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Pursuing Global Insurance Profitability Amid Tempered Economic Growth

Primary Credit Analysts:
Patricia A Kwan, New York (1) 212-438-6256; patricia.kwan@standardandpoors.com
Jose M Perez-Gorozpe, Mexico City (52) 55-5081-4442; jose.perez-gorozpe@standardandpoors.com
Mark Button, London (44) 20-7176-7045; mark.button@standardandpoors.com

Secondary Contacts:
Kevin T Ahern, New York (1) 212-438-7160; kevin.ahern@standardandpoors.com
Matthew T Carroll, CFA, New York (1) 212-438-3112; matthew.carroll@standardandpoors.com
Joseph N Marinucci, New York (1) 212-438-2012; joseph.marinucci@standardandpoors.com
Taoufik Gharib, New York (1) 212-438-7253; taoufik.gharib@standardandpoors.com
Amalia Bulacios, Buenos Aires (54) 11-4891-2156; amalia.bulacios@standardandpoors.com
Philip P Chung, CFA, Singapore (65) 6239-6343; philip.chung@standardandpoors.com
Connie Wong, Singapore (65) 6239-6353; connie.wong@standardandpoors.com
Ayako Nakajima, Tokyo (81) 3-4550-8750; ayako.nakajima@standardandpoors.com
Simon Ashworth, London (44) 20-7176-7243; simon.ashworth@standardandpoors.com
Carmi Margalit, CFA, New York (1) 212-438-2281; carmi.margalit@standardandpoors.com
Dennis P Sugrue, London (44) 20-7176-7056; dennis.sugrue@standardandpoors.com

Research Contributor:
Vinay Jonnakuti, CRISIL Global Analytical Center, an S&P affiliate, Mumbai

Research Assistant:
Michael L Forbes, London

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Pursuing Global Insurance Profitability Amid Tempered Economic Growth

When it comes to finding earnings growth in 2015, the challenge facing the global insurance industry will be uneven economic conditions in many parts of the world. The foremost obstacle insurers will confront is the widely varying prospects for economic growth from region to region. Making profitability even more difficult are extraordinarily low interest rates (negative, in some cases), which will likely stay lower for longer, particularly in the eurozone. In addition, insurers in many regions must cope with tighter capital standards, weak pricing due to excess capital, or stricter regulatory controls on product design and distribution in some markets. Standard & Poor's Ratings Services expects sectors exposed to these elements--especially Western Europe life insurance and global property/casualty (P/C) reinsurance--to see negative rating actions outnumbering positive ones (see Global Insurance Credit Outlook 2015: Policymakers Prolong Pain For Developed Markets' Insurers , published Dec. 10, 2014, on RatingsDirect).

However, we believe that, all things are considered, our rated insurers will show steady earnings growth overall despite the difficult economies in which many are operating. And when it comes to rates of earnings growth, insurers in developing markets will likely fare better this year and next than those in developed markets.

Overview

- Global insurers face several obstacles to earnings growth, including slack economies and extraordinarily low interest rates.
- Many insurers will have to contend with tighter capital standards, weak pricing, or stricter regulations on product design and distribution.
- Earnings growth overall should rise, but developing market insurers (13% to 20% growth) are likely to outrun those in more mature markets (about 5%).
- The relationship between earnings and ratings isn't simple: Rising earnings growth alone doesn't necessarily lead to higher ratings, but weak earnings generally weigh on ratings.

Generally supporting many of our rated insurers globally is their prospective capital redundancy, which we view as predominantly strong--redundant at the 'A' level--largely buffered by stable earnings, investment assets with high credit quality, and strong liquidity.

On aggregate, we see global insurance earnings trending modestly higher, clipping at around 6%-7% year-over-year through 2016. On a regional basis, we expect relatively robust earnings momentum from Asia-Pacific (APAC, 13% year-over-year), Latin America (LatAm, 18%), and CEEMEA (20%), while North America and Western Europe are likely to show moderate to soft earnings trajectories (both at about 5%). These regional variations reflect our view of the fast- and-slow growth opportunities that differentiate the developing and developed markets.

Table 1

Global and Regional Data

	Global*	APAC	Latin America	CEEMEA	Western Europe	North America
Median indicative SACP	a-	a-	bbb	bbb	a-	a-
Median SACP	a-	a-	bbb	bbb	a-	a-
Median FSR	A-	A-	BBB	BBB	A-	A
Median TAC size (2016 estimates, mil. $)	1,089	643	272	173	3,057	1,719
Capital redundancy level (2016, weighted)	A	BBB	BBB	A	A	AAA
TAC growth CAGR (2014-2016, %)	5	8	8	6	4	4
Earnings growth CAGR (2014-2016, %)	7	13	18	20	5	5

*Includes core and highly strategic entities.
TAC—Total Adjusted Capital.

Table 2

Sector Data

Global*	All	Health	Life	Multiline	P/C	Reinsurance
Median indicative SACP	a-	bbb+	a-	a-	a-	a-
Median SACP	a-	bbb+	a-	a-	a-	a-
Median FSR	A-	BBB+	A	A-	A-	A-
Median TAC size (2016 estimates, mil. $)	1,089	840	2,877	1,979	410	2,009
Capital redundancy level (2016, weighted)	A	AAA	BBB	AA	AA	AAA
Earnings growth CAGR (2014-2016, %)	7	11	7	6	6	(10)¶

*Includes core and highly strategic entities.
¶2013–2015

Before we get further into the breakdowns by region and sector, it's important to note that strong earnings growth by itself is not necessarily a precursor to higher ratings because we also consider other factors under our criteria. However, on the flip side, weak earnings or operating performance generally indicate rating pressure (as has been the case for the global P/C reinsurance sector, which has a negative outlook) or are associated with speculative-grade ratings ('BB+' and below). We'll return to these points below in the section "A One-Way Relationship On The Downside."

Following our criteria revisions published in May 2013, we explored the market forces shaping insurers' profiles that enable us to compare their unique characteristics and rating factors across regions (see "Around the World of Insurance: A Global Review of Ratings,"Dec. 18, 2013). We've now expanded that analysis to include our baseline view of capital and earnings along with underwriting performance and premium growth estimates from our analysts around the world who cover life, P/C, multiline, health, and reinsurance companies.

A Quick Roundup of Global Ratings: 2014 Versus 2013

During 2014, we affirmed 83% of our global insurance ratings on individual entities, raised 11%, and lowered 6%, reflecting our opinion that the worldwide insurance markets would largely remain stable.

Table 3

Rating Activity 2013-2014						
	--Upgrades--		--Downgrades--		--Affirmations--	
(%)	2013	2014	2013	2014	2013	2014
Global	14	11	5	6	81	83
APAC	21	12	5	6	74	81
Latin America	64	0	7	44	29	56
CEEMEA	13	5	6	12	81	83
Western Europe	9	9	6	6	85	85
North America	13	13	4	3	83	84

Similar to 2013, some 50% of our global indicative stand-alone credit profiles (SACPs) and 54% of our financial strength ratings (FSRs) were concentrated in the 'a/A' (SACP/FSR) range as of year-end 2014. The difference between an indicative SACP and FSR is that the former measures credit fundamentals prior to extraordinary group or government support and sovereign consideration, while the latter reflects the possibility of these considerations. Included in the rating distribution are core and highly strategically important companies to which we have assigned indicative SACPs. We are including these companies (which were excluded in the previous year's review) because of their growing influence in their respective local markets.

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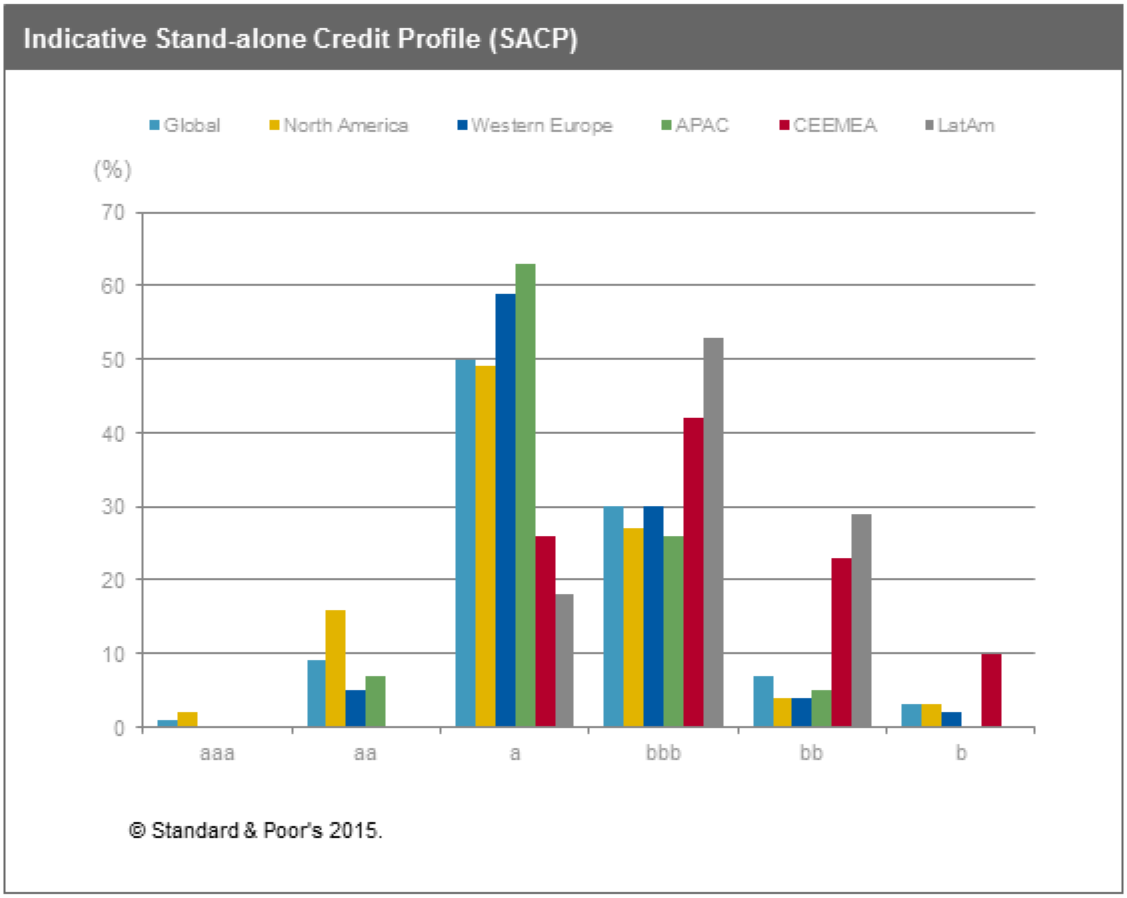
Chart 1



1391435 | 301967406

Chart 2

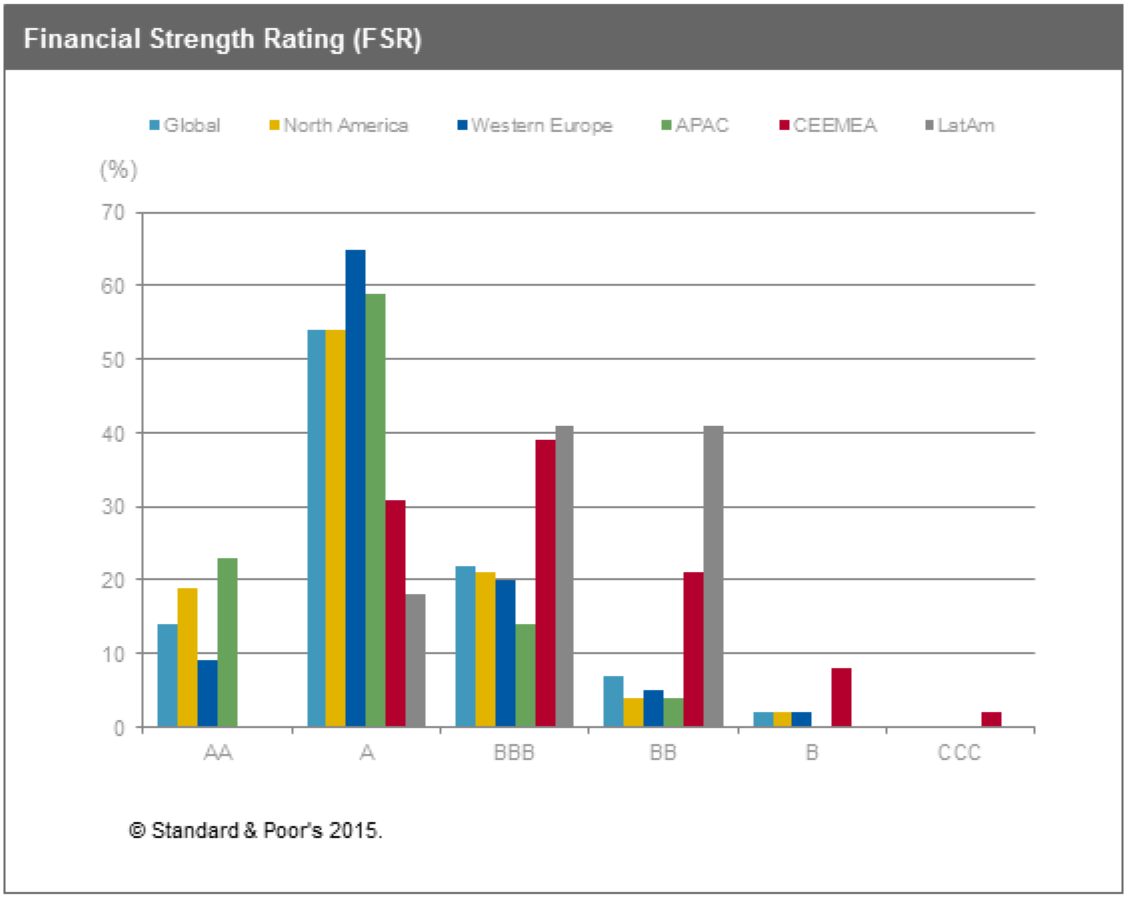

Financial Strength Rating (FSR)
Global
North America
Western Europe
APAC
CEEMEA
LatAm
(%)
70
60
50
40
30
20
10
0
AA
A
BBB
BB
B
CCC
© Standard & Poor's 2015.

Chart 3

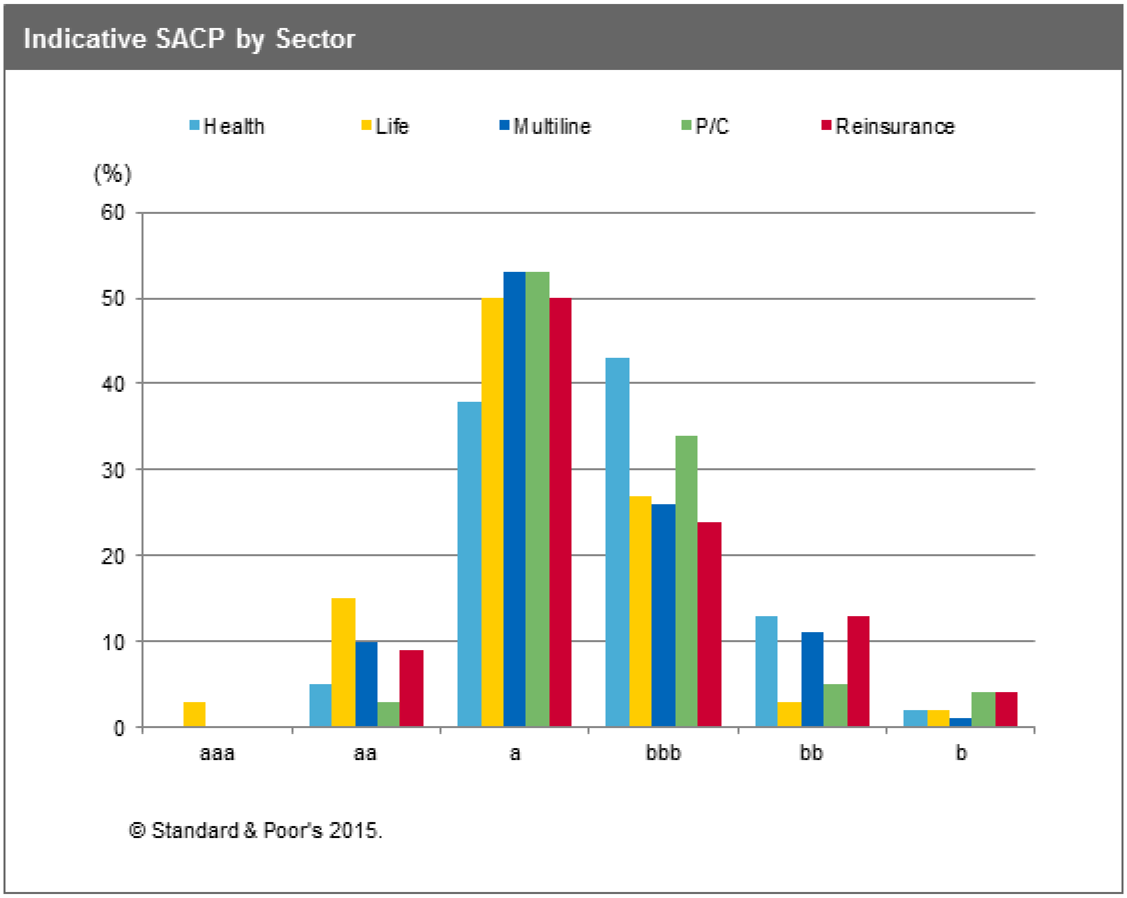
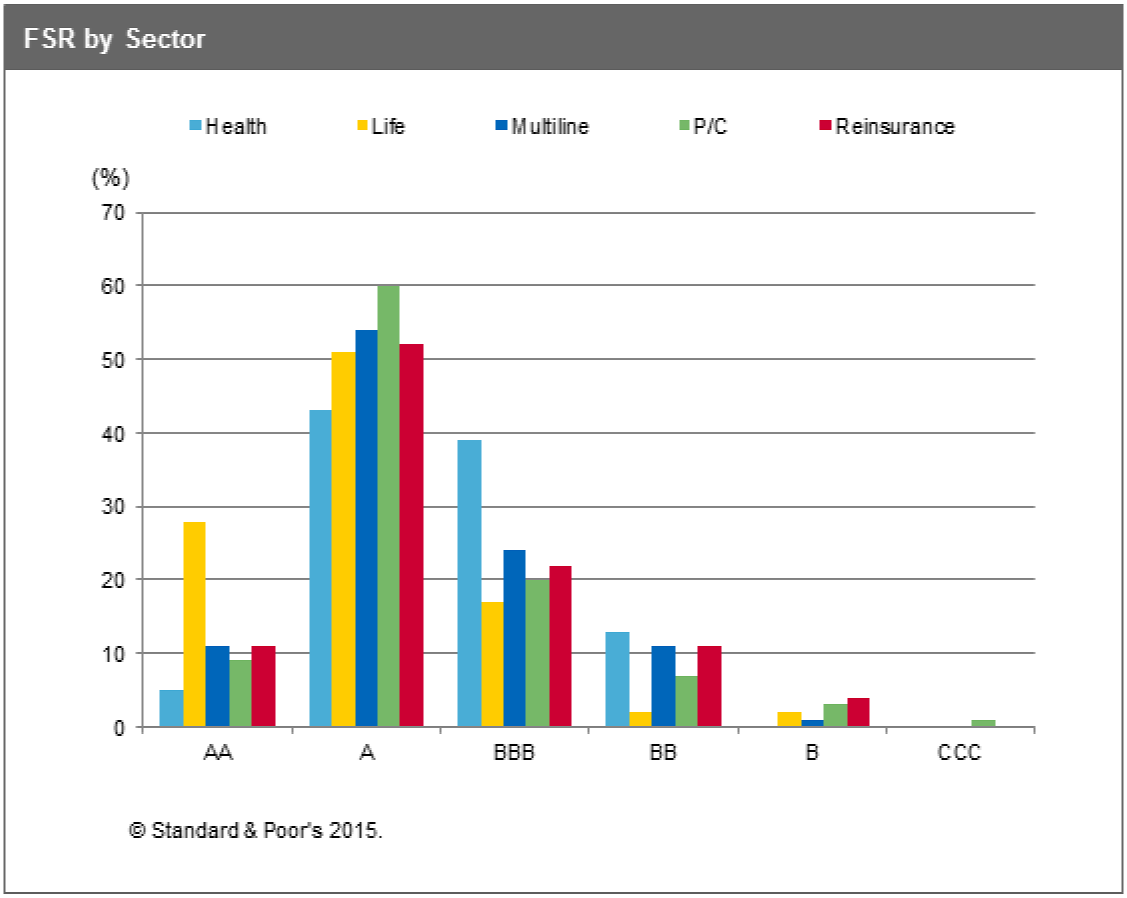

Indicative SACP by Sector
Health
Life
Multiline
P/C
Reinsurance
(%)
60
50
40
30
20
10
0
aaa
aa
a
bbb
bb
b
© Standard & Poor's 2015.

Chart 4



Key factors that dominate our ratings on insurers globally include strong business risk profiles, very strong to moderately strong capital and earnings, adequate financial flexibility, adequate enterprise risk management (ERM), and exceptional liquidity.

Table 4

Rating Drivers Heat Map

	Global*	APAC	Latin America	CEEMEA	Western Europe	North America
IICRA	Intermediate Risk	Intermediate Risk	Intermediate Risk	Intermediate Risk	Intermediate Risk	Low Risk
Competitive Position	Strong	Strong	Adequate	Adequate	Strong	Strong
Business Risk Profile	Strong	Strong	Fair	Satisfactory	Strong	Strong
Capital Adequacy	Very Strong	Strong	Strong	Strong	Very Strong	Extremely Strong
Median TAC (bil. $, 2016 estimates)	1,089	643	272	173	3,057	1,719
Capital & Earnings	Moderately Strong to Very Strong	Moderately Strong	Moderately Strong	Moderately Strong	Strong	Extremely Strong / Very Strong
Risk Position	Intermediate Risk	Intermediate Risk	Moderate Risk	Moderate Risk	Intermediate Risk	Moderate Risk
Financial Flexibility	Adequate	Adequate	Adequate	Adequate	Adequate	Adequate
Financial Risk Profile	Strong	Moderately Strong	Upper Adequate	Upper Adequate	Strong	Strong
Enterprise Risk Management	Adequate	Adequate	Adequate	Adequate	Adequate / Adequate with Strong Risk Control bias	Adequate
Management and Governance	Satisfactory	Satisfactory	Satisfactory	Satisfactory with Fair Bias	Satisfactory	Satisfactory
Indicative SACP	a-	a-	bbb	bbb	a-	a-
Liquidity	Exceptional	Exceptional	Adequate	Adequate	Exceptional	Exceptional
SACP	a-	a-	bbb	bbb	a-	a-
FSR	A-	A-	BBB	BBB	A-	A

*Includes core and highly strategic subsidiaries.

Where Do Insurers Get Their Profits?

As part of our examination of insurers' profitability, it's important to understand how we measure their earnings.

The principle components that largely make up our earnings are premium volume, investment income, other fee income, incurred losses and claims, underwriting and administrative expenses, deferred acquisition cost, interest expense and other expense, policyholders' dividends, and taxes. Embedded in our forward-looking earnings estimates are our assumptions on pricing, exposure/volume growth by product mix, investment yield, interest rates, equity market returns (for fee-based business), mortality, morbidity, reserve development, and catastrophic and medical losses. These underlying assumptions reflect the insurer's track record and our opinion of its abilities, prospects, market, and economic conditions. We generally exclude investment (un)realized gains/losses from our operating earnings projections.

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Many insurers operating in APAC, LatAm, and CEEMEA are experiencing double-digit premium and earnings growth, exceeding those measures in comparison to companies operating in North America and Western Europe. The common characteristics that differentiate our high-growth insurers are that they operate in countries that are typically densely populated, with a strong or growing middle class (for example, China, Mexico, Brazil, and South Africa), markets that are less fragmented (China, Japan, Colombia, and Korea) or where insurance penetration is low (Colombia, China, Thailand, Mexico, Brazil, Bahrain, Kuwait, Russia, and United Arab Emirates).

Not surprisingly, investment yields are generally high, which gives more support to double-digit earnings growth that further differentiates developing and developed markets. However, the high investment yields are generally tied to relatively weak sovereign ratings or lower credit quality on the fixed securities held by insurers domiciled in these developing regions, which in turn affect their capital redundancy.

Table 5

Selected Markets Sovereign Rating, Asset Quality, And Bond Data

			--Five-year government bond yield--			--10-year government bond yield--		
Current Rating	**S&P sovereign rating (foreign-currency long term)**	**Investment average credit quality held by insurers**	**03/25/15**	**12/31/14**	**12/31/13**	**03/25/15**	**12/31/14**	**12/31/13**
Australia	AAA	AA	1.83	2.26	3.47	2.32	2.74	4.24
Austria	AA+	AA	0.02	0.12	1.12	0.39	0.70	2.26
Brazil	BBB-	BBB	13.28	12.75	12.90	13.16	12.43	13.21
Canada	AAA	AA/A	0.73	1.34	1.94	1.30	1.79	2.76
China	AA-	BBB	3.31	3.55	4.48	3.49	3.63	4.58
Colombia	BBB	BBB	6.78	5.98	5.99	6.80	7.10	6.77
France	AA	A	0.09	0.18	1.22	0.51	0.82	2.55
Germany	AAA	AA	(0.07)	0.02	0.92	0.23	0.54	1.93
Hong Kong	AAA	A	0.99	1.48	1.43	1.35	1.85	2.29
Italy	BBB-	BBB	0.62	0.93	2.72	1.33	1.88	4.08
Japan	AA-	A	0.09	0.03	0.25	0.33	0.32	0.74
Mexico	BBB+	A	5.15	5.23	5.37	5.72	5.84	6.45
Netherlands	AA+	AA	0.01	0.10	1.20	0.40	0.67	2.23
Qatar	AA	BBB	1.13	1.22	N.A.	2.66	2.99	N.A.
Russia	BB+	BB	12.09	15.30	7.04	12.18	14.09	7.71
Singapore	AAA	AA	1.73	1.58	1.06	2.17	2.27	2.55
South Africa	BBB-	BBB	7.07	7.44	7.20	7.60	7.96	7.89
Spain	BBB	BBB	0.59	0.86	2.70	1.28	1.60	4.13
Switzerland	AAA	AA	(0.42)	(0.14)	0.19	(0.09)	0.31	0.94
Taiwan	AA-	A/BBB	1.03	1.11	1.10	1.55	1.61	1.68
Thailand	BBB+	BBB	2.29	2.44	3.41	2.72	2.69	3.90
U.K.	AAA	AA/A	1.12	1.16	1.86	1.48	1.76	3.02
U.S.	AA+	A	1.37	1.65	1.74	1.88	2.17	3.03

N.A.-Not available. Credit quality is by rating category (i.e., no +/-). Bond data source: Bloomberg.

Companies experiencing double-digit earnings growth are generally small, with a median capital size of less than $300 million, compared with the global median we estimate at $1.1 billion. Notwithstanding their strong earnings growth, their annual median net income of $19 million (in absolute dollars) pales in comparison with insurers operating in North America and Western Europe, where annual median net income exceeds $100 million.

Table 6

Median TAC And Income

(Mil. $)	--2016 estimates--			
	Median TAC	**Median income**	**Net income combined annual growth rate (CAGR) (2014-16) (%)**	**TAC CAGR (2014-16) (%)**
Global	1,089	82	7	5
APAC	643	36	13	8
LatAm	272	14	18	8
CEEMEA	173	15	20	6
Western Europe	3,057	126	5	4
North America	1,719	133	5	4

Asia-Pacific: Despite China's Slowdown, Insurers' Premium Growth Should Be Solid

With China recently resetting its official economic growth target to 7% in 2015 (the lowest in 15 years and down from 7.4% in 2014), it is surprising that our rated insurers in the APAC region have yet to feel a hard profitability pinch. Although we see China's lower growth trajectory as likely to continue, we expect overall APAC GDP growth to improve to 5.3% in 2015-2016 (from 5.1% in 2014), with the insurance sector expanding faster than GDP rates. We expect low-double-digit premium growth in emerging Asia, including China, to outpace that of more-mature markets in North America and Western Europe. In the region's insurance markets (China, Japan, and Singapore offshore), we see year-over-year earnings remaining relatively strong (or stable, in Japan's case), largely because of changes in business strategy, low penetration, and demand for insurance.

Table 7

APAC Selected Data

APAC	All	Health	Life	Multiline	P/C	Reinsurance
Median indicative SACP	a-	bbb+	a-	a	a-	a
Median SACP	a-	bbb+	a-	a	a-	a
Median FSR	A-	BBB+	A	A+	A-	A
Median TAC size (2016 estimates, mil. $)	643	124	3,216	8,864	289	373
Capital redundancy level (2016, weighted)	BBB	AAA	BBB	BBB	BBB	BBB
Earnings growth CAGR (2014-2016, %)	13	6	13	14	11	7

China: Pressure points build amid a growing market

China has the fastest-growing insurance market, and it still has room to expand, thanks to the macroeconomic tailwinds propelled by a large population and a booming middle class. In addition, the Chinese government is encouraging deeper insurance penetration during the next few years. But pressure points are building as regulators push for stronger risk and capital management, which may further squeeze capital that is already tight as it supports the increased risk exposure accompanying the ongoing premium expansion.

Our credit outlook on China's life insurance sector is stable, reflecting our confidence about growth prospects and strategies, particularly compared with two to three years ago when many life products distributed through bancassurance had shorter maturities with less emphasis on protection and lower margins. Premiums generated through bancassurance dropped to 37% of total life insurance premiums in 2013 from 50% in 2010. We see more life players emphasizing value creation, profitability, and agency productivity, which should help to stabilize earnings. The life insurance sector should benefit from resumed strong growth in premium income and an increasing emphasis on value creation during the next few years. We expect premiums to grow by about 10% annually during the next two years, compared with 20% in the first nine months of 2014 and 8% in 2013.

Our outlook on the Chinese non-life sector is stable. We expect the industry to grow about 15% and the combined ratio to stay close to 100% in 2015 and 2016, suggesting a thin underwriting profit due to soft pricing and steep competition (the combined ratio is a key metric of insurers' profitability, with readings below 100% showing stronger profitability). Pricing on both motor and property insurance is likely to remain soft through 2016, which may prompt non-life insurers to diversify to other product lines.

For instance, growth in agricultural insurance has been particularly noticeable, with premiums more than doubling during the past three years. But only a few insurers could benefit from the agricultural insurance business. We believe it will be tough for new entrants to compete with the incumbents--PICC Property and Casualty Co. Ltd. and China United Insurance Holding Co. Ltd.--due to the need for an extensive network and expertise in the agricultural sector. However, we also see potential for material losses insuring agricultural business. Meaningful geographic diversity would be important to mitigate this possible impact. China's agricultural insurance market, subsidized by the government, is the second-largest following the U.S.

Japan: Modest improvements in 2015

Many of Japan's life and non-life insurers boosted their investment profits and capitalization in 2014, thanks to the stock market recovery and weakness in the yen, which tend to benefit investment income for Japanese insurers who have more foreign fixed-security investments. With the Nikkei continuing to trade higher, we believe many of our rated large Japanese insurers will see modest improvements in their earnings and capital levels in 2015.

Declines in long-term interest rates will likely hamper the life insurance sector. The yield on 10-year Japanese government bonds, which exceeded 0.7% as of the end of 2013, dipped to less than 0.4% in January 2015. We believe it will remain low for the rest of the year. Major life insurers had seen their interest rate spreads improve gradually in recent years due to declines in average guaranteed rates of interest, but we believe further declines will hamper future earnings improvement. It is becoming even more difficult for insurers to lengthen asset duration by investing in ultra-long bonds because the yields of such bonds are also dropping. Life insurers are likely to invest more in foreign bonds and seek new avenues such as infrastructure to maintain investment income. However, we believe it will be difficult for them to improve investment yields significantly because they are unlikely to change their investment portfolios drastically and worldwide interest rates are low.

For the non-life insurance sector, we expect underwriting performance either to remain flat in 2015 or slightly improve from 2014, barring any large catastrophe losses. In fiscal 2013, the three major non-life insurance groups--Tokio Marine Group, MS&AD Insurance Group, and Sompo Japan Nipponkoa Group--saw their underwriting performance improve substantially, with the combined ratio of their non-life insurance segments falling to less than 100% (which indicates underwriting profit). We don't believe underwriting performance will improve dramatically in 2015, because each group has been achieving the combined ratio target its management has set, and they currently don't plan to make any major revisions in premium rates. Given that consumption tax hikes hurt non-life insurers' profitability, the postponement of the government's decision to delay the second increase in that tax to 10% from the current 8% would benefit them in the short term. We expect to see the impact of the second consumption tax hike in fiscal 2017 (ending March 31, 2018) and beyond, but we believe that insurers can mostly absorb this effect by cutting operating expenses and raising premium rates.

Singapore: Regional growth should keep offshore business growing

Singapore's fast growth as an insurance and reinsurance center in Asia-Pacific is no accident. While the government enhanced Singapore's competitiveness through tax exemptions and concessions on selected offshore insurance businesses, the Monetary Authority of Singapore (MAS) liberalized entry into the direct insurance industry and lifted restrictions on foreign ownership of local insurers in 2000. That catalyzed the industry's development and growth. Offshore gross insurance premiums in Singapore have quadrupled during the past 13 years amid the country's conducive business and regulatory environment for insurance and reinsurance business. We expect economic growth in Asia-Pacific to continue to fuel regional insurance demand and development of the industry in Singapore.

Singapore's offshore insurance premiums rose to more than $4.8 billion in 2014 from $1.1 billion in 2000, representing an average annual growth rate of about 11%. Offshore insurance and reinsurance premiums accounted for nearly two-thirds of total market premiums in 2014, reflecting the magnitude and significance of the overseas business to the overall Singapore insurance marketplace. The moderate 5.9% growth rate in 2012 gradually improved to 8.8% in 2013 and 10.6% in 2014. And we expect a similar strong premium growth trajectory in 2015 and 2016, though underwriting profit is less predictable. Due to the regional catastrophe in 2011 (Thailand flood), the combined ratio for insurers and reinsurers writing business to Singapore's offshore insurance fund rose sharply to 297% in that year. But during the benign catastrophic years of 2012 and 2013, the combined ratios were 80.5% and 74.5%, respectively.

For the Singapore non-life sector (excluding offshore business), premium growth has been less robust, and we expect it to remain that way. The Singapore insurance market is relatively mature and we continue to see margin pressure on profitable lines of business. The premium growth rate slowed to about 2% in 2014 from 3.1% in 2013 and 5.9% in 2012. We expect non-life premium growth to remain less than 5% in 2015. Nevertheless, the sector will likely remain highly profitable with a combined ratio of less than 90%, consistent with the average of 88.5% during the past five years.

Latin America: Colombia Just Might Lead The Pack

In the region's three fast-growing insurance markets (Mexico, Brazil, and Colombia), insurers face a range of conditions--from tax reform to economic growth--that could affect their capital and earnings. Credit conditions overall in Latin America deteriorated in 2014 amid volatile capital inflows and currencies, low growth, and inflationary pressures in some countries. In 2015, we expect regional GDP growth to remain subdued, around 0.8% from 2014's 0.9% growth.

A contraction in Brazil's GDP and slower-than-expected recovery in Mexico (which together represent about two-thirds of the region's GDP) will make it harder for most companies to maintain their operating performance in 2015. In Brazil, the government has made marked adjustments in various policies--not only fiscal--to restore lost credibility and strengthen the country's now weaker fiscal and economic profiles. In 2015, we forecast an economic contraction of 1% in 2015 and we expect inflation to swell to 8.3%.

Although our expectations for Mexico's GDP growth are more promising, we revised our projections to 2.2% for 2014 and 3% in 2015 (from our previous forecasts of 3.0% and 3.5%, respectively). We believe the impact of a recovery in exports to the U.S. and stronger growth in domestic consumption following significant structural reforms in Mexico will become more apparent in the next 18 to 24 months. Inflation will likely be 3.5% in 2015. As larger Latin American countries experience slower growth, smaller economies, including Colombia, may outperform the rest of the region, though perhaps not to the extent we had projected in early 2014.

Table 8

Latin America Selected Data

Latin America	All	Health	Multiline	P/C
Median indicative SACP	bbb	bb-	bbb	bbb-
Median SACP	bbb	bb-	bbb	bbb-
Median FSR	BBB	BB-	BBB	BB
Median TAC size (2016 estimates, mil. $)	272	9	461	550
Capital redundancy level (2016, weighted)	BBB	AAA	BBB	AA
Earnings growth CAGR (2014-2016, %)	18	17	18	9

Mexico: Despite headwinds, stable credit quality amid 18%-20% earnings trend

The Mexican insurance industry will likely face a second consecutive tough year in 2015. One source of new concern for Mexico's economy in 2015 will be the impact of lower oil prices on government finances. Already, the Mexican government has announced MXN124.3 billion in spending cuts (or approximately 0.7% of GDP). In our view, this will double the constraints on economic growth.

Limiting overall premium growth last year were difficult economic conditions, tax reforms that reduced household disposable income, and the tax benefits businesses received for providing insurance coverage to employees. We expect nominal gross premium growth (excluding pension business and the PEMEX policy, an annuity product offered to employees by the largest government-run petroleum company in Mexico) to be around 6% as of year-end 2014, down from 8.1% in 2013 and 13.6% in 2012. In 2015, we expect the nominal gross premium growth rate to remain around 6%-7%. Given the continued difficult economic conditions, we believe insurance companies will focus on controlling expenses and strengthening investment income amid a less-competitive market in some segments, which will likely bolster overall earnings this year. We expect net operating earnings to grow about 18%-20% in 2015, down from 22.1% in 2014.

Industry wide, insurers were able to improve expense controls and investment results, and reduce losses, which bolstered overall earnings in 2014. Notably, primary non-life insurers were able to limit weather-related catastrophic losses through a strong level of reinsurance. This helped nonlife insurers record a net combined ratio of about 98% in 2014, even though Hurricane Odile was one of Mexico's worst catastrophic events in recent history, incurring an estimated insured loss of MXN16.6 billion. We expect the nonlife insurers to report improved underwriting results with a combined ratio around 92%-93% for 2015, compared with an average combined ratio of 94% from 2010 to third-quarter 2014.

The competitive environment historically has been fierce as medium-to-large insurers fought for additional market shares in profitable businesses such as auto insurance and personal life products. However, we believe the competition will likely be tempered in 2015 because companies will pull back from aggressive pricing because operating results deteriorated in recent years. In a shift of strategy, we believe many life and nonlife insurers will focus on underwriting discipline and adequate pricing, although auto writers will still have a hard time increasing rates.

On the regulatory front, authorities gave Mexican insurers a small break when they delayed the new Solvency II capitalization rules to 2016 from April 2015. These rules might require Mexican insurers to hold higher levels of capital than they would otherwise to remain in good standing with the regulators. The regulators are still running different sets of calibrations for capitalization, so the impact on insurers' capital remains uncertain. We have been following this issue closely, and we believe our rated insurers (mostly midsize to large companies) will have fewer problems complying with the new capital standards. Overall, despite the headwinds, we expect strong capital adequacy and relatively stable credit among our rated insurers in 2015.

Brazil: Investment income will continue to power earnings

Improved investment yields and satisfactory underwriting performance have partially mitigated the challenging economic conditions the Brazilian insurance industry has faced in recent years. However, we expect premium growth to decline in 2015 amid a sluggish economy in Brazil. Although we expect non-life insurers to maintain adequate underwriting discipline, we anticipate moderately soft pricing offset by strong investment income as insurers fight for share in a competitive market. For the industry, we expect combined ratios to stay largely unchanged at around 100% and investment income to remain the primary contributor to earnings in 2015.

We expect nominal premium growth for life (including Vida gerador de beneficio livre, the largest savings product sold in Brazil) and non-life insurers at about 12%-14% and 10%-12%, respectively, in 2015. High investment yields will likely keep these products attractive to consumers. Earnings growth for the primary insurance industry in Brazil will likely hover around 7% in 2015, compared with 11% in 2014.

Improved operating performance as business scale and expertise increases underpins our stable outlook on our rated Brazilian startup reinsurers. We see similar characteristics for nonrated reinsurers in Brazil. Lowered barriers to entry since 2008 have kept competition intense in the Brazilian reinsurance market. The growing number of reinsurers entering the market will continue to squeeze profit margins, thanks to an excess supply of capital that limits pricing power. We expect combined ratios for the Brazilian reinsurers to stay largely unchanged at around 100% in 2015, compared with 99.6% as of third-quarter 2014, 105.6% in 2013, and 107.5% in 2012. Overall operating performance will likely improve because of reduced expenses and strong investment income.

Although 2014's underwriting results were fair, overall operating earnings have improved on strong investment income due to a spike in Brazilian government bond yields in 2013 (investment losses weren't significant because of short asset duration). For 2015, we expect to see similarly strong investment income as the Brazilian yield will likely stay at its current level. We expect that, as rated startup reinsurers gain expertise and economies of scale, they will increase retention, improve combined ratios, and boost overall bottom-line profitability in 2015 and beyond. However, excess capital will also likely decline from extremely strong levels.

Colombia: Life insurers' earnings trending up

Colombian non-life insurers continued registering underwriting losses in 2014, in line with their historical performance. Ending in third-quarter 2014, their combined ratio was about 104%, slightly worse than the 102% average from 2009 to 2013. Even with the backdrop of good economic growth prospects for Colombia, we do not expect the weak underwriting earnings to turn around in 2015 amid an increasingly competitive non-life market that is being flooded with fresh capital.

Similar to Mexico and Brazil, investment income continues to be strong in Colombia. With investment yields exceeding 7% through the first nine months of 2014, we expect operating earnings to grow for Colombian insurers in 2015. However, although life insurers reap the benefits of high investment yields, the same cannot be said for non-life companies. As of Nov. 30, 2014, net earnings for life insurers grew nearly two-fold (132%) but non-life insurers grew only 2.6%. For the latter, weak underwriting results largely offset strong investment income. Stiff competition has increased expense ratios while losses, especially in auto insurance, steepened due to inadequate pricing and corrections on underestimated loss reserves. Higher commissions are also contributing to rising expenses. We expect operating performance among nonlife insurers to stay largely status quo, while life insurers' earnings are likely to trend up for 2015.

In our opinion, low insurance penetration (premium volume as a percentage of GDP) of about 2.9% combined with sound economic growth prospects and improving employment levels will support overall insurance premium growth of about 8%-10% through 2016. We expect overall industry-wide combined life and non-life earnings of around 10%-12% in 2015. Nevertheless, we believe capital adequacy will remain lower adequate (below the 'BBB' confidence level).

Western Europe And CEEMEA: Enough Headwinds To Form A Hurricane

Unlike the U.S. and U.K. economies, the European Economic and Monetary Union (EMU, or eurozone) is entering 2015 with weak tailwinds. Long-term government bond yields in the eurozone have declined to--or near--historic lows in recent months, contributing to our view that business conditions are weak. The most recent indicators suggest that eurozone growth remained modest in the final months of 2014. Flash estimates for the fourth quarter show a slight

GDP pickup overall (0.3%), led by Germany and Spain (0.7% each), and France (0.1%), with Greece (negative 0.4%), Finland (negative 0.2%), and Austria (negative 0.2 %) remaining weak. Given our forecast that eurozone unemployment will stay high (though improved from 11.5% in 2014) at 11.2% and 11.0% for 2015 and 2016, respectively, earnings and capital for some insurers could, to some extent, come under pressure from the continued sluggish macroeconomic backdrop.

Ongoing extraordinarily low interest rates are a particular problem for life insurers. In the reinsurance sector, capacity is outstripping demand, and competition continues to intensify even as the sector is consolidating. We expect this to weigh on reinsurers' returns during the next 12 to 24 months. Combined, these factors could weaken creditworthiness in the sector as pricing and competition pressures may erode business and financial risk profiles.

We believe negative rating actions could slightly outweigh positive rating actions during the next year for Europe's life insurers and reinsurers. In this part of the world (including Western Europe and CEEMEA), 14% of our ratings on insurers have negative outlooks or CreditWatches versus 8% with positive outlooks or CreditWatches. Nevertheless, 78% of our insurer ratings continue to carry stable outlooks--better than the global average for all corporate sectors of about 70%--partially reflecting our view that capital and earnings will likely support the ratings for many of our insurers.

CEEMEA: Largely stable despite volatile oil prices and currency valuation

Despite the steep decline in oil prices, our outlook on CEEMEA has remained stable. The only exception to this is Russia, where a significant currency devaluation and sharp slowdown in economic growth has led to our negative view of the Russian insurance sector. Moreover, the decline of local currencies against the euro and the U.S. dollar is inflating claims costs, particularly for South African insurers, which may impair their earnings prospects.

Table 9

CEEMEA Selected Data

CEEMEA	All sectors (except reinsurance)	Reinsurance
Median indicative SACP	bbb	bbb
Median SACP	bbb	bbb-
Median FSR	BBB	BBB
Median TAC size (2016 estimates, mil. $)	211	156
Capital redundancy level (2016, weighted)	A	AA
Earnings growth CAGR (2014-2016, %)	20	26

For South African insurers, weak economic growth contrasts against good earnings for the nonlife insurance industry. President Jacob Zuma's second administration has maintained economic policies and we do not expect a significant boost to GDP from labor or other reforms. Underwriting results have improved, however. After two years of exceptional weather-related losses, 2014 provided a benign meteorological backdrop to rate increases, policy adjustments, and better claims management. All of these support our positive view of the sector's earnings. We estimate an industry combined ratio of 90%-95% and premium growth of 8%-9%, which is in line with nominal economic growth during the next two years.

Historically, Russia's insurance market has been volatile and highly sensitivity to macroeconomic forces. Its situation has been made more difficult by Western sanctions related to the conflict in Ukraine. Consequently, we expect insurance sector growth to decelerate in 2014. Our premium growth projection was about 8%-10% in 2014, down from 13% in 2013 and 21% in 2012. We now believe premium growth could be very volatile in 2015, given the several factors influencing premiums in different directions. But we believe growth in real terms will likely be flat at best because of expected inflation and declining disposable income of the Russian population. We believe that Russian insurers will try to increase rates in 2015 (particularly in motor vehicle physical damage) to cover foreign-exchange volatility. Demand for insurance will consequently fall because retail clients' disposable income is not growing. We already see that growth in corporate insurance, motor insurance--including obligatory motor third-party liability (OMTPL) lines--motor vehicle physical damage, personal accident insurance, and retail property insurance is slowing down.

The average combined ratio for the top-20 insurance companies in Russia is close to 100%, but deviation from this average can be very high, with combined ratios varying from about 70% to almost 130%. Recent changes in the law on OMTPL have increased limits of coverage and tariffs and introduced many technical changes in how claims are settled. It is very hard to say what the effect on the loss ratio in this product line will be, given the magnitude of changes, potential further changes under discussion, and areas that are still unregulated. In our base case, we believe the OMTPL loss ratio will rise at least by one-to-two percentage points in 2015. This does not include an increase in limits covering losses on life and health, which are likely to come into force in April 2015.

Competition is increasing as insurers chase fewer opportunities. Overall, we think Russian insurers will face another tough year in 2015.

Western Europe: High hurdles for life insurers, but relatively safe havens remain for non-life insurers

We view current business conditions in Western Europe as weak for life insurers with high interest-rate sensitivity, consistent with our expectations set earlier in 2014. We think the combination of low rates and tight credit spreads will continue squeezing Continental European life insurers, adding incremental downside risk to ratings during the next 12 months for insurers unable to mitigate the capital and earnings impact.

Table 10

Western Europe Selected Data

Western Europe	All sectors (except reinsurance)	Reinsurance
Median indicative SACP	a-	a
Median SACP	a-	a
Median FSR	A-	A
Median TAC size (2016 estimates, mil. $)	3,057	3,450
Capital redundancy level (2016, weighted)	A	AAA
Earnings growth CAGR (2014-2016, %)	5	(6)*

*2013–2015.

Like many other investors, insurers are searching for yield either to protect their investment spreads or maintain competitive policyholder returns. This is leading some insurers to assume additional credit, market, or liquidity risk. Insurers that lack the capital to absorb these additional risks are more likely to see an erosion of credit quality. On the other hand, diversification is one key differentiating factor. Insurers that have strategic options to deploy capital to products, business lines, or geographies that are less sensitive to low interest rates are likely to exhibit greater stability in their rating profile. We have seen ample evidence of life insurers shifting their strategic focus in response to these external conditions.

Satisfactory operating earnings and limited asset risks continue to support our stable outlook on the non-life sector. However, with relatively short asset durations, the impact attributed to the steep decline on the shorter end of the yield curve was greater for non-life insurers. Given that underwriting results are at a favorable point in the cycle--and unlikely to get much better--non-life insurers will need to maintain discipline in pricing, risk selection, and particularly cost management to protect profitability.

This focus on expense efficiency is likely to affect distribution, with traditional networks increasingly concentrating on value-added products and services, and with mass-market products trending toward digital strategies, such as selling insurance products online. This, of course, will require up-front cost to develop new technological capabilities, but it will become ever more important for insurers to succeed in a competitive market with low interest rates.

Reinsurance: Consolidation won't relieve competitive pressures

We changed our global P/C reinsurance outlook to negative from stable in January 2014. The tipping point came when we saw increasing competition among reinsurers that we believe would weaken profitability. We believe negative rating actions could slightly outweigh positive rating actions during the next year for global reinsurers.

Competitive pressures in the market are piling up as overcapacity continues to build on the back of historically strong earnings and record inflows of alternative capital. This is manifesting in premium rate pressures across regions and lines of business, as well as in saturation in many developed markets, limiting growth. Couple this top-line pressure with historically low investment returns and it's clear why we expect reinsurers' profitability to suffer over the next 12-24 months.

The industry is turning to consolidation as a potential means of survival, with a handful of deals involving Bermuda and London market participants announced in the past 12 months. We don't expect this recent spate of consolidation to alleviate that competitive burden. If anything, it confirms the challenges that management teams at global reinsurers face in the current soft market with regards to defending their competitive positions.

For the Western European reinsurers, talk of consolidation is more prevalent in London than on the continent as buyers look to diversify their product offering and boost their scale. A Lloyd's platform provides buyers with a global licensing network and access to a wide range of specialty lines of business. The large European reinsurers tend to have the scale, diversification by product and geography, and capacity that we believe partially insulates them from some of the competitive pressures we're seeing in the market.

North America Capital And Earnings: Robust Capital, But Earnings... Not So Much

The North American insurance sectors are starting 2015 strong. Our rated insurers, mainly in the U.S., continue to generate record-high capital attributed to favorable equity market returns, relatively light weather-related and medical losses, and a stable level of investment income as low interest rates are offset by growing investment assets. Although the lack of strong pricing and low investment yields continue to squeeze profit margins with less than 4% year-over-year earnings growth for many of our rated P/C and life insurers, we expect our rated health insurers to ride the tailwind generated largely from an improving labor market and the Affordable Care Act (ACA), which has broadened their revenue base. We expect double-digit earnings growth at around 11% for our rated health insurers through 2016 attributed to the healthcare reform. However, reinsurers' (mainly Bermuda-domiciled) excess capital is still causing them trouble in the weak pricing cycle. We expect earnings, though still positive, to decline by as much as 16% for many of our rated reinsurers since we revised our outlook to negative at the start of 2014.

Table 11

North America Selected Data

North America	All	Health	Life	Multiline	P/C	Reinsurance
Median indicative SACP	a-	BBB+	A	A+	A-	A
Median SACP	a-	BBB+	A	A+	A-	A
Median FSR	A	BBB+	A	A+	A	A
Median TAC size (2016 estimates, mil. $)	1,719	1,358	1,862	5,150	1,358	3,891
Capital redundancy level (2016, weighted)	AAA	AAA	AA	AAA	AAA	AAA
Earnings growth CAGR (2014-2016, %)	5	11	4	4	2	(16)*

*2013–2015.

P/C: Both the upside and downside for ratings are limited

Many of our rated North American primary P/C insurers closed their books with respectable earnings in 2014, and we expect them to generate a modest underwriting profit with a combined ratio of less than 100%. Looking ahead, we see them facing the same challenges as in recent years: flat underwriting margins and investment income, diminishing reserve releases, pricing pressure on certain lines of business (mostly commercial property), and heightened uncertainty over natural catastrophic losses (frequency and severity). On the positive side, we expect the stable sector outlook and ratings to stay largely intact. During the next 12-18 months, we see limited upside or downside to our ratings. We believe our rated North America P/C insurers are in a better financial position (as measured by their capital level, investment posture, financial flexibility, and liquidity) than in the recent past.

Life: Strong balance sheets limit downside risk

Strong balance sheets underpin our stable outlook on the U.S. life insurance industry. Based on our capital models, capital adequacy generally supports our high investment-grade ratings on life insurers, and we see ample liquidity at operating and holding companies. Investment portfolios have experienced few credit losses in what we expect to remain a relatively benign credit environment, notwithstanding recent losses in the energy sector. Disciplined matching of asset durations with liabilities has served the industry well amid ultra-low interest rates. Those interest rates limit upside potential for the industry because portfolio yields continue to grind lower, increasing pressure on spread-based earnings. In our view, a relatively fragmented industry with intense competition further limits room for margin expansion because pricing, producer compensation, and product features are key determinants of new sales. Overall, we believe the industry's strong balance sheets limit downside risk to our ratings, but interest rates would likely have to rise before we could have a more positive outlook on the industry. We expect modest ratings changes, likely balanced between upgrades and downgrades because we have positive outlooks on 10 groups and negative outlooks on nine at the start of 2015.

Health: Credit quality should be strong as insurers adapt to the ACA

We consider credit quality to be strong for the U.S. health insurance sector as companies navigate through unprecedented changes in the marketplace. Currently, about 85% of the ratings have a stable outlook, which reflects our belief that health insurers will sustain their credit quality as they continue to adapt to the ACA. Earnings have benefited from an expanding marketplace, improved employment, and the migration of government-sponsored business to managed care, as well as a subdued rise in medical costs, which may have bottomed in 2013. We believe our ratings reflect the sector's capacity to withstand a sustained period of moderate strain emerging in connection with the ACA transition now underway. Overall, the ACA by itself has not resulted in any rating actions, a trend we expect to persist through 2015. As more insurers become comfortable with the ACA and its implications for the marketplace, we expect the pace of mergers and acquisitions to pick up (perhaps slowly for 2015) partly due to increased emphasis on scale and diversity.

Reinsurance: A slew of challenges is raising risks

North American reinsurers face many of the same challenges as their European peers, but are arguably more exposed to the competitive pressures. As a result, we observe that the consolidation wave is most active in Bermuda, with more than one-third of the rated island-based reinsurers currently involved in a purchase or sale. These players have been more directly affected by the competition from alternative capital since their relative concentration on property catastrophe business has felt the sharpest impact from the inflow of cat bonds and other ILS structures.

As the remaining reinsurers look ready to adapt their business models to fit the current market conditions; the newly merged reinsurance groups that fail to use their new size and scale profitably could see their ratings deteriorate.

We think companies without a defendable competitive position, or those that are more aggressive in maintaining market share by competing on price or relaxing their underwriting discipline, are most at risk. If we see these forces at work in a reinsurer's product mix or risk profile, we could revise our assessment of its business risk profile to reflect the relatively higher risk. We also believe reinsurers that display diminished capital buffers, or those showing ongoing constrained earnings capacity, will face a trying future.

Financial Flexibility Ratios: 2014-2016 Coverage And Leverage

Our 2014-2016 forward-looking estimates show a median of 7.4x EBITDA fixed-charge coverage and 20% financial leverage for our rated insurers globally that have debt and/or hybrids outstanding. Comparing to the prior-year estimates for 2013-2015 of 8x, the fixed-charge coverage decline is largely because of more interest expense from a higher level of debt/hybrids issued in APAC and some modest earnings deterioration in Western Europe and CEEMEA. These credit ratios--EBITDA fixed-charge coverage and financial leverage--aren't meant to be benchmarks but rather to show certain characteristics for the purpose of global comparisons and trends.

Table 12

EBITDA Fixed-Charge Coverage By Sector

(x)	All sectors	Life	P/C	Multiline	Reinsurance	Health
Global (All)	7.4	8.0	6.9	7.3	6.2	8.9
APAC	9.3	9.3	17.9	7.2	0.0	0.0
North America	7.8	8.3	7.1	6.9	8.0	8.9
Western Europe	6.6	5.9	5.7	8.3	6.0	0.0
CEEMEA	5.1	0.0	7.9	5.2	1.6	0.0
LatAm	5.9	0.0	0.0	5.9	0.0	0.0

Table 13

Fixed Coverage By Region

		--Indicative SACP--				
(x)	All	aaa	aa	a	bbb	bb
Global (all)	7.4	8.5	10.6	7.0	7.1	4.6
APAC	9.3	0.0	15.1	8.8	7.8	5.0
North America	7.8	8.5	10.2	7.0	7.1	2.9
Western Europe	6.6	0.0	9.2	6.0	8.0	6.8
CEEMEA	5.1	0.0	0.0	18.0	5.2	4.0
LatAm	5.9	0.0	0.0	0.0	6.0	5.7

Table 14

Financial Leverage By Sector

(%)	All sectors	Life	P/C	Multiline	Reinsurance	Health
Global (all)	20	20	20	17	19	26
APAC	20	19	12	23	0	0
North America	20	21	20	17	17	26
Western Europe	18	18	21	17	21	0
CEEMEA	17	0	15	18	40	0
Latin America	18	0	0	18	0	0

Table 15

Financial Leverage By Region

		--Indicative SACP--				
(%)	All	AAA	AA	A	BBB	BB
Global (all)	20	13	19	20	17	37
APAC	20	0	8	20	30	30
North America	20	13	19	21	19	66
Western Europe	18	0	19	19	13	30

Table 15

Financial Leverage By Region (cont.)

CEEMEA	17	0	0	13	16	39
LatAm	18	0	0	0	10	65

A One-Way Relationship On The Downside

The final analytical point we want to make concerns the relationship between earnings and ratings. First, issuers with a track record of poor operating performance (or a negative earnings trend) typically face rating pressure or are associated with speculative-grade ratings. The majority of our lower-rated insurers (60% of those with indicative SACPs of 'bb+' and below) underperformed their competitors even though their earnings trend has been and will likely remain relatively robust at around 36% year-over-year through 2016.

Table 16

Operating Performance by Rating Category

	—Indicative SACP—				
Global insurance operating performance assessment (%)	Overall	aaa / aa	a	bbb	bb / b
Positive	17	48	23	4	7
Neutral	66	52	74	59	33
Negative	17	0	4	37	60
Total	100	100	100	100	100
Median TAC size (2016 estimates, mil. $)	1,089	19,699	2,454	348	81
Capital redundancy level (2016, weighted)	A	AAA	A	BBB	BBB
Earnings growth CAGR (2014-2016, %)	7	3	9	22	36

One explanation for this phenomenon is that strong earnings momentum often comes with trade-offs, such as higher capital charges in support of a company's growth effort. And not surprisingly, this is what we typically see for many of the lower-rated, smaller-capitalized companies domiciled in developing countries. Hence, an upward income movement does little to improve our forward-looking view of the company's capital.

In addition, although earnings play a role in our projection of total adjusted capital (our measurement of an insurer's ability to absorb losses), additional qualitative considerations ultimately determine our overall "capital and earnings" assessment, a rating subfactor. These considerations include the size of capital, quality of capital, acquisition tendency, and capital fungibility. Accordingly, profitability alone does not necessarily improve an insurer's capital position.

Next, unlike common stockholders, insurance policyholders and debt holders do not generally profit from earnings upside, but they most surely suffer if issuers fail to meet their claims and/or debt service obligations because of a significant earnings shortfall. Hence, a positive (or flat) earnings trend does not necessarily strengthen (or weaken) our ratings. Evidently, this is exactly what we are seeing for many of our highly rated companies (those in the 'aaa' to 'aa' range) that we expect to generate only about 2%-3% earnings growth through 2016.

Last but still key, the one-way relationship reflects that our criteria on insurers' credit analysis look beyond profitability.

We consider a company's business prospects and whether they're supported by ample capital, prudent management and governance, sound ERM capabilities, and sufficient financial flexibility and liquidity as more-comprehensive measures for capturing risk characteristics. We believe these components provide a deeper purview on our issuers' financial strength than what profitability alone could reveal. And so, before insurance investors get excited about the highs and lows of profit growth, we believe it's important to understand what our ratings are saying about the rest of these credit factors.

Related Criteria And Research

- Global Insurance Credit Outlook 2015: Policymakers Prolong Pain For Developed Markets' Insurers, Dec. 10, 2014
- Around The World Of Insurance: A Global Review of Ratings, Dec. 18, 2013
- Group Rating Methodology, Nov. 19, 2013
- Insurers: Rating Methodology, May 7, 2013