Global insurance review 2011 and outlook 2012/13

December 2011
The insurance industry faces three main challenges from the current economic and political environment. First, economic weakness, fiscal tightening and an accommodative monetary policy are keeping government yields low, particularly in Germany and the US. The low interest rate environment poses a huge challenge to the insurance industry, reducing investment yields and undermining the profitability of life savings products with interest rate guarantees. Second, the euro debt crisis poses a risk to insurers holding the sovereign debt of Greece, Portugal, Ireland, Spain and now Italy. In addition, insurers hold the debt of banks which, due to their exposure to sovereign debt, could be severely affected if the crisis becomes disorderly. Finally, emerging markets are not fully decoupled from the developed economies, so their growth is slowing, even as inflation remains elevated. Asset bubbles are forming, though unlikely to burst any time soon. Many insurers have been counting on emerging markets to support top line growth. The slowdown in mid-2011 and asset bubble risks have revealed a potential drawback to this strategy.

Global expansion is faltering

The European debt crisis, coupled with weak demand and mild fiscal contraction in the US, is slowing global growth. The Euro area may already be in recession and the US may, though this is not certain, follow early next year. Emerging market countries, particularly in Asia and Latin America, continue to expand, but at a slower pace than last year. Japan has recovered from recession and its economy is likely to expand at a fairly robust pace next year. The UK economy is in the doldrums, but is expected to escape an outright recession.

Weak global growth will keep inflation contained. Some of the emerging markets, notably China, Brazil and India, continue to struggle with inflation, but it is not expected to get out of control.

In North America and Europe, monetary policy has nearly reached its growth-supporting limit, but it is not terribly effective because banks, particularly in Europe, are restraining credit expansion to shore up their capital. In addition, demand for credit is weak due to the high degree of uncertainty about the economic outlook. Fiscal policy is slowing growth and this, like the loose monetary policy, is expected to continue into 2013.

Inflation accelerated in 2011, as oil and other commodity prices rose, but has begun to abate recently. Only the European Central Bank (ECB) felt compelled to raise rates as inflation climbed, but is now retracing its 50 basis point tightening. Economic weakness, moderate inflation, and fiscal tightening will keep the major central banks on hold well into 2013, so long-term government interest rates in Germany and the US will remain low for at least a couple more years.

After an initial upturn, capital markets faltered this year. Corporate bond spreads followed a similar pattern and continue to reflect the elevated risk of default embedded in the weaker economic outlook. Volatility is expected to continue due to uncertainties surrounding the euro debt crisis, the US fiscal situation and upcoming election and inflation and asset bubble risks in emerging markets. The volatility weakens insurers’ profitability slightly by increasing the cost of hedging. Lower asset valuations reduce shareholder equity.
Political risks could turn weak growth into a severe recession

The greatest risk stems from political developments in Europe, which could result in disorderly sovereign default(s) or even the collapse of the European Monetary Union. This is followed closely by risks associated with the political stalemate in the US, which is preventing the implementation of sensible fiscal adjustments that could support growth while reducing the deficit. The situation in these two major regions has increased the risk that they both have a prolonged period of low growth, low inflation and low interest rates, similar to Japan’s economic path over the past two decades.

Containing inflation and avoiding the bursting of asset bubbles in emerging markets is also dependent on sound government policies. So far, this appears to be working. Many countries are tightening their monetary policies (e.g., India, Malaysia and, until recently, Brazil) and attempting to dampen asset price gains (e.g., China).

Politics in the Middle East could also prove disruptive in 2012 or 2013. In particular, the Syrian unrest could spread to other countries and the tension created by Iran’s nuclear policies could escalate into conflict.

Inflation risk is still a few years away

For the past few years, the major central banks have been employing unusual techniques to alleviate market and banking sector stress. Frequently, this has involved quantitative easing (buying government bonds with printed money), which increases the risk of inflation a few years from now. Inflation could increase to uncomfortable levels if the monetary stimulus is withdrawn too late and/or too slowly once demand picks up. This could occur if the authorities misjudge the strength of economic activity. Alternatively, policymakers may deliberately allow inflation to increase above their target rates in an attempt to reduce the real government debt burdens. This risk of inflation has risen because weak growth is making debt reduction through fiscal consolidation more difficult. In addition, developed economies may end up importing some inflation from emerging markets.

Non-life re/insurance: growth improving but profits disappointing

The difficult macro-economic environment in the US and Europe will impact the growth and profitability prospects for non-life re/insurance in 2011 and 2012: low economic growth will lead to a more moderate premium growth than previously projected. For the mature markets, a real growth rate of less than 2% for 2012 can be projected for primary insurance. Demand for commercial lines insurance and trade and infrastructure related products will be moderate due to low growth. The Emerging Markets will continue to grow close to their trend of 7% in real terms. Their expansion, however, will be hindered to the extent that exports to the industrialised countries are lowered and capital flows slow down.

Non-life re/insurers are strongly capitalised based on accounting data. Assets are inflated, however, due to exceptionally low interest rates and liabilities may be understated. Recent capital market turbulences are an additional drag on earnings and the balance sheets of re/insurers, so far particularly in Europe.
The immense catastrophic losses in 2011 have led to a hardening of reinsurance rates in property catastrophe lines and this is likely to continue due to changes in catastrophe models, the frequency of recent events, and increased exposures. Casualty rates have stopped their long slide but are overdue for an adjustment to the low yield environment and poor profitability (particularly in the US). A broader based hardening is expected to start later in 2012/2013 when adverse development sets in.

With prolonged low interest rates, investment yields will be weak through 2012 and only gradually rise in 2013. Overall, non-life markets will have modest growth in the near term with poor profitability. Stronger growth and profitability are projected after 2012.

Life re/insurance: entering choppy waters again

Both global in-force and new business life insurance premiums fell in 2011, following a short-lived recovery in 2010. Growth will recover in 2012 and the industry will gradually return to its long term average growth after 2013.

The life industry’s capitalization has improved significantly and is better than before the 2007 crisis. The industry is well prepared to cope with a challenging future.

Profitability bounced partially back after the crisis due to improved financial markets, re-pricing and redesigning of products, and cost cutting programmes. Going forward, low investment returns, higher hedging costs, lower business volumes, and more onerous capital requirements will prevent a return to pre-crisis profitability levels.

In emerging markets in 2011, in-force premium growth almost came to a halt, driven by an approximate 6% premium decline in China as a result of newly introduced bancassurance regulation. Excluding China, emerging market growth remained strong at 5.5%.

Traditional life reinsurance (mortality and disability) is expected to stagnate for the next few years. In industrialised countries, life reinsurance premiums may decline by up to 1% per annum, while in emerging markets, they are estimated to grow by around 7%.

In the industrialised countries, longevity and large block transactions continue to be the growth engines for life insurance. Large block transactions will be boosted by consolidation, mergers and acquisitions, and spin-offs.
Emerging markets: growth in 2011 and cautious outlook

In 2011, life insurance business in emerging markets has failed to grow mainly due to the lacklustre performance of the Chinese and Indian markets, while non-life premiums have continued to expand strongly. In China, tighter regulations on bancassurance have resulted in a decline in life premiums. Changes to regulations governing unit-linked insurance products also impacted on the growth of life premiums in India. Healthy growth was reported in key emerging markets in the Middle East and Latin America, due to robust economic growth and rising household income. In Russia and Poland, the growth of life insurance premiums has also remained relatively strong. Non-life business has continued to benefit from the stable economic growth of emerging markets. Rising car ownership and sustained spending on infrastructure has added to insurance demand. In addition, the series of natural catastrophes in Asia may have helped to raise risk awareness and prompt corporations to seek sufficient insurance covers.

Given that emerging market economies are not fully decoupled from developed markets, their economies will increasingly be affected by the debt crisis in Europe and slow growth in the US. This will limit the expected rebound in life premiums in 2012, even when growth is expected to resume in China and accelerate in India. As in earlier episodes of heightened financial market risks, sales of investment-linked products are expected to recede while demand for traditional protection-type products will surge. Non-life business will similarly be slowed by weakening economic activity, although emerging market governments are well-positioned to support growth through fiscal stimulus. This fiscal stimulus will continue to add to insurance demand relating to infrastructure construction projects. Otherwise, sanguine growth is expected in motor (due to improvements in pricing in various markets), health and personal accidents, as well as some specialty lines (including agricultural insurance and warranty insurance). Overall, life insurance premiums are projected to recover and grow by around 8% in 2012 and 2013 (2011: +0.6%), while non-life insurance premiums will increase by 7% to 9%, slightly below the growth of 8.9% in 2011.

Recent peaking of inflation in many emerging markets will benefit life insurance by strengthening its value proposition, and non-life insurance by lowering the cost of claims. Low interest rates, however, will remain a key challenge since they will depress investment returns. Major liberalisations are also expected in some key markets, including the raising of foreign investment limits on insurance joint ventures from 26% to 49% in India, the opening of the motor third party liability market in China, and a proposal to increase the 25% limit of foreign capital in the Russian insurance market. Collectively, these liberalisation measures will further hasten the globalisation of emerging insurance markets.
The macroeconomic environment

The US and UK economies continue to grow in the current quarter and may well escape recession next year, though growth will be weak. On the other hand, a mild recession in the Euro area is likely. The agreement reached at the most recent EU summit is an important step in the right direction. However, there are still many uncertainties regarding the implementation of the measures and this deal is unlikely to be the final answer to the Euro area debt crisis. The recent brinkmanship around the Greek referendum is a reminder that a Greek exit of the Euro area – even though not in Greece’s interest – remains a risk.

Weak growth and highly accommodative monetary policies in Europe and the US will keep interest rates low, at least through the middle of 2013. Inflation is subsiding as the economic slowdown puts increased pressure on wages and prices. Swiss Re Economic Research & Consulting’s baseline projection assumes that growth will strengthen in the second half of 2012 and accelerate into 2013. Accordingly, yields on 10-year government bonds are expected to rise to between 3.5% and 4.0% by 2013 in the US and Germany. In the UK, they are expected to be a bit over 4.0% by the end of 2013. These are still low rates by historical standards and they will keep investment yields for insurance companies at low levels. Though low interest rates are generally considered beneficial to economic growth, they are detrimental to savers, such as pension funds, insurers and retirees.

| Table 1 | Real GDP growth, inflation, and interest rates in selected regions from 2010 to 2013, % |
|---------|---------------------------------|-----------------|-----------------|-----------------|-----------------|
| Real GDP growth, annual avg., % | US | 3.0 | 1.8 | 1.3 | 2.6 |
| | Euro area | 1.8 | 1.6 | 0.5 | 1.6 |
| | UK | 1.8 | 0.9 | 1.0 | 1.8 |
| | Japan | 4.1 | –0.2 | 2.3 | 1.6 |
| | China | 10.4 | 9.1 | 8.8 | 8.2 |
| Inflation, all-items CPI, annual avg., % | US | 1.6 | 3.1 | 1.4 | 1.5 |
| | Euro area | 1.6 | 2.6 | 1.8 | 2.0 |
| | UK | 3.3 | 4.4 | 2.6 | 2.0 |
| | Japan | –0.7 | –0.2 | 0.3 | 0.7 |
| | China | 3.3 | 5.3 | 3.5 | 3.2 |
| Policy rate, year-end, % | US | 0.25 | 0.25 | 0.25 | 2.00 |
| | Euro area | 1.00 | 1.00 | 1.00 | 2.00 |
| | UK | 0.50 | 0.50 | 0.50 | 1.50 |
| | Japan | 0.08 | 0.08 | 0.10 | 0.25 |
| Yield, 10-year govt. bond, year-end, % | US | 3.3 | 2.2 | 2.6 | 3.6 |
| | Euro area | 3.0 | 2.0 | 2.6 | 3.5 |
| | UK | 3.4 | 2.8 | 3.2 | 4.2 |
| | Japan | 1.1 | 1.1 | 1.2 | 1.7 |

Note: Euro area yields are from German benchmark rates.
Source: Swiss Re Economic Research & Consulting

Monetary policy will remain accommodative through 2013.

Central banks are primarily focused on economic growth at this time, so are keeping rates low. The ECB lowered interest rates by 25 basis points at its first meeting chaired by Mario Draghi and another 25bp cut is expected to follow soon. Though Draghi refused to accept a more significant role as lender of last resort for governments, the ECB appears likely to step up its bond purchases if needed. Elsewhere, monetary policy is on hold through the middle of 2013.
Credit and equity markets are expected to remain volatile for the foreseeable future. Sovereign risks in Europe continue to spread, with even French government bonds coming under increasing pressure. Particularly for banks, corporate bond yields in Europe especially reflect the stress of the current environment. Lately, corporate spreads in the US show renewed optimism about the US economy and have tightened from recent highs. The direction of equity markets is uncertain, but they are likely to reflect economic activity, with flat to modest rises at best and even declines if conditions worsen.

**Figure 1**  
*Equity market performance*

Credit and equity markets are expected to remain volatile for the foreseeable future. Sovereign risks in Europe continue to spread, with even French government bonds coming under increasing pressure. Particularly for banks, corporate bond yields in Europe especially reflect the stress of the current environment. Lately, corporate spreads in the US show renewed optimism about the US economy and have tightened from recent highs. The direction of equity markets is uncertain, but they are likely to reflect economic activity, with flat to modest rises at best and even declines if conditions worsen.

**Figure 2**  
*Yields on 10-year government bonds with forecast to end 2013, %*
The macroeconomic environment

The Euro area crisis

The Euro area remains trapped in a vicious circle in which weak economic activity, banking sector fragility, and unsustainable sovereign debts reinforce one another. To break the circle, policymakers are faced with several issues:

- A lender of last resort is needed for solvent but illiquid Euro area governments to prevent a liquidity squeeze from developing into a full-blown solvency crisis.
- The banking sector needs to be recapitalised so that it can absorb losses from the economic downturn and from smaller European peripheral sovereign defaults.
- Insolvent or close to insolvent governments need ways to reduce their debts in an orderly manner.
- Governments need to commit credibly to fiscal consolidation as well as to growth-enhancing structural reforms.

The decisions reached at the EU summit on 27 October 2011, did make some headway in addressing the above issues. Also, the formation of technocratic governments backed by broad political coalitions in Greece and Italy raise the chance that much-needed structural reforms will be implemented successfully. However, it takes a long time for the benefits of such reforms to become visible, and success is far from assured since delivering solutions ultimately depends on political will. Indeed, the recent widening of sovereign risk spreads, even beyond the Euro area periphery, is a sign that the announced measures are unlikely to be sufficient to reassure financial markets.

Swiss Re Economic Research & Consulting’s base case scenario assumes that policymakers will continue to address the most pressing issues gradually. However, these issues may not be addressed proactively enough. Stopping the current liquidity squeeze may be impossible without a commitment from the ECB to purchase significant amounts of bonds issued by countries such as Italy and Spain. However, for fear of compromising its independence, the ECB is reluctant to move further into territory that is considered the realm of fiscal authorities. For the ECB to intervene beyond its current Securities Market Programme (SMP) would require a significant step towards increased fiscal integration. The ECB will likely insist on at least partial guarantees from the stronger Euro area governments before extending credit to illiquid, but most likely solvent governments. This is unlikely to be a smooth process because it involves controversial political decisions. As a consequence, financial market volatility is likely to remain high.

The longer the current debt crisis continues, the higher the risk of a more severe and longer-lasting recession. The longer the current debt crisis continues, the higher the risk that the severity and duration of the economic recession will increase beyond baseline scenario assumptions. Downside risks could materialise if policymakers repeatedly fail to deliver on the necessary tasks, thus trapping the Euro area in a whirlwind of fiscal austerity, weak banking sectors, and economic stagnation. In addition, a disruptive event such as a unilateral Greek default and exit from the Euro area, could cause economic and financial market turmoil in the near term. However, such an event could also eventually foster the development of a stronger monetary union between the remaining members. In a more extreme scenario, repeated failure to find a permanent solution to overextended sovereign balance sheets could lead to the default of one or several major Euro area countries, and eventually the break-up of the entire monetary union. The repercussions of a break-up are very hard to assess, but may well be more severe than the failure of Lehman Brothers.
With a recessionary baseline in the US, UK and Euro area, there is some upside and some downside risk. On the upside, the US economy could grow at a moderate pace next year, particularly if the housing market improves. Single family home prices are falling, but demand and rents for multi-family housing are increasing. Indeed, construction for buildings with five units and above was up 97% year-on-year in October. US consumers also seem sufficiently confident to buy vehicles, particularly as a replacement for their older vehicles. Fiscal tightening, as in the UK, will moderate any improvement in growth. In the Euro area, swift action on the debt crisis is needed, in the form of support for illiquid but not insolvent governments, bank recapitalisation, fiscal improvements, and structural reforms. This action could come from the European Financial Stability Facility (EFSF), the ECB, and the new coalition governments. Under such a scenario, equity markets would improve, credit spreads would tighten, and US and German government bond yields would rise more rapidly. Nevertheless, investment yields for insurers would still be low.

On the other hand, the Euro area crisis could turn ugly with disorderly defaults. In such an extreme global recession scenario, deficits remain so elevated that fiscal tightening keeps inflation, growth, and interest rates low for a prolonged period. Equity markets decline and credit spreads stay wide. This scenario would put severe pressure on insurers, particularly life insurers with guaranteed interest rate products. In addition, widespread defaults on sovereign bonds and by banks would reduce capital significantly (see Box on the implications of the European sovereign debt crisis for European insurers).
The macroeconomic environment

Implications of the European sovereign debt crisis for European insurers

Insurers are key investors in government securities. Consequently, the on-going Euro sovereign debt crisis has a direct impact on their investments. In addition, insurers are indirectly affected through spill over effects on the value of other assets, especially bank securities, held in their portfolios and more generally the impact on economic activity.

Table 2 presents estimates of the potential sovereign debt write-downs, or realised losses, that the European insurance sector could face. The figures assume a 50% haircut, based on the proposed deal with private sector investors in Greek bonds following the EU summit in October 2011.

The assumed 50% haircut on the face value of Greek sovereign debt could translate into aggregate asset impairments of around EUR 14bn. These losses could be readily absorbed in existing capital resources as they represent less than 3% of European insurers’ combined shareholder funds.

Write-downs on sovereign debt are manageable if Spain and especially Italy can avoid debt restructurings.

A 50% haircut on sovereign debt issued by Portugal, Ireland, and Greece could prompt write-downs of around EUR 25bn, or 4.3% of European insurers’ capital. But losses would be materially higher if similar haircuts were also applied to the value of Spanish and, in particular, Italian sovereign debt. Some individual European insurers would be particularly affected given their relatively high exposures to Spain and Italy. If all five most vulnerable European countries were to default, losses could be equivalent to around a quarter of shareholders’ funds.1

These rough estimates may overstate the direct impact on insurers. However, the real problem could be with indirectly affected assets and the likely severe recession that would be prompted by multiple sovereign defaults.

These rough calculations may overstate the possible direct losses facing insurers. First, some of the prospective investment losses may ultimately be shared with policyholders since such bond investments might be funded by participating life policies. Second, investment losses could be offset against insurers’ future tax liabilities. Finally, most insurers would already have taken some Mark to Market (MTM), or unrealised, losses against equity on their sovereign debt holdings.

In the event of multiple sovereign defaults, insurers would face these direct losses and also see an impact on the value of their other investments. Indeed, such indirect effects could be severe. Vulnerable sovereigns may avoid outright default, but they would then face persistently elevated costs of finance. Finance costs would likely soar amidst heightened uncertainty about a breakup of the European Monetary Union and the brutal recession that would likely follow. The prices of bank securities and equity as well as corporate bonds would all come under intense pressure, although the value of some government bonds that are seen as safe havens might increase, providing a partial offset.

1 These realised losses are broadly similar to estimates produced by several investment banks and rating agency analysts.

Table 2

<table>
<thead>
<tr>
<th>50% haircut on sovereign bonds issued by:</th>
<th>Potential losses for European insurers (EUR bn)</th>
<th>% of shareholder funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>14</td>
<td>2.4</td>
</tr>
<tr>
<td>Greece, Ireland, Portugal (GIP)</td>
<td>25</td>
<td>4.3</td>
</tr>
<tr>
<td>Greece, Ireland, Portugal and Spain (GIPS)</td>
<td>58</td>
<td>9.8</td>
</tr>
<tr>
<td>Greece, Ireland, Portugal, Spain and Italy (GIIPS)</td>
<td>143</td>
<td>24.3</td>
</tr>
</tbody>
</table>

1. The estimates are based on BIS data on sovereign bond liabilities at the end of Q1/Q2 2011. The stock of outstanding debt is first multiplied by the share held globally by non-bank institutions (approximately 50% on average based on Citibank estimates). This is then multiplied by the share of EU insurance premiums relative to the aggregate for OECD countries (approx 40%), in order to approximate European institutions’ exposure. Finally, the resulting figures are multiplied by the share of insurance in total European institutional investors’ financial assets (approximately 45%) in order to isolate European insurers’ exposures.

Source: BIS and Swiss Re Economic Research & Consulting
Overall, the major European insurers’ capital buffers appear adequate enough to cope with direct losses on their sovereign bond holdings, provided losses are limited to the smaller peripheral countries. If write-downs on Spanish and especially Italian bonds were ultimately required, the direct and indirect implications would be much more serious. In such a scenario, the prospect of heightened volatility, disorderly markets, and a severe recession appear high. Additional realised and unrealised losses would be imposed on insurers’ investment portfolios, and their revenue stream would be restricted. Nevertheless, under such a severe global economic scenario, the insurance industry would probably fare relatively well compared to other industries.

Emerging market economic outlook

Growth in the Emerging Asian markets is decelerating slightly. Real GDP growth, for example, eased to 9.1% y-o-y in Q3 in China, from 9.5% in Q2. In recent weeks, Thailand, the Philippines and India have cut their growth forecasts for this year and next. Inflation readings and expectations are stabilising, however, allowing many Asian policymakers to shift from a tightening to a neutral policy stance. Indonesia opted to cut interest rates in October and the Philippines unveiled a PHP 72bn stimulus package to support growth. The global slowdown has reduced capital flows into Emerging Asia, resulting in increased depreciation pressure on Emerging Asian currencies. The biggest challenge remains calibrating economic policies to support growth against the backdrop of an increasingly complex global landscape.

The Gulf economies are expected to withstand the deteriorating global economic environment. Their strengths include robust hydrocarbon revenues, a solid service sector in the regional economies, vast government reserves, increased public spending plans, and a strong pipeline of infrastructure and developmental projects. Given global economic weakness, oil prices may decline, weakening growth in the oil-exporting nations. For oil-importing Middle Eastern and North African countries, the economic situation looks less favourable. Political unrest, political transition in some countries, the global economic slowdown (particularly in Europe), and ongoing fiscal issues all pose challenges. Growth in Turkey has been robust, but is expected to slow. Rising inflation and high levels of current account deficit continue to put pressure on the Turkish economy.

In Central and Eastern Europe (CEE), the economic indicators were surprisingly strong for Russia in Q3. Meanwhile, the European sovereign debt crisis and the economic slowdown in Western Europe have affected the rest of the CEE region. The Polish Zloty has strengthened again, but in CEE countries with structural problems, currencies remain weak. In combination with the stress in the European banking sector, key risks in the CEE region are intensified. (1) There is a high share of foreign currency denominated debt across the CEE region, (2) the region depends heavily on Western Europe for exports, and (3) Western European/Greek and CEE banks are highly interconnected.

Latin America will be exposed to three main external risks in the short and medium term. (1) It could experience a slowdown (or recession) in advanced economies, which would dampen growth particularly in economies linked to the United States such as Mexico or Colombia, (2) a potentially stronger deceleration in China could reduce the outlook for the region’s commodity exporters (Chile, Colombia, Venezuela, Peru), and (3) if global risk aversion remains high, there could be a reduction (or potential reversal) in capital inflows which would tighten external financing conditions. Inflation concerns moderated in several countries, but remain an issue in Venezuela, Argentina, and Brazil. Particularly in Brazil, interest rate cuts could potentially damage its credibility and increase the risk of permanently higher inflation expectations. Furthermore, the sheer growth of credit in most of the Latin American countries point to a potential deterioration in credit quality. Bank exposure to funding has also increased, although from a low base.
A hard-landing for the Chinese economy?

The latest economic reports still point to the outlook of a soft-landing for the Chinese economy. The key risks to China’s near-term economic outlook are 1) a recession in developed markets, 2) a re-acceleration of domestic inflation and overheating in the property market, and 3) rising local government debt. On the assumption that developed markets do not slip into a deep recession, these various risks are deemed manageable. Nevertheless, containing inflation and asset bubbles will remain top priorities for Chinese authorities in the near future.

China’s real GDP growth slowed from 9.5% year-on-year in the second quarter of 2011 to 9.1% in the third quarter. Exports are starting to show the impacts of slowing economic activities in the US and Europe. Meanwhile, domestic fixed asset investments have also eased amid more sluggish real estate market activities. Looking ahead, economic growth is set to steadily slow further. For example, China’s manufacturing Purchasing Managers’ Index (PMI) dropped to a two-and-a-half year low of 50.4 in October. The reading still stays slightly above the 50 expansion threshold but economic momentum is weakening. Overall, the economy is projected to grow by 9.1% in 2011 and 8.8% in 2012, although robust domestic consumption demand will help to buffer an expected weakening in external demand. Inflation is also moderating, as lower food prices attest. Consumer price inflation (CPI) eased for the third consecutive month to 5.5% in October, after having peaked at 6.5% in July. For the year as a whole, inflation is projected to average 5.3% in 2011 and 3.5% in 2012. In view of heightened uncertainties over the global economic outlook, the central bank is expected to shift increasingly from a tightening to a neutral policy stance.

Risks to monitor

Recession in developed markets

An imminent threat to China is recession in developed markets. Although China has reduced its dependence on external demand, exports still account for 15% to 20% of GDP and 30% to 40% of manufacturing growth. A sharp slowdown in external trade will have a profound impact on the Chinese economy. Nevertheless, there is room for policy responses to external shocks. Fiscal stimulus can be used to boost growth if needed, as China is expecting a bigger fiscal surplus this year. On the monetary front, there is ample room for China to lower commercial bank reserve requirement ratios (RRR, currently at 21.5%) to allow more credit into the system. Lowering interest rates, on the other hand, could be riskier given prevailing negative interest rates and elevated property prices.

Re-acceleration of inflation and overheating in the property market

Inflation is likely to have peaked in China. A high base effect and improved food supply chain will ensure lower CPI inflation in coming months. Furthermore, softening international oil and commodity prices have helped to prevent producer prices from surging and passing through into CPI inflation. Given that overall economic activity is expected to cool further, the risk of a re-acceleration in domestic inflation is deemed low. At the same time, house prices have started to fall in the second half of 2011 after the implementation of aggressive anti-bubble measures. While in some cities prices remain elevated, the risk of overheating has reduced.
Rising local government debts

There are also increasing concerns about the growing debt of local governments, some of which are reportedly beginning to default. According to the State Audit Office, the size of the by no means insignificant local government debt was CNY 10.7 trillion (USD 1.7 trillion) at the end of 2010. This amounts to about 26.8% of China’s nominal GDP. Most of these local government loans were used to fund road and infrastructure projects and 79% of them were financed by banks. A major concern is the mismatch of maturity since these long-term infrastructure projects are funded by medium-term bank lending (over 50% are due to mature within the next three years). Many investment projects will not be able to generate enough revenue to pay interest and/or principal. Depending on the scale of defaults, the banking sector’s non-performing loans could jump from their present level of 1% to over 11%. The issue may eventually need some kind of central government resolution to avoid big shocks to the banking system. The central government’s healthy balance sheet and strong economic growth should create sufficient revenue to meet the challenge.

Figure 4

The Chinese economy shows clear signs of moderation.

Figure 5

Exports look set to ease further on waning demand from developed markets.
The macroeconomic environment

Figure 6
Inflation has cooled.

Figure 7
House prices have stabilised.

Figure 8
Consumption holds up well.

Figure 9
Monetary policy is shifting to “on hold”

Source: CEIC
Non-life re/insurance

Growth in non-life insurance business accelerated marginally in 2011. Mature market growth was driven primarily by a rebound in insurance demand following the severe recent recession. Meanwhile, growth of non-life insurance in emerging markets slowed slightly, though at a much higher level than industrialised markets. In 2011, unlike 2010, all emerging market regions contributed to the high level of non-life insurance growth.

Alongside modest business growth, non-life insurance profitability has suffered a massive setback. In part, profitability was affected by record catastrophe losses in the first half of the year and large investment losses in the third quarter. Insurers’ operating profitability is also weakening. Beyond adjustments for catastrophe losses and reserves releases, underwriting results continued to erode mainly due to lower premium rates, although the situation differs by country and line of business. The industry also had weak investment returns, partially due to record low interest rates, sluggish cash flows, and feeble capital gains or capital losses. In addition, the widening spreads on corporate bonds and the weaker quality of sovereign bonds lowered MTM valuations of fixed income securities. Because of the uncertain outlook, equity markets also performed poorly. Squeezed from all sides, the average profitability for the industry was low, recording a return on equity (ROE) of only 4%, down from 6% in the prior year.3

Capitalisation, which now exceeds pre-crisis levels according to accounting figures, is overstated.

The solvency of the industry continues to be strong. With an average estimated solvency ratio of 114%, the industry has returned to its 2007, pre-crisis levels. Therefore, based on accounting data, the industry appears to be in a position of excess capital. However, in today’s macro-economic environment, accounting rules tend to overstate assets of the non-life insurance industry and understate its liabilities. Capital levels that are deemed excellent in accounting terms are actually not that strong from an economic standpoint.4

Low interest rates inflate insurers’ assets.

Several factors are currently important to keep in mind when evaluating non-life insurer capital levels. For one, MTM or fair market valuations of fixed income assets are inflated by low interest rates. Compared to 2010, benchmark interest rates of AAA government bond indices have further decreased by about 150bps. Since a return to higher long-term interest rates is expected over the next two years, asset values should again deflate, squeezing capital. According to Swiss Re Economic Research and Consulting calculations, a 100bps increase in long-term rates reduces capital levels by roughly 10%. Consequently, there is the danger that the industry might build up liabilities against these temporary values.

In addition, European non-life insurers are impaired by the European sovereign debt crisis and equity exposures.

Additionally, the European non-life insurers are significantly exposed to the European sovereign debt crisis. While impairments on the Greek bonds have had a limited direct impact on the non-life industry, MTM write-downs on Southern European government bonds are impacting asset values. In addition, uncertainty relating to sovereign debt is multiplied via its effect on the banking sector, ie the equity and bond holders of banks. Insurance companies domiciled in Southern European countries are especially impacted, with impairments and lending restrictions causing ripple effects in asset classes. Some European insurers have already shown significant losses in the third quarter from sovereign debt impairments as well as equity exposures.

2 Underwriting result is defined as the difference between premiums and the sum of expenses and claims costs.
3 The calculation of the industry average is based on data of the following eight leading non-life insurance markets: Australia, Canada, France, Germany, Italy, Japan, the United Kingdom and the US.
4 This phenomenon is the result of a discrepancy between accounting capital and economic capital. In a nutshell, under current accounting rules, the valuation of assets vary with changing interest rates, whereas liabilities remain stable. If liabilities such as claims reserves were discounted with the same interest rates, insurers’ capital would be far less volatile.
Non-life re/insurance

Apart from asset-related issues, the risks on the liability side are also rising. Due to higher precaution, insurers today are only willing to back less capacity with the same dollar of capital than before the crisis. Insurers have begun to wonder how adequate their claims reserves are after years of soft market conditions and rising inflation risks. Also the latest revisions to property catastrophe models show increasing exposures to natural catastrophes.

Last but not least, current capital market conditions are not favourable for raising capital, for example in case of a catastrophic event. Many insurers, perhaps realising that their capital levels are not what they seem from an accounting perspective, have started hoarding capital. Many reduced their share buyback programs in the second half of 2011, and analysts question the level of dividends for some insurers.

Growth still faces headwinds

Global premium growth continued to be weak, increasing only minimally by 1.8% in 2011. The increase was driven by a slight acceleration in mature market growth, which was primarily due to a rebound in exposure growth. Positive impacts from rate improvements were mainly limited to personal lines businesses in a handful of countries, such as the US, the UK, and Canada.

Premium growth levels were significantly higher in Emerging Markets than in industrialised markets. However, growth slowed slightly to 8.9% in 2011 from 9.6% in 2010, primarily because China’s extraordinary 30% growth rate in 2010 slowed to a more moderate 15% growth rate in 2011. Contrary to 2010, the premium growth in Emerging markets was broad-based, meaning that all regions contributed to economic expansion. Growth slowed in Asia but actually accelerated in Latin America and Eastern Europe.

Eroding underwriting profitability indicates the need for premium rate corrections

Underwriting profitability has deteriorated more in the US than in Europe. Adjusted for average cat losses and reserves releases, the overall combined ratio for US non-life insurers was about 104% in 1H 2011. It was about 103% for commercial lines and 106% for personal lines.

Table 3

<table>
<thead>
<tr>
<th>Points of combined ratio</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>1H 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Headline figure, based on calendar year</td>
<td>104.0%</td>
<td>101.2%</td>
<td>100.8%</td>
<td>109.6%</td>
</tr>
<tr>
<td>of which effective cat losses [-]</td>
<td>6.3%</td>
<td>3.4%</td>
<td>4.7%</td>
<td>12.8%</td>
</tr>
<tr>
<td>normal cat losses [+ ]</td>
<td>4.0%</td>
<td>4.0%</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Cat adjusted combined ratio</td>
<td>101.7%</td>
<td>101.8%</td>
<td>100.1%</td>
<td>100.8%</td>
</tr>
<tr>
<td>A&amp;E reserves additions [-]</td>
<td>0.4%</td>
<td>0.4%</td>
<td>0.9%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Core reserves releases [+ ]</td>
<td>2.2%</td>
<td>3.0%</td>
<td>2.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Adjusted AY combined ratio</td>
<td>103.5%</td>
<td>104.4%</td>
<td>101.7%</td>
<td>103.9%</td>
</tr>
</tbody>
</table>

Sources: A.M. Best, Swiss Re Economic Research & Consulting

In Europe, underwriting profitability in non-life insurance improved in 2011 compared to 2010. However, profitability was far below its pre-crisis levels, and stayed negative on average. The motor market was a strong driver for the slight rebound. Both 2009 and 2010 were characterised by mounting underwriting losses. Some insurers had to increase their loss reserves for prior years. By raising their rates, motor insurance companies in markets such as the UK and Italy were already able to improve their profitability in 2010. Germany and France followed in 2011. Such trends will lead to further improvements in the underwriting results for motor markets.
Unlike the motor business, other personal lines in Europe usually provide stable and risk-adequate earnings for non-life insurers. However, the commercial insurance segment, which also traditionally provides stable and positive results, is showing an increasing decline in underwriting profitability. In Japan and Australia, the two most important mature markets in the Asia Pacific region, the non-life industry’s performance was overshadowed by severe natural catastrophes.

**Investment profitability suffered from low interest rates and weak capital markets**

In the fourth consecutive year of financial market turbulence, the investment environment for the insurance industry remained difficult. After the rebound of capital markets in 2009 and some stabilisation in 2010, the current year brought some setbacks to the insurance industry’s investment profitability. Fears of another recession and the European debt crisis caused poor performance in equity markets, peripheral European government bond markets, and many other higher risk asset classes.

Therefore contributions from investment returns to overall profitability remained low compared to historical standards. For 2011, investment returns are estimated around 10% of net premiums earned, which is substantially below the 13.5% average achieved between 1999 and 2007. Low yields from current investments reflect low interest rates, capital losses from the Euro crisis, and weak equity markets. Together, these more than offset the positive effect of low interest rates on asset valuations.

Since profitability is under pressure from both the underwriting and the investment side, overall profitability is also at low levels. The ROE dropped to 4%, down two points from an already poor 6% and clearly falling short of the industry’s cost of capital.

**Outlook for 2012 and 2013: higher growth path but profitability remains weak**

Macroeconomic growth in Europe and North America is expected to slow down – or even possibly turn negative - in 2012. Therefore, the non-life insurance industry in these regions will probably face weak demand next year. For 2013, global economic forecasts are more positive so the demand for insurance should increase. For the emerging markets, strong premium growth is set to continue, although expansion will decrease slightly next year due to weaker macroeconomic expansion in Latin America and Asia.

Profitability overall is not expected to improve substantially next year. Pricing is just at the cusp of a broader-based hardening. Because there is a lag between price improvements and profitability, underwriting profitability is likely to deteriorate further in most markets and segments in 2012, before it begins improving.

Generally, there are signs that pricing may be stabilising at low levels. However there are varying pricing signals for different lines of business. A timid change in the underwriting cycle, both in commercial and personal lines of business, can be observed in several areas. In the US, commercial insurance rates are at the cusp of hardening according to recent surveys. A broader and stronger turn in insurance pricing is expected for 2012, setting the stage for improving profitability. In Europe, several market leaders have attempted modest rate improvements on the renewals of their commercial line books. Of the personal lines, motor is the largest and also most cyclical. Motor insurance has registered important improvements, even in markets with severe profitability issues, such as the UK and Italy.
The current market situation is typical for a mature soft market cycle. Prices have stopped softening, but they are also not hardening yet. Just when a broader-scale hardening will occur is uncertain, but several important factors point to an eventual turn in the market:

- Reserving may soon prove to be insufficient. It is difficult to estimate this effect and there are big differences between individual companies. Reserve releases from previous years will eventually result in the need to strengthen reserves. When this sets in, it will no longer be possible to ignore insufficient pricing and the scene will be set for a hardening of rates.
- The expected rise of interest rates (see macro-economic outlook) may turn out to be another trigger. It will reduce the value of the bond portfolio and shareholders’ equity under GAAP accounting. This could easily amount to 10% of the capital base.\footnote{Under statutory accounting, where asset values are not Mark to Market, this effect will be significantly lower.}
- Stricter solvency regulations and higher capital requirements expected by rating agencies will help turn the market. Solvency II is still on track to be implemented. Further tightening of rating agency models is also expected.
- RMS’s version 11 of its cat model tends to push up property prices due to higher expected losses

Any further delay of the market turn will only increase pressures later on. Thus, by 2013, the underwriting cycle could turn toward a general hardening if profits deteriorate in 2012, adverse developments occur, and MTM asset values decline due to rising interest rates. On the other hand, the macroeconomic slowdown works against the insurance industry as commercial insurance customers try to pass their economic pain on to their suppliers, including the insurance industry.

Declining underwriting results will be partially offset by improving investment results as interest rates rise, more so in 2013 than in 2012. Overall, investment results will improve, but are not expected to reach the pre-crisis levels any time soon. As a result, overall profitability will probably remain subdued for the next two years.

### Table 4

**Real growth of direct premiums written in major non-life insurance markets & regions**

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>0.1%</td>
<td>1.8%</td>
<td>1.8%</td>
<td>2.6%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Industrialised countries *</td>
<td>–0.5%</td>
<td>0.6%</td>
<td>0.6%</td>
<td>1.7%</td>
<td>2.9%</td>
</tr>
<tr>
<td>United States</td>
<td>–2.8%</td>
<td>–1.2%</td>
<td>–1.1%</td>
<td>1.6%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Canada</td>
<td>2.4%</td>
<td>3.9%</td>
<td>4.2%</td>
<td>1.7%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Japan</td>
<td>–0.2%</td>
<td>0.2%</td>
<td>4.2%</td>
<td>2.1%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Australia</td>
<td>4.3%</td>
<td>1.0%</td>
<td>1.2%</td>
<td>2.4%</td>
<td>4.7%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>–0.1%</td>
<td>3.1%</td>
<td>1.2%</td>
<td>1.7%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Germany</td>
<td>3.3%</td>
<td>1.6%</td>
<td>1.3%</td>
<td>0.8%</td>
<td>1.7%</td>
</tr>
<tr>
<td>France</td>
<td>1.7%</td>
<td>4.4%</td>
<td>1.8%</td>
<td>–1.0%</td>
<td>–1.7%</td>
</tr>
<tr>
<td>Italy</td>
<td>–2.8%</td>
<td>–4.4%</td>
<td>2.4%</td>
<td>0.5%</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

Emerging markets            | 3.9% | 9.6% | 8.9% | 7.0% | 8.6% |
Latin America                | 3.7% | 4.6% | 8.7% | 4.3% | 7.2% |
Eastern Europe               | –8.8%| –2.1%| 4.3% | 4.3% | 5.7% |
Africa                       | 4.0% | 5.8% | 4.9% | 3.2% | 5.2% |
South & East Asia            | 16.5%| 24.0%| 12.8%| 10.6%| 11.5%|
Middle East excl Israel      | 4.1% | 5.5% | 7.2% | 7.6% | 7.4% |

* Industrialised countries include the following regions and countries: North America, Western Europe, Israel, Oceania, Japan, Korea, Hong Kong, Singapore, Taiwan

Source: Swiss Re Economic Research & Consulting
Non-life reinsurance

For the global reinsurance industry, 2011 was marked by extraordinarily high natural catastrophe losses, likely amounting to more than USD 100bn for the global insurance and reinsurance industry combined. A substantial part of these losses is carried by the globally diversified reinsurance industry. In the first quarter, the industry reported an average combined ratio of 154%, and the whole year’s capacity was already exhausted in the first three months due to the severe earthquakes in New Zealand and Japan.

Luckily for the reinsurance industry, second quarter losses from tornadoes in the US remained widely below the attachment points of large reinsurance programs and are mostly retained by the primary sector. The third quarter was also relatively quiet, with below-average hurricanes making landfall in the US. However, the multi-billion Thailand flood losses from November will possibly develop into one of the largest insurance losses of the year.

Despite the financial crisis and the soft underwriting cycle, natural catastrophes are leaving the most substantial mark on earnings and capital developments for the reinsurance sector. For 2011, a combined ratio of between 108% and 110% is expected for the industry.

Reinsurance capital quickly recovered from its dip in the first quarter

By end-2010, capital and solvency were at record high levels, even slightly higher than before the financial crisis. The cat losses of the first quarter of 2011 reduced capital by 6%, which the industry was able to recuperate in the following two quarters. Reinsurers’ capital base continues to be strong, however, similar to the primary non-life insurance industry, it is likely to be overstated.

Reinsurance rates are levelling out overall, and hardening in some segments.

During the July 2011 renewals, capacity was seen as adequate-to-abundant across all lines and regions. Brokers reported that following the large losses and property catastrophe model changes, reinsurance rates had gradually started to harden. Areas that suffered the largest catastrophe losses showed the firmest upward rate pressure. Property catastrophe pricing improved between 5% and 10% on a risk-adjusted basis.

Re/insurance markets are improving, but a broad market turn is still to come. There are signs of long-tail rates reaching the bottom. These signs to the end of the soft market are encouraging. However, adequate pricing requires factoring in the current risk exposures and the low interest rate environment.

Underwriting profitability will worsen before it gets better

Reinsurer combined ratios have suffered from above-average claims due to natural catastrophes. The industry’s average combined ratio for the nine months through September was 114%, up from 96% in 2010, and from 94% in 2008 (the year of Hurricane Ike). The good news is that the third quarter 88% combined ratio improved from 92% in the previous year, reflecting strong underwriting results. The combined ratio for the year is expected to end between 108% and 110%.

Nevertheless, underwriting profitability in reinsurance markets held up better than in many primary markets. The industry still benefits from the hard market years of 2002 and 2003, and the more benign claims trends during the recession. Releases from loss reserves in prior years are currently helping to improve the underwriting results by two-to-three percentage points.
Non-life re/insurance

Weak capital markets have not helped investment and overall returns

Because, like primary insurers, reinsurers have suffered from the European debt crisis, low interest rates, and weak equity markets, their investment income is down as well this year. In 9M2011 they showed a yield of 3.4% compared to 4.5% one year prior. Reinsurers suffer more from falling asset values than primary non-life insurers due to their higher asset leverage.

ROE was only 3 to 4% in 2011, down from 11% in 2010.

Due to high natural catastrophe losses, overall profitability was low. ROE for 9M11 was only 2.1% compared to 10% in the prior year. The reinsurance industry’s average ROE level was lower than for primary insurers. For the full year, an ROE of around 3% to 4% is expected, down from 11% in 2010.

The outlook is subdued for 2012 but brighter for 2013

Premium income for 2012, which largely follows premium trends in the primary insurance sector, will be subdued due to the slowdown in growth in industrialised markets. The strong reinsurance demand in emerging markets, however, will support premium growth for global reinsurers. In 2013, the global economy is expected to recover, prompting accelerated exposure growth that will support premium growth.

Pricing signals from this year’s re/insurance industry conventions in Monte Carlo and Baden-Baden indicate that the 2012 renewals will be stable to slightly firmer. Hardening will be limited to lines and segments that have recently experienced high losses. Casualty rates, especially in the US, are still expected to harden only later next year along with an expected increase in adverse claim developments.

Assuming average catastrophe losses, the base-line combined ratio is expected to be around 100% in 2012. The estimate is based on a scenario that assumes subdued premium growth, less benign claims environment than the last three years, and declining reserve releases. Because of the low interest rate environment in industrialised countries, the overall profitability outlook for 2012 is gloomy. For the reinsurance industry, an average ROE of 5% to 7% can be expected, a level which is below the industry’s cost of capital.

Prospects for 2013 look brighter.

The outlook for 2013 is more optimistic. Economic growth is expected to normalise, pushing interest rates up. In this improving macroeconomic environment, reinsurance premium growth and investment performance will improve. However, the most critical factor for future profitability will be the turning of the underwriting cycle. Since the pressure from insufficient underwriting results will intensify in 2012, a change in market sentiment will be more likely toward year-end.

Table 5

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrialised countries *</td>
<td>−1.4%</td>
<td>−2.2%</td>
<td>−0.4%</td>
<td>2.6%</td>
<td>4.5%</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>−4.1%</td>
<td>1.6%</td>
<td>14.5%</td>
<td>9.9%</td>
<td>8.8%</td>
</tr>
<tr>
<td>World</td>
<td>−2.0%</td>
<td>−1.4%</td>
<td>3.0%</td>
<td>4.4%</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

Source: Swiss Re Economic Research & Consulting
Life re/insurance

In 2011, primary life insurance premiums decreased again, following a short-lived recovery in 2010.

Life insurers continued to improve their balance sheets following the crisis and are well prepared for the next bumpy ride.

Life re/insurance: entering choppy waters again

Global life insurance premiums fell 1.4% in 2011, following a short-lived recovery in 2010 when premiums rose by 3.7%. In developed markets, premium income declined by 1.8%. For the first time ever recorded in emerging markets, premium income nearly stagnated, up only 0.6% due to a 6% decline in China, which accounts for about 25% of the emerging markets premium.

Capital is at a solid level

The life industry’s capitalization has improved significantly and is better than it was before the crisis in 2007. Balance sheets are strong due to solid investment portfolios and enhanced hedging programmes, liquidity is abundant, products are better priced, and insurers have refrained from fancy margin-hunting activities such as securities lending.

Figure 10
The shareholder equity of 32 mainly life and global companies (IFRS/GAAP data), 2007Q4=100

Notes:
1) Missing Q1/Q3 values are interpolated
2) AFLAC; Allianz; Assurant Inc; Aviva; AXA; CNP; China Life; Delphi Financial; Generali; Genworth Financial; Great-West Lifeco; Hartford; Irish Life & Permanent; Legal & General; Lincoln National; Manulife; Metlife Group; Nationwide; Old Mutual; Phoenix Companies; Ping An; Principal Financial Group; Protective Life; Prudential (UK); Prudential (US); StanCorp Financial Group; Standard Life; St. James Place; Storebrand ASA; Sun Life; Swiss Life; Torchmark; UNUM Group; Zurich FS

Sources: Company reports, Bloomberg, Swiss Re Economic Research & Consulting

6 Inflation-adjusted.
Despite the remarkable improvement in capital positions, there are some concerns to keep in mind:

1. Part of the increase in capital following the crisis is due to positive accounting impact of the decline in interest rates. When interest rates drop, there is no corresponding change in liabilities which are measured at book value. However, the value of fixed income securities increases since they are based on the current market valuation. The positive accounting impact is temporary and will reverse over time as securities reach maturity or as interest rates rise. Realising investment gains today is not a solution since any reinvestments will result in lower yields going forward, thus offsetting realised capital gains. In an economic reporting framework, a decline in interest rates results in lower value, and hence lower risk capital for life insurers. This reduction is evident from companies’ embedded value reports. A decrease in interest rates by one percentage point results in a 1% to 19% reduction in embedded value, depending on the product mix and guarantees.\(^7\)

2. The Euro crisis remains a threat. Some insurers have substantial exposure to GIIPS\(^8\) government bonds, and these companies will likely seek solutions to fix their balance sheets. The main threat for the insurance industry is its substantial investment in the banking industry. If the European banking sector slides into a crisis this would spill over to the insurance industry, wrecking havoc for life insurers. In the US, there is still a threat of further asset impairments from mortgage investments.

3. Changes in accounting and regulation will likely reduce capital. Upcoming US GAAP accounting changes may lead to downward revisions to existing deferred acquisition cost assets, thus causing some reduction in capital. In Europe, with the introduction of the risk-based regulatory framework Solvency II in 2013, solvency levels are expected to be lowered on average.

All in all, the sector is well-prepared to withstand the next shock-wave. However, there are huge differences in capital strength between companies and some companies will struggle going forward. As always during tough times, the weakest may fall by the wayside. As a result, we expect that some companies will have to further improve their balance sheets, sell books or subsidiaries, raise capital, or merge with stronger companies.

\(^7\) Source: Swiss Re Economic Research and Consulting, based on EEV/MCEV reports of nine European and Asian companies.

\(^8\) Portugal, Italy, Ireland, Greece, and Spain.
In-force premiums and new business dipped in 2011

Overall, global life insurance premiums fell in 2011. However, there are remarkable differences in the development of premium income across various markets.

In the US and UK, the decline of in-force life premiums that began in 2008 finally ended in 2011, with premiums improving modestly, driven by a rebound in savings products. However, in Germany, Italy, and France, where the life industry withstood the crisis well, in-force premiums fell sharply in 2011.

In emerging markets in 2011, in-force premium growth almost came to a halt, driven by an approximate 6% premium decline in China as a result of newly introduced bancassurance regulation. Excluding China, emerging market growth remained strong at 5.5% (with only Hungary and Slovakia facing lower premiums in 2011 compared to 2010). In Latin America, premiums increased almost 10%, while Emerging Asian countries premium income declined by 2.1%. Had it not been for China, Emerging Asian markets would have grown by 4.2%.

The life industry needs new business to grow. However, new business dropped 3.2% in 2011 for a sample of selected markets, after increasing by 2.7% in 2010. The decline was mainly due to slumping sales in Italy and Germany (and likely also in France, for which no data are available), where, after a boom in 2009 and 2010, new business in single premium savings business collapsed. In the US and UK, new business increased only marginally, by less than 1%.

Table 6
In-force life real premium income growth, %

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>–12.3%</td>
<td>–0.6%</td>
<td>0.7%</td>
<td>2.7%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Canada</td>
<td>3.4%</td>
<td>–0.7%</td>
<td>–2.2%</td>
<td>1.0%</td>
<td>2.6%</td>
</tr>
<tr>
<td>UK</td>
<td>–11.6%</td>
<td>–3.3%</td>
<td>–0.6%</td>
<td>2.3%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Japan</td>
<td>4.7%</td>
<td>4.6%</td>
<td>3.0%</td>
<td>2.0%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Australia</td>
<td>–15.6%</td>
<td>–0.7%</td>
<td>6.7%</td>
<td>4.0%</td>
<td>4.5%</td>
</tr>
<tr>
<td>France</td>
<td>13.1%</td>
<td>2.7%</td>
<td>–14.3%</td>
<td>1.5%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Germany</td>
<td>6.0%</td>
<td>6.5%</td>
<td>–8.2%</td>
<td>–0.3%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Italy</td>
<td>47.4%</td>
<td>9.4%</td>
<td>–16.4%</td>
<td>0.7%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Spain</td>
<td>6.0%</td>
<td>–10.0%</td>
<td>15.3%</td>
<td>2.1%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>–18.5%</td>
<td>–0.9%</td>
<td>0.8%</td>
<td>2.6%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Industrialized World</td>
<td>–1.1%</td>
<td>2.6%</td>
<td>–1.8%</td>
<td>2.2%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>6.5%</td>
<td>10.5%</td>
<td>0.6%</td>
<td>8.4%</td>
<td>8.3%</td>
</tr>
<tr>
<td>World</td>
<td>–0.2%</td>
<td>3.7%</td>
<td>–1.4%</td>
<td>3.1%</td>
<td>3.7%</td>
</tr>
</tbody>
</table>

Source: Swiss Re Economic Research & Consulting

In 2011, new business declined due to falling sales in Italy and Germany.

Table 7
Real growth of new business in selected countries

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>–15.1</td>
<td>–3.5</td>
<td>0.7</td>
</tr>
<tr>
<td>UK</td>
<td>–28.4</td>
<td>1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Australia</td>
<td>–17.3</td>
<td>–9.1</td>
<td>–5.0</td>
</tr>
<tr>
<td>Japan</td>
<td>12.0</td>
<td>5.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>–27.6</td>
<td>–16.4</td>
<td>–13.4</td>
</tr>
<tr>
<td>Germany</td>
<td>32.7</td>
<td>23.9</td>
<td>–17.7</td>
</tr>
<tr>
<td>Italy</td>
<td>44.3</td>
<td>13.9</td>
<td>–26.4</td>
</tr>
<tr>
<td>Sample*</td>
<td>–5.4</td>
<td>2.7</td>
<td>–3.2</td>
</tr>
</tbody>
</table>

* Inforce premium weighted average of new business growth rates

9 Figures are for a sample of seven industrialized markets, including the US, UK, Australia, Japan, Netherlands, Germany and Italy.
Although they held up relatively well during the crisis, the sales of protection products declined in many markets in 2011. Term sales contracted in the US, UK, Canada, and Italy, partly reflecting price increases and fewer product offerings in some markets. The contraction was also due to slowing global economic growth and renewed softening in the UK housing market, where term sales are closely linked to mortgage activity. Disability sales were flat to slightly down in the US, since the bulk of sales is from group business which remains depressed due to weak employment growth. Critical illness sales were flat in the UK. On the upside, however, protection sales have increased slightly in Germany and the Netherlands.

### Profitability has stabilised at below pre-crisis levels

Profitability bounced back after the crisis thanks to financial market improvement, product repricing and redesign, and company cost cutting. Since early 2010, profitability has stabilised at about 12% ROE, or below its pre-crisis levels of 15% and higher. Going forward, low investment returns, high hedging costs, low business volumes, and more onerous capital requirements will prevent a return to pre-crisis profitability levels in the foreseeable future.

![Return on equity of 32 mainly life and global companies (IFRS/GAAP data), %](image)

1) Missing Q1/Q3 values are interpolated
2) AFLAC; Allianz; Assurant Inc; Aviva; AXA; CNP; China Life; Delphi Financial; Generali; Genworth Financial; Great-West Lifeco; Hartford; Irish Life & Permanent; Legal & General; Lincoln National; Manulife; Metlife Group; Nationwide; Old Mutual; Phoenix Companies; Ping An; Principal Financial Group; Protective Life; Prudential (UK); Prudential (US); StanCorp Financial Group; Standard Life, St. James Place; Storebrand ASA; Sun Life; Swiss Life; Torchmark; UNUM Group; Zurich FS

Sources: Company reports, Bloomberg, Swiss Re Economic Research & Consulting
In the short-term, life premium growth will be sluggish. The challenging macro-economic environment will keep the life industry outlook rather depressed. Weak GDP, employment, income growth, and housing markets will constrain consumer savings and limit group business. Historically low interest rates, increased volatility in financial markets, and regulatory changes with more onerous capital requirements may require life insurers to restructure and innovate products to better reflect the costing environment vis-à-vis consumer needs and expectations.

For industrialised countries, growth is expected to increase to about 3% in 2013 (after inflation). In emerging markets, growth is estimated to be around 8% in 2013. From 2013 onwards, premium growth should strengthen gradually and return to its long-term trend.

In the long-term, demand for savings products, longevity insurance and long-term care will be robust and will continue to be driven by the needs of aging populations preparing for retirement. The demand for more traditional mortality and disability protection products will also be solid since they meet important consumer needs and there are hardly substitutes available outside the industry. Therefore, the business case for life insurance remains strong.

Low investment yields will pressure profitability and capital

Life insurers will face some challenges over the next few years. Should interest rates remain low for a prolonged period of time, profitability will suffer and there may be a solvency threat for some insurers in markets where products contain rigid long-term interest rate guarantees that are inadequately hedged or assets and liabilities that are not duration-matched. Low interest rates result in spread compression and even negative spread, decreasing profitability and potentially reducing capital should earnings fall short of the required increase in reserves. Also at risk are products with long-tail liabilities such as long-term care and long-term disability, where in many cases asset duration is short and reserves have to be reinvested at the current historically low yields.

While new business can be adjusted to the low investment return environment, old books of business with interest-linked guarantees pose significant risks to profitability. Most exposed is the savings business in Germany, the annuity business in the UK, and savings products with return guarantees in the US. Exposure to interest rate risk will keep up reserve pressures, putting constraints on capital and leading to earnings and profits volatility. In Germany, long-term guarantees are locked-in above the current actual investment yields for a large part of the business (see BOX: Low interest rates and average guarantee levels in Germany).

More stringent capital requirements will be another drag on profitability. Under Solvency II, capital requirements for asset risk and long-term guarantees will be more stringent. Also, insurers will face much more severe stress tests and investing in riskier assets will incur material charges. Companies will need to balance higher expected investment results against higher capital charges. This balancing will need to go hand in hand with strategic decisions concerning the level and amount of guarantees they sell.

10 Spread compression means a lower difference between investment yield and guarantees.
Life re/insurance

A Japan-style life insurance industry crash is not expected

In the current low interest rate environment, there are concerns that what happened in Japan a few years ago could be the present fate of the global life insurance industry.

Since the mid 1990’s, the Japanese life industry has operated in a low interest rate environment, leading to the bankruptcy of Nissan Mutual Life which heralded the Japanese life insurance crisis. By 2002, another 7 major life companies had been liquidated.

However, Japan’s case is very different from what the global life industry faces today. In Japan, many life companies at the time were poorly managed and had poor product designs. A build-up of risky assets, combined with regulatory and systemic weaknesses resulted in desolate conditions for the life industry. Low interest rates contributed to an extremely stressful situation.

Today’s global life insurers are generally in much better shape than Japan’s life insurance companies were when the Japan life insurance crisis unfolded. Balance sheets are strong, risk management has improved, products have been repriced and redesigned, and regulation is now more risk-based and provides better guidance. Despite the low-interest rate environment that global life insurers face, another Japan-style industry breakdown is unlikely in the near future.

Life reinsurance: declining mortality business, increasing concentration

The top ten life reinsurers increased their net premiums in 2011 by consolidating and making large deals.

Traditional life reinsurance contracted in 2011, driven by the strong decline in the US and UK.

Premiums from traditional life reinsurance are estimated to have decreased by 2.5% globally in 2011. In part, their strong growth was driven by consolidation. Berkshire Hathaway Reinsurance Group acquired Sun Life of Canada’s life retrocession business and Scor acquired Transamerica Re from Aegon. Additionally, block transactions, longevity risk reinsurance, enhanced annuities and accident & health business supported reinsurance growth and helped reinsurers diversify away from traditional mortality business in the US and the UK.

Traditional life reinsurance premiums continued to decline

Premiums from traditional life reinsurance are estimated to have decreased by 2.5% globally in 2011. In industrialized countries, premiums fell 3%, while in emerging markets they increased 5%. The decline in industrialized countries was driven by ongoing contraction in the US and UK markets, which account for 60% of global cessions. Reinsurance premiums in the US and UK fell by more than 5% in 2011 due to 1) depressed sales of protection products, and 2) declining cession rates as a result of receding regulatory arbitrage opportunities, regulatory changes, and solid levels of capital at the vast majority of direct companies.

Table 8

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrialised countries</td>
<td>4.4%</td>
<td>–0.6%</td>
<td>–3.0%</td>
<td>–0.7%</td>
<td>–0.6%</td>
</tr>
<tr>
<td>Emerging markets</td>
<td>4.9%</td>
<td>8.7%</td>
<td>5.1%</td>
<td>6.8%</td>
<td>7.2%</td>
</tr>
<tr>
<td>World</td>
<td>4.4%</td>
<td>–0.2%</td>
<td>–2.5%</td>
<td>–0.3%</td>
<td>–0.1%</td>
</tr>
</tbody>
</table>

11 Based on preliminary data. The 10 companies are: Munich Re, Swiss Re, RGA, Hannover Re, Berkshire Hathaway (Gen Re; BHRG), Scor (incl. Transamerica Re), Generali, Partner Re, GECS.
Outlook for 2012 and 2013: looking for growth opportunities

Traditional life reinsurance, consisting of mortality and disability, is expected to stagnate in the next few years. In industrialised countries, life reinsurance premiums will decline by up to 1% per annum. In the US and the UK, business opportunities will fade away with changes in regulation. In other industrialised countries, where cession rates are much lower than in the US and UK, traditional reinsurance will continue to record low, single-digit growth rates in line with growth of the protection business on the primary side. In emerging markets, life reinsurance is expected to increase at around 7% per year over the next few years. In these areas, reinsurers’ main value proposition will be to support primary insurance in product development, underwriting, and claims management.

However, strong growth in emerging markets will not be sufficient to compensate for the fading business in the US and UK, so life reinsurers will seek non-traditional or less developed areas of growth. In the next few years, direct insurance companies will need solutions for managing the capital strain that the macroeconomic environment will put on them. Some companies will shed unprofitable or non-core business while others will look to grow through mergers and acquisitions, thus creating opportunities for transferring blocks of in-force business to reinsurers and specialised consolidators.

Reinsurers are increasingly developing solutions for transferring longevity risk from primary companies with annuity business as well as through private and public pension plans. The market for longevity risk transfer continues to have strong momentum. Compared to USD 9.8bn in 2009, USD 8.0bn of longevity liabilities were transferred via publicly disclosed longevity re/insurance and swap transactions in 2010. The 2011 year-to-date notional value of these longevity liabilities is USD 7.0bn. The market is active primarily in the UK, but there have been two transactions with Australian insurers and one with a Canadian insurer. Longevity re/insurance activity is expected to develop in other markets as well, including the Netherlands, Switzerland and the US, where there is significant potential demand, particularly from pension funds.
The German life insurance industry is heavily exposed to a decline in interest rates. A substantial part of existing contracts are endowment policies with a minimum annual return guarantee that is fixed at the outset and lasts for the lifetime of the policy.

The level of the guarantee has been adjusted by the German regulator according to financial market conditions, as the grey line tracing the 10-year government bond yield in the graph below shows. The guarantees have been stepwise lowered from 4% in 1995 to 1.75% in 2012 (dotted dark blue line). The light blue line shows the average portfolio guarantee level, assuming an average term of 20 years. It continuously decreases as new policies with lower guarantees are added to the portfolio. In 2012, it is estimated that the average guarantee will be close to 3%. The 10-year government bond yield has only exceeded the average guarantee in two out of the eight years from 2005 to 2012.

Since 2002, when insurers reduced their stock market exposure significantly, insurers have been earning an investment income slightly above a reference investment portfolio consisting of ten subsequent 10-year government bonds (dotted light blue line). This reference portfolio and hence the insurers’ investment yields are converging towards the average guarantee level.

The average guarantee level reacts very slowly to changes in the regulatory minimum guarantee levels because of the very long duration of liabilities. Many insurers have not duration-matched their assets and liabilities, hence investment yields will fall further than average guarantees, resulting in negative spreads if low interest rates persist.
Emerging markets

Emerging markets: growth in 2011 and cautious outlook

Emerging market economies have continued to grow robustly in 2011, by an average of 5.8% (+7.7% in 2010). However, growth has mildly slowed in the second half of the year, due to heightened concerns about the debt crisis in Europe and the health of the US economy. Overall, favourable economic performance has brought further insurance premium growth in most emerging markets, with the notable exception of the life business in China (and to a lesser extent India). Life and non-life premiums in emerging markets are estimated to have risen in 2011 at the inflation-adjusted rates of 0.6% (2010: +10.5%) and 8.9% (2010: +9.6%), respectively. Falling premiums in China and slower growth in India, both reflecting the impact of recent regulatory changes, have dampened overall emerging market life insurance business growth. Meanwhile, non-life business has largely continued to grow at a steady tempo in most key markets.

Profitability in 2011 is likely to have remained stable. On the one hand, low interest rates have continued to depress insurer investment income. However, underwriting and operating results are likely to have stayed fairly healthy in most markets. While major natural catastrophes have hit the profitability of mature market insurers in 2011, most emerging market insurers have weathered the year relatively well. However, the recent floods in Thailand may have a heavy impact on local insurers. Also, though it improved in 2010, emerging market insurer capital is increasingly coming under pressure from business growth and tightening capital requirements.

Growth of life insurance premiums stalled in 2011

Life insurance premiums in emerging markets are estimated to have grown only marginally by 0.6% in 2011, whereas in 2010 they grew by 10.5%. The dismal performance of the Chinese and Indian life insurance markets can account for most of the slowdown. In both cases, insurance operations have proved vulnerable to regulatory changes. In China, since the liberalisation of bancassurance in 2003, premiums from bank channels grew to account for 45% of life insurance premiums in 2010. However, in November 2010, Chinese regulators tightened rules governing the distribution of insurance products through banks. This resulted in a sharp decline in sales of savings and single premium life products. The more stringent regulatory environment has had a significant impact particularly on some small and medium sized insurers that rely heavily on bank channels to sell savings-type products. Likewise, in India, unit-linked insurance products were a key driver of premium growth. However, recent tightening of regulations governing the distribution of these products has also led to a slump in new business.

Figure 13
Life insurance premium real growth rate, 2007–2012, by region

Source: Swiss Re Economic Research & Consulting.
Regulatory measures to improve consumer protection through tighter supervision of intermediation and product designs will benefit the industry’s long-term, sustainable growth. However, the measures are already having a negative impact in the short-term as consumers and industry practitioners adjust to the new environment. Overall, life insurance premiums are estimated to have declined by 2.1% in emerging Asia in 2011, against a 15.3% increase a year earlier.

Elsewhere, life insurance business expanded healthily. For example, it expanded by 12% in the Middle East and by 9.9% in Latin America. Growth remained strong in key emerging markets in these regions, including Brazil, Mexico, Turkey and the UAE. However, premium growth in Central and Eastern Europe lagged behind the other emerging regions, rising only 4.7% as the evolving debt crisis in Europe dampened consumer sentiment. However, demand for short-term deposit type products continued to support growth in Poland, the largest life market in Eastern Europe. In Russia, premiums surged by more than 50% in the first half of 2011, though still from a very low level.

Non-life premiums experienced broad-based growth

In 2011, non-life insurance premiums in the emerging markets grew by 8.9% (2010: +9.6%), in line with the long-term trend rate of around 9%. Strong growth was recorded in emerging Asia (+12.8%), particularly in China (+15%), Indonesia (+10.3%) and Vietnam (+6.9%). Sustained public sector investment in infrastructure and an average economic growth of around 7% have been the principle contributors to non-life premium growth in Emerging Asia. In addition, the series of natural catastrophes that hit Asia in 2010 and early 2011 may have raised insurance awareness and prompted corporations to acquire sufficient insurance covers to protect their exposures. Non-life business also continued to recover in other emerging regions. Premium growth accelerated in Latin America, from 4.6% in 2010 to an estimated 8.7% in 2011. Premiums in Central and Eastern Europe which had declined in 2009 and 2010, saw a modest recovery in 2011 of 4.3%, thanks to growth in Russian and rising prices for motor and property insurance in Poland.

Source: Swiss Re Economic Research & Consulting.

Figure 14
Non-life insurance premium real growth rate, 2007–2012, by region
Over the year, motor business benefited from further increases in car sales in many key emerging markets. Health and personal accident insurance also experienced strong growth, prompted by increasing risk awareness and demand from the growing middle class for better protection and medical care. Agricultural insurance, though it is still a small-scale business, also reported strong year-on-year growth. In China, for example, agricultural insurance increased 82% per year (nominal growth rate) between 2004 and 2010, backed by favourable governmental support including premium subsidies.

**Takaful developments in emerging markets**

Of all the different models of Islamic insurance, takaful is the one most accepted by shariah scholars. Takaful is based on mutual assistance, joint risk-taking by the policyholders, and a clear segregation of policyholder funds and shareholder (operator) funds. Takaful companies adhere to a shariah-compliant investment strategy and are supervised by an independent board of shariah scholars.12

Despite the global financial crisis and slowdown in growth in the conventional insurance sector, takaful continued to achieve an average annual growth rate of nearly 30% (inflation adjusted) between 2007 and 2010. In 2010, total takaful contributions amounted to USD 3.2bn, or 4.4% of total insurance premiums and takaful contributions in Muslim countries. Malaysia is the largest and most advanced market, followed by Saudi Arabia, the United Arab Emirates and Indonesia. Strong economic and population growth is likely to support the growth of the takaful industry over the next few years. Given current low penetration of takaful insurance, total contributions could reasonably double by 2015. However, the takaful industry will remain concentrated in only certain key emerging markets in the Middle East and Southeast Asia.

Takaful industry practise is gradually converging towards hybrid business models, which combine a fixed fee model for underwriting (wakalah) with profit-sharing for investment activities (mudarabah). Against this wave of standardisation, however, lie persisting business barriers. Sustained growth over the longer term and an extension of takaful beyond the Muslim countries will require more standardisation in terms of business models and regulation. Low consumer awareness for takaful and the still underdeveloped Islamic financial markets are further hurdles for growth. Last, but not the least, to uphold the integrity of the industry, strict observance of shariah principles is required in every aspect of takaful operations. Otherwise, consumers might perceive takaful as being the same as conventional insurance. One example of best-practice abidance to shariah law is consistent use of retakaful instead of conventional reinsurance, particularly given the present availability of highly-rated retakaful capacity in the market.

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12 More background on takaful and other Islamic insurance models can be found in the Swiss Re expertise publication “Islamic insurance revisited” (2011).
Emerging insurance markets are expected to continue to outperform industrialised markets in 2012 and 2013.

Insurance supervision is converging and moving toward the adoption of risk-sensitive regimes.

Both China and India are considering further market liberalisation measures.

Life insurance growth will rebound in 2012.

### Insurance developments in 2012 and 2013

Economic growth in emerging markets is expected to slow in 2012, in tandem with the weakening global economic outlook. However, they will continue to maintain faster GDP growth (2012: +5.6%) than industrialised countries (+1.3%). Slow but sustained economic growth will help to underpin insurance demand. Furthermore, consumer price inflation has recently peaked in some emerging markets and the prospect of slowing global economic activities points to receding inflation in 2012 and 2013. This will benefit non-life insurers in terms of lower claims inflation and strengthen life insurers’ core value proposition. However, with interest rates still low, insurers will have to contend with another year of weak investment returns.

Regulators in emerging regions will continue to improve their regulatory and supervisory regimes. This will include further convergence of supervisory standards and the adoption of more risk-sensitive solvency regimes. In many Emerging Asian and Latin American markets, insurance regulators have adopted risk-based capital (RBC) solvency regimes. In the EU member states of Central and Eastern Europe, the introduction of Solvency II is the main change on the agenda and is expected to result in another round of consolidation among the smaller insurance companies. Solvency II could also lead to a decrease in the pure savings business which will no longer be as attractive to insurers.

Despite the challenges, the strong growth potential of emerging markets beyond that of developed countries will continue to draw the attention of international insurers, leading to further globalisation of regional markets as well as increasing competition. In particular, China, India and Russia will be closely watched for possible further liberalisation. A bill to increase the share of foreign capital in insurance joint ventures to 49% (currently 26%) could be passed by the Indian parliament in 2012. At the same time, China is considering opening the country’s third party liability motor insurance market to foreign participation. Both of these expected changes will further increase the attractiveness of Emerging Asia to international insurers. In Russia, there are proposals to increase the 25% limit of foreign capital in the insurance industry, as this limit has been reached. This will be important in order to allow foreign-owned companies to increase their minimal capital as required from 2012 onward. Furthermore, increased minimal capital requirements will reduce the number of companies in the Russian market (currently still around 600).

*Life insurance to shift toward protection products in 2012 and 2013*

After a temporary set-back in 2011, life insurance premiums will resume their upward trend in 2012. This mainly reflects the expected recovery in Emerging Asian premium growth to around 10% in 2012 (2011: –2.1%). In China and India, life premiums will largely resume growth close to trend level. In Latin American and Central and Eastern Europe, premium growth will remain robust. Rising affordability, health and pension reforms as well as increasing awareness will contribute to sustained demand for life insurance. For example, the recent changes to the pension systems in Poland and Hungary, where contributions to the private pension pillars have been cut or nationalised, should help to raise awareness and demand for private life insurance products.

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13 The 25% limit applies to the whole insurance sector, not to individual companies. For EU-domiciled companies, full control of a Russian company is allowed, with no restrictions on business activities.
A main challenge, as well as an opportunity, for the industry is to help close the protection gap in different emerging markets. Although insurance has expanded significantly in emerging markets over the past decade, much of the growth has been driven by savings-type products. Meanwhile, individuals and households are far from adequately protected against major adverse events such as long-term serious illness or sudden death. The outlook for protection-type products has arguably improved for 2012, since historically sales of traditional life protection products surge when economic and financial risk increases. However, a sustained strategy to increase the penetration of protection-type products in emerging market is needed to ensure the healthy development of the sector.

Non-life insurance growth will be at its trend in 2012 and 2013.

Non-life insurance premiums are projected to increase by 7-9% per year in 2012 and 2013, close to the growth by 8.9% in 2011. Financial and fiscal turmoil in Europe is expected to affect non-life business growth, particularly those businesses related to trade and investment activities. The strong dominance of European corporations and financial institutions in Central and Eastern Europe also hints at significant downside risk—in terms of both economic and insurance business growth. Emerging Asia will be similarly affected. However, collectively the region is still expected to report double-digit growth in 2012, driven by further increases in car ownership and government spending on infrastructure. Rising risk awareness should also increase insurance demand from corporations seeking to protect their assets against natural catastrophes.

Most regions are expecting robust growth but there are also tangible down-side risks.

Insurance premium growth in Latin America also faces downside risk given the weakness of the US economy. Nevertheless, insurance premium growth is expected to remain solid (between 5% and 8%) in 2012, riding on strong demand for personal and specialty lines of insurance. Specialty lines such as surety and engineering should benefit from planned massive investments in infrastructure and energy. Agricultural insurance is also expected to grow rapidly in the mid-term due to further increase in overseas demand for the region’s agricultural output.

Protection-type products will likely see stronger demand in 2012.
# Emerging markets

## Table 15

### A glance back and a look ahead at insurance in emerging regions

<table>
<thead>
<tr>
<th>Emerging regions</th>
<th>Performance 2011</th>
<th>Outlook 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asia</strong></td>
<td><strong>Life</strong>&lt;br&gt; ■ Sales performance was weak in China and India due to regulatory tightening of product distribution and design. Other markets, especially Indonesia and the Philippines, had strong, stable growth.&lt;br&gt; ■ Consumer interest in protection products increased amid rising investment risks.&lt;br&gt; ■ Profitability is expected to have been dampened by low interest rates.</td>
<td><strong>Outlook 2012</strong>&lt;br&gt; ■ Growth in China and India will rebound in 2012.&lt;br&gt; ■ However, the prospect of slower economic growth and rising unemployment could limit the recovery of life premium growth in emerging Asia to below trend level.&lt;br&gt; ■ Rising economic and investment risks will continue to favour the growth of traditional protection-type products.&lt;br&gt; ■ Annuities and health products continue to grow robustly.</td>
</tr>
<tr>
<td><strong>Non-life</strong></td>
<td>■ Growth remained strong across most emerging Asian markets including China, India and Indonesia, in line with stable economic growth and sustained investment in infrastructure.&lt;br&gt; ■ Further increases in car ownership and increasing demand for health and personal accident products were key growth drivers.&lt;br&gt; ■ The series of natural catastrophes in Asia has had a limited impact on the results of emerging Asia insurers. Rising risk awareness is expected to have bolstered insurance demand.</td>
<td><strong>Premium growth will align with lower GDP forecasts across emerging Asian markets.</strong>&lt;br&gt; ■ Liberalisation of motor pricing will bring more enthusiastic competition to the Chinese motor market.&lt;br&gt; ■ Expected low interest rates will put pressure on profitability.&lt;br&gt; ■ Lower inflation could benefit insurers’ claims expenses.</td>
</tr>
<tr>
<td><strong>Latin America</strong></td>
<td><strong>Life</strong>&lt;br&gt; ■ Insurance growth remained robust in 2011 but is being negatively affected by the deteriorating global economic conditions.</td>
<td><strong>Overall, premium growth will slow slightly due to a more cautious regional economic outlook.</strong></td>
</tr>
<tr>
<td><strong>Non-life</strong></td>
<td>■ Growth of non-life premiums improved in 2011. In Mexico, one of the largest markets in the region, premiums recovered from a sizeable contraction in 2010 and grew at a double-digit pace in 2011.</td>
<td><strong>Growth will slow in 2012 due to weaker economic activities, though demand for speciality and personal lines will stay strong.</strong>&lt;br&gt; ■ Specialty lines such as surety and engineering should benefit from massive investments in infrastructure and energy.&lt;br&gt; ■ Personal lines should benefit from a growing middle class and strong economic performance.</td>
</tr>
<tr>
<td><strong>Eastern Europe</strong></td>
<td><strong>Life</strong>&lt;br&gt; ■ Premium growth slowed or even contracted in some markets as their economic recovery lost momentum towards the second half of 2011.&lt;br&gt; ■ Growth of premiums, however, remained strong in Poland and Russia. In Russia, growth of consumer credit probably supported related life insurance products.&lt;br&gt; ■ Life business continued to derive support from demand for short-term deposit-type and unit-linked investment products.</td>
<td><strong>The Euro debt crisis and slowing economic growth will limit life insurance premium growth in the near term.</strong>&lt;br&gt; ■ Recent changes to the pension systems in Poland and Hungary, where contributions to private pensions have been cut or nationalized, should help to raise awareness for private life insurance savings instruments and protection.&lt;br&gt; ■ Low interest rates will continue to depress investment income.</td>
</tr>
<tr>
<td><strong>Non-life</strong></td>
<td>■ Weakening economic growth and softening prices took a toll on non-life premium growth in most regional markets, with the exception of Poland and Russia. Both markets had stronger domestic demand for non-life business.&lt;br&gt; ■ Elsewhere, premiums remained weak or declined in the first half of 2011.&lt;br&gt; ■ Underwriting profitability in the main markets improved thanks to fewer natural catastrophe losses (floods and droughts) and improved motor and property insurance pricing in Poland.</td>
<td><strong>Slowing economic growth will be the biggest hurdle to non-life business growth in 2012.</strong>&lt;br&gt; ■ Premium growth in key markets, including Poland and Russia, will likely slow. Elsewhere, competition is expected to remain very strong.</td>
</tr>
<tr>
<td><strong>Middle East</strong></td>
<td><strong>Life</strong>&lt;br&gt; ■ Growth of life premiums improved in 2011, driven by accelerated growth in Turkey and the UAE, and a rebound in business in Saudi Arabia.</td>
<td><strong>Fairly stable economic growth is expected in 2012.</strong>&lt;br&gt; ■ The life sector will benefit from strong demand for takaful products.</td>
</tr>
<tr>
<td><strong>Non-life</strong></td>
<td>■ Overall business growth continued to improve in 2011, due to strong growth in Saudi Arabia and the UAE. However, premium growth in markets with political turmoil slowed or contracted.&lt;br&gt; ■ Gulf markets continued to invest in infrastructure, creating more non-life business opportunities.</td>
<td><strong>Despite rising global economic uncertainty, strong growth is expected to continue at a good-paced tempo, fuelled by large-scale government spending plans.</strong></td>
</tr>
</tbody>
</table>

Source: Swiss Re Economic Research & Consulting.