European Insurance Industry Outlook

2017 and Beyond

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Commentary

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1. INTRODUCTION

2016 was a relatively benign year for European insurers despite the highly uncertain and volatile operating environment. Although the preliminary 2016 year end results have just been released, the following main trends can be clearly identified:

- The macro and political environment constrained insurance industry in Europe with continuing low economic growth, significantly increased political risk due to highly unlikely and improbable events actually happening (Brexit, the US presidential election, etc.) and elevated volatility of the financial markets and FX.
- While the interest rates in Europe reached new lows, FED has started to raise them in the US and is widely expected to repeat it at least a few more times in the next 12 months.
- The life business growth was challenged by reducing yields, the low and in some cases negative interest rate environment that resulted in shrinking business volumes and reducing profitability. The new and more prudent solvency regime with high-risk based capital requirements has resulted in many Life companies changing their product portfolios and increased costs of complying with regulations.
- The Non-life business growth was more resilient, but still challenged by increasing competition and slow economic growth.
- The profitability weakened due to reducing investment income, tightening underwriting margins and various optimisation and reorganisation costs.
- The natural catastrophe level increased (highest in the last four years) but made no major negative impact to the industry's earnings or hardening in pricing.
- In our view, the capitalisation of the industry was strengthened, largely driven by industry adjusting to more prudent capital requirements from the new Solvency II regulatory regime.

In this commentary, we will present our expectations for the European insurance industry and the main European insurance markets in 2017 and beyond (the UK, France, Germany, Italy, the Netherlands, Spain, and Portugal). These countries together comprised about 72% of the total European insurance premiums in 2015. We believe that many of the 2016 trends will continue while we also see some new and evolving risks and opportunities going forward. The uncertainty, the constant change and the low yield environment will remain the key themes, while the ability to adapt quickly and make the right long-term decisions will be the key differentiating factor for long-term success, in our view.

2. METHODOLOGICAL NOTE

We base our analysis, opinions, and expectations on data from EIOPA, regulatory disclosures, aggregated industry players' financials and our experience and expertise. The majority of our charts and graphs use EIOPA statistics to allow more comparability and consistency across the countries, because differences in depth and breadth among individual regulator's disclosures vary significantly. However, it does not capture all data consistently either. In cases where data disclosed by EIOPA and regulators vary significantly or have coverage gaps, we apply our analytical judgement in presenting the data that is more representative of the industry and its trends. The figures showing market players' premiums and performance represent the domestic operations and exclude the foreign operations.

For the macro and financial market related parts, we use data from Bloomberg, Eurostat, IMF and Dagong Global.

3. 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, amplified political risk, and increased regulatory burden. In addition, increasing competition, persistent low and in some cases negative interest rate environment suppress growth and elevate pressure on profitability and return on capital. These, coupled with risks and opportunities coming from rapid advances in innovation and technological progress, changing consumer needs and lifestyles will challenge insurers' established business models and sustainability in the medium and long term. Having said that, we expect that in the next two years, European insurance industry will maintain its robust credit characteristics based on strong capitalisation, high liquidity, and prudent risk management, and also helped by improving governance and close regulatory supervision.

Main Expectations 2017-18:

- We expect the operating environment on average to remain challenging and uncertain with improving but still low economic growth and low or negative interest rates at least until 2018. However, we believe that yields in some countries could rise if political risks were to increase.
- We expect Non-life insurance premiums to grow at about 1.5-2% just below the European Union GDP growth[1], 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.
- On average, we expect similar or lower asset risk levels and improved investment management largely due to stricter Solvency II regulatory requirements. However, we also expect that some insurers will increase asset risk in search of higher yields by venturing to higher risk and more complex asset classes such as real estate, infrastructure, speculative grade credit, equities, etc. In addition, we expect that investment choices continue to be reduced by ECB's Quantitative Easing (QE) program, which absorbs a large amount of high quality assets.
- We expect pricing trends to vary significantly between countries, but on average, to soften slightly or remain the same at best. We expect competition to intensify and put pressure on pricing, partially offset by the industry's increased focus on underwriting profitability, improving efficiency and effectiveness of distribution channels, claims handling and reducing operating costs.
- We believe that merger and acquisition (M&A) activity and industry consolidation will continue and are likely to gain pace, driven by more favourable regulatory solvency calculation terms for large and better-diversified companies, lack of organic growth opportunities in most mature European markets, divestments and need to support profitability 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 streamlined organisational structures.
- We also expect the 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' credit characteristics. However, in the long term, we expect the

[1] Relative to IMF expectations for EU real GDP growth.

industry to find a way to transform and adapt to the rapidly changing world and become more relevant, robust, efficient and agile.

From the credit risk perspective in the 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 stemming from weakening capitalisation levels due to lower profitability, increased risk taking or capital reduction to improve return on equity. While in the long term, we believe the major challenge will be to adapt business models to rapidly changing operating environment, keep up with innovation and technology, stay relevant and satisfy ever-changing needs from the customers and business partners and ensure sustainability for policyholders and shareholders.

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

- **Prolonged low yield and low-interest rate environment** – is challenging insurers' profitability, but could also lead to a need to significantly strengthen reserves, in particular for Life insurers. In our view, if the current low-interest rate environment were to stay for longer than five years, the capital and profitability of Life insurers would show signs of significant weakening, especially those having a large book of long-term products with guaranties and large asset liability mismatch.
- **Cyber and data security** – cyberattacks on insurers' IT systems pose increasing threat and possibility of major operational disruption, loss of private data, significant reputational damage or financial loss. At the same time, aggressive underwriting of cyber risks could also lead to major losses.
- **Innovation and technology** – such as artificial intelligence, data analytics, robotics, mobile, wearables etc., are developing faster than ever and if not considered seriously can leave insurers' long-established business models obsolete, unprofitable and unable to reach and serve customers and business partners.
- **Regulatory risk** – while meant to protect industry stability and policy holders, the fast pace of change of laws and regulations, increased complexity and costs are putting significant financial and operational burden on insurers.
- **Geopolitical risk** – increased uncertainty and instability of geopolitical environment in Europe and across the World can have significant, wide-reaching negative and disruptive effect on businesses, FX rates, financial markets, regulation, people's lifestyles and social stability, among others. The real impact from these major recent causes of elevated uncertainty– Brexit and Trump's presidency, is yet to be seen. In addition, upcoming French elections and other political developments across Europe and neighbouring countries add to the level of uncertainty for potential business disruption and increased expenses.

Main opportunities

- Innovation & technology is developing faster than ever and is already challenging the long-standing insurance business and operating models. In the coming years, it will be the major driving force for a radical change and reinvention of insurers' business models and the main way to adapt to changing operating environment and customer needs. Increasing investments in innovation and technology in the current challenging operating environment could be a hard sell, but we strongly believe, that it is one of the most important strategic decision and opportunities the industry has to make. We believe that technology and innovation can help to reduce insurance protection gap in developing and mature markets, drive industry growth, improve efficiency and profitability.

Some of the major innovations and advances changing insurance world:

- Adoption of a block-chain and smart contracts in creating new products, enhancing distribution, claims management, allowing faster and more efficient interaction with customers and eliminating need for intermediaries.
- Increasing use of big data, advanced analytics, sensor connectivity (telematics, wearables, etc.) in customer analysis and segmentation, new product development, underwriting and in other areas.
- Spread of mobile technology and its use in almost every step of insurance process from marketing to claims settlement. It enables faster and broader client base reach, lowers transaction costs and encourages new product development, in particular on demand insurance.
- Various InsureTech companies[2] using aforementioned technologies and innovations or finding new ways to improve or eliminate existing processes are making good progress in challenging and changing the status quo.

- Growing M&A opportunities helped by difficult operating environment, more stringent regulatory requirements that encourage consolidation and divestiture, and the low valuations of the insurance companies. We expect the number of M&A deals to increase as it is one of very few ways to grow and improve profit margins in this challenging environment.

[2] Such as MetroMile, CoverFox, Oscar, fitSense, MyFutureNow, Lemonade and many others.

4. EUROPEAN INSURANCE INDUSTRY - 2017 AND BEYOND

Operating environment

The 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 some cases negative interest rate environment, volatile equity markets and fierce competition exert pressure on profitability and capitalisation. These factors, together with rapid innovation and technological progress and change in consumer needs and lifestyle are challenging insurer's established business models and long-term sustainability.

Macro environment

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

The macro-economic fundamentals and development trends of the European countries vary significantly. On an overall basis, we consider Europe to have good fundamentals based on large population, strong GDP per capita, and relatively high insurance penetration level, however, to suffer from higher unemployment rate and low economic growth. Comparing with the top three insurance markets in the world – the US, Japan and China, in our view, the macro conditions in Europe will be more supportive for industry growth than in Japan, but less than in China and the US.

Tbl.1 2015 Macroeconomic Data and GDP Growth Estimates

Country	Population (Mn)	GDP per Capita (USD)	Unemployment	Estimated GDP Growth		
	2015			2016	2017	2018
Germany	81.2	40,953	4.6	1.7	2.2	2,1
UK	64.9	43,902	5.3	1.8	1.6	1.0
France	66.4	37,653	10.4	1.3	12	1.4
Italy	60.7	29,866	11.9	0,8	0.7	0.8
Spain	46.4	25,843	22.1	3.1	2.3	2.0
Netherlands	16.9	44,322	6.9	1.7	2.3	2.0
Portugal	10.4	19,117	12.6	1.0	1,5	1,5
US	321.6	56,083	5,3	1,6	2,3	2,1
China	1373.5	8,140	4.1	6.6	6.5	6.3
Japan	127.0	32,478	3,4	0.5	1.2	1.0

Source: 2015 & 2016 macro data of European countries: Eurostat; GDP per capital of all countries and other macro data of USA, China and Japan: IMF; 2017-2018 GDP growth estimates: Dagong Global.

Investment environment

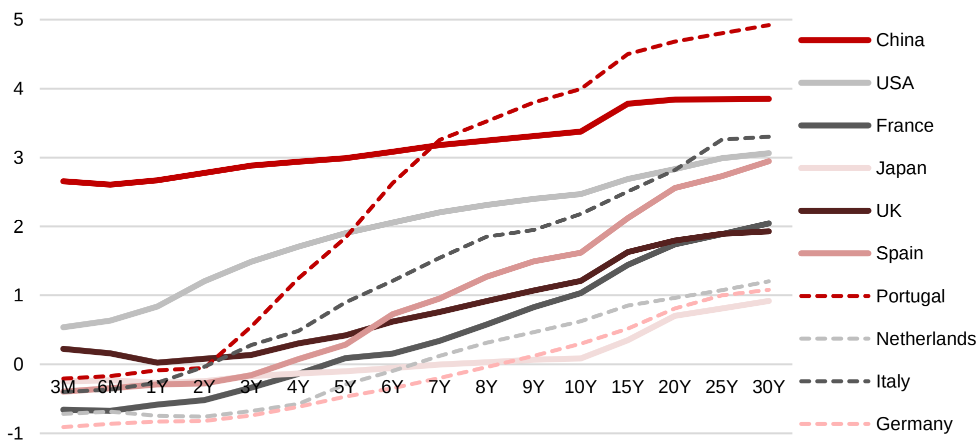
While the quantitative easing and low-interest rates meant to stimulate the economy and create a window of opportunity for businesses to get cheap financing, grow and fuel consumption, it has a negative effect on insurance and banking industries, especially on Life insurance. The low-interest rates have reduced the attractiveness of Life products, diminished investment income – the major source of profitability for the industry especially for Life, eroded insurers' reserves and in some cases capitalisation.

We expect low or negative interest rates in Europe to remain at least until 2018 as ECB continues its commitment to economic stimulus and policy of interest rates following the path of inflation. However, we believe that yields on debt instruments could rise if political risks were to increase. In Feb 2017, all countries with the largest insurance industries apart from the UK had negative yields on sovereign debt issuances at the auction date for maturities up to two and some up to six years. Germany had negative interest rates on its debt up to eight years and at a very comparable level with Japan for durations above eight years.

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

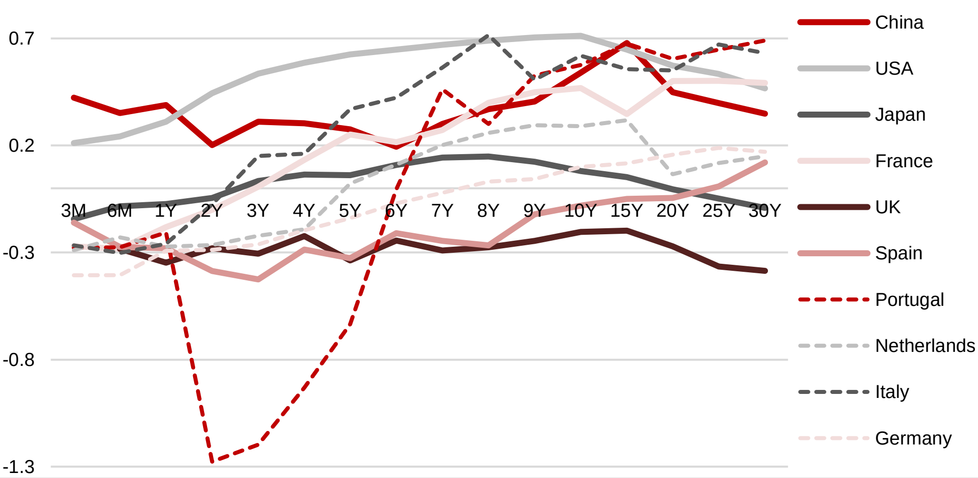
The insurance industry is one of the biggest investors in the sovereign debt, which also comprises the major part of the industry's investment portfolios. Therefore, significantly reduced and in some cases negative interest rates have a major impact on the industry's profitability, product offering,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

Ex. 1 Government Bond Yields - Feb 2017



Source: Bloomberg, Dagong Europe

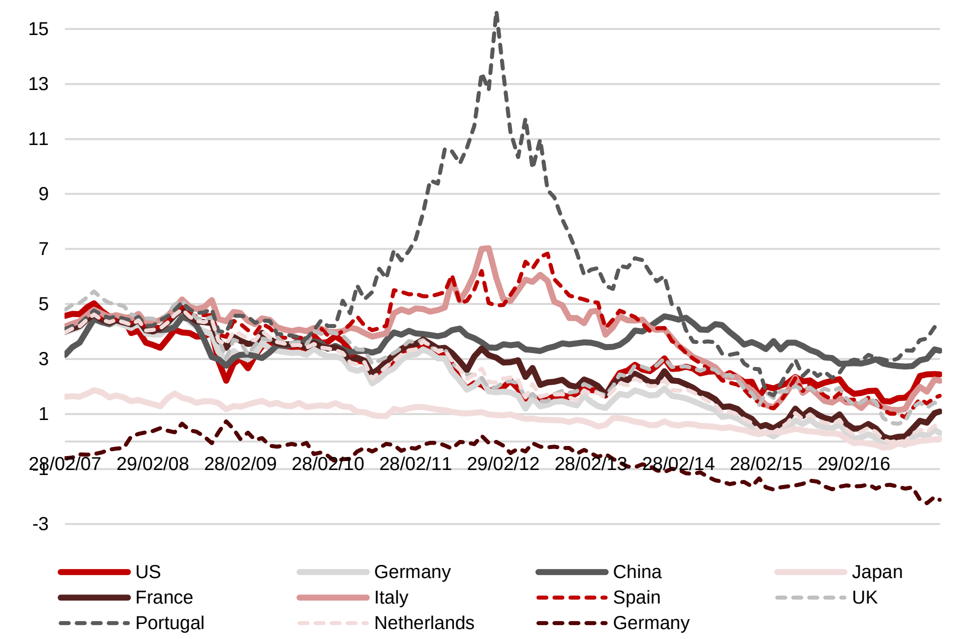
Ex. 2 Change in Government Bond Yields - Feb 2016 to Feb 2017



Source: Bloomberg, Dagong Europe

The ten-year government bond yields have reduced dramatically during the last ten years, presenting major challenges to the Life industry, especially for the companies with long-term products with guarantees and large duration mismatch. However, during the last few months, the yields on long-term bonds showed some improvement. In our view, it was driven by the results of the US presidential elections, the expectations that FED will continue raising interest rates and gradually improving long-term economic perspective in the US and Europe.

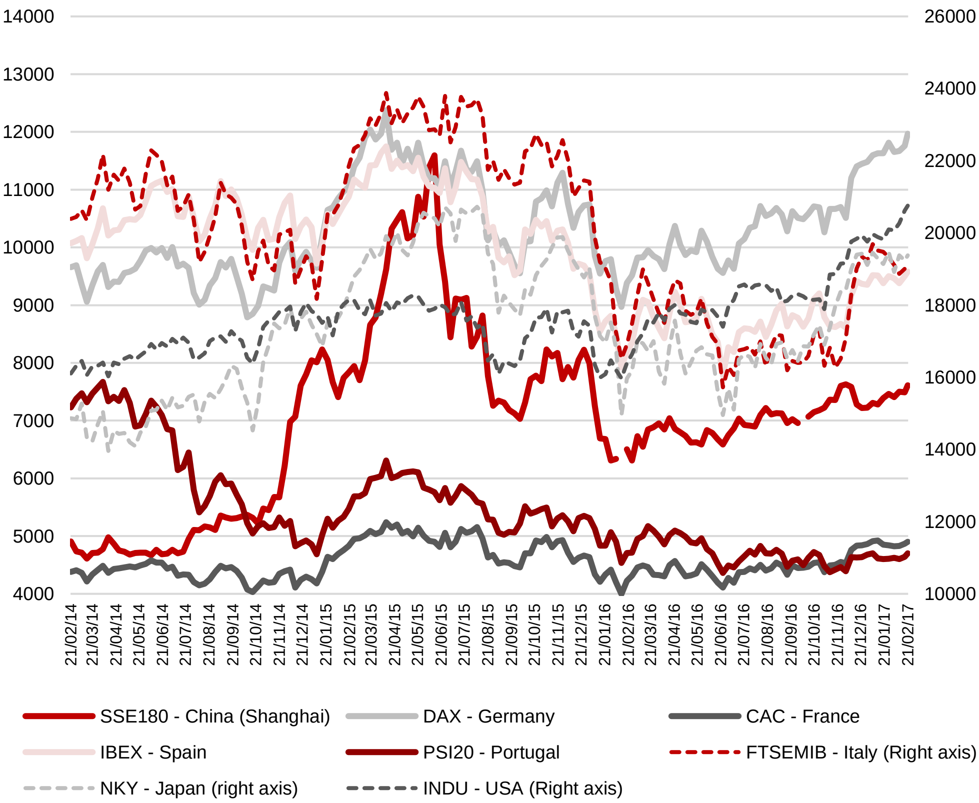
Ex. 3 Government 10-Year Bond Yields - Feb 2007 to Feb 2017



Source: Bloomberg, Dagong Europe.

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

Ex. 4 Volatility of Major Equity Market Indexes - Feb 2014 to Feb 2017



Source: Bloomberg, Dagong Europe.

Investments

The European insurance industry is facing a difficult investment environment affected by low yields, reduced high quality asset pool (due to ECB's QE) and increased financial market volatility. We expect some changes in the composition of the investment portfolios, but no radical shift.

On average, we expect the stricter regulatory Solvency II requirements to drive industry to de-risk investment portfolios, improve diversification and overall investment risk management. We expect that the fixed income instruments, in particular the sovereign debt instruments will continue to dominate the investment portfolios, followed by corporate debt.

At the same time, we expect that some players will increase their asset risk due to profitability pressures in search of yields. We expect a gradual shift from government to corporate debt instruments to continue. Such trend might improve diversification and yields, while increasing credit risk. We also expect that some insurers will venture to higher risk and more complex asset classes such as infrastructure, speculative grade credit, equities, real estate, derivatives, etc.

Geopolitical risk

In 2016, the geopolitical risk has increased its ranking of importance in the agendas of insurers and other businesses across the Europe and the world. The result of Brexit referendum and the US presidential election had created significant degree of uncertainty regarding future economic and political policy direction and are likely to lead to operating costs increase, reshuffle and put on hold development and expansion strategies.

In our view, the elevated geopolitical risk will remain high in 2017-18. While in 2016 insurers and global investor community had to deal with more sentimental shock of Brexit or Trump becoming the president of the US, in 2017-18 they will have to face the real consequences of that with continuing high uncertainty. In particular, the risk of losing passporting rights for UK based insurers doing business in Europe, regulatory equivalence, international trade agreements and broader economic impact from Brexit and various changes of policies by the US presidential administration, to name a few.

In addition, populism and euro-scepticism are increasing across European countries. The outcomes of important elections across Europe (such as in France) are harder to predict and some of them could have significant negative and disruptive effect to European economy and the EU project itself. The political and economic developments in Europe's neighbouring regions, in particular the Middle East, Russia, and Northern Africa, could also negatively affect European political and economic environment.

While the direct impact of this to the insurance industry is limited, the potential indirect impact is vast and can affect industry via increased asset value volatility, political and regulatory changes, social instability, reduced demand for insurance products, potential changes in business development strategies, increased operating and claims servicing costs, among others.

The positive side of increased geopolitical risk, in our view, is limited. It could create windows of opportunities for some players such as development and growth of new products or investment opportunities, however, the scope is limited.

Regulation

After the financial crisis of 2008-11, the regulation of the financial institutions and insurers has increased and tightened significantly. In our view, the Solvency II and other regulatory changes, in general, brought more prudence, improved governance, put the right controls and checks in places and reinforced the industry's conduct and resilience. In addition, the transparency and comparability of the industry will significantly improve with the regulators' effort to collect a large scope of data and intention to make it public. However, the risk related to increasing complexity, costs of complying and impact of a 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 only positive impact to the industry. One of the latest examples is the UK, with 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.

Apart from bringing the aforementioned benefits, in our view, SII also increased a risk of missing some key risks and change in trends due to high degree of complexity and over reliance on the model outcomes. In our view, due to high diversity and complexity of the industry, it is difficult to create a single model or formula with a set of transparent, comparable and risk based measures, which would fit equally well to all insurers across Europe. However, with time we expect the new SII regime and solvency calculation to evolve, strengthen and help to improve resilience of the industry.

Competitive and business environment

Competitive and business environment in our view is increasingly challenging in most of the European countries. We expect the pricing environment to continue to be very challenging and any pricing increases would be very difficult, despite industry's returned focus on underwriting profitability.

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

We expect pricing to be particularly tough in Motor, Workers' compensation and Commercial insurance. Rates also have been falling in Property insurance due to higher margins and relatively low number of major catastrophes, which usually drive prices up. However, regulatory changes and increasing costs of claims will certainly push prices up in some countries in order to get to more sustainable underwriting results.

We consider 2017-18 to be challenging for organic business growth in Non-life due to increasing competition and stagnating or only very slowly improving economic growth, and for Life business due to low yield environment and difficulty in structuring attractive products. Overall in Europe, we expect Life industry premiums to contract while Non-life to grow at about 1.5% - 2%.

The difficult conditions for organic growth, higher regulatory capital requirements, deteriorating profitability, and need of scale to increase operational efficiencies will drive M&A activity in the European insurance markets in 2017-18. In addition, many insurance groups are streamlining and simplifying their organisations and divesting non-core assets, which will increase a number of potential targets. Although growth in Europe is stagnating, the relative stability and low valuations also could be attractive for foreign buyers and Brexit might boost M&A activities in continental Europe.

An example of industry consolidation and a response to current challenges can be NN Group acquiring Delta Lloyd (Dutch insurers). After the financial crisis, there are still many companies with relatively good fundamentals, but in our view, struggling to survive due to challenges from prevailing low yields environment, increased regulatory capital requirements, growing operating costs and need for material investment in IT and technology. At the same time, we recognise, that companies face challenges in finding the right target at the right price, as smaller players are often priced out by the big international groups. In addition, the integration risk and high costs of IT systems' harmonisation remain important considerations for those considering M&As.

Tbl. 2 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.

We expect European insurers to look for M&A opportunities within domestic markets or in neighbouring countries, due to tight budgets and familiarity with the markets. While in our view, only large international European groups will have the appetite and financial capacity for M&As in other continents.

Profitability

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

We expect defensive strategies with a focus on operational cost reduction and optimisation to dominate insurers' agendas. However, more material and sustainable improvement in efficiency, in our view, require large investments in IT systems, digital and other innovations, which is difficult to do due to tight budgets and focus on cost cutting. Those who started optimising costs earlier and maintained investments in IT and innovation can expect to have more sustainable and higher margins relative to peers. In addition, in the current increasingly competitive environment with low growth, price increases could be difficult to achieve, while optimised and reduced cost base is likely to be the primary driver for improvement in profitability.

The return on equity (ROE) in the sector is reducing, and many cases is below the cost of equity. However, in our view, the sector is still attractive to investor community due to its relative stability, low credit risk and strong long-term fundamentals.

The investment income historically has 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.

Capitalisation

We see insurance industry in Europe to have on average strong capitalisation, improved in 2016 due to stricter SII regulatory capital requirements and supported by the relatively large, high-quality capital base, in general conservative investment portfolios and improving risk management practices. We expect capitalisation to remain strong on average in 2017-18, however, largely dependent on the development of interest rates and yields going forward.

The full SII results are due to be published for the first time in May 2017. This will allow us to assess the underlying capitalisation 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 the currently strong industry's capitalisation, EIOPA's stress test applied on 236 mainly Life insurers in 30 countries and published at the end of 2016, revealed some interesting insights including the insurers' high sensitivity to the "double-hit" stress scenario (Abrupt increase in risk premiums combined with prolonged low yield environment) and the intense use of transitional measures in some European countries (including the UK, Portugal, and Germany). While the stress test revealed vulnerabilities, it also showed resilience of the industry. We also believe that, if the test were performed on a group basis rather than on the single entity basis, the results would have been stronger.

On average, the market risks make up the largest amount of solvency capital required in calculating solvency ratios, which in turn are often most sensitive to interest rate volatility and changes in credit spreads. While insurers often 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, especially in the currently uncertain geopolitical environment with highly sensitive investor sentiment.

Industry's capitalisation could deteriorate gradually if the low or in some cases negative interest rate environment were to stay for the long term. It would reduce long-term discount rate and possibly change other assumptions in calculating insurance's technical reserves. This would lead to a lower present value of reserves and a need for reserve strengthening. The most affected would be the Life insurers with long-term liabilities, high guarantee rates, and large asset & liability duration gap.

We also see increased use of reinsurance and improved protection, which in our view is positive for industry's capitalisation and profitability. The increase is driven by higher capital requirements from SII, more centralised and strategic approach to reinsurance purchasing and continuing soft pricing. We expect this trend to continue.

5. EUROPEAN INSURANCE INDUSTRY - COUNTRY SNAPSHOT

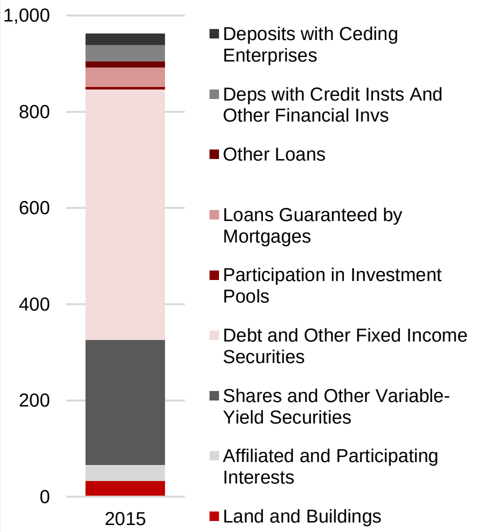
The UK

We expect the operating environment in the UK to remain challenging, largely due to high uncertainty and operational risks created by Brexit referendum and regulatory changes. The economy since the 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 the UK insurance industry, in our view, could come via the potential weakening of the economy, the asset and FX volatility, delayed business decisions, the disruption to business operations, increased costs and the risk of regulatory change.

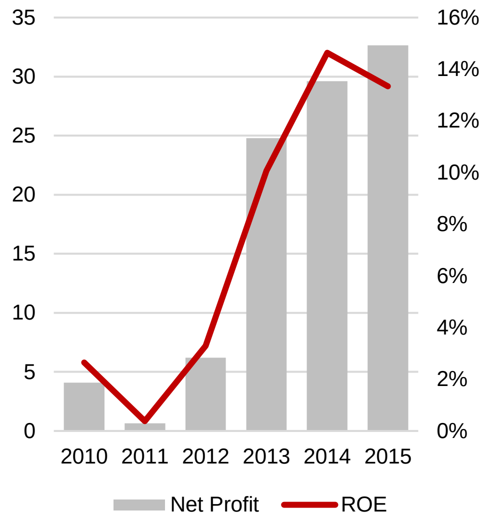
We expect regulatory and political risks in the UK to be one of the major risks for the industry in 2017-18; in addition to Brexit, also illustrated by the ongoing pension reforms and the recent Ogden discount rate cut[3], resulting in higher cost of claims settled as a lump sum and bringing material 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, M&A could become more attractive alternative.

Ex. 5 Investment Portfolio Composition (Bn, EUR)



Ex. 6 Industry Net Profit and ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

We believe that the UK Life insurers are likely to maintain strong capitalisation based on high and good quality capital base and close asset and liability matching, providing resilience to interest rate movements. However, EIOPA stress test revealed that on average the UK Life insurance sector is highly reliant on transitional measures in calculating regulatory solvency ratios, which makes it hard to compare and indicate a degree of vulnerability.

We expect to see more hybrid debt issuance due to attractive pricing and increasing focus on optimisation of return on equity.

We also expect the UK insurers to keep their investment portfolios well diversified and on average with high credit quality. Low yield environment is driving some of the insurers to increase riskier assets in search of higher returns. We believe a slow increase in alternative

[3] Discount rates used for calculating lump sum damages for personal injury claims.

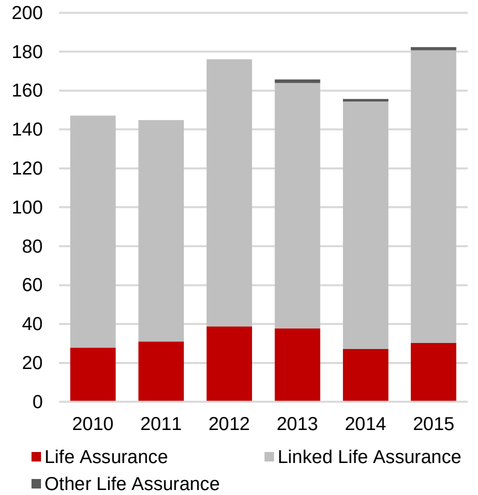
asset classes such as infrastructure, direct lending and real estate, among others will continue in coming years.

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

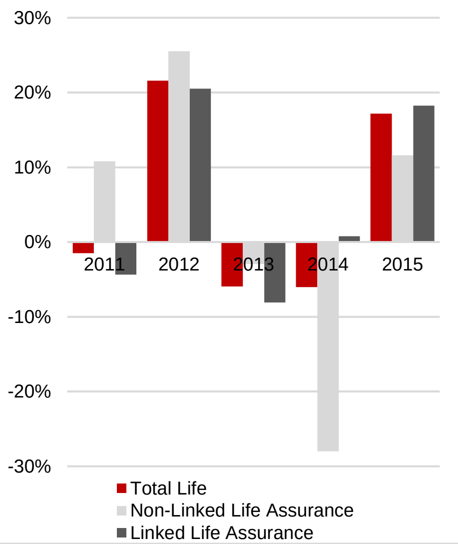
Life

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

Ex. 7 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 8 Life Insurance Growth Rates



Source: EIOPA, Dagong Europe

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

According to the EIOPA stress test results, the UK Life industry has one of the lowest SII ratios before and after applying the transitional measures. However, the solvency ratio proved to be relatively resilient and less sensitive than the European average to the stress scenarios performed by EIOPA.

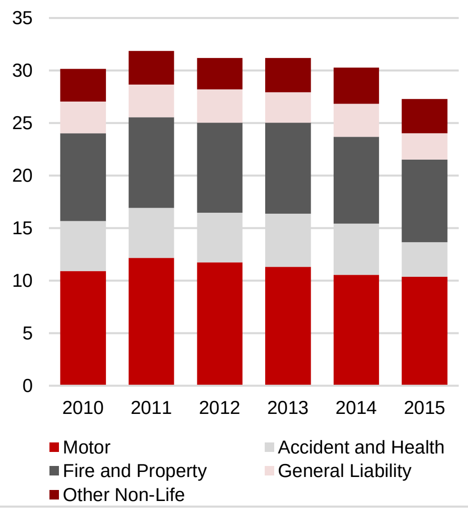
Non-Life

We see the UK Non-life insurance sector to be resilient and well capitalised, however, changing regulations, high competition levels and low-interest rate environment will significantly challenge growth and profitability.

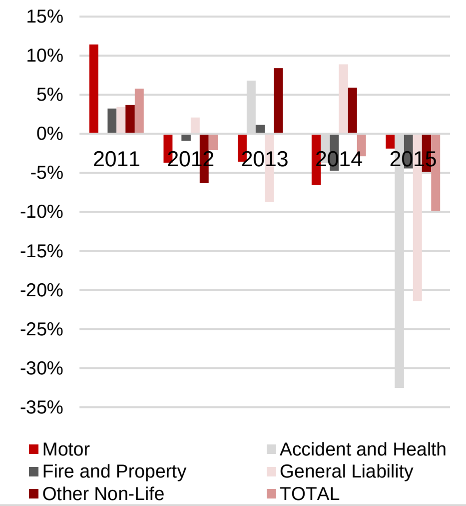
In our view, the operating environment will remain challenging, characterised by volatile financial markets, and the uncertainty created by the Brexit referendum and regulatory changes such as Ogden discount rate reduction. This decrease in the discount rate will increase costs of claims settled as a lump sum, and will have a material negative impact to Motor insurers' reserves that will have to be strengthened and attribute to lower profitability.

We expect the UK Non-Life premium volumes to increase in 2017-18. In our view, despite fierce competition, Motor prices will continue increasing driven by claims inflation, insurers' focus on improving weak underwriting profitability and regulatory changes. While at the same time, we expect premiums and pricing on household insurance to come under pressure from the growing use of aggregator websites.

Ex. 9 Non-Life GPE Development and Composition (Bn, EUR)



Ex. 10 Non-Life Premium Growth by Major Business Line

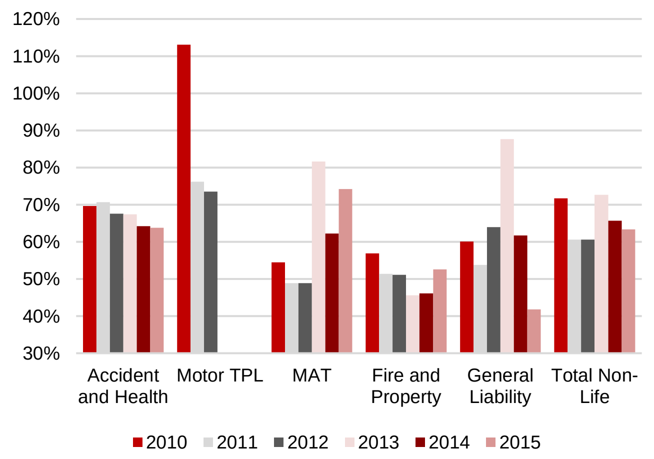


Source: Association of British Insurers, Dagong Europe

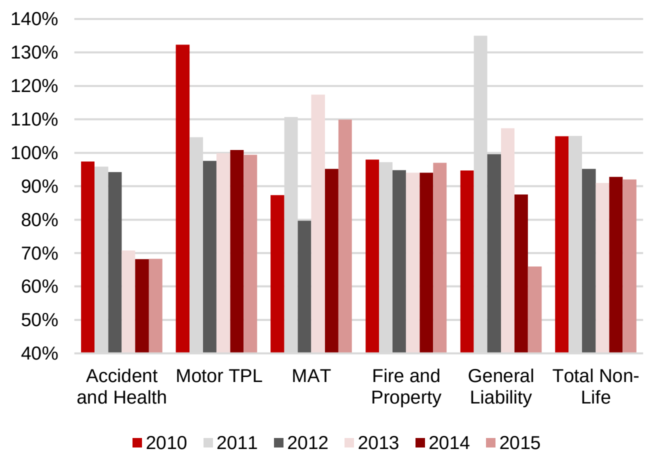
We expect the Non-life profitability to remain good, but strained by regulatory change and decreasing investment income. We expect Motor insurance to be loss making or break-even on underwriting basis with combined ratio at around 100% in 2016 and to be similar or few percentage points higher in 2017-18. This trend, in our view, will be driven by continuing claims inflation, high competition, unfavourable outcome on Ogden's discount rate change, 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 to maintain stronger profit margins and drive overall Non-life profitability.

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

Ex. 11 Loss Ratios by Major Busines Line



Ex. 12 Combined Ratios by Major Business Line



Source: EIOPA, Association of British Insurers, Dagong Europe

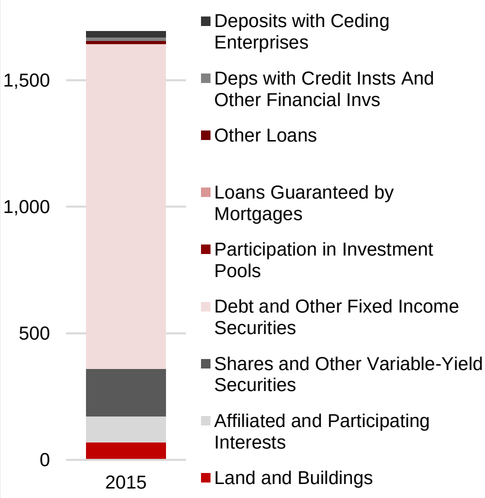
FRANCE

We expect the operating environment for the 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.

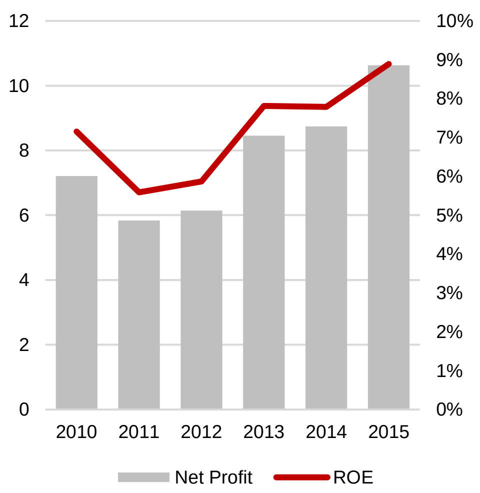
We see the French insurance industry as well–capitalised, and we expect it to show strong regulatory solvency ratios under Solvency II regime. However, as EIOPA's stress test revealed, the industry is highly sensitive to "double hit" stress scenario and to a lesser extent to "low for long" scenario. 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 the profitability of the industry to weaken but remain good in 2017-18 due to prevailing low-yield environment, high competition, and decreasing margins.

Ex. 13 Investment Portfolio Composition (Bn, EUR)



Ex. 14 Industry Net Profit and ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

Life

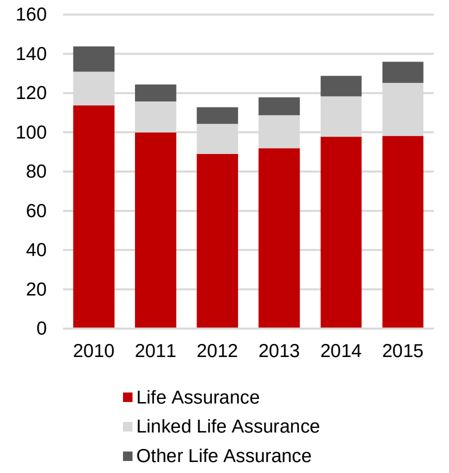
We expect the operating environment for the French Life insurers to remain challenging with the main risks stemming from low-interest rates, stagnating economy and regulatory changes.

The historic Life book is dominated by traditional business, but the linked business share has been increasing rapidly and driving the growth during the last years. However, the headwinds from unfavourable financial market conditions and challenging operating environment will constrain the future growth of the industry, in our view.

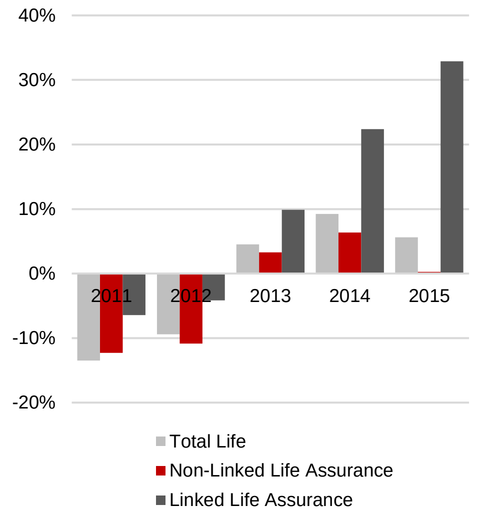
We see the French Life sector as well-capitalised and expect to remain as such in 2017-18. However, the large share of historical business with guarantees and duration gap between assets and liabilities bring a degree of vulnerability.

We expect the 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. 15 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 16 Life insurance Growth Rates

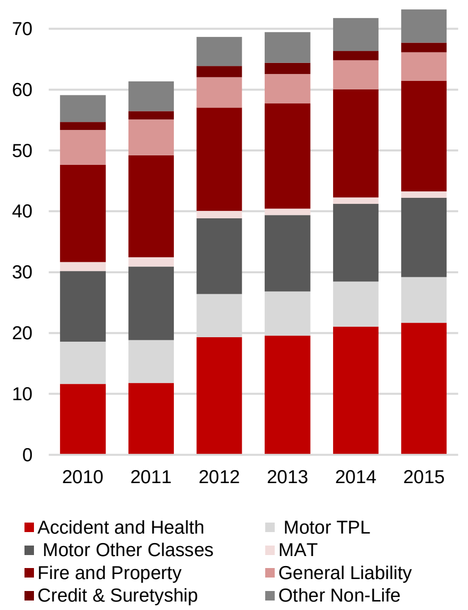


Source: EIOPA, Dagong Europe

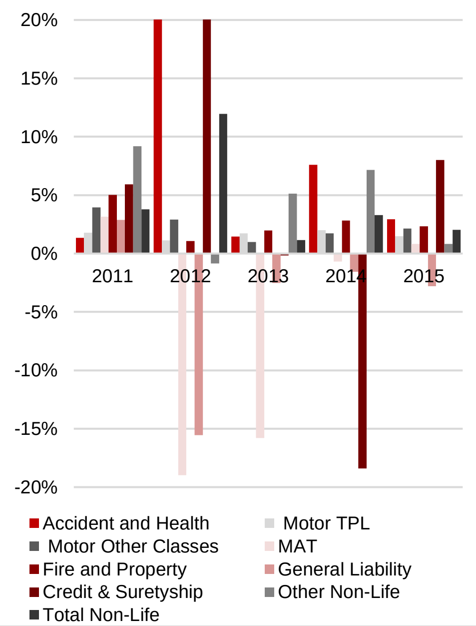
Non-Life

We expect the operating environment for the 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. 17 Non-Life GPE Development and Composition (Bn, EUR)



Ex. 18 Non-Life Premium Growth by Major Business Line

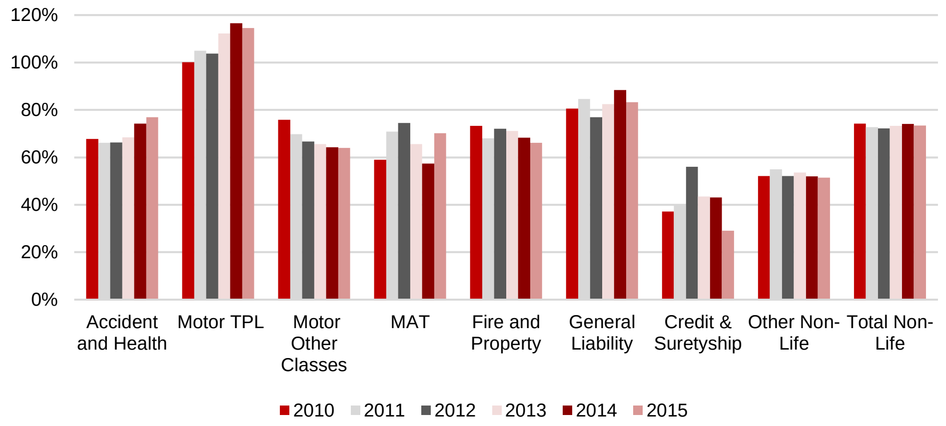


Source: EIOPA, Dagong Europe

The Non-life industry has good product mix with Motor and Property taking the largest shares. As in other countries, the competition in French Motor sector is fierce, and we expect this to continue. It is exacerbated by increased 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.

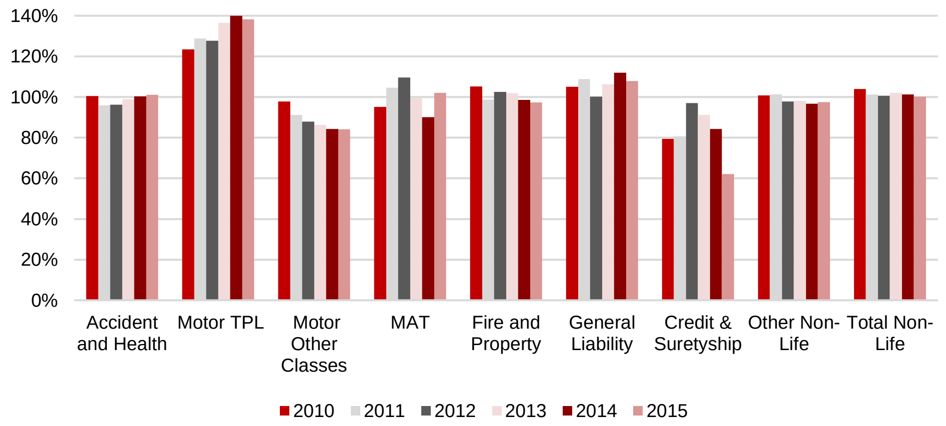
Underwriting profitability historically has been poor and highly reliant on investment income. We expect this trend to start changing and see more prudence at least in some business lines as investment income declines. Higher-than-usual occurrence of natural catastrophes could hit profitability, but could also 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. 19 Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. 20 Combined Ratios by Major Business Line



Source: EIOPA, Dagong Europe

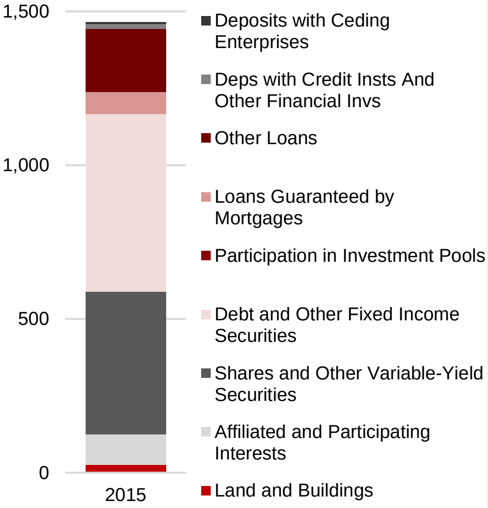
GERMANY

We expect the operating environment in Germany to remain satisfactory 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 some cases negative interest rate environment will remain the major risk for the industry, in particular for Life insurers.

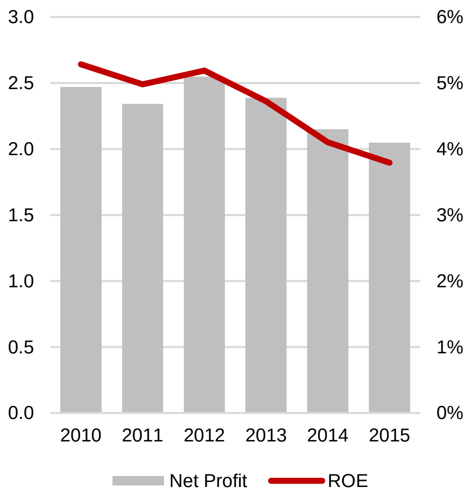
The industry's investment portfolio is well diversified; however, the share of high-risk assets such as equities, is high, and exposes capital to volatility. If the low yield environment prevails, we expect the asset mix to shift incrementally towards higher-yield/ higher-risk assets.

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

Ex. 21 Investment Portfolio Composition (Bn, EUR)



Ex. 22 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

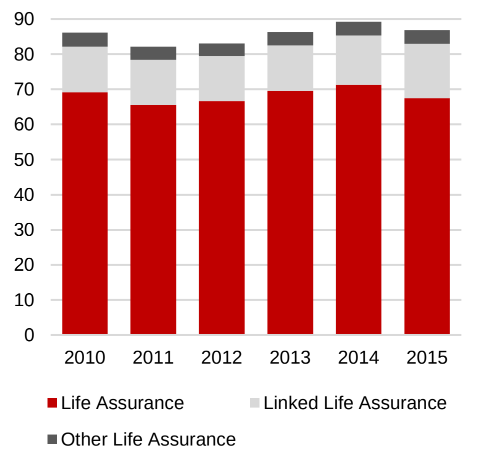
In our view, the German Life insurance sector will maintain strong credit characteristics in 2017-18, based on strong capitalisation and although weakening, still good profitability. However, at the same time, it is vulnerable and sensitive to prolonged low-interest rate environment due to its large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

We expect the sector's capitalisation 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 considerable challenges for the German Life insurers. We will be able to understand better the scale of the challenges, after the regulatory disclosure of underlying solvency metrics without transitional measures later this year. We believe that additional reserve requirements (ZZR) introduced by the insurance regulator in 2010 will help mathematical reserves to bridge the gap between the book and economic value in the long term.

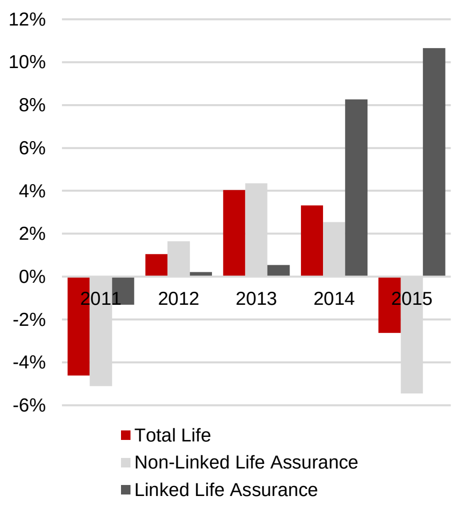
The German Life insurers' product portfolio is dominated by traditional Life products with guarantees. The share of linked and capital-light products is still low but is showing positive signs of growth and we expect this trend to continue.

Despite that, we do not expect a material shift in the product portfolio mix in the medium term, due to unfavourable financial market conditions, customers' preference for products with guarantees and insurers' reluctance to more radical change in product mix to avoid negative impact to cash flows and lower market shares in the short-medium term. For these reason, we expect a proportion of traditional products to contract slowly, while linked, hybrid and biometric products to grow only moderately.

Ex. 23 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 24 Life Insurance Growth Rates



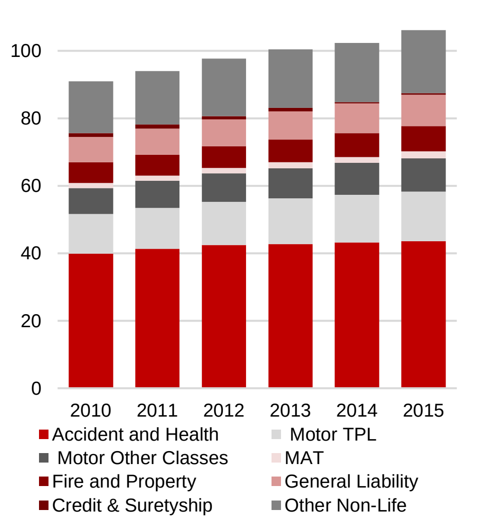
Source: EIOPA, Dagong Europe

According to the EIOPA stress test results, the German Life insurers are highly reliant on using transitional measure to calculate SII ratios. We see average base rate solvency ratios as very strong, however, more sensitive to stress scenarios than the European average.

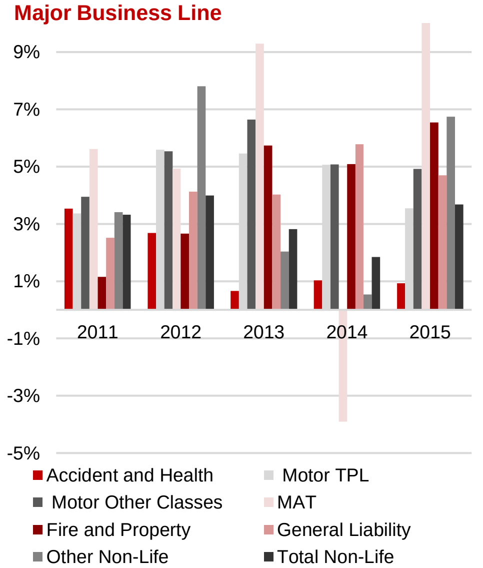
Non-Life

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

Ex. 25 Non-Life GPE Development and Composition (Bn, EUR)



Ex. 26 Non-Life Premium Growth by Major Business Line



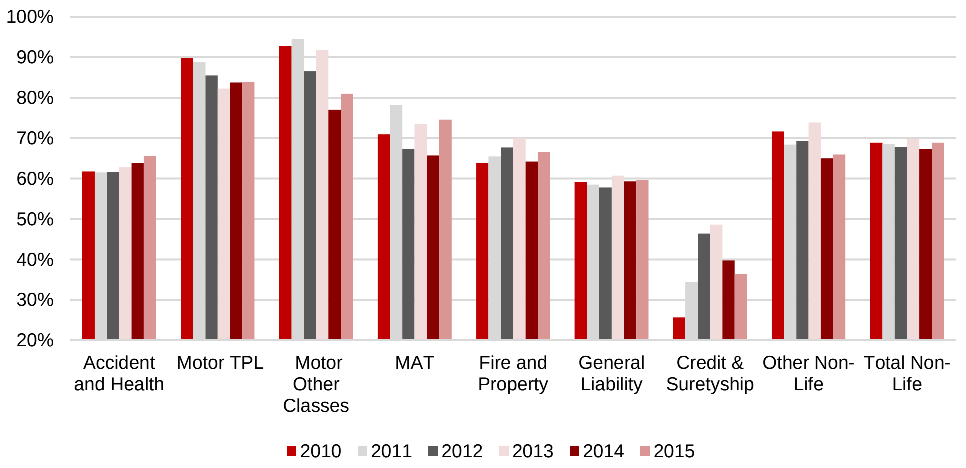
Source: EIOPA, Dagong Europe

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 a fast expansion of about 5% while Motor to slow down to about 2%.

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

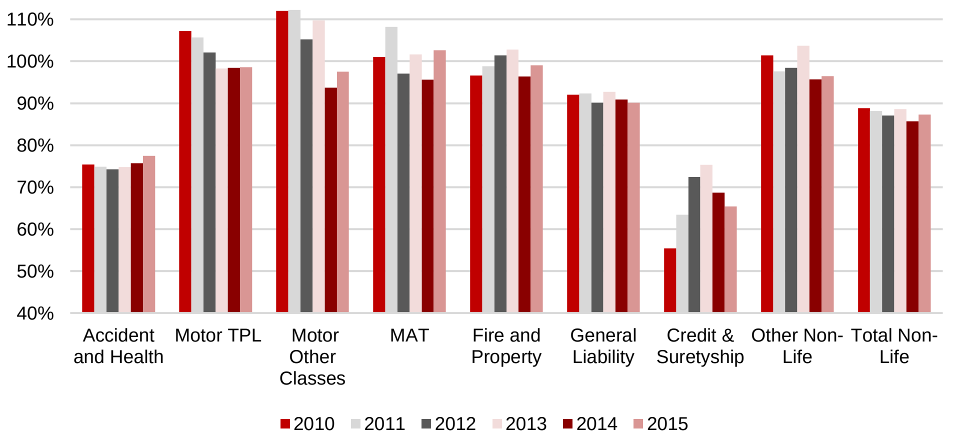
We expect profitability in 2017-18 to remain strong, helped by improvement in underwriting results, but the largest share of contribution still coming from investment income. We expect the industry's net combined ratios to remain strong within 94-96% range. The Motor industry has been showing good underwriting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

Ex. 27 Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. 28 Combined Ratios by Major Business Line



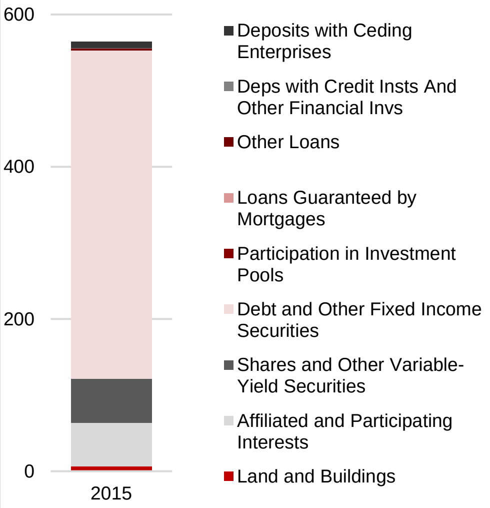
Source: EIOPA, Dagong Europe

ITALY

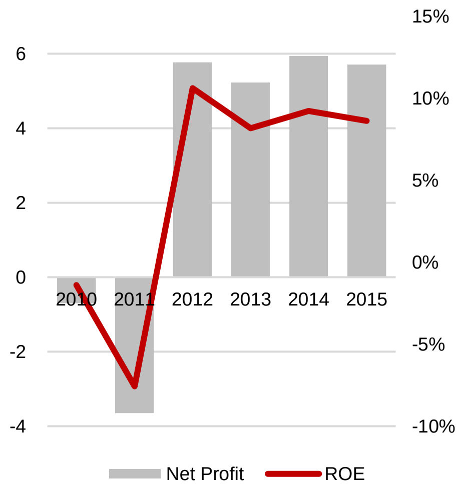
We expect the operating environment in Italy will remain challenging due to weak economic growth prospects, high unemployment rate, a vulnerable banking sector with a large stock of non-performing loans, increased risk of political instability and high sensitivity to the change of investor sentiment, increasing competition and decreasing interest rates. On the positive side, the purchasing power and savings rates are relatively high and the unemployment rate is slowly improving, which we expect will benefit the industry.

We expect growth and profitability in the Italian insurance industry to be under pressure, but capital levels to remain good, with our estimated average solvency ratio at about 170%. The industry's investment portfolio is dominated by fixed income instruments and with a large concentration in Italian government debt, which supported the industry's profitability due to historically higher yields. However, this material concentration in the Italian government bonds, coupled with challenging operating environment and a possible sudden increase in bond yields and widening credit spreads, leave insurers exposed to volatility and weakening of the solvency ratios. Still, good matching of assets and liabilities provides a degree of resilience.

Ex. 29 Investment Portfolio Composition (Bn, EUR)



Ex. 30 Industry Net Profit and ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

Life

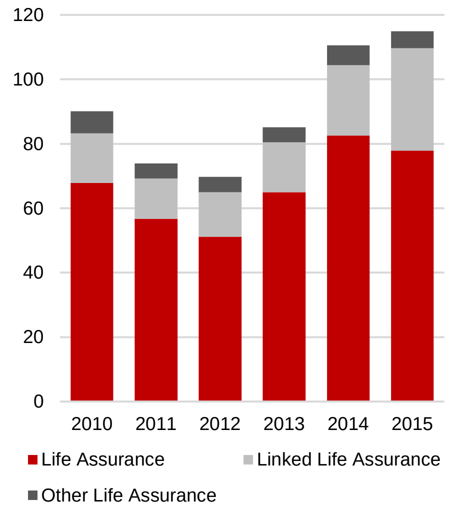
We expect the overall Life premiums in Italy to shrink at high single-digit or at best to remain stable in 2017-18. We believe that traditional products with guarantees and capital protection features will remain popular. Due to the SII risk charges, we expect the industry's share of capital-light products like Unit-linked to increase in the long term. However, in 2016 sales of unit-linked products decreased significantly due to difficult financial market conditions and customer demands for products with capital protection. We also expect the capital-light product growth to be negatively affected by low-interest rate environment and high volatility of the financial markets in 2017.

Life sector historically delivered strong return on equity averaging 10% over 2013-2015[4]. However, due to the changing operational and investment environment, we expect it to drop to about 4-7% in 2017-18. The industry has been reducing average guarantees that helped its profitability. The new products now offer 0-1% guarantees. The share of guarantees above

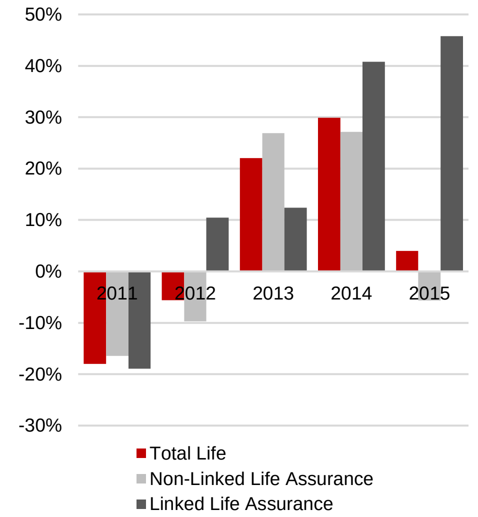
[4] ANIA

2% is manageable at about 18%, however, if interest rates were to stay lower for longer, it would be eroding future profits, but not challenging capitalisation and reserving.

Ex. 31 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 32 Life Insurance Growth Rates



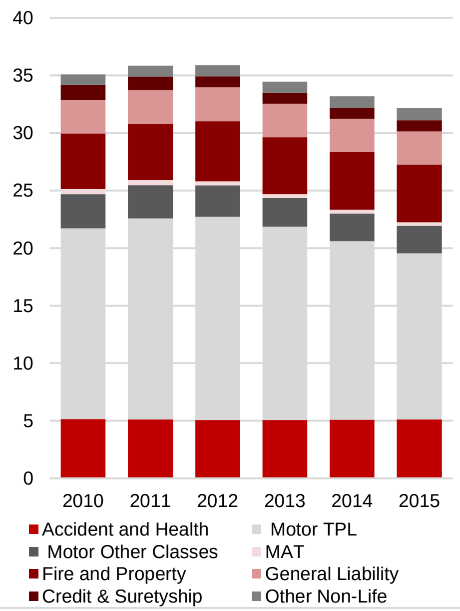
Source: EIOPA, Dagong Europe

We consider the industry to be strongly capitalised and relatively more resilient to “low-for-long” stress scenario compared to other major European markets.

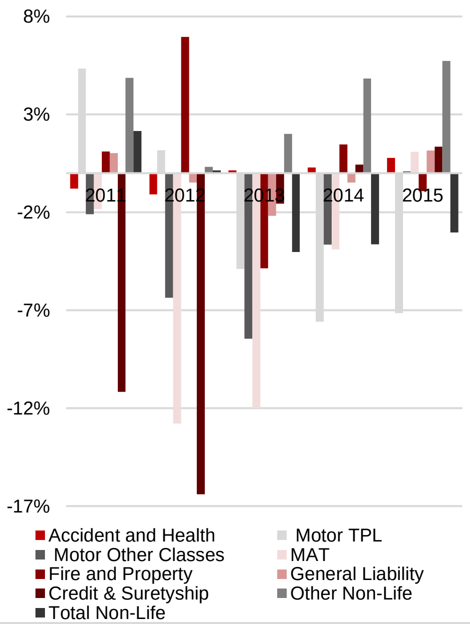
Non-Life

We expect that the overall Non-life premiums volumes will remain flat in 2017-18. The industry is dominated by Motor with higher market share than other major European countries and is facing fierce competition. In 2016, Motor rates reduced by around 6%. We expect rates to stabilise, but continue to face intense pressure. We also expect the Non-motor business to grow across different lines and support overall premiums volume.

Ex. 33 Non-Life GPE Development and Composition (Bn, EUR)



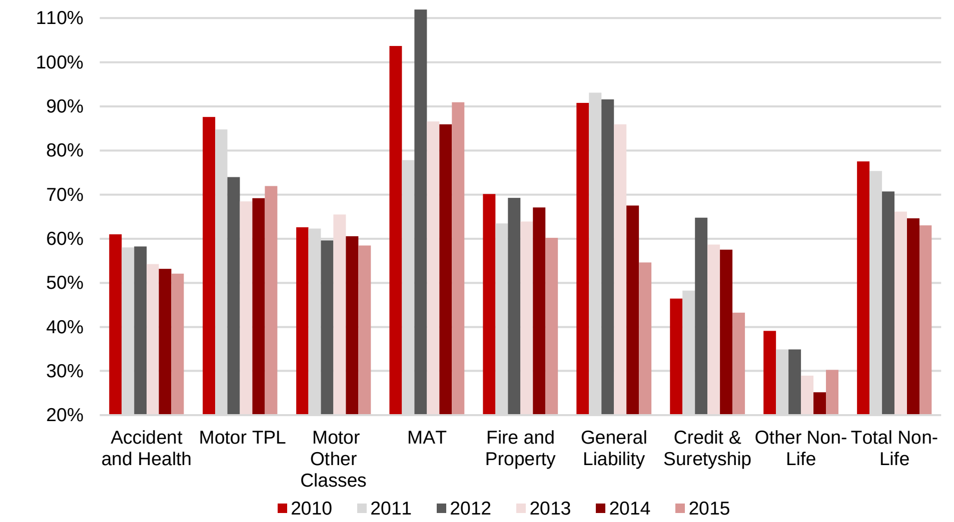
Ex. 34 Non-Life Premium Growth by Major Business Line



Source: EIOPA, Dagong Europe

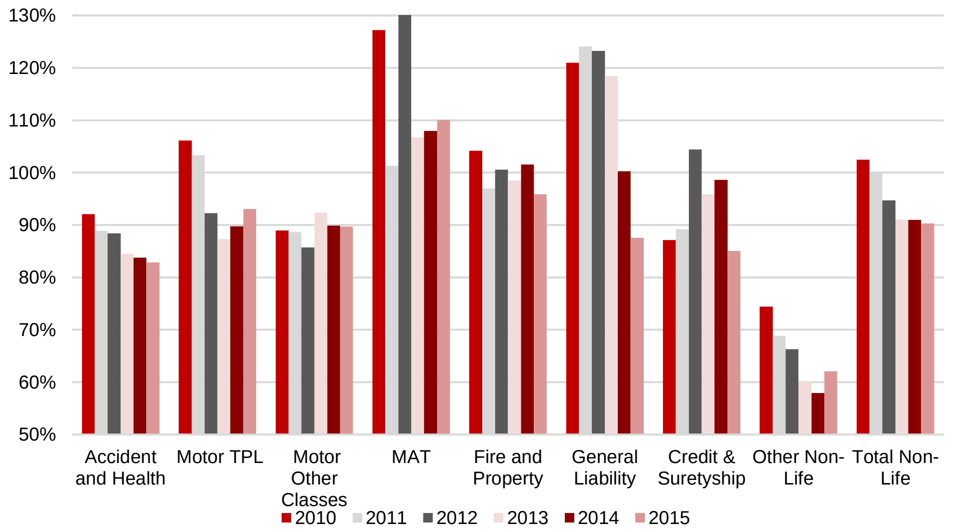
Over 2013-2015 the Italian Non-life sector had strong profitability with combined ratio at around 90% and return on equity at about 9%. In 2016, we observed significant increase in price competition and a small increase in claims frequency in Motor line, which weakened the loss ratio and caused the combined ratio to increase to about 100%. However, improved and strong performance of non-Motor lines partially counterbalanced this deterioration. We expect these trends to continue and the Italian Non-life industry's combined ratio to be at about 95-98% in 2017-18. On top of this, the historically low-interest rates, lower realised gains and various one-off charges will weaken the overall profitability and result in lower return on equity at around 5-7% in 2017-18.

Ex. 35 Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. 36 Combined Ratios by Major Business Line



Source: EIOPA, Dagong Europe

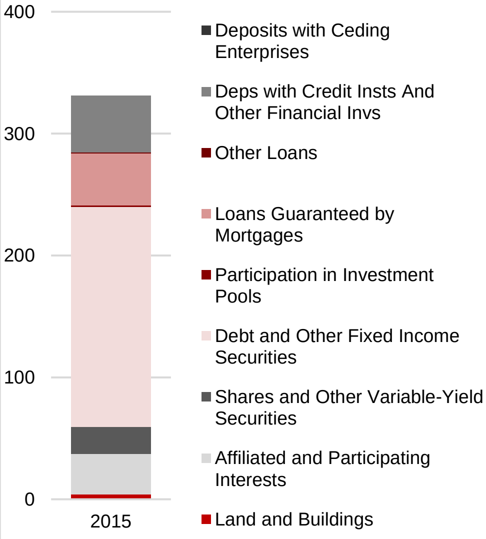
THE NETHERLANDS

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

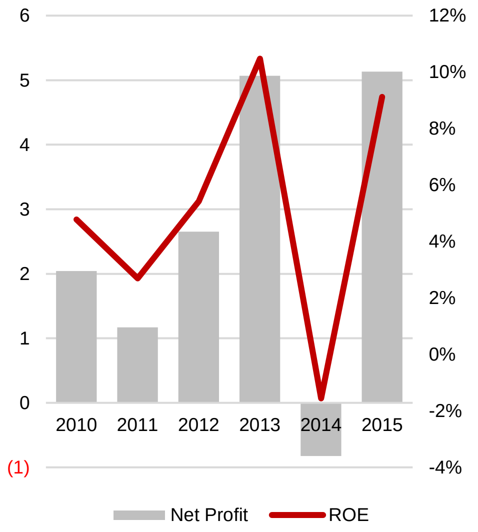
Historically the industry's profitability has been volatile and negatively affected by changes in regulation, reducing investment yields, increasing claims costs, high competition and weather-related losses. In 2017-18 we expect the situation to stabilise and see more stable returns with ROE of about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

We consider the 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 in our view, carry relatively less risk compared to other countries due to very well set-up and efficient legal framework and low default rates.

Ex. 37 Investment Portfolio Composition (Bn, EUR)



Ex. 38 Industry Net Profit and ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

Life

We expect the operating environment for the 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 ratio calculation.

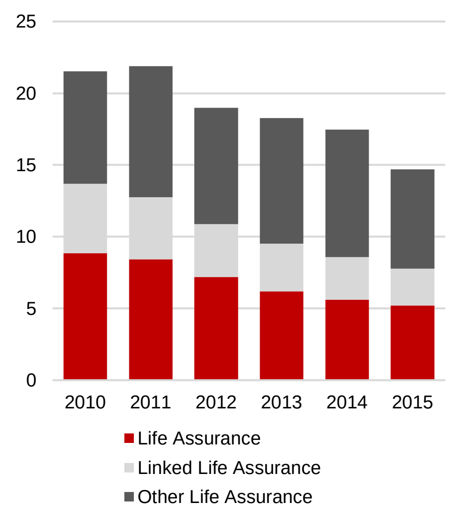
Life premium volumes have been decreasing for a number of years and we also expect this trend to continue in 2017-18. This reflects industry's shift from traditional guaranteed savings business to more capital efficient products, such as unit-linked or asset management products. The new business is growing,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

This shift has negatively affected insurers' business growth and profitability. However, it has helped the Dutch Life insurers to improve their risk profile, to prepare for more prudent SII regulatory requirements and to position themselves better to face changing customer needs and challenging operating environment. We consider this approach to have a positive effect on the industry's long-term sustainability, while some other major Life industries in other countries were reluctant to do so, and consequently could be facing more serious challenges.

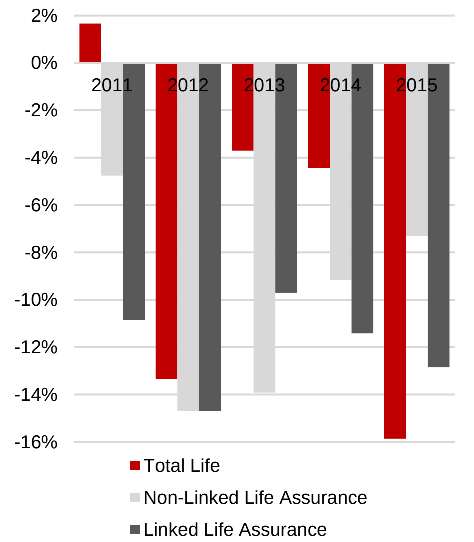
We regard industry's capitalisation as strong, however, exposed to prolonged low-interest rate environment, widening of credit spreads, assumption changes behind the best estimate of reserves calculation and in particular, reduction in ultimate forward rate.

We expect industry's profitability to remain suppressed, due to a shift to lower risk/lower margin products and high competition. However, we expect earnings to improve as efforts on cost optimisation, innovation and new products development start to pay off. In addition, some consolidation in the industry could also have some positive effects on earnings and capitalisation.

Ex. 39 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 40 Life insurance Growth Rates

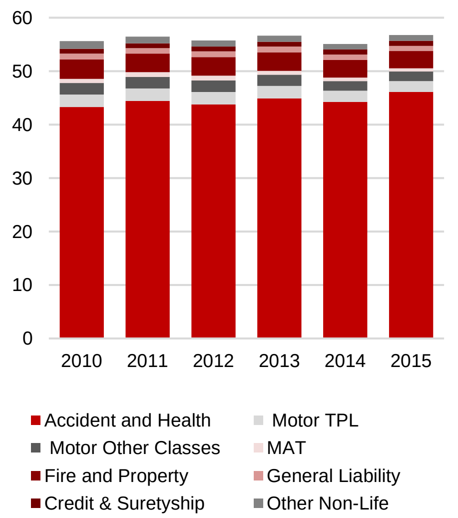


Source: EIOPA, Dagong Europe

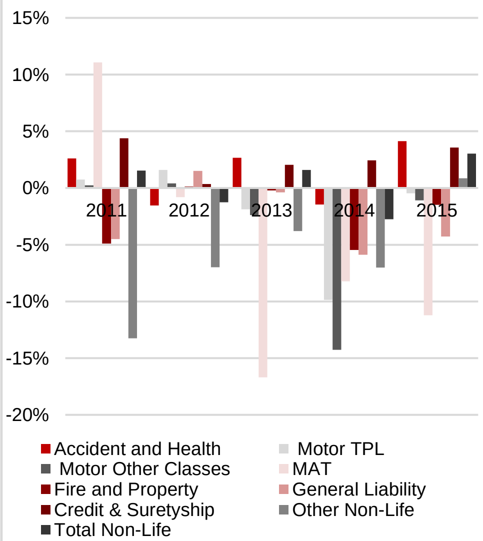
Non-Life

We expect operating environment for the Dutch Non-life players to remain challenging due to high industry saturation and intense competition, low-interest rate environment and increasing claim frequency and severity.

Ex. 41 Non-Life GPE Development and Composition (Bn, EUR)



Ex. 42 Non-Life Preium Growth by Major Business Line

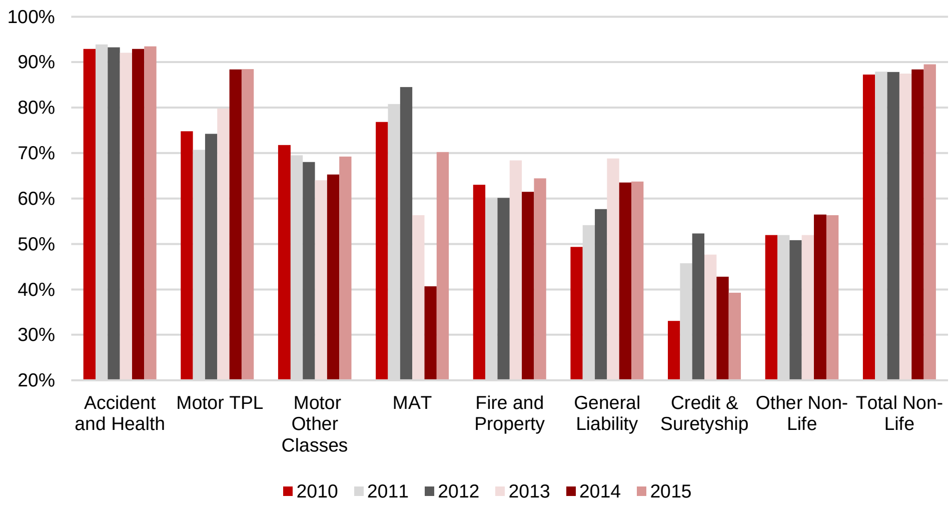


Source: EIOPA, Dagong Europe

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

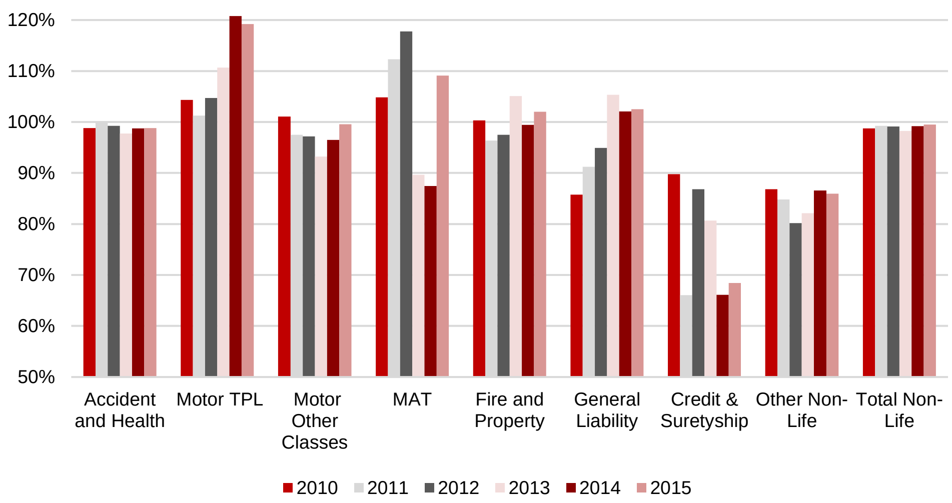
The Dutch Non-life industry is well diversified in traditional product lines. However, it also has a well-developed Health and Accident (H&A) product class, which dwarfs other Non-life product lines. The fact that it is mandatory to have Health insurance in the Netherlands is a main driver to the industry size. In addition, H&A insurance was the major growth area and reason for the overall relatively stable Non-life industry's premium volumes.

Ex. 43 Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. 44 Combined Ratios by Major Business Line



Source: EIOPA, Dagong Europe

SPAIN

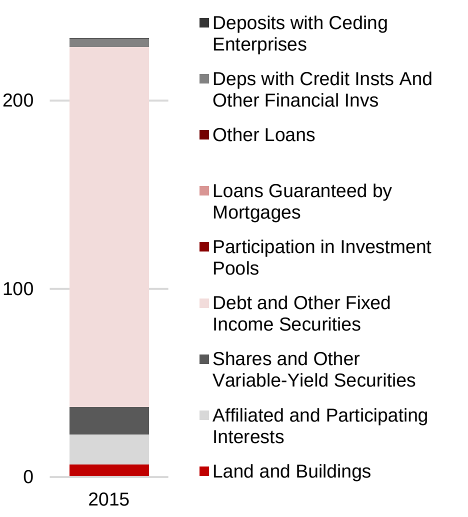
We expect the operating environment for the insurance sector in Spain will be challenging but improving in 2017-18, supported by improving economic growth, domestic financial system and asset quality. However, low-interest rates, high competition and regulatory changes will continue to challenge the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

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

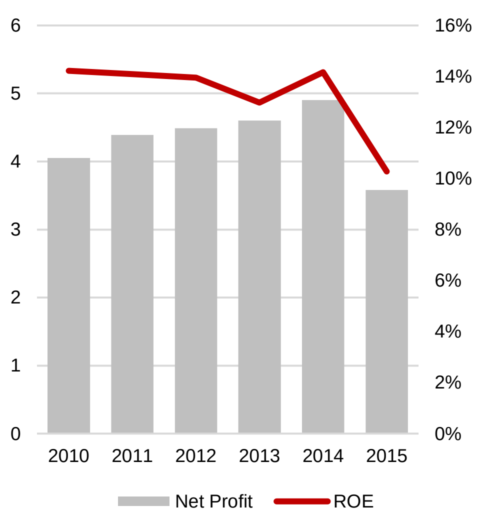
We expect the industry's investment portfolio to maintain conservative asset mix with a predominant concentration in fixed income instruments. However, we expect some increase in higher-yield/ higher-risk assets as companies are trying to support falling returns.

In our view, industry's capitalisation will be strong and supported by good quality capital base, close assets and liabilities matching, and conservative investment portfolio composition, in our view.

Ex. 45 Investment Portfolio Composition (Bn, EUR)



Ex. 46 Industry Net Profit and ROE (Bn, EUR)



Source: EIOPA, Dagong Europe

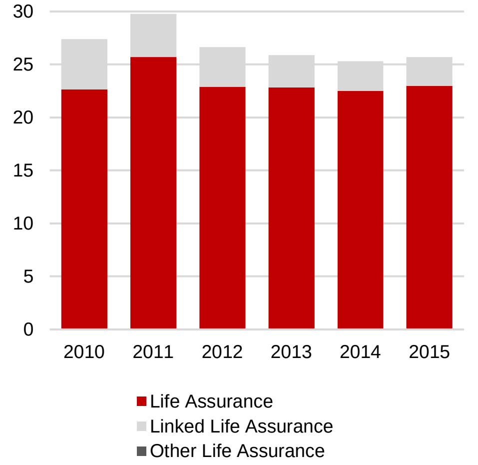
Life

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

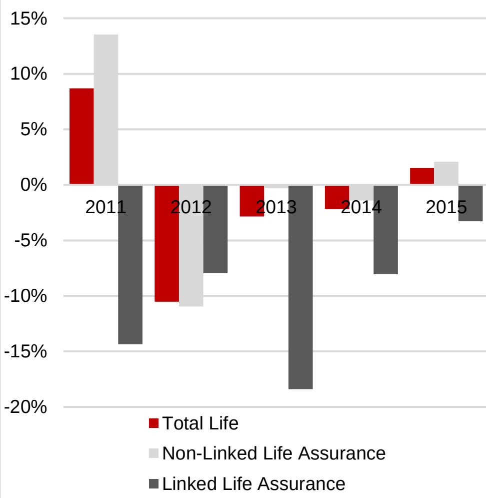
The product portfolio predominantly consists of traditional products. The new business in linked products has started to grow in 2015 and we expect the pace to increase. The industry benefits from good asset liability matching and reserves for long-term Life products being close to economic value.

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

Ex. 47 Life Insurance GPW Development and Composition (Bn, EUR)



Ex. 48 Life insurance Growth Rates

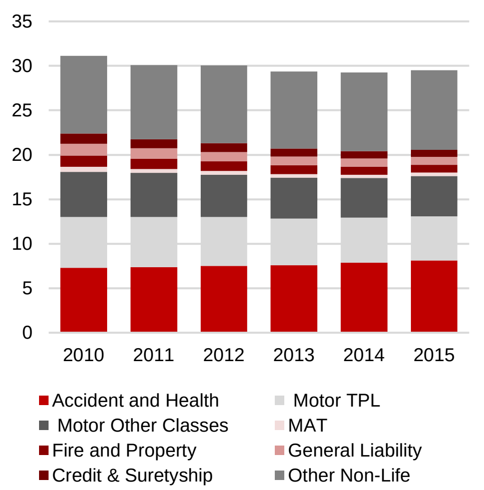


Source: EIOPA, Dagong Europe

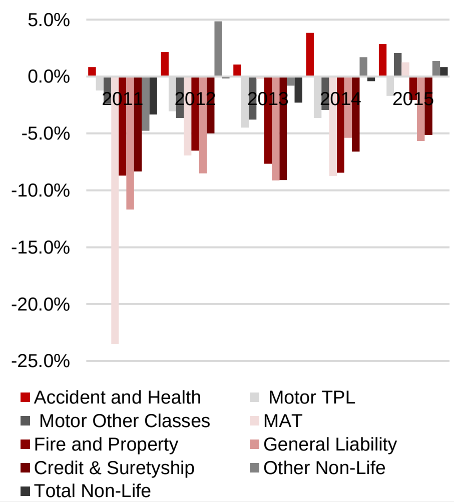
Non-Life

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

Ex. 49 Non-Life GPE Development and Composition (Bn, EUR)

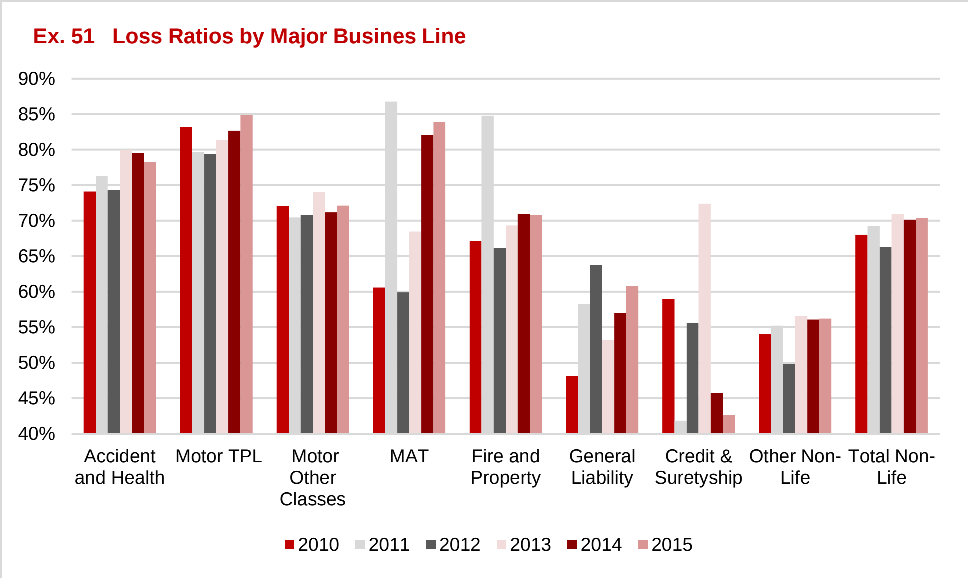


Ex. 50 Non-Life Premium Growth by Major Business Line

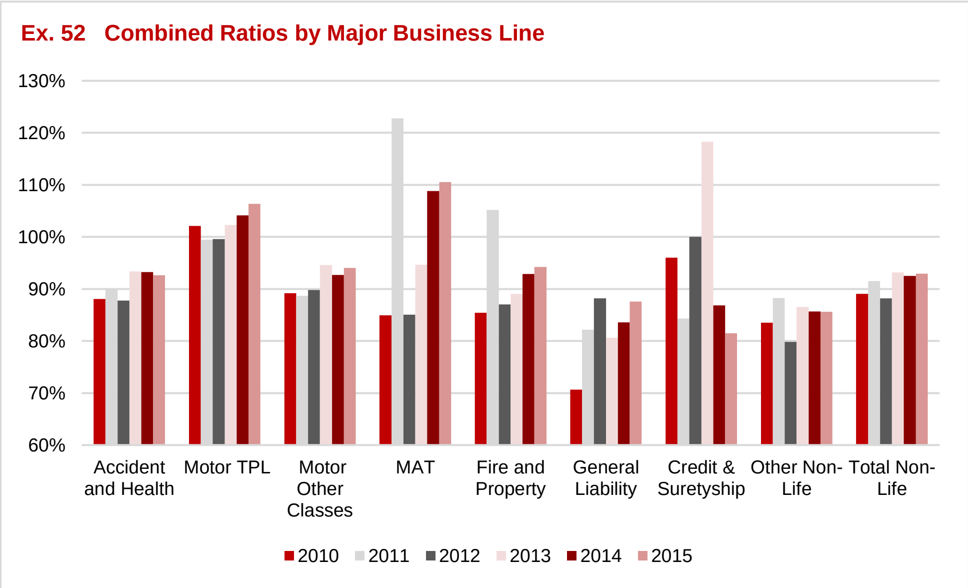


Source: EIOPA, Dagong Europe

We also expect the Spanish Non-life industry to show good overall profitability. Underwriting results are expected 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 competition and claims inflation, which might inflate loss ratios.



Source: EIOPA, Dagong Europe



Source: EIOPA, Dagong Europe

PORTUGAL

In our view, the operating environment in Portugal is challenging due to weak economic fundamentals, volatile domestic financial market, and low-interest rate environment. However, the GDP growth is improving and the unemployment rate is slowly reducing.

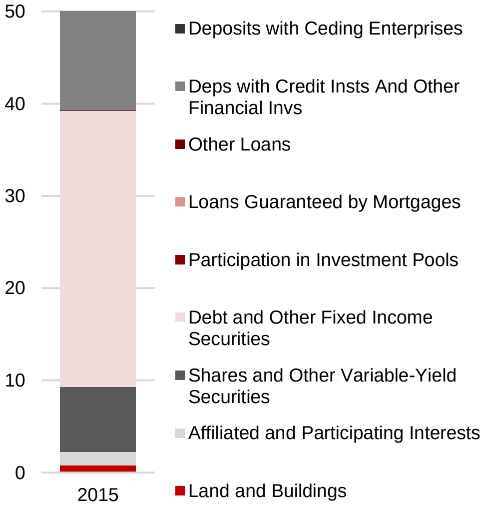
The Life insurance sector historically has dominated the Portugal's insurance industry. However, its share of total premiums has reduced to about 63% end of Sept 2016 due to its rapid contraction in the last few years and the return to growth in the Non-life industry. We expect this trend to continue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

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

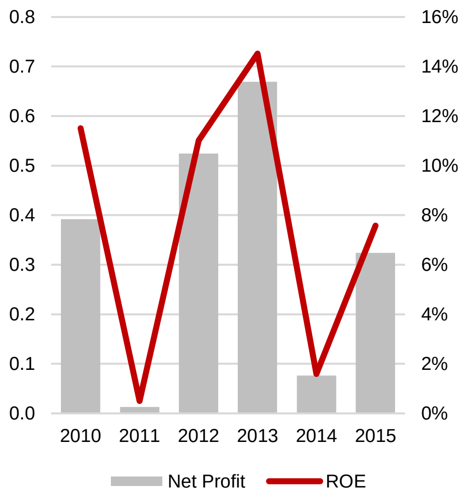
The investment portfolio has a conservative asset mix dominated by fixed income instruments, cash, and deposits. We expect the industry to increase slightly its share in higher- yield/higher-risk assets, but to maintain this mix overall.

Historically the industry's profitability has been very volatile with ROE ranging from 1% to 14% during the 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 increasing competition. The main profit contributor will remain the Non-life business, helped by its strong underwriting performance.

Ex. 53 Investment Portfolio Composition (Bn, EUR)



Ex. 54 Industry Net Profit and ROE (Bn, EUR)



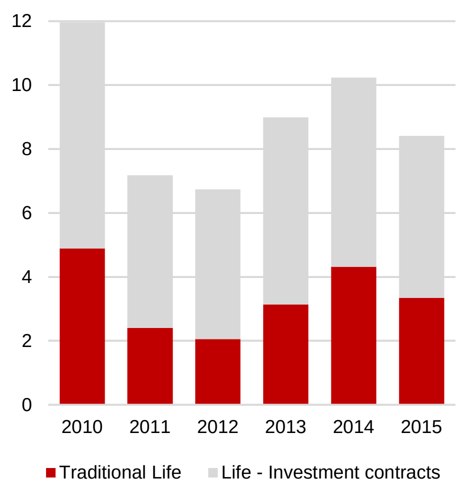
Source: EIOPA, Dagong Europe

Life

We see the operating environment for Portugal's Life insurers as challenging, negatively affected by the 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 the Life insurance products.

This weak operating environment has a significant negative affect on the Life insurance's growth, particularly in the last two years. In the first three quarters of 2016 the industry's premiums contracted by 27.5%. Unless the economy and the banking sector start showing a higher level of activity, we expect the Life industry to continue to shrink in 2017, however, to stabilise in 2018.

Ex. 55 Life Insurance GPW Development and Composition



Ex. 56 Life insurance Growth Rates

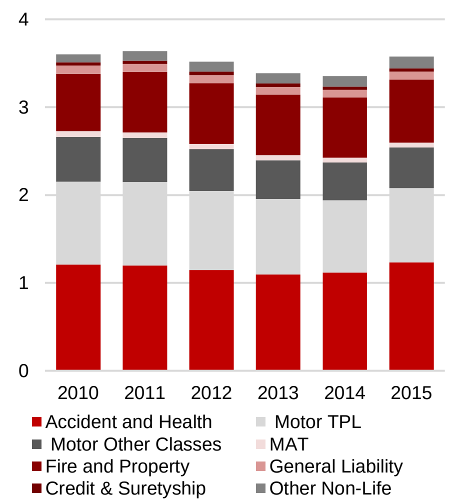
Source: ASF, Dagong Europe

According to the EIOPA stress test results, Portugal's Life insurers are highly reliant on the use of transitional measure to calculate regulatory solvency ratios. The average solvency ratio of the life industry is one of the lowest in Europe, before and after the use of transitional measures. It is also very sensitive to "double-hit" stress scenario, significantly above the European average, but more resilient to "low-for-long" stress scenario.

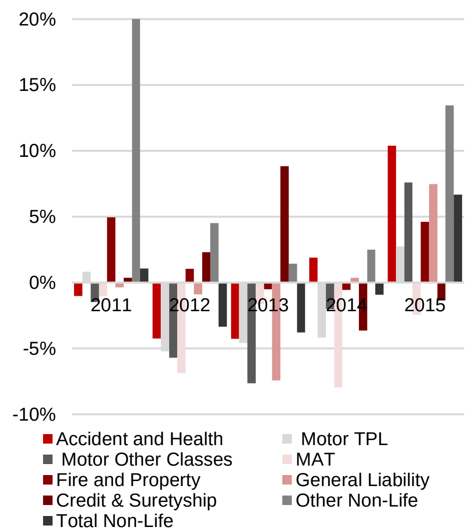
Non-Life

After three years of premium decline, 2015-16 showed the reverse of trends and improving growth rates across most of the Non-life business lines (6.3% in Sept 2016). We expect this positive trend to continue in 2017-18 with volumes increasing at about 5-7%. The growth will be supported by slowly improving economic environment and focus on technical profitability.

Ex. 57 Non-Life GPE Development and Composition (Bn, EUR)



Ex. 58 Non-Life Premium Growth by Major Business Line

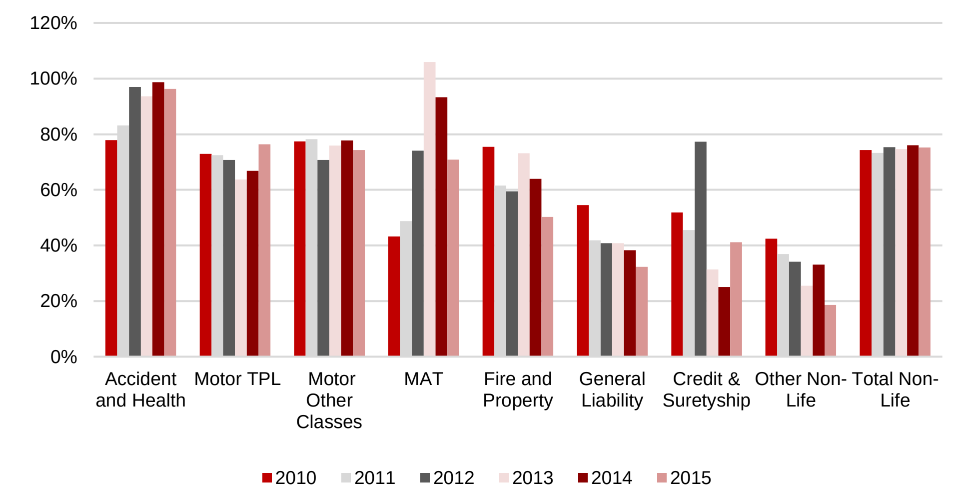


Source: ASF, Dagong Europe

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

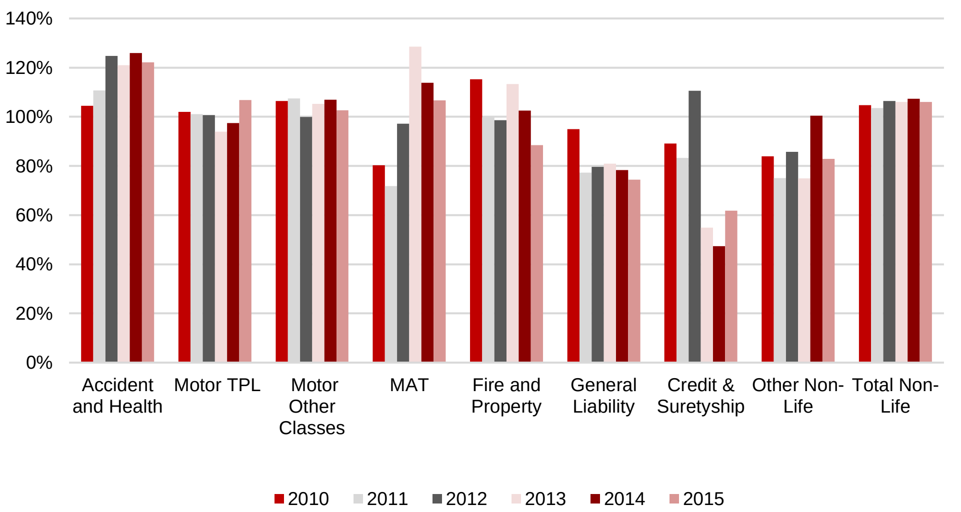
Looking at the main business lines, Worker's Compensation had a very weak loss ratio of 98.2% in Sept 2016. We see an improving trend over the last three years, helped by premium increases, however, there is still a lot work to be done before it gets to more normal levels. The other lines showed significantly better results with Motor and Health businesses reporting loss ratios at 74.4% and 68.5% respectively.

Ex. 59 Loss Ratios by Major Busines Line



Source: EIOPA, Dagong Europe

Ex. 60 Combined Ratios by Major Business Line



Source: EIOPA, Dagong Europe

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