European Insurance Industry Outlook
2017 and Beyond

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Commentary

Linas Grigaliunas
Senior Director
Head of Insurance
linas.grigaliunas@dagongeurope.com

Carola Saldias
Senior Director
Sector Head Financial Institutions Analytical Team
carola.saldias@dagongeurope.com

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1. INTRODUCTION

2016 was a relatively benign year for European insurers despite the operating environment being highly uncertain and volatile. The preliminary 2016 year end results are just coming out however the high level trends are relatively clear:

- The macro and political environment constrained insurance industry with continuing low growth, significantly increased political risk with highly unlikely and improbable events actually happening (Brexit, US presidential election, etc) and elevated financial markets and FX volatility.
- Life business growth was challenged by the low and in cases negative yield environment and new more prudent solvency regime resulting in many life companies changing product portfolios and reducing premiums written.
- The Non-life business growth was more resilient, but still challenged by increasing competition and slow economic growth.
- The profitability weakened due to historically low interest rates and reducing investment income, tightening underwriting margins and various optimisation and reorganisation costs.
- Natural catastrophes level increased (highest in the last 4 years), but did not make a major negative impact to the industry’s earnings or pricing.
- The capitalization of the industry, in our view, strengthened largely driven by more prudent capital requirements from the new Solvency II regulatory regime.

In this commentary, we will review our expectations for European insurance industry based on our analysis and assumptions for the main European insurance markets in 2017 and beyond (UK, France, Germany, Italy, Netherlands, Spain, Portugal). We believe that many of 2016 trends will continue and will present new risks and opportunities going forward. The uncertainty and change will remain the key themes, while ability to adapt quickly and make right long-term decisions will be the key differentiating factors for long-term success.

2. EXECUTIVE SUMMARY

We consider 2017 for the European insurance industry to be more challenging than 2016 underpinned by highly uncertain, volatile and difficult operating environment, with weak economic growth, increased political risk and new regulations. In addition, increasing competition and enduring low and in cases negative interest rate environment will elevate pressure on profitability and return on capital. These coupled with risks and opportunities coming from rapid improvement in innovation and technological progress, changing consumer needs and lifestyles will challenge insurer's established business models and long-term sustainability in the medium and long-term. Having said that, we expect that in the next two years European insurance industry will maintain robust credit characteristics based on strong capitalization, high liquidity and prudent risk management. However, at the same time it will have to face weakening profitability and low growth.

Main Expectations 2017:

- Operating environment on average to remain challenging and uncertain with low economic growth and low or negative interest rates at least until 2018. However, we believe that interest rates could rise earlier if political risks were to increase significantly.
- We expect Non-Life insurance to grow at about 1-2% just below to the GDP growth, negatively affected by increasing competition.
- We expect Life insurers to shift product portfolio to more capital efficient products, however growth and profitability to weaken and to depend on changes in interest rates, behaviour of financial markets and any regulatory changes.
- We expect similar or lower asset risk levels and improved investment management largely due to stricter Solvency II regulatory requirements. The fixed income instruments will continue to dominate investment portfolios, but will shift from government to corporate debt instruments. However, we also expect that some insurers will increase asset risk in search for higher yields and by venturing to higher risk and more complex asset classes such us real estate, infrastructure, speculative grade credit, equities, etc.
- We expect competition to intensify and put pressure on pricing, efficiency and effectiveness of distribution channels and operational costs. On average, we expect pricing to soften slightly or at best to remain the same, helped by industry's increased focus on underwriting prudence.
- We believe that M&A activity and industry consolidation will continue and are likely to gain the pace. This could be driven by more favourable regulatory treatment for large and better diversified companies; lack of organic growth opportunities and need to support profitability by improving operational efficiency and competitiveness.
- We expect industry capitalisation to remain strong and resilient supported by weakening, but still good earnings, more prudent regulation, optimised investment portfolios and organisational structures.
- We also expect increased and enhanced use of reinsurance protection driven by tougher regulatory capital requirements, improving risk management practices and attractive pricing.

Main risks

The European insurance industry is facing a rising number of risks, which could materially weaken individual companies, however, in the long-term, we expect, the industry not to weaken significantly, but rather find a way to transform and adapt to rapidly changing world and become more relevant, robust, efficient and agile.

From the credit risk perspective in a short-term, we see the European insurance industry as robust and resilient, with the main risks coming from uncertain and volatile geopolitical and regulatory environment, deteriorating profitability and low or no premium growth. In the medium-term, we see main risks steaming from weakening capitalization levels due to lower profitability, increased risk taking or capital reduction in drive to improve return on equity. While in the long-term, we believe the major challenge will be to adapt business models to rapidly developing operating environment, keep up with innovation and technology, stay relevant and satisfy ever-changing customers' and business partners' needs and ensure sustainability for policyholders and shareholders.

The other material risks for 2017-18, in our view, are mainly rising from volatile and uncertain operating environment and external factors, in particular:

- **Prolonged low or negative interest rate environment** – is challenging insurers' profitability, but also could lead for need of a significant reserve strengthening in particular for life companies. In our view, if the current low interest rate environment were to stay for longer than 5 years the capital and profitability of Life insurers with large amount of business with high guarantees and large asset liability mismatch would be significantly weakened.
- **Cyber and data security** – cyber-attacks on insurers' IT systems pose also increasing threat and possibility of major operational disruption, loss of private data, significant reputational damage or even financial loss. Aggressive underwriting of cyber risks also poses significant risks for insurers and might lead to major losses.
- **Innovation and technology –** such as AI, data analytics, robotics, mobile, wearables and other are developing faster than ever before, and if not considered seriously can leave insurers' long-established business models obsolete and unable to reach and serve customers and business partners and remain profitable.
- **Regulatory risk** – fast pace of change, high complexity and high costs, new laws and regulations are putting significant financial and organisational burden on insurers and are likely to be one of the major risks.
- **Geopolitical risk** – increased uncertainty and instability of geopolitical environment in Europe and across the World has significant, wide reaching negative and disruptive effect on businesses, FX, financial markets, regulation, people's lifestyles and social stability among other. The real impact of Brexit and Trump's presidency is yet to be seen, however it, together with upcoming French elections and many more other hot spots add to the increasing uncertainty and potential of serious negative effects to industry.

Main opportunities

- Innovation & technology is developing faster than ever before and already now challenge long-standing insurance business and operating models. In coming years it will be the major driving force behind the radical change and reinvention of insurers business models and concepts and the main way to adapt to changing operating environment and customer needs. It will be driving growth and reducing protection gap, improving efficiency and ensuring profitability.

  Some of the major innovations entering insurance world so far:
  - Adoption of Block-chain and smart contracts in product distribution, claims management, interaction with customers without intermediaries among other.
  - Use of Big data, advanced analytics, sensor connectivity in customer analysis, underwriting, new product development and other areas.

  - Mobile technology used in almost every step from marketing to claims settlement and enabling faster and broader reach and lower transaction costs.
  - There are also many examples of InsureTech companies making significant progress and challenging and changing status quo.

- M&A opportunities, helped by difficult operating environment and more stringent regulatory requirements encouraging consolidation, favourable pricing and one of very few ways to grow and protect profitability in the current challenging environment .

3. EUROPEAN INSURANCE INDUSTRY - 2017 AND BEYOND

Insurance industry in Europe is facing challenges like never before. Volatile and uncertain operating environment with weak economic growth, increased geopolitical risks and new regulations represent major challenges to business growth and development, costs and operational structures. In addition, prevailing low and in cases negative interest rate environment, volatile equity markets and fierce competition exert pressure on profitability and capitalisation. These coupled with, rapid innovation and technological progress, change in consumer needs and lifestyle are challenging insurer's established business models and long-term sustainability.

We expect European economy to grow at about 1.6% - 1.7% 2017-18, a faster pace than a year before. However too slow to reduce meaningfully unemployment rate, increase disposable income, properly stimulate consumption and insurance industry's growth.

Country	Real GDP Growth (%)	Population (M)	GDP per Capita ($)	Unemployment	Estimated GDP growth		
	2015				2016	2017	2018
Germany	1.5	81.9	41,054	4.6	1,6	2,3	2,1
United Kingdom	2.2	64.4	44,418	5.4	1,04	1,7	1.0
France	1.2	64.4	37,584	10.0	1.0	1,2	1,4
Italy	0.6	59.8	30,461	11.9	0,9	0.7	0.8
Spain	3.2	46.1	25,878	22.1	3,2	2,3	2.0
Netherlands	2.0	16.9	44,423	6.9	2.1	1.9	1.6
Portugal	1.6	10.5	18,999	12.4	1,2	1,5	1,5
USA	2.6	321.3	56,129	5,26	1,6	2,3	2,1
China	6.9	1,361.0	8,221	5,9	6.7	6.2	4.2
Japan	1.3	126.6	34,638	3,38	0.8	1.0	0.6

Source: SNL financial, Dagong Europe

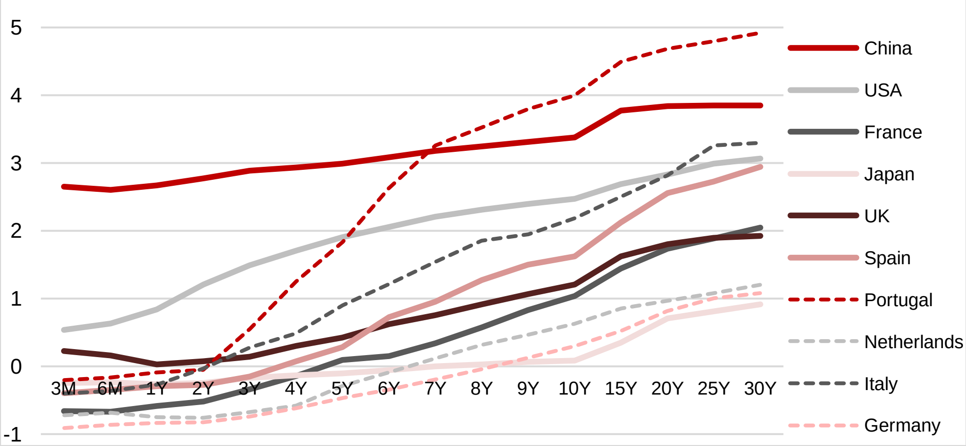
While the quantitative easing and low interest rates meant to stimulate the economy and create a window of opportunity for businesses to get cheap finance and grow, it has an opposite effect on insurance and banking industries, especially on Life insurance. The low interest rates reduces attractiveness of Life products, diminishes investment income – the major source of profitability for the industry, especially life, and erodes insurance reserves and in cases capitalisation.

We expect low or negative interest rates to remain at least until 2018. However, we believe that they could rise earlier if political risks were to increase significantly. Feb 2017 all the countries with the largest insurance industries apart the UK had negative interest rates on debt up to two years of maturies and some up to six years. While Germany had negative interest rates on its debt up to 8 years and at very comparable level with Japan for durations above 8 years.

During the last year we also noticed that interest rate curve got steeper throughout the spectre with the rates falling on the shorter durations and increasing for longer durations. However, this already incorporates markets reaction to increasing political risk, in particular Brexit and US presidential elections. As insurers usually try to match their liabilities with the same duration assets, the change in yield during the last year had increased negative impact on shorter duration businesses such as Non-life insurers and more positive on longer duration businesses such as Life insurance.

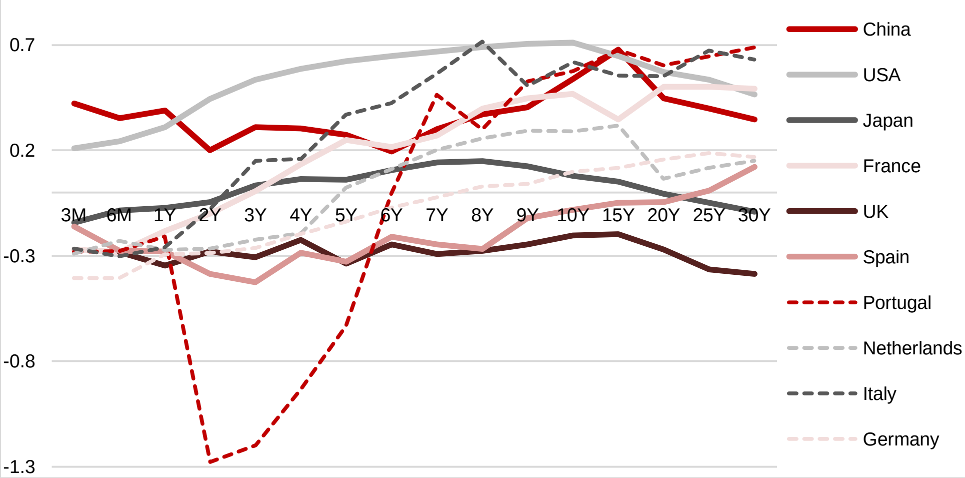
Insurance industry is one of the biggest investors in the sovereign debt and which also comprises the major part of industry's investment portfolios. Therefore significantly reduced and in cases negative interest rates have a major impact to industry's profitability, product offering, reserves and capitalisation.

Ex.Sovereign bond yields Feb 2017



Source: Bloomberg, Dagong Europe

Ex. Change in Sovereign bond yields Feb 2016 to Feb 2017



Source: Bloomberg, Dagong Europe

The ten-year government bond yields have reduced dramatically during the last 10 years presenting major challenges to Life industry, especially for the companies with long-term products with guarantees and large duration mismatch. However during the last few month the yields showed some improvement, mainly due to US elections and increased long t

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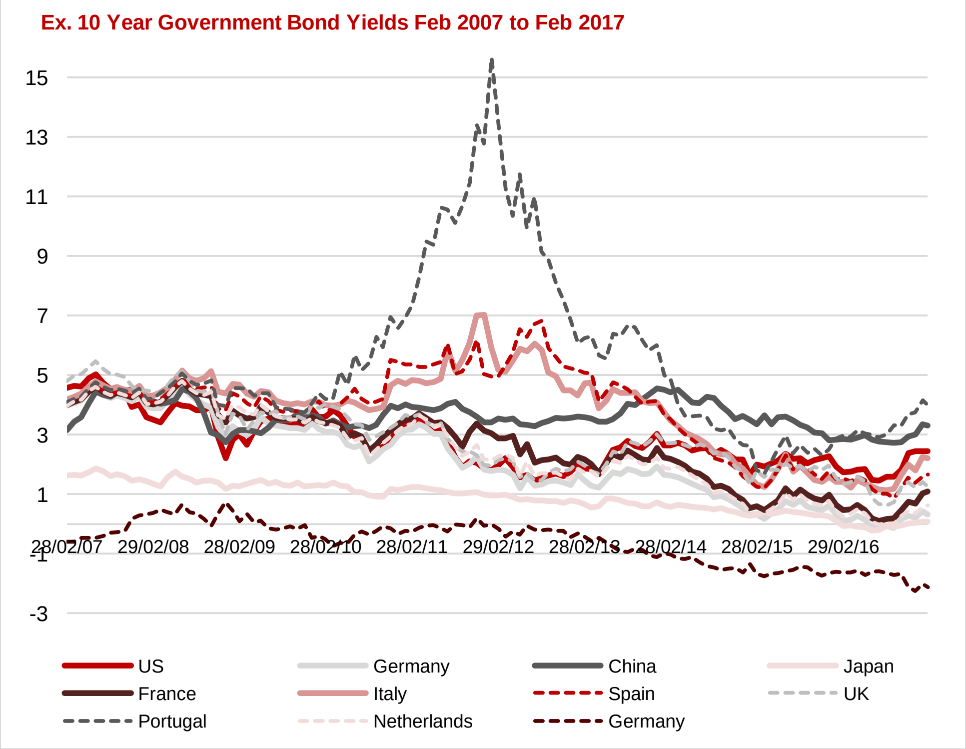
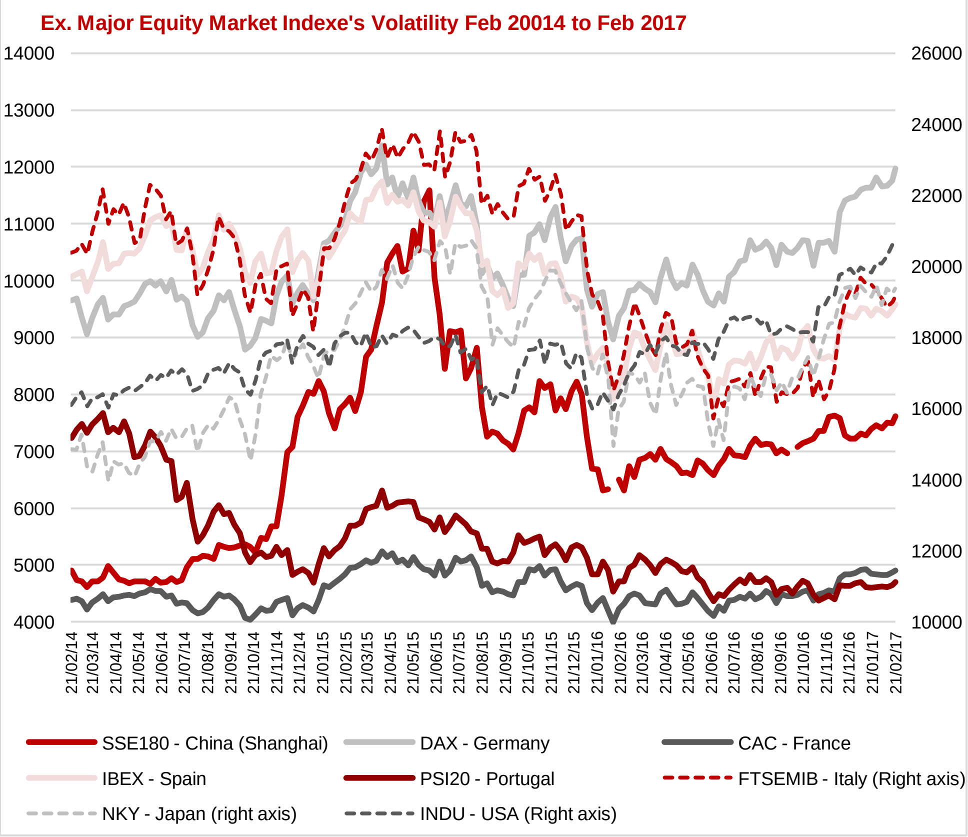


Source: Bloomberg Dagong Europe.

The major equity markets showed increased volatility over the last 3 years. In addition, political uncertainty and investor sentiment changes increased significantly FX volatility presenting further challenges to insurers' profitability and capitalization.



Source: Bloomberg, Dagong Europe.

In 2016, the geopolitical risk came back with a bang to agendas of businesses across the world creating uncertainty, disturbing old order and business operations, raising costs and challenging future prospects and in our view it is here to stay.

While in 2016 insurers and global investor community had to deal with sentimental shock of some highly unlikely events taking place like Brexit or Trump becoming president of the United States of America. In 2017 and 2018 the whole World and European insurers will have to face the real consequences of that and continuing high uncertainty.

In addition, in 2017 there are number or other very important events and developments the outcome of which is highly uncertain and could have significant negative impact to European political order and economic prospects, such as a number of elections across the Europe (in particular French) and political developments in Europe's neighbouring regions (in particular Middle East, Russia, Northern Africa).

After the financial crisis of 2008-2011 regulation of financial institutions and insurers has increased significantly. In our view, the Solvency II and other regulatory changes in general brought more prudence, put right controls and checks in places and reinforced the industry's conduct and resilience. However, the risk related to increasing complexity, costs of complying and impact of potential change in regulation became also very significant.

Sudden domestic regulatory changes, market structure reforms, changes to accounting practices have often wide reaching and not necessary only positive impact to the industry. As one of the latest examples in UK with the Lord Chancellor revising the Ogden discount rate from 2.5% to -0.5% resulting in delayed reporting of financials, need for motor reserve strengthening and negative impact to profitability.

Competitive and Business environment in our view is increasingly challenging in most of European countries. We expect pricing environment to continue to be very challenging and any pricing increases very difficult, despite industry increasing focus on underwriting profitability.

We believe that service, product or experience diversification will be very important to gaining competitive advantage. However, in the countries with relatively similar products and service levels (ie. Netherlands), any higher margins would have to come from improved efficiency and innovation.

We expect pricing to be in particularly tough in motor, workers compensation and commercial insurance. Rates also have been falling in property insurance due to relatively higher margins and relatively low number of major catastrophes, which usually drive prices up. However, some regulatory changes and increasing costs of claims will push prices up in some countries.

We consider 2017-18 to be challenging for organic business growth due to increasing competition and stagnating economic growth in Non-life and difficulty of structuring attractive products for Life business. Overall in Europe we expect Life industry to contract and non-life to grow at about 1% - 2%.

These difficult conditions for organic growth, higher regulatory capital requirements, deteriorating profitability and need of scale to gain operational efficiencies and diversification benefits will drive M&A activity in European markets in 2017-18. Although growth in Europe is stagnating, the relative stability and low valuations could be attractive for foreign buyers also. Brexit might also result in increase in M&A in continental Europe.

Ex. Insurance industry M&A deals announced during the calendar years 2014-2016

	2014	2015	2016
Portugal	5	3	2
Spain	11	9	6
Italy	8	4	5
Germany	9	6	5
France	6	13	2
UK	88	88	88
Netherlands	3	7	11
China	5	6	9
US	431	583	536
Japan	1	2	4

Source: SNL Financial, Dagong Europe.

A great example of industry consolidation and response to current challenges can be NN Group acquiring Delta Lloyd (Dutch insurers). After the financial crisis there are still many struggling companies with relative good fundamentals and small players, which will struggle to survive in prevailing low interest rate environment and increased regulatory capital requirements and growing costs. Having said that, at the same time, it is challenging in finding the right target at the right price. Often the smaller players are priced out by big global groups. In addition, the risk of integration and high costs of IT systems harmonisation are slowing M&A activity.

We expect that industry's profitability will be challenged in 2017-18, but remain good. We forecast the non-life insurance to drive the industry's profitability, with focus on prudent underwriting. The life industry's profitability we expect to weaken further, however it will vary and depend on the business mix, scale of operations, investment management capabilities and regulatory changes. Sustainable and material increase in interest rates could bring back business fortunes with recovery in investment income and free up capital by changing long-term assumptions on technical provisions, however we do not expect it soon.

We expect defensive strategies focussed on operational cost reduction and optimisation, to dominate insurers' agendas. However, more material improvement in efficiency require large investments in IT systems, digital and other innovations. Due to the difficult environment mainly the large companies can afford it or those, which started few years earlier and can see more sustainable improvements now, can expect better margins relative to peers and improved profitability. In addition, in the current increasingly competitive environment with low growth, price increases could be difficult to achieve, while optimised and reduced cost base could be the primary driver for improvement in profitability.

The return on equity (ROE) in the sector is reducing and in cases is below cost of capital, however relative stability, low credit risk and strong long term fundamentals, in our view, are still attractive characteristics for investor community.

The investment income historically been the main driver and contributor to insurers profitability and is reducing rapidly, especially for companies with short-term asset and liabilities profile or long-term liabilities, but with large duration mismatch. While large insurers with strong investment capabilities continue showing 2% to 3% average yields and still strong margins, the smaller ones are struggling.

We see insurance industry in Europe to have on average strong capitalization, improved in 2016 due to stricter SII regulatory capital requirements and supported by relatively large capital base, on average conservative investment portfolios and improving risk management.

We expect capitalization to remain strong on average in 2017-18 however face increasing pressure thereafter largely dependent on the development of interest rates.

The full SII results are due to be published for the first time in May 2017. This will allow us to asses the underlying capitalization stripping down the impact of transitional measures and improve comparability. However, the differences between standard formula and internal capital model results will be difficult to compare due to different approaches and assumptions behind.

Despite, currently strong industry's capitalization, EIOPA's stress test results disclosed end of 2016 revealed insurers high sensitivity in some countries to double hit stress scenario and high use of transitional measures. In addition, while often insurers hedge a material part of their exposure to interest-rate changes, few do it for changes in government and corporate credit spreads. This in our view could be the significant source of regulatory solvency ratio volatility in currently uncertain geopolitical environment with highly sensitive investor sentiment.

In addition, capitalization could deteriorate materially if low or in cases negative interest rate environment were to stay for long-term due to its impact to discount rate and other assumption in calculating insurance reserves and consequential need for reserve strengthening. The most affected would life companies with long-term liabilities, high guarantee rates and large asset & liability duration gap.

We also forecast increased use of reinsurance and improved protection driven by higher capital requirements from SII, more centralized and strategic approach to reinsurance by insurance groups and continuing soft pricing.

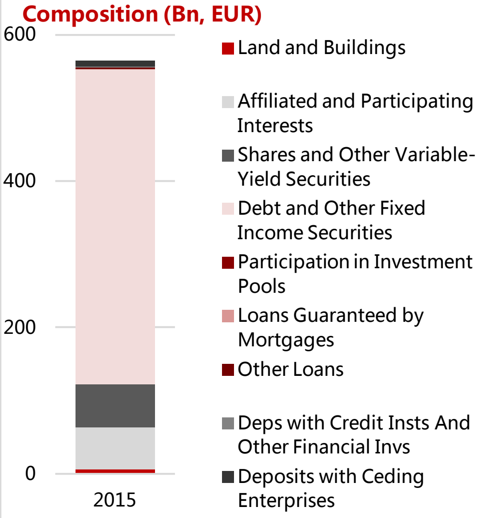
4. INSURANCE INDUSTRY SNAPSHOT BY COUNTRY

ITALY

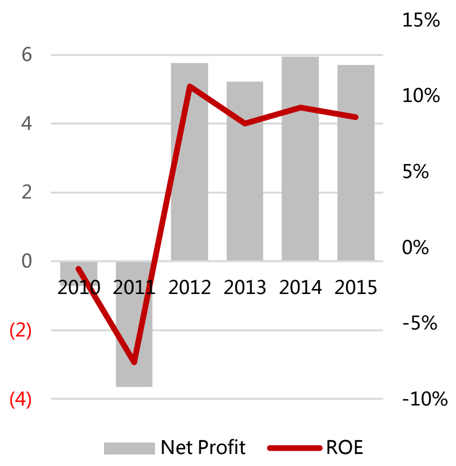
We expect that operational environment in Italy will remain challenging due to weak economic growth prospects, high unemployment rate, vulnerable banking sector with large stock of non-performing loans, increased risk of political instability and high sensitivity to change of investor sentiment.

We expect growth and profitability in Italian insurance industry to be under pressure, but capital levels to remain good. We believe that profitability will continue to be supported by historically higher yields on Italian government debt, however it to come at a cost of higher vulnerability to market shocks and change in investor sentiment. This material concentration in Italian government bonds, coupled with challenging operating environment and possibility of sudden increase in bond yields leaves insurers exposed to material weakening of the capital.

Ex. Investment Portfolio Composition (Bn, EUR)



Ex. Industry Net Profit And ROE (Bn, EUR)

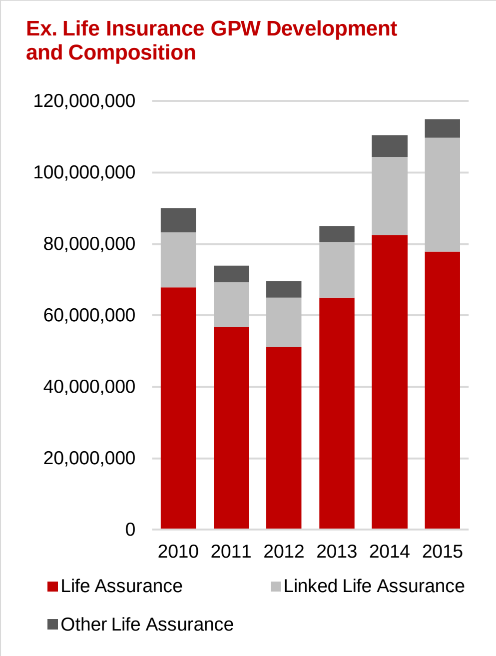


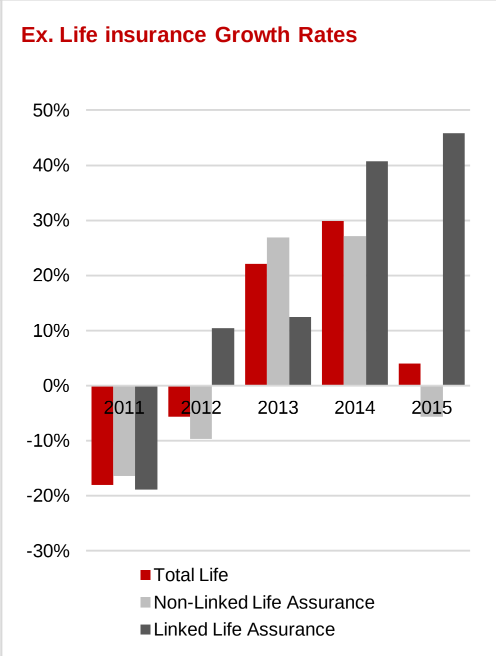
Source: EIOPA, Dagong Europe

Life

We expect overall Life premiums to shrink at high single digits or at best to remain the same in 2017-18. We believe that traditional products with capital protection features to remain popular, but continue shrinking, while capital light products like Unit-linked to grow, however to be negatively affected by low interest rate environment and high volatility of financial markets.

Life sector historically delivered strong return on equity averaging 10% over 2013-2015. However due to changing operational and investment environment, we expect it to drop to about 7-4% in 2017-18. The industry has been reducing average guarantees, which helped profitability, however there still is a large amount of old long-term policies with high guaranties which will be eroding future profits.

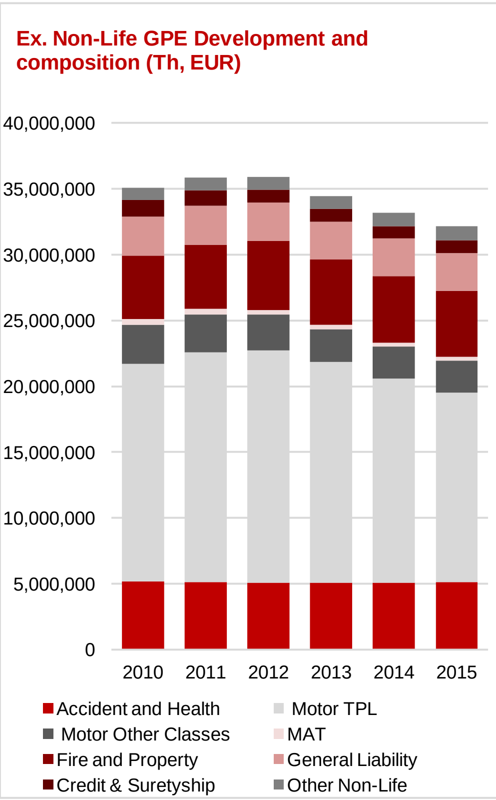


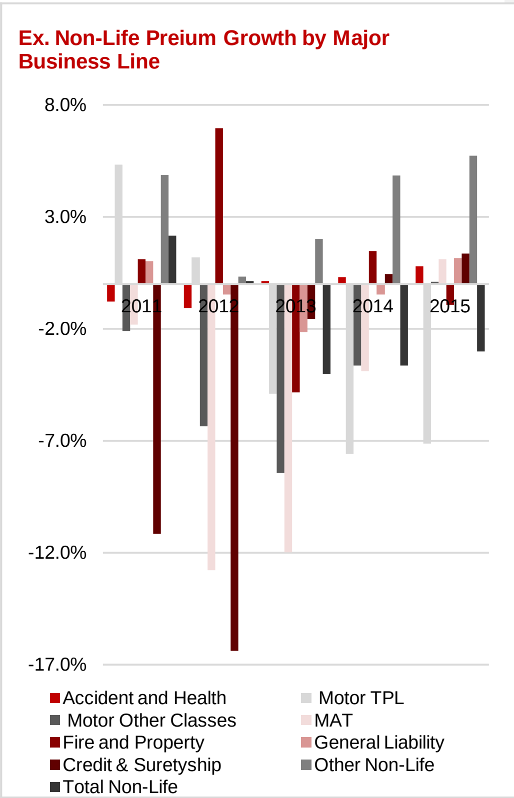


Source: EIOPA, Dagong Europe

Non-Life

We expect that Italian Non-Life insurance market will continue to be dominated by motor, which share is also higher than other major European counties. After reducing around 6% in 2016, we expect motor rates to stabilise, but continue to face intense pricing competition. We expect that the share of non-motor premiums will increase slowly, but overall premium level to remain flat in 2017-18.

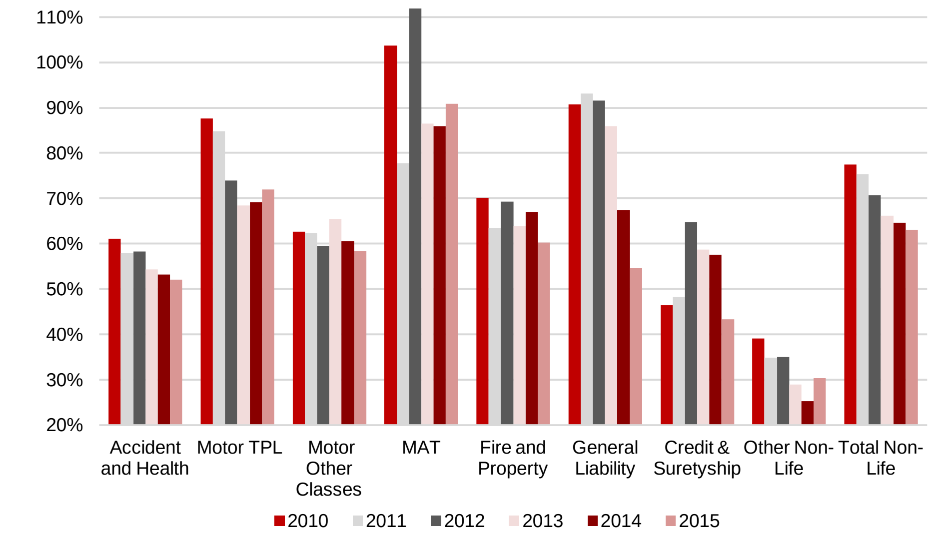




Source: EIOPA, Dagong Europe

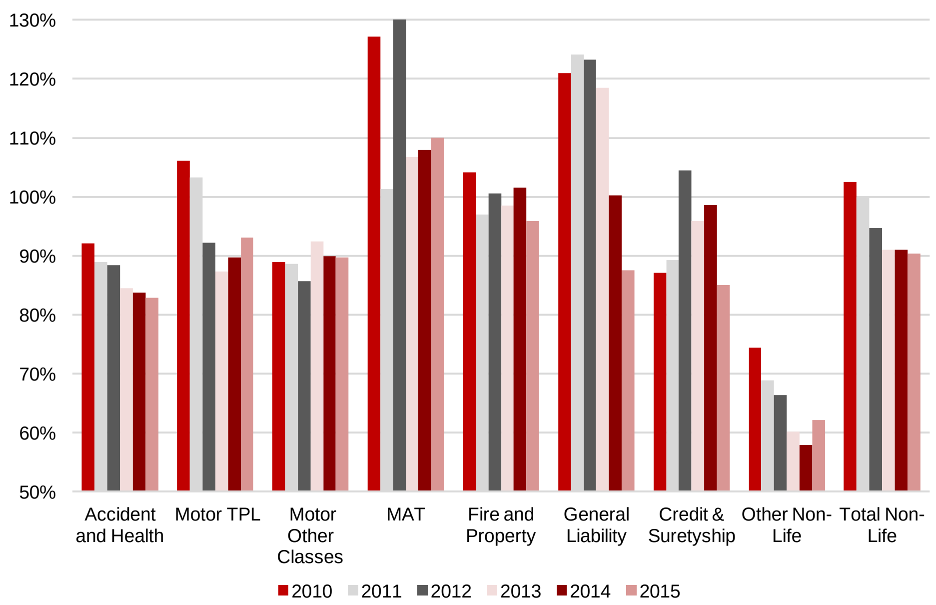
Over 2013-2015 Italian Non-Life sector had strong profitability with combined ratio at around 90% and return on equity of about 9%. In 2016, we observed significant increase in price competition and small increase in claims frequency in motor line, which weakened the loss ratio and lead to combined ratio to about 100%. However, non-motor lines performed better. We expect this trend to continue and Non-Life industry combined ratio to be at about 95-98% in 2017-18. This coupled with decreasing interest rates, lower realised gains and various one-off charges will result in lower return on equity of around 5-7% in 2017-18.

Ex. Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. Combined Ratios by Major Business Line



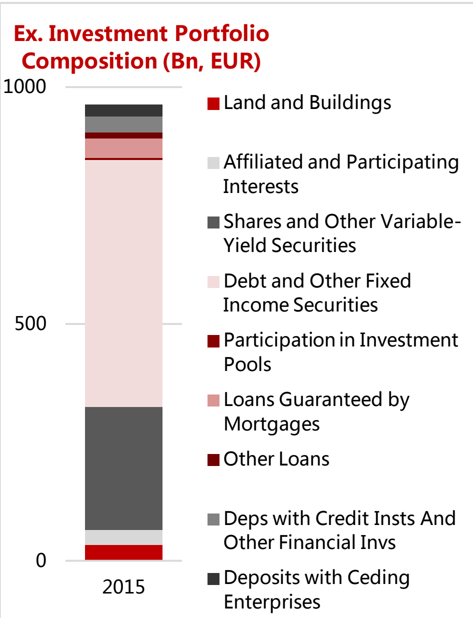
Source: EIOPA, Dagong Europe

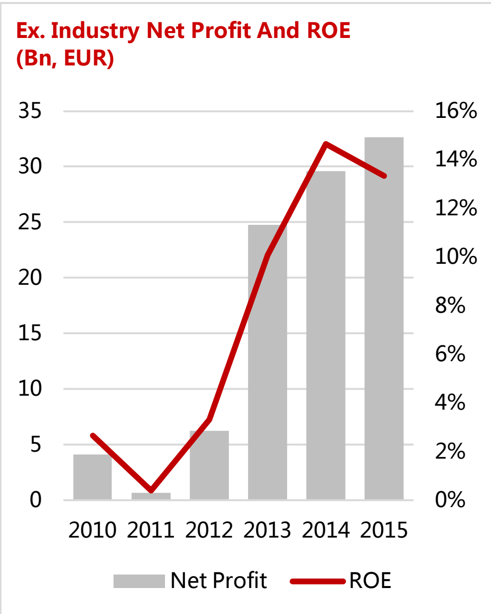
UK

We expect operational environment in UK to remain challenging largely due to high uncertainty and operational risks created by Brexit referendum and regulatory changes. The economy since referendum performed better than expected, however to sustain the growth, especially in the hard Brexit scenario, will be difficult. The negative impact of the Brexit to UK insurance industry, in our view, would come via potential weakening of the economy, asset and FX volatility, delayed business decisions, disruption to business operations, increased cost and use of management time adjusting and increased risk of regulatory change.

We expect regulatory and political risks in UK to be one of the major risks for the industry in 2017-18 illustrated by ongoing pension reforms or recent Ogden discount rate cut (discount rate used for calculating lump sum damages for personal injury claims), which will result in higher cost of claims settled as a lump sum and will have material negative impact to motor insurers' reserves and profitability.

The organic growth opportunities for both Life and Non-Life are limited in our view and therefore use of M&A could become more attractive.





Source: EIOPA, Dagong Europe

We believe that UK Life insurers are likely to maintain strong capitalisation based on high good quality capital base and close asset and liability matching, providing resilience to interest rate movements. However, EIOPA stress test shows on average UK insurance sector is highly reliant on transitional measures in calculating regulatory solvency ratios, which makes it hard to compare and indicates a degree of vulnerability. We also foresee increase in hybrid debt issuance due to attractive pricing and increasing focus on optimization of return on equity.

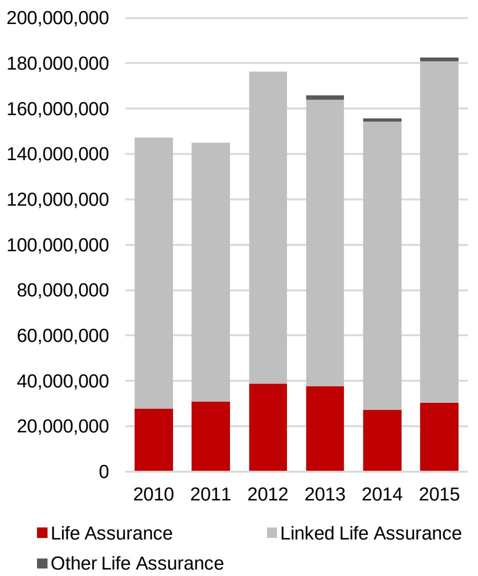
We expect UK insurers' to maintain their investment portfolios well diversified and on average high credit quality. Low yield endowment is driving some of insurers to increase riskier assets in search for a higher returns. We believe slow increase in alternative asset classes such as real estate, infrastructure, direct lending among others will continue in coming years.

Profitability historically has been strong and to large extend reliant on investment income contribution. Going forward we expect profitability to weaken due to low interest rates, high competition and unfavourable regulatory developments.

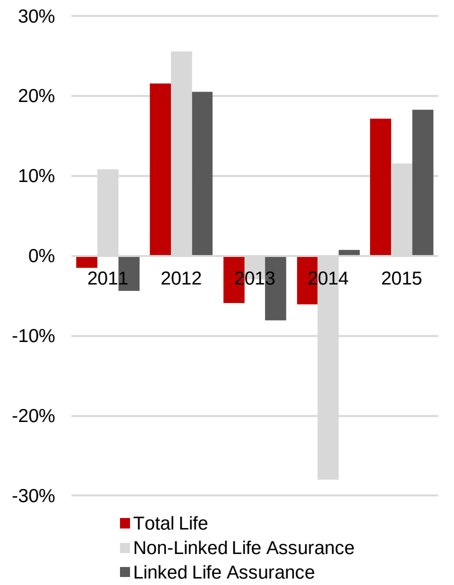
Life

We see low growth opportunities for Life sector in the UK. The industry is dominated by unit-linked products and its growth will be negatively affected by volatile financial markets and low interest rates. We also do not expect material improvement in the annuity sales, which were hit by change in regulation on annuity purchase in 2015. The historic growth rates were volatile and we expect this trend to continue due to current uncertain and volatile environment.

Ex. Life Insurance GPW Development and Composition



Ex. Life insurance Growth Rates



Source: EIOPA, Dagong Europe

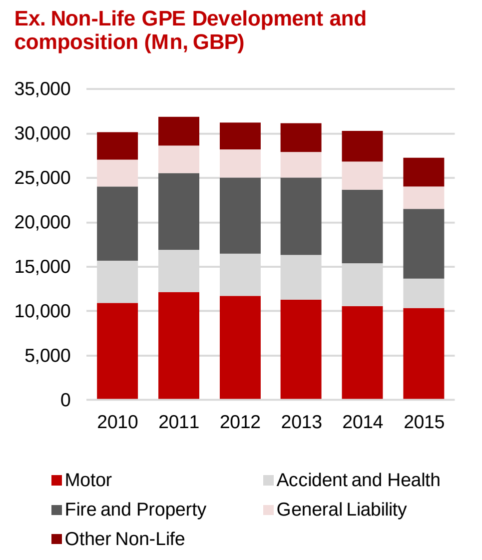
We expect UK Life insurer's profitability to be good, but challenged by low yields, lower fee income from unit-linked portfolio and regulatory scrutiny. We expect to see some consolidation in the market between smaller players with aim to remain profitable and competitive if current challenging operating environment remains.

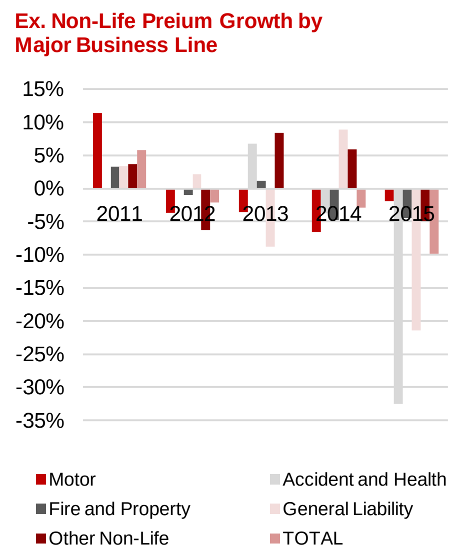
Non-Life

We see the UK Non-Life insurance sector to be resilient and well capitalised, however growth and profitability to face significant challenges from changing regulations, high competition levels and low interest rate environment.

Operating environment we expect to remain challenging, characterised by volatile financial markets, uncertainty created by Brexit referendum and regulatory changes, such as Ogden discount rate cut (discount rate used for calculating lump sum damages for personal injury claims), this will increase costs of claims settled as a lump sum and will have material negative impact to motor insurers' reserves and profitability.

We expect premium volumes for motor insurance to increase in 2017-18, driven by higher focus on underwriting profitability and price increases. While at the same time we expect premiums and pricing on household insurance to come under pressure from increasing use of aggregator websites. Despite fierce competition, we expect motor prices to continue increasing in 2017-18, driven by claims inflation, focus on improving weak underwriting profitability and changes in regulation.

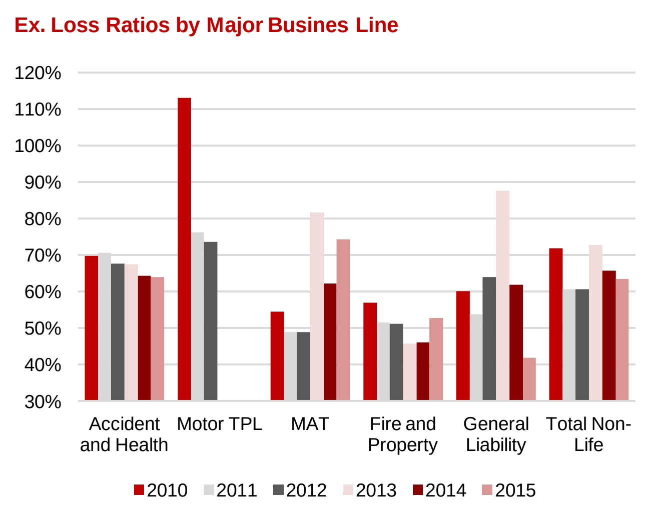


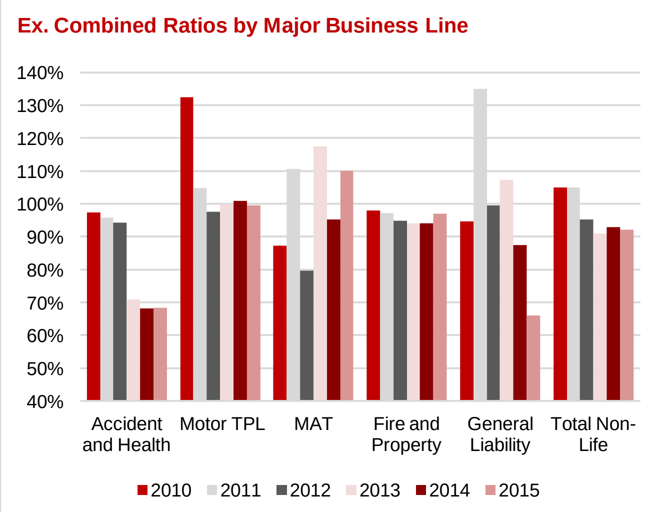


Source: Association of British Insurers, Dagong Europe

We expect Non-Life profitability to remain good but weaken due to regulatory change and decreasing investment income. We expect motor insurance to be loss making or break even on underwriting basis in 2016 with combined ratio of around 100% and in 2017-18 to be similar or few percentage points higher. The key drivers for this negative trend we see as continuing claims inflation, high competition, unfavourable outcome on Ogden's discount rate and difficulty to maintain high reserve releases. We expect cost savings from reforms on whiplash claims to start showing results only from 2018. While household insurance and other product lines, we expect to maintain stronger profit margins and support overall underwriting profitability.

Investment income will continue to be suppressed by low interest rates, but will remain the main contributor to industry's earnings.





Source: EIOPA, Association of British Insurers, Dagong Europe

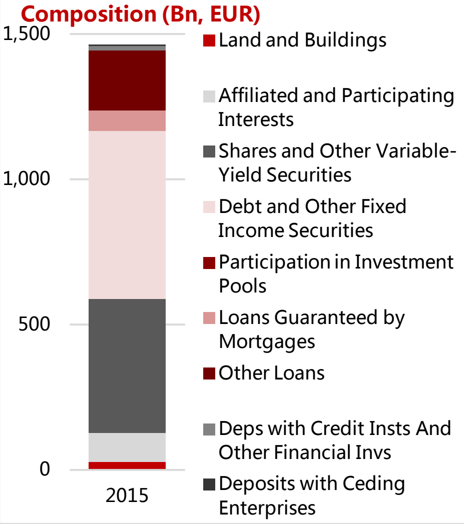
GERMANY

We expect operating environment to remain strong in 2017-18 following strong gross domestic product expansion in 2016, low unemployment, stable and prudent regulation and efficient legal system. However, the enduring low or in cases negative interest rate environment will remain the major risk for the industry, in particular for Life insurers.

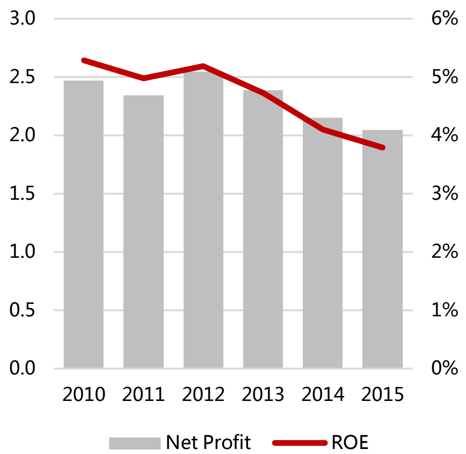
The industry's investment portfolio is well diversified, however exposure to equities is high and exposes capital to volatility. If the low yield environment prevails, we expect the asset mix to shift incrementally towards higher yield, higher risk assets.

The probability of the sector will be constrained by low yield environment and weakening results of Life insurers. We expect overall industry return on equity to be at about 4%, partially affected by higher than average capital levels.

Ex. Investment Portfolio Composition (Bn, EUR)



Ex. Industry Net Profit And ROE (Bn, EUR)



Source: EIOPA, Dagong Europe. The industry profit and ROE numbers include only Life and Non-life companies' results and exclude multilines.

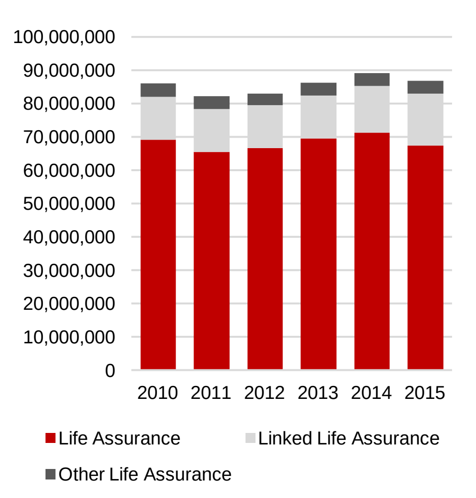
Life

In our view German life sector will maintain strong credit characteristics in 2017-18, based on strong capitalization and, although weakening, but still good profitability. However, at the same time it is vulnerable and sensitive to prolonged low interest rate environment due to its large asset liability mismatch in traditional long-term products with guarantees.

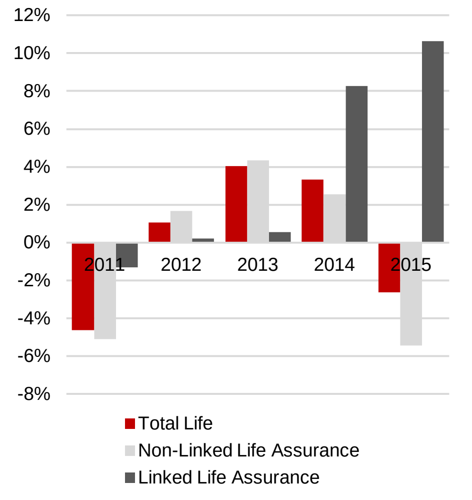
We expect capital to remain strong, however to experience continuous pressure from low interest rates and contracting capital buffers. We also believe that SII regulatory requirements will present material challenges for German life insurers and the scale of that we will be able to judge better in spring after disclose of underlying solvency metrics without transitional measures. We believe that additional reserve requirements (ZZR) introduced by regulator in 2010, will help mathematical reserves to bridge the gap between the book and economic value in the long term.

German life portfolio is dominated by traditional life products with guarantees. The share of linked and capital light products is still low, but is showing positive signs of growth. Despite that, we do not expect more material shift in portfolio structure in the medium-term due to unfavourable financial market conditions, that make it difficult to structure attractive products; customer base used to products with guarantees; and insurers' themselves reluctance to change due to negative impact to cash flows and market shares. For these reasons we expect proportion of traditional products to contract slowly, while linked, hybrid and biometric products to grow only moderately.

Ex. Life Insurance GPW Development and Composition



Ex. Life insurance Growth Rates



Source: EIOPA, Dagong Europe

Source: EIOPA, Dagong Europe

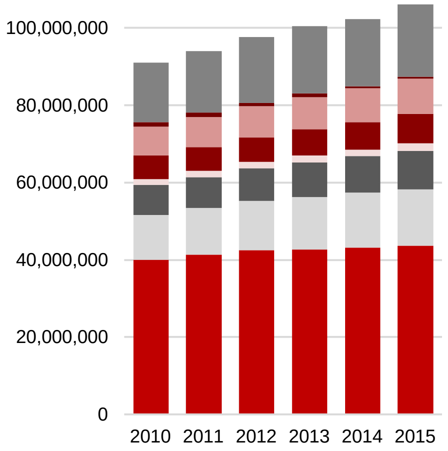
Non-Life

We consider German Non-Life sector to maintain its resilience in 2017-18 with very strong capitalization, good but reducing profitability and moderate growth.

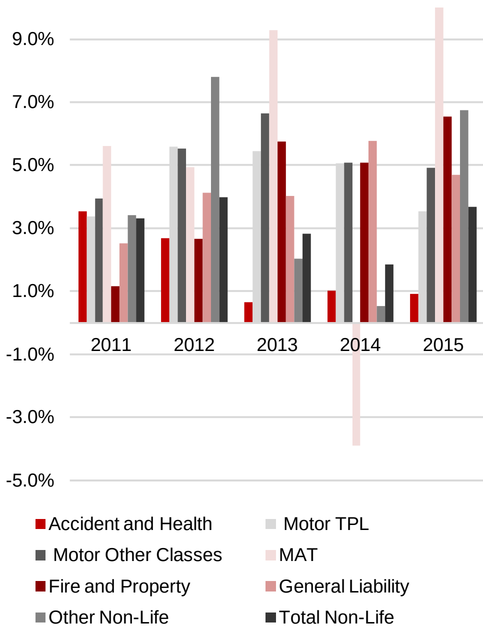
We expect growth in non-life premiums to slow down, but remain higher than that of GDP at about 2%. We expect property insurance to continue fast expansion of about 5% while motor to slow down to about 2%.

We expect capitalisation industry's capitalisation to remain very strong and also show very strong SII ratios.

Ex. Non-Life GPE Development and composition



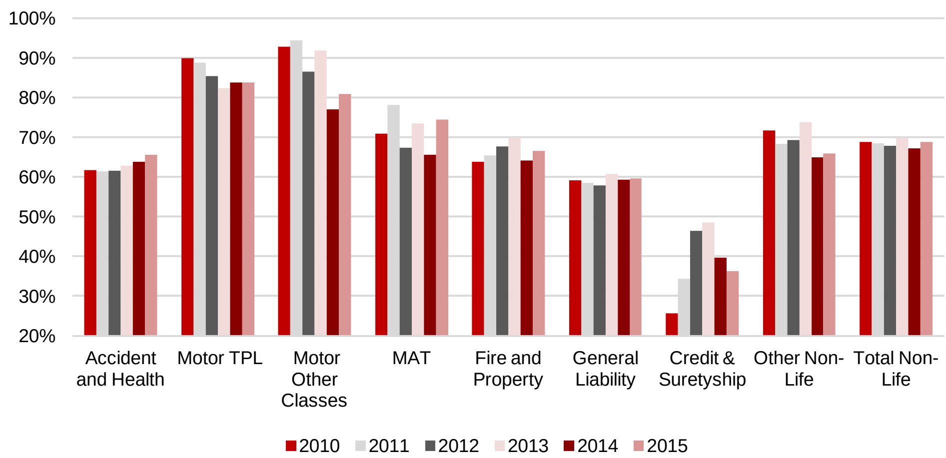
Ex. Non-Life Preium Growth by Major Business Line



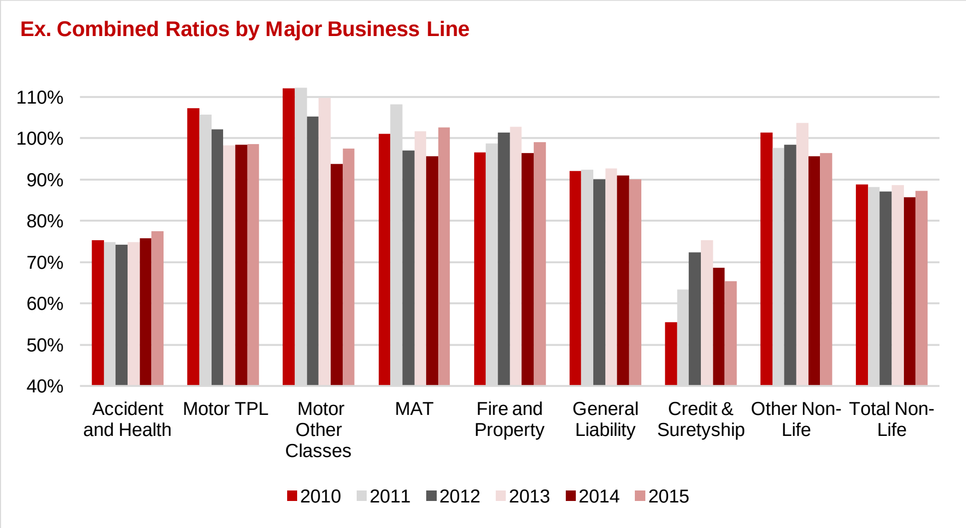
Source: EIOPA, Dagong Europe

We expect profitability in 2017-18 to remain strong, helped by improvement in underwriting results, but still with the largest share of contribution coming from investment income. We expect industry net combined ratios to remain strong in 94-96% range. Motor industry has been showing good underwriting results and we expect it to last as investment income shrinks, however the competition is high and there is a risk of price softening.

Ex. Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe



Source: EIOPA, Dagong Europe

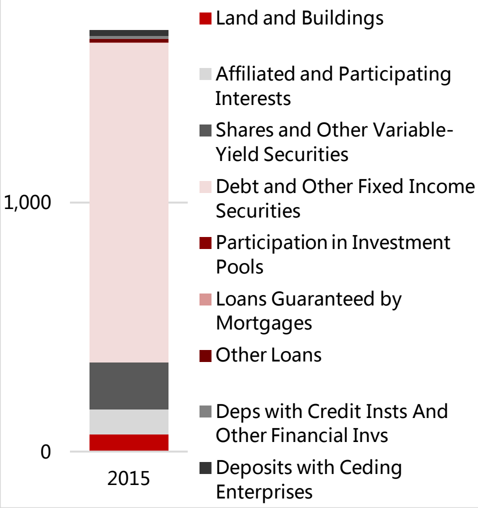
FRANCE

We expect operating environment for French insurers to remain challenging due to low and only slowly improving economic growth, high unemployment rate, low interest rates, high and increasing competition and elevated risk of political and regulatory changes.

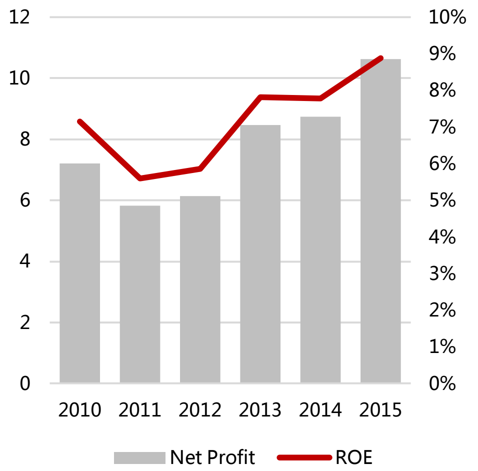
We see French insurance industry as well capitalised and we expect it to show Strong regulatory solvency ratios under Solvency II regime. However as EIOPA's stress test revealed its high sensitivity to "double hit" stress scenario and to lesser extent to "low for long" scenario. The investment portfolios in our view have conservative asset mix and composed mainly of fixed income instruments. We expect investment composition to remain similar, however the share of higher yield – higher risk assets to increase slowly.

We expect profitability of the industry to weaken but remain good in 2017-18 due to prevailing low interest rate environment, high competition and decreasing margins.

Ex. Investment Portfolio Composition (Bn, EUR)



Ex. Industry Net Profit And ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

Life

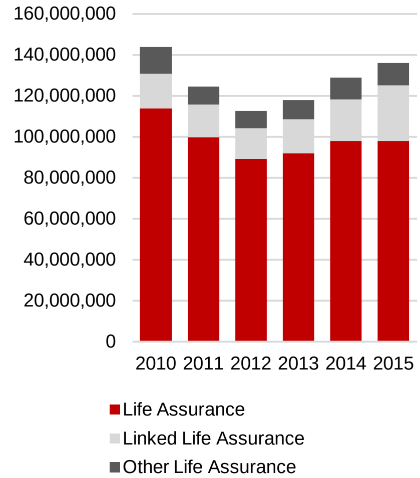
We expect operational environment for French life insurers to remain challenging with the main risks stemming from low interest rates, stagnating economy and regulatory changes.

The historical life book is dominated by traditional business, however the linked business share has been increasing rapidly and driving the growth during the last years. However, the headwinds form unfavourable financial markets conditions and challenging operating environment will constrain the future growth of the industry, in our view.

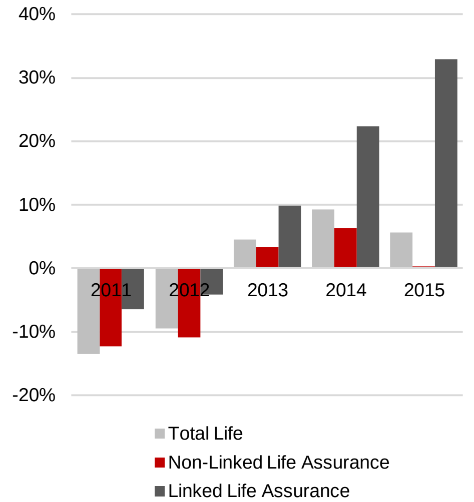
We see French life sector as well capitalised and expect it to remain in 2017-18, however the large share of historical business with guarantees and duration gap between assets and liabilities bring degree of vulnerability.

We expect French life insurers profitability to be good but challenged further in 2017-18 by lower interest rates while supported by strong earnings from protection products.

Ex. Life Insurance GPW Development and Composition



Ex. Life insurance Growth Rates

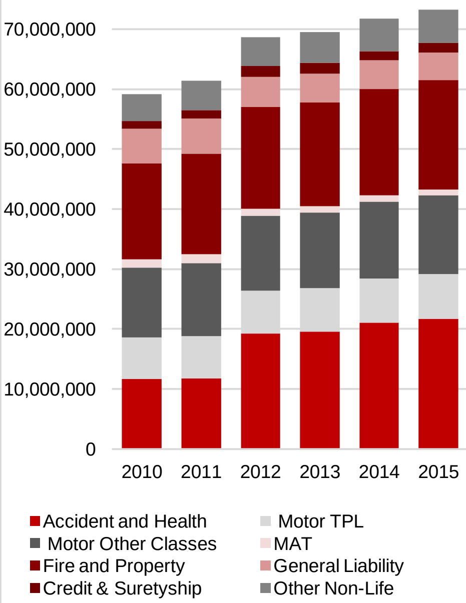


Source: EIOPA, Dagong Europe

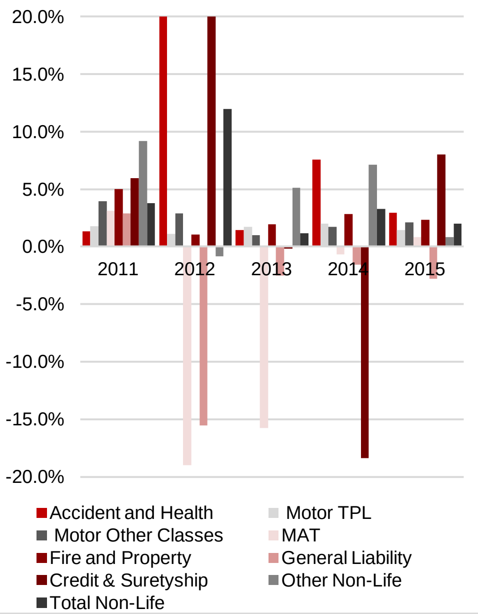
Non-Life

We expect Operational environment for French non-life insurers to be challenging, due to low economic growth, high insurance penetration level, decreasing investment income and risk of regulatory and political changes.

Ex. Non-Life GPE Development and composition



Ex. Non-Life Preium Growth by Major Business Line

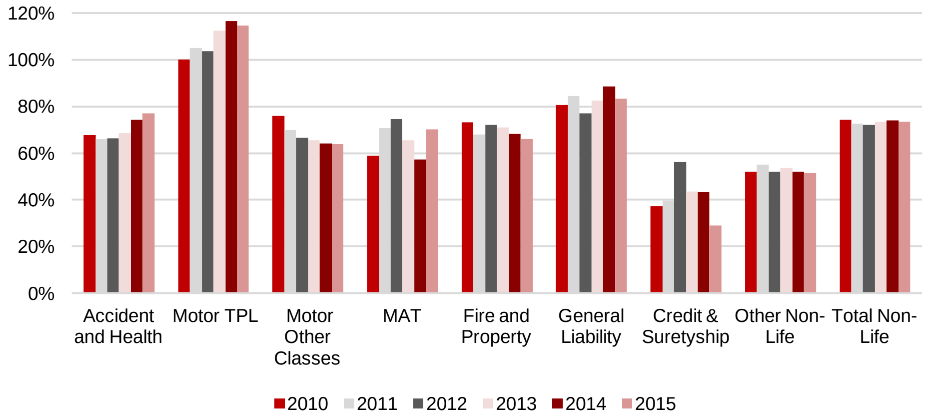


Source: EIOPA, Dagong Europe

The non-life industry has good product mix with motor and property taking largest shares. As in other countries, the competition in motor is fierce and we expect it to continue. It is exacerbated by increasing use of aggregators and the “Hamon law”, which allows policyholders to cancel policies at any time and shop around. However, we expect to see some growth and price hardening to offset increasing claim’s frequency and costs.

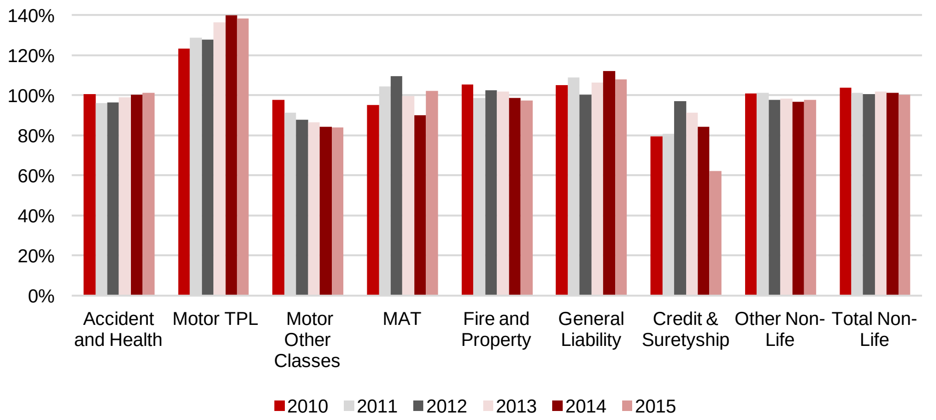
Underwriting profitability historically has been poor and reliance on investment income high. We expect this trend to start changing and some more prudence at least in some business lines as investment income decline. The unfavourable development of natural catastrophes could hit profitability, but also could encourage more prudence and hardening of the prices in the medium term. In our view, the improvement in profitability is more likely to come from increased efficiency and reduced costs.

Ex. Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe
Source: EIOPA, Dagong Europe

Ex. Combined Ratios by Major Business Line



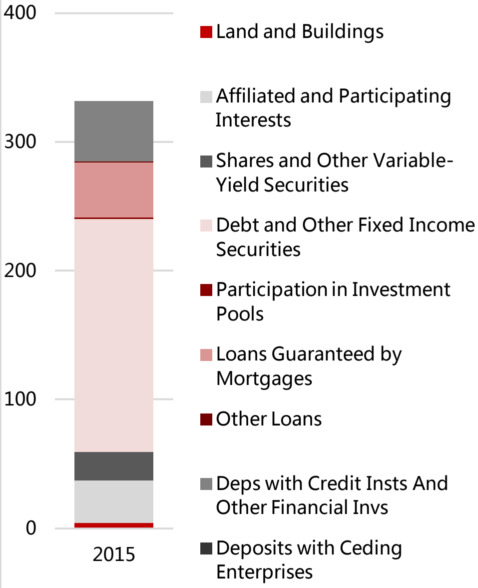
NETHERLANDS

We expect operating environment for Dutch insurers to be challenging in 2017-18, in particular for life insurers, due to highly competitive environment, high regulatory requirement and weak technical profitability.

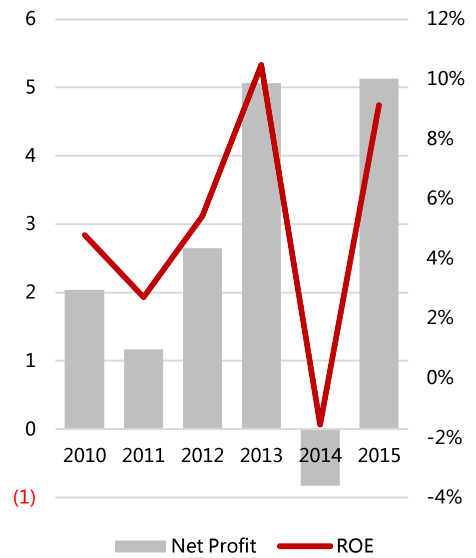
Historically industry's profitability has been volatile and negatively affected by changes in operating environment, regulation, reducing investment yields, increasing claims costs, high competition and weather related losses. In 2017 -18 we expect it to stabilize and deliver more stable returns with ROE of about 5-8%, helped by optimised operations and reduced costs, adoption of new technologies and innovation and more prudent underwriting.

We consider Dutch insurers investment portfolios to be prudent and relatively well diversified with the main focus on fixed income instruments. In addition, it has a larger share in loans and residential mortgages, which carry relatively less risk compared to other countries, due to very well set-up and efficient legal framework and low default rates.

Ex. Investment Portfolio Composition (Bn, EUR)



Ex. Industry Net Profit And ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

Life

We expect operational environment for Dutch life insurers to be challenging in 2017-18 due to low interest rate environment, high competition, unfavourable financial markets and tougher regulatory requirement on solvency margins.

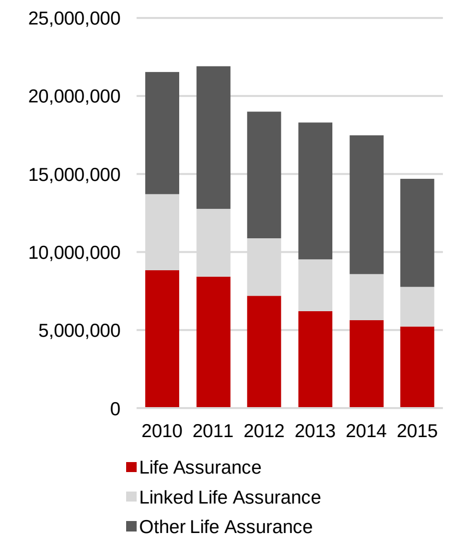
Life premium volumes have been decreasing for number of years and we also expect this trend to continue in 2017-18. This reflects industry's shift from traditional guaranteed savings business to more capital efficient products, such as unit linked or asset management products. The new business is growing, but facing challenging financial market conditions and is not able to offset maturing book of traditional products.

This shift has negatively affected insurers' business growth and the profitability, however it has improved Dutch life insurers risk profile, helped to prepare for more prudent SII regulatory requirements and positioned better to face changing customer needs and operating environment. We consider this approach to have positive effect on industry's long term sustainability, while some other major Life industries in other countries were reluctant to do and will be facing more serious challenges.

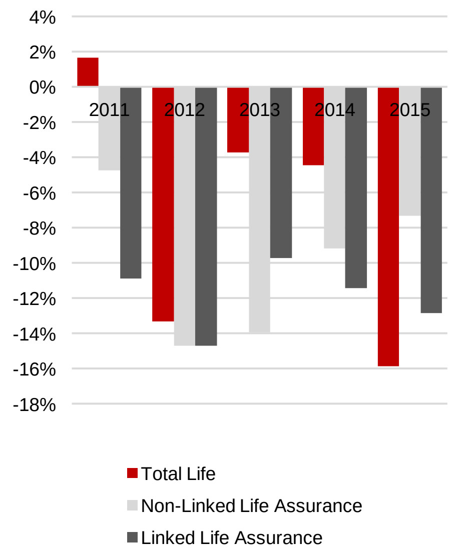
We regard industry’s capitalization as strong however exposed prolonged low interest rate environment, widening of credit spreads, assumption changes behind best estimate of reserves and in particular reduction in ultimate forward rate.

We expect industry’s profitability to remain weakened, due to a shift to lower risk, lower margin products and high competition. However, we expect earnings to improve as efforts on cost optimization, innovation and new product development start to pay off. In addition, some consolidation in the industry could also have positive effect on earnings and capitalization.

Ex. Life Insurance GPW Development and Composition



Ex. Life insurance Growth Rates

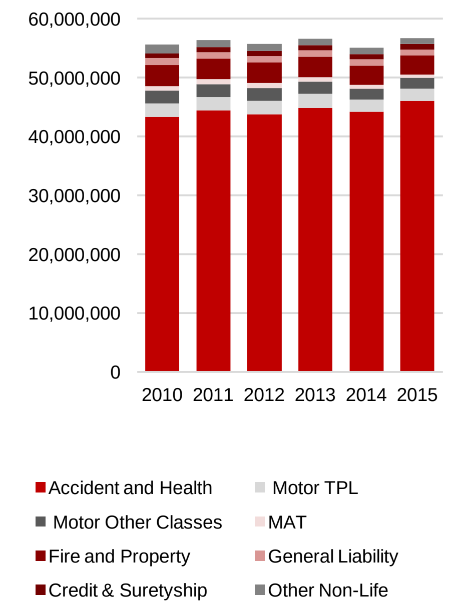


Source: EIOPA, Dagong Europe

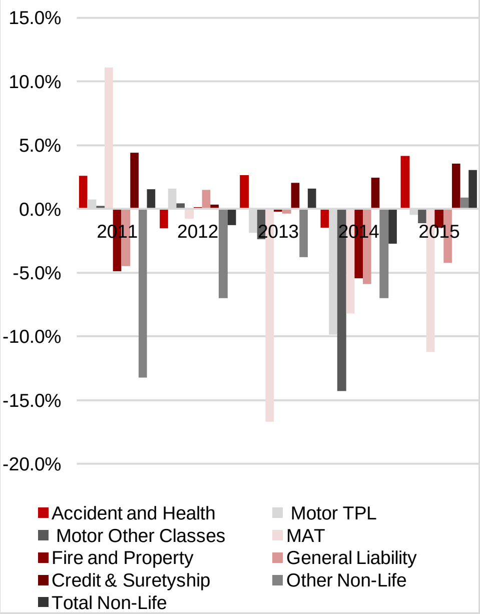
Non-Life

We expect operating environment for Dutch non-life players to remain challenging due

Ex. Non-Life GPE Development and composition



Ex. Non-Life Preium Growth by Major Business Line



to high industry saturation and intense competition, low interest rate environment and increasing claims frequency and severity.

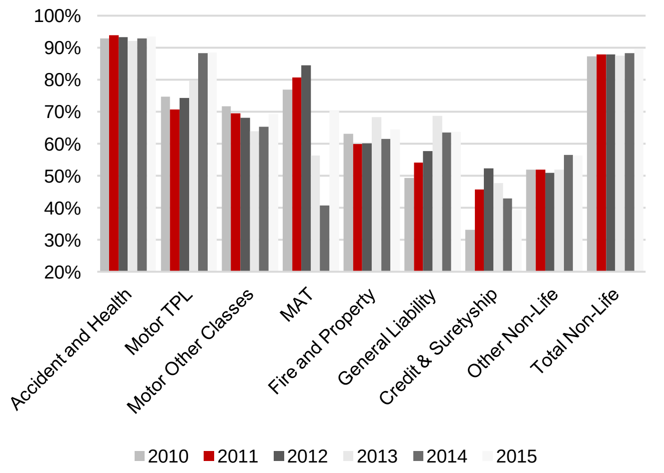
Source: EIOPA, Dagong Europe

We expect industry to maintain large capital base and on average strong regulatory solvency, however we recognise its volatile nature and sensitivity to interest rate fluctuation and widening of credit spreads.

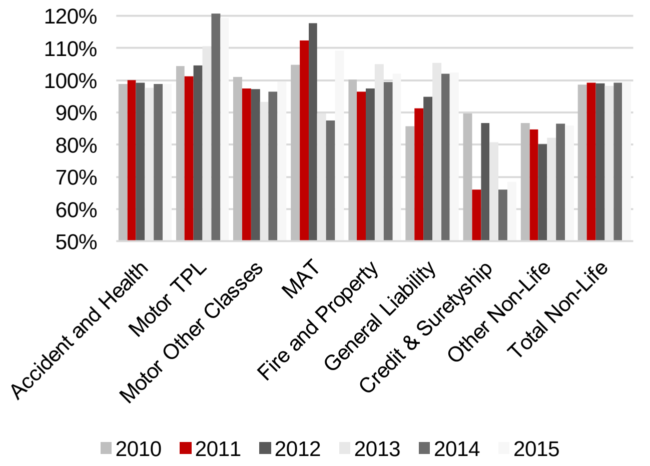
Source: EIOPA, Dagong Europe

Dutch non-life industry is well diversified on traditional non-life business lines, however unique with its health and accident (H&A) line, which dwarfs other non-life product lines. It is mandatory to have health insurance in Netherlands and it is the major driver behind its size. In addition, H&A insurance was the major growth area and reason for overall relatively stable Non-life industry's premium volumes.

Ex. Loss Ratios by Major Busines Line



Ex. Combined Ratios by Major Business Line



SPAIN

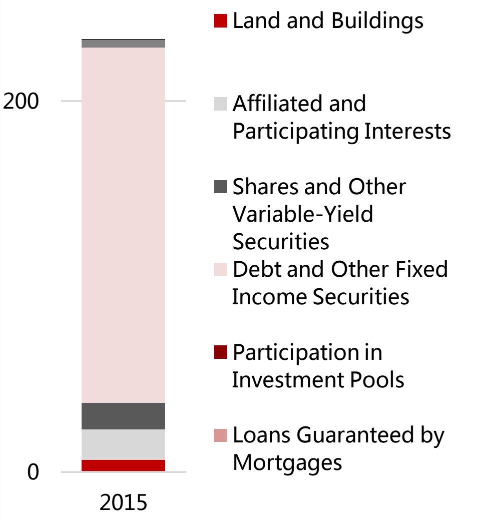
We expect that operating environment for insurance sector in Spain will be challenging, but improving in 2017-18 supported by improving economic growth, improving domestic financial system and asset quality. However low interest rates, high coopetition and regulatory changes will continue challenging the industry.

Historically the industry delivered strong profitability with ROE averaging about 14%. It started to weaken in 2015 due to decline of investment income and reached ROE only of about 9%. We expect this trend to continue in 2017-18 largely due to prevailing low interest rate environment and increasing competition.

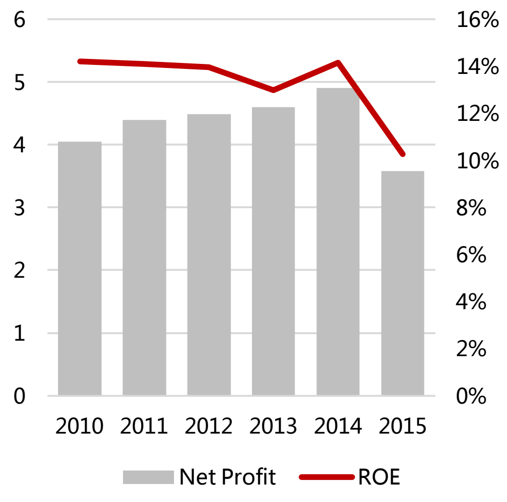
We expect investment portfolio to maintain conservative asset mix and predominant concentration in fixed income instruments. However, we expect some increase in in higher-yield higher risk assets as companies try to support falling returns.

Capitalization we expect to be strong and supported by good capital base, close asset and liabilities matching and conservative investment portfolio composition.

Ex. Investment Portfolio Composition (Bn, EUR)



Ex. Industry Net Profit And ROE (Bn, EUR)



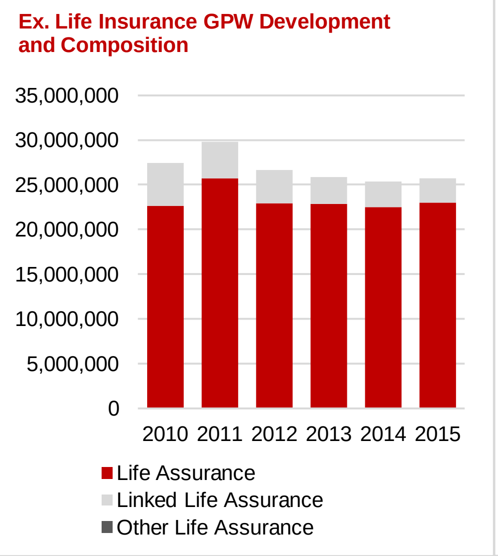
Source: EIOPA, Dagong Europe

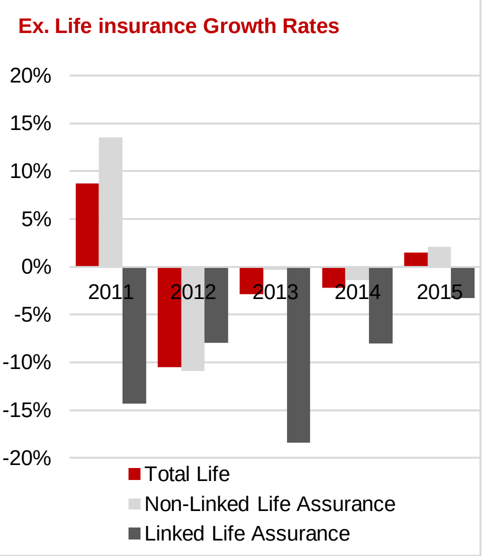
Life

Spanish Life industry premium volumes have been reducing in 2012-2014, due to do challenging economic and financial environment, however since 2015 we see return of growth, helped by recovery of economy, increasing banking distribution activities and mortgage lending. We expect industry to grow about 3-5% in 2017-18.

The product portfolio predominantly consist of traditional products. New business in linked products started to grow in 2015 and we expect the pace to increase. The industry benefits from good asset liability matching and long-term life reserves being close to economic value.

We expect sector's profitability to weakening due to decreasing investment returns, but remain good.

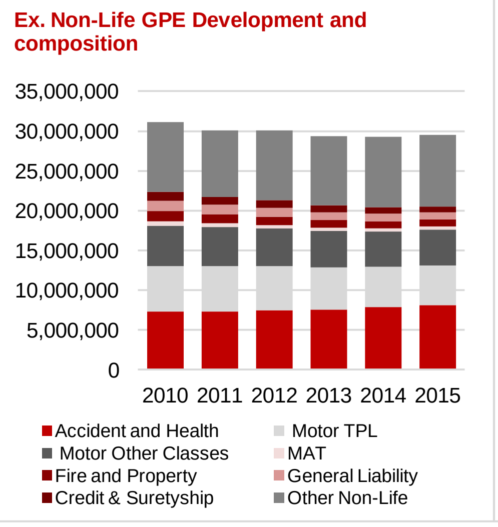


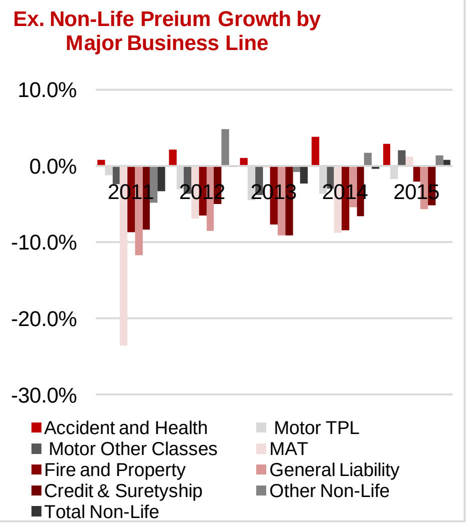


Source: EIOPA, Dagong Europe

Non-Life

We expect Spanish Non-life industry to recover and grow at about 3-5% in 2017-18, helped by improving economy. The industry is well diversified and we see signs of recovery across all major business lines.

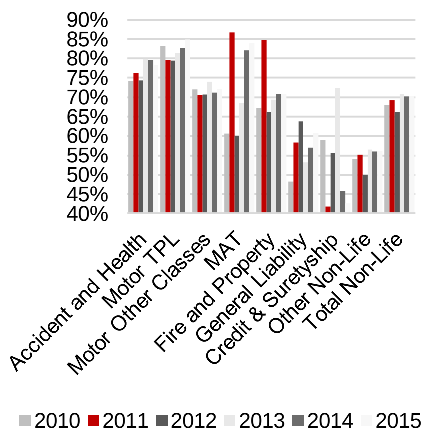




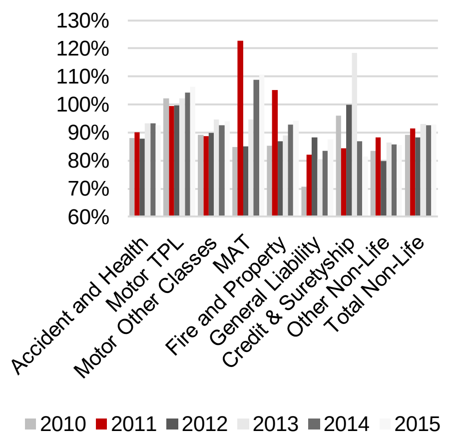
Source: EIOPA, Dagong Europe

We also expect Spanish non-life industry to show good overall profitability. Underwriting results to remain strong supported by improving economic environment and combined ratios of about 93-95% in 2017-18. However, it will be constrained by high pricing completion and claims inflation which might inflate loss ratios.

Ex. Loss Ratios by Major Busines Line



Ex. Combined Ratios by Major Business Line



Source: EIOPA, Dagong Europe

PORTUGAL

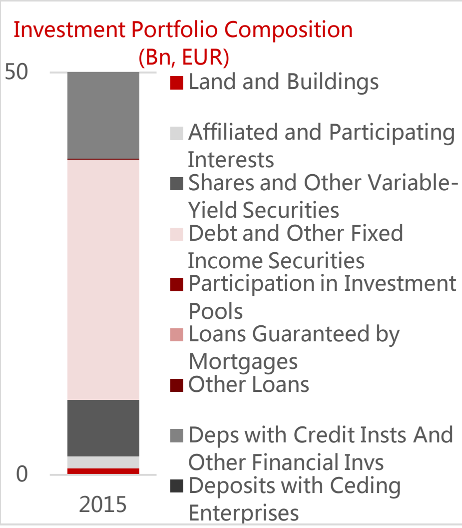
In our view, operating environment in Portugal is challenging due to weak economic fundamentals, volatile domestic financial markets and low interest rate environment.

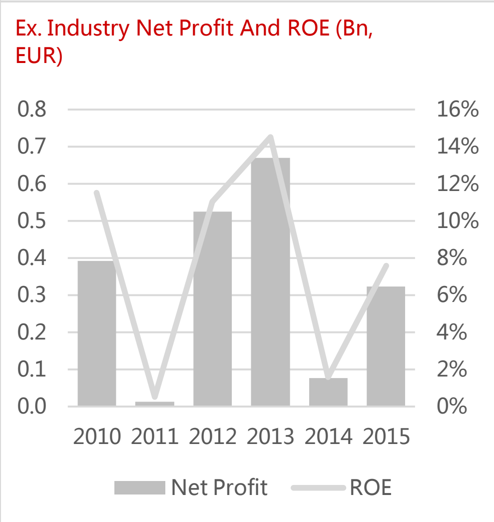
Portugal's insurance sector is dominated by Life insurance, however due to rapid contraction in last few years and return of growth in the Non-life industry, its share of total premiums reduced to about 63% end of Sept 2016. We expect this trend to continue in 2017-18.

We perceive industry capitalisation to be satisfactory. Its regulatory solvency ratio is relatively low at 137% in Sept 2016, however has been strengthening and we expect this trend to continue in 2017-18 also.

Investment portfolio has conservative asset mix dominated by fixed income instruments, cash and deposits. We expect industry to increase slightly its share in higher risk higher yield assets, but overall to maintain this mix.

Historically industry's profitability has been very volatile with ROE ranging from 1% to 14% during last five years. We expect profitability to be satisfactory in 2017-18 and face pressure from decreasing investment income (in high single digits over the last few years), reducing life business volumes and profitability and increasing competition. The main profits contributor will remain Non-Life business and its strong underwriting performance.



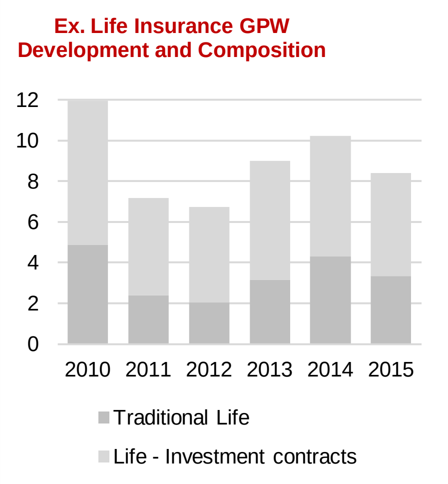


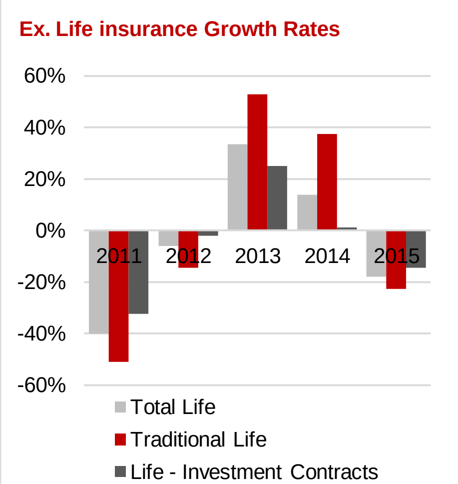
Source: EIOPA, Dagong Europe

Life

We see operational environment for Portugal's Life insurers as challenging, significantly affected by low interest rate environment, onerous regulatory requirements, weak economic fundamentals, weakened and not so active banking sector, which is also the main distribution channel of Life insurance products.

This week operating environment had significant negative affect to Life insurance growth in particular in the last two years (27.5% in thirst 3 quarters of 2016). Unless economy and banking sector starts showing higher level of activity, we expect life industry to continue to shrink in 2017, however to stabilise in 2018.

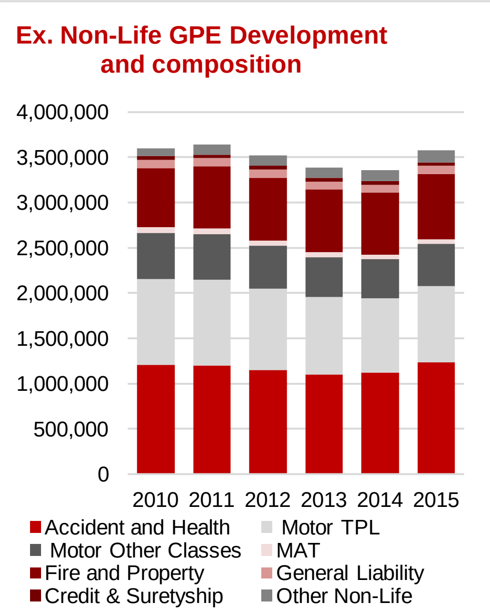


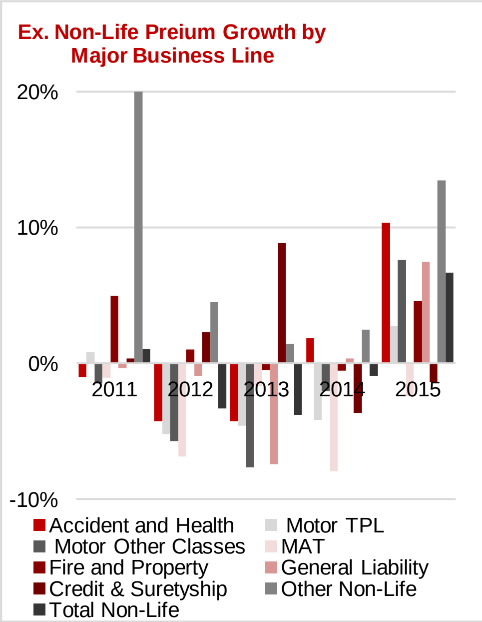


Source: ASF, Dagong europe

Non-Life

After three years of premium decline 2015 and 2016 shifting the trend and show improving **growth** rates across most of the Non-Life business lines and we expect this to continue (6.3% in Sept 2016) in 2017-18 with volumes increasing at about 5-7%. The growth is supported by slowly improving economic environment and focus on technical profitability.

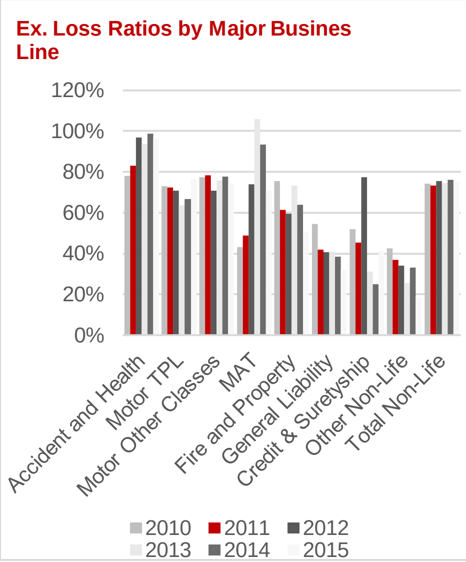


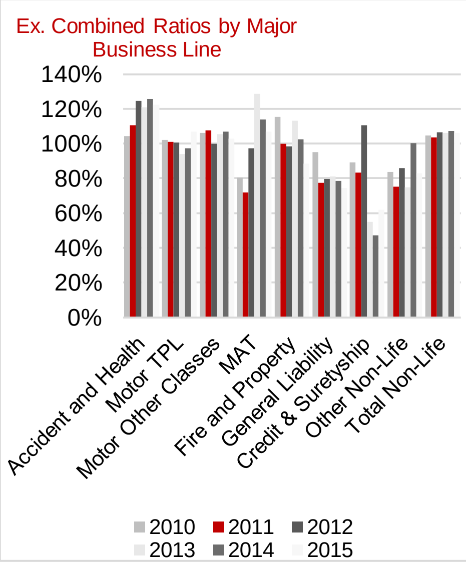


Source: ASF, Dagong Europe

The claims in the sector rose faster than premiums during 2015-16. We expect that loss ratio will experience more pressure in 2017-18, due to increasing competition and claims costs inflation, however stay at about 70%.

Looking at major business lines, workers compensation had very week loss ratio of 98.2% in Sept 2016. We see an improving trend over the last 3 years, helped by premium increases, however there is still a lot work to be done before it gets to more normal levels. The other lines showed significantly better results with motor and health business reporting loss ratios at 74.4% and 68.5% respectively.





Source: EIOPA, Dagong europe

5. METHODOLOGICAL NOTE

We base our analysis and opinions on data from EIOPA, regulatory disclosures, aggregated industry players' financials covering more than 50% of the industry's premiums and our experience and expertise. Majority of our charts and graphs are based on EIOPA statistics in order to have more comparability. However, in cases where domestic regulator's data significantly differ from that disclosed by EIOPA, we apply analytical judgement in presenting data which is more representative of the industry and its trends. For the macro and financial markets related parts, we use data from Bloomberg and SNL Financial.

大公欧洲资信评估有限公司
DAGONG EUROPE CREDIT RATING

Via dell'Orso 8, 20121 Milan Italy
Tel (+39) 02 72746011, Fax (+39) 02 72003544
www.dagongeurope.com