still declining claims payments. In motor comprehensive and motor partial damage insurance, the much stronger estimated increase to 90.5% and 79% is mostly driven by the claims resulting from winter storm Kyrill.

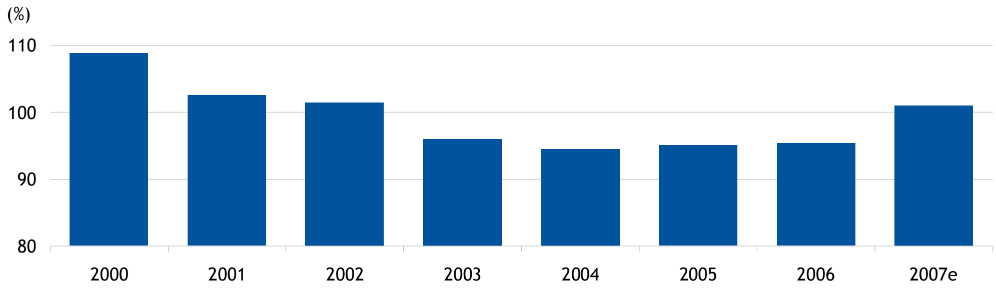
Expected combined ratios for total motor and for all motor lines above 100% in 2007

As discussed in the appendix in the section *Analysing the underwriting performance in German non-life insurance*, the gross combined ratio after reserves (but before equalisation reserve) is heavily influenced by the development of the technical reserves. Therefore loss ratios and gross combined ratios after reserves do not move in parallel. The gross loss ratio in motor liability increased from 91.9% in 2004 to 94% in 2006. However, the combined ratio for these years even decreased from 96.8% in 2004 to 95.3% in 2006 due to an increase in the reserve releases. These increased from 4.46% (or EUR1.4bn) of the prior year's claim reserves (including IBNR, claims settlement costs and other reserves) in 2004 to 6.02% (EUR1.9bn), thereby lowering the motor liability combined ratio to 95.3%.[3] An increase to about 101% is estimated for 2007 by the GDV for the motor liability line.

[3] Source: BaFin, Fitch calculations. For details please refer to the special focus chapter at the end of this report.

In motor comprehensive insurance, the gross combined ratio after reserves increased more strongly from 92.2% in 2004 to 98.4% in 2006. In motor partial damage, the gross combined ratio decreased from 86.2% in 2004 to 87% in 2006. The combined ratios (after reserves) are expected to increase to 101% in motor partial damage and to 105% in motor comprehensive insurance. The combined reserve releases for both lines increased slightly, from 26.72% of total prior year reserves to 27.76% in 2006. For the overall motor line, the gross combined ratio after reserves increased from 94.5% in 2004 to 95.4% in 2006. An increase to about 101%, mostly due to the impact of winter storm Kyrill, is estimated for 2007.

Combined Ratio Motor (After Reserves)



Source: GDV. 2007 estimate

When looking at motor insurance loss ratios it must be noted that motor insurance traditionally has relatively low expense ratios when compared with those of other insurance lines. In 2006, motor liability insurance had a gross expense ratio of 16.1% (BaFin, net expense ratio 15.2%), a slight increase from the 2005 gross value of 15.4% (net expense ratio 14.5%) due to the declining premium level. On average however, the German non-life market had a gross expense ratio of 25.3% in 2006 (net expense ratio 25.5%). The positive difference between the average expense ratio and the motor line's, especially in motor liability, is achieved partly due to the high volume of business, whereby strong economies of scale can be generated. The low expense ratio is however also the result of internal cost distribution between insurance lines: Traditionally, expenses are re-distributed from highly competitive lines such as motor and are allocated to less competitive lines like accident insurance. Evidence of this is naturally anecdotal, as the cost distribution is signed off by the auditor. Nevertheless, combined ratio analysis on an individual insurance line level should take the cost allocation into account.

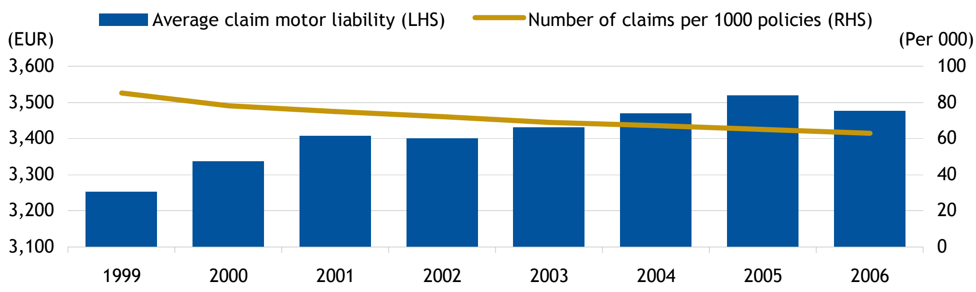
Fitch also notes that the administrative burden for insurance policies is materially higher in the first year, as the policy has to be administered and policyholder details, including data required from the previous insurer, are added. This of course increases the administrative burden for the insurer, and can reduce the already slim profit margins on new contracts. Therefore, the profitability of motor contracts often only begins in the second year. It is important to keep this fact in mind as more and more policyholders are switching their motor insurer. This is also reflected by the press releases of many insurers which describe a strong rise in new policyholders in motor insurance. Fitch points out that this information does not take into account the large number of motor insurance lapses in the respective portfolios and inadequate pricing, and thus may actually represent a strong decline in underlying profitability.

New motor contracts often not profitable in year one

Motor Claims Development

The claims development in German motor insurance over the last decade has been very favourable for the industry, and is one of the reasons why the current rate decline is still continuing. The claim frequency per 1,000 insurance contracts has declined strongly in both motor liability and motor comprehensive insurance and has reached unprecedented lows. The number of claims per 1,000 policies has declined by about 35% since 1999 in motor liability, while in motor comprehensive insurance, the number of claims per 1,000 policies has declined by about 8.5%. The average settlement claim has also declined by about 8.1% in motor comprehensive insurance, from EUR1,559 in 1999 to EUR1,442 in 2006. In motor comprehensive, the average claims settlement has decreased by 6.8% from EUR1,559 in 1999 to EUR1,442 in 2006, while in Motor liability this amount increase from EUR3,252 in 1999 to EUR3,476 in 2006. However, this constitutes a below-inflation increase, therefore even in motor liability, the real claim settlement cost has actually declined.

Motor Liability: Claims Frequency and Average Claims Settlement Amount



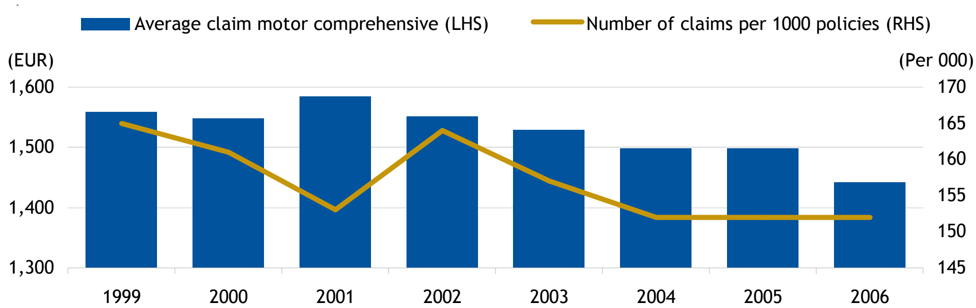
Source: GDV

Number of claims reaches unprecedented lows

The decline was mainly due to structural reasons: firstly, as economic growth in Germany during the early 2000s was relatively subdued, there were fewer goods transported commercially and thus lower exposure of fleet motor business to potential claims. Secondly, on the consumer side, the stagnant or even declining development of German real wages caused the average age of insured vehicles to rise, thereby substantially reducing claims paid. Third-party commentators have also cited a generally more cautious style of driving as being a further contributing factor behind the declining number of claims, however evidence for this remains anecdotal.

The technical progress has had two contrary effects on claims: On the one hand, the number of car-related fatalities is declining due to improvements in automotive safety equipment. On the other hand, this very improvement is increasing the long-term cost to insurers, as the ratio of heavily injured accident victims who require more expensive rehabilitation is increasing.[4]

Motor Comprehensive: Claims Frequency and Average Claims Settlement



Source: GDV

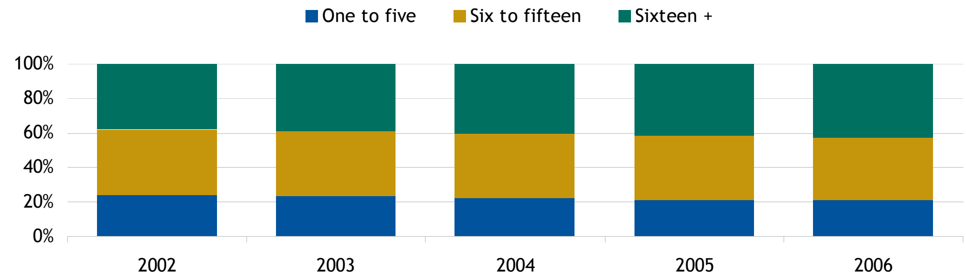
[4] Many insurers are responding to this development by creating their own aftercare programmes, which focus on getting the patient into specialist treatment quickly in order to reduce long-term costs.

Contrary to assumptions of market participants, the decline has not been halted by the very favourable 2007 economic development. As the amount of commercial goods generally increases in times of strong economic growth, the increasing exposure of motor fleets should have caused the claims frequency to increase. The real increase in wages in Germany in 2007 should also have decreased the average age of insured vehicles, and thus caused an increase in claims settlement amounts. However, this has clearly not happened so far. In motor liability, the sum of claims is expected to decrease even further in 2007.

The decline in the claims frequency, as well as the real (i.e. inflation-adjusted) decline in average claims, has greatly benefited the German motor insurance industry. If the claims frequency had remained unchanged over the last years, the underwriting losses would have appeared much earlier. This would have increased the pressure on insurers to increase rates. Therefore the current rate decline cannot only be attributed to an increasingly competitive environment, but also to the underlying claims development. Fitch believes that the decline of the claims frequency will however end in the foreseeable future, and is expecting a stable development in 2008 (excluding wind storm and hail events). This should increase pressure on insurers to increase rates.

Accident Free Years Motor Liability

In % of all contracts



Source: GDV

Structural level of motor insurance premium declining

Another issue for the German motor insurance industry is the changing demographics in Germany. The increase in the proportion of elderly people is creating additional pressure on motor insurance premiums. Policyholders are awarded a no-claims discount (“Schadenfreiheitsrabatt”) for every year without an insurance claim. These discounts build up over the years: while a new (generally young) driver is expected to pay up to 225% of the calculated premium, a driver with seven years of no claims has already reached a 50% no-claims discount per year. In a “normal” or historical demographic development with population growth this system is beneficial to insurers, as a constant stream of young drivers provide high premiums. However, Germany is currently experiencing zero or even declining population growth, which means that the relative ratio of elderly drivers versus younger drivers increases. As the amount of motor-related accidents generally declines with age and driving experience, the demographic development causes an ever-larger portion of policies to migrate into higher no-claims discount bands. In 2002, 24.1% of all policies were in the no-claims discount band of 1-5 years, while the 6-15 year band included 38.1% of all policyholders. Both no-claim bands have declined continuously to 21.1% and 36.1%, respectively, in 2006. The no-claims band of policyholders with 16 or more years has increased from 37.8% in 2002 to 42.6% in 2006, making this category the most numerous.[5]

[5] Data source: GDV. The arrangement into three classes of 1-5 years, 6-15 years, and 16+ years is done by Fitch in order to illustrate the underlying dynamics. The industry is using a more detailed classification

As a consequence, the structural level of German motor insurance premiums is declining. This is ultimately limiting profitability, for while lower premiums are corresponding with lower claims, the premium available for investments is ultimately lower. Fitch expects this structural trend to continue. A stabilisation or even reverse is possible in the long term, as drivers over the age of 75 are responsible for rising claims. However, this is a very long-term development.

Market Development Motor

The second soft market in German motor insurance began in 2005 with the opening move of market leader Allianz (IFS 'AA'). The company had experienced a steady decline of market share over the last decade and was set upon reversing the trend by reducing the price of motor cover significantly and the creation of direct motor insurer "Allianz24". This was reinforced by other insurers, which followed with their own direct motor insurers, and a generally reduced premium level. This was accompanied by large-scale marketing campaigns by many market participants in the run-up to the November termination date (most motor policies last for one year and can be terminated with a month's notice before automatic renewal). The campaigns focused strongly on the price of motor cover as the single most important criterion.

After Allianz has launched its competition offensive in 2005, the second-largest German motor insurer, HUK Coburg (Q-IFS rating: 'Aq')[6] launched the surprise move of 2006 with a large-scale introduction of its own motor repair shop network, which was consequently picked up by the industry.[7] Policyholders who sign up to a tariff including a "repair shop obligation" receive a 15% discount on their total yearly premium. By introducing a repair shop obligation, insurers are able to control the actual claims assessment and repair process. This should bring down costs as well as increase the customer loyalty if the service is performed to a high standard. There may also be a positive effect on insurance fraud if the assessment and corresponding repairs are performed at managed repair shops.

A notable innovation of 2007 was the widespread introduction of the no-claims discount preserver ("Rabattretter"). This option or complement to motor liability and motor comprehensive insurance policies is neutralising the reduction of the no-claims discount after an accident, thus preventing the increase of premiums following an accident. The no-claims discount preserver is however no standardised feature; insurers are offering this option with a wide range of characteristics (eligibility criteria, number of claims covered, free of cost or with premium charge, etc). The no-claims discount preserver seems to have been well received by policyholders, as it has been in other markets where it has been introduced such as the United Kingdom.

Motor insurance innovations damaging for profitability

Motor Insurance Outlook

Fitch does see a degree of innovation in the current motor insurance industry. For example, Fitch believes the repair shop obligation can serve as an innovative element in the motor insurers' strategy to manage the cycle. However, innovations should also benefit the profitability — and thus the financial strength — of an insurer. The agency is reaffirming its doubts that the cost savings in claims on average is material enough to offset the associated premium rebate which is awarded when choosing the repair shop option. Average single-digit claims management savings of total claims will only partly offset the rebate of 15% of premiums granted by many motor insurers, thereby further reducing overall profitability of motor insurance. Fitch also points out that the premium reduction

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6 Q-IFS ratings are generated solely using a statistical model that utilizes financial statement information. For a detailed definition please refer to the appendix

7 The repair shop option and the no-claims discount preserver described above were not necessary introduced by the mentioned companies first, but have received wide-scale recognition through the introduction by these companies.

associated with this option is reducing the funds which can be invested and thus has an impact on investment returns. As pointed out by the agency in its prior report, the repair shops are not run by the insurance company, but are contracted, thereby removing the actual risk of running these operations.[8]

The widespread introduction of the no-claims discount preserver in 2007 is viewed by Fitch as another potentially damaging innovation in terms of profitability. The agency is aware of the fact this feature was demanded by policyholders after it was first introduced by one insurer in 2007, thus prompting other insurers to follow. However, Fitch thinks it is possible that this feature, especially if offered free or at a very low charge, may not contribute to the bottom-line development of an insurer except by increasing the number of claims.[9]

Many insurers are reacting to the intensifying competition by implementing more sophisticated pricing tools with more detailed assessments of individual policyholder risk. Policyholders with “bad risk” characteristics are thus systematically priced out of the portfolio, with the insurers retaining only the groups with favourable claims experience or expectations. For these groups, very competitive rates are offered, as the balancing of risk is performed on a more favourable basis. Fitch believes that this is a viable strategy for offering competitive rates while maintaining technical underwriting profits in a declining market. The agency however observes that this strategy is being adopted by quite a number of players, making significant market share gains relatively unlikely for insurers employing this approach. Due to the substantial block of fixed cost associated with insurance operations, the loss of too many policyholders due to overpricing might also adversely affect the expense ratio. The agency also points and that large-scale innovations in this field can be expected more in the medium- to long term, as a thorough profit-oriented scoring of policyholders is contrary to the strategy of many insurers of using motor policies as a “door-opener”.

Fitch observes that another measure to meet increasing competitive pressure is that some insurers try to lower premiums while at the same time also lowering the actual cover of the policy by changing the respective terms & conditions, resulting in a balanced combined ratio.

Motor still profitable due to investment income, no rate increases for 2008

Fitch currently does not see supportive evidence that rates will increase in motor insurance in 2008. While a stabilisation of rates was expected and communicated by insurers in 2007, with some companies even increasing rates slightly during spring, the rate decline continued again in autumn of 2007. The agency is currently expecting profitability (as measured by loss ratios) to continue to deteriorate in 2008. Fitch points out that the relative low increase of the gross combined ratio in 2006 to 95.4% (from 95.1% in 2005) was influenced strongly by the increase in reserve releases. While the estimated increase of the gross combined ratio to 101% in 2007 is heavily influenced by the claims resulting from winter storm Kyrill in the motor comprehensive and motor partial damage insurance lines, this is just reinforcing the already existing negative trend, as can be seen in the development of the loss ratios. Including investment returns and interest on existing claim reserves, the motor insurance industry is nevertheless still profitable. However, Fitch believes that structurally, motor insurance is becoming less profitable, due to demographic changes, increased competition and the entry of new insurers to the market.

[8] Please refer to the 2006 German non-life report “Competition on a new pitch” (published in October 2006) for details on the entrance of German automobile producers into the motor insurance market.

[9] Technical note: The normal no-claims discount is transferable when a policyholder changes his insurer. Information received by Fitch indicates that any rebate “saved” by the use of the no-claims discount preserver is non-transferable, although the actual administration of this is challenging.

The agency remains cautious about the profitable entry of competitors into the German motor insurance market. As the market is already very competitive and features a relatively high degree of underwriting expertise, using a multitude of policyholder attributes for pricing, the strategy to establish operations as a niche underwriter is probably challenging. The current profitability in German motor insurance is also not provided by the underwriting result, but by the interest of the claims and equalisation reserves. These are by definition not available to new entrants, thereby making profitable operations a long-term goal. Fitch also points out that while start-ups benefit from a low personnel and cost base as well as the lack of legacy issues, they do not have the economies of scale in their operations that larger entities do.

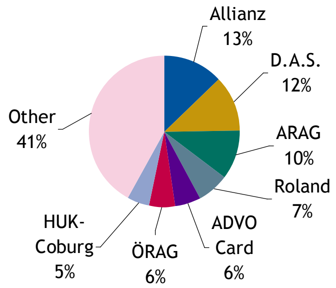
Fitch is also aware that a number of German insurance companies are setting up reinsurance subsidiaries in order to offset lost premiums in motor primary insurance with reinsurance motor business. The agency does continues to evaluate the impact of this on the credit quality of German primary insurance companies, however points out some issues besides the general higher risk for start-up companies. The impact on credit quality will depend on the actual business model these companies are following: a focus on domestic motor insurance would allow companies to use the existing underwriting expertise and to maintain an adequate risk/return profile. The reinsurance market is currently also showing signs of further softening, which limits profitable underwriting opportunities.

The agency is however very cautious about domestic German primary insurance companies entering the international reinsurance market. Historical experience indicates that this approach often leads to insurers taking risks without adequate underwriting expertise and/or risk management sufficiently evolved to control the situation. Fitch will however evaluate the impact on credit quality on a case-by-case basis.

Private Insurance - Legal

Legal Insurance Market 2007

EUR3,199m total



Note: 'Other' includes ADAC and LVM
Source: BaFin

Legal insurance in Germany covers the costs of protecting the policyholder in legal disputes. The insurance policy covers the cost of the policyholder's solicitor, the cost of the counterparties' solicitor (if payable), as well as the costs of court, independent appraiser and expenses for witnesses. There are several sub-lines in legal insurance, which may be covered by the policy, for example employment-, contract-, property-, personal injury- and tax legal insurance. Current legal insurance policies generally follow the modular approach, i.e. different components ("legal insurance modules") are combined into one individual policy. The protection for compensation of damages by third persons is however not covered by legal insurance, as this is covered by private liability insurance.

It must be noted that the business model of the German legal insurers is materially different in Germany when compared with those in many other European jurisdictions, as German insurers are restricted in the way they can offer legal advice to their policyholders. The "Rechtsberatungsgesetz" (legal consulting law, which traces its origin to the 1930s, severely restricted the rights of organisations other than solicitors to offer legal services except monetary compensation. With the reform of this law and the introduction of the "Rechtsdienstleistungsgesetz" on 1 July 2008, the possibility to offer specific advice has been extended to other professions. However it is still not possible for anybody except solicitors to offer full legal advice, and despite intensive lobbying, this includes legal insurers. This

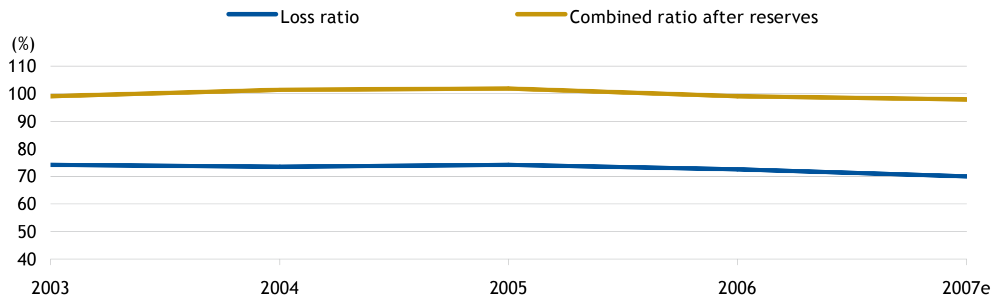
German specialty (or rather European anomaly) is severely restricting the business model of the German legal insurer, as control over claims expenses is very difficult. Legal insurers are still offering legal advice insurance ("Rechtsauskunftsversicherung") by cooperating with existing solicitors chosen by the company, but this procedure is no substitute for being able to offer full legal advice. Nevertheless, the legal advice insurance has had a strong impact on the market.

The German legal insurance market generated about EUR3.1bn of GWP in 2006, a slight increase from the previous year's GWP of about EUR3.0bn. Legal insurance is a relatively specialised insurance line, with not all German insurance groups offering this product line, and often offering third-party products. In 2006, there were 31 legal insurers in Germany. The market is fairly concentrated, with about two-thirds of GWP generated by the top nine players.

Legal insurance combined ratios close to 100%, but low volatility

The profitability of the legal insurance line has not been very good in the recent past, as the market is relatively competitive. In the last 20 years, the loss ratio has been below 70% only twice (1990/1991). As the gross cost ratio is slightly above 30% (BaFin), this would put the gross combined ratio before reserves above 100% since 1991. However, the investment earnings as well as interest generated by the technical reserves, especially the IBNR-reserves, would have made this insurance line profitable overall.

Legal Insurance Combined and Loss Ratios



Source: GDV. 2007 estimate

While the total number of insurance claims has peaked in 2004 at 3.7 million, the stricter underwriting guidelines and the reorganisation of the portfolio of many insurers caused this number to decline to 3.4 million in 2005. In 2006, the number of claims increased again to 3.5 million. The total claims settlement amounts have however increased over the last few years, from EUR2.08bn in 2003 to EUR2.22bn in 2006. Including the run-off of loss reserves, the combined ratio peaked in 2005 at 101.9%. Due to tighter underwriting guidelines and a review of the existing portfolios, the industry managed to reduce both loss ratios and overall combined ratios in 2006 and 2007 (estimate).

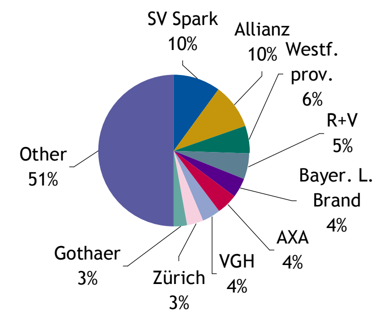
Contrary to many predictions by market participants, the introduction of the new "Rechtsdienstleistungsgesetz" (Lawyer's Compensation Act) did not have a devastating effect on the legal insurance business model. Besides the restrictions described above, the law increased solicitors' fees, which had been frozen since 1991, by 12%-21% (estimate depending on data source). As insurers are not able to provide legal advice themselves, the law had the potential to increase the claim costs to legal insurers by at least this margin. However, it currently seems that stricter underwriting guidelines have managed to decrease the number of claims, which has overcompensated for the increase in claim settlement costs.

Fitch is of the opinion that legal insurance, if underwriting controls are managed accordingly, may have the potential to increase medium- to long-term profitability beyond historical levels. Some restrictions applicable today might be overturned by European courts, and insurers have proven that they are able to offer new product variation into the market. The margin for error, however, remains small.

Private Insurance – Home and Contents

Private property insurance, consisting of home, contents and glass insurance, is one of the largest non-life insurance lines. 13% of total non-life GWP are generated with this line, split between an estimated EUR4.1bn for home insurance in 2007 (2006: EUR4.1bn), contents insurance estimated at EUR2.6bn in 2007 (2006: EUR2.6bn) and glass insurance at about EUR0.4bn (2006: EUR0.5bn).

Home Insurance Market 2006
EUR4,039m total



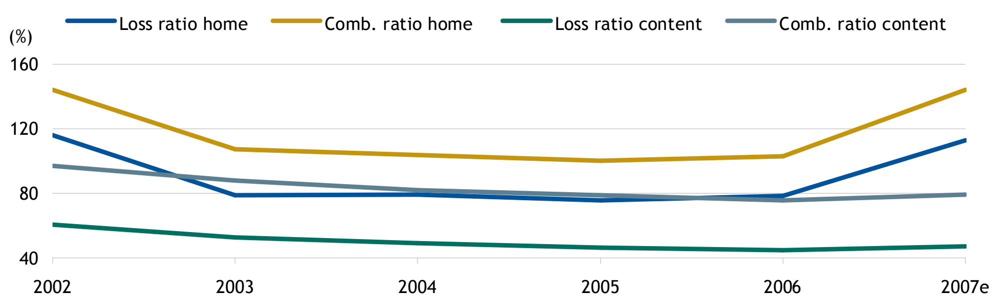
Source: BaFin

The home insurance line consists of four different sub-lines for claims with regards to buildings (not contents): fire insurance, burst pipe insurance, storm insurance and elementary loss insurance. Therefore, the term 'combined home insurance' ("Verbundene Wohngebäudeversicherung/WGV") is frequently used. The market for the combined home insurance is fairly evenly distributed, with 53 German insurers writing business in 2006 (BaFin).

The top 10 companies have a combined market share of about 50%, with the public insurers (SV SparkassenVersicherung, Westfälische Provinzial Versicherung, Provinzial Rheinland Versicherung, Bayerische Landesbrandversicherung, VGH Landschaftliche Brandkasse) having a strong market share. These insurance institutions under public law ("öffentlich-rechtliche Versicherer"), not to be confused with publicly listed companies, are owned by the savings banks and regional authorities.[10] Until the establishment of the European internal insurance market and the deregulation of 1994, the public insurers held the monopoly on building insurance in their respective regions (they covered approximately 60% of the western German federal states and 50% of these states' buildings insurance requirements). Even after liberalisation, they managed to retain their large regional market share, although larger public insurance groups were formed.

Home insurance remains unprofitable

Home and Content Insurance Gross Loss & Combined Ratios



Source: GDV. 2007 estimate. Combined ratio gross after reserves

[10] For details, please refer to the Fitch special report *"Ratings of German Public Sector Insurance Companies - After the Lapse of State Guarantees"*, published in October 2003 and available from www.fitchresearch.com

The underwriting performance of the combined home insurance has been clearly negative in the recent past. The insurance line is heavily exposed to natural hazards such as storm and flood, which can drastically affect the technical result of an underwriting year. The combined ratio for this line was 144% in 2002, when the August floods in eastern Germany caused insured losses of EUR1.8bn. A similar combined ratio is estimated for 2007, when winter storm Kyrill caused insured losses of c. EUR2.4bn. However, despite these losses and steadily continuing premium increases (from EUR3.6bn in 2002 to EUR4.1bn in 2006), the industry's pricing does not seem to reflect the insured risks in this line, as the market's combined ratio in the years between these two major events has always exceeded 100%. Even when factoring in the investment returns and the technical interest generated on equalisation and claims reserves (c. EUR2.4bn in 2006), the home insurance line does not seem able to compensate the underwriting losses caused by the natural hazards in the medium term. A highly cyclical claims market such as home insurance would be expected to generate high returns in years without above-average natural hazard occurrence. Fitch currently has no evidence of large-scale rate increases for 2008.

High exposure to winter storm Kyrill, combined ratios expected to increase to 144%

Fitch acknowledges that the impact on individual insurers from winter storm Kyrill seems to have been subdued, as the reinsurance proved to be adequate in most cases and thus the actual claims increase was manageable. However, the agency points to media coverage of some insurers that did experience a material impact on their earnings for 2007.

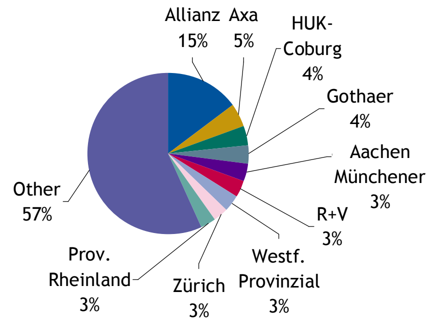
On a positive note, Fitch points out that singular storm events, even of the devastating magnitude as Kyrill, are primarily a profitability issue, and only to a second degree a credit issue, due to the sound financial strength and the typically adequate reinsurance cover of the German non-life sector.

The combined contents insurance ("Verbundene Hausratsversicherung/VHV") consists of six different sub-lines: Fire, burglary, burst pipe, storm, elementary loss and glass insurance. This insurance line covers all damages to contents like furniture, clothing, or the like. Not covered are any damages on buildings. Nevertheless, this insurance line also has material exposure to natural hazards. However, damages will occur first in the home insurance line, and only second in the home contents line. Therefore, while a winter storm like Kyrill had a devastating effect on claims in home insurance, the actual damage to the home contents were very subdued. A flood, similar to the one in August 2002, will however also damage contents.

The contents insurance market is more fragmented than the home insurance market in terms of market share: The top 10 insurers only control 43% of all GWP. There are also fewer insurers writing this line: 43 versus the 56 insurers writing home insurance.

Contents Insurance Market 2006

EUR2,582m total



Source: BaFin

Excellent profitability in contents insurance

Unlike the home insurance line, the contents insurance line is very profitable, although also exposed to natural hazards. Loss ratios have declined steadily from 60.5% 2002 to 45.0% in 2006, while the combined ratio has declined from 97.0% in 2002 to 75.4% in 2006. Both the loss ratio and the combined ratio of 2002 were materially influenced by the floods in eastern Germany, as both ratios increased by about 10 percentage points versus the previous year (2001 loss ratio: 51.4%, combined ratio 86.3%). The GWP of this line has increased steadily from EUR2.4bn in 2001 to EUR2.6bn in 2006.

A slight deterioration of both the loss ratio to 47.0% and the combined ratio to 79.0% in 2007 are expected, as insurance policies include an automatic premium reduction if the multi-year claim average is declining.

Fitch points out that the content insurance line's excellent and relatively stable profitability is probably influencing the pricing of the home insurance line, as both products are often sold as a bundle.

Commercial and Industrial Insurance

Overview

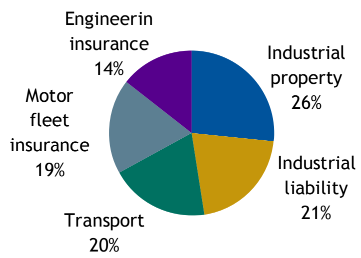
The German industrial insurance market is a very specialised market, home to a multitude of domestic and international players, primary and reinsurance companies as well as specialised brokers. The German industrial insurance market has historically been dominated by three domestic insurance groups, Allianz, Gerling Allgemeine (GKA) and HDI VVaG. The remaining players consist of medium-sized national industrial insurers (Gothaer, Württembergische, and others); the traditional industrial insurers now part of larger international groups (AXA, formerly Colonia, Zurich, formerly Agrippina) and an array of international players like AIG, ACE, FM Global and others. Reinsurers operate not only in the reinsurance field, but also engage in direct underwriting. Major industrial companies have also established their own primary and reinsurance operations, with which they place business independently. The German industrial market is heavily broker-dominated.

Industrial insurance not clearly defined, size of market can only be estimated

Industrial insurance is more a collective term used for insurance linked to industrial and larger commercial enterprises than a clearly defined segment, although the term is widely used in the media and the insurance industry. The main problem in defining this segment is the lack of a clearly defined border, the point at which an enterprise moves from the general commercial insurance (for all businesses irrespective of size and business volume) to the industrial insurance cover. This is nowhere more evident than in motor fleet insurance: The definition of a motor fleet may begin with 10 commercial vehicles per company, which puts the total number of motor fleets at about 36,000, or at 500 commercial vehicles, which reduces the total number to only about 200.[11] To Fitch's knowledge, insurers use different definitions for managing their own portfolio, which complicates the overall analysis.

Split of Industrial Insurance Market 2007

EUR9.7bn total



Source: GDV/BaFin data. Fitch estimate

Partly owing to this unclear definition, there is no specific data available for the size of the industrial insurance market. It is generally accepted that the insurance lines normally classified as industrial insurance are industrial property ("Industrielle Sachversicherung"), engineering insurance ("Technische Versicherungen"), and transport (sometimes labelled "Marine"), as well as industrial liability ("Industrielle Haftpflicht") and the motor insurance fleet business ("Kraftfahrzeugflottengeschäft").[12] The industrial property line, totalling GWP of EUR2.6bn in 2006 (2005: EUR2.8bn), consists of the industrial fire line with GWP of EUR0.8bn (2005: EUR1.0bn), fire business interruption insurance with GWP

[11] Source: Hannover Re, presentation at the Handelsblatt industrial insurance conference, November 2006, Cologne

[12] These definitions are based on published GDV statistics.

of EUR0.4bn (2005: EUR0.4bn), extended coverage with GWP of EUR0.8bn (2005: 0.8bn) and all risks insurance with GWP of EUR0.6bn (2005: EUR0.6bn). Engineering insurance, generating GWP of EUR1.4bn in 2006 (2005: EUR1.3bn), consists mainly of machinery breakdown insurance with GWP of EUR0.5bn in 2006 (2005: EUR0.5bn) and electronic equipment insurance with GWP of EUR0.3bn (2005: EUR0.3bn). Transport insurance generated GWP of EUR1.9bn in 2006 (2005: EUR 1.8bn). The size of the industrial liability insurance can only be estimated, as this business is included in the general liability line. In 2006, the non-private liability line generated GWP of EUR3.7bn (BaFin). This however includes professional and small business liability, therefore Fitch estimates industrial liability to be roughly EUR2.0bn. The fleet motor business is estimated by market observers to have been at about 8.3% of total motor premium in 2006, roughly EUR1.8bn. This estimate would put the size of the German industrial insurance market at about EUR10bn.

The above definition does not include credit insurance, which may also be included and would add EUR1.4bn of GWP in 2006 (2005: EUR1.4bn). Credit insurance however deals with very different risks than the industrial insurance lines mentioned above, therefore Fitch excludes this line from the calculation of the market size. The agency does view credit insurance as being connected to industrial insurance, and will, as in past sector reports, publish its analysis of the German credit insurance market in the industrial insurance section of the German non-life sector report.

Many definitions also include company pension business ("Betriebliche Altersversorgung", "bAV"), which would increase the estimated size of the industrial insurance market to about EUR19bn. However, Fitch will exclude this business line from its industrial insurance analysis, as this area is covered in the upcoming life insurance sector report.

Historical Development

Germany experienced a very soft insurance market between 1998 and 11 September 2001. In the light of strong capital market gains, industrial insurers were engaged in large-scale cash-flow underwriting, i.e. taking losses on the technical account in order to invest the liquidity generated in equity markets. As a consequence, loss ratios were breaching the 100% ceiling frequently, three out of five times within industrial non-life insurance between 1998 and 2002. Following pressure from the stock market crash of 2001 and exploding costs of reinsurance (at reduced cover) following 11 September 2001, the industrial insurance market experienced a period of underwriting discipline and fundamental restructuring: Long-term insurance relationships were terminated on a large scale, while overall rates were increased in combination with reduced cover and rising retentions. A number of long-standing players also significantly scaled down their operations, which resulted in a reduced market capacity.

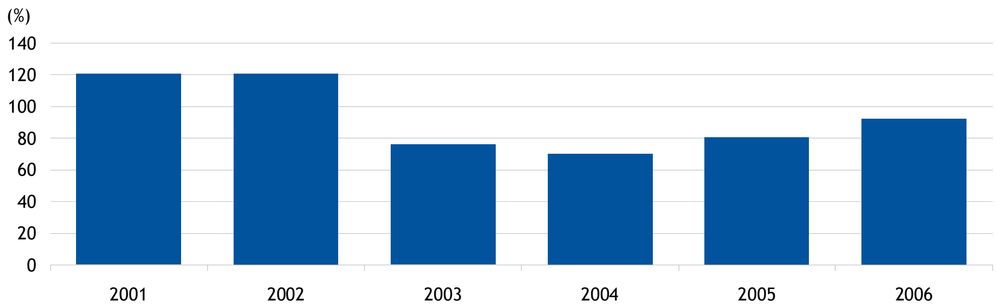
Industrial non-life: Combined ratio declined by 43% in 2003

Within one year, the gross combined ratio (before reinsurance) declined by about 43 percentage points, which can be mostly attributed to the strongly declining loss ratio due to reduced cover, in combination with premium increases. The general absence of single large-loss events in 2003 and 2004 also supported the strong positive technical result.

This allowed those insurers still active in the market to generate substantial profits. The technical result in industrial non-life and engineering, for example, is estimated at EUR3.0bn over the three years between 2002 and 2005, with yearly premiums for 2005 amounting to only EUR4.1bn.

In Germany the reduced competitive environment followed a cartel agreement in some lines. 17 insurers from the public and non-public sector were fined a total of EUR150m by the Federal Competition Authority ("Bundeskartellamt") for anti-competitive agreements in the industrial engineering & non-life, transport and property insurance. However, the companies involved did challenge the fine in court, and the legal dispute is still not settled for the majority of companies. Fitch points out that the size of the fine, divided by companies, is negligible. The main problem for terminating the issue is that by accepting the fine, the responsible board member for the cartel behaviour would no longer be deemed fit for office by the regulator. The agency points out that insurers seem to accept the fine after the board member responsible has retired or left the company. Therefore, in the light of current attrition rates at board level, Fitch expects the cartel issue to be resolved in the near future.

Gross Combined Ratio (After Reserves) Industrial Property and Engineering



Source: GDV

As insurers' balance sheets have regained strength following the positive development of loss ratios as well as the rising equity markets, an increasingly competitive environment is currently making itself felt in the market in some lines.

Mergers, Competition, and the Capacity Flood

The announced merger of HDI and Gerling caused concern in the German industrial insurance market in 2005. HDI, Gerling and market leader Allianz were the dominant players in the industry. Following the reduction of cover or market exit of other industrial insurers in the early 2000s, these three insurers were the major players capable of offering the sufficient capacity and know-how that large corporates required. Faced with an uncertain financial situation with one of these major players, a number of corporates reportedly took a holding in Gerling Allgemeine in order to preserve market capacity and avert a duopoly of Allianz and HDI. The surprise announcement of the merger thus threw the industry in turmoil.

However, it seems that the scenario predicted by observers of scarce capacity and a duopoly with strong pricing power has not materialised. On the contrary, a benign worldwide natural hazard development as well as rising equity markets (until January 2008) has led to a massive increase in available capacity, while the demand for insurance is relatively stable. According to market participants, the capacity on offer is equivalent to a "capacity flood". As a result, the rate decline continued in 2007.

Ample insurance capacity in almost all industrial insurance areas, prices relative more stable for lead insurers

It seems that the capacity increase (and consequent rate decline) is caused by established players engaging in "normal" competitive practises, and not in the entry of new competitors into the market. This does increase the competitive pressure further than could normally be expected, as industrial insurance includes some unique features not common in private insurance: the insurance cover of large industrials covers different insurance lines, as well as a multitude of special agreements. The terms of this combined insurance treaty are agreed with a lead insurer ("Führungsversicherer"), while other insurers ("Mitversicherer") may participate on a selection of risks of the insurance contract. While the change of a follower insurer is quite frequent in an industrial insurance package, a change of lead insurer is a relatively rare event. It takes years to fine-tune the details and special agreements surrounding an industrial insurance cover, and therefore the change of leadership is a major step, not taken lightly.

If the competitive environment had solely increased by the entrance of new insurers to the market offering capacity, the impact on rates for the lead insurer would have been relatively subdued. However, as the competitive pressure is increased by resident established insurers, the lead insurer rates are declining as well.

Rate decline driven by established insurers, impact of numerous new entrants currently small

The entry of foreign insurers into the German market has been far more significant than expected by Fitch in its previous publications. While the agency has acknowledged in the past that it would be easier for non-domestic insurers to enter the German market due to the availability of experienced personnel released by the Gerling/HDI merger, the speed has come as a surprise. New insurers entering the German market have been named as Mapfre, Quinn Direct, QBE, Arch, Catlin, while Mitsui Sumitomo and AIG have been expanding existing operations (AIG by acquiring insurer Wüba). Reinsurer Munich Re (IFS 'AA-') has also set up a primary industrial insurance business, which retrocedes most of the underwriting risk to its parent. Non-German industrial insurers were already active in the market in the past, largely participating as following insurers (in big industrial policies) by underwriting a quota of the respective risk(s), with the lead in these contracts generally being held by Allianz, AXA or HDI. Foreign insurers' local operations were frequently only collection and marketing departments, with the actual underwriting performed in other countries. Any increase in experienced personnel would have been a tedious and uncertain process. However, the quantity of experienced personnel available has made the build-up an easier procedure. It is not uncommon to hear of new industrial insurance operations staffed by dozens of ex-Gerling personnel. Fitch therefore agrees with the majority of market observers that without the merger, the German industrial insurance market would be a much more closed operation than it has become in 2007.

While policyholders have high hopes of foreign insurers using the opportunity to expand their coverage in the German market, this is not a viable option for large companies in the short term. There are, however, signs that new entrants are viewed as strategic options by corporates, and are included as follower insurers in order to build up future leaders.

Historically, big German corporates have always been very reluctant to place major insurance cover with foreign insurers. The relationships between corporates, insurers and reinsurers were seen as being very long-term, with current unfavourable conditions being offset in following years. Moreover, German industrial companies have traditionally placed emphasis on rapid claims management and have preferred domestic players on this basis.

Fitch expects increasing competition in industrial non-life business due to the German industry's relocating parts of its production capacities to Eastern Europe and Asia. This could place a continuous strain on the size of the market, leading to increased competition in the medium- to long term. That said, the transfer of capacity to foreign countries will also increase the risk to German industrial insurers as they follow policyholders, extending cover to include foreign operations into their policies. Fitch believes that there is a danger in an insurer writing risks but having no previous experience in the particular region. Support from reinsurers and/or cooperation agreements with foreign insurers would be a more prudent approach.

Although the HDI-Gerling merger is causing other players to expand their market share, Fitch expects higher rates in special lines in the short term and constant or slightly declining rates in the more general lines. The agency believes that this cycle is likely to be shallower than previous cycles, as reinsurers are unwilling to participate in large-scale cash-flow underwriting by way of quota share treaties.

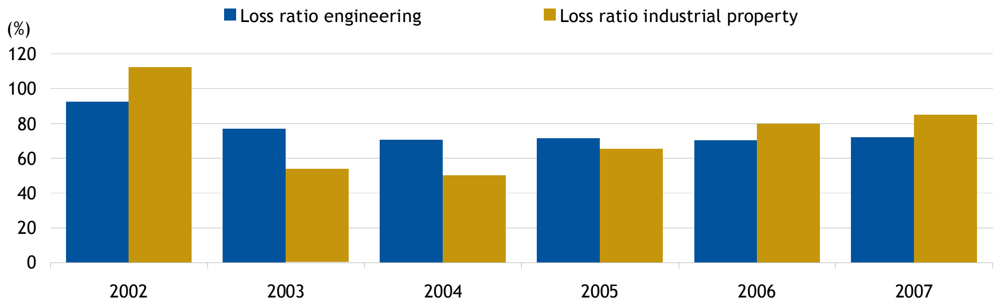
With the exposure thus fully on primary insurers' balance sheets, Fitch expects the period of overall negative combined ratios to be short. This however does not apply to individual insurance lines, which may show prolonged negative periods.

Fitch points out that the increased pressure by capital markets and/or rating agencies has caused a reversal of communication strategies of insurers. Historically, underwriting losses were very well publicised in order to aid the negotiation of better rates. Due to the pressure of market participants mentioned, the current communication strategy on the contrary stresses the virtues of prudent underwriting. The reality in both cases is probably identical, which is why some market participants claim the current cycle is a repeat of the prior soft markets.

Industrial Non-Life & Engineering

In industrial non-life & engineering, Fitch expects the trend towards premium reductions, observed since mid-2005, to weaken in 2009. However, this was already expected in previous years, and no change has been reported for the 2008 renewals.

Engineering/Industrial Property Loss Ratios



Source: GDV. 2007 estimate. Loss ratios before reserves

The total industrial property market is expected to decline to EUR2.5bn in 2007.[13] This is a further decrease of GWP by 4.0%, following the 2006 reduction by 5.3% to EUR2.6bn. The market reached its peak in 2004 with GWP of EUR2.9bn. The decline in the sub-lines of industrial fire and fire interruption insurance is especially strong, with the former declining by 12.6% yoy (2005: -5.6% yoy), while the latter has declined by 11.7% (2005: +0.4% yoy). However, Fitch agrees with market participants that the real premium decline is much greater, with two effects being noted: first, as production increased in many corporates in 2006 due to the positive economic environment, the sum insured increased (and the premium). Second, market participants are using the low rates to increase the extent of risks covered in their policies, a procedure not uncommon in soft markets. Unfortunately from a credit perspective, the increase in insured risks is much harder to quantify than the premium development. Historically, a strong increase in capacity at inadequate rates has however always resulted in long-term losses in the end, not least because of changes in policyholder behaviour.

Loss ratio expected to increase to 85% despite low large claim intensity

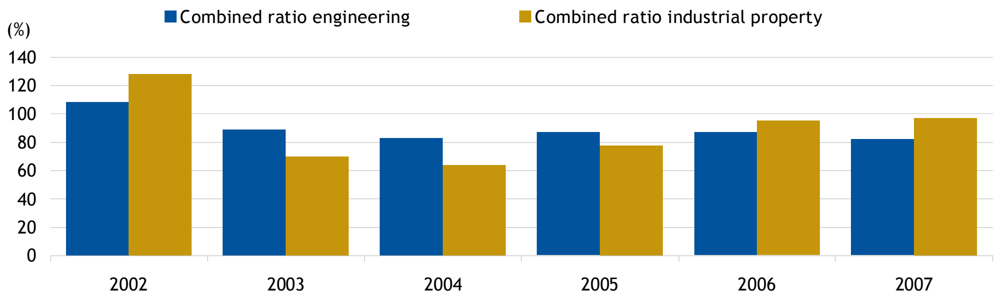
The loss ratios have been reflecting not only the trend of declining premiums, but also the strong increase in claims, especially in the industrial fire line. As described in Fitch's prior German non-life publication, the years 2004 and 2005 were benign and historically rather unusual years for large fire claims. These have then increased dramatically in 2006, heavily influenced by the fire incident at ThyssenKrupp Nirosta (Krefeld, Germany), which was the single most damaging event in German industrial insurance history. This increased the industrial property loss ratios by about 15% to 79.8% (2005: 65.7%). The development of the estimated loss ratio in 2007 is in Fitch's view a very good indicator of the negative development of this line: No major above-average industrial fire claims were

[13] Source: GDV

reported in 2007, but still the loss ratios are widely expected to increase further to 85%. If the loss ratio development of 2006 is seen as largely driven by large claims, then the softening of the market is reflected in the jump from about 65% in 2005 to 85% in 2007.

The relatively smaller industrial engineering line is showing a relatively different development. Following a decrease of GWP of 1.5% in 2005, GWP has increased by 4.0% to EUR1.4bn in 2006 (2005: 1.3bn). The increase is largely caused by the positive economic growth in Germany, which has increased the demand for additional capacity in this area. Contrary to the industrial property line, GWP is expected to increase by 1.0% in 2007. However, this is still below the 1995 peak of EUR1.5bn.

Gross Combined Ratio (After Reserves) Industrial Property and Engineering



Source: GDV. 2007 estimate

The combined ratios of the engineering and the industrial property insurance lines show a diverging development in 2006 and 2007: While the industrial property line is expected to further increase to 97%, the engineering line is showing an expected decrease versus 2006. While loss ratios have increased only by about 2% in 2007, the continuing GWP growth as well as the release of the claim reserves is expected to reduce the combined ratio to 82% for 2007 (2006: 87.0%).

Rates should increase following large claims

The rate increases in 2003 and 2004 were viewed by many participants as not having been sustainable, mainly driven by the post 9/11 shock and capital markets turmoil. While Fitch sees the benefits of such rates on the credit quality of insurers, the agency will not measure underwriting quality by such peak market standards, although insurers, in their communication with rating agencies, did place great emphasis on their underwriting performance in these years. Fitch points out that the correct price for insurance cover does of course depend on the angle and position of the person performing this analysis, but that a sustainable price (and corresponding underwriting result) is probably the middle ground between the peak and trough of a cycle. There is however little doubt in the agency's mind that this point has been passed in 2007 in industrial fire insurance. The increase in risks in the renewals of 2007 and 2008 will be the main credit driver in 2008 and 2009, as losses should (by historical experience) increase and drive the industrial property insurance towards underwriting losses. Fitch would expect rates to rise after a series of large claims.

Industrial Liability/D & O Insurance

The industrial liability line is, besides industrial property and engineering, one of the central components of an industrial insurance treaty. As mentioned above, the data for this line is shown together with private liability business; hence the exact size of the market can only be estimated. As mentioned in the prior section of this report, Fitch estimates the size of the German industrial liability market at about EUR2bn. The agency points out that this is a very rough estimate, with a relatively high margin for error.

Industrial liability for large corporates is an insurance line dominated by large insurance groups. Due to the very long period during which a claim can still be made, large corporates generally prefer large insurance groups. These offer a degree of certainty that claims can still be met, and typically have high financial strength ratings to support this claim. An example of long-tail risk would be asbestos, where current claims are based on exposure decades ago (this is not an issue in domestic German liability business, as this risk is covered by specialised institutions, the "Berufsgenossenschaften"). The long-tail distribution of claims is however also positive, as the interest generated from existing claim reserves is relatively high. Please refer to the "Special Focus" section below for details.

Contrary to prior expectations of market participants and Fitch, there appears to be ample capacity in the German industrial liability market. The experience of 2006 led to the expectation that cover for exposed risks like pharmaceuticals and hospitals would remain scarce, and that the merger of HDI and Gerling would reduce capacity further (please refer to the previous German non-life report for details). However, insurance cover for these risks is apparently in plentiful supply, and while general prices were reduced by as much as 15% in 2007, prices are set to decline even in high-risk lines. Significant increases are only reported for liability risk from agricultural and retail food products.

This comes in the context of a general trend in German liability insurance of following stricter industry underwriting guidelines. Fitch believes that the days of unlimited cover, including many unnamed risks in liability policies, are over for the foreseeable future and that the move towards greater exclusions represents a genuine structural change in the way in which the industry is conducting its business. It remains to be seen how the industry responds to these new needs.

D&O market very opaque, market participants reports levelling out of rates following decline in the last years

Another part of the liability line is the Directors' and Officers' liability insurance. D&O insurance is relatively new to the German market, and was introduced in the 1980s by international insurers such as Chubb. Initially considered a rather exotic product, D&O insurance has become relatively popular in the last decade and has successfully established itself in the German market. This is partly due to the intensive sales pressure of insurers, as D&O cover often functions as a "door opener" for a variety of other industrial and commercial insurance products. Also, the product is highly appealing to persons ultimately responsible for the purchase of insurance cover.

The German D&O market is estimated to have a GWP of around EUR350m in 2007, with some estimates putting the German market significantly higher. The actual size, structure, and profitability of the market are not public, as market data is not separated from general liability lines. The industry itself is relatively opaque, with a very restricted information flow. There are more than 30 insurers writing D&O insurance in Germany, including many foreign insurers. Market leaders in this line according to market participants are Allianz (IFS 'AA') and AIG (IFS 'AA+'). Another material player is VOV, which acts as the combined underwriting pool for seven insurers, among them Gothaer (IFS 'A'), Condor (IFS 'A'), Nürnberger (IFS 'A+'), Generali (IFS 'AA'), and AachenMünchener (IFS 'AA').

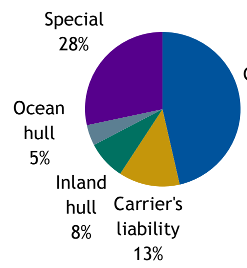
According to market participants, the prices for D&O cover in Germany have been falling over the last years but have bottomed out in 2007. While stable prices are expected for 2008, the rising losses resulting from subprime events are expected to increase claims. This could lead to higher prices in 2009.

Claims Management

Historically, claims management in German industrial insurance was relatively undisputed by international comparisons. As stated earlier, the degree of cover included in policies was fairly comprehensive, leaving little room for interpretation. Due to the nature of the market, with long-lasting client-insurer (and reinsurer) relationships, any large-scale losses would be "repaid" in later years by higher premiums. The soft market of the early 2000s, coupled with increased reinsurance premiums as well as general pressure by stakeholders, are beginning to fundamentally change the habits of German claims management. Especially large claims are subjected to intense scrutiny. Due to the complex nature of many treaties, in combination with causes of the respective incidents often being unclear, the claims are more frequently disputed and sometimes have to be mediated. Most affected are the industrial liability and industrial property lines, but the trend is clear in the motor fleet lines too. The intensified scrutiny is however not confined to the client-insurer relationship, as insurer-reinsurer disputes are also increasing in frequency and intensity. Some policyholders also claim that the continuing development towards leaner organisational structures of primary insurers, which often goes hand-in-hand with a reduction of personnel, has had an adverse effect on the quality of claims management.

Fitch believes that the development of claims management described above reflects the broader structural change in German industrial insurance of shorter-term relationships and a move towards a more international standard of claims management. However, this comes as a mixed blessing, as potential reductions in claims costs are likely to be partly offset by legal costs.

Transport Market 2006
Total EUR1.9bn



Source: GDV

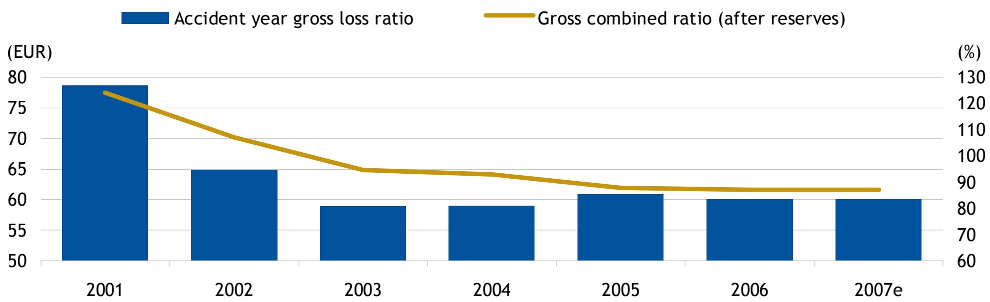
Positive development in Transport (Marine) insurance

Transport (Marine)

Transport, or marine insurance line, is a combination of many different sub-lines. Transport can be roughly split into traditional transport insurance, whose origins can be traced back to the beginnings of insurance in the 14th century, and special transport insurance, which insures very different risks and policyholders.

The traditional transport insurance, totalling GWP of EUR1.3bn in 2006, consists of EUR850m goods in transit insurance, EUR23m of goods in transit war premium, EUR232m carrier's liability, EUR84m ocean hull and EUR148m inland hull insurance. Special transport insurance, with a total of EUR520m in 2006, consists of many different sub-lines, including baggage, valuables in transit and travel cancellation insurance.

Gross Loss and Combined Ratios Transport



Source: GDV. 2007 estimate

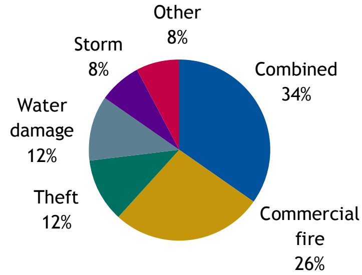
Total GWP in the entire transport line peaked in 2004 at EUR1.9bn, following decades of virtually uninterrupted growth. GWP declined in 2005 by 3.5% in total, mostly caused by the decline of the carrier's liability insurance by 12.7% to EUR235m (2004: EUR265m) due to the reorganisation of portfolios and more stringent underwriting guidelines by insurers, as well as the rise in retention of policyholders. Good in transit insurance declined as well, and both lines still show slightly declining GWP in 2006. In light of the growing German economy, the development of premiums is not in line with the economic environment. GWP is expected to increase by 2.0% for 2007 to about EUR1.9bn, which will probably — as in 2006 — be mostly attributable to special transport insurance. The development of the loss ratios has been positive since 2001, when the gross loss ratio was 78.6%. Following the more stringent underwriting and capacity reductions following 9/11, the loss ratios dropped to 58.9% in 2003 and has remained roughly at this level since. The combined ratio has a similar development, and has remained below 90% since 2005. Apparently, winter storm Kyrill did not cause any material impact on these ratios, despite the loss of an insured ship in the English Channel. Therefore, despite slightly increasing GWP, constant loss ratios and combined ratios are expected for 2007.

Commercial Property Insurance

The commercial insurance line includes 9 different sub-lines, generating a total of GWP of EUR2.6bn in 2006. This is an increase of 2.5% versus 2005, but for 2007 total GWP is expected to remain unchanged at EUR2.6bn. Commercial property insurance covers small- and medium-sized companies not classified as "industrial insurance"

Commercial Property Market 2006

In EURbn. Total EUR2.6bn



Source: GDV

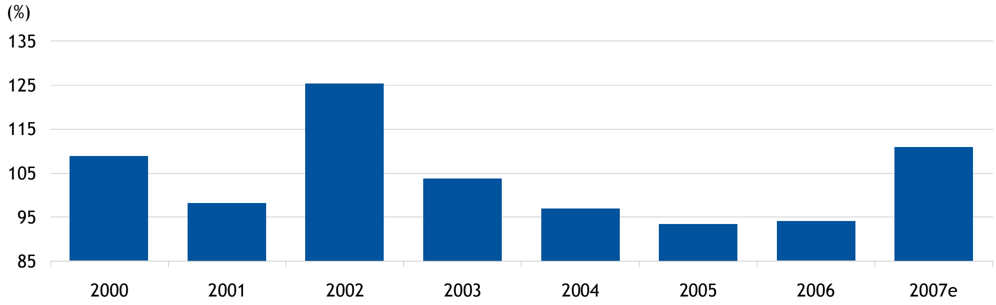
Major sub-lines of the commercial insurance are commercial fire insurance with GWP of EUR0.7bn in 2006 (2005: EUR0.7bn) and combined commercial property insurance with GWP of EUR0.9bn in 2006 (2005: EUR0.8bn), which combines the other eight sub-lines.

The total commercial property line had a loss ratio of 68.8% in 2006, a slight decrease versus the previous year's loss ratio of 70.4%. While claims paid stayed virtually unchanged at EUR1.8bn in 2006, the increase of total GWP by 2.5% resulted in the declining loss ratio. In the commercial fire line, claims decreased slightly despite an unchanged GWP, which resulted in the loss ratio declining from 68.2% in 2005 to 67.2%. The combined commercial property insurance increased its claims by 3.8% to EUR0.6bn, which in combination with increasing GWP (by 7.4% to EUR0.9bn) resulted in a similar decline of the loss ratio 71.6% (2005: 73.6%). Any movement of loss ratios and GWP within the commercial property lines is however influenced by the underlying growth of the combined commercial property line, which takes over the shares of other sub-lines.

A massive increase of the loss ratio is expected for 2007, due to the impact of winter storm Kyrill, which will increase the loss ratio by around 35 percentage points to about 104% in 2007. In Fitch's view, the much higher impact of storm Kyrill on this line than on the industrial insurance line is probably caused by the much higher number of claimants, together with lower retentions.

The combined ratio after reserves is expected to reach 111% for 2007 as a result of the storm damage, in combination with higher administrative cost burden. Fitch does expect the combined ratio to decline in 2008, factoring in normal natural hazard patterns. However, the commercial property market is currently also experiencing strong competitive pressures, which will hinder price increases for 2008. Therefore, a combined ratio near or above the 100% mark might, in the agency's view, be possible.

Combined Ratio Commercial Property



Source: GDV. 2007 estimate. Gross combined ratio after reserves

Special Focus – Reserve Release and Profitability

Overview

While most attention is generally focused on the analysis of combined ratios by market observers, the liabilities side of the balance sheet and its impact on profitability is often overlooked. Therefore, Fitch is including a special focus on this topic in this report. This special focus includes, besides a general overview, a section on the payment patterns, equalisation reserve, and reserve releases. The reserve development has a strong impact on combined ratios and earnings, while the interest generated on liabilities (shown as part of the investment result) frequently dwarfs the underwriting result in soft markets. It is important to bear in mind that the investment result shown in the profit-and-loss statement therefore only partly reflects the premium income of the current year, but also that of previous years in the form of technical reserves.

Concept of technical interest artificial, matches investment return to liabilities. Internationally relatively uncommon.

As stated in the summary, the concept of technical interest is artificial to a degree. The concept aims to enhance the total profitability analysis by matching a part of the investment income to the technical reserves. This concept is not widely communicated in international terms, as the investment result is analysed by asset class and performance and not matched to insurance line liabilities. Fitch acknowledges that from a bottom-line perspective, it is irrelevant whether the investment result is matched by liabilities or equity positions. However, in soft markets this concept allows for a more detailed analysis of the profitability of an individual insurance line.

Total gross technical reserves in the German non-life market were EUR108.6bn in 2006, slightly higher than the previous year's reserves of EUR105.0bn. Net of reinsurance, total technical reserves were still at EUR86.9bn in 2006 (2005: EUR82.7bn). The largest single item in 2006 are the claim reserves of EUR74.8bn (Net: 55.8bn) and the equalisation reserve of EUR14.0bn (Gross equals net, 2005: EUR13.3bn), therefore this report will focus on these two items.

Claim Reserves and Payment Patterns

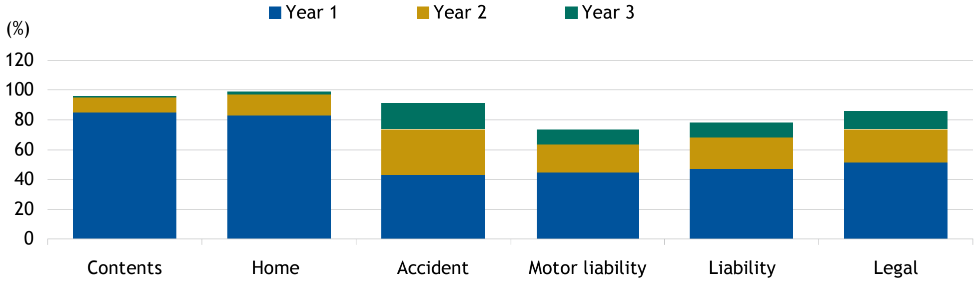
As mentioned above, the interest generated by the technical non-life reserves can frequently exceed the actual underwriting result of an insurance line. It is however relatively hard to quantify the exact impact on profitability, as reserves are not a homogenous block. Non-life claim reserves can be separated into three categories: the known claim reserves, the incurred-but-not-reported (IBNR) claims reserves and the reserve for regulation expenses. The "normal" claim reserves, total gross size EUR13.8bn for the 2006 underwriting year and EUR35.1bn for the previous year's, is set up following an actual insurance claim. As there is no collective reserving in German statutory accounting, as each claim is in principle reserved individually. At year-end, the reserves remaining are attributable to insurance claims not settled. The IBNR-reserve is set up as an estimate of claims that have not yet been reported.

The gross IBNR reserve for the German non-life market's 2006 underwriting year was EUR5.5bn, and EUR14.9bn for previous years. The smallest of the claim reserves is the reserve for regulation costs, at EUR2.0bn for the 2006 underwriting year and EUR3.3bn for previous years.

The profitability arising from these reserves differs markedly between lines. This is due to the fact that the reserves are run-off over differing time periods. Some lines have very long run-off periods, in which the insurers can generate interest on the remaining reserves for a multiple of years, while other lines have very short periods as claims are paid out almost immediately. In the table below, the payment patterns of selected lines have been listed. Not surprisingly, home and contents insurance pay out between 85% and 83% of total claims in year one, with another 10% and 14% in year two. Therefore, the interest generated on these reserves is relatively low, and the underwriting result is supported only slightly by the reserves. On the contrary, the liability lines of motor liability and general liability (this includes industrial liability and D&O insurance) have a very long settlement period. In motor liability, only 74% of claims are paid after three years, therefore this insurance line can strongly support the underwriting result by the interest generated on technical reserves. Surprisingly, this also applies to the accident insurance line, increasing the already high profitability of this insurance line further.

Payment Patterns - % of Claim Reserves Paid Out

Selected lines



Source: Fitch. Average of selected companies.

Fitch excludes in this analysis the risk that reserves may be deficient. For some insurance lines such as accident insurance, reserving accurately is relatively straight forward due to a large portfolio and low claims volatility. Other lines, such as industrial liability insurance, face large potential claims volatility, and thus the margin of error for known and unknown risk is greater.

Equalisation Reserve

The equalisation reserve is a very material item on the balance sheet of any German non-life insurer. It is a mandatory reserve in German non-life insurance under §341H of the commercial code (HGB) and §29 of the insurance accounting code (RechVersV). The equalisation reserve acts as an additional buffer between the underwriting result and the balance sheet. Therefore, the underwriting result of a German non-life insurer is rarely reflected in the actual profit-and-loss statement. The equalisation reserve acts as a "reverse momentum", and may eliminate underwriting losses of one year or reduce underwriting gains.

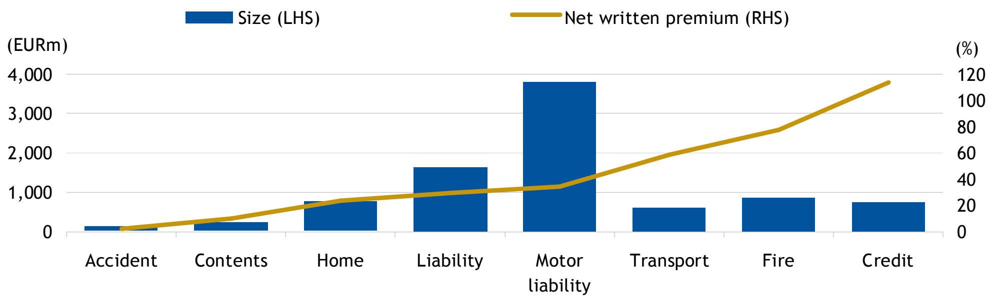
The equalisation reserve has to be set up once the following three criteria have been met:

- the average gross earned premiums exceed EUR125,000 for the last three years;
- the standard deviation of the loss ratio from the average loss ratio has been higher than 5% for the last 15 years (30 years in credit and hail storm insurance); and

- the combined ratio has exceeded 100% in the last 15 years (30 years in credit and hail storm insurance).

In practice, almost all insurance lines have an equalisation reserve. Please note that equalisation reserves in the insurance line "sonstige Sachversicherung" are voluntary following the change of the regulatory reporting standard "BersVersV" in 2005.[14] The results of some insurers have been materially affected in 2005 and 2006 as a result of this release.

Equalisation Reserve - Selected Lines 2006



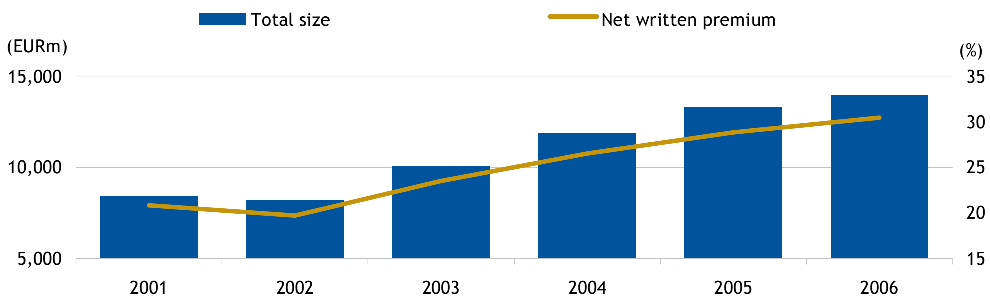
Source: BaFin. Selected lines. Total amount EUR14bn

The allocation and release of the equalisation reserve is governed by the detailed guidelines in the insurance accounting code. Please refer to the annex of §29 of the RechVersV for details.

The total equalisation reserve for the German market in 2006 was about EUR14bn, or about 30.4% of total net written premiums (equal to 22.5% of total non-life GWP. Source: BaFin). As the size of the equalisation reserve is governed by historical claims ratio deviation, insurance lines with stable loss ratios have lower equalisation reserves than highly volatile lines. For example, the very stable accident insurance (the loss ratio deviation is only 3.9% between 2001 and 2006) only has an equalisation reserve of 2.5% of total net written premiums (NWP), while at the other extreme, the credit insurance line, with its exposure to large losses and loss ratio deviation of about 60% in the same period, has an equalisation reserve of 157.2% of NWP.

Strong increase of the equalisation reserve since 2002

Equalisation Reserve 2006



Source: BaFin

In economic capital models (for example Prism) this is frequently added to the shareholders funds. This procedure is in line with IFRS accounting, which rebooks the equalisation reserve into equity.

[14] Insurers may still set up an individual profit-and-loss account for this line, and retain their equalisation reserve. Sub-lines in the "sonstige Sachversicherung" are glass, storm, technical insurance, extended coverage, Interruption, pipe water, and theft insurance.

Total reserve releases increased slightly in 2006, but strongly in motor liability

Run-Off Result in % of Prior Year Reserves

	Total (%)			
	2006	2005	2004	2003
Health	22.01	34.44	18.08	30.70
Accident	11.16	11.15	11.87	11.56
Liability	3.99	3.96	2.25	4.13
Motor - liability	6.02	4.64	4.46	5.16
Motor - other	27.76	29.57	26.72	25.76
Aviation	18.86	38.32	4.76	28.85
Legal	3.86	3.72	4.09	7.20
Fire	20.39	26.55	23.97	18.02
Contents	29.29	36.85	25.80	23.45
Home	16.58	19.38	16.82	9.11
Transport	19.36	18.19	10.62	9.89
Credit	18.05	19.34	19.76	17.12
Benefit (assistance)	21.17	24.83	22.15	19.95
Aviation-liability	15.19	28.28	12.94	27.66
Other property	19.47	24.96	23.04	19.07
Other	11.42	10.23	7.36	4.89
Market	**7.93**	**7.72**	**6.98**	**7.53**

Source: BaFin. Fitch calculation. Includes regulation reserve

The equalisation reserve has increased strongly since 2002, mostly attributable to the development of the loss ratios in the motor insurance lines described in the corresponding section of this report. The equalisation reserve in motor lines has increased from EUR3.8bn in 2002 to EUR6.8bn in 2006.

The equalisation reserve not only acts as a buffer against underwriting losses of a given year, but also supports overall profitability by generating interest on these reserves. Assuming a risk-free interest of about 4.0% at year-end 2006, corresponding to the yield on the German government 10-year treasury, the total equalisation reserves generated about EUR560m in interest. Some market observers attribute the ongoing price competition in motor insurance partly to the interest generated by the technical and equalisation reserves, which “reduce the underwriting pain”. Fitch subscribes to this opinion.

Reserve Releases

German statutory (HGB) accounting adheres to the principle of prudence when setting up technical reserves (i.e. claims and IBNR reserves). This is a differing approach from many international jurisdictions and from international accounting conventions, where the governing principle is the “best estimate” approach. German statutory accounting also focuses on the individual valuation of claims reserve (“Einzelbewertungsprinzip”), while international accounting standards follow collective reserving principles (“kollektive Bewertung”).[15] In some instances, this can cause difficulties for groups reporting under both HGB and IFRS accounts.

Reserve redundancies vary widely in the industry, but there are some general trends. The redundancy (measured by the multi-year average of the release of the prior years’ reserve) for motor liability lines and general liability lines is frequently only in the low single-digits (about 4%); individual insurers even have slight reserve deficiencies in motor liability. It should however be noted that reserve deficiencies are a rather unusual event in these lines, attributable to small insurers. Reserve redundancies are generally high in the other motor lines, and fire, contents and home insurance frequently have redundancies of more than 30%. Fitch is using the run-off of the prior year reserve as a proxy for reserve redundancies, a procedure which is backed by third party reserve estimates provided by insurance companies.

As a result of this accounting difference, German technical non-life reserve redundancies are generally relatively higher than in many other countries. This fact is important when analysing the underlying profitability of an insurance line: while loss ratios, consisting of claims paid during the respective year and the addition to the claim (and other) reserves, are a good indicator of the current year’s performance, they do not capture the release of the prior year’s reserves. The release of these reserves is reflected in the loss ratio of the current year, or loss ratio after reserves. Any changes in either reserving standards (i.e. the level of safety in these reserves) or changing release patterns can affect the analysis fundamentally.

Due to the large size of non-life reserves relative to premiums, even small changes in the release patterns of an insurance line will have an immediate impact on the combined ratios. Total non-life reserves for the German market were EUR72.3bn in 2006 — much higher than total reported non-life GWP.[16]

[15] For details on German non-life reserving, please refer to Radtke/Schmit “Handbuch der Schadenreservierung”, Karlsruhe 2004, and Thomas Mack “Schadenversicherungsmathematik”, Karlsruhe 2002

[16] Statistical note: The reserves are based on the BaFin statistic, which also includes insurance lines not covered by the GDV (for example aircraft liability), assumed reinsurance as well as a small portion of non-German business. Therefore these reserves are not fully attributable to German primary business as shown by the GDV in its statistics. The differences are however not material on the level where the above analysis is being conducted

The 2006 reserve releases were slightly higher than in previous years, increasing from 7.72% of total reserves in 2005 to 7.93% in 2006. This is still almost one percentage point, or about EUR890m higher than the 6.98% in 2004. While this overall picture shows only a gradual increase, the reserve release in motor liability insurance was however much higher. The reserve release increased from 4.64% in 2005 to 6.02% in 2006, which equals about EUR477m. This has materially influenced German motor insurers' combined ratio, and has reduced the impact of the current soft market and weak pricing conditions on motor insurance.

It should be noted that changes to the reserving standards may have different causes: a structurally changed insurance line, with fewer and lower claims per policyholder will require different reserves than an insurance line with rising claims. On the other hand, new information about the future size of claims may necessitate additions to past reserves. And since reserving is performed not only according to historical experience and regulatory and accounting standards, but also according to a discretionary safety margin above the best estimate individually set by the company, the size of a reserve release is thus partly a management decision.

Appendix

Analysing the Underwriting Performance in German Non-Life Insurance

The combined ratio, as shown above, is defined as "gross combined ratio after reserve development". This excludes reinsurance, which, depending on the structure of the reinsurance programme and claims development of the underwriting year, has a negative or positive effect on the combined ratio (then defined not in relation to earned gross premium but to earned net premium). In 2006, market data compiled by the German regulator BaFin show a difference of 2.0 (2005: 3.0) percentage points for the industry. Therefore in a "normal" claims year the combined ratio after reinsurance should be higher. The combined ratio, as defined above, also includes reserve development, i.e. the increase or decrease of technical reserves. A material part of the current year's premiums has to be added to the reserves, as claims are settled in the following years and an additional reserve is created for incurred but not reported (IBNR) claims, as well as claims settlement costs. A significant proportion of these reserves are redundant, as the reserving takes a certain safety margin into account. The release of this redundant amount thereby lowers the next year's combined ratio. The reserves may also be too low, i.e. the final claims settlement amount is higher than the reserved amount, which make reserve strengthening necessary and hence raise the future combined ratio. A strong decrease, or run-off of claim reserves will have a favourable impact on the combined ratio. Reserve releases may also be caused by changing reserving guidelines or structural claims evolution. Therefore the singular analysis of the combined ratio as defined above is not a full indicator of the underlying profitability of the German non-life industry. Reserve releases have increased materially in some lines in 2006, therefore having an impact on the combined ratio analysis. For details on the technical reserves in German non-life insurance, please refer to the special focus chapter above.

The combined ratio is also affected by the development of the expense ratio. This ratio is also more an indicator of the underlying costs than an absolute figure. As most German non-life insurers are part of larger insurance groups, the cost distribution from overheads such as asset management or general administration can be influenced by the insurance group's priorities, which may result in individual entities carrying an uneven share of associated costs. This is also possible on an individual insurance line level: Traditionally, expenses are re-distributed from highly competitive lines such as motor and are allocated to less competitive lines like accident insurance. Evidence of this is naturally anecdotal, as the cost distribution is signed off by the auditor. Nevertheless, combined ratio analysis on an individual insurance line level by Fitch takes the cost allocation into account.

An additional but very important item in German insurance accounting is also the equalisation reserve. This mandatory reserve has to be set up for (almost) all insurance lines, and amounted to about EUR14bn in 2006 (BaFin, 2005: about EUR13.3bn.[17] Scale, allocation and release of this reserve is governed by strict guidelines issued by the German financial services authority and is reflective of the current loss ratio in relation to past underwriting performance. The equalisation reserve acts as a "buffer" between the underwriting result and the actual transmission of this result into the bottom line in the insurance accounts. Therefore the combined ratio is only an indicator of the current year's profitability, as any underwriting profits may be reduced or amplified by the development of the equalisation reserve. From a rating agency standpoint, the equalisation reserve is considered (in line with IFRS accounting) to be part of the company's equity position, and is therefore beneficial to the company's financial strength. For details on the equalisation reserve, please refer to the special focus section of this report.

[17] Note: Gross and net reserves are equal, as the reinsurer does not participate in the development of this reserve.

The underwriting result is supplemented by investment returns. Due to the relatively high ratio of reserves to premiums in Germany due to the underlying accounting standards, the interest and the release of these reserves is heavily supporting the underwriting profitability. The equalisation reserve serves as an additional buffer and interest generating reserve.

Statistical Note

There are two main publicly available data sets for the German market: the industry statistics published by the German insurance association (Gesamtverband der Deutschen Versicherungswirtschaft – GDV) and those of the German financial services authority (BaFin). Both data sets are published with a time lag versus the previous year of about eight months (GDV) and about 11-12 months (BaFin). The structure, as well as level of detail, are materially different, due to the fact that the GDV collects data of its member companies, while BaFin publishes data of companies under German insurance supervision. This can lead to differences in the number of included companies, therefore resulting in differing data. Furthermore, the GDV does not include nuclear, aviation, aircraft and aerospace liability or insurance of liability against economic loss ("Vermögensschadenhaftplicht"), while the BaFin also includes foreign (i.e. non-German) insurance premiums.

In order to ensure relative consistency with Fitch's 2006 special report *"German Non-Life Insurers: Competition on a new Pitch"* and to provide the necessary granularity in certain insurance lines, Fitch is basing its analysis in this report on the data published by the GDV. This will be supplemented by BaFin data where appropriate, especially in the technical parts of this report. Data sources have been clearly marked.

Fitch Insurer Financial Strength Ratings of German Non-Life Insurers

		IFS Rating	Outlook
1.	AachenMünchener Versicherung AG	AA	Stable
2.	Advocard Rechtsschutzversicherung AG	A+	Stable
3.	Allianz Versicherungs-AG	AA	Stable
4.	Axa Versicherung AG	AA	Stable
5.	Coface Kreditversicherung AG	AA	Stable
6.	Condor Allgemeine Versicherungs-AG	A	Stable
7.	Cosmos Versicherung AG	AA	Stable
8.	DBV-Winterthur Versicherung AG	AA	Stable
9.	DBV Deutsche Beamten-Versicherung AG	AA	Stable
10.	Generali Versicherung AG	AA	Stable
11.	Gothaer Allgemeine Versicherung AG	A	Stable
12.	Nürnberger Allgemeine Versicherung AG	A+	Stable
13.	Optima Versicherungs-AG	A	Stable
14.	Volksfürsorge Deutsche Sachversicherung AG	AA	Stable
15.	Württembergische Versicherung AG	A	Stable
16.	WWK Allgemeine Versicherung AG	A+	Stable

Source: Fitch

Fitch Quantitative Insurer Financial Strength Ratings (Q-IFS) of German Non-Life Insurers

		Q-IFS Rating
1.	ADAC-Schutzbrief Versicherungs-AG	BBBq
2.	ADLER Versicherung AG	BBBq
3.	Alte Leipziger Versicherung Aktiengesellschaft	BBBq
4.	Baden-Badener Versicherung Aktiengesellschaft	Bq
5.	Badische Allgemeine Versicherung AG	BBBq
6.	Badischer Gemeinde-Versicherungs-Verband	Aq
7.	Barmenia Allgemeine Versicherungs-AG	Aq
8.	Bayerische Beamten Versicherung Aktiengesellschaft	BBBq
9.	Bayerische Hausbesitzer-Versicherungsgesellschaft aG	BBBq
10.	Bayerische Landesbrandversicherung AG	Aq
11.	Bayerischer Versicherungsverband Versicherungsaktiengesellschaft	Aq
12.	Concordia Versicherungs-Gesellschaft auf Gegenseitigkeit	BBBq
13.	Continentale Sachversicherung Aktiengesellschaft	BBBq
14.	Deutscher Ring Sachversicherungs-AG	BBBq
15.	DEVK Deutsche Eisenbahn Versicherung und HUK-Versicherungsverein aG	BBBq
16.	Docura Brandkasse Deutscher Lehrer VVaG	BBBq
17.	Europa Sachversicherung Aktiengesellschaft	Aq
18.	Fahrlehrerversicherung Verein auf Gegenseitigkeit	BBBq
19.	Gartenbau-Versicherung VVaG	BBBq
20.	Gemeinnützige Haftpflicht-Versicherungsanstalt Darmstadt	BBBq
21.	German Assistance Versicherung AG	BBq
22.	Grundeigentümer-Versicherung VVaG	BBBq
23.	GVV-Kommmunalversicherung VVaG	Aq
24.	GVV-Privatversicherung AG	BBBq
25.	Haftpflicht-Unterstützungs-Kasse kraftf. Beamter Deutschlands aG in Coburg	Aq
26.	Häger Versicheurungsverein auf Gegenseitigkeit	BBq
27.	Hamburger Feuerkasse Versicherungs-Aktiengesellschaft	BBBq
28.	HanseMerkur Allgemeine Versicherung AG	BBBq
29.	HUK-COBURG-Allgemeine Versicherung AG	Aq
30.	Inter Allgemeine Versicherung Aktiengesellschaft	BBBq
31.	InterRisk Versicherungs-AG	BBBq
32.	Itzehoer Versicherung/Brandgilde von 1691 Versicherungsverein auf Gegenseitigkeit	BBBq
33.	Landesschadenhilfe Versicherung VaG	BBBq
34.	Landschaftliche Brandkasse Hannover	Aq
35.	Lippische Landes-Brandversicherungsanstalt	BBBq
36.	LVM Landwirtschaftlicher Versicherungsverein Münster aG	Aq
37.	Mannheimer Versicherung AG	BBBq
38.	Mecklenburgische Versicherungs-Gesellschaft aG	Aq
39.	Münchener Verein Allgemeine Versicherungs-AG	BBBq
40.	NV-Versicherungen VVaG	BBBq
41.	Öffentliche Feuerversicherung Sachsen-Anhalt	Aq
42.	Öffentliche Versicherung Bremen	BBBq
43.	Oldenburgische Landesbrandkasse	Aq
44.	ONTOS Versicherung Aktiengesellschaft	BBBq
45.	Ostangler Brandgilde	BBBq
46.	Ostfriesische Landschaftliche Brandkasse	BBBq
47.	OVAG Ostdeutsche Versicherung Aktiengesellschaft	BBBq
48.	Provinzial Nord Brandkasse Aktiengesellschaft	BBBq
49.	Provinzial Rheinland AG	Aq
50.	PVAG Polizeiversicherungs-Aktiengesellschaft	BBBq
51.	RheinLand Versicherungs AG	BBBq
52.	Schwarzmeer und Ostsee Versicherungs-AG SOVAG	BBBq
53.	S direkt Versicherung Aktiengesellschaft	BBBq
54.	Saarland Feuerversicherung AG	BBBq
55.	Union Reiseversicherung AG	BBq
56.	Vereinigte Hagelversicherung VVaG	BBBq
57.	VPV Allgemeine Versicherungs-AG	BBBq
58.	VRK Versicherungsverein aG im Raum der Kirchen	BBq
59.	Wertgarantie Technische Versicherung Aktiengesellschaft	BBBq
60.	Westfälische Provinzial Versicherung Aktiengesellschaft	Aq
61.	WGV-Schwäbische Allgemeine Versicherung Aktiengesellschaft	Aq
62.	Württembergische Gemeinde-Versicherung aG	Aq
63.	Würzburger Versicherung-AG	BBq

Source: Fitch

Quantitative Insurer Financial Strength Ratings Definitions

Q-IFS ratings differ from traditional IFS ratings based on the methodology employed. Traditional IFS ratings are established by a Fitch rating committee using a methodology that incorporates a comprehensive review of both quantitative and qualitative factors. In-depth discussions with senior management typically play an important part in Fitch's evaluation.

In contrast, Q-IFS ratings are generated solely using a statistical model that utilizes financial statement information. This information is the historical publicly available information generally available to brokers, Independent Financial Advisers and other counterparties to insurers. The model incorporates "rating logic" that mirrors the quantitative analysis used to assign traditional IFS ratings, and the model itself is subject to rating committee review. However, individual ratings are not established or reviewed by the rating committee.

The statistical model generally requires a minimum of three years of financial statement information - Fitch will not publish Q-IFS ratings if the information is deemed incomplete. Additional differences between the Q-IFS ratings and traditional IFS ratings include the following: Q-IFS ratings make no assessment of management quality; affiliate/parent relationships are not considered; and qualitative factors requiring subjective assessment are excluded, such as prudence of reserving assumptions, reinsurance and asset hedging strategies.

Q-IFS Ratings are identified using a "q" subscript. They are 'point-in-time' ratings, and are reviewed on no less than an annual basis. The concept of 'point-in-time' is intended to denote the fact that the ratings are valid as of the last balance sheet date used to derive the rating and carry no forward-looking elements. The ratings do not incorporate Rating Outlook or Rating Watch designations used in traditional IFS ratings.

The Q-IFS rating uses a rating scale and definitions that are similar to that used by Fitch for traditional IFS ratings. Ratings of 'BBBq' and higher are considered to be 'Secure', and those of 'BBq' and lower are considered to be 'Vulnerable'. The rating scale does not utilize the '+' and '-' suffixes associated with traditional IFS ratings. In addition, the rating scale does not incorporate the 'CC' and 'C' equivalent ratings, which require certain qualitative analytical judgements that are not included in the model.

Insurers that have either failed to make payments on their obligations in a timely manner, are deemed to be insolvent, or have been subject to some form of regulatory intervention are assigned ratings using the traditional IFS rating scale (i.e., 'DDD', 'DD', 'D').

AAAq: Exceptionally strong. Insurers assigned this highest rating are viewed as possessing exceptionally strong capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. For such companies, risk factors are minimal and the impact of any adverse business and economic factors is expected to be extremely small.

AAq: Very strong. Insurers are viewed as possessing very strong capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Risk factors are modest, and the impact of any adverse business and economic factors is expected to be very small.

Aq: Strong. Insurers are viewed as possessing strong capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Risk factors are moderate, and the impact of any adverse business and economic factors is expected to be small.

BBBq: Good. Insurers are viewed as possessing good capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Risk factors are somewhat high, and the impact of any adverse business and economic factors is expected to be material, yet manageable.

BBq: Moderately weak. Insurers are viewed as moderately weak with an uncertain capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Though positive factors are present, overall risk factors are high, and the impact of any adverse business and economic factors is expected to be significant.

Bq: Weak. Insurers are viewed as weak with a poor capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Risk factors are very high, and the impact of any adverse business and economic factors is expected to be very significant.

CCCq: Very weak. Insurers rated in this category are viewed as very weak with a very poor capacity to meet policyholder and contract obligations based solely on their stand-alone publicly available financial statement information. Risk factors are extremely high, and the impact of any adverse business and economic factors is expected to be insurmountable. Some form of insolvency or liquidity impairment appears probable or imminent.