

**Report on Financial Conditions and Financial Stability in the
(Re)Insurance and Occupational Pension Fund Sectors 2003-2004
Risk Update**

- NOTICE -

CEIOPS prepares a Financial Stability Report on the insurance and occupational pension fund sector on a semi-annual basis. The autumn report is primarily based on supervisory information, whereas the spring report is primarily based on market information. The current version is the public version of the spring report, which is only based on public information. Although some detailed information has been left out from this public version, it does not change the overall assessment on the insurance and occupational pension fund sector.

Introduction

The CEIOPS Financial Stability Committee has prepared a new report on the financial stability of the insurance market in the EU/EEA, as well as the market for occupational pensions and the reinsurance sector as requested by the Economic and Financial Committee (EFC) and the CEIOPS Members. The report has been discussed at the CEIOPS Members Meeting of 24 February 2005. The report has subsequently been sent to the EFC Financial Stability Table for its discussion on the macro-financial conditions and overall stability of the EU financial system at its meeting in April 2005.

This report mainly contains an update of the autumn 2004 report. As most Member States do not have new regulatory data on the insurance and pension fund sector on 2004, the report is primarily based on qualitative information based on market information, anecdotal evidence, and survey data.

1. Main issues and conclusions

Overall, 2004 was a good year for insurance companies and pension funds in most Member States. The insurance companies are expected to report further improvements in profitability relative to 2003 – the first overall good year for the industry in many years. In many ways the year 2003 seems to have been a turning point for insurance companies and pension funds in the Member States. Most countries that do report new figures indicate a continuation in premium income growth in the non-life sector. The life segment has in 2004 in certain countries shown a recovery compared to 2003, showing however disparate movements depending on the country considered.

Based on the traditional way of valuation of the liabilities, the financial situation of insurers and pension funds in 2004 has improved, mainly due to favourable investment results. However, based on market interest rates to value liabilities the outcome of the financial situation is not clear upfront. In that case, the solvency margin of insurers and pension funds has been negatively affected by the drop in long-term interest rates during the second half of 2004. It is not clear upfront whether this negative impact was outweighed by the rise in equity, and this will vary from country to country.

Firms in most countries did not actively change their asset mix during 2004. This means that, in general, changes in exposures to equity risk and interest rate risk since 2003 are due to market movements. The most significant concern for the insurance and pension fund sector appears to be the current low yield environment: in countries where life insurance companies have guaranteed returns, low interest rates reduce the margin between investment returns and the guaranteed rates, potentially opening a gap between the two. The issue has already prompted risk mitigation action in many countries.

The financial health of reinsurers, which improved since 2003, overall continued to stabilize in 2004 despite a high number of severe natural disasters. This is encouraging since both 2001 and 2002 were particularly bad years for reinsurance worldwide. First terrorist attacks and floods generated large payouts, and then a global credit and equity meltdown coincided with an exceptionally low interest rate environment (see the appendix on a detailed description of the reinsurance market in Europe).

The Financial Stability Committee is undertaking further work to develop a systematic approach to the way in which challenges and vulnerabilities facing the EU insurance sector can be identified and analysed. It will report the results of this work, together with a more in-depth study of challenges and vulnerabilities, in the autumn report.

2. General development on financial markets

Market trends provide a good indication of financial conditions facing insurance firms, even if they themselves do not have actively traded shares or bonds. Most

importantly, general market developments have a significant effect on firms' investment revenue, capital position and ability to write business. In addition, market developments also provide a good indication of the sector's business and financing prospects. For example, weak equity and bond prices for insurance companies suggest that investors are (1) taking a negative attitude towards the earnings prospects for the sector and (2) placing a higher risk premium on insurance firms. Both factors are likely to make fresh capital from whatever source more difficult and more expensive to raise.

Financial markets in the second half of 2004 showed a confirmation of the trends that had started in 2002 and 2003. Short-term interest rates in the Euro Area had declined during 2003 as a consequence of the rate cuts by the European Central Bank (see figure 1). During 2004 the interest rate at the short end of the money market has been relatively stable, and was as 2.12 percent by the end of the year. Analysts expect a resumption of a tightening of monetary policy and thus interest rate increases at the end of the third, beginning of the fourth quarter of 2005. Current consensus forecasts indicate a gradual rise to just over 3% by mid 2006. Long term government bond yields in the euro area continued to decline by mid 2004 from 4.4% in June 2004 to 3.6% in February 2005. Both European and US long term interest rate appear surprisingly low compared to previous levels in business cycle. In Europe, the relatively stable real yield on 10Y index-linked government bonds since the end of 2003 indicates that growth expectations have remained broadly unchanged. Hence, the evolution of both nominal and real yield shows that the expected inflation has decreased in the euro area. This could explain why the Consensus forecasts a very slow increasing path for long-term interest rate (3.9% at the end of April 2005 to only 4.4% for the end of January 2006).

Both European and the global equity markets recovered in 2003 after the start of the Iraq war following almost three years of consecutive decline (see figure 2). And despite showing mixed signals during the six-nine months of 2004, however, world but particularly European equities performed strongly in the last quarter of 2004. From the start of September 2004 to the end of December, the world index had increased by 7% whilst the European index had risen by about 20%. US stocks also resumed their upward development in the last three months of 2004, based among other things on stronger reported earnings and more recently, the halt in the rise of oil prices.

Both EU life and non-life insurance sectors underperformed EU equities in 2004: whilst European equities rose by 12%, the quoted life sector appreciated by 10.9% and non-life by 9.3% (see figure 3). The life sector's underperformance was largely attributable to the marked fall in the quoted Dutch life sector (-14.5%) whilst UK and German insurers were weak performers in the non-life sector. So far in 2005¹, only the life insurance sector outperformed the wider European benchmark, rising by 5.6% year-to-date compared to a 5.4% increase in European equities overall. The life insurance sector has outperformed the overall market in Germany . Whilst the non-life sector has been lagging, rising by 2.7%, although strong returns have been seen in Greece, Austria, the Czech Republic, Spain and the UK. In the reinsurance sector has especially seen a strong performance in France. The EU insurers have performed well also in

¹ Performance numbers based on close of business 10 February 2005.

comparison to the US and Japan, with both EU non-life and life sectors outperforming their international peers. See the tables 1 and 2 for full details of performance statistics.

This information more or less corresponds to the developments in ratings on insurance companies. During 2004, ratings on insurers in Europe showed some movements but most continued to stabilise. A couple of companies were downgraded. Some companies got an upgrade. Also some companies were upgraded after recent downgrades. Only a couple of large European insurers covered continued with a negative outlook. Credit Default Swap (CDS) spreads overall only gradually declined during 2004 (see figure 4.1) The spread levels had declined sharply since the high rates following the terrorist attacks in the US in September 2001. The sharp rise of the CDS spreads in October 2004 (see figure 4.2) was probably the reaction to the investigation of an American insurance broker. Since then, the spreads normalised again.

3. Development in premiums written

Countries that report new developments, in general mention a further improvement of production and underwriting results in 2004

Non-life

Most countries that do report new figures indicate a continuation in premium income growth in the non-life sector. Several factors accounted for this profit increase in the various countries: increasing premium rates by higher reinsurance premiums, growing premium income together with lower claims, and lowering claims costs despite reduced premiums. However, growth of premium income is slowing in some other countries, either due to low economic growth, or because of a very competitive non-life insurance market. Some of the new Member States report high growth figures for premium income but even higher growth rates for claims, putting downward pressure on profits. In addition, in one country, non-life insurers face higher claims growth than premium income growth, meaning that profitability could come under pressure. Finally, the tragic natural disaster in South East Asia in December 2004 apparently had a limited effect on European non-life insurers, albeit that the impact varies from country to country and from company to company.

Life

The life segment has in 2004 in certain countries shown a recovery compared to 2003. Some countries mention that some of the larger firms have reported even better new sales than the market overall, suggesting that intermediaries and consumers are preferring companies that they perceive to be more strongly positioned. Double-digit growth figures were reported in a number of countries, in one country prompted by tax measures and by wealth effects due to increases in real estate prices which induced consumers to buy life products. More moderate growth figures are reported in other countries. Several countries reported that sales of unit linked products continued to rise. The sometimes spectacular growth of unit-linked premium income reflects the common trend of life companies to move from traditional lines to less risky unit-linked products to transfer the investment risk to the policy holder. On the contrary, one country

has experienced strong growth in with-profit and traditional contracts and a decrease of unit linked contracts.

4. Financial strength and performance

The financial performance of insurers and pension funds can be measured in two ways depending on the policy used to value the liabilities. Based on the existing traditional way of valuation, there has been an improvement of the financial situation. Solvency ratios of insurance companies and pension funds improved since end 2003, mainly due to favourable investment results. The decline of long term interest rates in the second half of 2004 (from 4,4% 30 June 2004 to 3,55% mid January 2005, see also figure 2) had a positive impact on the financial position of insurers and pension funds through the portfolio of fixed income securities. The rise of the stock markets towards the end of 2004 strengthened this development (see also figure 1).

Based on market interest rates to value liabilities the outcome of the financial situation is not clear upfront. The drop in long-term interest rates during the second half of 2004 has had a negative impact on the solvency margin of insurers and pension funds. This is because the decline in interest rates increased the net present value of liabilities by more than the increase in the value of fixed income assets, the effect being stronger the wider the negative duration gap. The opposite effect of the interest rate movement on the financial position of the insurance and pension industry under marking to market shows that volatility in interest rates will be a real element in the overall risk management of pension funds and insurance companies.

Some countries report problems with the solvency position of, in most cases, smaller companies in 2004 and some of these undertakings are still being monitored by the supervisor.

One country mentioned that although recent asset returns have been satisfactory, further falls in long-term interest rates have slightly worsened the position of defined benefit pension schemes.

5. Exposure to equity and interest rate risk

As reported in the autumn report, most insurance companies have been reducing their equity exposures over the last few years and have thus not been able to reap the full benefit of the upturn in the equity market since beginning of 2003. Since 2003, firms in most countries have not been actively changing their asset mix. This means that in general, changes in exposures to equity risk and interest rate risk since then are mainly due to general market movements. As a result, most countries that have new data for 2004 available report no significant changes in exposures to equity risk. Nonetheless, some countries point to an increased equity exposure due to large unrealised gains. In this respect one country points to the risk of overvalued shares. One country reports increases in exposure to equity risk due to new equity investments rather than the increases

in the value of equity, whilst another country saw further reductions in insurers' equity exposure in 2004. Yet another country points to the fact that most life assurance written by their authorized life assurance companies is unit- or index-linked with limited or no capital guarantees. Thus, investment risk on such policies is borne by policyholders and not by the insurance companies and movements in asset prices are immediately reflected in policy values.

Insurance companies are exposed to interest rate risk on both sides of the balance sheet. In general, changes in asset exposure during 2004 have also been mainly due to general market movements. In the current low rate environment, it is primarily life insurance contracts with interest rate guarantees (based on historic high rates²) that are sensitive to further falls in interest rates. An interest rate decline would also imply capital gains on the bond portfolios, but these capital gains would not be sufficient to cover the need for further provisions on the liability side. The difficulty of servicing guaranteed return contracts in a low interest rate environment has induced companies to offer guaranteed rates more in line with market rates. It is already noticeable that many new life contracts apply lower guaranteed rates and reduced profit payouts.

As mentioned in the autumn report, insurance companies have become more aware of the risk of interest rate changes on their solvency and have started to monitor these risks better by, for example, stress testing. Movements in interest rates, but also in equity yields and property values form part of the scenarios used in stress-testing by insurers and supervisors. Insurance companies and supervisory authorities in several countries regularly perform stress tests on insurance companies' financial position. Insurance companies should have buffer capital sufficient to withstand the scenarios (or at least the most realistic ones). The focus of these stress tests may vary. New stress tests in a few countries show an improved ability to withstand negative shocks, due to the increased buffer capital. In most countries however, no new stress tests have been conducted since the autumn report. Results of tests in some of the countries that have conducted new tests are not yet available.

6. M&As

With regard to structural developments, there is an increased trend towards mergers and acquisitions, both within and across national borders. The emergence of a Finnish financial group with operations in the Nordic and Baltic countries as well as Poland, and the plans to create a Portuguese/Belgian bancassurance joint venture are an example of this trend. A number of countries reported some cross border mergers during 2004. In general, a number of countries faces further consolidation in the insurance, in some instances by reorganisation processes within insurance groups.

The new Member States report rapid growth in the insurance market. However, there is a high degree of concentration in the insurance markets in the new Member States, with only a few companies controlling the majority of their respective markets and further mergers occurring (e.g. among composites).

² The guarantee covers both contributions already paid and future contributions.

7. Challenges and vulnerabilities

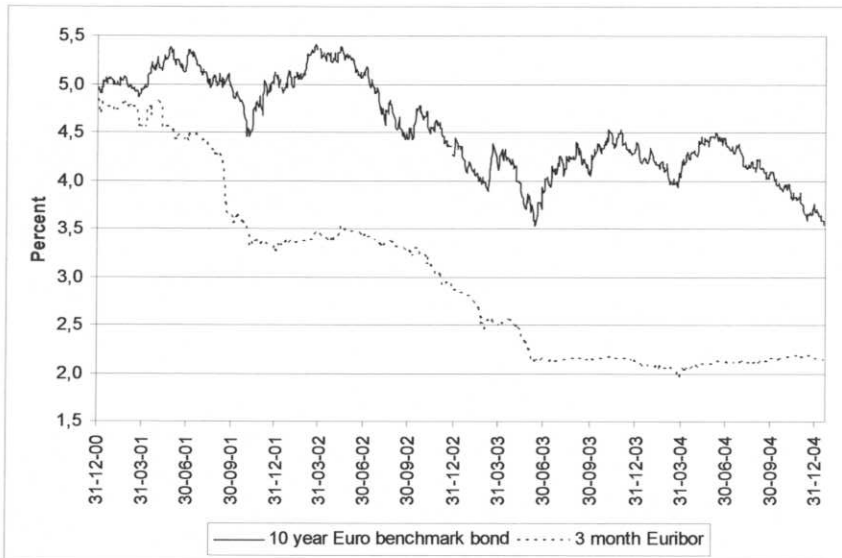
The Member States report a wide range of challenges and vulnerabilities with regards to their insurance sectors. However, the largest concern appears to be the current low yield environment: in countries where life insurance companies have guaranteed returns, low interest rates reduce the margin between investment returns and the guaranteed rates, and indeed opening a gap between the two. The issue has already prompted risk mitigation action. A number of countries reduced the maximum guaranteed interest rate in 2004 but this provides only some degree of relief as the reduction only applies to new contracts (see table 3). Other countries are currently debating possible reductions to the maximum guaranteed interest rate. Similarly, some countries pointed out the risks related to equity markets and their importance on life insurers. This risk may have become less important over the past year, partly because of recovery in equity markets, and partly because of efforts by firms which had a heavy equity exposure to diversify their portfolios.

Many Member States drew attention to the many regulatory and reporting changes that European insurance companies face currently. One country notes that although it believes that its programme of modernisation will result in an industry that is financially more robust, helping to improve confidence in the national insurance market, the implementation of a number of new regulatory requirements in 2005 creates compliance risk. A few countries highlighted the issues arising from the implementation of international accounting standards (IAS), and also ultimately from the new Solvency 2 framework. The implementation of IAS varies across the European Union as in some countries only group accounts can be done under IAS whereas in others also individual group companies may choose to use IAS. The fact that assets are valued on realistic basis whilst liabilities are not suggests an inherent mismatch. This would be particularly visible should interest rates rise sharply: insurers would record losses on their bond holdings whilst their liabilities would not be reduced.

Beyond these risks, there were few common risk themes among the reporting countries. Risks related to reinsurance were mentioned by a number of countries, whilst several new EU Member States mentioned the challenges posed by the entry of new insurance firms in their markets following the EU accession. Some countries voiced concern over rapidly rising cost of claims and others also highlighted the fragility of consumer confidence in the life insurance sector.

A few countries reported no challenges or vulnerabilities in their markets.

Figure 1: The development of European long and short interest rates



Source: Datastream.

Figure 2: The development of European and world equity indexes, rebased start 2004

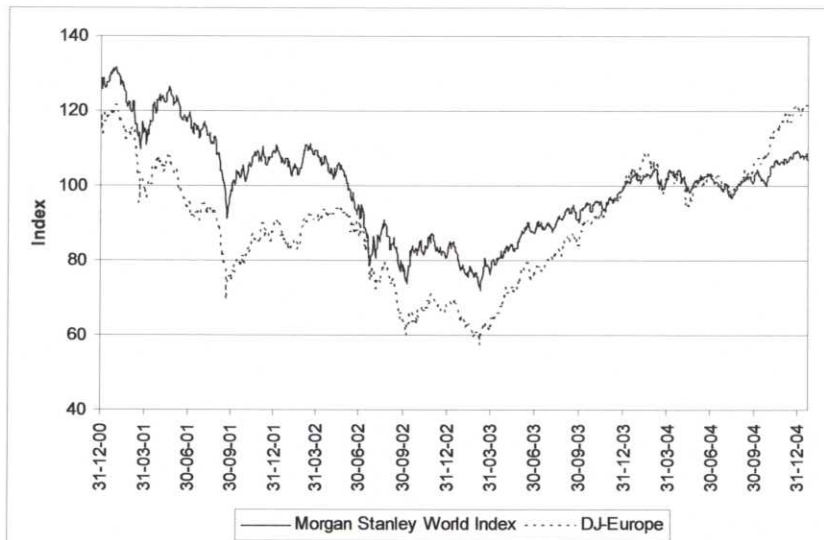
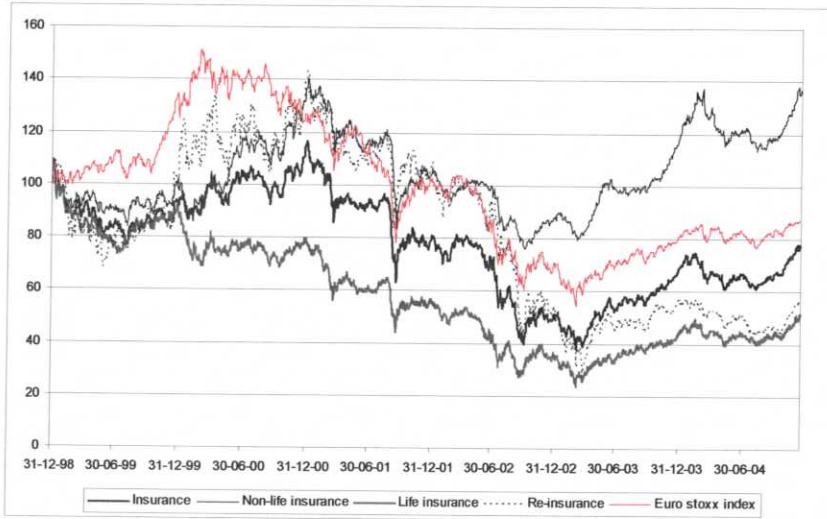


Figure 3: EU stock market indices (31/12/1998 = 100)



Source: Datastream.

Figure 4: Credit Default Swap Spreads (bp above Euribor)

4.1: January 2003 – January 2005 4.2: July 2004 - January 2005

Source: Bloomberg, own calculations (5 year CDS, Euro, senior; ** Index of nine liquid European insurers)

Table 1: Equity market performance in 2004

%	Non-life Insurance	Re-insurance	Life	Total mkt
Austria	17.4	na	na	46.9
Czech Republic	89.0	na	na	62.9
Denmark	43.9	0.1	na	20.7
Finland	23.2	na	na	2.0
France	11.2	6.1	27.7	9.7
Germany	-3.8	-4.5	24.8	6.1
Greece	16.0	na	na	22.0
Ireland	39.5	na	7.8	26.6
Italy	20.2	na	5.6	19.9
Luxembourg	38.8	na	na	15.4
Netherlands	20.3	na	-14.5	5.5
Poland	8.0	na	na	43.4
Spain	15.7	na	na	17.9
Sweden	na	na	26.9	22.1
U.K	-5.9	-24.1	17.6	8.6
EU	9.3	-4.7	10.9	12.0
Japan	6.2	na	37.3	6.5
U.S.A	-3.0	-8.8	11.0	1.8
Switzerland	0.6	-7.7	-16.1	6.6

Source: Datastream

Note: Data from 31 December 2003 to 31 December 2004, all changes in euro terms

Table 2: Equity market performance year-to-date

%	Non-life insurance	Re-insurance	Life	Total mkt
Austria	21.5	na	na	5.4
Belgium	na	na	na	5.5
Czech Republic	19.9	na	na	12.1
Denmark	-0.2	-0.1	na	5.8
Finland	1.8	na	na	5.6
France	4.6	15.1	3.1	4.4
Germany	-0.8	0.6	6.4	2.9
Greece	22.9	na	na	4.7
Hungary	na	na	na	11.7
Ireland	5.2	na	4.0	7.4
Italy	5.1	na	4.7	5.2
Luxembourg	2.9	na	na	4.0
Netherlands	0.2	na	2.1	6.0
Poland	3.3	na	na	2.4
Portugal	na	na	na	5.7
Spain	11.4	na	na	5.1
Sweden	na	na	5.0	1.3
U.K	8.9	0.9	7.0	7.1
EU	2.7	1.2	5.6	5.4
Japan	-0.4	na	3.0	3.1
U.S.A	9.7	6.3	4.7	4.1
Switzerland	3.1	0.9	6.6	3.1

Source: Datastream

Note: Data from 31 December 2004 to 10 February 2005, all changes in euro terms

Table 3: Maximum guaranteed rates life insurance

Country	15 Feb. 2005	15 April 2004	1 July 2000	Before 1 July 2000
Austria		2,75% (as of 1 Jan. 2004)	3,25%	4,0% until 1 July 2000 3,0% until 1 Jan. 1995
Belgium	unchanged	3,75%	3,75%	4,75% until 1 Jan. 1999
Denmark	unchanged	2,0%	2,0%	5,0% until 1 July 1994 3,0% until 1 Jan. 1999
Finland		2,5%	3,5%	4,5 % until 1 Jan. 1999
France	unchanged	Lt: 2,5% St: 3%	Lt: 3,0% St: 3,75%	Lt: 3,0% St: 3,75% (until 1 Jan. 1998)
Germany		2,75% (as of 1 Jan. 2004)	3,25%	4,0% until 1 July 2000
Hungary		4,0% (as of 1 Jan. 2002) 2,9% from 1 Jan. 2006	5,5%	
Italy		2,5 (as of 1 Dec. 2003)	3,0%	
Luxembourg		2,5%	2,75%	3,75% before 1998
Netherlands	unchanged	3,0%	3,0%	4,0% before 1998
Norway		3,0% (for all new premium income from Jan. 2004)	3,0%	4,0% until Nov. 1993
Portugal		4,0%	4,0%	
Spain	2,42%	2,68% (as of 1 Jan. 2004)	3,15%	4,0% until 21 June 1997
Sweden	2,75%	3,0%	3,0%	4,0% before 1998
UK		na	na	

Notes:

Belgium Maximum technical interest rate of 3,75% applies to life contracts denominated in Euro. For contracts with a duration of less than 8 years, an actuarial rate based on the spot rate of Belgian Government bonds for that duration is used.

France Two different interest rates are used, for durations above (Lt) and below (St) 8 years.

Portugal The maximum rate is subject to the term structure of business written and may only be allowed if stress tests show the capacity of the company to pay these rates.

Spain A dynamic adjustment to market changes (based on Spanish Treasury bonds) is used. The following maximum interest rate for mathematical provisions are used in each year, without considering when the policy was subscribed:

1999	3,20%
2000	3,15%
2001	3,15%
2002	3,11%
2003	2,89%
2004	2,68%
2005	2,42%

Sweden Maximum guaranteed rates: February 2005 2,75 % (for new business from March 1 2005, for older business 3,0 - 3,5 %).

Appendix Reinsurance in Europe

1. Reinsurance – a worldwide business

Reinsurance is a worldwide, highly specialized business which offers coverage for primary insurers against the risk that they will experience financial problems as the result of a major loss. Reinsurance diversifies the exposure of primary insurers and stabilizes their loss experience. This includes non-standard risks - typically rare events with a large impact, like natural disasters – for which reinsurers have valuable expertise with respect to underwriting and pricing. At the level of the whole economy, reinsurance improves the intertemporal and geographic diversification of risks and therefore contributes significantly to economic growth.

According to the first IAIS Global Reinsurance Market Report 2003³, the world reinsurance market amounts to a total of US\$149.5bn gross premiums written⁴. The market of pure reinsurers is largely dominated by European groups and companies. The European firms among the top 10 reinsurance groups in 2003 were, by decreasing order of net premiums written, Munich Re, Swiss Re, Hannover Re, Lloyd's, Allianz Re, SCOR, and Converium.

Most of the activity of a typical European reinsurer is carried out cross-border. For example, more than 80% of Munich Re Group's gross premium income originates from outside Germany – the most important markets being the U.S. and the UK, contributing to around 25% and 20% of the premium income, respectively. In addition, more than 90% of Swiss Re's gross premium income originates from outside Switzerland, with about 50% from Europe. The U.S. remains the most important source of international business for Lloyd's of London. Different major reinsurers own reinsurance subsidiaries in other jurisdictions: SCOR Italia Riassicurazioni and Swiss Re Ireland are examples of such firms. Traditionally, reinsurance business covers property/casualty and accident business as well as life and health insurance. About 80% of the total market (again in terms of gross premiums written) comes from non-life and about 20% from life business.

³ The report, available at http://www.iaisweb.org/041223_RTG_report_final.pdf, was published in December 2004. It analyses a selected number of reinsurers worldwide, including primary insurers with substantial reinsurance business – in-house reinsurers are not taken into consideration.

⁴ This figure covers 43 reinsurance entities. A.M. Best, covering 35 reinsurance groups, evaluates gross premiums at US\$ 172.5 bn. For the same year, the main rating agencies evaluated the global market in terms of net premiums written at between US\$ 95.8 bn and US\$ 163.6 bn.

Agency	Net reinsurance premium written
Fitch (34 selected reinsurance groups operating on a global basis)	US\$ 95.8bn
Moody's (top 30 reinsurance groups)	US\$ 120.8bn
A.M. Best (top 35 reinsurance groups)	US\$ 146.0bn
Standard & Poor's (appr. 250 reinsurance companies worldwide)	US\$ 163.6bn

2. Recent developments in the reinsurance market

Stabilizing trend

The financial health of reinsurers, which improved since 2003, overall continued to stabilize in 2004 despite a high number of severe natural disasters. This is encouraging since both 2001 and 2002 were particularly bad years for reinsurance worldwide. First terrorist attacks and floods generated large payouts, and then a global credit and equity meltdown coincided with an exceptionally low interest rate environment.

The estimated insured losses of over US\$40bn⁵ due to natural disasters in 2004 exceeded by far those of the previous record year 1992 of Hurricane Andrew. Although the Niigata earthquake in Japan in October was the third most expensive ever (US\$450mn), over 85% of the insured losses due to natural catastrophes in 2004 were weather-related. The Caribbean hurricanes in the autumn alone caused insured losses of over US\$28bn that were, however, mostly retained by U.S. primary insurers. Europe stayed largely unscathed with only a few minor tornadoes in Germany, France, Italy, the UK and the Nordic countries.

During 2004, the reinsurance industry consolidated further – though this movement mainly affected the U.S. life-market – and nearly all major companies achieved higher net profits. Currently reported renewals reveal that the beginning trend towards a soft market, which was widely expected, has been stopped. Whereas reinsurance rates tended to shrink in the first two quarters of 2004, the damage by the autumn hurricanes seem to have strongly contributed to stabilize the price level. New capacity offered by Lloyd's and some Bermuda-established companies so far does not seem to offset this development. It seems to be difficult for the latter to gain market shares in Europe.

Developments in the regulatory environment

In 2004, the regulatory environment of reinsurers has been improved further. The International Association of Insurance Supervisors (IAIS) published its report on "Enhancing Transparency and Disclosure in the Reinsurance Sector" in March⁶. As a result, new reinsurance statistics with aggregate figures were made available by the IAIS in December 2004. At the European level, the EU-Commission proposed a draft Reinsurance Directive on 21 April 2004, with the aim of a harmonized framework for reinsurance supervision in the EU, to be implemented in 2008. The fast-track directive basically transposes the existing regulatory framework of the insurance industry introduced by the Third Insurance Directive to reinsurance. Currently, a number of European countries do not supervise reinsurers. In the UK, the Financial Services Authority (FSA) has taken direct oversight of the Society of Lloyd's of London, the managing agents and the members' agents. Lloyd's will face a new risk-based capital regime from 2006 on.

⁵ Press release by Munich Re on 28 December 2004. The figure does not include the Tsunami event which caused losses estimated at US\$4bn.

⁶ This report follows two other publications: "Principles on minimum requirements for supervision of reinsurers" in 2002 and "Standards on supervision of reinsurers" in 2003 (see <http://www.iaisweb.org>).

Remaining challenges and developments

Although there is a clear positive trend for the reinsurance sector, several possible challenges have to be kept in mind.

Credit Risk Transfer (CRT): It is sometimes claimed that reinsurers are involved in credit risk transfers to a significant degree. Available data does not allow to check this claim. However, it is known that offshore financial centers (OFCs) like the Bahamas, Barbados, Bermuda, and the Cayman Islands are of increasing importance with respect to CRT. At the same time, newly founded reinsurers aim at using capital markets to manage risks and investment banks are among the primary founders of new reinsurance companies in OFCs. Preliminary investigations show that only a small number of specialists engage in credit insurance and that exposure of reinsurers via credit derivatives is very limited. Therefore, the emergence of systemic problems due to the involvement in CRT products seems to be unlikely at present.

Natural catastrophes: The frequency and severity of natural catastrophes, in particular those due to weather conditions, has increased significantly in recent years. The hurricane which hit the Brazilian coast in March 2004 was the first ever recorded in this region and Japan was hit by the record number of ten cyclones this year. Despite large annual fluctuations, a trend towards larger insured (and even more so uninsured) losses due to natural catastrophes is observable since 1970. At the same time, improved risk management techniques allow reinsurers to better alleviate unexpected losses.

Alternative Risk Transfer (ART): Recently, new types of reinsurance emerged in the alternative risk transfer market. This market covers two segments: alternative carriers and alternative products. Risk transfer through alternative carriers, like captives, increased over recent years. The market for alternative products, like financial reinsurance, finite risk insurance, securitization and weather risk products⁷, is currently still relatively small. Its growth potential seems to be limited, since it is a specialized business for specific risk profiles. Through the transfer of top-level risks to the capital market, the ART market contributes to a better risk sharing in the economy. Reinsurers are using securitization for large risks concerning man made and natural catastrophes. For example, CAT bonds business⁸ increased in volume from approximately US\$700mn in 1997 to US\$1,700mn in 2003.

Cyclicality: Not all reinsurers have been able to benefit from the recent turn towards a sustained general enhancement in reinsurance rates. Reinsurers with a very strong capital base are gaining relatively and absolutely more business than weaker companies. The explosive increase in reinsurance premiums after the year 2001 seems to have heightened the risk in the primary insurance sector at least in the short run, because many companies prefer, in comparison to pre-2001 levels, to pay the same premiums for less coverage. As premiums are high and new capital becomes harder to come by, reinsurers may well be under pressure to return unused capital to shareholders. Reinsurers will need to ensure that short-term returns to investors are not made at the expense of long-term

⁷ Financial reinsurance is a mixture of banking and reinsurance products. Finite risk insurance is also a combination of risk transfer and risk financing, but it involves more risk transfer than financial reinsurance. Securitization is the pooling of assets into a negotiable security. Reinsurers offer weather risk management in the form of insurance and derivatives.

⁸ Catastrophe bonds.

commitments: the reserve risks and asset risk associated with longer-tail business are likely to fall at a slower pace than current premium income.

Long-tail exposures: So far, European companies seem to be less exposed to long-tail exposures, like asbestos and environmental liabilities, than their U.S. counterparts. As the environment in Europe is expected to become more litigious, this could change in the years to come.

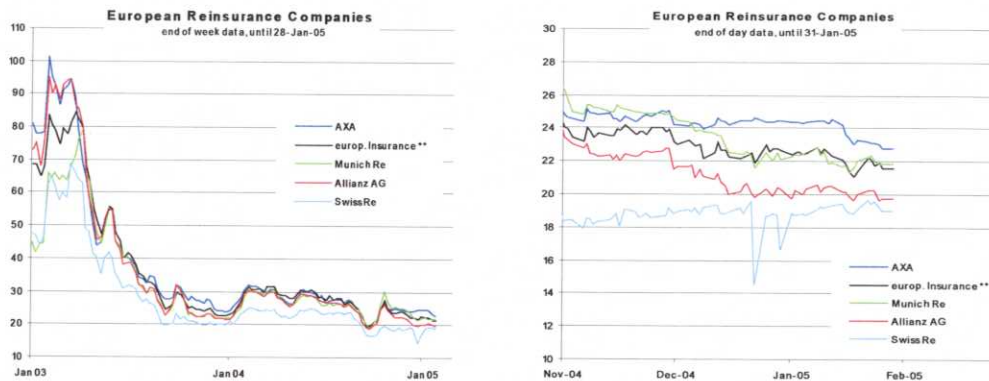
Terror: The world trade center terrorist attack was the largest single man-made reinsurance incident ever with a loss of over US\$40bn. A large share of the insured loss was paid by U.S. reinsurers, subsidiaries of European reinsurance groups and primary insurers. The demand for reinsurance in this area increased due to the U.S. Terrorism Risk Insurance Act of 2002 (TRIA). The non-renewal of TRIA, due to expire at the end of 2005, raises questions about the availability of reinsurance capacity in the US.

Market indicators

Market indicators point towards improved conditions for the financial stability of the European reinsurance industry.

CDS spreads: CDS spreads strongly decreased throughout 2003 and remained at a comparatively low level of around 20 basis points above EURIBOR in 2004, indicating little financial risk among major European reinsurance companies.

Figure 1: Credit Default Swap Spreads (5 years; Euro, senior)



Source: Bloomberg; ** Index: Equally weighted CDS spreads of 9 liquid European Insurance CDS spreads. The figures for Axa and Allianz also reflect the non reinsurance business of these groups.

Ratings: Downgrades by rating agencies have been observed over a number of years - especially in 2002 and 2003. This trend seems to have been stopped. In 2004, most rating agencies upgraded the reinsurance outlook from negative to stable. This stabilization of ratings has however taken place at a level markedly below where ratings have typically been at this stage of the cycle.

Figure 2: Average Reinsurance Ratings weighted by Total Assets

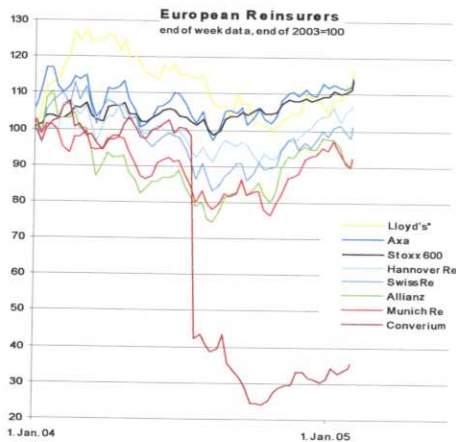


Source: Isis database, own calculations

DE = Germany, DK = Denmark, EU = European Union, FR = France, IT = Italy, LU = Luxembourg, SE = Sweden, UK = United Kingdom (Insurers Financial Strength Ratings until 21.1.05, Total assets [2003])

Equity markets: Most European stock indices recovered in 2003 after three consecutive years of decline, and insurance sector indices started rising as well. In 2004, the development has been mixed for reinsurers in the different European jurisdictions. Nearly all major reinsurance companies underperformed in comparison to the DJ Stoxx 600 index for Europe. However the last quarter 2004 almost offset the negative performance during the first half of the year.

Figure 3: Share Prices of major European Reinsurers



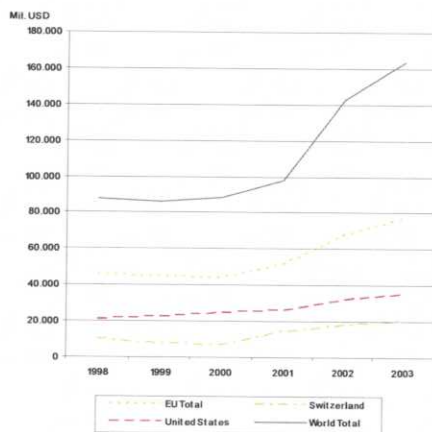
Source: Bloomberg, own calculations (because of weekly data, the end of the year does not exactly correspond to the value 100). Axa, Allianz and Lloyd's also include non reinsurance business. * The Lloyd's index is calculated as a weighted average.

Corporate indicators

The analysis of accounting data also confirms a further stabilization of the reinsurance sector.

Net insurance premium written: The steady increase of the net reinsurance premiums written over the last six years reflects the increasing role of reinsurance products in the economy worldwide. The increase in the EU is mainly due to Germany and the UK. The decrease of Europe's market share relatively to the world total is due to the appearance of new market players in Japan and Bermuda.

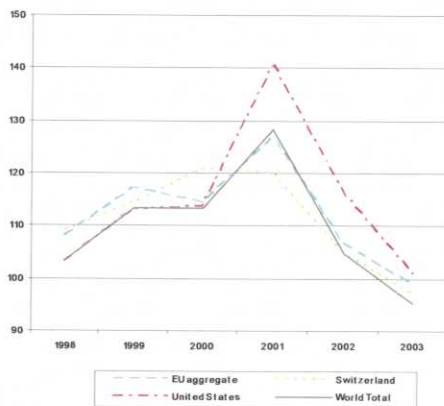
Figure 4: Net Reinsurance Premiums Written - Selected Countries and World Total



Source: S&P, own calculations.

Combined Ratio (CR): Healthy combined ratios are among the main profitability indicators against which reinsurance companies are judged by the market. The combined ratio expresses the sum of the loss ratio⁹ and the expense ratio¹⁰, with a lower combined ratio indicating improved financial strength. In 2003, most European reinsurers reached a combined ratio below the threshold level of 100%. The peak in the combined ratio in 2001 is due to the consequences of the terror attack in New York City on 11 September. Since U.S. reinsurers owned a larger share of the affected treaties, they were hit harder. As a consequence, the aggregate combined ratio of US reinsurers stayed since significantly above the aggregated combined ratio of European reinsurers. The London market recovered quickly from the incurred losses and achieved a particularly low CR of about 91% in 2003¹¹.

Figure 5: Combined Ratio - Selected Countries and World Total



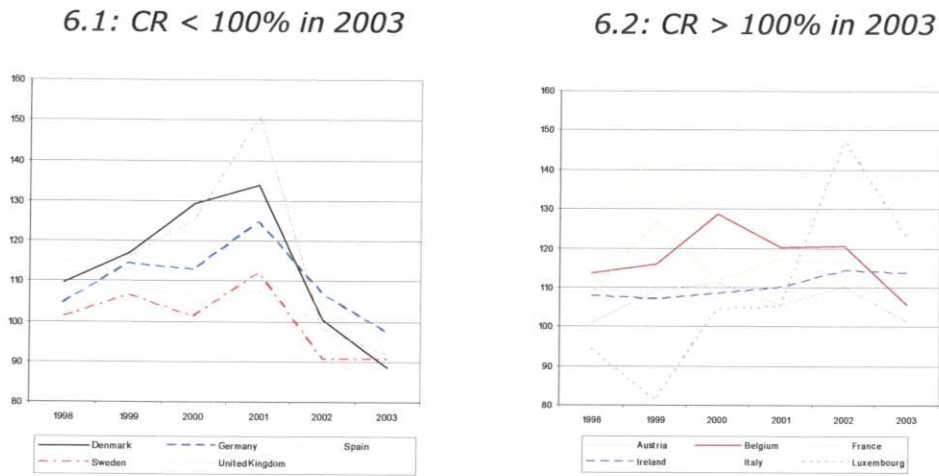
Source: S&P, own calculations.

⁹ Loss ratio: claims incurred as a percentage of net premiums earned.

¹⁰ Expense ratio: acquisitions and administration expenses as a percentage of the net premiums written.

¹¹ For Lloyd's, the CR figure includes however both reinsurance and primary insurance business.

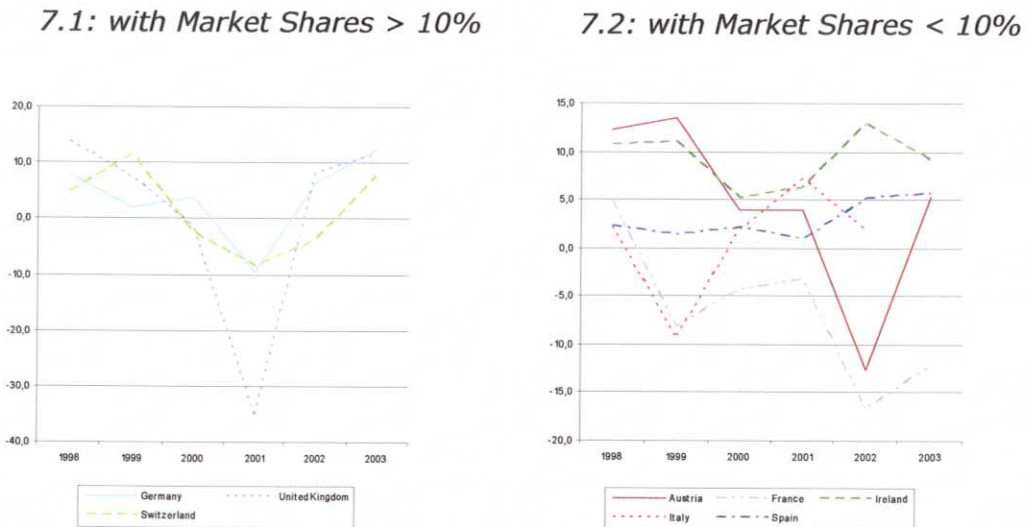
Figure 6: Combined Ratio – European countries



Source: S&P, own calculations; for the UK market, the CR includes both reinsurance and primary insurance business.

Return on revenues (ROR): Return on revenues is an indicator of profit sustainability. It includes investment income before capital gains. This indicator has the advantage of being relatively unaffected by financial leverage and short term capital gains, which have the potential to distort return on equity.

Figure 7: Return on Revenue in European Countries

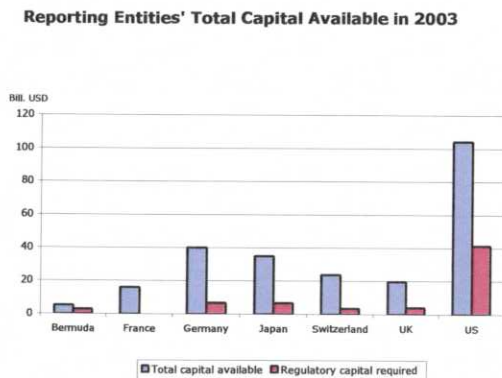


Source: S&P, own calculations (the ROR for Italy is not available for 2003).

The overall relatively stable ROR of the main players over the last 10 years - with the exception of the terror incident on 11 September 2001 - is an indicator of long-term financial stability in the reinsurance sector. The quick recovery of the ROR after the 11 September shock highlights the flexibility and strong absorption capacity of the companies involved.

Capital adequacy: Actuarial techniques are used to determine the amount of capital to be held as buffers against unexpected losses. Regulatory capital is not currently a requirement in all countries for reinsurance companies. The national data available indicate that reinsurers held in 2003 more capital than required. It should however be noted that there raise some problems in comparing the capital adequacy between countries, e.g. because national regulatory requirements and accounting principles differ considerably.

Figure 8: Total Capital Available in selected Countries



Source: IAIS Global Reinsurance Report 2003.

Occasionally, due to restructuring operations or group supervision, the adequacy of own funds had to be checked with particular care in 2004 – including those of foreign branches operating in the country.

3. Outlook for 2005

Overall, all three main rating agencies, Standard&Poor's, Moody's and Fitch, changed their outlook for the European reinsurance industry from negative to stable. This was the result of a reduction in the high premium volatility which shaped the profile of the sector in the past, as well as technically adequate near-term premium rates, rising investment yields, adequate reserves and declining adverse reserve developments.

A commitment to continued risk-adjusted pricing will be crucial for this trend to persevere. It will be particularly needed in areas where adequate pricing is difficult, like terrorism reinsurance, which will be demanded for as a result of TRIA. In case prices would be subject to unwarranted downward pressure, significant unexpected losses could result. A continuing trend to stable or positive outlooks would also alleviate the risk of primary insurers retrieving from contracts as a result of rating trigger clauses.

One particular area of concern is the lack of contract certainty which can give rise to considerable operational risk. It is not uncommon for six to nine months to elapse between an insurer underwriting a risk and the production of the policy wording. This creates risks to policyholders, insurers and the brokers. The issue is a priority, for example, both for the UK supervisor and the London market's own 2005 reform agenda.

The financial strength of a reinsurer remains a crucial determinant for primary insurers which want to insure part of their business. Weaker reinsurers are expected to continue gradually losing market shares in the segment of attractively priced business. Market forces are pushing primary insurers into what some market participants call flight to quality. In this respect, one should notice that, in contrast to the flood catastrophe in Southern Asia, the storm events in the U.S. and Japan are expected to influence the loss ratio of at least some market participants, thus leading to lower profits.

A potential challenge is the reinsurance price cycle. Many leaders in the reinsurance sector consider it crucial to avoid a replication of similar adverse consequences on financial health as those of the last soft market. In this respect, the sophistication and accuracy of price-monitoring tools will be essential to combat uneconomic pricing levels. Current favorable hard market conditions have the potential to improve the financial situation of reinsurers. Recent favorable reinsurance contract clauses and the fact that the retrocessional market still indicates a limited capacity, suggest that the hard market could remain stable over the medium term. Some even expect a "harvesting-period" for reinsurers until at least 2006. Be this as it may, in 2005, the overall outlook for reinsurers should be stable.
