Introduction

CEIOPS’ Financial Stability Committee (FSC) has prepared a new report on the financial stability of the insurance market and the pension fund sector in the EU/EEA as requested by CEIOPS’ Members and the EFC. An interim report on the financial conditions and financial stability in the insurance sector had been sent to the EFC Financial Stability Table for its discussion on the macro-financial conditions and overall stability of the EU financial system at its meeting early September 2008. The current report covers developments in the insurance and occupational pension fund markets for 2007 and further elaborates on preliminary findings for 2008.

This current report is based on:

- supervisory data on the insurance and reinsurance sector for 2005-2007, which are summarised in the statistical annex (SA) as well as fast-track reporting for parts of the reinsurance sector for 2008;
- qualitative information from supervisors pertaining to the insurance market situation and the occupational pension fund sector in the respective countries. A more focussed analysis on pension funds based on supervisory data for 2007 and more recent will be covered in the forthcoming Spring report for 2009;
- market information on developments in the reinsurance sector;
- information on recent financial market developments.

The current report addresses the following items:

1. Summary of main issues and conclusions
2. Financial market developments
3. Update on monolines
4. Developments in the European insurance sector
5. Developments in the European reinsurance sector
6. Developments in the European pension fund market
7. Insurers' and pension funds' exposures to commercial property markets

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1. Summary of main issues and conclusions

- The growth of gross premium written was less than 2% in 2007, with the increase especially modest in the life insurance sector. In 2008 the financial market turmoil has reduced demand of life products significantly, and recessionary pressure on households will likely reduce demand further.

- Investment returns in 2007 were still at a healthy level, however the average returns on equities were somewhat lower than in 2006. In 2008 financial performance of most insurers will be weaker than in 2007 due to low investment yields and flat or decreased premium income. Year 2009 will be especially challenging due to a possibly prolonged period of deteriorating macroeconomic environment. The outlook for the European insurance sector is also reflected in the widening Credit Default Swap spreads of the major European insurance groups towards the end of 2008.

- At the end of 2007 the total solvency surplus of the European insurance sector could have theoretically absorbed a loss equivalent to a 41% drop in the equity portfolio. During 2008 solvency positions have deteriorated and many companies have increased their capital buffers by now. It seems that most insurers’ solvency margins still include some shock absorption capacity.

- 2007 was another relatively mild year for catastrophe reinsurance losses. Weather-related events remained the largest source of losses; these effects on the reinsurance sector were mitigated in most cases, because many of them did not affect densely populated, economically developed areas.

- In 2008, the course of the softening global reinsurance market continued, but the year was earmarked by higher catastrophe reinsurance losses than in the past. The 2008 hurricane losses as well as the financial turmoil will certainly have an impact on demand prospects for reinsurance in 2009, the reinsurance capacity available and consequently on prices for reinsurance cover. There are indications that price increases in 2009 for at least certain segments of cover will be noticeable.

- The insurance industry as a whole faces several risks and challenges going forward, of which the most prevalent are financial risks, in particular the risk of low or even again decreasing interest rates as well as risks related to equity markets. A prolonged period of economic recession will be particularly challenging for the underwriting performance.

- The degree of concentration is stable; no exceptionally big M&A operations have taken place in the period 2007-2008. Moreover, internationalisation of the European insurance industry has proceeded slowly, for instance the market shares of foreign companies conducting cross border business through freedom of services is still almost negligible.

- The financial position of the defined benefit (DB) occupational pension fund sector is coming under increased pressure, due to negative developments in equity markets, low interest rates and prevailing longevity risk. In a number of member states sponsors are increasingly choosing to set up defined contribution (DC) plans instead of traditional DB plans. This gradual trend will help reduce the vulnerability of sponsors and the pension fund sector as a whole to the funding risks traditionally related to DB plans. On the other hand the shift to DC plans transfers a number of risks to individual members, often requiring them to make difficult decisions such as investment choices and making information to members.

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and financial education crucial issues, especially if there is an absence of sensible default options. Overall, there is a residual risk that unless suitable DC plans are in place, this movement might result in a smaller retirement income than that provided by DB plans.

- Markets for financial guarantors continue to be essentially closed, with the exception of US municipal business where there had been demand at attractive rates for AAA players. European regulators are monitoring closely the effects of market developments through enhanced supervisory oversight, liaison with other regulators, and contingency planning in the event of further downgrades or even insolvency.

- According to recent information received from CEIOPS Members, direct exposures to structured credit products, including subprime related risks remain limited in CEIOPS’ sectors. Exposures to debt instruments and equity shares issued by the banking sector were on average 10% of total investments for those countries that provided data. Of these debts, 7% were qualified as relating to troubled banks, with a more significant exposure to troubled bank shares. Most of the equity impairment has already been booked as a realised loss.

- Given the deterioration in some European commercial property markets as a result of weak economic conditions, some European insurers and pensions funds have recorded reduced incomes in recent quarters, or even losses. Further losses are likely if the negative developments in commercial property markets continue but on the whole exposures appear to be manageable and should not jeopardise the solvency of insurers and pension funds.
2. Financial market developments

Since the second half of 2007 the crisis in the US subprime mortgage market provoked severe turbulence in global financial markets. In September and October 2008, an abrupt loss of confidence in complex securitisation products and a general decrease in risk tolerance resulted in extensive losses on high-risk assets, higher price volatility on most capital markets and reduced liquidity in the overall financial system. With the bankruptcy announcement of Lehman brothers in mid-September 2008, the financial crisis was in an acute phase, marked by failures of US and European banks and by continuous government efforts to rescue distressed financial institutions. The deteriorating liquidity conditions in the money market led in early August 2008 to a widening gap between short-term interest rates and the official policy rates. The three month Euribor increased above 5,25% by mid-October 2008 (see figure 1), while the ECB's main refinancing rate was lowered to 3,75% from 4,25% in July 2008 – in two further steps the ECB lowered the rate to 2,50% by mid-December. In this period of uncertainty, long-term government bond yields fell as investors moved out of the market but also because of an anticipated weakening of the global economic environment. The yield on the 10 year European benchmark bond dropped towards 3,0%, well below the three month Euribor, creating an unprecedented gap between short- and long-term interest rates (see figure 1).

Figure 1: European short- and long-term interest rates

European and global equity markets initially recovered after the correction in July 2007 (see figure 2). However, a more severe equity market correction followed since January 2008, marked by a free-fall in the months between September and November 2008. The equity market decrease has, obviously, been detrimental to the financial position of insurers and pension funds via their significant equity exposures.
Because of the turmoil in the financial markets, the development of share price indices of the European insurance sector (life, non-life and reinsurance) fell behind the European wide share index (see figure 3). Reinsurers' stock prices suffered from potential losses related to winter storms that swept Europe in the beginning of the year, but are now more greatly exposed to insured losses related to the Atlantic hurricane season. The life insurance sector recorded the poorest equity performance, falling well below the DJ Eurostoxx index in the beginning of November 2008. This could be related to the higher sensitivity of this type of activity to the adverse stock market circumstances, given the higher importance of investment income in the net result of these companies and their relatively sizeable equity investment portfolios.
Whereas in 2007 the financial strength ratings of European insurers have been subject to more upgrades than downgrades, this trend has slightly reversed over the course of 2008 (see figure 4). Although the number of insurers with a negative rating outlook increased since September 2007, the large majority of the insurance ratings still have a stable to even a positive outlook (see figure 5).

**Figure 4: Development of leading European insurance group’s financial strength: Credit ratings distribution**
The spillover effects of the financial crisis to the real economy could pose further challenges in the quarters ahead, as insurance coverage to business related risks and household expenditures on life insurance products are reduced. This increased risk perception by financial markets is also reflected in the widening of Credit Default Swap spreads for the major European insurance groups, as observed especially towards the end of 2008 (see figure 6).

**Figure 5: Development of European insurance ratings outlook distribution**

![Leading European Insurance Groups: Outlook / Credit Watch Distribution](chart)

Source: S&P

2 Explanatory note - Rating outlooks are defined as follows:
A Standard & Poor's rating outlook assesses the potential direction of a long-term credit rating over the intermediate term (typically six months to two years). In determining a rating outlook, consideration is given to any changes in the economic and/or fundamental business conditions.

An outlook is not necessarily a precursor of a rating change or future CreditWatch action.
- Positive means that a rating may be raised
- Negative means that a rating may be lowered
- Stable means that a rating is not likely to change
- Developing means a rating may be raised or lowered

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**Figure 6: Development of CDS spreads on European insurance groups**

![CDS spreads European Insurance companies](chart)
3. Update on monolines

Financial guarantee insurers (or monolines) are firms that provide credit insurance to lenders or bondholders. There are nine\(^3\) monoline firms, seven of which have subsidiary operations in the UK, and one of which is operating in France. These firms provide guarantees (wraps) typically to market counterparties. The continued deterioration in structured credit markets, and in particular in securities related to US subprime mortgages, has increased the potential for higher than expected claims to emerge, and more recently monolines have set aside related reserves in addition to substantial mark to market losses. Although, liquidity should not, in the main be an issue for monoline insurers, Ambac, MBIA and Financial Security Assurance ['FSA'] all faced ratings related liquidity risks arising from Guaranteed Investment Contracts from their Asset Liability Management side of their businesses. These risks have now crystallised, in some cases to near total extent, and to date, the groups have successfully managed the liquidity payments required.

The sector continues to be under significant stress and there has been significant activity in the monoline sector throughout 2008. All the previously triple A rated firms have been downgraded by at least one rating agency, with most suffering substantial downgrades. Some monolines have agreed commutations with counterparties to commute stressed contracts, with the possibility of more to follow.

Earlier in 2008, the largest monolines, Ambac and MBIA, were downgraded despite completing capital injections. They are now both rated at the Baa1 level with Moody's. Both have previously stated that they are considering restructuring which may include establishing new US municipal bond only companies. FSA and Assured Guaranty, who appear to have less stressed contracts than most of their peers, have recently been downgraded to Aa3 and Aa2 respectively with Moody's. Assured Guaranty has now announced a deal to acquire FSA from Dexia, subject to necessary regulatory approvals.

Other more stressed monolines have been downgraded further, some to junk status. Some of these firms have been approaching their US minimum statutory capital requirements and have sought measures to improve their position: FGIC agreed a large reinsurance of much of their US public finance book to MBIA; Syncora reached agreement with XL Capital for termination, elimination, or commutation of reinsurance, guarantees and other agreements in exchange for a payment; CIFG agreed a reinsurance of some of its US public finance book to Assured Guaranty and reached an understanding with some of its derivatives counterparties; Radian announced restructuring of its monoline business under its mortgage insurance entity and ACA agreed a settlement and restructuring plan.

Table 1: Monoline ratings\(^4\)

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<th>S&amp;P</th>
<th>Moody's</th>
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<td>Assured</td>
<td>AAA</td>
<td>Aa2</td>
<td>AAA</td>
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\(^3\) Direct writing, as opposed to reinsurance monolines, prior to Berkshire Hathaway's entry.

\(^4\) All the below monolines were rated the equivalent of triple A stable by all three rating agencies in mid 2007, except Radian and ACA who operated at around the double A and single A level respectively.
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<th>Stable outlook</th>
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<tr>
<td><strong>FSA</strong></td>
<td>AAA</td>
<td>Aa3</td>
<td>AAA</td>
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<td>Creditwatch negative</td>
<td>Developing outlook</td>
<td>Rating watch negative</td>
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<td><strong>Ambac</strong></td>
<td>A</td>
<td>Baa1</td>
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<td>Negative outlook</td>
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<tr>
<td><strong>MBIA</strong></td>
<td>AA</td>
<td>Baa1</td>
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<td>Negative outlook</td>
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<tr>
<td><strong>Radian</strong></td>
<td>BBB+</td>
<td>A3</td>
<td>Rating withdrawn</td>
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<td>Rating under review for downgrade</td>
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<td><strong>FGIC</strong></td>
<td>CCC</td>
<td>B1</td>
<td>Rating withdrawn</td>
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<td></td>
<td>Negative outlook</td>
<td>Rating under review for downgrade</td>
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<tr>
<td><strong>Syncora [previously SCA]</strong></td>
<td>B</td>
<td>Caa1</td>
<td>Rating withdrawn</td>
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<td></td>
<td>Creditwatch developing</td>
<td>Rating under review direction uncertain</td>
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<tr>
<td><strong>CIFG</strong></td>
<td>B</td>
<td>B3</td>
<td>CCC</td>
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<tr>
<td></td>
<td>Creditwatch developing</td>
<td>Rating under review direction uncertain</td>
<td>Rating watch evolving</td>
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<tr>
<td><strong>ACA</strong></td>
<td>Rating Withdrawn</td>
<td>N/A</td>
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Whilst the claims paying resource within parts of the sector is still considerable, there is potential for further deterioration; for example if firms' restructuring plans are unsuccessful, commutation negotiations are unsuccessful, the underlying economic fundamentals deteriorate further or if rating agencies further re-evaluate their stance. Indeed, it now appears likely, that the previous operating entities of Ambac, MBIA, FGIC, SCA, CIFG look to be effectively moving towards run-off for existing entities, although some may look to write new business in future, probably with restructured business models..

Markets for monolines have been essentially closed for most of 2008, with the exception of US municipal business where there had been demand at attractive rates for triple A players such as FSA, Assured Guaranty [before their downgrades] and Berkshire Hathaway Assurance. There are reports of further possible new entrants (for example Macquarie are now licensed in New York) into the sector focused solely on US Municipal business.

European regulators are monitoring closely the effects of market developments through enhanced supervisory oversight, liaison with other regulators (particularly the NY State Insurance Department), and contingency planning in the event of further downgrades or even insolvency.
4. Developments in the European insurance sector

The following analysis of developments in the European insurance sector in 2007 is based on the reporting of key figures and on the qualitative reports provided by member countries in August 2008. As 2007 data for SE was not available, 2006 data has been used as an approximation. Several countries have sent material which is incomplete in some details. For these reasons some aggregated figures are possibly somewhat imprecise.

The ratio gross premiums to gross domestic product (= insurance penetration) is of a very different size in different countries, showing only gradual change over time. The variation is mainly explained by volumes of life insurance. In the non-life business penetration is highest in NL (due to the privatisation of health insurance in 2007).

Figure 7: Gross premiums written in % of GDP

Development in premiums and claims

For the reporting countries the total aggregate gross premiums written increased by 1.8% in 2007 compared to 2006 (composite undertakings included, reinsurance premiums excluded).
Life Sector

Premium growth for the life sector in 2007 was modest: the weighted average gross premiums increased only by 0.7% (15.1% growth in 2006). However, a number of countries, especially in the Eastern part of Europe (PL, BG, HU, CZ, LV, SI), experienced high growth figures also in 2007. BE had strong growth in premiums after a sharp decline in 2006 following the introduction of a 1.1% premium tax on individual life contracts. Also in IE and in NO premiums increased significantly.

Four countries (FI, FR, IT and PT) reported on premium decline in the range of 10-20% compared to 2006, although the decline in PT was purely due to statistical changes (one life undertaking was changed to a composite undertaking).

Only in NL and in BE the share of unit-linked products in 2007 was smaller than in 2006, although the growing trend of these products was not as clear as in the previous years. Unit-linked products accounted for more than 50% of the life market in 8 countries, but the share was 25% or less in 8 other countries.

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5 For AT and IT gross premiums written for composite premiums are split into life and non-life premiums
During the last year an increase in interest rates has revived competition between life insurance products and bank savings products. That has forced life insurance companies to promise to pay higher returns in 2008 in order to gain back savings business.

Many countries reported on changes in market and competition conditions for life products. As to business potential, some of these changes were positive, some negative.

**Non-life Sector**

The weighted average premium growth in the reporting countries in 2007 was 1,5%. In 2006 the growth was 5,5% (excluding the effect of the privatisation of the health insurance sector in NL). Premium increase was highest in RO, LV, MT, CZ, BG and in IS. Growth was significant also in ES, HU and in PL. New EEA members in the Eastern part of Europe experienced strong growth, mainly as a result of a significant growth in Motor Third Party Liability (MTPL) insurance (broader coverage of risks) and car damage premiums. NL reported on premium decline in the non-life activity.

Competition seemed to increase further, which also had a dampening effect on growth rates. DE, DK and SK reported on an extremely tough competition situation, especially in car and in MTPL.

**Profitability in 2007**

In the non-life business about half of the countries reported a higher combined ratio compared to 2006. The worsening underwriting performance was especially noticeable in LU. The aggregate net combined ratio for the reporting countries was 95,5% in 2007, compared to 95,3% in 2006.
Figure 10: Net combined ratio*

* Defined as claims and operating expenses divided by premiums, net of reinsurance.

In the non-life business the loss ratio weakened in LU, NO and PL, slightly also in ES and DE.

Figure 11: Net loss ratio (claims in % of net premiums)

The operating results of the life insurance business are highly dependent on the yield of the investment portfolio. From August 2007 onwards the return on the investment portfolio suffered from higher volatility and lower prices on worldwide stock markets. In the last quarter of 2007 many companies began to feel the impact of credit-spread widening on profitability, compounded by downgrading of certain assets, leading to write-downs on asset values.

Profits for the year 2007 (reinsurance excluded) were 1.3% of total balance sheet assets (0.8% in 2006). The variation between the countries ranges from
-2,2% (RO) to 13,5% (IS). Not a single country showed a drastic change in 2007 compared to the previous year.

The weighted average return on equity for the reporting countries in the life sector was 15,4% (16,3% in 2006). The corresponding figure in the non-life sector was 9,8% (13,1% in 2006) and 18,5% for the composite enterprises. All in all, returns in 2007 were still at a healthy level.

The life sector in CY, NL, NO and in PL earned very satisfactory returns on their equity base as well as for the non-life sector in IS, IE and in HU.

Figure 12: Return on equity* 2007

*Defined as profit or loss after tax for the financial year divided by total of capital and reserves

The weighted average return on assets was 1,0% in the life business and 2,0% in the non-life business. In the life sector the figure was highest in IS and BG, in the non-life sector positive outliers were IS, EE and CY.

Figure 13: Return on assets* 2007

*Defined as profit or loss after tax for the financial year divided by total balance sheet assets

6 For some countries data for composite enterprises is split into life and non-life enterprises

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Negative developments on stock markets, high volatility on interest rates and spread widening further into 2008 mean a substantial decline in investment income for insurers. However, according to the reporting countries, in general the overall performance of insurance business remained relatively resilient in 2008.

**Financial Strength**

The high level of profits generated in the recent years has improved the financial strength of the European insurance sector. The solvency ratio (available solvency margin divided by required solvency margin) has increased accordingly. At the end of 2007 the total solvency surplus (available margin – required margin) was EUR 554bn. This surplus amount could have theoretically absorbed an average loss equivalent to a 41% drop in the equity portfolio.

In the life sector the aggregate solvency ratio also increased last year, reaching a level of 362% at the end 2007 (compared to 302% at the end of 2006). In the life business the solvency ratio was especially high in BG and the UK. The ratio was more than 200% in most countries.

In the non-life sector the corresponding figure was 333% on aggregate (449% at end 2006). The solvency ratio was more than 600% in three reporting countries and less than 200% in five other countries.

There were no severe incidents of insolvencies reported for the 2007 period. Several countries reported on one or few companies, whose technical provisions were not fully covered by eligible assets or whose solvency ratio fell temporarily below the minimum required level. Most of these cases were settled during the year.

The solvency surplus compared to equity investments for end 2007, indicate that on average a drop of 41% in equities can be absorbed by the solvency buffer. Because of the financial crisis in 2008 companies’ solvency ratios went more or less down depending on the structure of the asset portfolio, especially in September and in October 2008. It should be noted that solvency figures for life and non-life are combined and that equity investments also include units in unit trusts, even those that invest in fixed income investment classes. This might distort the results to some extent as in some countries, insurers invest quite substantially in unit trusts.

**Asset allocation**

Several countries reported on a decreased share of fixed income investments in 2007, moving to 51% of total assets compared to 64% at the end of 2006. The decrease was especially strong in NL. The aggregate equity share of total balance sheet assets amounted to 27% at the end of 2007, compared to 28% in 2006. However, figures 14 and 15 show that the variation between countries is still very high.
Figure 14: Share of the countries in total assets (excluding investments for the benefit of life-assurance policyholders who bear the investment risk)

- **UK**: 25%
- **FR**: 21%
- **DE**: 20%
- **IT**: 7%
- **NL**: 5%
- **BE**: 4%
- **DK**: 4%
- **ES**: 4%
- **SE**: 4%
- **NO**: 2%
- **OTHERS**: 4%

Total assets

Figure 15: Shares and units in unit trusts in % of total investments 2007 (excluding investments for the benefit of life-assurance policyholders who bear the investment risk)

- **Weighted average**: 27%
Financial risks in general, equity risk and interest rate risk in particular, have materialised during the reporting year and have already deteriorated insurers’ returns and solvency positions into 2008. Now that the financial crisis is already affecting the real economy - GDP growth is expected to be very slow or even negative in 2008 and 2009 - the rapidly worsening economic cycle can be seen as a major challenge affecting the whole business opportunities and environment. Developments of market indicators (stock prices, price/earnings ratios etc.) for the insurance sector already reflect this increased uncertainty and negative outlook.

Volumes in the non-life business are anticipated to be flat or even decrease. In the life sector the financial market turmoil has reduced demand significantly. Operating expenses have been increasing, and are expected to be adjusted according to volumes. In the non-life business claims seem to remain stable, meaning that combined ratios could still stay at acceptable levels. But a low level of investment income is the most contributing factor in reducing profits, especially for life insurance companies. In 2009, the yields on equities can remain modest, losses on investments in commercial property and in corporate bonds can materialise to a larger extent and interest rate levels will probably remain low. All in all, financial performance of most insurers will be weaker than it has been in previous years.

Solvency positions of insurers have already deteriorated. Many insurance companies have in 2008 increased their capital buffers and some have received capital injections from governments or third-party consortiums. However, it seems that most insurers’ solvency margins still include shock absorption capacity helping them to survive over the coming recession period.

For DE not all bonds are included in fixed-income investments. Missing are bonds that are bought indirectly by investments in units in unit trusts, which are included in Figure 17. The amount of investments in bonds was about 44% in 2007 for DE.
Insurers that are part of financial conglomerates can meet particular risks in the current environment: ownership links and contagion risks from banking activities can affect these insurers more negatively.

Longevity risks remain important in the life insurance sector. This risk is especially relevant for countries where the volumes of annuities are relatively sizeable. Adjusted mortality tables and increases in technical provisions are measures used in certain countries to take account of longevity risk.

In the non-life business other prevailing risks frequently mentioned are premium risk and reserve risk. Fierce competition can lead to an unhealthy low premium level or to increased risk-taking in underwriting. Especially several countries in the Eastern part of Europe reported on high reserve risk. Risk of natural catastrophes can also be considered as premium and reserve risks. Insurers may not be able to collect sufficient premium income and increase their technical reserves in order to stand up against unexpected big losses in future periods.

In October 2008 CEIOPS also carried out another survey of insurers' investments in structured credit products and their exposure to subprime related risks. Data was collected on the basis of the 5 largest or systemically relevant insurance groups for each member country. The sample comprised 103 groups, covering all the main markets. Total investments of the sample were EUR 3.997bn covering 83% of the EU market investments. The exposure data referred to end September 2008 or more recently where available.

Total exposure to structured credits (ABS, CDO, CLO, CLN, RMBS, CMBS, ABCP, other ABS) net of hedging arrangements amounted to 2.5% total investments. Of the exposure to structured credits, the share of remaining subprime related exposure was 7%, i.e. 0.2% of total investments. Realised losses and further expected writedowns were EUR 129m.

The CEIOPS survey conducted in October 2008 examined also exposures to banking sector debts and shares. Total exposure to debt instruments issued by the banking sector was 10% of total investments of those countries that provided data. Of these debts, 7% were issued by troubled banks (qualified by national supervisors). The total exposure to banking sector shares was EUR 6.5bn, with a current market value of EUR 6.0bn (EUR 344m of loss already booked). Of these shares EUR 3.5bn refer to shares issued by troubled banks with a current market value of EUR 2.5bn (EUR 895m realised loss has already been booked). Exposures to the Lehman default were on average very limited.

A quantitative analysis has been conducted in May 2008 for the European occupational pension funds sector, on the basis of data collected by pension fund supervisors. On the basis of information provided, it appears that the European pension funds sector is remotely affected by the subprime crisis. This can partly be explained by the existence of restrictive investment rules in certain jurisdictions that prohibit pension funds from investing in such structured credit products. A limited amount of net direct exposure to structured credit products has been reported, which represents 2.1% of the total assets from the monitored pension funds. Available evidence indicates

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8 Data for IT refers to all insurance undertakings under supervision.
that pension funds are only marginally involved directly in subprime-related investments. Indirectly, they are likely to be negatively affected by the general pressure on stock market prices since the second half of 2008.

**Degree of concentration**

Some countries reported on increased concentration in 2007 due to mergers, although the situation was stable or slightly decreasing in most countries. No exceptionally big M&A operations have taken place in the period 2007-2008. Concentration is higher in the life business than in the non-life business. The life segment is a relatively concentrated market in IS, MT, RO and CY, whereas in the non-life business the concentration ratio is highest in IS, SI, RO and FI. In the bigger countries ES, FR, DE, UK, IT as well as NL the sector is most fragmented. Figures 17 and 18 illustrate the degree of concentration across countries for Life and Non-life enterprises (excluding business of composites).

**Figure 17: Concentration ratios of life enterprises 2007**

![Concentration ratios of life enterprises 2007](image)
Internationalisation

Although a large number of companies have asked for authorisations to enter foreign markets through freedom of services, the actual market share of these activities abroad is almost negligible. Most of international business is done through subsidiaries and branches. Figure 19 shows the numbers of national enterprises, branches of third countries and branches of EU/EEA countries. FI, IS and RO have no branches, DK, ES and SL have only two or three. The share of EU/EEA branches (number of branches/total number of enterprises) is biggest in PT, LT and AT. Only some countries have a significant number of branches of third countries.

The share of these foreign branches measured in terms of gross premiums written is more than 10% only in NO and CY. In NO a large company became a branch of its Danish parent company. The average share in the reporting countries was 3.4%. The share has increased in LT and LV because the subsidiary companies of two Estonian life insurers became branches. The changes in other countries in 2007 were only moderate.
5. Developments in the European reinsurance sector

General comment

The period 2007 was another relatively light year for catastrophe reinsurance losses. Weather-related events remained the most important source of losses; these effects on the reinsurance sector were mitigated in the most cases, because many of them did not affect densely populated, economically developed areas.

In 2008, the course of the softening global reinsurance market continued, but the year was earmarked by higher catastrophe reinsurance losses than in 2007, compounded by the aggravation of the financial turmoil.

Structure of the European reinsurance market

Reinsurers based in Continental Europe continue to dominate the global reinsurance market. Four of them are present among the top five global reinsurance groups in 2007. These companies were Munich Re, Swiss Re, Hannover Re and Lloyd’s.9 As regards the regional distribution within the European Union major reinsurers have their headquarters domiciled in France, Germany, Switzerland and the UK.

The opening of local European offices by many Bermudian reinsurers - as a result of the European Reinsurance Directive 2005/68/EC - indicates that their involvement in the region is expected to grow in the future. Increased competition in the European market10 could be the consequence of such development. The Reinsurance Directive has also made it easier to move reinsurance business portfolios within the European Union.

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10 See Guy Carpenter: 2008 Reinsurance Market Review - Near Misses Call for Caution, page 45
Increased activity is expected in the run-off sector, as companies seek to unlock capital in preparation for Solvency II requirements.

**Developments in the reinsurance sector in 2007**

In 2007, the absence of large catastrophe losses was a key factor in the softening of the reinsurance market. However, the frequency of catastrophes was high; in Europe reinsurers were faced with record floods in the UK, windstorm Kyrill in Northwest and Central Europe and wildfires in Greece. On a worldwide basis they had to cope with hurricanes, several earthquakes that exceeded 7 on the Richter scale, storms, floods, landslides and wildfires. The number of natural catastrophes (number of events: 960) that occurred in 2007 was the highest since 1974 – the beginning of the systematic recording. Nevertheless, the losses for the reinsurers (overall losses USD 82bn; insured losses: USD 30bn)\(^\text{11}\) were relatively low.

Underwriting results were weaker in 2007 compared to 2006, resulting in higher combined ratios for all reinsurers. The financial markets crisis until the end 2007 had little impact on their investment income. Profit growth originated mainly from life and health segments. P&C profits were flat, because many insured parties continued to increase their risk retention and took on more weather-related risks as reinsurers raised prices and tightened standards after the large catastrophe losses in 2005.

The collapse of the subprime mortgage market did not impact European reinsurers as deeply as might have been anticipated, except for Swiss Re. On 19 November 2007, Swiss Re wrote-down CHF 1,2bn on its credit default swap book and still has meaningful exposure to subprime related business and to the monoline financial guarantee insurers.\(^\text{12}\) Conservative investment behaviour contained the other reinsurers from the crisis for the time being. As far as known the exposure to the subprime sector on the balance sheets remains extremely small, with no direct involvement in subprime related business or financial guarantee (re)insurance.

Winter storm Kyrill, the largest loss event in 2007, occurred in the first quarter and caused losses of USD 6,1bn for reinsurers\(^\text{13}\). German reinsurers took the largest part of the losses, where recoveries were made from first and some second layers. Most UK losses were not covered by catastrophe programmes.

In the summer of 2007, parts of the UK were flooded by rainfall that was the heaviest since records began in 1914. In June, heavy rain caused severe pluvial and fluvial flooding in the north of England and Wales. A month later parts of central England and Wales were subject to fluvial flooding, as water flowed over the top of riverbanks. Damage has been estimated at USD 7,2bn\(^\text{14}\) (the insured loss was USD 4,8bn), but only a relatively small proportion of these losses were ceded to reinsurers.

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\(^\text{11}\) See Munich Re Group: Press release, High death toll marks the 2008 half-year natural catastrophes figures, Munich, July 9th 2008
\(^\text{12}\) See Benfield European Quarterly: FY 2007 Waiting Game, April 2008, page 12
\(^\text{13}\) See Swiss Re: Sigma No 1/2008, Natural catastrophes and man-made disasters in 2007, page 3
\(^\text{14}\) See Swiss Re: Sigma No 1/2008, Natural catastrophes and man-made disasters in 2007, page 3
There were no significant man-made catastrophes to be reported in 2007.

**Company Information**

The commercial relevance of a reinsurance company is expressed by the net reinsurance premiums written. This figure is illustrated in the following chart for the years 2006 and 2007, which for the bigger players has remained more or less stable.

*Figure 21: Net reinsurance premiums written*

![Net Reinsurance Premiums Written](chart)

The (net) combined ratio expresses whether the underwriting practice of a reinsurance company is profitable or not. The following chart presents this data for 2006 and 2007. A slight increase in the combined ratio, or slight worsening of the underwriting business, can be observed for the biggest and smallest reinsurers in the sample.

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15 The company data for the reinsurance sector has not always been reported by the countries in the required manner. Therefore, the data was taken for the combined ratio (net) and net reinsurance premiums written from Benfield European Quarterly. The figures from Benfield present only the P&C reinsurers market segment, this is the most important market segment for reinsurers. There are no figures available for 2007 which imply the P&C and the Life reinsurance market.

16 Net combined ratio expressed as sum of net expenses, net claims and net increase in technical provisions as % of net written premiums
M&A activity in the reinsurance sector 2007

In June 2008, SCOR completed its acquisition of Converium with the squeeze-out and the delisting of its shares in Switzerland and in the United States. SCOR Holding (Switzerland) Ltd. is now a fully owned subsidiary of the SCOR Group17.

Developments in the reinsurance market in 2008 and outlook

A protracted period without large losses as well as abundant capital buffers has put downward pressure on reinsurance prices for 2008 and increased the temptation to chase market share in this segment. The development of Insurance Linked Securities (ILS) and other investment vehicles, which allow the direct transfer of risk to investors without the intermediation of a reinsurer, also played a role in this very competitive environment. However, the 2008 hurricane losses as well as the financial turmoil will certainly have an impact on the demand for reinsurance for 2009, the reinsurance capacity available and consequently on prices for reinsurance cover. At this point in time it is too early to exactly forecast any precise developments. However, there are strong indications that prices for at least certain segments of cover will increase for 2009. The exact outcome of the 2009 renewal process will not be available before early 2009.

Until the end of June 2008 there were about 400 natural catastrophe events worldwide, which claimed the lives of more than 150,000 people. The worst human catastrophes happened in developing and emerging countries. In

---

Myanmar the official death toll of Cyclone Nargis has reached 78,000, with another 56,000 missing so far. The insured losses are substantial and amount to about USD 13bn (overall losses roughly USD 50bn).18

**Table 2: Major losses in the first half of 2008**:19

<table>
<thead>
<tr>
<th>Occurred on</th>
<th>Event</th>
<th>Region</th>
<th>Market loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. /6. January 2008</td>
<td>Industrial fire claim</td>
<td>USA</td>
<td>EUR 277m</td>
</tr>
<tr>
<td>January/February 2008</td>
<td>Snow and ice storm</td>
<td>China</td>
<td>EUR 194m</td>
</tr>
<tr>
<td>30. January 2008</td>
<td>Shipping accident</td>
<td>Brazil</td>
<td>EUR 29m</td>
</tr>
<tr>
<td>February 2008</td>
<td>Flood Queensland</td>
<td>Australia</td>
<td>&gt; EUR 610m</td>
</tr>
<tr>
<td>18. February 2008</td>
<td>Industrial fire claim</td>
<td>USA</td>
<td>EUR 244m</td>
</tr>
<tr>
<td>1. /2. March 2008</td>
<td>Winter storm Emma</td>
<td>Europe</td>
<td>EUR 300 – 1,300m</td>
</tr>
<tr>
<td>3. March 2008</td>
<td>Industrial fire claim</td>
<td>Korea</td>
<td>EUR 82m</td>
</tr>
<tr>
<td>12. March 2008</td>
<td>Fraud claim</td>
<td>USA</td>
<td>EUR 222m</td>
</tr>
<tr>
<td>2. May 2008</td>
<td>Cyclone</td>
<td>Myanmar</td>
<td>not available</td>
</tr>
<tr>
<td>12. May 2008</td>
<td>Earthquake Sichuan</td>
<td>China</td>
<td>EUR 13,000m</td>
</tr>
<tr>
<td>May/June 2008</td>
<td>Hailstorm</td>
<td>Germany</td>
<td>EUR 100m</td>
</tr>
</tbody>
</table>

**Table 3: Latest major losses of 2008**:20

<table>
<thead>
<tr>
<th>Occurred on</th>
<th>Event</th>
<th>Region</th>
<th>Market loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>28. August 2008</td>
<td>Aviation claim</td>
<td>Spain</td>
<td>EUR 146m</td>
</tr>
<tr>
<td>August/September 2008</td>
<td>Hurricane Gustav</td>
<td>USA</td>
<td>EUR 630 - 4,900m</td>
</tr>
<tr>
<td>September 2008</td>
<td>Hurricane Ike</td>
<td>USA</td>
<td>EUR 10,500 – 14,000m</td>
</tr>
</tbody>
</table>

Reinsurers of D&O (Directors and Officers) and E&O (Errors and Omissions) lines are unsure of the impact of securities litigation (related to the financial turmoil) on profitability. Because investors are still filing cases, new causes of action continue to be discovered. Furthermore, the list of companies potentially affected by securities litigation is growing. Swiss Re stated that they cut US casualty activities by 20% in 2007. Hannover Re has cut its US D&O book to less than USD 100m. SCOR and Paris Re are expected to escape largely unscathed21. Financial losses in the D&O and E&O sector are minor at the moment, but Guy Carpenter estimates that D&O losses may reach USD 3bn throughout 2009.

Reinsurers “initially” appeared immune to the turmoil on the financial markets, with corporate bond portfolios almost exclusively allocated to investment grade securities. The following table shows the subprime exposure as percentage of total investments. The exposure is comprised mainly of

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18 See Munich Re Group: Press release, High death toll marks the 2008 half-year natural catastrophes figures, Munich, July 9th 2008
21 See Guy Carpenter: 2008 Reinsurance Market Review - Near Misses Call for Caution, page 21
investments in US subprime residential mortgage securities and credit default swaps22.

**Table 4: US subprime and CDS exposures of reinsurers**

<table>
<thead>
<tr>
<th>Company</th>
<th>Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hannover Re</td>
<td>0,2%</td>
</tr>
<tr>
<td>Munich Re</td>
<td>0,2%</td>
</tr>
<tr>
<td>Paris Re</td>
<td>0,2%</td>
</tr>
<tr>
<td>SCOR</td>
<td>0,3%</td>
</tr>
<tr>
<td>Swiss Re</td>
<td>1,4%</td>
</tr>
</tbody>
</table>

Capital management remains a crucial issue for the sector's future strategic direction. Munich Re increased its share repurchase programme, aiming to buy back another EUR 3bn by 2010, in addition to the EUR 3bn they have already repurchased23. Swiss Re also increased its share repurchase programmes from CHF 6bn to CHF 7,75bn24. In November 2008, Swiss Re had suspended its share repurchase programme, as a result of the significant increase in client demand for reinsurance and the high volatility in the financial markets. Newcomer Paris Re (acquisition of AXA Re in 2006, holding located in Switzerland, operative business located in Bermuda) announced a share buy-back programme and proposed USD 400m return of capital to shareholders, contingent upon a subordinated debt issuance in the same amount in 200825. In September 2008, Paris Re purchased 4,589,286 of its shares at a price of EUR 12,10 per share. As far as known other European Reinsurers do not have any repurchase programmes at the moment.

On 31 July 2008, SCOR acquired 100% of the share capital and voting rights of Prévoyance et Réassurance and its Life and health reinsurance subsidiary Prévoyance Ré located in Paris. This enlarged SCOR’s leading role in the French Life and Health reinsurance market and the social protection field.

6. Developments in the European pension fund market

This section highlights the main developments recorded in the European pension funds sector, mainly on the basis of qualitative feedback provided by members, but also taking into account market-based information as far as available. Not all EU countries are covered, as in some of them IORPs (i.e. pension funds falling under the scope of the EU Directive) are still non-existent or are just starting to be established (BG, CZ, HU, RO). In FR the occupational retirement provision is treated as a line of insurance business, and is therefore not covered in this section.

**Developments in the first half of 2008**

a. Recent developments relating to mergers, acquisitions, liquidations of occupational pension funds – background and explanations.

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23 See Munich Re Group Annual Report 2007, page 3
24 See Swiss Re Annual Report 2007, page 123
There has been no major activity in this area. Two countries (CZ, LI) reported very few new funds, whilst two other members (FI, UK) saw a reduction in the number of pension funds. In RO contributions to privately managed schemes started in May. In the UK there has been a small number of acquisitions of closed pension funds by investment vehicles which intend to increase the assets by higher investment returns in order to eventually buy out the liabilities with an insurance company. This has caused some regulatory concern as the investment vehicle may not have sufficient capital to pay the debt on the employer if the investments underperform expectations. Thus new regulatory powers have been proposed by the government (see below in c). Two industry wide schemes merged in DK.

In ES modifications were made to existing pension regulations on the implementation of employers' pension agreements with employees and beneficiaries. The main changes introduced are:
- actuarial items, information obligations to members and beneficiaries, pension fund investment rules, internal control in managing entities and the creation of a new savings instrument.
- In the case of occupational pension plans, the regulation defines more clearly professional activity of actuaries, especially in the case of actuarial revisions. The level of reserves which constitute the solvency margin is reduced, so requirements demanded to pension plans are more flexible. It promoted equality between men and women in the calculation of premiums and benefits.
- In investment rules, this regulation introduces more flexibility in order to adapt new Pension Funds to modern investment alternatives. Actually, it introduces the possibility to investment in some types of derivatives and new Investment Funds. This new regulation insists on the separation between the managing and depositary entity.
- Consumer confidence and protection: the reform of the regulation has increased the information obligations (periodicity and volume of disclosure) from managing entities to members and beneficiaries. The objective is to improve financial education.
- Other important changes relate to new tax regulation: The maximum amount of annual contribution has been limited to EUR 10,000, and there is more flexibility in the payment of benefits which could be a lump sum, an annuity, mixed or other

b. Main drivers/impediments (fiscal, regulatory, or other) to the growth of the occupational pension fund sector.

Drivers mentioned across different countries were:
- Fiscal inducements through tax deductions of contributions (CZ, SI)
- Zero performance guarantee (CZ)
- State contributions (CZ)
- Public awareness about the need for saving for retirement (CZ)
- Reduction in state provisions (PT).

Impediments mentioned were:
- Prohibition of DC schemes (being removed) (FI)
- Unfinished legal framework (PL)
- Increasing longevity (UK)
- Volatility of asset returns (UK).

c. Other relevant developments or events in the pension fund sector.
Developments mentioned were:

- Funds increasing capital after unrealised losses and deferred costs. (CZ)
- Steady growth in membership. (CZ)
- Private pension reform legislation being planned. (CZ)
- Stress testing of balance sheets leading to 6% of funds requiring to strengthen their reserves. (DE)
- Widely fluctuating funding ratios due to exceptionally high volatility in the financial markets. (NL)
- A decline in adjusted return on capital in the last two years. (NO)
- New rules regarding governance and the regulation of investment policies were issued by the national regulator. The main objectives are the implementation of a greater flexibility in investment policies, together with stronger requirements for transparency and management responsibility, as a means to achieve a greater balance and protection to participants and beneficiaries. (PT)

In the UK the Pensions Act 2008 introduced some significant changes; 

1. Structural reform - from 2012 onwards a requirement on all employers to auto-enroll their employees into either a new universal defined contribution trust based occupational scheme called Personal Accounts or an alternative qualifying scheme that offers benefits that are at least equivalent to those from Personal Accounts. For this purpose a qualifying occupational scheme is a defined benefit of at least 1/120th or a defined contribution of at least 8% with employer contributions of at least 3%. Employees will be free to opt out. For those who do not opt out, the minimum member contribution will be 4% of band earnings (£5,000 - £33,000) plus tax relief of 1% and employers will have to pay 3%. Members can however opt out and do nothing. The new scheme will be regulated by The Pensions Regulator.

2. Changes in legislation –

- the Regulator was given strengthened powers:
  1. to intervene if the technical provisions set by trustees are calculated using assumptions which are not considered prudent;
  2. no longer has to prove intent when an employer’s action or non-action has the effect of avoiding a debt to the scheme;
  3. new alternative tests that could trigger the issue of a Financial Support Direction or a Contribution Notice when

- moving the employer or pension scheme to another jurisdiction;
- splitting the operating company from the pension scheme without appropriate mitigation for the pension scheme;
- splitting the assets from the operating company without appropriate mitigation for the pension scheme;
- transferring scheme assets and liabilities to another scheme which did not have adequate support from an employer;
- running a scheme for profit without adequate account being taken of member interests;
- or business models in which risk is predominantly borne by scheme members, but high investment returns would benefit investors.
The rate of revaluation of deferred benefits is mandatory at the increase in retail price inflation over the whole period from leaving service to normal retirement date but capped at a maximum rate. The cap was at 5% pa and new legislation reduced the cap to 2.5% pa for the period after 6 April 2009.

The impact of structural reforms and/or changes in the legislation is that the introduction of Personal Accounts is expected to increasingly influence the occupational pensions sector, as employers come to terms with auto-enrolment and the likelihood that scheme membership and hence their contributions could increase (especially for DC schemes and group personal pensions where uptake is variable and can be relatively low).

The Government has been consulting on “Risk Sharing” by means of new pension benefit design, some of which are similar to current Dutch designs of conditional indexation.

Funds are increasing their use of contingent assets and there is some switching from equities to fixed interest. Equity allocation went down to 54% from 60% over the year, with fixed interest up to 33% from 30%. The National Association of Pension Funds reports more schemes investing in property and hedge funds.

Preliminary assessment and/or expectations of results in 2007:

1. membership – Defined benefit schemes show a reduction in the percentage of active members and slight rise in deferreds and pensioners. A small number of schemes have bought out liabilities from insurance companies, and this trend is increasing.
2. performance – markets were little changed over the year other than real yields falling. Inflation outlook has risen and newly published mortality data disclosed further longevity gains, with no sign of lessening in the rate of improvement in longevity.
3. DB funds- funding levels are expected to have ended lower than at the start of the year, despite special deficit contributions having been paid, as real yields have fallen from 1.1% to 0.9% and longevity has improved, with fixed interest and equities at much the same levels as a year ago.
4. subprime turmoil relevance for the pension funds system – little direct involvement as investment in other assets less than 3%. However indirect effects are already seen in widening of credit spreads showing falls in corporate bonds and, of more concern, increase in borrowing costs for sponsoring employers and of credit insurance. Another concern is the financial strength of investment firm counterparties with whom trustees have dealt ‘over-the-counter’ in swaps and other derivatives.

DK reported on a lost trial at the European court regarding tax exemption on pension premiums. Only pension premium paid to an insurer/bank based in DK are allowed tax exemption. This rule comes from the fact that pension schemes pay taxes on their earnings and the DK tax authorities are so far unable to collect this type of tax from foreign units. But rules will probably be changed, and if and when foreign suppliers can handle this specific type of tax and the DK authorities accept tax exemption to foreign companies, this could improve the competition as foreign companies could enter the market.
In ES, as a consequence of the new pension funds regulation it is expected that risk management and asset allocation policies will be more efficient because the supervisor will check the implementation by the managing entity of proper internal control mechanisms.

d. An evaluation of up to five of the most important risks/challenges facing pension funds.

<table>
<thead>
<tr>
<th>Number of members reported</th>
<th>Risk type</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>Equity market risk</td>
<td>AT, DK, FI, IT, LI, NL, NO, PL, PT, UK</td>
</tr>
<tr>
<td>7</td>
<td>Longevity risk</td>
<td>CZ, DE, DK, ES, NL, PT, UK</td>
</tr>
<tr>
<td>7</td>
<td>Interest rate risk</td>
<td>AT, DE, ES, NL, NO, PL, PT</td>
</tr>
<tr>
<td>2</td>
<td>Low yield environment</td>
<td>DE, SI</td>
</tr>
<tr>
<td>2</td>
<td>Administration risk</td>
<td>CZ, PL</td>
</tr>
<tr>
<td>1</td>
<td>Insolvency of sponsoring employer</td>
<td>UK</td>
</tr>
<tr>
<td>2</td>
<td>Consumer confidence</td>
<td>AT, IT</td>
</tr>
<tr>
<td>1</td>
<td>Liquidity risk</td>
<td>CZ</td>
</tr>
<tr>
<td>1</td>
<td>Developments in world financial markets</td>
<td>EE</td>
</tr>
<tr>
<td>1</td>
<td>Disability risk</td>
<td>PT</td>
</tr>
<tr>
<td>1</td>
<td>Internal controls</td>
<td>CZ</td>
</tr>
<tr>
<td>1</td>
<td>Property price and rental drops</td>
<td>DK</td>
</tr>
<tr>
<td>1</td>
<td>Costs</td>
<td>IT</td>
</tr>
<tr>
<td>1</td>
<td>New competitors</td>
<td>LI</td>
</tr>
<tr>
<td>1</td>
<td>Competition from banks and other financial institutions</td>
<td>SI</td>
</tr>
<tr>
<td>1</td>
<td>Underdevelopment of long term investment market</td>
<td>SI</td>
</tr>
<tr>
<td>1</td>
<td>Capacity of long term investment market</td>
<td>SI</td>
</tr>
<tr>
<td>1</td>
<td>Regulatory changes in host states</td>
<td>LI</td>
</tr>
<tr>
<td>1</td>
<td>Commutation</td>
<td>CZ</td>
</tr>
<tr>
<td>1</td>
<td>Tax &amp; pension reform</td>
<td>ES</td>
</tr>
</tbody>
</table>

Descriptions of the risks identified:

- Subprime turmoil, via the fall of the price of the securities held (ES, FI, IT). In principle, a fall in pension funds’ value of assets may also affect the companies which sponsor DB pension schemes: they are committed to ensure pension commitments and could be forced to increase their contributions (FI). In ES, the supervisor questioned the 20 biggest managing entities with reference to the subprime turmoil asking if their funds had investments that were affected by the US credit crisis and the answer in all cases was negative.
- Interest rates lower than those guaranteed (DE).
- Market risk - the recent volatility in financial markets has once more demonstrated that pension funds are exposed to swings in market prices (IT, NL, PL, PT, UK).
• Longevity risk - changes in life expectancy can have a material impact on the funding ratio of pension funds (NL, PT, UK).
• Administration risk, especially when services are outsourced (PL)
• Consumer confidence (IT)
• Cost containment, as after the reform many plans still lack the critical size necessary in order to exploit the economies of scale, and many plans offered by commercial providers are characterised by high fees which could reduce significantly the accrued benefits. (IT)
• Underdevelopment of the local market in long-term investment-credit instruments (various bonds, including mortgage and other guarantee instruments) having insufficient capacity to absorb annual increases in valuable long-term assets, and consequently the volume of investments in European securities is growing steadily. It seems that domestic savings will to a large extent boost investments and employment outside the country (SI).
• The insolvency of the sponsoring employer, due to the winding up of a defined benefit pension scheme there is a debt on the employer to provide full benefits by purchase in the insurance market. If the employer is unable to pay this debt and so goes insolvent there is a Pension Protection Fund which pays compensation, but at a level less than full benefits (UK)
• Rising inflation (UK)
• Common administration of shareholders’ and participants’ assets reduces transparency of financial statements and has a negative impact on system processing. The pension fund system guarantees non-negative yearly appreciation of participants’ contributions which does not motivate pension funds to acknowledge total profits fully. On the other hand, shareholders’ willingness to bear potential losses (after drawing of reserve fund) is limited and the losses are accumulated in the balance sheet (liabilities) as an “unrealised loss” (CZ)
• Marketing, sales and distribution costs are booked in the balance sheet as deferred costs. Such a practice is not transparent in relation with participants because they are not informed about related up-front fee. In fact deferred costs represent a significant amount in the balance sheet and they grow up with continuous market redistribution. Consequently, following the problems described above it is impossible to determine the NAV per each participant, unlike the case of mutual funds (CZ)
• Current legal regulation does not determine exact liquidity or solvency requirements for pension funds as it is set for banks or other financial institutions. Due to this fact pension funds are not motivated to hold its assets in such amount and structure which would cover all participants’ contributions in case they are required to be settled at one time (CZ)

7. Insurers’ and pension funds’ exposures to commercial property markets
Commercial property markets can be important for the financial condition of European insurers and pension funds as they are sometimes large investors – both directly and indirectly – in various types of commercial property. 26 Analysing such exposures is of particular importance at present as conditions in several European commercial property markets have deteriorated during

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the last year. For these reasons, this box discusses insurers’ and pension funds’ exposures to commercial property and recent developments in the markets.

Pension funds and insurance companies are mainly investing in various types of commercial property investments because such investments often provide a long term income stream that can match insurers’ and pension funds’ long term liabilities. In addition, commercial property investments can provide investment diversification benefits as developments in commercial property markets are often not correlated with other investments such as equities and bonds.

Direct commercial property investments in land and buildings account for almost 7% of total investment assets of occupational pension funds in the Europe and around 3% for European insurers (see Chart A). It should however be noted that these shares in commercial property investments vary significantly across individual institutions. Pension funds and insurers are, however, also large investors in indirect commercial property investments, such as property funds and they are also selling credit protection on commercial property loans by buying commercial mortgage-backed securities (CMBS) (see Chart B).

**Chart A** European occupational pension funds’ and insurance companies’ direct investments in commercial property

(2006; percentage of total assets)

**Chart B** Exposures to commercial mortgage backed securities (CMBSs) for selected European insurers

(H1 2008; percentage of shareholders’ equity)

Source: CEIOPS. Source: Individual institutions’ financial reports.

At present conditions in several European commercial property markets have deteriorated.27 It should, however, be noted that developments in commercial property markets across Europe differ in some cases significantly which makes it difficult to draw conclusions for Europe as a whole. Capital values are easing, even declining in a number of countries as a reaction to the large increases in previous years but also due to the deteriorating macroeconomic environment and higher cost of, and reduced access to finance for property investors (see Chart C). Capital values were affected by reduced commercial property investment activity in the latter part of 2007 and thus far in 2008. Investment volumes declined by more than 60% in the third quarter of 2008 compared to the same quarter the previous year (see Chart D).

The financial turmoil that erupted in the summer of 2007 in some cases contributed to the decreasing returns on commercial property and without the financial market turmoil at least some European commercial property markets would probably have experienced a correction somewhat later.

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Turning to developments in CMBS markets, issuance in Europe grew rapidly in recent years and the issued amount totalled around EUR 50bn in 2007.\(^{28}\) However, since the onset of the turbulence in credit markets, the issuance of commercial CMBSs came to a near halt in Europe, with only limited private or retained issuance taking place (see Chart E). Issuance activity in Europe during the first ten months of 2008 dropped to EUR 5bn from EUR 44bn during the same period of the previous year. At the same time, secondary market spreads widened considerably including for AAA-ratings, which were the rating for most CMBS issuances in 2007, which has caused marked to market losses for some insurance companies (see Chart F).

To sum up, the overall outlook for some European commercial property markets is uncertain. Stabilising or, in some cases, falling property prices and higher funding costs have lowered investor demand and are likely to weaken demand further. Furthermore, the deteriorating economic outlook in Europe has negatively affected demand for rented commercial property, and is likely to reduce demand further. Given the deterioration in some European commercial property markets, some European insurers and pensions funds

have recorded reduced incomes in recent quarters, or even losses. Further losses are likely if the negative developments in commercial property markets continue but on the whole exposures appear to be manageable and should not jeopardise the solvency of insurers and pension funds.
**Annex 1: Country abbreviations**

<table>
<thead>
<tr>
<th>Country Abbreviation</th>
<th>Country Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>AT</td>
<td>Austria</td>
</tr>
<tr>
<td>BE</td>
<td>Belgium</td>
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<tr>
<td>BG</td>
<td>Bulgaria</td>
</tr>
<tr>
<td>CY</td>
<td>Cyprus</td>
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<td>CZ</td>
<td>Czech Republic</td>
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<td>DE</td>
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