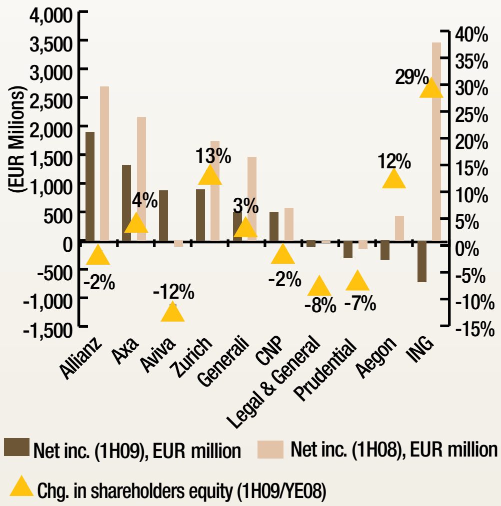
Financial Review

September 21, 2009

Sectors

Life, Non-Life, Reinsurance

Changes in Shareholders' Equity & Net Income For Selected Major European Insurance Groups



Source: Company Reports

Related Reports

2009 Special Report:
European Life & Non-Life – Financial Review:
Economic Slump, Financial Crisis
Hit Europe's Insurance Industry

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European Insurers Employ Derisking And Capital Deployment Initiatives To Improve their Financial Strength

European insurers reported varying first-half 2009 financial results. Some of the major groups still posted losses for the half year and recorded further erosion in their shareholders' equity base.

A.M. Best Co.'s analysis of Europe's 10 biggest insurance groups and the "Big Four" European reinsurers highlights a number of issues:

• European insurers seem to enjoy greater financial flexibility due to positive developments in the capital markets and better access to equity and debt facilities, but risk-adjusted capitalisation remains under pressure.

• A.M. Best believes improvement in the insurance groups' profitability – and translating this improvement into greater capital strength – are key factors in the recovery of Europe's primary insurance sector.

• Despite improved liquidity, tightening credit spreads and rising equity indices, volatility can pose significant challenges for European insurers.

• Economic conditions continue to constrain earnings prospects with depressed insurance sales, whilst the current low interest rate environment increases the cost of guarantees in life products. Higher inflationary prospects may escalate claims costs in future years.

• Insurance companies also face strong market competition. A.M. Best will continue to assess pricing discipline under these tough operating conditions.

• Major European reinsurers are relatively better positioned than direct writers. With favourable prospects for underwriting performance fuelled by increased demand for reinsurance (especially life), full-year 2009 results will inevitably depend on the degree of catastrophe losses incurred in the remainder of 2009 and the sustainability of improved market conditions.

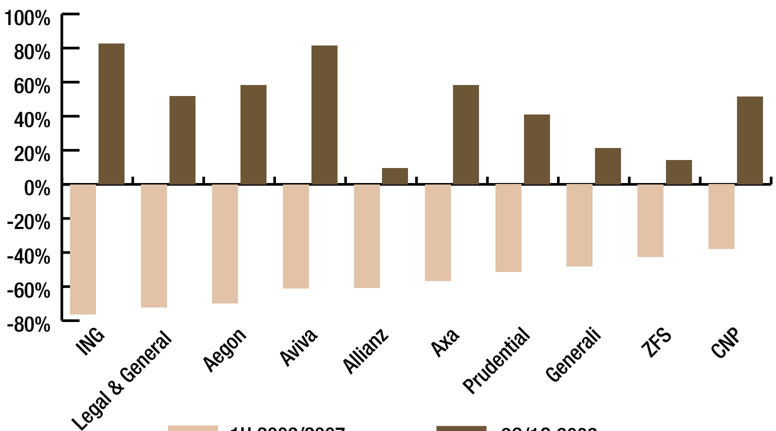
• A.M. Best recognises that European (re)insurance groups took steps toward derisking, restructuring and improving cost efficiencies, although the effects of these efforts did not fully materialize during the first half of 2009. (Re)insurers focused more on capital management and utilised various tools to strengthen capitalisation.

Capitalisation in Focus – First-Half 2009 Highlights

The combined effect of depressed underwriting results and deteriorating investment performance with increased magnitude of write-downs led to significant erosion in European insurers' capital cushions in 2008. European insurers reported further write-downs through the first quarter of 2009; however, the aggregated amount of write-downs in the first half of 2009 was significantly less compared with the preceding quarters or the USD 65.05 billion recorded by European banks (based on Bloomberg data).

Exhibit 1

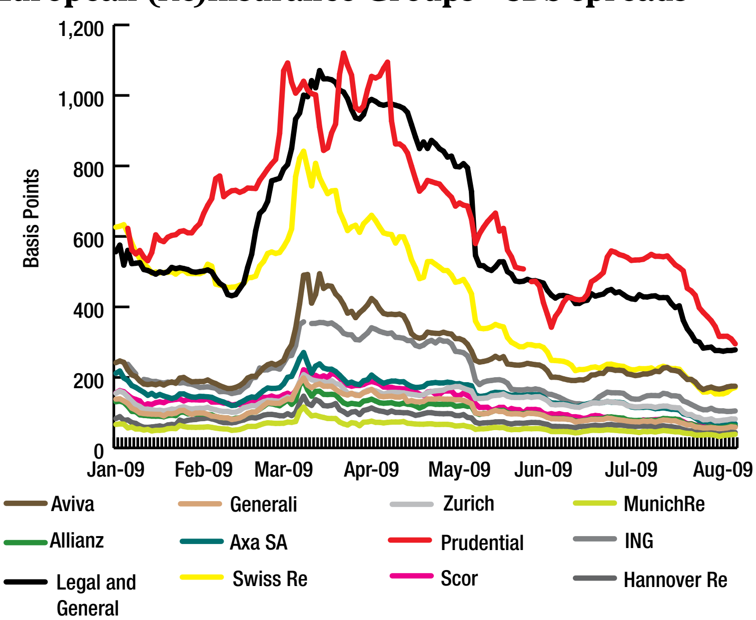
European Life & Non-Life – Changes in Market Capitalisation



Source: MSCI

Exhibit 2

European (Re)Insurance Groups - CDS spreads



Note: On senior debt (with 5 year maturity).
Source: Bloomberg

As **Exhibit 1** highlights, the market capitalisation of top European insurance groups dropped significantly – by up to 80% – over the past two years, although it showed some recovery during the second quarter of 2009.

The top European insurers' credit default spreads (CDS) on average increased significantly above those of the top European banks and the iTraxx Europe Senior Financials Index in late February 2009, but most of the major European insurers' CDS narrowed rapidly during the second quarter of 2009 (see **Exhibit 2**).

Debts and Hybrid Issuance To Boost Capital

To rebuild their capital base, several major European insurers decided to turn to the capital markets for a fresh infusion. With improved liquidity in the credit markets, most of the debt and hybrids were issued in the second and third quarters of 2009 (see **Exhibit 3**). A.M. Best notes that the quality of capital is also important in the current capital management environment. The recent transactions suggest that insurers are taking further capital management actions. To further optimize its capital structure, for instance, Zurich Financial Services Group (ZFS) announced a cash tender offer for certain outstanding preferred securities (subordinated debt).

Strategic Decisions to Improve Capital Efficiency

Depressed demand for insurance and strong competition are driving some insurers to expand geographically and pursue the benefits of diversification. Insurers used various financing techniques to support their mergers and acquisitions. For example, ZFS acquired American International Group's (AIG's) personal automobile insurance group to enhance its position in the U.S. market, and the resulting need for more capital was financed through the sale of ordinary shares in April 2009, as well as the issuance of capital notes.

In Eastern European markets, most of the European insurance groups are focused on profitability instead of growth.

Insurers have shown a strong focus on the strategic allocation of capital. Aviva, for instance, announced a partial initial public offering of Delta Lloyd to release capital and also sold its Australian business, where it saw limited opportunities for organic growth. It is noteworthy that Prudential has a strong presence and interest in Asia, but it decided to sell its Taiwanese agency unit, releasing reserves tied up in the business to strengthen its capital and surplus.

Apart from geographical market strategies, to rebuild their capital strength, insurers also reviewed their business mix while trying to avoid the high capital requirements of older guaranteed products. In this effort, several life insurers developed new products such as short-term deposits, which can be converted into unit-linked type products.

European insurance groups with significant U.S. variable annuity (VA) business took various actions. Axa, for example, repriced and redesigned some of its existing products, restructuring the VA funds to reduce basis risk. Furthermore, it intends to launch new, less complex products by the end of the year (where it is exposed to more hedgeable risk such as inflation and interest rate). A.M. Best also notes that several insurers, such as Aegon and Prudential, employ "macro" equity capital hedging to improve hedging efficiency.

Analysis of annual premium equivalent (APE) and gross premiums written (GPW) reveals that top European insurers continued to report low sales on the life side during the first half of 2009. However, it is important to note that some of the insurers, including Aegon, Aviva, Legal & General and Prudential, recorded increases in the APE margin, which enhances present value of new business premium (PVNBP) margin figures.

European insurers posted lower underwriting results for their non-life business units. The recession has a significant negative effect on the motor business, as the drop in car sales reduced demand for primary insurance (although offset by government scrappage schemes to some extent), and price competition drives average premiums down in certain countries. A.M. Best also notes that rises in premium rates have generally been below the level of claims inflation, and earnings prospects for this line of business remain under pressure.

Some insurers were also hit hard on credit insurance – the other financial crisis correlated business. For example, Allianz's combined ratio worsened to 118.9% in the second quarter of 2009.

Overall, most European insurance groups' combined ratios deteriorated further or remained flat in the first half of 2009 (see **Exhibit 4**). Certain insurers (for example, Allianz), in order to achieve better combined ratios, continue their restructuring, which will result in further cost reductions.

Exhibit 3

European Life & Non-Life – Recent Selected Debt & Hybrid Issuance (2009)

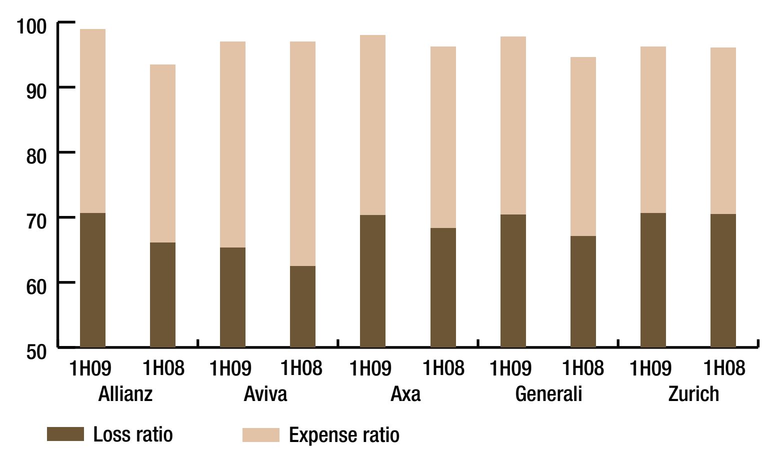
(Amounts in millions)

	Issuer	Type	Principal	Coupon	Call
1H 09	Aviva	T2 Hybrid	GBP 200	-	-
	Aegon	Senior	EUR 1000	7.00%	4 yrs
	Prudential	T2 Subordinated	GBP 400	11.38%	10 yrs
	Axa	Senior	EUR 1000	4.50%	5.5yrs
3Q09	Allianz	Senior	EUR 1500	4.75%	10 yrs
	ZFS	T1 Perpetual	EUR 425	7.50%	10 yrs
	Prudential	T1 Perpetual	USD 750	11.75%	10 yrs
	Legal and General	T2 Subordinated	GBP 300	10.00%	12 yrs

Source: Company Reports

Exhibit 4

European Non-Life –
Development of Combined Ratios (1H 2008-1H 2009)



Note: Figures are not fully comparable, as calculation methods for combined ratios may differ.
Source: Company Reports

Conservative Investments to Limit Market Shocks

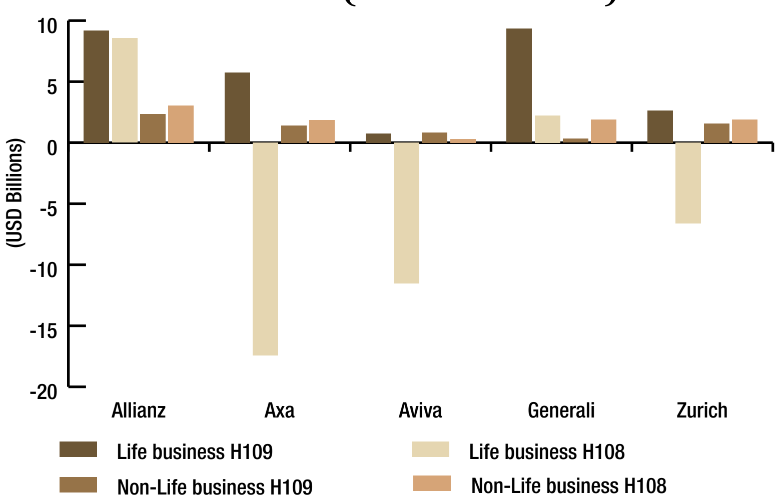
A.M. Best notes that liability-driven investing (LDI) strategies have gained importance, as annuity writers face challenges to close their asset-liability mismatches. Legal & General, for example, purchased duration-extension swaps. Insurers also widely use interest-rate hedges to reduce their interest-rate exposure and to efficiently manage cash flow and duration matching. Aviva employs such a programme to hedge minimum related guarantees in the Netherlands and guaranteed annuity exposures in the United Kingdom.

Another issue is credit write-downs on bond investments backing annuity portfolios. Insurers showed continued focus on default reserving. Legal & General, for example, set up additional reserves against further investment write-downs and defaults – strengthening its total reserves to GBP 1.3 billion, although actual defaults on corporate bonds amounted to GBP 1 million in the first two quarters.

Meanwhile, Aviva's short-term provision of GBP 550 million against defaults on corporate bonds and commercial mortgages remain unused, but it built up further provisions of GBP 42 million for the U.K. general insurance mortgage portfolio. This brought the total amount to GBP 68 million, of which GBP 16 million is set against specific mortgage loans.

Exhibit 5

European Life & Non-Life – Net Investment Income (1H 2008-1H 2009)



Note: Amounts are not reported in local currency but in USD. They include realized and unrealized gains/losses from insurance activities only.
Source: A.M. Best Quantitative Analysis Reports (QAR)

As a result of de-risking initiatives, certain insurers decided to reduce their exposure to bank subordinated debt. For example, Legal & General's non-senior bank debt portfolio has decreased (on a market-value basis) by 26% in the United Kingdom and 28% worldwide, reflecting active disposals and movements in market value.

Despite the rally in the equity markets in the second quarter of 2009, European insurers remain generally cautious and did not increase the weight of equities in their investment portfolios compared with 2008 year-end asset allocations. In fact, they have limited their net exposure to the volatile markets via hedging programs.

Overall, insurers seemed to have benefited from the narrowing spreads on their fixed-income portfolios in the second quarter of 2009. This, combined with lower losses from equity investments (hedging and valuation), resulted in better investment performance on the life side at the end of June 2009 (see **Exhibit 5**).

In terms of cash and other cash equivalents, major European insurers' balance sheets remained relatively liquid at the end of June 2009. Furthermore, they benefited from good operating cash flow for the first half of 2009, and their short-term liquidity positions are underpinned by access to committed credit facilities and commercial paper programs.

Capitalisation Still Under Pressure

While Aegon, Legal & General and Prudential still posted half-year net losses, others (Allianz, Aviva, Axa, Generali and ZFS) reported profits, but significantly less (by as much as 66%) than a year earlier. ING's insurance arm continued to book half-year losses (EUR 701 million before tax), unlike the banking operation, which maintained a pretax profit of EUR 494 million.

Although Allianz and Aviva recorded profits for first half of 2009, their total equity levels shrank further compared with year-end 2008. Several insurers, such as Aviva and Legal & General, decided to cut their dividends to boost their capital positions. However, Prudential announced it will increase the dividend despite a comprehensive loss of GBP 129 million (although this was significantly less than the GBP 355 million loss a year earlier) and a decrease of 7% in shareholder capital compared with year-end 2008.

Exhibit 6 shows that at the end of the first half of 2009, European insurance groups maintained significantly lower capital and surplus levels than a year earlier.

Comparing capitalisation levels to the prior year end and on a regulatory capital basis (although it is not measured on a risk-based approach and the reported solvency figures are not fully consistent and comparable) it is worth noting that Allianz reported a 2 percentage point drop in its solvency ratio (based on the European Commission's Financial Conglomerate Directive), whilst the remainder of the top 10 European insurers published improved first-half 2009 ratios (based on surplus under the EC's Insurance Group Directive).

Review of the 'Big 4' Reinsurers' Performance

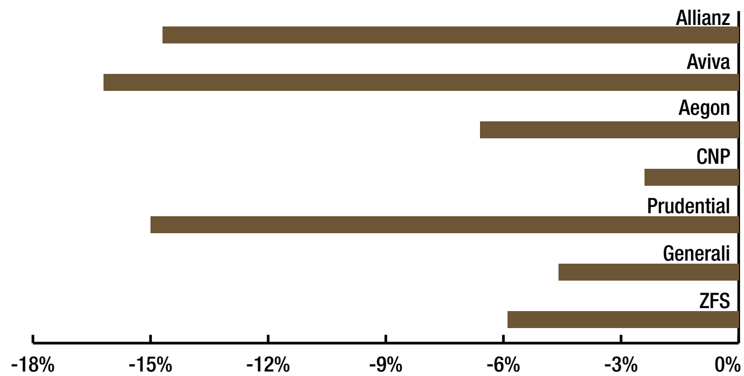
The capital depletion at primary insurers has created stronger demand for reinsurance, thereby boosting reinsurers' premium income. In life business, some of the reinsurers recorded further profitable growth with M&A transactions. For instance, Hannover Re significantly increased its premium income as a result of the acquisition of the ING Life Re portfolio. The acquisition of XL Re Life America is expected to help Scor to strengthen its position in the mortality-protection area. While Munich Re, Hannover Re and Scor managed to book double-digit growth in their reinsurance premium income on the life side, Swiss Re still reported a decrease of 5.9% on an annualized basis.

On the non-life side, all of the "Big Four" reinsurers increased their reinsurance premium income, with Hannover Re and Scor recording double-digit rises of 16.0% and 14.2%, respectively. Munich Re made some strategic acquisitions, including the purchase of Hartford Steam Boiler Group. This transaction closed at the end of the first quarter of 2009 and is expected to strengthen Munich Re's global business profile by adding U.S. specialty insurance segments.

Top European reinsurers reported favourable technical results and significant improvements in their combined ratios in the first half of the year, driven by the lower impact from natural catastrophes. In certain cases, such as Hannover Re, combined ratios also benefited from reserve releases (see **Exhibit 7**).

Exhibit 6

European Life & Non-Life– Changes in Capital & Surplus (1H 2008-1H 2009)

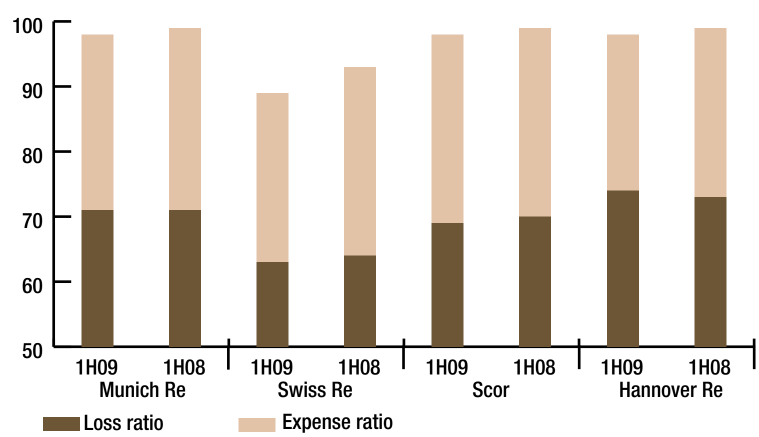


Note: Capital & surplus includes: capital; uncalled and paid-up capital; distributive, non-distributive, and claim equalisation reserves; life and non-life funds; and retained earnings. (Please note that this does not cover all the unrealised gains/losses, reserves or other adjustments under Best's Capital Adequacy Ratio.)
Source: A.M. Best Quantitative Analysis Reports (QAR)

Exhibit 7

European Reinsurance – Development of Combined Ratios (1H 2008-1H 2009)

For the 'Big 4' groups.



Note: In case of Munich Re, figures cover reinsurance business only. For Hannover Re, split is not available; based on A.M. Best's calculation.
Source: Company Reports

Divergent development in the reinsurance and direct businesses can also be observed in Munich Re, which showed a year-on-year improvement of 1.8 percentage points for its reinsurance combined ratio, but also published an increase of 4 percentage points in the primary insurance segment.

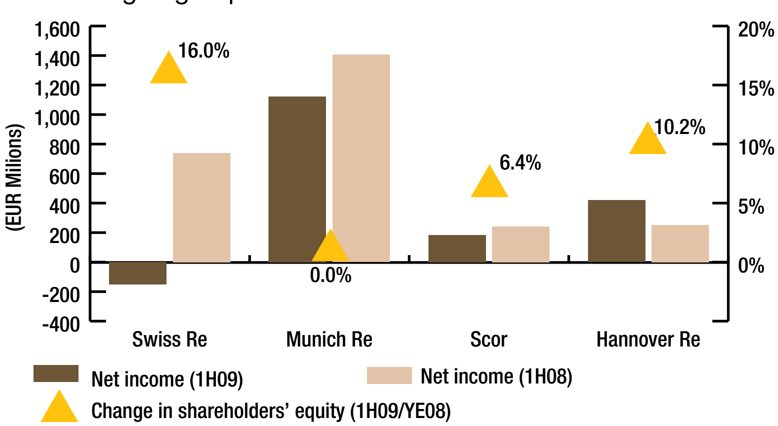
Despite the rebound in equity markets in the second quarter of 2009, reinsurers continued to show limited appetite for risk. But as a result of active portfolio management, some insurers reduced hedge quotas as stock indices increased, therefore reporting somewhat higher equity exposure compared with the first quarter of 2009. In contrast to other reinsurers, which reported no more than 4% equities within their investments at the end of June 2009, Swiss Re's portfolio still contained a relatively high proportion of equities at 9.5%. This is lower than in the first half of 2008, however.

The overall credit quality of fixed-income portfolios remained high, despite the deterioration derived from the increasing number of downgrades in each asset class (government, financials, corporate bonds and structured products) over the first six months of 2009. With regard to structured products (excluding covered bonds) only, it should be highlighted that while 98.9% of Scor's portfolio is rated AAA, AA or A, similar to Munich Re's percentage of 97%, Swiss Re reported a significantly lower figure at 86.3%.

Exhibit 8

European Reinsurance – Changes in Net Income & Shareholders' Equity

For the 'Big 4' groups.



Note: Exchange rate for Swiss Re: 1 Swiss Franc = 0.62185 Euro (June 30, 2008); 1 Swiss Franc = 0.65586 Euro (June 30, 2009).
Source: Company Reports

Investment performance of the "Big Four" reinsurers deteriorated significantly during the first quarter of 2009. However, Swiss Re reported a drop of 36.9% in its net investment income, Scor had an investment loss of EUR 4 million, compared with income of EUR 161 million a year earlier, and Munich Re's and Hannover Re's net investment income decreased by 18.5% and 24.5% respectively; at the end of June 2009, Munich Re and Hannover Re still published improved total half-year investment results, benefiting from the recovery in the financial markets in the second quarter.

Concerning derivative exposures, Swiss Re made significant steps in de-risking its "legacy portfolio," even reporting an operating profit (CHF 71 million) relating to the portfolio during the second quarter of 2009. Overall, however, it posted a net loss of CHF 381 million for the second quarter, driven mainly by losses from hedging of corporate bonds, impairments and other items (related to the valuation of variable annuity guarantee business).

With the exception of Munich Re, reinsurers reported significant increases in shareholders equity for the first half of 2009 (see **Exhibit 8**). To boost overall capitalisation further, Swiss Re, for example, also decided to raise capital by issuing senior debt instruments of CHF 300 million and CHF 700 million in May 2009.

A.M. Best believes reinsurers' risk-adjusted capitalisation levels remained strong at the end of June 2009, although future catastrophic and investment losses could strain those capital cushions in the second half of the year.

Conclusion and Outlook

Financial institutions' 2009 half-year results varied widely. While some of the major banks announced bonus payments after posting improved net results for the second quarter, insurance companies seemed to remain more cautious. Certain insurers even considered reducing the interim dividend, given the uncertain economic conditions. Although liquidity is improving in the credit markets and some positive signals also can be seen regarding the economy's recovery, European insurers have faced tough market conditions.

A.M. Best also recognizes that insurers have focused strongly on the strategic allocation of capital. Faced with depressed demand for insurance and strong competition, certain insurers use M&A transactions to gain benefits of diversification or to unlock capital from businesses with limited opportunities for organic growth. Apart from geographic market strategies, to rebuild their capital strength, insurers also moved to review their business mix, avoiding capital-intensive, low-margin life business and redesigning some of their products.

A number of insurers also turned to the capital markets to strengthen further their capital base. Owing to the difficult operating environment, insurance companies are likely to continue to focus on de-risking and cost efficiency during the second half of 2009. A.M. Best notes that insurers demonstrated increased focus on capital management and utilised various tools to strengthen their capitalisation levels.

Compared with direct insurers, major European reinsurers enjoy a relatively better position and benefit from favourable underwriting performance prospects due to the higher demand for reinsurance. However, an abnormal level of future major catastrophe losses, combined with investment losses, could stretch capital levels during the second half of the year. For more details on major European insurance and reinsurance groups' current ratings and individual rating actions, see **Exhibit 9**.

Exhibit 9

European (Re)Insurance – A.M. Best's Financial Strength & Long-Term Issuer Credit Ratings of Major Groups

	Ratings					
	FSR	Outlook	ICR	Outlook	Type of Rating Action	Date of Last Rating Action
Allianz	A+	Stable	aa	Stable	Affirmation	11/3/2009
Aviva	A	Stable	a+	Stable	Downgrade of FSR & ICR	12/3/2009
Generali	A+	Stable	aa-	Stable	Affirmation	18/8/2008
Legal& General	A+	Negative	aa-	Negative	Downgrade of ICR, negative outlook for FSR & ICR	25/3/2009
Zurich	A	Stable	a+	Stable	Affirmation	11/12/2008
Hannover Re	A	Stable	a+	Stable	Revision of the outlook for both FSR& ICR from positive to stable	20/7/2009
Munich Re	A+	Stable	aa-	Stable	Affirmation	20/7/2009
Scor	A-	Positive	a-	Positive	Revision of the outlook for both FSR & ICR from stable to positive	4/9/2009
Swiss Re	A	Stable	a+	Stable	Downgrade of FSR & ICR, revision of outlook to stable	27/2/2009

Note: The list presents the ratings on the (main) operating company level. See *http://www3.ambest.com/ratings/RatingsSearch.asp* for a complete listing of companies and debt instruments.
Source: A.M. Best

Published by A.M. Best Company

Special Report

September 21, 2009

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SR-2009-150

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