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Investment Market Volatility Could Trigger Further Downgrades For French Insurers In 2012-2013

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Investment Market Volatility Could Trigger Further Downgrades For French Insurers In 2012-2013

Standard & Poor's Ratings Services believes that uncertain economic conditions, constrained operating performance, increasing credit risk, low interest rates as well as equity market volatility continue to weigh on its ratings on French insurance companies. These factors largely explain our mainly negative rating actions over the past year (see tables 1 and 2). In particular, risk-adjusted capital adequacy, one of the sector's weaknesses relative to the average rating, further weakened during 2011 to reach a five-year low, according to our risk-based insurance capital model.

Overview

- Insurance sector risk remains limited in France, despite uncertainties about tax advantages for the life market.
- Retirement needs will continue to support long-term life premium collection, despite dampened growth prospects in the short term.
- Liquidity is strong for the French insurers we rate.
- Risk-adjusted capital adequacy continues to be a weakness for the ratings, as we see rising capital requirements for credit risks.
- We see dampened earnings prospects, particularly in the life business.

The average rating on French insurers we rate is in the 'A' range (see chart 1), which denotes "strong" financial strength, as our criteria define the term. This average rating includes uplift. Many of the French insurers we rate are subsidiaries of large international groups, and for that reason, notches of uplift are included in their ratings based on their "core" or "strategic" importance to, or guarantee from, their parent groups, according to Standard & Poor's criteria. Excluding this uplift, the average stand-alone credit profile of the French insurers we rate would be at the low end of the 'A' range.

A sizable number of our ratings continue to carry negative outlooks (56%) or are on CreditWatch with negative implications (12%), however (see chart 2). Risk-adjusted capital adequacy in our view remains a key driver for potential further negative rating actions. The French insurers we rate have significant exposure to equities (11%), but also rising credit risk following several downgrades, particularly Italy, Spain, Portugal, Ireland, Greece, and their related local financial institutions. Owing to rated French insurers' substantial exposure to these counterparties, in particular to Italian and Spanish government bonds--representing 5% and 3% of their mathematical reserves, according to our estimates--we believe that a further weakening of these economies could be a drag on the ratings.

Factors we generally consider as relative credit strengths for our ratings on French insurers are their strong competitive positions. This is underpinned by our view of limited sector risk and good long-term growth prospects in the pension business due to retirement needs, as well as strong liquidity positions, with sometimes a substantial increase of investments in cash during 2011.

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Factors we generally consider as credit weaknesses are risk-adjusted capital adequacy and dampened earnings prospects in life. Most of our negative outlooks reflect our belief that the insurers we rate may face obstacles to rebuilding capital adequacy to levels commensurate with their ratings in the coming 12-24 months as economic and financial conditions remain uncertain.

Chart 1

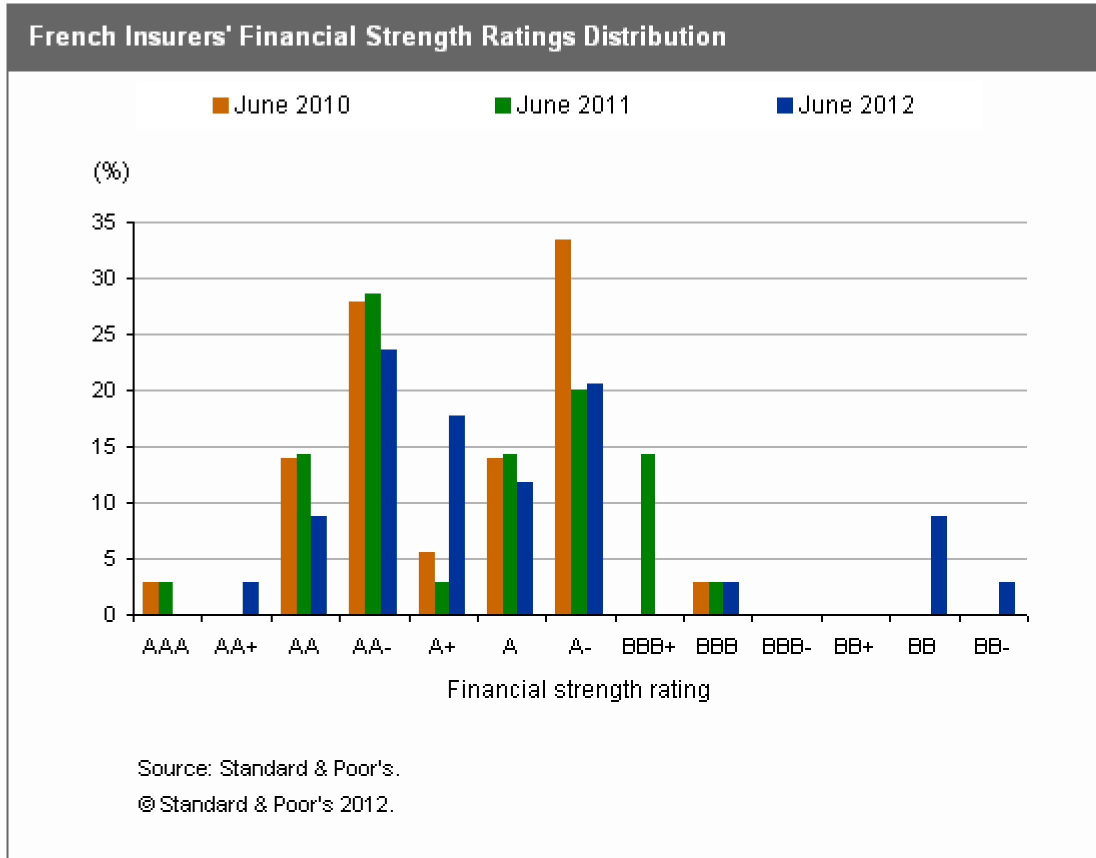


Chart 2

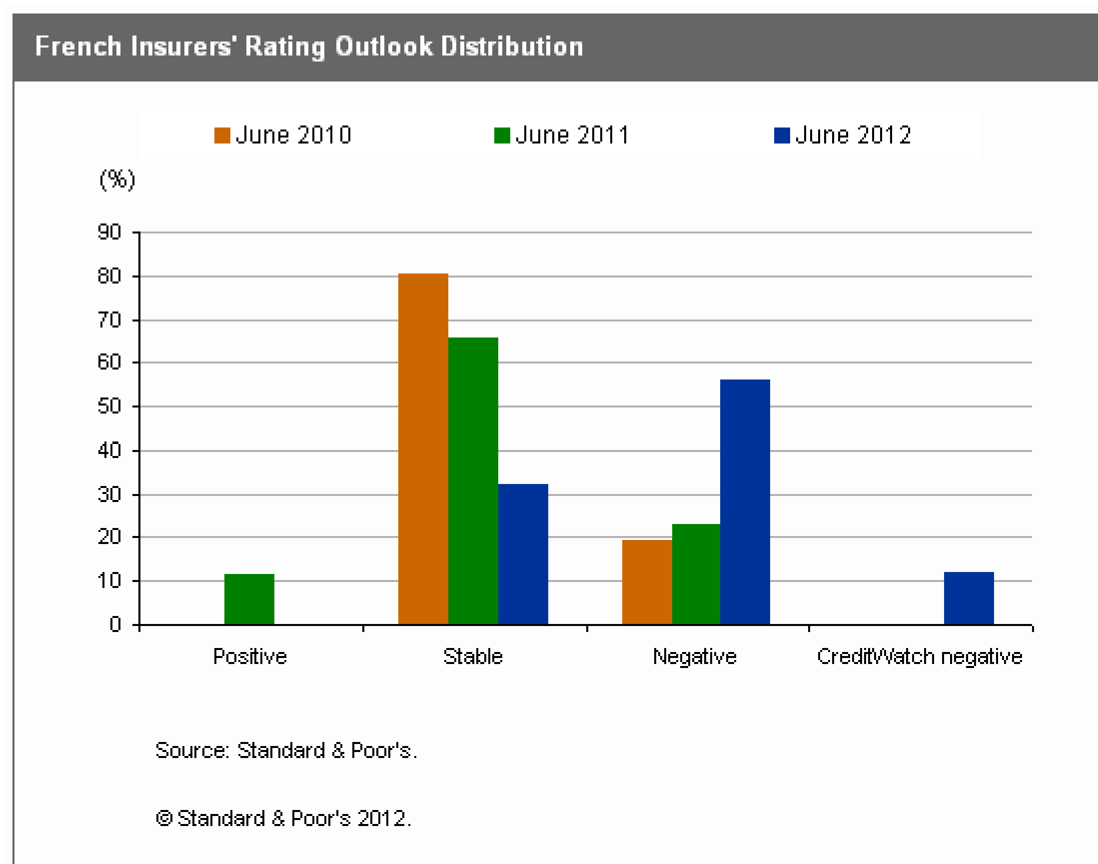


Table 1

French Insurance Market Interactive Rating Actions June 2011-June 2012

Group	To	From	Date	Rated entities (No.)
Groupama	BB/Negative	BBB-/Watch Neg	June 25, 2012	4
SCOR	A+/Stable	A/Positive	June 4, 2012	4
Aviva France	AA-/Watch Neg	AA-/Negative	May 17, 2012	2
Allianz France	AA/Negative	AA/Stable	Jan. 27, 2012	4
Aviva France	AA-/Negative	AA-/Stable	Jan. 27, 2012	2
AXA France	AA-/Negative	AA-/Watch Neg	Jan. 27, 2012	4
CNP Assurances	A+/Negative	AA-/Watch Neg	Jan. 27, 2012	2
Euler Hermes	AA-/Negative	AA-/Stable	Jan., 27 2012	1
Generali France	A/Stable	A+/Watch Neg	Jan. 27, 2012	2
BNP Paribas Cardif	AA-/Negative	AA-/Watch Neg	Jan. 23, 2012	3
Caisse Centrale de Reassurance	AA+/Negative	AAA/Watch Neg	Jan. 17, 2012	1
Generali France	A+/Watch Neg	AA-/Watch Neg	Jan. 17, 2012	2
Groupama	BBB-/Watch Neg	BBB/Watch Neg	Dec. 15, 2011	4
Caisse Centrale de Reassurance	AAA/Watch Neg	AAA/Stable	Dec. 9, 2011	1
AXA France	AA-/Watch Neg	AA-/Stable	Dec. 9, 2011	4
CNP Assurances	AA-/Watch Neg	AA-/Negative	Dec. 9, 2011	2

Table 1

French Insurance Market Interactive Rating Actions June 2011-June 2012 (cont.)				
Generali France	AA-/Watch Neg	AA-/Stable	Dec. 9, 2011	2
Groupama	BBB/Watch Neg	BBB/Negative	Dec. 9, 2011	4
BNP Paribas Cardif	AA-/Watch Neg	AA-/Stable	Dec. 7, 2011	3
AG2R	A-/Negative	A-/Stable	Nov. 25, 2011	2
BNP Paribas Cardif	AA-/Stable	AA/Negative	Oct. 14, 2011	3
Groupama	BBB/Negative	BBB+/Watch Neg	Sept. 23, 2011	4
Groupama	BBB+/Watch Neg	BBB+/Negative	Sept. 13, 2011	4
CNP Assurances	AA-/Negative	AA-/Stable	Sept. 13, 2011	2

Source: Standard & Poor's.

Table 2

Standard & Poor's Interactive Ratings On French Insurance Companies And Subsidiaries

Group	Insurer financial strength rating	Outlook	Entities rated (No.)	France-based rated entities
AG2R	A-	Negative	2	AG2R Prévoyance, PRIMA*
Allianz France	AA	Negative	4	Allianz Vie, Allianz IARD, Allianz Global Corporate & Specialty* (France), Allianz France (holding company; counterparty credit rating A+/Negative/A-1)
Chartis Europe	A	Stable	1	Chartis Europe S.A.
Aviva France	AA-	CreditWatch negative	2	Aviva Vie S.A.*, Aviva Assurances S.A.*
AXA France	AA-	Negative	4	AXA France Vie*, AXA France IARD*, AXA Corporate Solutions Assurance*, AXA (holding company; counterparty credit rating A/Negative/A-1)
April	A-	Stable	1	Axéria Prévoyance
BNP Paribas Cardif	AA-	Negative	3	Cardif Assurance Vie*, Cardif-Assurances Risques Divers*, BNP Paribas Cardif (holding company; counterparty credit rating: A+/Negative/--)
Caisse Centrale de Reassurance	AA+	Negative	1	Caisse Centrale de Reassurance
CNP	A+	Negative	2	CNP Assurances, CNP Caution†
Euler Hermes	AA-	Negative	1	Euler Hermes SFAC
Groupama	BB	Negative	4	Groupama S.A., GAN Eurocourtage IARD†, Groupama GAN Vie*, GAN Assurances IARD†
Generali France	A	Stable	2	Generali Vie*, Generali IARD*
La Mondiale	A-	Negative	1	La Mondiale
La Société Hospitalière d'Assurances Mutuelles	BBB	Stable	1	La Société Hospitalière d'Assurances Mutuelles
MMA	A-	Stable	1	MMA IARD Assurances Mutuelle
Prévoir	A-	Stable	3	Prévoir Vie, Prévoir Risques Divers, Société Centrale Prévoir (holding company; counterparty credit rating BBB/Stable/--)
SCOR	A+	Stable	4	SCOR Global Life SE, SCOR Global P&C SE, SCOR SE, Prévoyance Re†

*Core group operating entity. †Guarantee provided by the parent. Note: For our criteria on insurance groups and operating entities, see "Group Methodology," published on April 22, 2009, on Ratings Direct. Source: Standard & Poor's.

We Believe That French Life Insurers Will Have A Tougher Time Than Their Non-Life Counterparts

The French life market is focused on general savings, where insurers bear the investment risk, and for that reason, we believe they face tougher times than the country's non-life players. Because of today's low interest rates, options and guarantees related to savings products are increasingly costly. Life players also face competition from bank deposits, particularly because crediting rates are decreasing--leaving a large share of life insurance products with few visible advantages. In particular, any potential reduction of tax advantages for life products in France may further weaken their attractiveness against banking deposits. Nevertheless, we believe that some insurers have deliberately put the brakes on growth in general account savings, because it alleviates pressure on capital adequacy. We therefore expect that insurers will reduce competition on rates credited to policyholders, to safeguard margins and monitor capital requirements.

For property/casualty (P/C) insurers, we still see good prospects for underwriting profitability for the remainder of 2012 and in 2013, excluding major exceptional events. This is despite our view that P/C earnings will likely slightly deteriorate in 2013 with a net combined ratio for the industry of 100%, after 99% in 2012, excluding major natural catastrophes. The year 2011 saw a recovery in the net combined ratio to about 99% for the industry, mostly because there were on average a lower number of natural catastrophes and, to a lesser extent, increasing pricing discipline and higher risk selection (see table 3). Low interest rates and consequently low investment income will contribute to market discipline. We believe, however, that competition will likely remain high, in particular because mutuals and bancassurers remain highly growth-focused. Based on our forecasts, we nevertheless see no pressure on ratings coming from underwriting profitability excluding major natural catastrophes.

Table 3

French Insurers' Selected Competitive Position Indicators*

(Bil. €)	2011e	2010	2009	2008	2007	2006
Life						
Gross premium written (GPW)	114,916	127,627	128,762†	109,315	119,754	121,103
Total life provisions	930,397	881,091	870,428†	772,827	722,579	671,255
Unit-linked reserves (% of life and savings reserves)	15.2	17.4	16.9	16.2	22.6	22.9
Outflows on average reserves (% including lapses, death, and contractual maturities)	8.4	8	8.5	8.0	7.2	7.0
Credited amounts on average reserves (% guaranteed contracts)	3.1	3.5	3.8	4.2	4.5	4.6
Net inflows (% reserves)	0.6	4.2	4.3	2.5	4.8	6.4
Non-life						
Gross premium written (GPW)	44,382	42,793	41,574†	44,060	41,763	40,524
Net premiums written (NPW)	40,768	39,694	38,539†	39,808	37,587	36,420
Total claims reserves	67,284	63,967	64,351	61,990	60,883	56,012
Non-life reinsurance utilization ratio (%)	8.1	7.2	7.3	9.7	10.0	10.1

*Data based on the 20 largest life and non-life French insurers, excluding reinsurers. e--Standard & Poor's estimates based on 2010 available accounts. †2009 data reflects accounts restatement of one large player; on a like to like basis non-life premiums would have slightly increased. Source: Standard & Poor's.

Life Insurance: Low Interest Rates And Rising Investment Risks Are Likely To Reshape Products

The Role Of France's Life Insurance Industry

The French life insurance industry has an important role in the economy. It also plays a big role in savings, and its savings products are often compared to other forms of savings, such as bank deposits, the tax-advantaged Livret A, term deposits, and mutual funds.

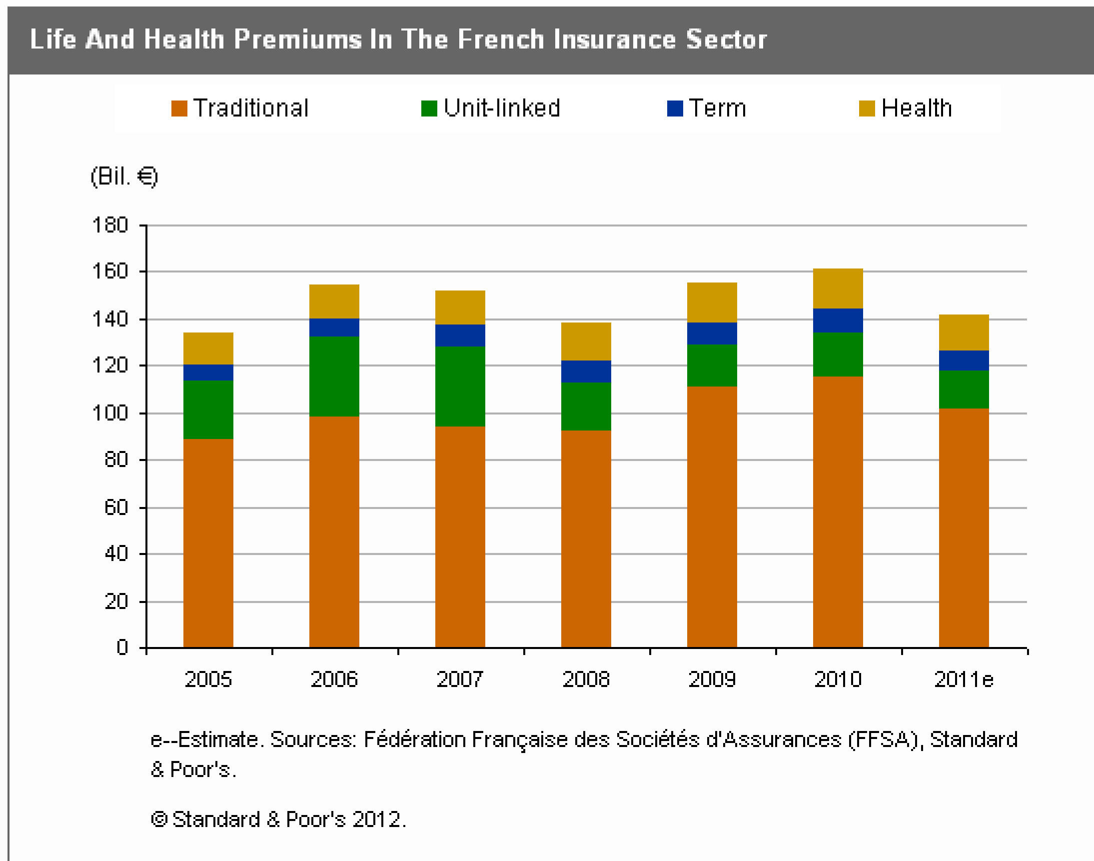
The French insurance market has, since the 1980s, been increasingly dominated by general account savings with the sheer growth of its bancassurance sector leading on many occasions to double-digit growth, often reflecting the collection of maturing banking deposits, eventually reinvested under a life insurance "label" and tax regime by the banking group. Traditional players followed, which has further favored comparison and competitiveness with banking deposits, and so has the simplification of life products, with a particular focus on the level of credited rates and tax advantages. Life insurance in France, unlike many other European markets, plays the role of pension vehicle, in the absence of flexible pension schemes.

The most important advantages of life policies were to provide long-term investment returns, coupled with a guarantee on capital (with therefore limited downside risk for the policyholders from troubled capital markets), while benefiting from tax advantages.

Traditional life insurance policies continue to largely dominate market premium collection. However, their long-term growth prospects are increasingly coming into question because of the low investment returns on the assets backing life insurance reserves, the highly capital-intensive nature of traditional policies as well as the increasing competitiveness of bank deposits. Most players are thinking about offering both savings and protection policies, or growing their protection business. In addition, they are encouraging sales in their unit-linked businesses, but its contribution to the overall business hasn't changed significantly since 2008 because of adverse capital market conditions.

We expect a decrease in premium collections for full-year 2012 for the French life insurance industry. This would follow a 14% drop in 2011 compared to 2010, and a continuous downward trend in 2012, after a 13% drop in the first five months (see chart 3). Net inflows could be negative for the full year (-€3.6 billion net inflows for the first five months) particularly because outflows (lapses and maturities) are likely to experience further growth (+18% over the first five months). Of the companies we rate, we believe that dampened growth prospects will hurt those insurers more whose business mix is heavily concentrated on traditional policies. We see continuing competition from short-term deposits--especially if the current cap on the Livret A were to be increased. In addition, the narrowed gap between long-term and short-term interest rates is encouraging customers to invest in short-term deposits.

Chart 3



However, France's savings rate continues to be high, at 17% in the first quarter of 2012, which will support premiums in the absence of real alternatives to insurance policies for retirement and long-term savings needs. Policyholders between 40 and 60 years old, who represent in our view the largest clientele for insurance, quote retirement needs as their main reason for buying a life insurance policy (Institut national de la statistique et des études économiques or INSEE, 2010).

Lapse risk continues to be an important risk to the traditional life insurance business. We estimate that lapses averaged 6% of mathematical reserves in 2011 versus about 5% in 2010. With the first five months of 2012 registering negative net inflows, a sharp increase in interest rates could push up lapses and represent a major threat for life insurance, although these are not our current expectations. Instead, we see a moderate increase of lapses to 7% as much more likely, resulting mostly from higher policyholder consumption needs. This level in our view is manageable for the French market and in and of itself is unlikely to trigger rating actions. However, we continue to see increasing natural maturities as policies come to expiration, owing to aging policies and lower new business volumes. At end-2011, just under 50% of policies were eight years old or more and therefore can be surrendered with no tax penalty.

Uncertainties about tax advantages could further weaken growth prospects

Given France's ongoing commitment to budget deficit reduction, we believe there is a possibility that the French government may try to reduce life insurance's fiscal advantages further, although we believe any changes will likely be

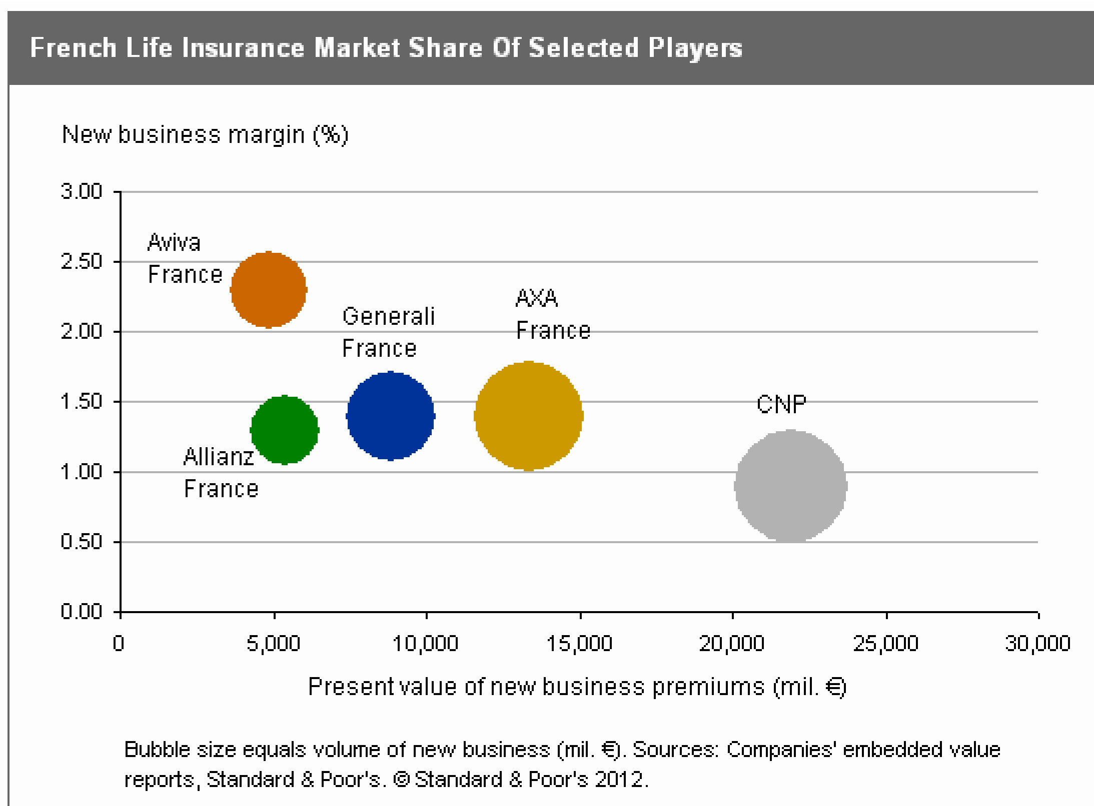
gradual. Past tax changes so far have proven manageable for French life insurers.

Life insurance assets represent €1.5 trillion of invested assets and French insurers hold 20% of traded French government bonds with maturities longer than one year (France's Cour des comptes). This means that the industry would wield much bargaining power over radical tax reform in our view. It is also uncertain whether potential changes would apply to all life insurance policies irrespective of the duration of the contract, given that retirement needs will only grow at a time of scarce government resources. However, we believe that tax changes would particularly affect life insurers targeting a wealthy clientele, who have historically been more sensitive to these changes and have a greater ability to invest in other product types.

Profitability is set to weaken further

We think new business margins for rated life insurance companies this year are likely to decline slightly to an average 1.2% on a present value of new business premiums basis, from about 1.3% in 2011 (see chart 4). Similarly, we estimate average operating return on embedded value at about 5% in 2012, which is at the low end of its historical range of between 5% and 7%.

Chart 4



Management actions are likely to differentiate players in the market, especially in the area of crediting policies, in our view. For 2012, we expect players to become even more cautious about rates guaranteed and credited to policyholders, particularly since the 10-year French government bond is hitting historical lows. We estimate that players reduced credited rates 20 to 30 basis points (bps) in 2011 and reached about 3.1% during that year, after a 30

bps drop in 2010. In addition, we think that life insurers have reduced flexibility to support credited rates, as we estimate that the policyholder reserve to absorb losses (provision pour participation aux excédents or PPE) decreased further for rated companies by about 10% in 2011.

The rising credit risk of southern European countries may continue to weigh on French insurers' ratings

We stated last year that impairments to French insurers' exposure to Greece represented an impact on policyholder credited rates of about 50 bps. The exposure to Greece is lower than to Italy or Spain. We estimate that the rated French life insurers' exposure to Italian and Spanish government bonds represent on average about 5% and 3%, respectively, of mathematical reserves, though the average masks wide differences. We therefore believe that the ability of French insurers to pass potential losses onto policyholders is more limited, given that average credited rates were 3.1% in 2011.

P/C Insurance: Prospects Are Improving For Underwriting Earnings, But Competition Is Likely To Limit The Upside

We expect P/C volumes, that is, excluding price increases, to continue to broadly follow the pace of French GDP growth, which Standard & Poor's economists put at 0.5% in 2012 and 1% in 2013. We believe the market will continue to benefit from the predominance of mandatory retail cover, and we don't expect significant changes in its business profile over the next two years.

Table 4

Republic of France Selected Economic Indicators

	2011	2010	2009	2008	2007	2006
Real GDP (€ at constant prices)	1,800.4	1,770.4	1,743.0	1,797.8	1,801.2	1,761.5
Real GDP (% change)	1.7	1.6	(3.0)	(0.2)	2.3	2.6
TEC 10 (average annual % yield)	3.3	3.1	3.6	4.2	4.2	3.7
TEC 10 (annual % change)	(5.3)	(0.5)	(0.6)	0.0	0.5	0.4
CAC 40 (points at year end)	3,160	3,805	3,936	3,218	5,614	5,542
CAC 40 (annual % change)	(17.0)	(3.33)	22.0	(42.7)	1.3	17.5
Three-month EURIBOR (at year-end)	1.4	1.0	0.7	2.9	4.7	3.7

*Standard & Poor's estimate. TEC 10 Index--Benchmark for the French 10-year government bond. Sources: Agence France Trésor, euribor.org, S&P Capital IQ, Eurostat.

The maturity of the P/C market in France suggests that tariff increases remain the predominant source of growth. It also reflects the willingness of insurers to pass claims inflation on to customers, in particular because of soaring bodily injury costs in motor, by about 70% since 2004, as well as the impact of natural catastrophes. Price increases ranged between 2% and 3% in motor and 3% and 5% in property, based on reported market figures for 2011, which should translate into premium growth (including the impact of volumes and rate increases) of about 3% in 2012 (see chart 5). This level shows that insurers are willing to favor pricing discipline, although uncertain economic conditions mean that additional tariff increases could be more difficult to pass on to policyholders.

We expect premium volumes to continue increasing in 2013, but at lower rate of about 2.5%. Sound claims

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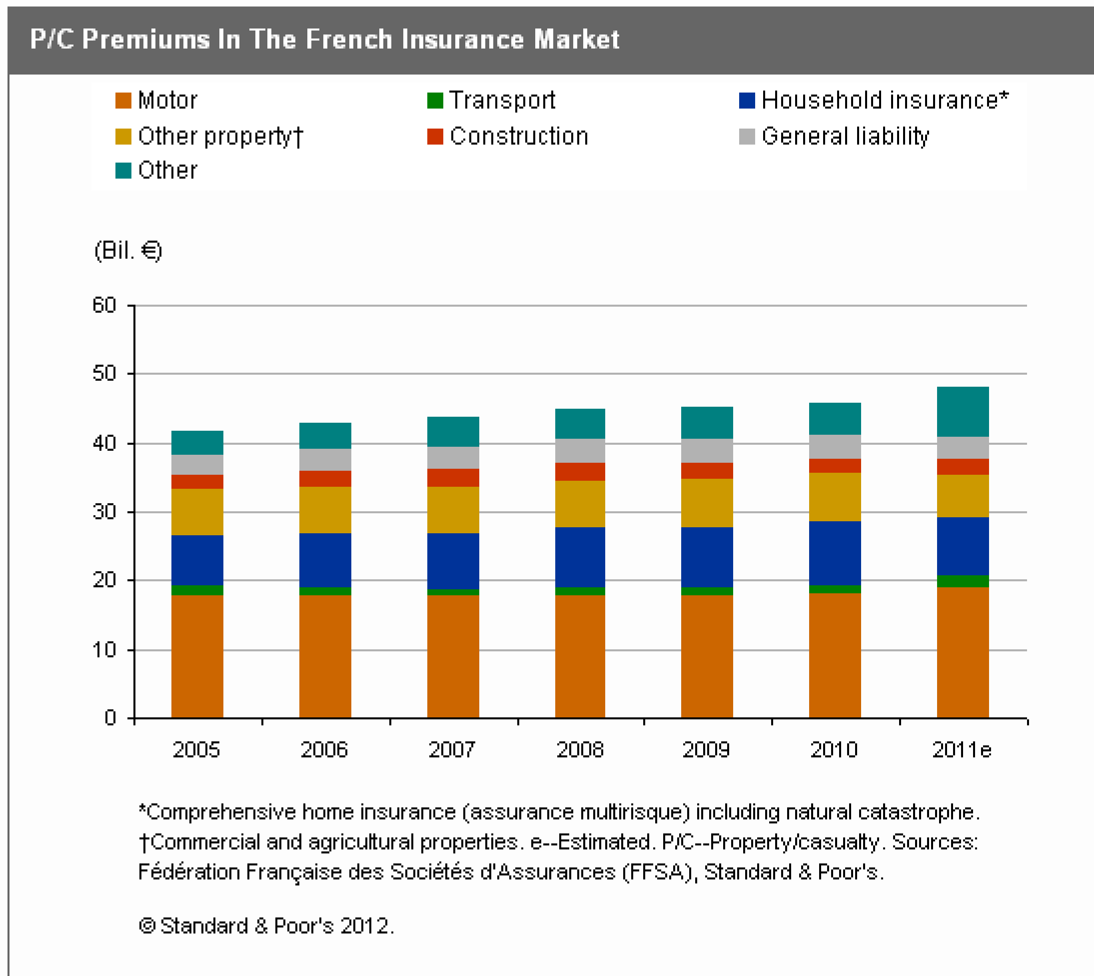
management practices and cost effectiveness will remain key factors for long-term success in the P/C business, in our view. We believe that traditional players have been more stringent about price increases than mutuals or bancassurers, which is keeping down the average across the market and maintaining high competitive dynamics across players.

Chart 5



Underwriting results are likely to stand at good levels over the next two years in the absence of major natural catastrophes

We believe that the French P/C industry's combined ratio in 2011 is at its strongest point in the cycle. We estimate that last year, the net combined ratio was 99% on average for the industry, down from 103% in 2010. The main reasons for the improvement, in our view, were the absence of natural catastrophes and, to a lesser extent, lower claims frequency in motor as well as repricing and portfolio pruning by insurers last year.

As we see it, insurers were of the belief that they had to improve underwriting results last year given tough conditions: Investment gains weakened, given historically low interest rates, dampened equity markets, and increasing credit risk. We expect insurers to keep the same philosophy in 2012 and 2013, given the volatile capital markets and underpricing in a few business lines, in particular property. However, we are skeptical that the industry can durably break away

from cyclical underwriting swings.

Based on our forecasts, we don't expect that P/C underwriting results will weigh on ratings over the next two years. Excluding the occurrence of major natural catastrophes, we expect the net combined ratio will remain broadly stable in 2012 at about 99% and rise slightly to about 100% in 2013. We believe that most insurers will strengthen their reserves, on the back of good underwriting results in 2011 and 2012, which we believe were previously relaxed to offset higher losses in the 2009 and 2010 underwriting years (see table 5). According to our estimates, reported net claims reserves to net premiums written increased by 5 points to 165% in 2011. Inflation risks, in particular those attached to the cost of bodily injuries, will likely encourage P/C insurers to strengthen their reserves.

Table 5

French P/C Insurers Operating Performance*

	2011e	2010	2009	2008	2007	2006
Return on equity (%)	3.1	8.7	8.3	10.8	14.7	15.9
Gross loss ratio (%)	71	77	78	71	74	72
Net loss ratio (%)	73	79	79	75	77	76
Gross combined ratio (%)	95	101	102	94	96	95
Net combined ratio (%)	99	104	104	99	101	100
Net claims reserves to net premiums written (%)	165	161	167†	156	162	154

*Data based on the 20 largest life and non-life French insurers, respectively, excluding reinsurers. e--Estimates based on 2010 available accounts. †Reserve ratio increase in 2009 reflects accounts restatement of one large player; on a like to like basis reserve ratios would have decreased. Source: Standard & Poor's.

Based on our observations over the past five years, natural catastrophes in a given year can increase the net combined ratio by about 3 points on average, although it could be higher for larger natural catastrophes--like the 1999 Lothar and Martin windstorms. In our view, this explains why most P/C French insurers focus their reinsurance protection against this risk. We have also observed that a few insurers have actually reinforced their aggregate cover to better face the risk of several events occurring in a given year, which happened when several natural catastrophes occurred in 2009 and 2010.

Because Solvency II offers capital relief for insurers that opt for reinsurance, we believe that they may increase its use slightly. However, we don't expect significant recourse to reinsurance and, therefore, capital relief for French insurers. Instead, because the asset risk remains the largest contributor to insurers' capital requirements, most of them have chosen to gradually reduce market or credit risk to alleviate capital pressure.

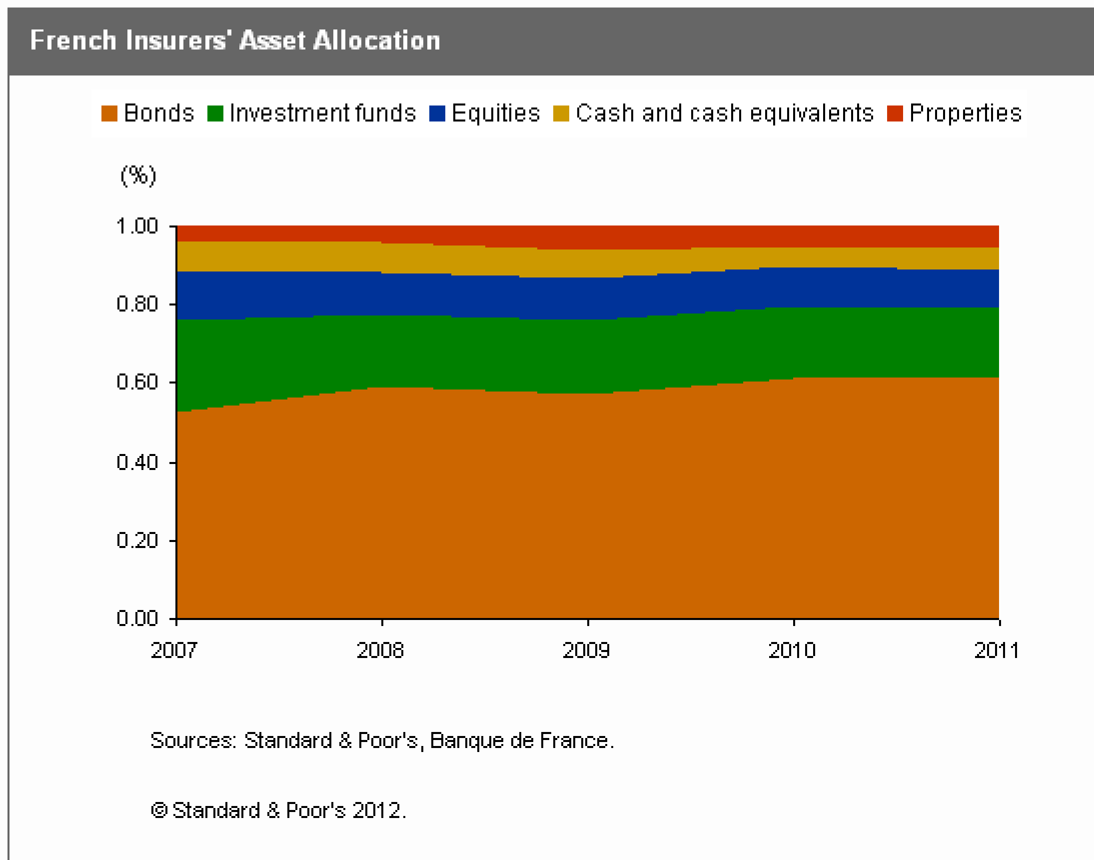
Investment risk remains a key rating driver

We believe that investment risks remain a key rating driver for rated French insurers. In particular, we note that credit risk stemming from exposures to southern European bonds increased when French insurers' capital bases had already been weakened. Market risk also remains higher than for European peers, reflecting French insurers' comparatively greater exposure to equities.

Although showing an average 'A' rating, we believe that the credit quality of the fixed-income portfolios of rated French insurers has deteriorated on the back of downgrades of several sovereign and bank ratings. The contribution of credit risk to total capital requirements according to Standard & Poor's capital model is the third-largest component

after market and life insurance risk. The rating downgrade of France and southern European countries increased credit risk capital charges according to our model. To mitigate deteriorating credit quality, we have observed that several insurers have started to divest holdings of southern European government bonds, increase their investments in highly rated corporates, and boost their cash position (see chart 7).

Chart 7



Market risk for French insurers--which includes concentration risk as well--remains high relative to European peers and is the largest capital requirement according to Standard & Poor's risk-based model. Exposure to equities stands on average at 11% of total invested assets, but varies markedly from one player to another. French insurers have also increased their exposure to investments in properties in recent years to between 5% and 6%.

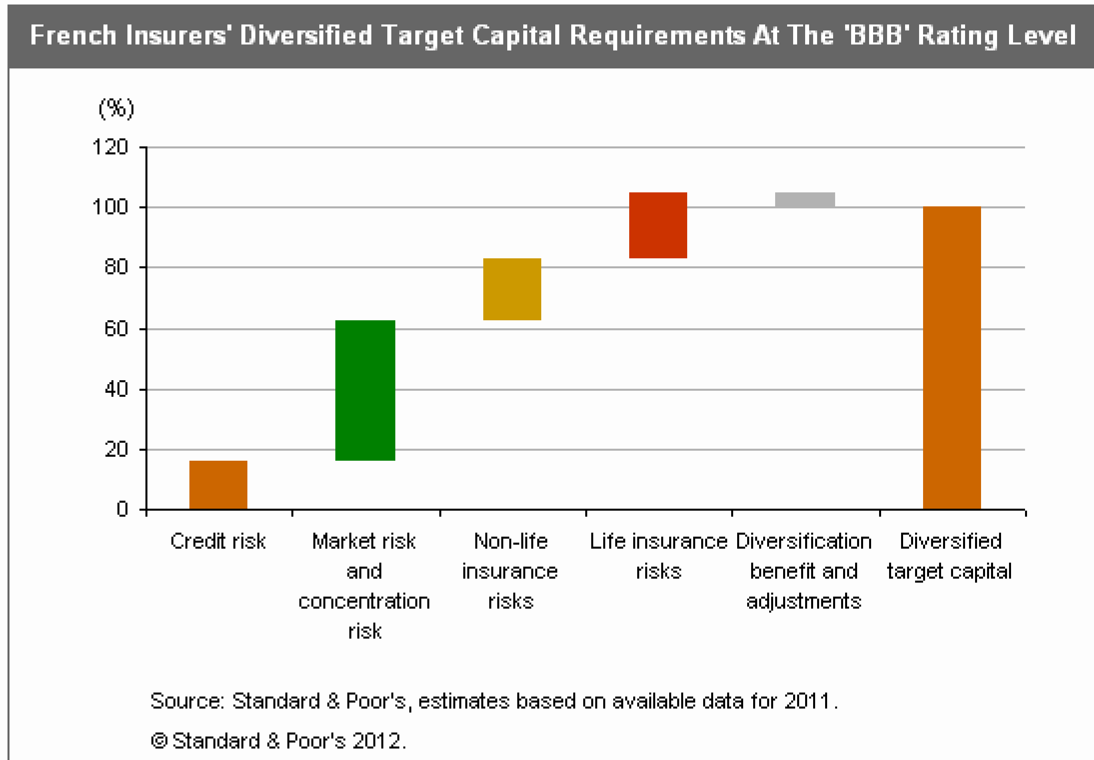
Risk-adjusted capital adequacy is at the lowest point in the last five years

Risk-adjusted capital adequacy stood in the 'BBB' range at the end of 2011, according to our estimates derived from our risk-based capital model. That's the reason we consider capital adequacy as one of the key drivers for potential negative rating actions in the coming two years.

Total adjusted capital (TAC) decreased in 2011, according to our estimates, because of lower unrealized gains and present value of future profits. Retained earnings were not enough to offset these negative trends. At the same time, the mix of capital requirements under Standard & Poor's capital model was broadly stable, with market, concentration,

and credit risk representing the majority of capital requirements (see chart 8). A decline of capital requirements related to equity risk, due to falling stock values, was partly offset by increases in both credit and to a lesser extent concentration risks.

Chart 8



We believe that the Solvency II framework represents an additional constraint for most French insurers in already tough times. The new regulatory framework will likely lead to changes in business mix, since risk-return considerations will become a key area of attention for capital management. Similarly, investment strategies will increasingly incorporate capital management considerations in the choice of assets.

With the exception of the largest players, which benefit from more advanced risk management practices, the new framework represents big change for the French insurance industry, which has so far managed business mix and investments only with traditional metrics, such as percentage limits for each asset type in total investments. Furthermore, we are of the view that most French players have yet to take sufficient notice of Solvency II's supervisory review (Pillar 2) and disclosure requirements (Pillar 3) in their planning.

Related Criteria And Research

- Interactive Ratings Methodology, April 22, 2009
- Group Methodology, April 22, 2009
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

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