2018 Credit Outlook for the Global Insurance Industry

Dagong Global Credit Rating Co., Ltd

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Main Opinions

● In 2018, the recovery of the global economy and the expected tightening of monetary policy will improve the profitability of insurance industry. However, the accumulated credit risks still exist.

● The United States will continue interest rate hike. However, slow economic recovery and rising claims in the U.S. insurance industry cause severe pressure on underwriting capacity. Overall profitability will be challenged.

● Weak economic fundamentals and ultra-low interest rates have led to a rise of preference for high investment returns in Japan's life insurance industry, raising its portfolio risk and thus its credit risk.

● Under the influence of long-term low interest rate environment and strict supervision, the profitability of European insurance industry continues to be under pressure, and the preference for life insurance investment continues to rise.

● Due to the tightening of regulation policies, the growth rate of insurance premiums in China is slowing down, challenging short-term liquidity. But the long-term credit risk is still under control.

Contact

Financial Research Department

Feng Zhou, Mo Yunhua, Han Xiliang

hanxiliang@dagongcredit.com

Tel：(8610) 51087768

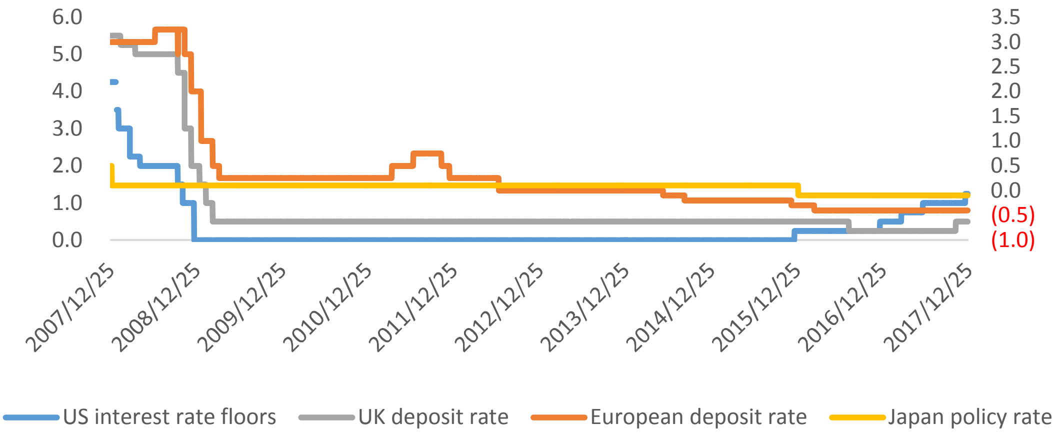
Address：30th Floor, Eagle Run Plaza A, No.26 Xiaoyun Road, Chaoyang District, Beijing, China.

With the slow recovery of the global economy and withdrawal of the major developed economies from loose monetary policy, the global insurance underwriting demand and investment returns are expected to rise accordingly. Tighter financial regulations will reduce the liquidity risk of insurance companies and ensure prudent operation, mitigating the global insurance credit risk. However, under the influence of long-term ultra-low interest rate and low growth macro-environment, underwriting and investment have accumulated risks and have to be adjusted for risk control in the future; there are potential risks in global insurance industry.

I. In 2018, the recovery of the global economy and the expected tightening of monetary policy will improve the profitability of insurance industry. However, the accumulated credit risks still exist.

The monetary policy of the world's major economies in 2018 will shift from loosening to tightening, but there are still some differences among regions. Internationally, the U.S. economy will remain stable, the Federal Reserve is expected to continue moderate interest rate hikes and balance sheet reduction, and the yield on the 10-year treasury is expected rise to about 3%; the European economic recovery has stabilized, while the European Central Bank (ECB) has maintained a loose monetary policy to spur economic growth while reducing debt purchases, and the UK has been affected by factors such as Brexit and high inflation, and long-term economic growth prospects are not optimistic, and the space of British Central bank to interest rate hike is limited; Japan's economic remains weak, and the Bank of Japan (BOJ) will continue to maintain the loose monetary policy, but the Federal Reserve’s pressure to raise interest rates will spur it to gradually start the process of normalizing the monetary policy by reducing debt purchases or by reducing the introduction of new quantitative easing measures. China's economy will maintain a steady growth, as the regulatory policy to reduce macro-financial leverage continues to be strong and monetary tightening is expected to be stronger, and the central bank is expected to maintain a neutral monetary policy to guide the supply-side reform and to achieve the goal of reducing systemic risks (Figure 1).

Figure1: Global Major Economics Policy on the Base Rate（2007-2017）



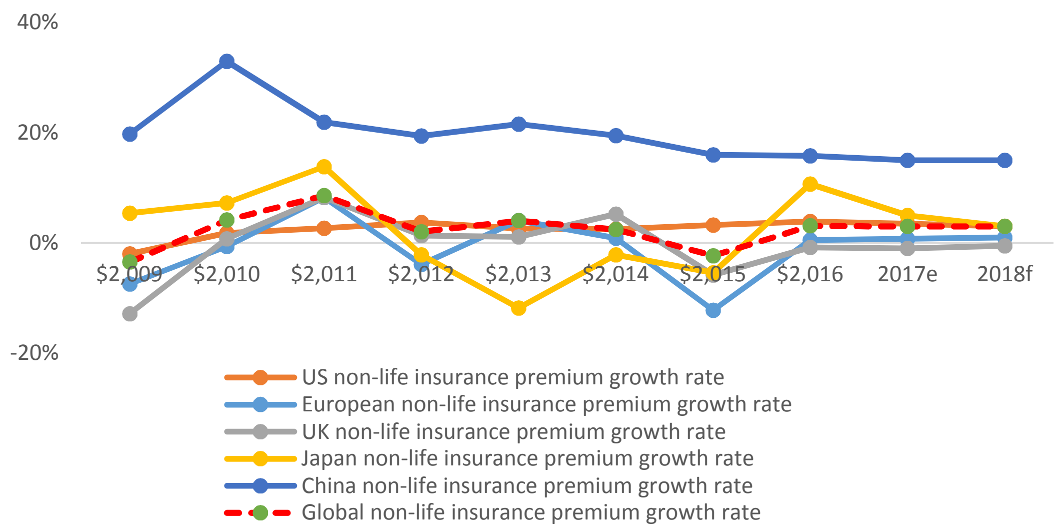
Source：Bloomberg, Dagong

With the improvement of the global economic outlook, the demand for the insurance industry will increase, and the global monetary policy tightening is expected to assist in improving investment income; thus, the 2018 insurance industry profitability will be improved, the overall credit risk will be mitigated. The growth rate of global insurance premiums is estimated to be about 3%[1] in 2018 (Figure 2), in which emerging markets will continue to be the main drive; the actual growth rate in the next two years will reach 6% to 7% and China is the main drive in the emerging market premium growth, expecting a growth rate of 15%. On the other hand, due to the long-term low interest rate and the macro-environmental effect, the investment yield of global insurance industry is low and the rate adjustment and catastrophe losses increased significantly resulting in underwriting losses and investment income continued to decline. In 2017, profitability of global non-life insurance dropped significantly, return on equity (ROE) fell from 6% in 2016 to 3%. It is expected that in 2018, under the precondition of the return of catastrophe losses to normal, along with the economic recovery of the developed countries, the advance of the normalization of monetary policy, and the interest rate gradually enters the upward channel and other factors, so the global

[1] The growth rate is the actual rate of growth minus the inflation factor.

insurance industry investment income is expected to increase slightly, and ROE will be at 7%-8% level.

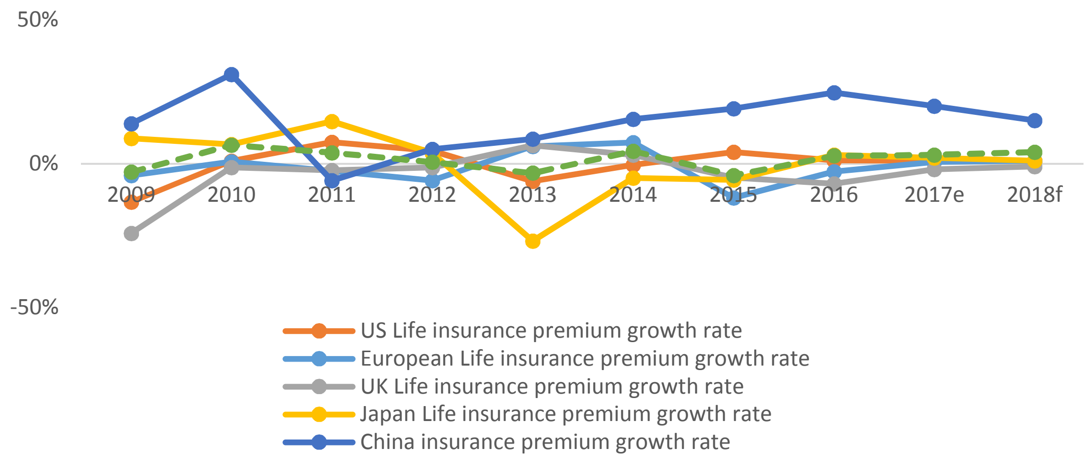
Figure2: Global Non-life Insurance Premium Growth Rate and Forecast（2009-2018）



Source: SwissRe, Dagong

With the tightening of financial supervision, the global life insurance industry liquidity risk will continue to be mitigated, the global life insurance industry premium is expected to grow steadily, and the 2018 global life Insurance premium growth rate is expected to increase slightly to 4% (Figure 3). But due to ultra-low interest rates in recent years, the higher investment risk preference is still a potential risk factor. The overall credit risk will be under pressure. As the US economy gradually recovers, life insurance premiums are expected to grow modestly, and the Fed's steady interest rate hike will also help to boost investment earnings, and the diversity of life insurance products is strong, so liquidity risk is expected to improve. Japan's life insurance industry will further adjust the asset-liability structure to deal with the long-term ultra-low interest rate environment in Japan, thus controlling the exposure of assets and liabilities, but its investment portfolio share of large foreign portfolio investment will still face a certain currency risk. The European life insurance industry has also stepped up the sales of insurance products concerning investments and lowered the guaranteed interest rate, thereby mitigating the risk of product pricing resulting from low interest rates. A marked decline in the portfolio credit rating suggests that its investment preference for risk continues to rise. China's life insurance industry, under the effect of regulatory policy, sees a transition from short-term holding of savings-type product sales to long-term payment of security-oriented products, so that the short-term life insurance industry credit risk climbed. But in the long run, it helps to reduce the mismatch risk of balance. However, the growth of other investments with a larger portfolio and less liquidity (long-term equity investment, bank financial products and trust programs) shows that their investment risk preference has increased rapidly, which leads to an increase in the overall portfolio risk, but the portfolio structure is basically stable and still controllable.

Figure3：Global life insurance premium growth rate and forecast（2009-2018）



Source：SwissRe、Dagong

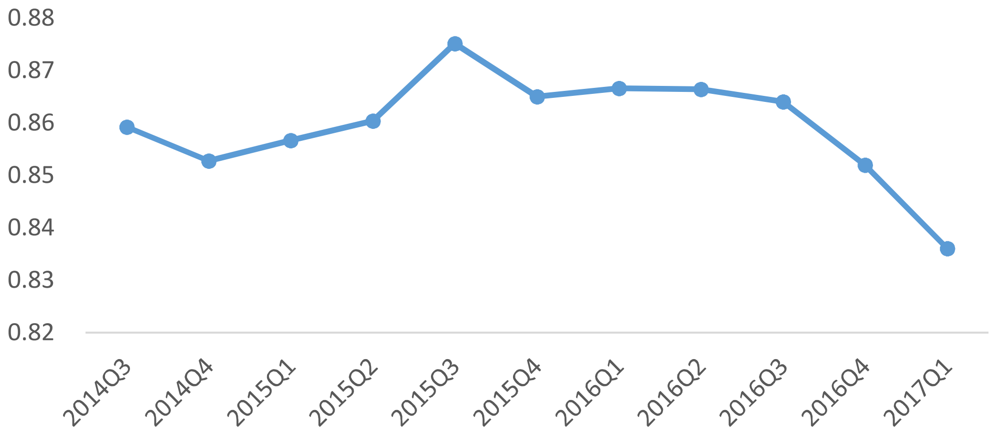
II. The United States will continue interest rate hike. However, slow economic recovery and rising claims in the U.S. insurance industry cause severe pressure on underwriting capacity. Overall profitability will be challenged.

In 2018, the U.S. economy will continue to recover in 2018, unemployment will remain low, and the normalization of monetary policy will push forward, the U.S. long-term Treasury bond yield will be further raised (about 3%), which is conducive to stimulating the insurance industry product demand and improve investment income. On the other hand, under the influence of the fierce competition of the insurance industry, the renewal rate of the US insurance industry continues to decline, while the increase in natural disaster compensation and payment directly weakens the profitability and the overall credit risk is under pressure. In addition, the 2017 major natural disasters (Hurricane Harvey, "Alma", "Maria", the Mexican earthquake and so on) caused a sharp rise of claims in the insurance industry. The three hurricanes and the Mexican earthquake caused up to 95 billion U.S. dollars in the payments, close to 2011-year historical peak. And the non-life insurance will be seriously affected and the underwriting loss shall occur. By the end of the first quarter of 2017, the US insurance industry's underwriting capacity has broken the historical record (up to 709 billion U.S. dollars), 4.8% rise year-on-year, the chain growth falling to 1.2% but still higher than the average (0.5%) in the first 11 quarters. At the same time, the US insurance industry underwriting capacity adequacy index[2] declined in three consecutive quarters (Figure 4), far below the previous 20-year historical average (1.08). Both factors are expected to drag down the downward trend in the subsequent decline in the rate of insurance premiums, or to form a sustained and narrow momentum to the global insurance industry, with limited support for the growth of 2018 premium. It is expected that 2018, the US premium of insurance for catastrophes will be increased, but considering the continued adequacy of the insurance market underwriting capacity[3] will promote competition in the industry, and the future overall renewal rate decline will increase, directly restricting the future growth of premium.

[2] Indicators for loss and loss adjustment reserve/policy holder surplus, the smaller the indicator value, indicating that the more adequate underwriting capacity

[3] The underwriting capacity is the residual amount of the policy holder under US accounting standards, similar to the owner's equity.

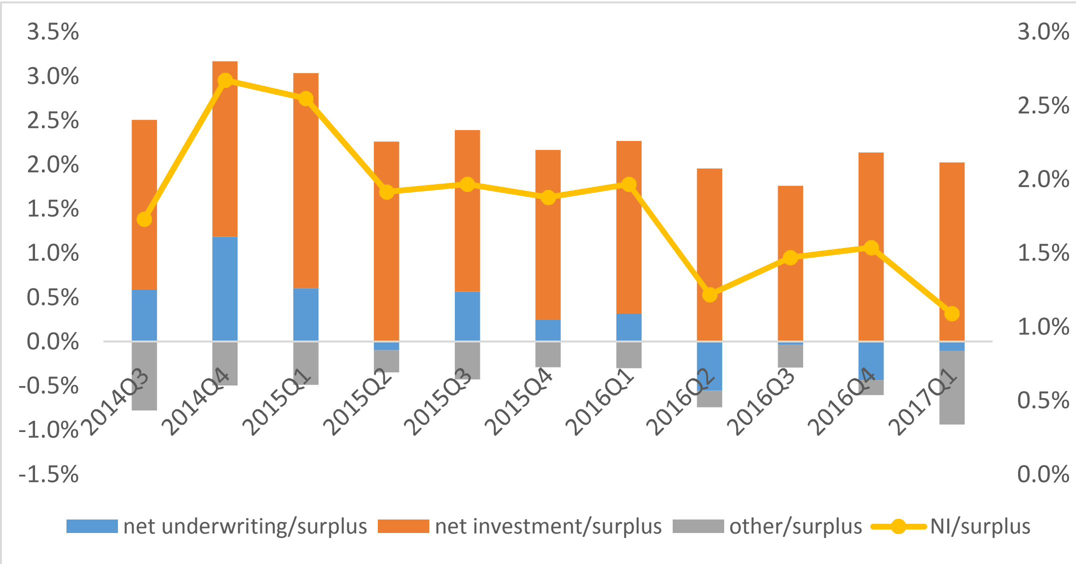
Figure4: Adequacy of Underwriting Capacity in U.S. Insurance Industry



Source: United States property and Accident Insurance Association, Dagong

In terms of profit structure, the contribution of the U.S. insurance industry investment income is relatively high (about 60% to 70%, Figure 5) and relatively stable, the source of change is usually from underwriting earnings fluctuations. The consecutive years of low interest rates environment have prompted the US insurance company to achieve more stable investment gains through active investment management such as increasing the proportion of equity investment. Furthermore, the Fed's interest rate hike policy and the continuous good of the stock market are conducive to increasing investment returns. On the other hand, due to the fierce competition in the industry led to a limited rate increase and inflation to raise the cost of the impact of insurance, underwriting profit is relatively limited; In 2018, the overall profitability of the U.S. insurance industry will face a certain downward pressure led by the limited underwriting profit, the industry's overall credit risk continues to be under pressure.

Figure5: Profit Structure and Profitability of U.S. Insurance Industry

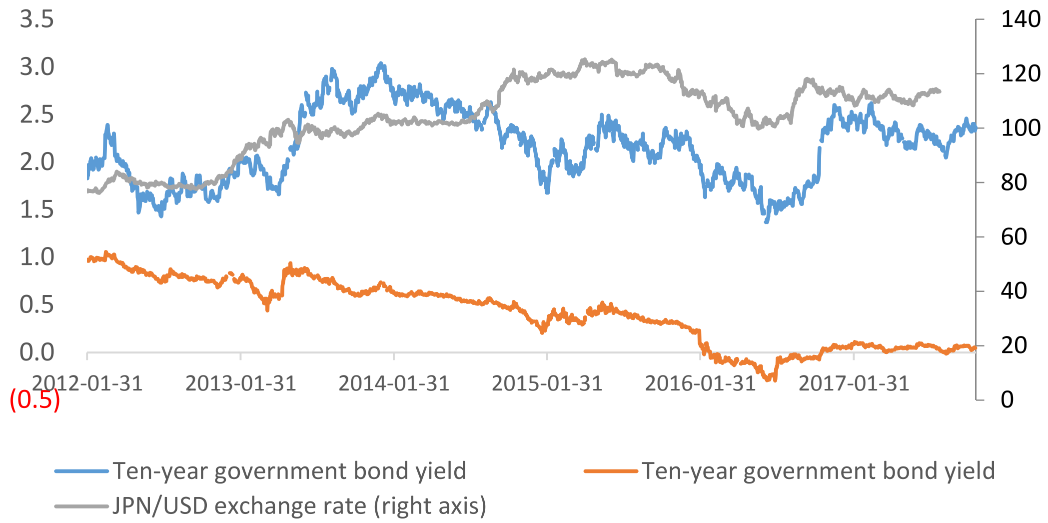


Source: United States property and Accident Insurance Association, Dagong

III. Weak economic fundamentals and ultra-low interest rates have led to a rise of preference for high investment returns in Japan's life insurance industry, raising its portfolio risk and thus its credit risk.

In 2018, the Bank of Japan will maintain the loose monetary policy in order to continue stimulating the weak economy, which will promote life insurers in Japan to continue reducing their holdings of national debt and increasing the holding of foreign portfolio investment. Portfolio risks are thus heightened. Japan's central bank's unconventional monetary policy has led to a prolonged period of ultra-low interest rates in Japan, with 10-year treasury yields of about 0.05% (Figure 6), while yields on the same maturities are about 2.35%. The treasury yields are expected to rise to around 3% in 2018 as the Fed continues to raise interest rates. The BOJ will continue to rein in the long-term yields of treasury at around 0% before the signs of recovery and inflation rebound, leading to a widening of future U.S. and Japanese bond spreads. In order to raise the reinvestment income and reduce the profit pressure after the maturity of Japanese government bonds, Japan's life insurance industry under the guidance of large life insurance companies continue to reduce the size of Japanese bond investment, to transfer in dollar denominated overseas securities (including investment-grade U.S. corporate debt, supranational bonds, overseas real estate, etc.) or domestic stocks, relatively high risk area (Figure 7), which pushes up portfolio risk and investment income pressures.

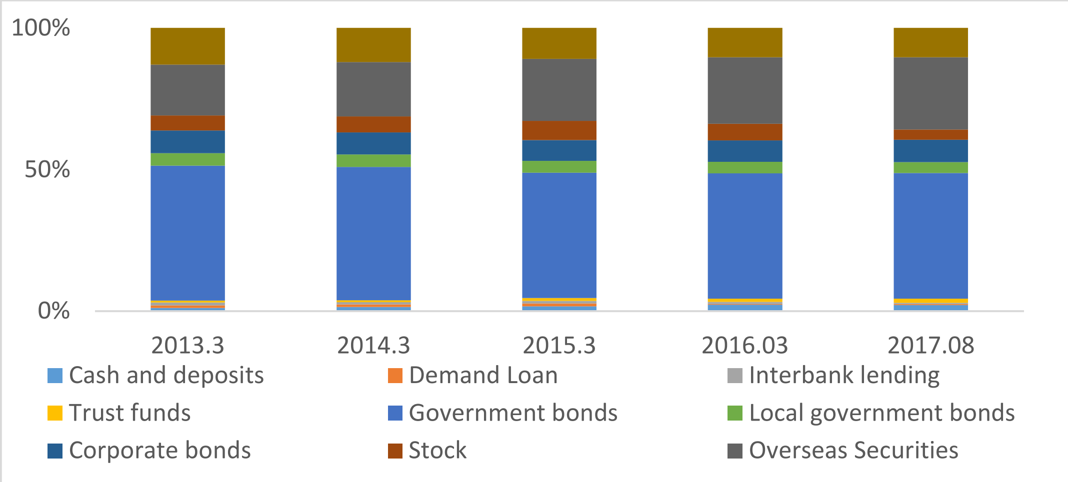
Figure6: Japanese and U.S. Government Bond Yields and Exchange Rate（%）



Source: Japan Life Insurance Industry Association, Dagong

In terms of currency risk, as the inconsistency between Federal Reserve and the Bank of Japan monetary policy becomes glaring, and USD/JPN exchange rate is highly correlated to the US and Japan's long-term bond spreads, USD/JPN exchange rate is expected to continue to strengthen in the short term. In anticipation of a weaker yen and rising exchange-rate hedging costs, there will be very little room for real investment yields after the exchange rate hedging. Therefore, Japanese life insurance companies in the background of increasing profit pressure is expected to actively assume exchange rate risk, and will continue to reduce overseas investment portfolio with exchange rate risk in the short term, and increase the overseas investment portfolio without exchange rate. This measure will increase the profit margins and let the investment portfolio exchange rate exposure become larger, which is not conducive to credit risk mitigation.

Figure7: Assets Distribution of Japan Life Insurance Companies

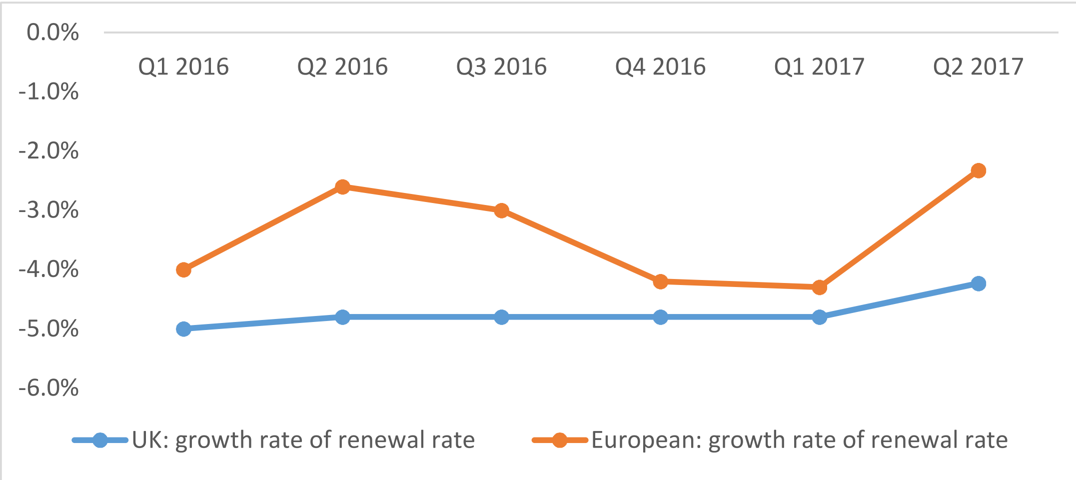


Source: Japan Life Insurance Industry Association, Dagong

IV. Under the influence of long-term low interest rate environment and strict supervision, the profitability of European insurance industry continues to be under pressure, and the preference for life insurance investment continues to rise.

In 2018, European non-life insurance premium will continue to grow at a low speed on the basis of sustained economic environment and the decline of rate will continue to narrow. Since 2017, under the background of the high speed of global economic recovery and the sustained stimulus of the euro zone's loose monetary policy, the growth of GDP in the major euro-zone economies has been accelerating, investment and consumer demand have resumed growth, and economic activity has boosted the underwriting needs of various non-life insurance products (Figure 8). Affected by this, the reduction of renewal rate significantly narrow in the European mainland business policy, which is conducive to the growth of European insurance premium. On the other hand, because of the uncertainty of the process of the Brexit negotiations, the strong impact of high inflation and the expected devaluation of the pound, the UK economy has shown a sustained downward trend, while the slump in insurance demand has led to no significant improvement in the decline of renewal rate. Both the overall insurance premium growth outlook and underwriting profitability are not optimistic.

Figure8: Trend of Renewal Rates for Commercial Policies in Europe and UK Insurance Industry



Source：Marsh、Dagong

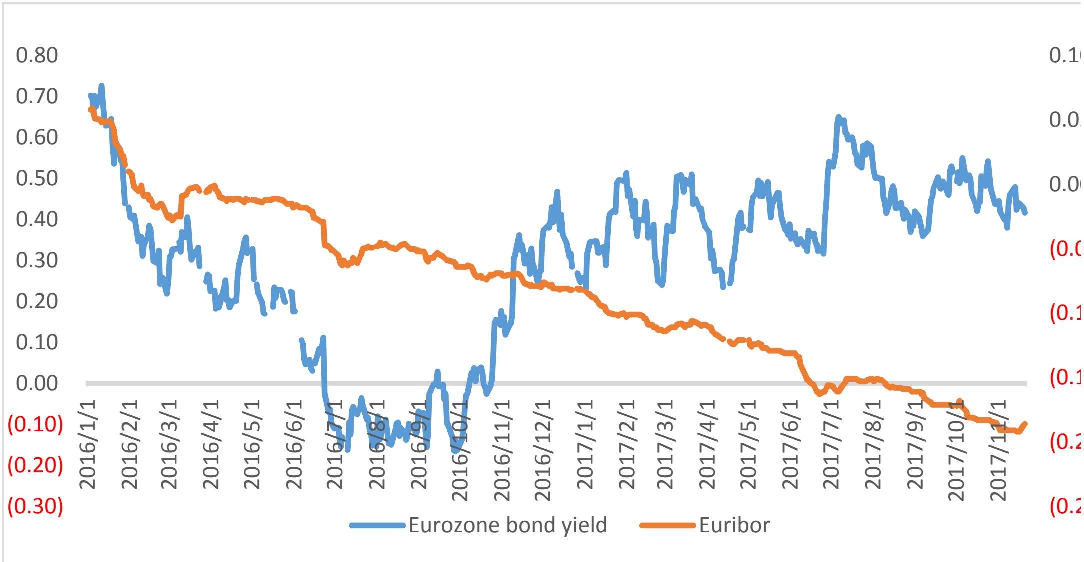
In terms of life insurance, in 2018, due to the severe impact of ultra-low interest rate environment and tighter financial regulations, investment yield decreases and the European life insurance industry profitability is under pressure. Long-term low interest rates not only directly affect the investment income of European insurance companies, but also prompted regulators to reduce the discount rate of risk reserve, resulting in high debt costs and bidirectional balance-sheet pressure. The EU loose monetary policy directly led to the downward market interest rates, which result in the pressure[4] on insurance companies' investment income to rise sharply. Euro zone interbank lending rates continued to be negative since 2017, while government bond yields[5] have risen slightly (Figure 9). It is expected that the government bond yields will recover further and be stable in the basis of a good euro zone economy and withdrawal of the quantitative easing in 2018, which will help to ease the pressure on investment yield of European insurers. For the cost of debt, in the case of UK, since March 2017, Solvency II required that the discount rate of risk reserves declined from 2.5% to -0.75%, which

[4] In the case of Germany, according to the data from Bank of German in the third quarter of 2016 to 2017 in the second quarter, for the Germany insurance industry, the proportion of bond investment among Eurozone is steady at around 62%, the proportion of stocks and investment funds investment in Eurozone are over 90%.

[5] Government bonds include national debt, local government debts, state-owned enterprises and unit debts.

significantly increased the British insurance company's reserve costs. In addition, as more detailed guidelines of Solvency II become clear, European insurers will accept stricter risk reserves, capital checks and disclosure requirements. Correspondingly, their financial and compliance costs will increase, making profitability under pressure.

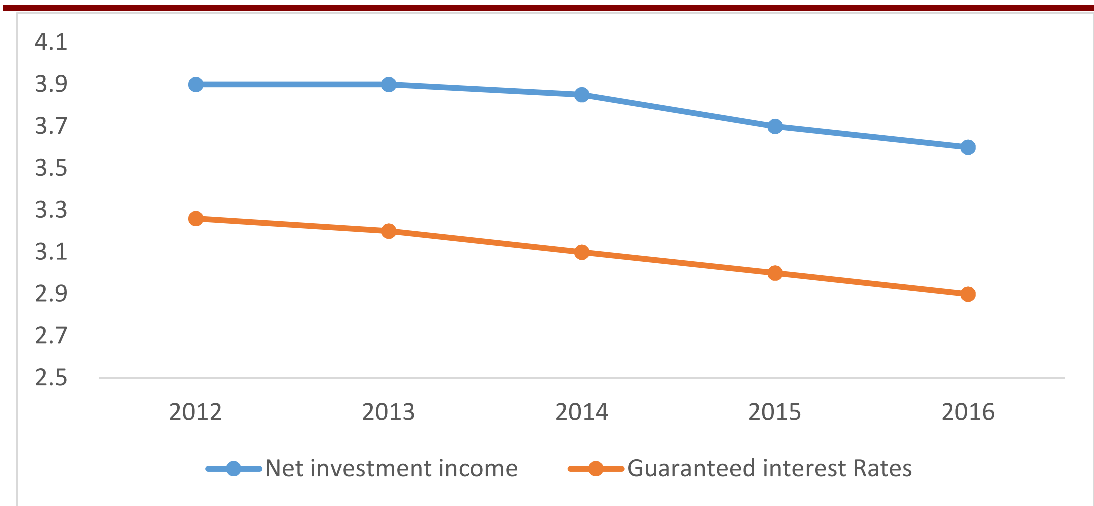
Figure9：Eurozone Bond Yields and Euribor（%）



Source：Wind、Dagong

To mitigate the impact of long-term low interest rates on operating profitability, the European life insurance company in 2018 will continue to expand investment-linked product sales in order to transfer part of the investment risk to the policy holder, while reducing the sales of interest-guaranteed products and its implied guaranteed interest rate level, so as to stabilize or even increase the net profit margin of life insurance products, reduce the risk of asset-liability mismatch. In terms of product structure, the proportion of Eurozone's life insurance industry's investment-linked product risk reserves in the total reserves has increased by 1.82%, from 18.87% in the third quarter of 2016 to 20.69% in the second quarter of 2017, according to the data in European Central Bank. For the product guaranteed interest rates, takes Germany as an example, net yield of its life insurance investment portfolio continue to decline because of continued low interest rates. However, due to guaranteed interest rates of new sale interest rate sensitive product decline simultaneously (Figure 10), the net interest margin steady at around 0.7%, maintain a stable business benefit.

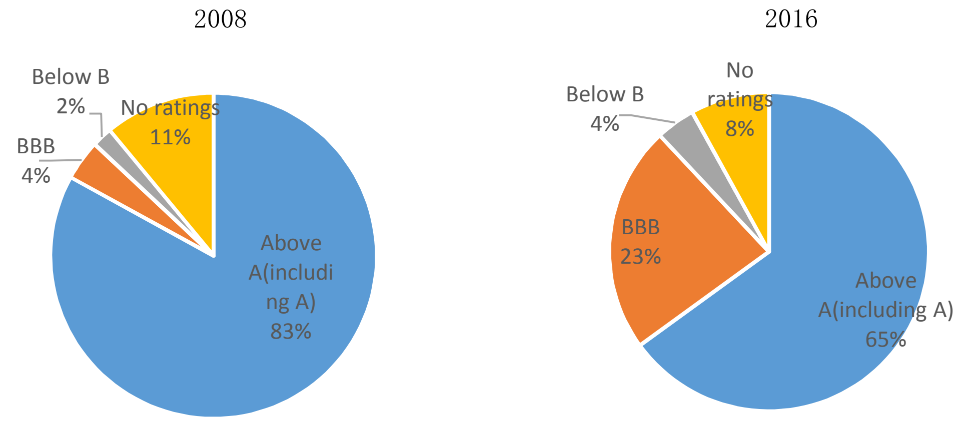
Figure10:German Life Insurance: Net Investment Income and Guaranteed Interest Rate(%)



Source：Bank of German, Dagong

In terms of investment asset, the European life insurance industry will continue to enhance the investment risk appetite and increase the proportion of high-risk investment assets in order to seek higher investment returns and push up the risk of future portfolio in 2018. Since 2008, as for European life insurance companies, the proportion of BBB bonds has risen from 4% to 23% in 2016 (Figure 11), and the proportion of bonds in A and above has fallen from 83% to 65%. Sovereign ratings of some EU countries have been downgraded as a result of the European debt crisis, leading to a passive decline in the average level of government bonds. However, because of years of low interest rates and even negative interest rates, European life insurers are seeking more aggressive investments to boost their investment earnings. To increase investment in low-rating bond, infrastructure projects, and even equity, shows that European life insurance companies risk appetite and tolerance have increased, and portfolio risk will continue to bear pressure in the future.

Figure11: Changes of Bond Portfolio Distribution in European Life Insurance Industry (%)



Source: SNL Financial, Dagong

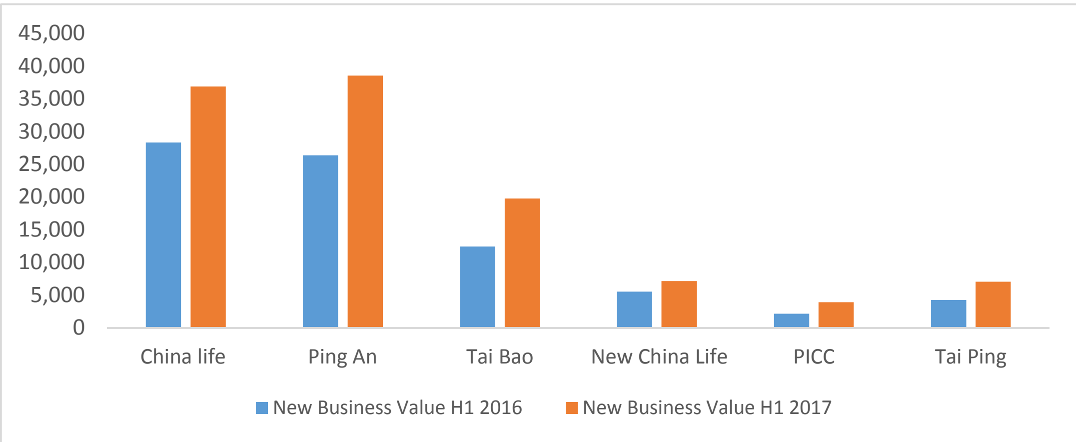
V. Due to the tightening of regulation policies, the growth rate of insurance premiums in China is slowing down, challenging short-term liquidity. But the long-term credit risk is still under control.

In 2018, China's economy will deleverage in a moderate way under the guidance of steady supply-side reform as well as moderate and neutral monetary policy. The economic growth rate is expected to maintain the current level (6.8%). The continuous improvement of per capita disposable income is conducive to the sustained stimulus insurance demand, and the insurance premium of the Chinese insurance industry will continue to grow rapidly. In addition, with the tightening of financial regulations, the Chinese insurance industry has conducted different levels of business structure adjustments, in which the restriction on the limited sales of life insurer will further adjust the sales of short-term products, and gradually transfer to the long-term regular payment of products. However, non-life insurance company is affected by the pressure of rate reform to expand the business structure from auto insurance to non-auto insurance business. In terms of investment portfolio, in order to mitigate the impact of low interest rate environment, China life insurance company will continuously improve the investment risk, and increase the proportion of other investment assets with poor liquidity (long-term equity investment, bank financial products and trust plan, etc.). While the introduction of other investment risk reserve policy will prompt insurance companies to change their investment strategies and reduce the allocation of alternative assets, which will ultimately help to mitigate the concentration risk and liquidity risk of the portfolio.

In terms of regulation policies, the second reform strategy of Solvency II in 2018 is expected to be launch and completed in next three years, mainly aimed at the comprehensive risk management system and the risk capital accounting based on time risk. As for risk capital accounting, the China Insurance Regulatory Commission will improve the relevant capital standards for risk insurance products to improve underwriting profitability, and encourage insurance companies to increase the sales of subsidized products and reduce their reliance on the profit and loss of spread. In addition, the China Insurance Regulatory Commission will also modify some assets (including long-term equity investment, equity and alternative assets such as real estate and infrastructure investment) and the minimum capital reserve for the type of business. The reform is expected to ease the serious single and concentrated investment risk due to the use of long-term equity investments with a lower risk accrual ratio (15%) as the preferred asset allocation. It has also helped to reduce the use of complex, opaque structures to cover up the real exposure of risky investments, thereby improving its portfolio allocation. In terms of risk management systems, the risk management assessment of the stress test, the liquidity test, IRR, and SARMRA will be further defined in detail.

In terms of life insurance underwriting, in the first half of 2017, the new business value average growth rate of life insurance was 52% (Figure 12), indicating that the sales of new products for the life insurance industry were continuously transformed from the short-term and single payment to long-term and regular payment protection products. At the same time, the declining sales of short-term savings products (universal insurance) caused by the restrictions of the Insurance Regulatory Commission had reduced the growth rate of the original premium. However, there are some problems such as high settlement interest rate, short payment period and lower refund fee, which pose great risks to the liquidity of life insurance companies. With the deepening of regulatory policy adjustment, although short-term life insurance company profitability is under pressure, long-term product structure adjustment is conducive to reduce liquidity risk, and to maintain the steady development of life insurance companies. As for investment, the stock market continued to recover, and the stock investment return of life insurance companies recovered steadily. The recent increase in market interest rate also helps to improve the investment income of future insurance companies' bond portfolios. The proportion of other investment increased from 29% in 2015 to 38% in the third quarter of 2017 (Figure 13), while the introduction of other investment risk reserve policies will promote insurance companies to change their investment strategies and reduce non-standard investment products. However, due to the strong internal risk management ability and strict external financial supervision, portfolio risk is still controllable and has a limited impact on the overall credit risk.

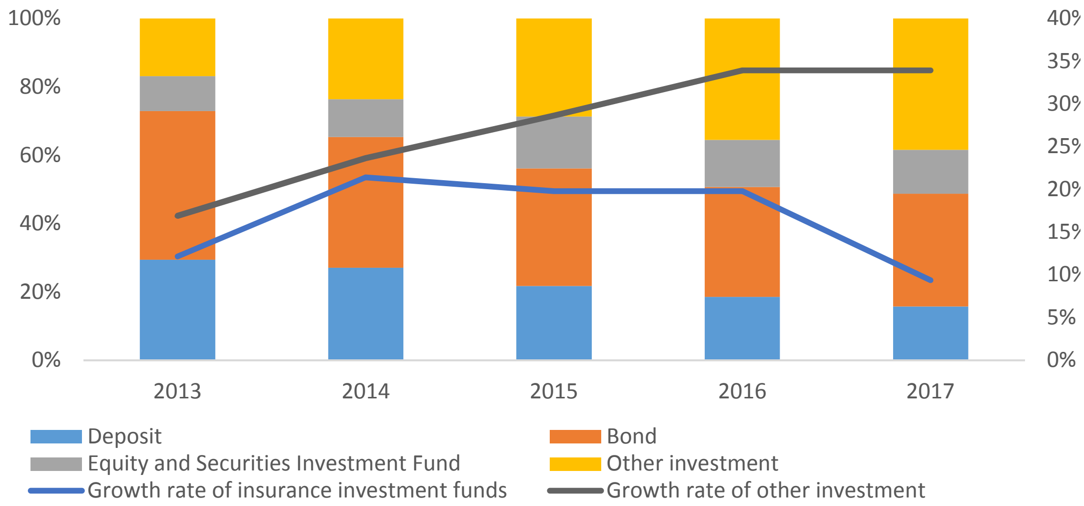
Figure 12: Trend of New Business Value of Listed Life Insurance Companies (million ¥)



Source: Company reports, Wind, Dagong

In the area of the non-life insurance industry, the introduction of the reform policy of

Figure13: China's Life Insurance Industry: Portfolio Structure



Source: CIRC, Dagong

Note: Data in 2017 means data by the end of the third quarter of 2017.

non-compulsory vehicle insurance rate increases the flexibility of non-life insurance companies in the formulation of rates, and also increases the market competition degree. Ultimately, it promotes the expansion of non-life insurance industry from the auto insurance business only to both auto and non-auto insurance businesses. First of all, a further increase of rate adjustment will restrict the underwriting profitability of the auto insurance business, and make its profitability more challenging and force non-life insurance company enter into the field of non-auto insurance. Although the underwriting cost rate has declined due to the policy reform that controls the risk of high underwriting costs, the underwriting profitability of the insurance industry is expected to be difficult to improve significantly in 2018, because of the increase in the average payout rate after the reform of the insurance rate and the fierce competition in the car insurance business itself. In addition, the capital situation of the non-life insurance company is relatively good, and adequacy ratio in solvency II is stable at a higher level. Solvency adequacy ratio in 2018 is expected to maintain the level of more than 200%. In terms of investment portfolio, in the low interest rate environment, in order to enhance profitability and market competitiveness, the investment risk appetite of the insurance company has gradually improved. However, given the continuous enhancement of the risk management system and financial supervision, investment portfolio risks and overall credit risks are still controllable.