

Insurance – Europe

2019 outlook remains stable as solid economic growth, increasing rates offset rising M&A and asset risks

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2019 European insurance outlook is stable

NEGATIVE

What could change outlook to negative

- » Interest rates stay low for longer, pushing insurers to buy lower quality assets, or rise abruptly
- » Material deterioration in capitalisation or leverage, for example to support M&A
- » Financial instability, leading to volatile financial markets
- » Rising claims and competition, or reserve strengthening due to higher inflation, for P&C sector
- » Technological disruption

STABLE

Drivers of the stable outlook

- » Macroeconomic growth remains solid, supporting insurance sales
- » Pressure from low interest rates will gradually ease for P&C insurers and remain manageable for most life insurers
- » Continued shift in business mix
- » Pricing discipline will limit deterioration in P&C combined ratios
- » Capital ratios will remain solid and asset mix will change slowly

POSITIVE

What could change outlook to positive

- » A gradual 200-300 bps interest rate rise, improving insurers' investment yields
- » A material sales increase as demand for protection and retirement products grows, driven by Europe's ageing population
- » Insurers leveraging technology to improve sales, offer new services, and improve profits

The Industry Outlook (positive, stable or negative) indicates our forward-looking assessment of fundamental credit conditions that will affect the creditworthiness of the property & casualty and life insurance industries over the next 12-18 months. As such, the outlook provides our view of how the operating environment for the property & casualty and life insurance industries, including macroeconomic, competitive and regulatory trends, will affect, among other things, asset quality, capital, funding, liquidity and profitability. Since outlooks represent our forward-looking view on credit conditions that factor into our ratings, a negative (positive) outlook suggests that negative (positive) rating actions are more likely on average. However, the outlook does not represent a sum of upgrades, downgrades or ratings under review, or an average of the rating outlooks of issuers in the industry, but rather our assessment of the direction of credit fundamentals overall within the industry broadly.

Macroeconomic trends support stable outlook, but pockets of risk are growing

Key credit themes

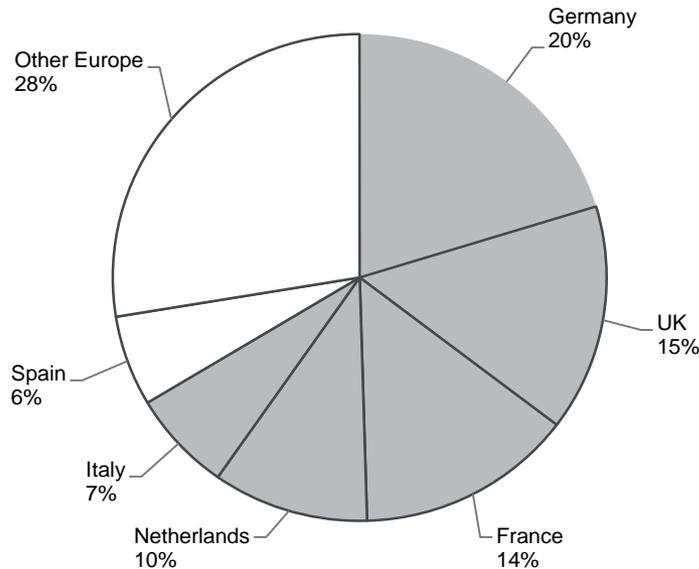
- » Continued economic growth will support the European insurance sector over the next 12-18 months
- » Low interest rates will likely rise gradually, but will still weigh on life insurers' profits; most are adapting, but some, e.g. in Germany, will face solvency pressures
- » P&C insurers will maintain pricing discipline despite intense competition, and pressure on their investment returns will gradually ease
- » Margins will remain low and are increasingly under pressure due to competition from non-insurers (e.g. asset managers)
- » M&A activity will continue as insurers alter their business models and pursue growth, eroding capital, and increasing both leverage and execution risk
- » Run-off and disposals of life portfolios will continue
- » Investment in illiquid and lower quality assets will continue, increasing exposure to late-cycle corporate debt risk
- » No credit impact from prudential and accounting regulation in the next 12-18 months, but national legislation remains unpredictable
- » A hard Brexit and any further deterioration in Italian sovereign credit quality are key downside risks to our stable outlook; flat rates, an abrupt rise in rates, technological disruption and climate change are also potential threats

2019 country outlooks are mostly stable

Outlook key: NEGATIVE STABLE POSITIVE NO OUTLOOK

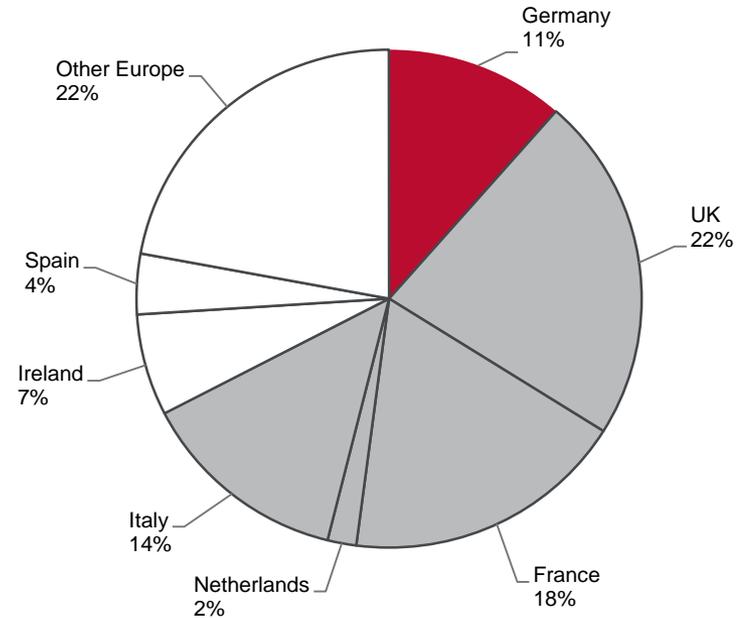
European non-life premiums by country

2017: total \$0.6 trillion



European life premiums by country

2017: total \$0.9 trillion



Sources: Swiss Re Sigma, Moody's Investors Service

Macroeconomic trends remain supportive

Economic growth will support P&C and life insurers, interest rates set to rise



Growth

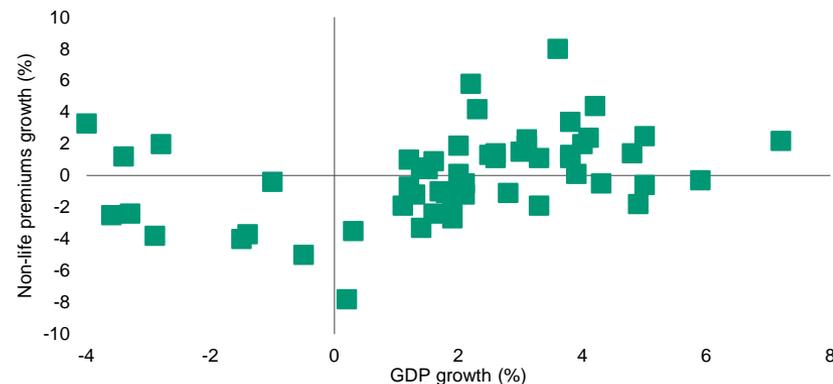
- » [Euro area growth will remain robust at around 1.8% in 2019, albeit down from an estimated 2.0% in 2018 and 2.5% in 2017](#)
- » Economic expansion helps drive growth in P&C premiums, while lower unemployment supports life business



Financial stability

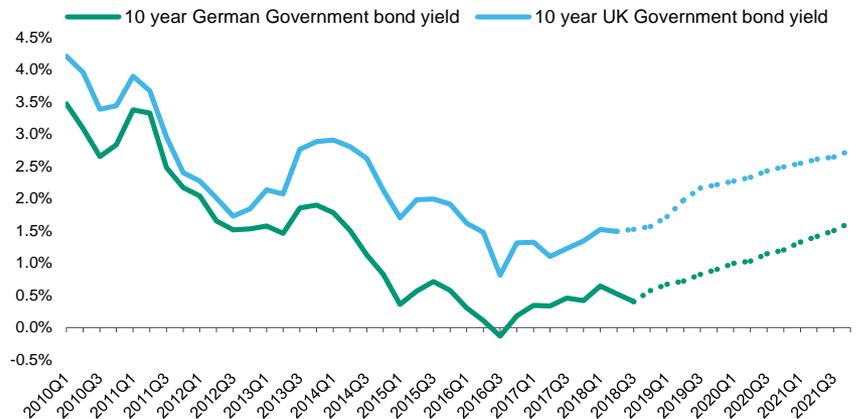
- » [The European Central Bank will end additional asset purchases under the quantitative easing program by the end of 2018 and will likely raise interest rates in the second quarter of 2019](#)
- » Expected interest rate rise is credit positive for insurers as it will support investment returns...
- » ... but volatility will return to financial markets

P&C premium growth is correlated with GDP growth



Note: data from 2007-2017 for Germany, France, Netherlands, Italy and Spain
Sources: Swiss Re Sigma, Moody's Investors Service

We expect interest rates to increase gradually



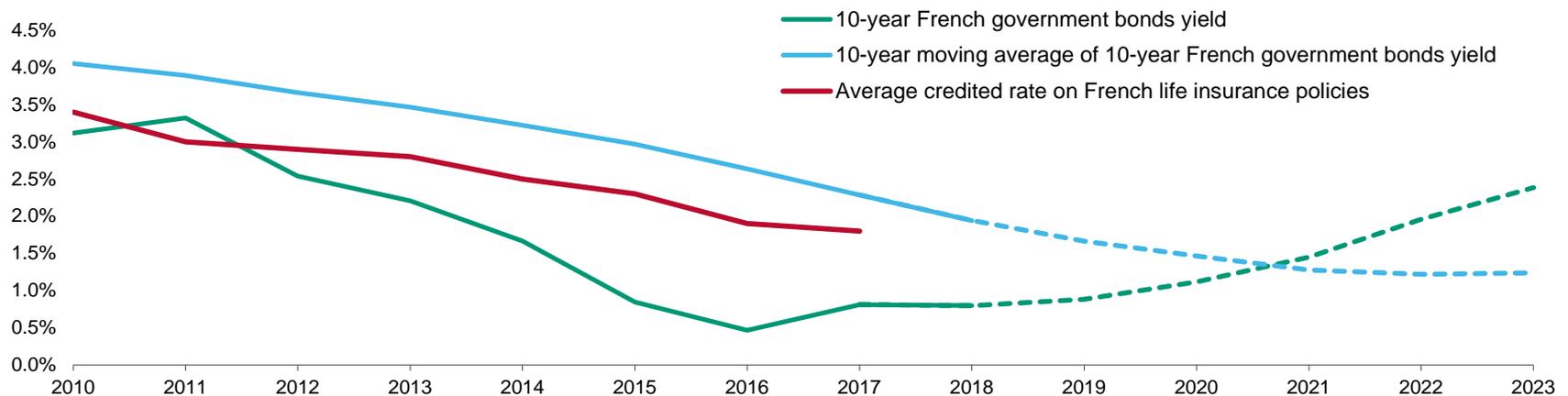
Sources: Deutsche Bundesbank, Bank of England, Moody's Investors Service

Life insurers' investment returns will continue to decline, but so will credited rates

- » Although rising, rates will remain below the yields that insurers generate on their assets, forcing them to (re)invest at lower rates, putting their investment yields under continued pressure
- » We expect the investment return of European life insurers to fall by 10-20 bps p.a. for several years
- » Most life insurers will continue to offset declining investment income by reducing payments (“credited rates”) to customers holding life policies

Moving average of spot rates (a proxy for insurers' investment yields) will decline despite increasing spot rates, partly offset by lower credited rates

The French example



Sources: Banque de France, Fédération Française de l'Assurance, Moody's Investors Service

Life insurers will continue to cut costs and adapt products, but at a slower pace



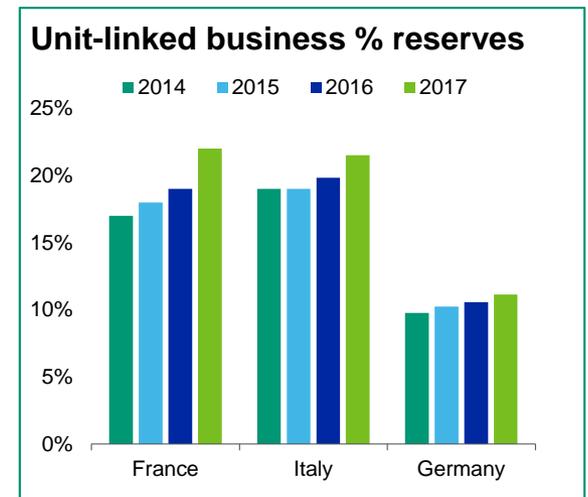
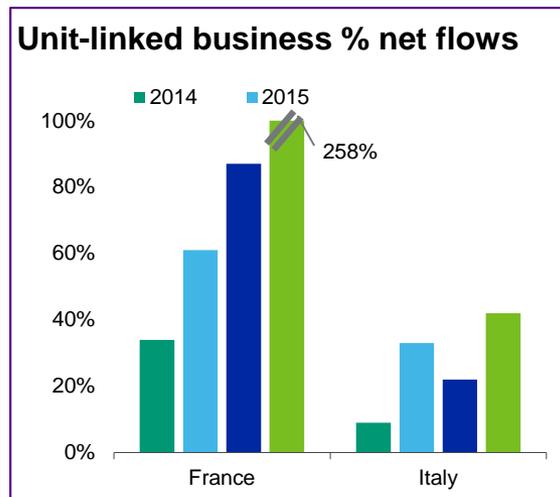
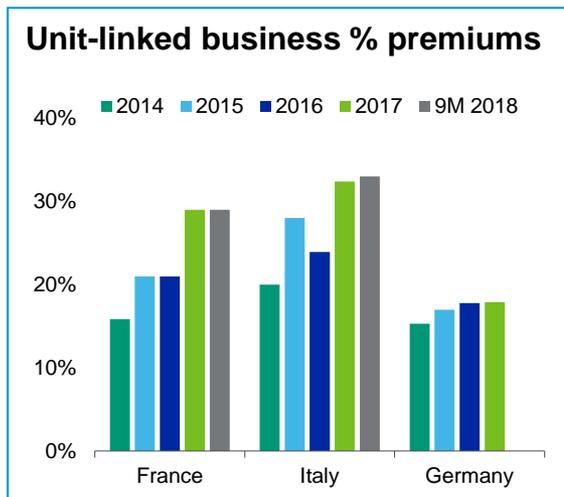
Cost reduction

- » We expect insurers to continue reducing costs
- » Efficiency gains will be partly offset by restructuring costs and technology investments
- » Rising inflation will add upward pressure to expenses



Change in new business

- » Life insurers will continue to lower guaranteed policyholder returns on new business, even selling products with negative guarantees (e.g. in France)
- » Life sector will focus on selling unit-linked products (41% of premiums in Q4 2017 vs 28% in Q4 2016)
- » Growing unit-linked sales will be more challenging in 2019 due to increased market volatility



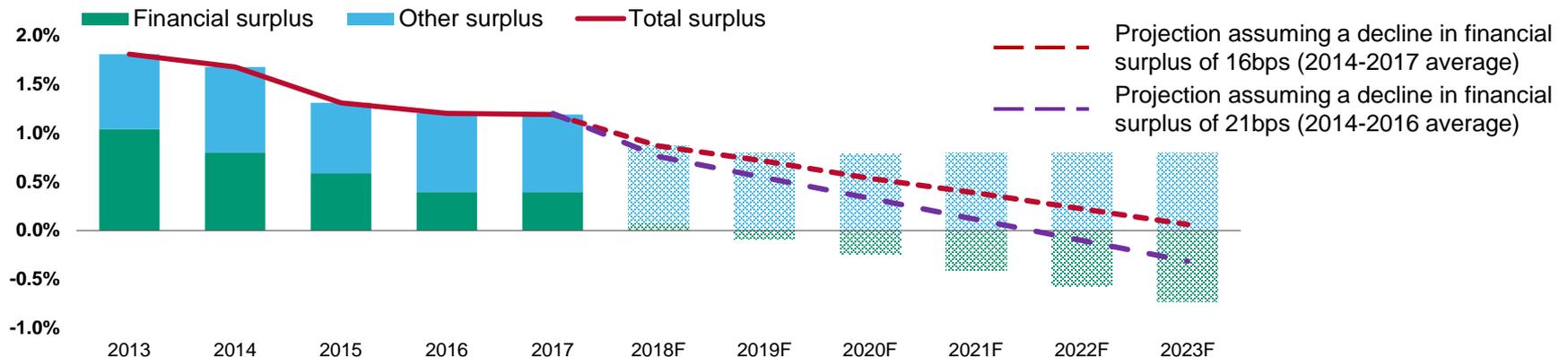
Sources: Associazione nazionale fra le imprese assicuratrici, Fédération Française de l'Assurance, Der Gesamtverband der Deutschen Versicherungswirtschaft, Moody's Investors Service

German life market under particular pressure

Some insurers face solvency risks if interest rates stay low

- » Some German insurers' investment yields are close to or below guaranteed policyholder return rates
- » 27 German insurers are under close regulatory scrutiny as they rely on transitional measures to keep their Solvency II ratios above 100%
- » The overall result of the German life market may turn negative in less than five years if interest rates remain low, despite positive mortality/morbidity expense results
- » [Reduction in ZZR](#) reserve contributions will ease profitability pressure, but solvency risk remains

German life insurers' pre-tax profit, before profit sharing with policyholders



Financial Surplus: financial income in excess of guarantees, before profit sharing with policyholders (includes realised capital gains and financing of ZZR); data for 2013 and 2014 have been partly estimated

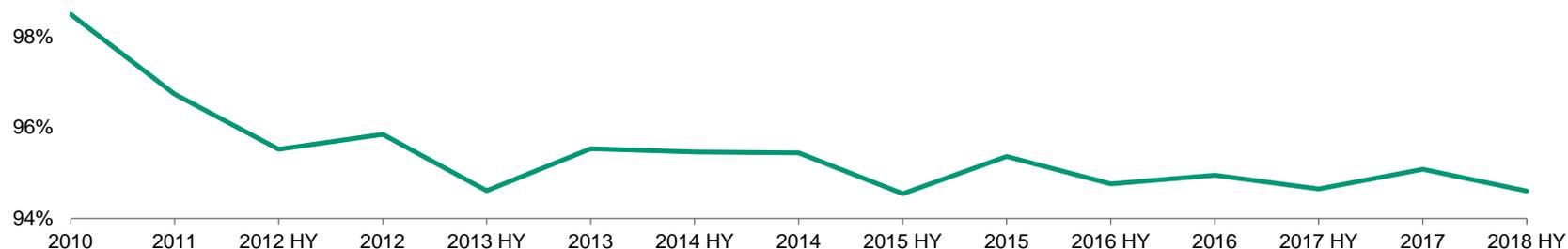
Other surplus: Technical result (mostly mortality and morbidity results) and expense result, before profit sharing with policyholders

Sources: Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Moody's Investors Service

Good P&C results, but no immediate upside

- » Given the lower duration of their assets, P&C insurers face less pressure on investment returns than life insurers, but investment returns will still decline in 2019
- » We expect P&C insurers to remain disciplined in their underwriting, but tough competition will curb their ability to offset rising claims by increasing prices, leading to some deterioration in combined ratios in most markets

Average P&C combined ratio reported by selected large European insurers



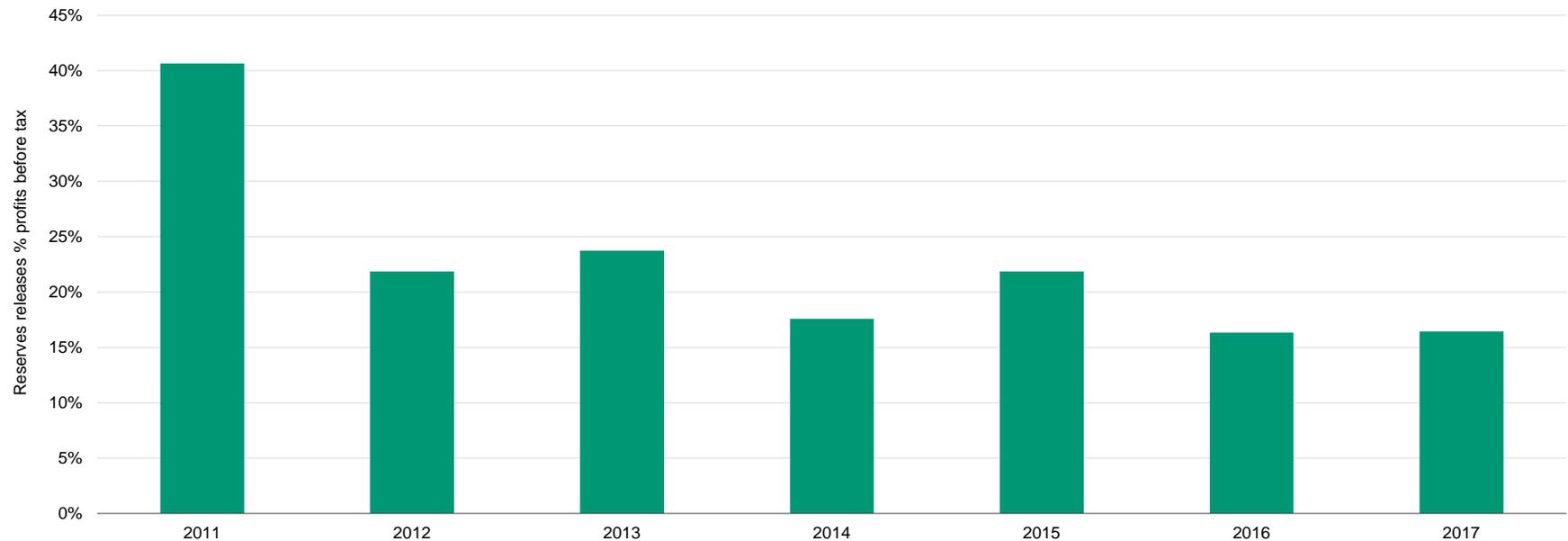
Sources: Ageas, Allianz, Aviva, AXA, Generali, If P&C, Mapfre, RSA, UnipolSai, Zurich Insurance, Moody's Investors Service

Expectation by market						
Pricing trends	> 0	> 0	[+1% ; +3%]	[-1% ; +1%]	[-1% ; +1%]	> 0
Combined ratio trend	↑	=	= or ↑	↑	= or ↑	= or ↓
2017 combined ratio	95% <i>(motor and property)</i>	95%	98%	91%	93% <i>(Moody's estimate)</i>	101%

Reserve releases remain a wild card

- » Reserve releases account for around 20% of European insurers' consolidated pre-tax profits
- » In some countries (e.g. Italy, UK), reserve releases have reached unsustainably high levels
- » Rising inflation poses an additional risk to reserve releases

Reserve releases as a % of pre-tax profits for European Insurers

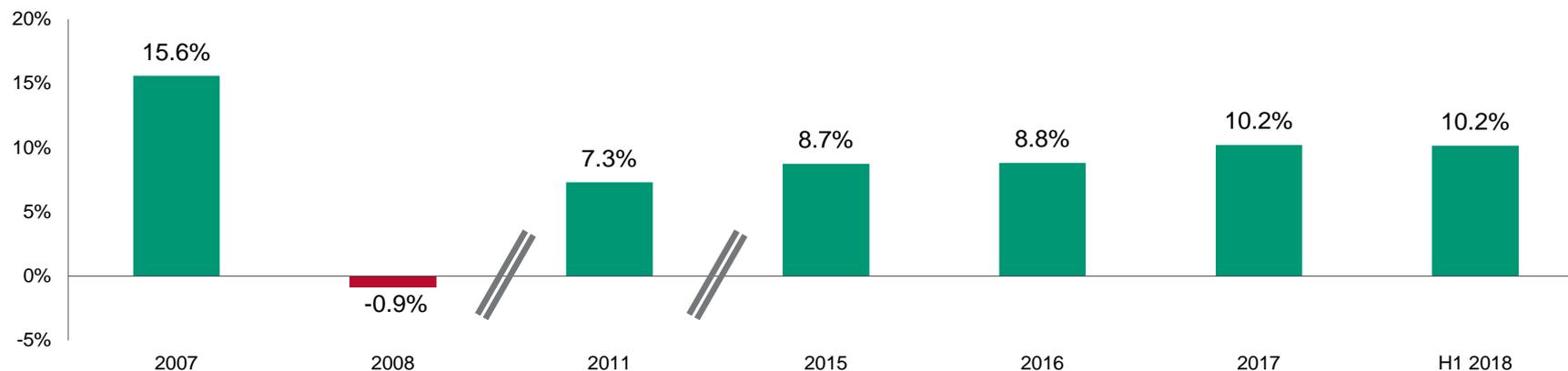


Sources: Data disclosed by Direct Line, RSA, Aviva, Allianz, AXA, Zurich, Generali, Bupa, Mapfre, If P&C, Tryg AS, Ageas, Macif, Swiss Re, Munich Re, Unipol, Lloyd's of London, Moody's Investors Service

Profitability still below pre-crisis levels and under threat from external competitors

- » Despite recent improvements, European insurers' profitability remains lower than before 2008
- » Profitability pressures partly reflect competition from players outside the primary insurance universe
- » We expect more direct competition from asset managers in some countries (e.g., [in France following the PACTE law](#))
- » Reinsurers will continue to diversify into commercial P&C insurance (39% of reinsurers' premiums globally are primary P&C premiums), and seize opportunities to grow in health/protection
- » The insurtech sector will continue to grow, and may challenge insurers in the medium to long term
- » Banks have targeted growth in insurance in some countries (e.g., France, Italy)

Return on equity for selected large primary European insurers

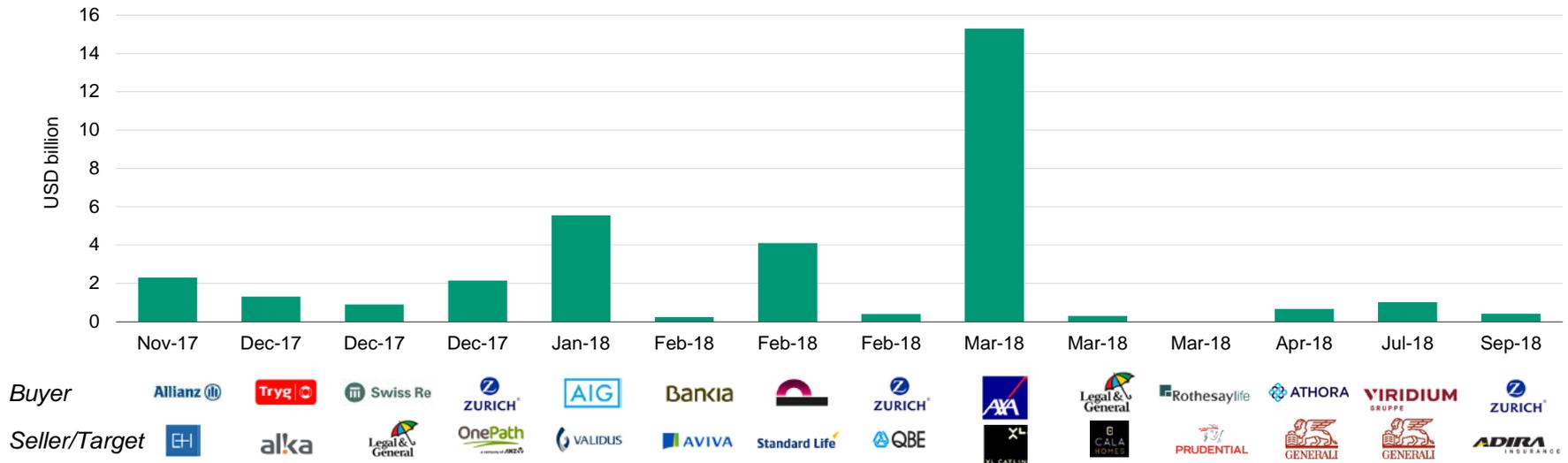


Sources: weighted average based on Aegon, Allianz, Aviva, Axa, Generali, L&G, Old Mutual, Prudential and Zurich, Moody's Investors Service

Insurers will increasingly use M&A to transform their business models

- » We expect more M&A as insurers accelerate efforts to change their business models and look for profitable growth opportunities
- » Redeploying capital has been a priority for European insurers since 2018
- » We expect cross-sector M&A (e.g. insurers merging with asset managers, technology firms or reinsurers) to become more frequent

Selected Insurance M&A deals in the last 12 months



Sources: Companies' press releases, Moody's Investors Service

M&A typically reduces capital, increases leverage, and creates execution risk

- » We look at the impact of M&A on a case by case basis and determine whether greater scale, increased market relevance, or better diversification can offset reduced capital, growth in intangibles, higher leverage and increased execution risk
- » Positive or negative change in risk profiles is also a key factor determining the ultimate credit impact

Key factors driving credit implications of M&A



Closed book transactions are also rising

- » European insurers are increasingly putting life businesses into run-off, notably in the Netherlands and Germany, paving the way for future consolidation, similarly to the UK
- » High risk legacy books and regulatory resistance has slowed back book consolidation in Germany, but the closing of Viridium's acquisition of Generali Leben (transaction announced in 2018) could encourage further deals
- » Private equity firms are showing a growing interest in back book consolidation

Closed book / company run-off



Sale of closed book or of company



Selected examples in the UK:

- » Friends Life created to manage a large run-off portfolio
- » 2005: Zurich UK annuity in quasi run-off
- » 2010: Aegon UK annuity in quasi run-off

- » 2015: Aviva acquires Friends Life
- » 2015: Zurich sells annuity portfolio to Rothesay
- » 2016: Aegon sells annuity portfolio to Rothesay/L&G
- » 2018: M&G Prudential sells one third of its annuity portfolio to Rothesay
- » 2018: Standard Life Aberdeen sells life portfolio to Phoenix



Since 2008, most Dutch life insurers have closed their traditional individual life and group operations to new business

- » 2017: NN Group acquires Delta Lloyd
- » 2017: ASR acquires Generali Nederland
- » **2018: Vivat put up for sale**



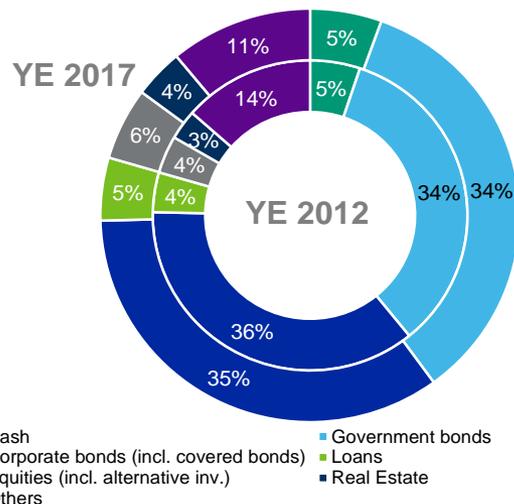
- » 2009: Victoria Leben in run-off
- » 2012: Balaise German life business in run-off
- » 2016: ERGO Leben in run-off
- » 2017: Generali Leben in run-off

- » 2017: Frankfurter Leben acquires Balaise's closed book
- » 2018: Viridium (backed by Hannover Re and private equity firm Cinven) acquires Generali Leben business (subject to regulatory approval)
- » **To be continued...**

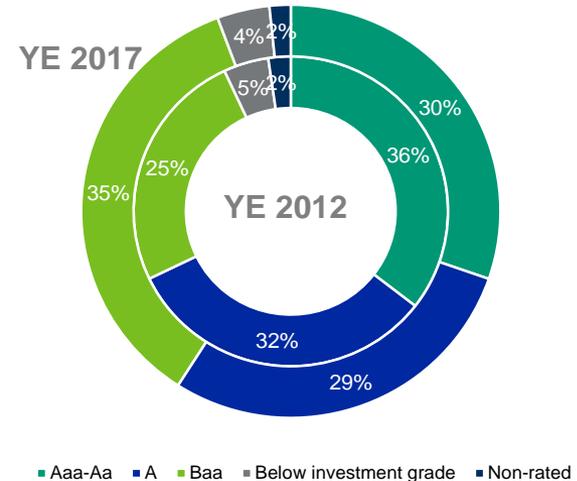
Changes in asset mix: a one-way road towards more illiquid assets and greater risk

- » We expect the trend of insurers investing in higher-yielding illiquid assets and lower quality corporate bonds to continue, as interest rates remain very low
- » Overall balance sheet impact remains limited, as insurer demand for such assets outstrips supply
- » In the US and Europe, nonfinancial corporate leverage is rising and covenants are weakening, signaling late-cycle risks; not all European insurers are equipped to deal with a deterioration in the credit quality of illiquid assets

European insurers' asset mix remains broadly stable



Quality of corporate bond portfolio deteriorates



Sources: Data disclosed by Aviva, Allianz, AXA, Aegon, Zurich, Generali, Munich Re, Moody's Investors Service

No immediate changes in European and global regulations, national legislation unpredictable

- » Developments in prudential and accounting regulations are slow-moving, and will not drive insurers' credit quality in 2019

Solvency II	IAIG - GSII	IFRS 17
<ul style="list-style-type: none"> » Planned (gradual) decrease of the UFR will lower Solvency II ratios, especially in Germany and the Netherlands » 2018 SCR review will not lead to significant changes » Next revision in 2020 (review of long-term guarantees measures) 	<ul style="list-style-type: none"> » Consultation paper on ICS2.0 released in July 2018 » Field testing to continue in 2018 and 2019; adoption scheduled in 2019 for confidential reporting for a five year monitoring period » Application of HLA to GSII's pushed to 2022 (from 2019) » Potential drop-off of the GSII's list 	<ul style="list-style-type: none"> » IASB published the IFRS 17 norm in May 2017 » EFRAG ran an impact study in 2018 » EFRAG to give its opinion to EC in December 2018 » Proposed postponement of IFRS 17 introduction (to January 2022 from January 2021 initially)

UFR: Ultimate Forward Rate; SCR: Solvency Capital Requirements; IAIG: International Active Insurance Group; GSII: Global Systemically Important Insurer; ICS: International Capital Standards; HLA: Higher Loss Absorbency; IASB: International Accounting Standards Board; EFRAG: European Financial Reporting Advisory Group; EC: European Commission

- » However, national legislation continues to emerge in an unpredictable manner



- » Regulatory review of pricing methods in motor and property insurance may constrain insurers' pricing strategies



- » Ongoing discussions on potential commission ban



- » PACTE law will increase competition between insurers and asset managers in the pension segment, and may pressure margins

Brexit and Italy are key geopolitical risks



Political risks



- » Our base case is that a Brexit agreement will be reached after fraught negotiations...
- » ... but risks of a « no-deal » scenario are significant
- » [Risks of a hard Brexit](#) for insurers include pressure on revenues (modest) and operating profits driven by weaker economic growth and increased financial market volatility, which would weigh on the UK life sector's capitalisation
- » Loss of passporting would have a moderate impact
- » Regulatory risk would be limited as we expect the post-Brexit UK regime to gain Solvency II equivalence

- » Moody's downgraded Italy to Baa3, stable outlook, on 19 October 2018
- » Further deterioration in Italy's credit quality would affect Italian insurers, and insurers operating and investing in Italy
- » There could also be a negative financial impact on the broader euro area, which could affect a wide array of insurers

Other downside risks remain elevated



No increase in rates



Spike in rates



Technology and innovation



ESG risks

- » Rates remaining flat at current levels would further pressure European insurers' profitability, and would likely accelerate the search for yields and deterioration in the quality of their assets
- » An abrupt spike in rates would also be a risk for life insurers, particularly in France and Italy; higher inflation could force P&C insurers to add to their reserves
- » Technological disruption could affect traditional players' profitability and business models
- » Climate change could increase the frequency and severity of P&C claims: this would be negative if insurers were unable to increase prices to cover additional claims costs



Appendices

Country outlooks – Life

Stable outlooks with the exception of Germany



STABLE

UK

- » Resilient performance to continue thanks to growth in pensions and retirement products
- » Bulk annuity demand is strong
- » Solvency II capitalisation is comfortable
- » Regulatory headwinds are likely to exacerbate margin pressure
- » Brexit impact expected to be moderate, but uncertainty has increased.



STABLE

France

- » Insurers have a high ability to lower credited rates and offset the impact of low rates on their profits
- » Focus on unit-linked will continue, but increasing sales will be more challenging
- » New legislation will increase competition from asset managers
- » Health and protection revenues are growing but competition is also increasing



NEGATIVE

Germany

- » Low interest rates will continue to weaken life insurers' profits
- » Changes in new business mix to accelerate, but positive effects to remain modest
- » Reported Solvency II ratios are high but not especially economic
- » Around one third of the industry has submitted a remediation plan to the regulator



STABLE

Italy

- » Low guarantees limit risks from low interest rates
- » Focus on unit-linked will continue but volatility will constrain sales of these products
- » High sovereign exposure constrains insurers' credit profiles



STABLE

Netherlands

- » Significant efforts to address weaknesses and re-focus on core businesses
- » Consolidation likely to continue
- » Mis-selling dispute constrains unit – linked growth
- » Onerous capital requirements under Solvency II, more so than for many EU peers

Country outlooks – P&C

Stable outlooks



STABLE

UK

- » Underwriting profitability to remain robust
- » Rising claims inflation and falling reserve releases to pressure profitability
- » Low interest rates constrain earnings
- » Capitalization to remain healthy; moderate downside risk from Brexit



STABLE

France

- » Rising prices and lower claims frequency in the motor market
- » However, no significant improvement expected in the overall combined ratio, given fierce competition and a high level of nat cat claims
- » Anticipated rise in interest rates will gradually reduce pressures on investment



STABLE

Germany

- » Price increases will help offset lower investment income and higher motor claims inflation
- » For 2018, we expect a combined ratio below 100%, absent any further outsized catastrophe losses
- » Moderate but steady economic growth supports stable outlook



STABLE

Italy

- » Flattening of motor insurance prices
- » Combined ratios will likely increase, but from a level well below 100%, allowing P&C insurers to remain profitable
- » Reserve releases likely to taper off



STABLE

Netherlands

- » Combined ratios consistently above 100%, with fierce competition especially in motor
- » Recent price increases to improve underwriting performance
- » Economic conditions supportive of economic demand

Global credit conditions to weaken amid slowing growth and rising risks

Credit risks will build in 2019 as economic growth slows, funding costs rise, liquidity tightens and market volatility returns. Trade tensions and growing geopolitical risks will likely escalate and have significant sector and regional impacts. Advances in digital technologies could trigger productivity improvements as well as business disruptions, while the ESG issue that is most likely to materially influence credit in 2019 is carbon transition risk.

Learn more: www.moody's.com/2019outlooks

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