German Public Sector Insurers

Non-Life Operations Profitable; Life Business Exposed to Low Investment Yields

Special Report

Integral Part of SFG: Public sector insurers form an integral part of the German public sector financial group Sparkassen-Finanzgruppe (SFG) and represent a third type of insurer in Germany after stock companies and mutual insurers. Historically, they were the exclusive providers of compulsory home insurance in many German regions and tend to operate within their own tightly defined geographical area ("Gebietshoheit").

Provinzial NordWest Rated: Fitch Ratings rates the public sector insurance group Provinzial NordWest's operating insurers Westfälische Provinzial Versicherung AG and Provinzial NordWest Lebensversicherung AG (IFS rating: AA−/Stable). The rating benefits from ultimate ownership by Sparkassen-Finanzgruppe (Sparkassen; IDR: A+/Stable). We align the insurers' implied IDRs with that of Sparkassen.

Sustainable Market Position: Measured in gross written premiums (GWP), public sector insurers had an 11.1% share of Germany's primary insurance market in 2015. Viewed as one single group, they form the country's second-largest primary insurance group.

Group Includes Reinsurance: Reinsurance forms an integral part of public sector insurance operations. The public sector insurance association, Verband öffentlicher Versicherer (VöV), provides reinsurance cover solely for public sector insurers. The reinsurer Deutsche Rückversicherung AG (Deutsche Rück) is also important as public sector insurers reinsure their storm risk with the company. In total, VöV and Deutsche Rück generated about EUR1bn of net earned premiums in 2015.

Restricted Consolidation: Versicherungskammer Bayern (VKB) is the largest public sector insurance group, ranking eighth in German primary insurance with 3.8% of premiums in 2015. VKB operated only in Bavaria prior to mergers with public sector insurers from Berlin-Brandenburg and Saarland. Fitch believes that these mergers were driven by financial distress and that the potential for further consolidation in the sector is restricted by a lack of alignment of interests between the owners of the various insurers.

Limited Merger Benefits: As public sector insurers operate in their own defined regions, synergies from mergers are likely to be smaller than for other insurers. In addition, office disposals are unlikely as the owners will ask for an office guarantee or block a merger, to safeguard jobs. In the case of VKB, all legal entities still exist, and no mergers between the operating companies have taken place.

Strong Underwriting Profitability: Public sector non-life insurers reported strong underwriting profitability and an average net combined ratio (CR) of 96.6% for 2011-2015, which was in line with the German market average of 96.7%, despite their high market share in German home insurance (the weakest line for underwriting profitability).

Guarantees Dominate Life Business: The sector's life business is dominated by traditional German life policies with onerous investment guarantees. The contribution of unit-linked and disability lines to new business has grown, but remains significantly below the market average.

Exposed to Low Yields: Fitch believes that public sector life insurers have above-average exposure to the effects of persistently low investment yields because of their limited earnings diversification. In addition, funds for future appropriation were slightly below the German life insurance average at end-2015.

Related Research

2017 Outlook: German Life Insurance – Low Interest Rates Put Capital Ratios Under Pressure (December 2016)

2017 Outlook: German Non-Life Insurance – Motor Rates Set to Decline – But Timing Uncertain (December 2016)

ALM Risks Weigh on German Life Insurer Ratings (August 2016)

Telematics Faces Slow Growth Among German Insurers (November 2016)

Sparkassen-Finanzgruppe (Sparkassen) (January 2016)

Sparkassen-Finanzgruppe (Sparkassen) (December 2015)

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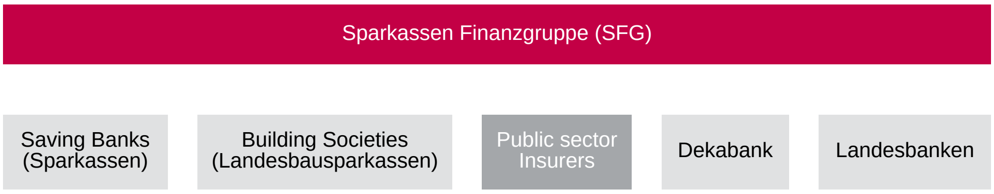
Integral Part of SFG

Structure Diagram



Source: Fitch

- Public sector insurers have a long tradition and have been part of SFG since their foundation.

All public sector insurers are part of the financial services group SFG, which had total assets of EUR2.2trn and shareholder funds of EUR153bn at end-2015, excluding public sector insurers. The SFG comprises five major activities: saving banks ("Sparkassen"), building societies ("Landesbausparkassen"), public sector insurers, investment manager "Dekabank" and "Landesbanken" (see diagram above). Sparkassen and public sector insurers provide bancassurance to their customers. These insurers had total assets of EUR144bn and shareholder funds of EUR8.9bn at end-2015.

The SFG is organised into regional groups, most of which have their own insurance groups. There are 11 regional public sector insurance groups in Germany. All of these are public-law institutions except for Provinzial NordWest Holding AG and SV SparkassenVersicherung Holding Aktiengesellschaft, which are public limited companies.

There were 403 Sparkassen in September 2016. The high number results from their statutory role to support their respective regions and enhance a savings culture among German citizens. Historically, Sparkassen provided access to a bank account and money for inhabitants outside larger cities. Their strategy is to have close contact with customers and fulfil any needs for financing (subject to their underwriting standards), savings and investments, and private wealth management and pensions. Public sector insurers provide insurance policies to Sparkassen and their customers. The business advantage is that customers stay within the SFG group because of the 'one-stop-shop' arrangement.

- More than one-sixth of the German primary insurance market's premium income is generated by the insurance arms of SFG and GFG.

Like Sparkassen, the Genossenschaftliche FinanzGruppe (GFG; AA−/Stable) focuses on bancassurance, and has distribution agreements with the insurance groups R+V and DEVK. Sparkassen and GFG generated more than one-sixth of the German insurance market's premium income in 2015. Sparkassen are allowed to offer policies from other insurers but most do not. The high market share of public sector insurers reflects their strong cooperation with Sparkassen. The partnership also creates a secure profit source for the associated banks.

In line with regulatory requirements, public sector insurers are not part of Sparkassen's protection schemes. Nevertheless, Fitch believes that Sparkassen would provide support to any public sector insurer should the need arise. This is partly because a shortfall would result in a significant decline in Sparkassen's customer base due to loss of trust and customer switching. Sparkassen's reputation would also be damaged.

Historically, public sector insurers provided compulsory fire insurance policies for buildings, on which they often had a monopoly. Many of their non-life subsidiaries still hint at this background with names such as "Feuer" (fire) or "Brand" (burning).

Combined public sector insurers represent the second-largest primary insurance group in Germany with 11.1% of the market in 2015, 12.8% of which was in non-life, 11.5% in life and 6.9% in health. Their aggregate investments stood at EUR133bn at end-2015.

Related Criteria
Insurance Rating Methodology (September 2016)

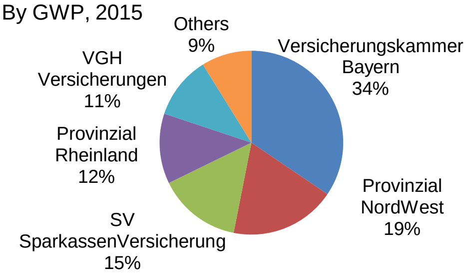
Highly Fragmented Group

In 2015, public sector insurers reported GWP of EUR22.1bn (2014: EUR21.3bn), of which the largest group, VKB, generated EUR7.6bn (2014: EUR7.3bn). They are represented through 11 separate insurance groups under public ownership (see chart). These groups comprise 43 primary insurers and provide legal expense insurance via joint-venture ÖRAG.

- German public sector insurance includes 46 primary insurers, most of which belong to 11 insurance groups.

All sector analysis in this report refers to primary insurance alone. Mutual insurance organisations founded to provide cover for public institutions are not included (for example, GVV-Kommunalversicherung VVaG, HDNA Haftpflichtgemeinschaft Deutscher Nahverkehrs- und Versorgungsunternehmen Allgemein VVaG).

Public Sector Insurance Market
By GWP, 2015



Others include Sparkassen-Versicherung Sachsen, Öffentliche Braunschweig, BGV Badische Versicherungen, Öffentliche Sachsen-Anhalt, Ostfriesische Landesbrandkasse, ÖRAG, Deutsche Assistance, GHV Darmstadt and HAVA Kassel
Source: Fitch

Fitch considers public sector insurance to be highly fragmented. Although synergies from mergers could be considerable, we regard such potential as below-average. This is because these insurers tend to operate only within their own tightly defined geographical area, and synergies for larger groups are primarily limited to having one headquarters and related head office activities instead of two.

Due to their ultimate public ownership, the disposal of headquarters and head offices after a merger would be challenging. Public decision makers are reluctant to support the disposal of head offices as this would lead to job losses in their region.

- VKB, the largest PS insurance group, comprises 12 operating insurers.

In 2005, Westfälische Provinzial and Provinzial Nord were merged into one group, Provinzial NordWest. In addition, groups from Saarland and Berlin-Brandenburg became part of the Bavarian group VKB. However, more than 10 years later, head offices of the former groups remain open. Fitch believes that expense synergies from the mergers were lower than could have been achieved.

Fitch regards another merger of public sector insurers as unlikely, primarily because public officials are not willing to see job losses in their regions. In 2015, public sector insurers reported, on average, a pre-tax return on equity (ROE) of 11.0% and a net income return of 6.7% and provided adequate profitability to their owners – especially given that their primary purpose is fulfilling public service needs rather than generating profit.

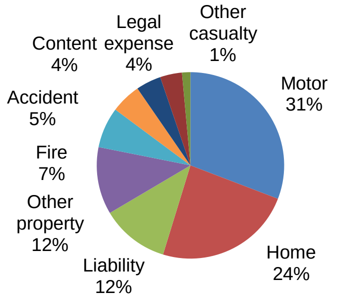
However, the German regulator introduced an additional actuarial life reserve requirement, the Zinszusatzreserve (ZZR) in 2011. The annual expense for the ZZR is directly linked to interest rates. Ongoing low interest rates put increasing pressure on earnings for insurers with significant life operations. This could result in a need to improve expense efficiency, which is often limited for small to medium-sized companies as achievable synergies are low.

Smaller groups with total assets of less than EUR5bn and life insurance operations (Sparkassen-Versicherung Sachsen, Öffentliche Braunschweig, Öffentliche Oldenburg and Öffentliche Sachsen-Anhalt) could be forced to find a larger partner within the public sector insurers for generating synergies to achieve the necessary cost reductions.

This could drive future mergers within the sector. In the event that non-life operations are not profitable enough to compensate for high costs of life insurance operations, even larger groups could be open for mergers to generate additional synergies.

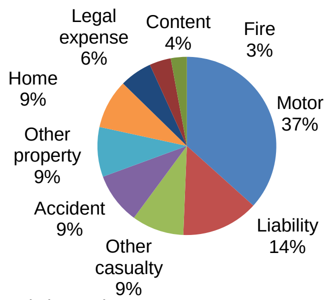
Sustainable Market Position

Public Sector Insurers' Non-Life Premium Split
By line of business, 2015



Source: Fitch, Verband öffentlicher Versicherer

German Market Non-Life Premium Split
By line of business, 2015



Source: Fitch, BaFin

- Non-life underwriting profitability is in line with the German market average, despite a high home insurance share.

Non-Life: Strong Underwriting Profitability Despite Challenging Business Mix

On a consolidated basis, public sector insurers reported a gross combined ratio of 92.4% (2014: 93.7%) for 2015, which was better than the German market average of 94.0% (2014: 92.8%). Driven by high natural catastrophe activity in Germany in 2013, the 96.9% average gross combined ratio for these insurers over 2011-2015 exceeds the market average of 95.8%. Public sector insurers tend to largely cede the risk arising from windstorms and flooding, reflected in the fact that the average net combined ratio of 96.6% was in line with the market average of 96.7%.

The high share of home insurance (24% versus 9% for the market) initially appears to be a clear disadvantage for underwriting profitability. However, public sector insurers reported a 2015 gross combined ratio of 93.7% (2014: 96.9%) for this line, against a much weaker market average ratio of 99.6% (2014: 99.7%). While the German home line reported an average gross combined ratio of 109.6% for 2006-2015, public sector insurers achieved a much stronger figure of 102.4%.

Fitch believes that premium rates for public sector insurers are stronger than for the market as a whole as the claims and expense ratios are better than the market average over the period. For 2006-2015, public sector insurers' average loss ratio was 77.7% against 81.1% for the market, and the expense ratio was 24.7% against 28.5%. However, the claims ratio was in line with the market average in 2013 and 2014.

The table below provides more details about gross combined ratios for different business lines for 2012-2015. High natural catastrophe activity in Germany in 2013 is reflected in the poor gross combined ratio that year, due to the high share of home insurance. However, the public sector net combined ratio was 100.3%, which was slightly weaker than the market average of 99.2%.

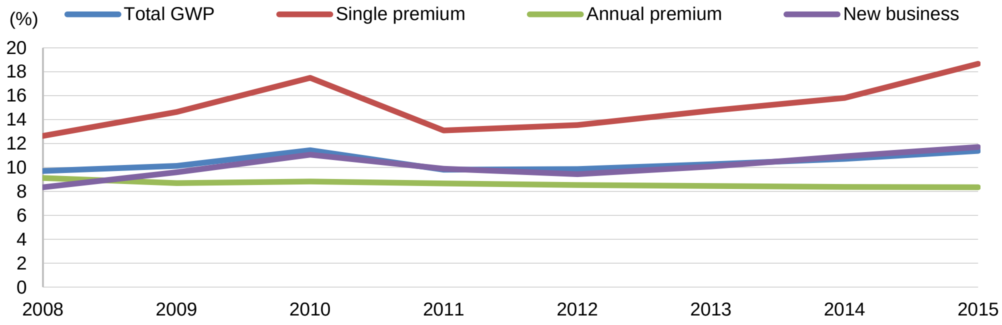
Gross Combined Ratios (Aggregate)

	2012		2013		2014		2015	
(%)	Public sector	Market	Public sector	Market	Public sector	Market	Public sector	Market
Motor	102.5	102.5	105.4	104.6	96.9	96.7	98.9	97.7
Home	94.8	102.1	130.0	133.6	96.9	99.7	93.7	99.6
Fire	89.8	98.1	94.3	90.5	96.2	94.7	90.9	104.0
Content	73.3	80.2	73.8	82.4	75.2	82.4	70.6	80.0
Other property	94.4	93.2	127.6	104.3	95.6	88.3	94.6	91.1
Liability	88.6	88.8	93.4	91.5	87.2	90.0	88.2	94.3
Accident	76.1	82.3	74.1	86.1	77.1	88.9	74.8	90.0
Legal expense	97.2	96.4	99.6	99.9	101.3	100.7	104.8	99.3
Total	94.1	94.8	108.2	100.4	93.7	92.8	92.4	94.0

Source: Fitch, BaFin, w/o reinsurance, 2015 data not available yet

Public sector insurers reported non-life GWP of EUR9.5bn for 2015, which equates to a market share of 12.8% (2014: 12.8%). Viewed as one group, they maintained second place in terms of market share, after Allianz (18.6%) and ahead of Talanx (8.4%).

Public Sector Insurers' Life Market Share
2008-2015



Source: Fitch

Life: Most Challenging Segment

Public sector insurers' market share in the German life segment was lower than for non-life, at 11.5% of GWP (2014: 10.8%). Viewed as one group, public sector insurers ranked third in the German life sector, behind Allianz and Generali with 19.2% and 12.6%, respectively, and ahead of R+V with 6.4%. Germany's life segment has benefited from significant growth in single premium business in recent years.

- Single premium business helped public sector insurers improve their market share in life insurance.

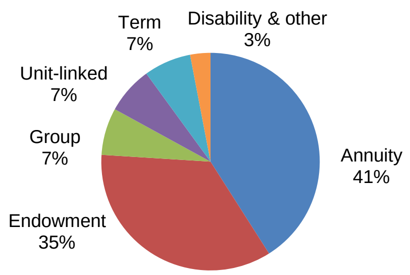
The proportion of single premium business is typically higher for bancassurance. Single premiums accounted for 48% of GWP compared with 29% for the market as a whole. The strong single premium business helped public sector insurers to strengthen their market share. In addition, their share of single premiums increased to 18.6% in 2015 from 12.6% in 2008 and new business to 11.7% from 8.3% while their annual premium share fell to 8.4% from 9.1%.

As part of the SFG, public sector insurers tended to introduce unit-linked policies later than competitors because investment funds were distributed directly by SFG's investment fund manager, Deka. This led to a much lower ratio of unit-linked investments-to-total assets than for the market: 3.3% versus 9.7% at end-2015. Fitch does not expect public sector insurers to close the gap in the short to medium term, as premium income from unit-linked policies is much lower than the market average (see charts below).

- Low level of earnings diversification in life because of concentrated product mix.

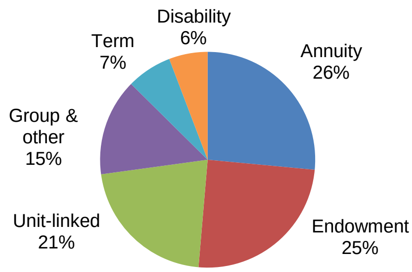
If single premium business declines and annual premium new business does not improve, public sector insurers will most likely lose some GWP market share because sales are constrained by their small market position in the unit-linked and disability lines, which represent a material share of the industry's annual premium new business.

Public Sector Insurers Product Mix
2015, in force regular premiums



Source: Verband öffentlicher Versicherer

German Market Product Mix
2015, in force regular premiums



Source: GDV Gesamtverband der Deutschen Versicherungswirtschaft e.V.

Unit-linked policies increase the overall profitability of German life insurers and earnings. Management fees and kickbacks help diversify profits from pure investment income above the guaranteed interest payment. The same applies for the disability line underwriting result.

Life policies are primarily sold via banks, which predominantly sell traditional policies. Firstly, unit-linked products compete directly with investment fund products from Deka. Secondly, bank agents are often not very familiar with selling pure risk cover policies and are reluctant to distribute disability products.

- Below-average funds for future appropriation

Funds for future appropriation of 5.0% (2014: 5.3%) were weaker than the market average of 5.3% (2014: 5.6%). Overall, Fitch considers public sector life business to be more exposed to the effects of low investment yields than the German life market as a whole.

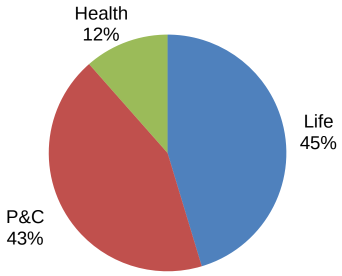
However, Fitch considers that investment fund fees from Deka should be included in a consolidated approach for SFG. In addition, the total business mix includes an above-average share of non-life business (see charts below). As a result, Fitch views public sector insurers as resilient to ongoing low investment yields.

- Life product mix needs to improve to stay competitive.

Fitch believes that life segments will remain competitive only if the share of non-traditional products increases significantly in future. Life insurers with a predominantly traditional book of business are challenged by high capital requirements under Solvency II, especially while investment yields remain at current low levels.

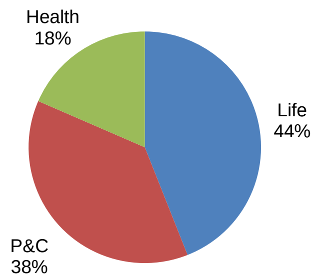
Unit-linked new business has improved in recent years, but remains below the market average: In individual business, it accounted for 17.4% of public sector insurers' life new business against 23.2% for the market in 2015. The same applies for the disability line with 6.5% against 11.6% for the market.

Public Sector Insurers GWP Split
By segments, 2015



Source: Fitch, BaFin

German Market GWP Split
By Segments, 2015



Source: Fitch, BaFin

Stable Market Position for Health

Health cover is only provided by two public sector insurance groups, VKB and VGH, while life and non-life cover are provided by most groups. Both groups have two health insurers, with one in each having neutral branding. All common health insurance products are provided.

Investment income is pressured by the low interest rates. However, German health insurers are allowed to claim higher premiums from policyholders if the technical discount rate is lowered – except for life insurance.

The health segment accounted for only 6.9% of the German market at end-2015 (2014: 7.0%). On a consolidated basis, public sector insurers form the sixth-largest health insurance group in Germany, as is VKB on a stand-alone basis.

Reinsurance Allows for Better Geographical Diversification

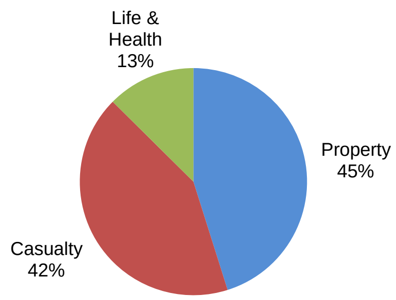
VöV and Deutsche Rück are the group's operating reinsurers. While VöV writes public sector insurance only, Deutsche Rück writes selective business from elsewhere and some European business too via its Switzerland-based subsidiary. Most business is German and derives from public sector insurers.

Deutsche Rück is fully-owned by public sector insurers while the German mutual insurance group VHV owns 25% of the Switzerland-based subsidiary, with the remainder fully owned by Deutsche Rück.

After allowing for net retention, public sector insurers cede their geographically focused risks to Deutsche Rück, which bundles all local risk exposures into one, geographically more diversified exposure. A large share is then returned to public sector insurers, which improves their geographical diversification. Public sector insurers generally receive better rates for extended reinsurance cover, such as XS and PML, after the exposure has been diversified.

Reinsurance GWP

By line of business, 2015



Source: Fitch, Annual Reports

Deutsche Rück is therefore highly integrated in this market and important for the sector. It improves geographical diversification and the expense efficiency of reinsurance programmes.

High prior-year reserve adjustments (PYRA) indicate that Deutsche Rück conducts its business cautiously. It reported average PYRA of 13.3% for 2006-2015.

Summary

Germany's public sector insurance market remains as fragmented as it was a decade ago. Fitch considers that mergers of holding companies tend not to create significant added value – as demonstrated by VKB. Fitch believes that there is no requirement for such a high number of these insurers, but regards mergers and consolidation as unlikely in the short term given the current ownership structure.

However, ongoing low rates could pressure market consolidation to increase synergies and improve expense efficiency. Fitch considers that this is especially true for smaller insurance groups with significant life operations.

Public sector insurers have been able to affirm their strong market position in all three primary insurance segments in recent years. Fitch expects them to continue to report strong non-life underwriting profitability.

The product mix in life insurance is one of the main weaknesses of the sector and Fitch believes that greater diversification into unit-linked and protection products would significantly improve the quality and stability of earnings.