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S&P's Insurance Industry And Country Risk Assessments Offer A Global View Of The Forces Shaping Insurance Markets

Primary Credit Analyst:
David Laxton, London (44) 20-7176-7079; david.laxton@standardandpoors.com

Secondary Contacts:
Kevin T Ahern, New York 212-438-7160; kevin.ahern@standardandpoors.com
Angelica G Bala, Mexico City (52) 55-5081-4405; angelica.bala@standardandpoors.com
Mark D Nicholson, London (44) 20-7176-7991; mark.nicholson@standardandpoors.com
Connie Wong, Singapore (65) 6239-6353; connie.wong@standardandpoors.com
Anvar Gabidullin, CFA, London (44) 20-7176-7047; anvar.gabidullin@standardandpoors.com
Mario Chakar, London +442071767070; mario.chakar@standardandpoors.com

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S&P's Insurance Industry And Country Risk Assessments Offer A Global View Of The Forces Shaping Insurance Markets

Standard & Poor's for the first time assigned Insurance Industry and Country Risk Assessments to 97 insurance sectors worldwide on May 7, 2013. We use the assessments as a factor in rating insurance companies, and have designed them to provide us and market participants with a comparative and global view of insurance risk across sectors, regions, and countries. Now that we've completed the assessments, we can draw some initial conclusions. Though not entirely surprising, the most striking conclusion for the two main sectors, life and property/casualty (P/C), is that the overall risks are, on average, much lower in developed than in emerging markets (see chart 1 below). Standard & Poor's Ratings Services for a long-time has factored industry and country risks into our view of an insurer's competitive position. Under our revised criteria ("Insurers: Rating Methodology," published on May 7, 2013, on RatingsDirect), and to increase transparency, we now separately assess and publish our views on industry and country risk.

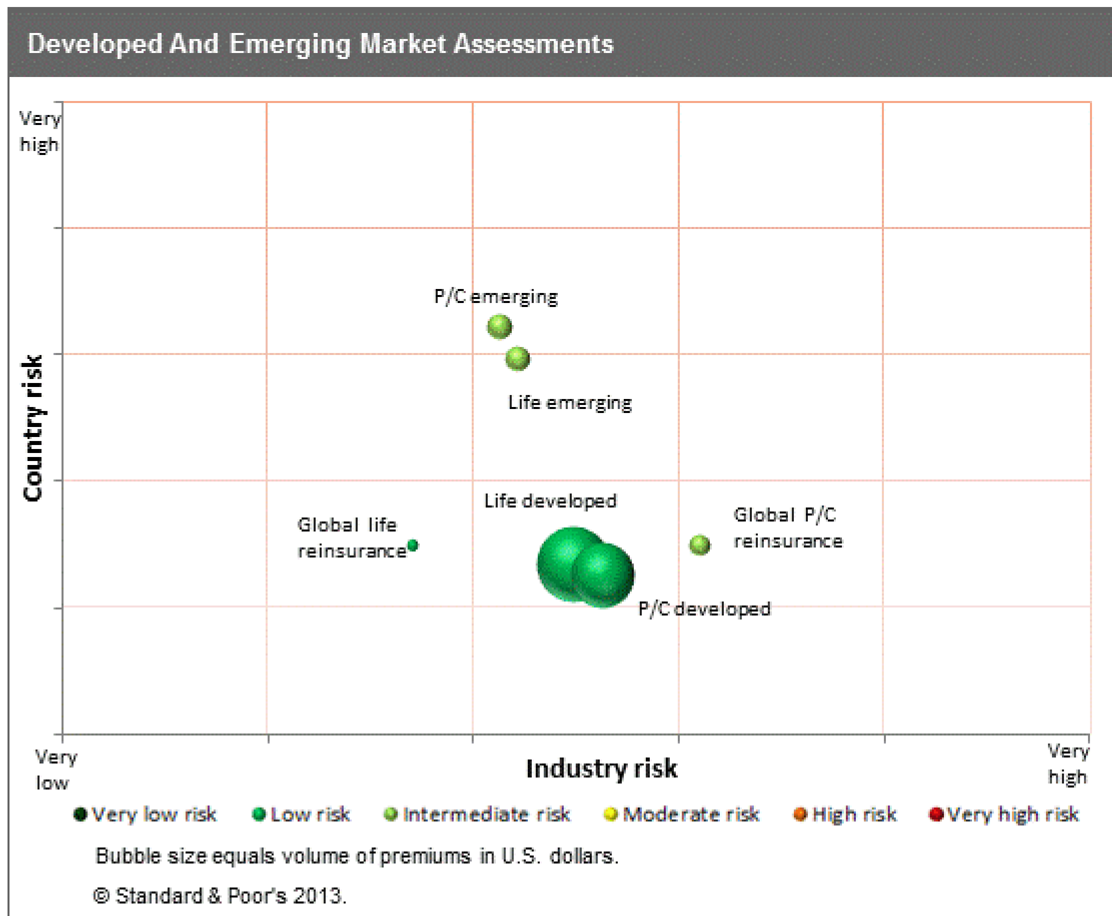
What is also noticeable is that industry risk is lower in emerging P/C markets than in developed ones. That's because more favorable competitive dynamics in emerging markets have allowed for continued strong profit margins, which have declined under competitive pressure in more mature markets. We see good profitability in emerging markets, together with positive premium growth and straightforward products with lower product risk. However, these advantages are partly offset by generally less developed institutional frameworks.

Overview

- Our Insurance Industry and Country Risk Assessments, which we assigned to 97 sectors around the world on May 7, 2013, show that for two main sectors, life and property/casualty (P/C), these risks are much lower, on average, in developed markets.
- However, the average industry risk in emerging P/C markets is lower than in developed ones.
- Showing the highest industry risk is the global P/C reinsurance sector because it assumes high-severity risks, such as catastrophe risks, from the P/C insurance sectors.

Life insurance in emerging markets is usually well established only in the more advanced countries that have more stable economic, financial, and legal systems. Consequently, they exhibit lower country risk.

Chart 1



Our assessments in developed countries show similar levels of risk for both the P/C and life sectors, and reflect highly competitive markets, modest growth, and the risks associated with complex products. However, markets in developed countries benefit from stable economic and legal systems and sophisticated financial sectors.

Showing the highest industry risk is the global P/C reinsurance sector. That's because this sector assumes the high-severity risks, such as catastrophe risks, coming from the P/C insurance sectors. To cope with these risks, global reinsurers tend to be strongly capitalized and exhibit sophisticated enterprise risk management skills.

In contrast, life reinsurance is a sector dominated by a few internationally diversified groups with specific market expertise. This represents a significant barrier to entry for others and preserves the sector's positive operating performance, leading to significantly lower industry risk.

Here we survey, in detail, our view about industry and economic risk in the P/C and life sectors in the following regions: Western Europe, the Americas, the Asia-Pacific, and Central and Eastern Europe, the Middle East, and Africa (CEEMEA). We intend to publish more detailed reports for individual country insurance sectors starting in the second half of this year.

Western Europe: Risks Are Higher On The Periphery

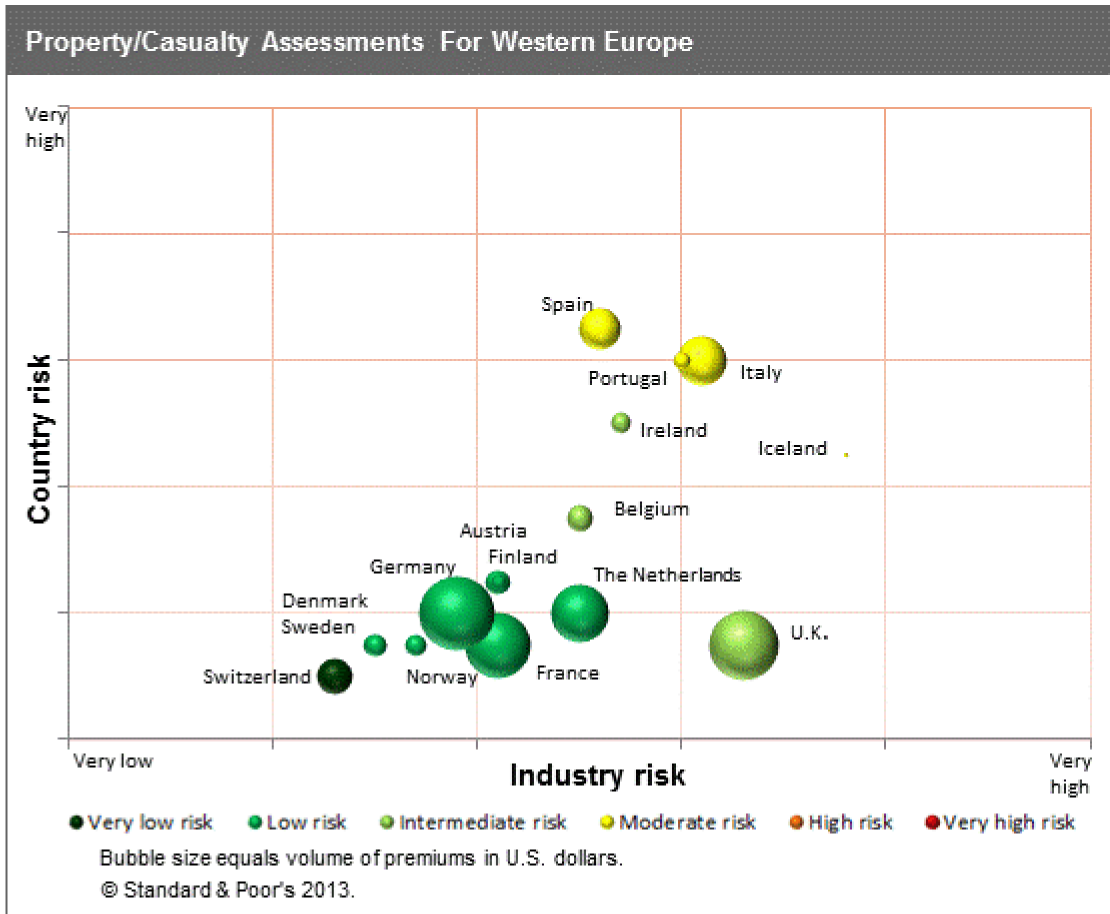
Our country risk assessments for Western European markets illustrate the divide between the weaker economies on the "periphery" of the eurozone--Greece, Italy, Spain, Ireland, Portugal, and Iceland--and the other, stronger core economies. Conversely, elements of industry risk are largely similar across much of the region.

The core markets, which have lower country risk, are mature, affluent economies with relatively high insurance penetration and consequently lower insurance growth prospects relative to emerging markets. Political and financial systems are mature and the rule of law is strong.

Markets on the periphery, with higher country risk, are either economies that we expect to contract further or which are still recovering from significant contraction, as in the case of Iceland. As a result, debt and unemployment rates typically remain high. In addition, significant risk exists within their financial systems.

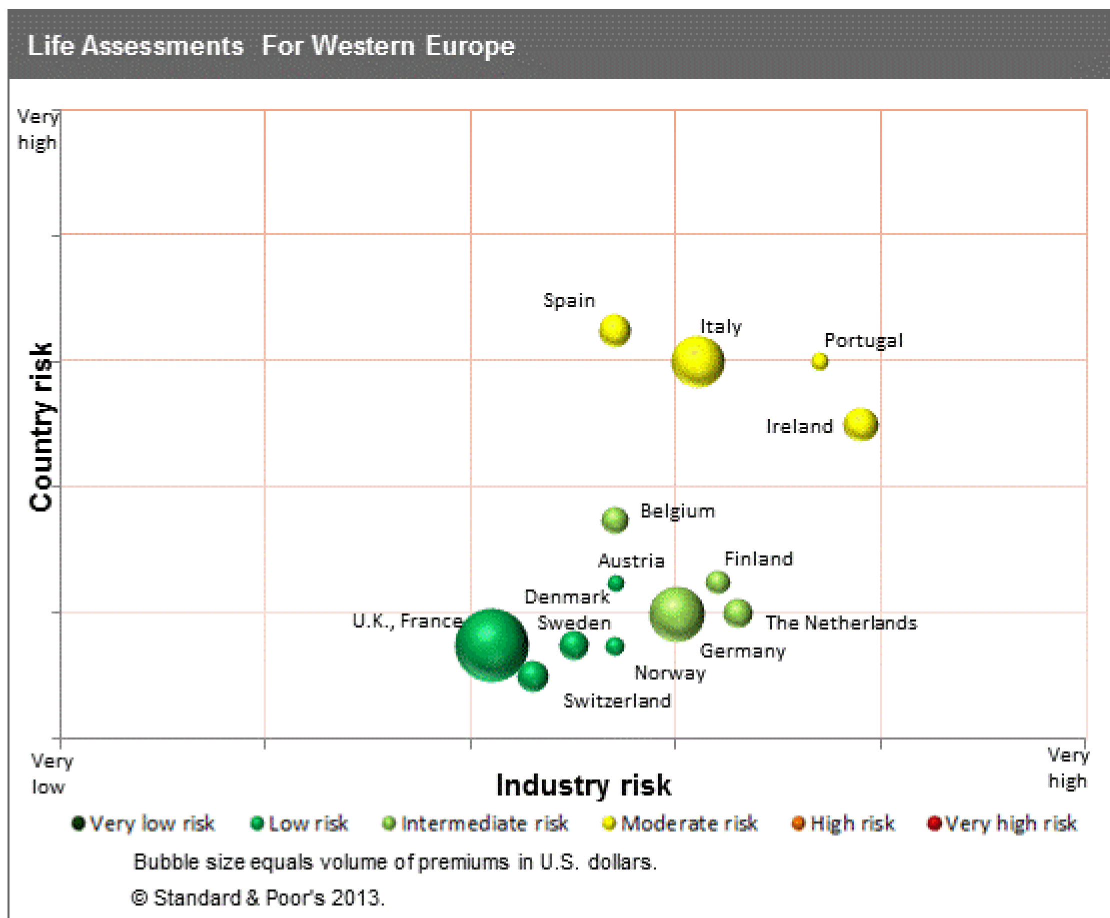
P/C industry risks across Western European are typically low to intermediate (see chart 2). Growth prospects for the insurance industry, however, remain muted. This reflects the recessionary environment in 2013 and the prospect of only weak economic recovery in 2014. As a result, we expect P/C premium growth in the developed European market to remain modest. Returns on equity are relatively low, in part reflecting the high capital levels that regulators and industry participants require. Product risks are most significant in the U.K. and Italy, where recent inflation in motor bodily injury claims has depressed profitability and enhanced volatility. The P/C sector in the U.K. also suffers from the relatively greater commoditization of its core lines and low barriers to entry, because policies are increasingly sold on a direct basis. This is in contrast to the relatively high barriers to entry of other Western European markets, where a significant sales network or agreements with sales partners remain necessary to access business.

Chart 2



Low interest rates are the key challenge facing most Western European life markets (see chart 3). We expect interest rates across the core European markets to remain low against the backdrop of weak economic conditions. This raises asset-liability management (ALM) risks, especially in markets where life products with guaranteed rates are prevalent. These guarantees are less easily affordable for insurers at a time of low investment returns. As a result, regulators in a number of countries took forbearance measures to ease the pressure of low interest rates on solvency ratios. Operational barriers to entry are high in most markets due to the substantial sales network needed to sell life products. Western European life premiums are more volatile than P/C premiums representing more of a discretionary form of spending. In the longer term, we expect that aging demographics in Western Europe should be a positive for market growth. But in the short to medium term, we expect that slow GDP growth and wider economic uncertainty will act as constraints on the growth of life insurance premiums.

Chart 3



The Americas: Canada Is One Of The Lowest-Risk Markets

Latin America: Country risk varies widely depending on a market's competitive dynamics

Diversity in country risk, especially regarding economic dynamics, greatly influences our assessments for Latin America. Penetration rates are limited because of low incomes that limit purchases of insurance products, high unemployment rates, and a poor understanding of insurance benefits in general. Our views about the riskiness of the political and financial system, as well as institutional framework, are not a concern in the cases of Brazil, Colombia, and Mexico, but these risks are high for Jamaica.

Investment income is a significant component of profit for insurers in the region, and so far the impact of low interest rates on profitability has been limited. Large companies in some of these countries represent the highest barriers to entry, for example, insurance companies in Brazil and Mexico that are owned by large banks, or that are well established and have positive reputations. In Colombia, healthy economic prospects, which provide a positive environment for insurance penetration, are an incentive for participants wanting to enter the market.

Overall, we see good growth potential in the region, but economic dynamics are key to market penetration. The current penetration rate of insurance products in Latin American countries is about 3%, except in Brazil, where it is

slightly higher. Social mobility is a supporting factor that could provide stronger fundamentals for growth, which we have seen in Brazil, but is a hurdle in Jamaica, where economic prospects are poor. Institutional frameworks vary from country to country in our view, with a more conservative, stronger institutional framework in Mexico and a weak one in Jamaica.

North America: Profitability and product risk weigh on overall risk

The assessments for the life and P/C insurance sectors in North America reflect very low to intermediate industry and country risk. Along the continuum is Canada life, which we assess as very low risk, U.S. life and Canada P/C as low risk, and U.S. P/C as intermediate risk. We believe profitability and product risk are influential factors, with barriers to entry as secondary to the North America assessments. We see prospects for high income bolstered by resilient economic growth, effective policymaking reinforced by stable political institutions, sophisticated financial systems with deep capital markets, combined with a strong payment culture, enhanced market growth prospects, and insurance frameworks that run from supportive to strong (see charts 4 and 5).

Chart 4

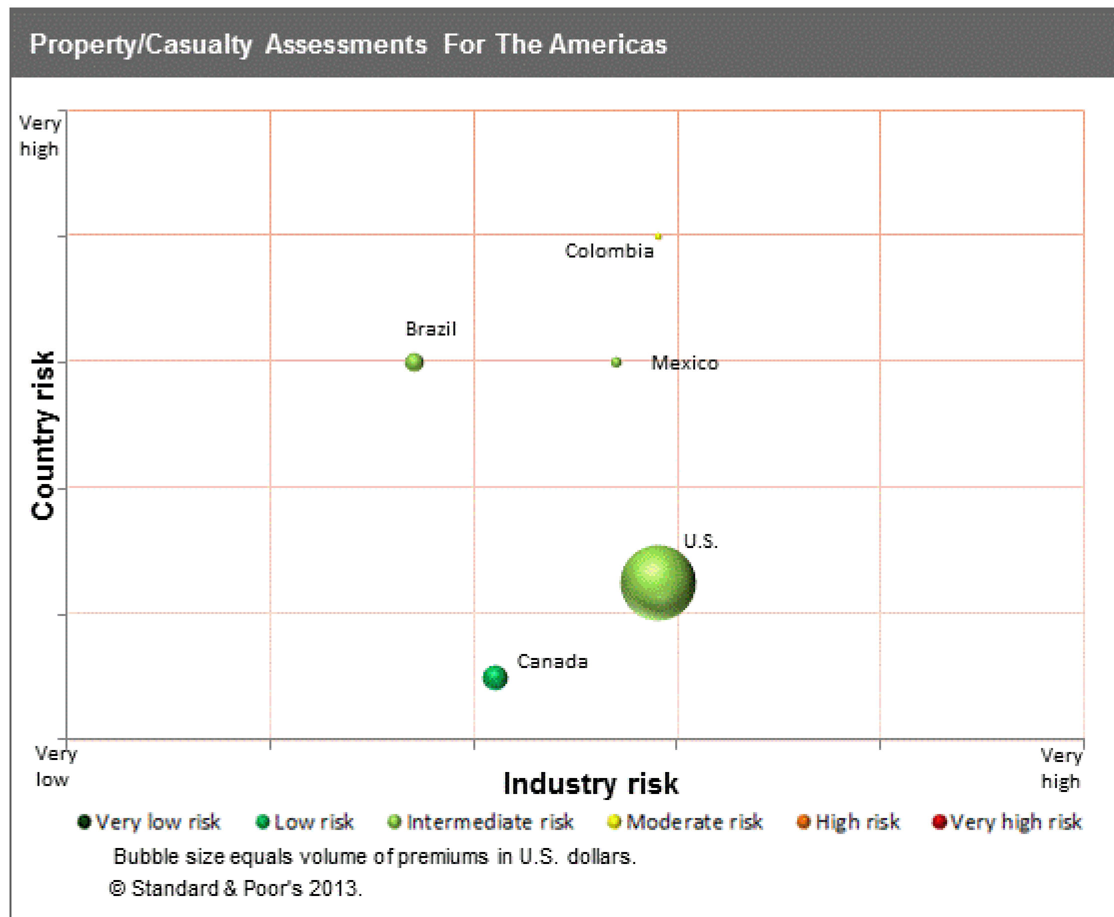
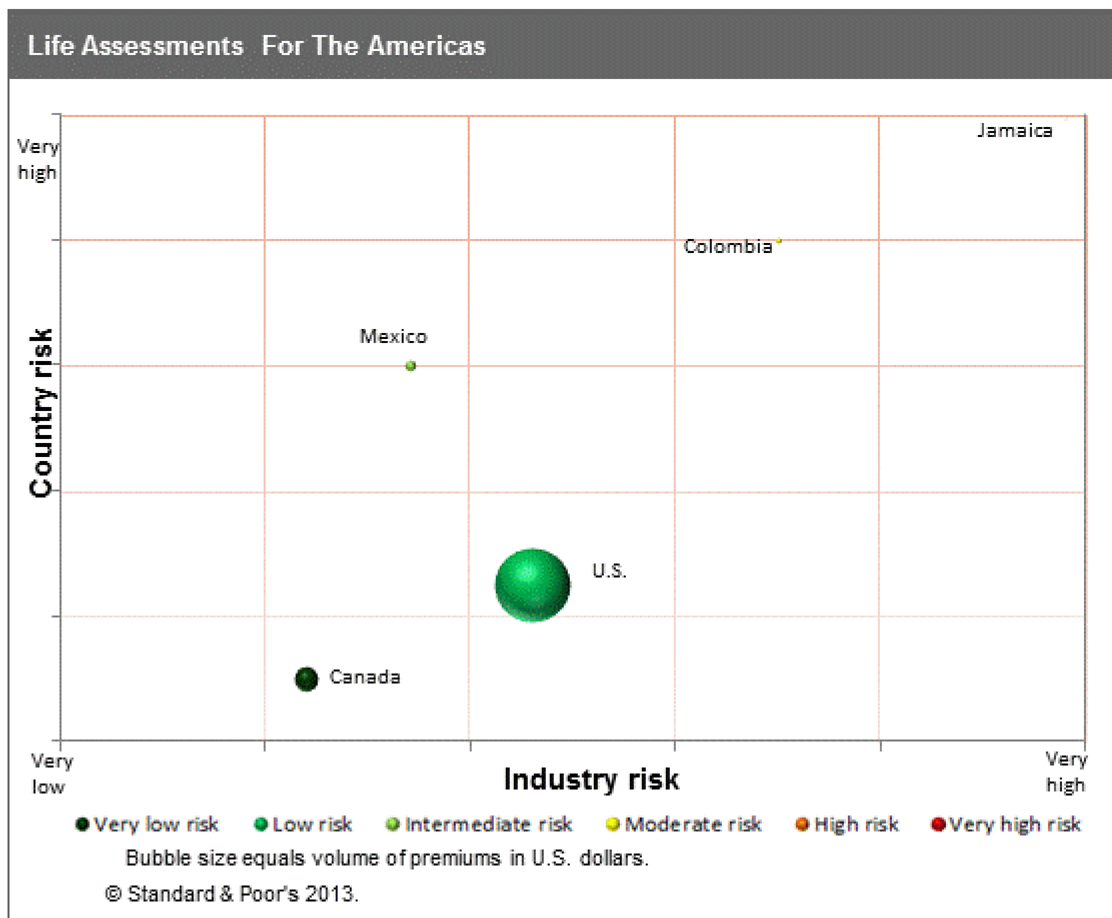


Chart 5



In the long run, we expect the North America insurance industry to remain profitable, generating an ROE between 4% and 10% across the sectors. Based on our data, the five-year weighted average statutory ROE for the U.S. life and P/C sectors was about 5% and 6%, respectively, over the last five years. The strongest performers were Canadian life and P/C insurers with 8% and 9%. We believe North American insurers will continue to benefit from stable underwriting margins and investment income. However, prolonged low interest rates, severe equity market downturns, or material natural catastrophe losses could erode their profitability.

Our product risk assessment shows that U.S. and Canadian life insurers have a strong track record of maintaining ALM mismatch within one year. The high availability of fixed-income instruments of sufficient duration in the capital markets to match the companies' insurance liabilities greatly supports this capability. However, sensitivity to interest rates and equity market volatility offset this strength. Although we anticipate uncertainty about claims amounts and payment patterns stemming from reserve volatility or catastrophe losses throughout North America, we believe U.S. P/C insurers are more susceptible than their Canadian counterparts because of the litigious legal system in the U.S., especially in the asbestos and environmental, and medical practice lines of business.

Barriers to entry are generally not particularly high. Regulators impose a rigorous but not onerous process of approving new licenses for insurers, and it is not prohibitively difficult to establish and build viable distribution relationships and networks. However, we view the barriers to entry for Canadian life insurers as high because of the

extensive reach of the life insurance oligopoly, where four insurers control more than 70% of the domestic market.

Overall, we believe the North American insurance industry will maintain stable profitability over the long run, thriving under a dynamic insurance market that mimics a diverse and stable economy governed by an effective governance framework. These attributes will continue to promote an efficient, innovative, but also competitive landscape, supportive of industry and country risk assessments ranging from very low, to intermediate.

Asia-Pacific: Risks Vary Widely Across the Region

Our assessments in the Asia-Pacific region vary between very low risk and high risk. This mirrors, among other reasons, low catastrophe exposure in Malaysia, Korea, and Singapore, and significant catastrophe exposure in the Pacific region and Japan, though mitigated by relatively strong management risk controls. Although Thailand was exposed to significant flood losses in 2011, we view the market's industry risks as intermediate since greater awareness has led to improved risk controls. The relatively low to moderate country risks across most of the region are supported by strong prospects for economic growth and adequate to strong legal and financial systems. However, for markets like the Philippines, country risks remain high, which feed into its overall assessment as high risk (see charts 6 and 7).

Chart 6

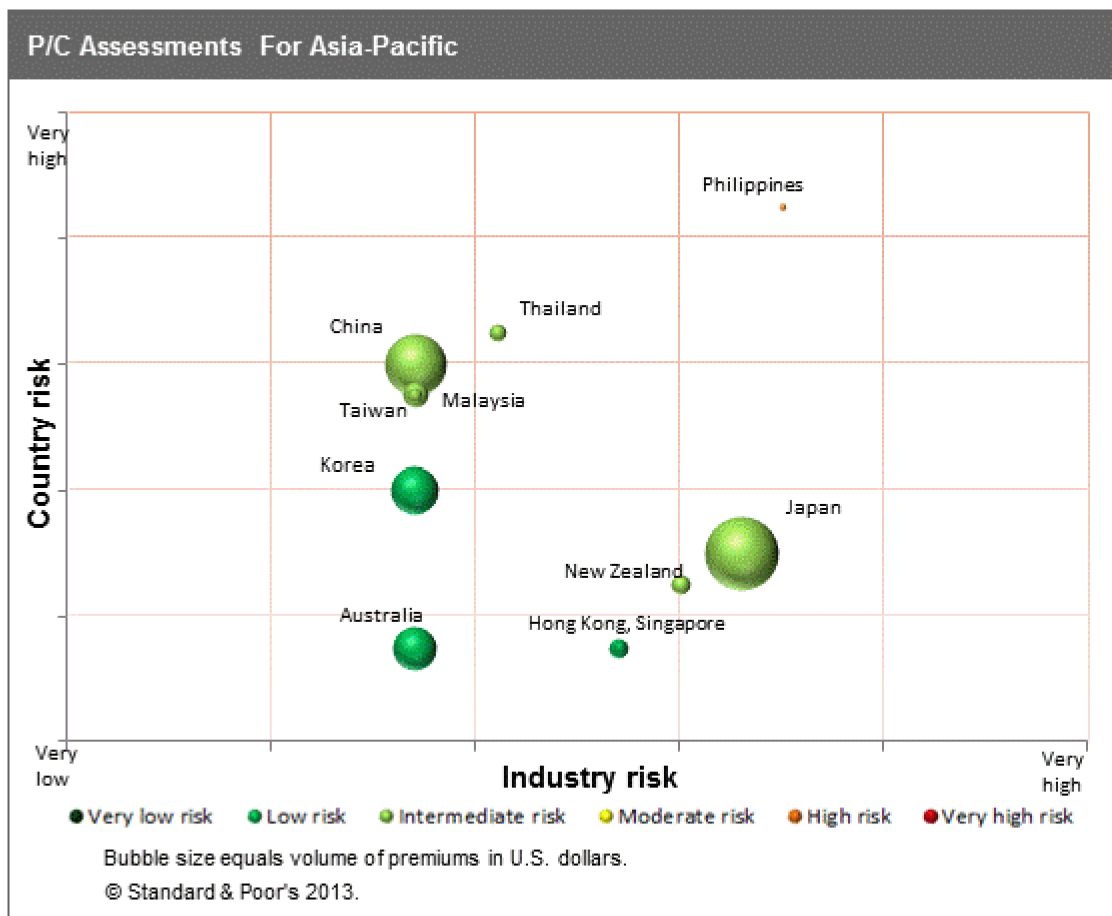


Chart 7

Most products in the region carry moderate risk because they are simple and are relatively short-tailed. The key product risk is catastrophe risk in some markets such as Australia, Japan, New Zealand, and Taiwan. Others are longer-tail risks for workers' compensation, motor liabilities, and other liability products in markets like Hong Kong, Singapore, and Australia. However, we see claims tails as manageable. Other product risks include special line and large projects, especially in more sophisticated markets or for large industrial clients. However, those risks are generally well managed. For emerging markets such as China, Thailand, and Malaysia, motor insurers are often one of the largest business lines. The motor business has relatively low and sometimes non-existent profit margins. However, it provides a large volume of business with relatively stable income, where other, higher-margin business can make up for low profit margins. China's motor performance, where more than 70% of the market's premiums are motor, is still favorable, in our view, despite some deterioration in recent years.

Strong growth prospects in most markets are stemming from rapid economic growth in the region, setting it apart from developed markets outside the Asia-Pacific region. Although insurance growth in the region slowed slightly after the global financial crisis, it's still between about 5% and 20% in most markets.

Institutional frameworks in the Asia-Pacific region vary from the most sophisticated in Australia and Japan, to less

developed in the Philippines. However, regulation has been progressing and has made the transition to risk-based measures in most markets. Regulatory development is in line with the global trend in terms of risk management control, risk capital requirements, and corporate governance, although implementation varies.

For the life insurance sector, our assessments range from very low to moderate risk in the region, similar to the spread on the P/C side.

Among the markets we assess, the lowest risks are in Australian life market, partly because of low country risk, but mostly because of comparatively low product risk. The relatively low risk assessment for New Zealand stems from its predominately Australian-owned life insurers, which are under their parent group's risk management control, which encourages both market discipline and low product risk.

The key product risk in the Asian region is for guaranteed-type products. Most products are savings, with profit, or other traditional types of products, with growing, but still small, amounts of annuities. Investment products were the key growth driver over the past decade, until the financial crisis brought sluggish securities markets and an increasing preference for protection products. ALM risk is a relative weakness for the region due to the limited choices for long-dated assets relative to long-term liability risks, especially in emerging Asian markets.

The Asian markets subject to relatively higher industry risks are those for example in Taiwan, China, and Japan, with still-high proportions of products with high guaranteed rates carried over from the past. In Japan, product and investment risks have evolved in response to two decades of low interest rates. China's high guaranteed-rate book shrank after regulatory control in the late 1990s. In Taiwan, life insurers' profitability nevertheless remains modest because of the weight of legacy guaranteed products amid prolonged low interest rates.

For developed markets like Hong Kong and Singapore, we consider industry risks as low, and product risks as limited. Supported by more sophisticated players, the sectors are more disciplined in terms of pricing and risk control.

Life insurance markets in the Asia-Pacific region have strong growth prospects. Bancassurance remains a supportive driver for growth for some markets due to underpenetration and preferences for savings-like products. These products nevertheless have lower profit margins than traditional ones.

Central And Eastern Europe, The Middle East, And Africa: Banking And Financial System Risk Tends To Run Higher

Our assessments across Central and Eastern Europe, the Middle East, and Africa (CEEMEA) are consistent with the developing nature of many of the countries in the region. Country risk is therefore higher (mostly intermediate or moderate) than in most Western European and North American countries, in many cases because of high banking and financial system risk (see charts 8 and 9).

Chart 8

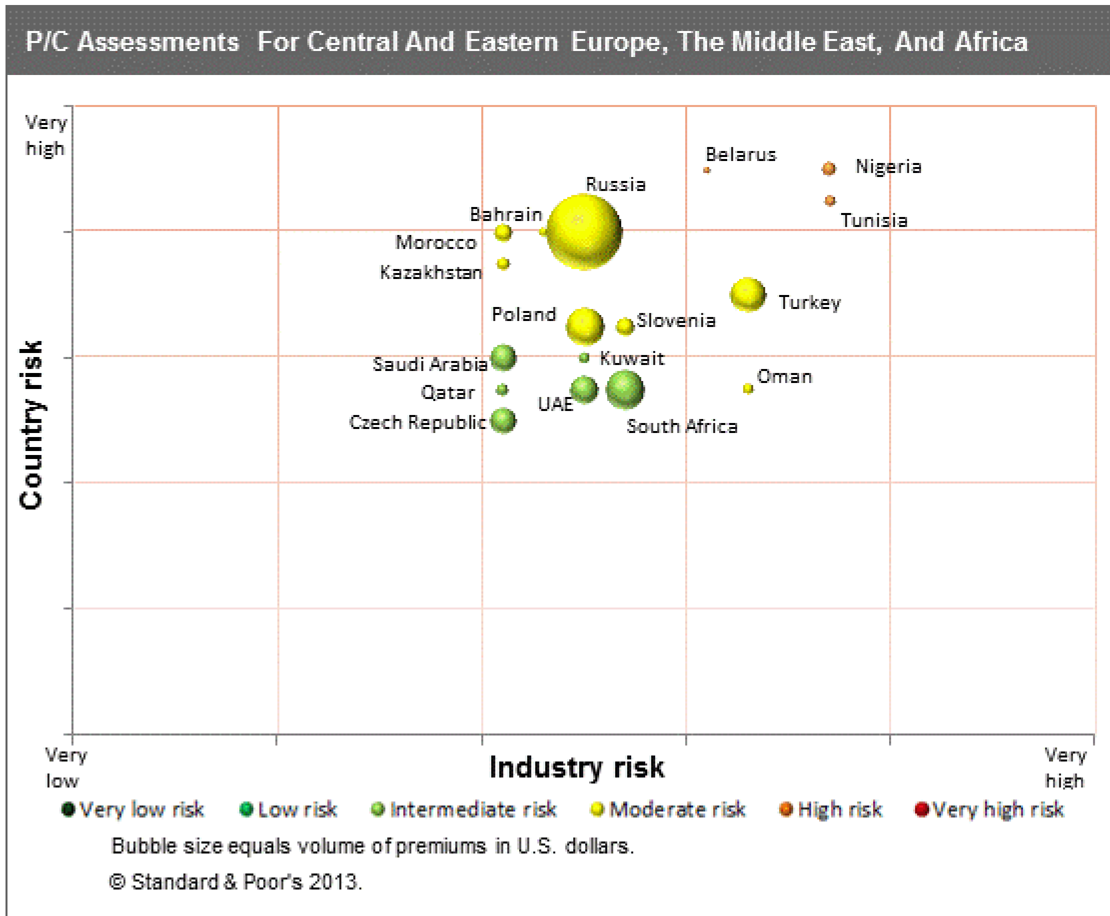
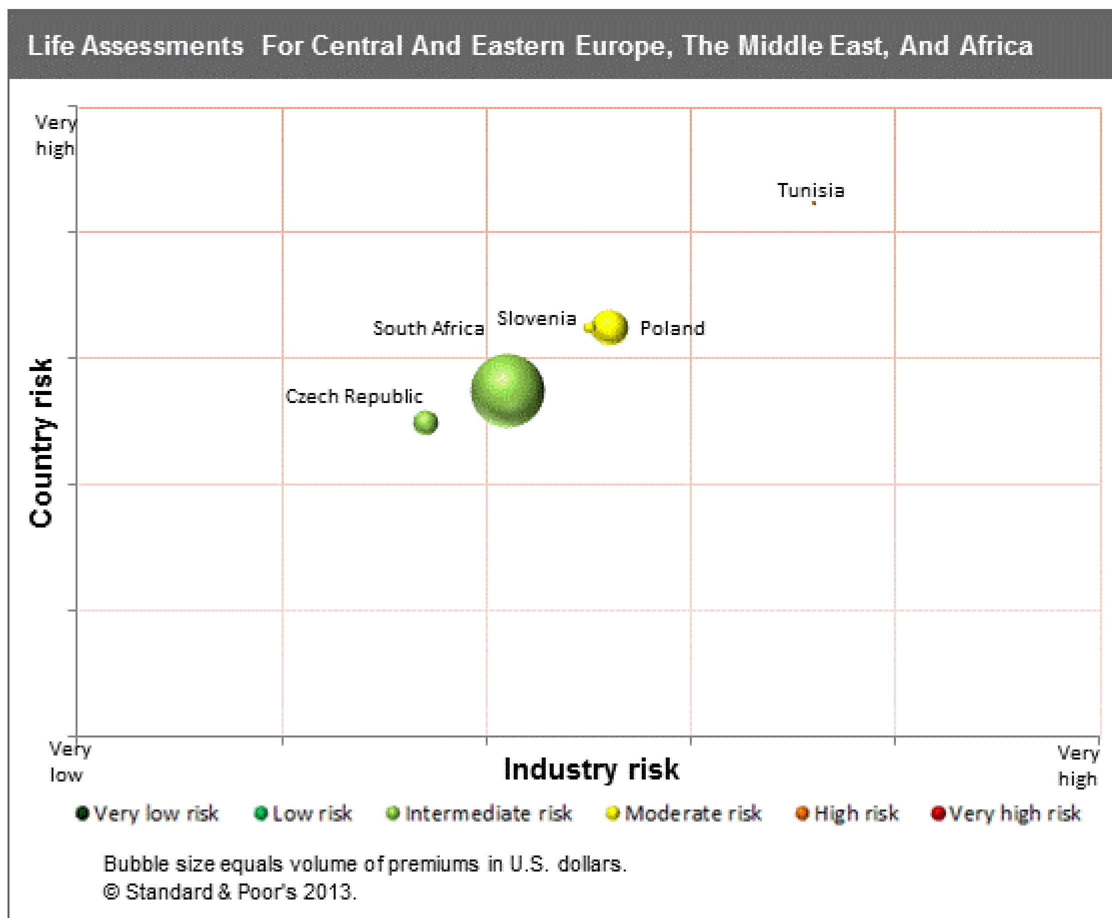


Chart 9



Our view of industry risk, which mostly falls in the intermediate range, is not out of line with that of other regions, but often reflects a mix of positive and negative factors. The CEEMEA markets are still not mature, and as a result they have stronger growth prospects than we see in the mature markets. In markets where individuals' spending power and the range of product offerings are increasing, there has been dramatic growth--35% in Kazakhstan and 22% in Russia in P/C premiums in 2012. Products are seldom complex and do not carry undue product risk. Catastrophe exposure is largely confined to Central Europe and Turkey. Profitability in CEEMEA markets is generally good, particularly for the insurance of industrial and commercial risks, and is a negative factor only where competition is particularly high, such as in Turkey. These generally positive factors are somewhat offset by the institutional frameworks in many countries that are not yet fully developed. Institutional frameworks in Central Europe have benefited from EU membership, South Africa's is closely modeled on Solvency II, and the regime in Saudi Arabia is based on international best practices. However, some other regimes are less advanced and negatively influence our assessment of industry risk.

Life insurance in the region, which possesses true long-term insurance characteristics, is far less developed in CEEMEA than is P/C insurance. We have assigned assessments to only five countries in the region. These are mostly the more developed countries: the Czech Republic, Poland, Slovenia, and South Africa, where life insurance is well established. However it also includes Tunisia, which has high country risk, where the life insurance industry is still in its infancy and the institutional framework is underdeveloped. For these reasons we assess the sector as high risk.

For the well-established life insurance markets, we view industry risk as low or intermediate, in view of their generally positive earnings and limited product risk. For example, the high interest rate guarantees that once existed in countries such as the Czech Republic have been eliminated over the last decade and the replacement products carry much lower risk.

As the markets across CEEMEA develop we would expect to see a slow process of decreasing country risk and intensifying competition leading to higher industry risk.

Related Criteria And Research

- Insurers: Rating Methodology, May 7, 2013
- Standard & Poor's Assigns Insurance Industry And Country Risk Assessments, May 7, 2013

Additional Contact:
Insurance Ratings Europe; InsuranceInteractive_Europe@standardandpoors.com

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