Market Review
October 21, 2015

Sticking to the Basics Ensures Resilience of the Spanish Insurance Sector

"The insurance sector continues to execute its business plans according to its traditional roots and remains relatively resilient."

Spain's insurance market has continued to show resilience, with companies focusing on profitability as the country's economy showed further signs of recovery.

While total gross written premium (GWP) contracted further in 2014, the pace at which the market has shrunk has slowed. The non-life sector in particular has been affected by competitive conditions for motor insurance, its predominant line of business, although a recovery in car sales is expected to assist this line of business in 2015.

Insurance penetration in Spain remains below European standards, particularly in the life segment. In 2014, Spain's total insurance penetration was 5.3%, compared to 9.1% in Italy and 9.5% in France. Historically, domestic consumers have not had the incentive to save through insurance products and principal guaranteed long-term deposits have been the bread and butter of the risk-averse household in Spain. However, A.M. Best expects Spanish savers will continue to evolve towards a new reality in which long-term investment risk moves from state-guaranteed benefits to households' own accounts, which, in turn, will create opportunities for life insurers.

After enduring the worst recession in the last three decades, Spain's gross domestic product (GDP) expanded by 1.4% in 2014 (**Exhibit 1**). The economy performed well in the first half of 2015 and is forecasted to post a 2.5% growth in 2015. External tailwinds have included the European Central Bank's EUR 1.1 trillion quantitative easing programme, increased

Exhibit 1
Spain - Non-Life & Life – Key Facts

Indicator	2008	2009	2010	2011	2012	2013	2014
Population (Millions)	46.0	46.4	46.6	46.7	46.8	46.6	46.5
Gross Domestic Product (EUR Billions)	1,116.2	1,079.0	1,080.9	1,075.2	1,055.2	1,049.2	1,058.5
Change in Real GDP (%)	1.1	-3.6	0.0	-0.6	-2.1	-1.2	1.4
Inflation (%)	1.5	0.9	2.9	2.4	3.0	0.3	-1.0
Unemployment Rate (%)	11.3	17.9	19.9	21.4	24.8	26.1	24.5
Insurance Penetration (%)							
Life	2.46	2.71	2.53	2.78	2.53	2.47	2.39
Non-Life	2.94	2.97	2.87	2.90	2.94	2.89	2.90
Total	**5.40**	**5.68**	**5.40**	**5.68**	**5.47**	**5.36**	**5.29**
Insurance Premiums Written (EUR Billions)							
Life	27.45	29.20	27.40	29.86	26.71	25.91	25.32
Non-Life	32.78	32.10	30.97	31.20	31.04	30.35	30.70
Total	**60.23**	**61.30**	**58.37**	**61.05**	**57.75**	**56.26**	**56.02**
Change in Total Premium Volume (%)	7.98	1.78	-4.77	4.59	-5.42	-2.57	-0.44

Numbers may not add up due to rounding.
Sources: International Monetary Fund, World Economic Outlook Database, April 2015; Dirección General de Seguros y Fondos de Pensiones; A.M. Best data and research

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demand for Spanish products from European Union partners, and lower energy prices benefiting Spanish consumers. In recent years, the Spanish government has taken steps to make structural reforms, helping to re-balance the economy. Changes to its fiscal stance have supported employment creation and heightened business and consumer confidence, which has resulted in higher retail consumption and private investment. Following six years of recession, household consumption is recovering with improved spending patterns evident in the first half of 2015. For example, low inflation has helped boost disposable income and has assisted a rise in car sales.

The Spanish insurance sector experienced a slight 0.8% contraction in total GWP in 2014 and this continued in the first half of 2015 with a 4% fall when compared to the same period last year, according to Investigación Cooperativa entre Entidades Aseguradoras y Fondos de Pensiones (ICEA), which compiles and publishes industry statistics representing approximately 95% of the sector's premiums. Figures from the Spanish insurance regulator, Dirección General de Seguros y Fondos de Pensiones (DGSFP) estimated a 0.4% fall in total GWP in 2014; however, the decline was lower than that experienced in the previous two years, reflecting to some extent, the stronger economic backdrop (**Exhibit 1**). A.M. Best also notes that in the first six months of 2015, there has been a marked difference between the non-life sector, which increased year-over-year by 2.4%, and the life sector, which continued its correction in volumes endured during 2014 with a 12% fall in life premiums, according to ICEA.

Economic Improvement to Assist Non-Life Insurance Recovery

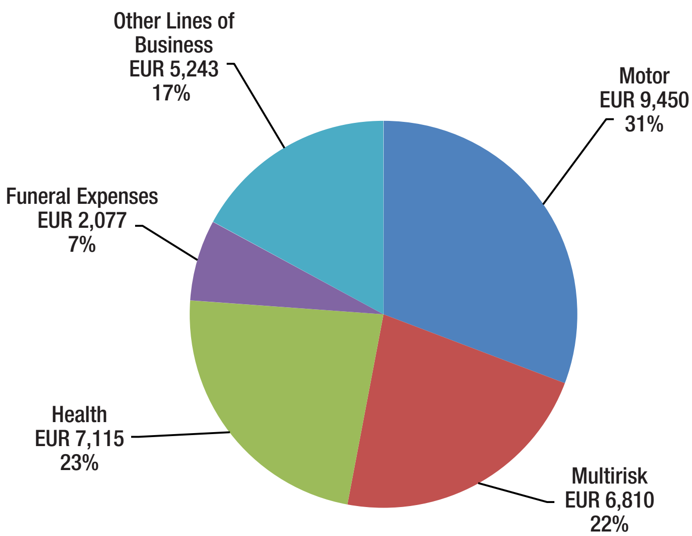
In 2014, the non-life sector grew for the first time since 2011, increasing by a modest 0.8% to EUR 30.5 billion, according to ICEA. DGSFP also estimated a rise, with a 1.2% increase in non-life premiums to EUR 30.7 billion. In A.M. Best's view, the non-life sector has been relatively resilient during a period of severe economic stress. Pricing dynamics have been very heterogeneous across different risk classes, with more cyclical lines of business such as motor insurance decreasing substantially in recent years, but other segments (like health) achieving positive year-over-year premium growth rates.

With regard to distribution channels, non-life products continue to be sold predominantly by agents and brokers. A.M. Best considers that selling the majority of their general insurance products through a network of exclusive agents allows insurers to generate more stable underwriting profits and helps them to build long-term relationships with customers.

Motor insurance accounted for 23% of total non-life GWP during the first quarter of 2015 and overall in 2014, motor accounted for 31% of GWP (**Exhibit 2**), broadly unchanged when compared to previous years

In 2014, rates for this line of business were flat, reflecting the intense competition among motor insurers. However, demand

Exhibit 2
Spain Non-Life – Direct Premiums by Line of Business, 2014 Premiums (EUR millions), Market Share (%)



Source: Dirección General de Seguros y Fondos de Pensiones dynamics are recovering; car registrations increased by 18% during 2014 and they are expected to grow in double digits in 2015 in response to more favourable developments in households' disposable income levels.

Profitability remains challenging, and A.M. Best estimates that the combined ratio for this class of business has fluctuated between 98% and 104% since the second quarter of 2012 up to the first quarter of 2015. Spanish motor insurers have taken the opportunity to invest in operational efficiencies, focusing on streamlining claims processing, damage valuations and strengthening their car repair networks. In A.M. Best's view, these improvements will provide some support to technical performance, partially offsetting the likely rise in claims frequency as a result of the effect of new sales and the increased use of the car for long distance trips supported by the more buoyant economic situation and low fuel prices. However, A.M. Best considers that margins will remain narrow in this line of business for the foreseeable future.

Widely anticipated new regulation for the assessment of damages in personal injury claims ('baremo') will result in significant cost increases for insurers, with predictions of awards more than doubling in some particular cases from January 2016. In A.M. Best's opinion, insurers have long been expecting this development as they have participated in the drafting of the legislation since its conception. While increased costs will be unavoidable, A.M. Best considers the regulation to be a positive development that brings greater certainty and clarity to personal injuries claims. Increases in motor insurance prices are likely to be gradual and the high level of competition will naturally cap abrupt rate hikes.

The second largest line of business in the Spanish general insurance market continues to be health insurance. During the first three months of 2015, health represented 23% of total GWP, which reflects seasonal purchasing trends and is in line with previous years. Health insurance premiums represented 13% of premiums in 2014.

In a muted consumer price inflation environment, health insurance rates have increased in real terms each and every year since 2011. Profitability for health insurance has remained steady for a number of years. A.M. Best estimates that loss ratios remain anchored in the mid-80% range, demonstrating that health insurance providers have been able to increase premiums to support performance. A.M. Best considers that pharmaceutical product costs have been the main driver of claims inflation, which is continuing to push up rates in this segment; however, insurers have managed to keep rate hikes within levels supportive of growth in a number of policies. A certain degree of appetite for consolidation in the private hospital space remains, which is likely to lead to further cost pressures for insurers if service providers increase their bargaining power, that has been traditionally very low against the largest health insurers.

Going forward, in A.M. Best's view, demand will continue to be supportive for the health sector on the back of improving economic conditions and the decreasing role of state-sponsored social benefits in response to fiscal budget constraints.

Funeral expenses outperformed other classes of business throughout 2014, although this remained a small part of the non-life sector, equating to 7% of total general insurance GWP. "Decesos" are a historical feature of the Spanish insurance market, providing a sum to pay for funeral services, and has benefited from consumers seeking the security it provides during uncertain times. A.M. Best expects decesos to continue to be an important part of the general insurance portfolio in the foreseeable future.

Overall, premium volumes in the non-life sector have been slowly recovering during 2015, and increased by 2% in the first quarter, but still remain below pre-crisis levels. Growth is fundamentally supported by the improvement in household disposable income levels. Expectations for the remainder of 2015 are optimistic, in line with more robust economic conditions.

Life Insurance Market Continues to Decline

Life premiums contracted by 12% in the first quarter of 2015 when compared to 2014, dragged down by low volumes of single premium business. This reflects consumer demand for higher yields than what insurers are able to offer in this low interest rate environment. On the other hand, regular premium contracts appear to be more resilient. Demand for savings and deposits are stronger due to higher contributions to pension plans, driven largely by public sector restructuring in recent years and demographic–led changes contributing to the perception that government retirement income security is insufficient. Other factors behind the growth in savings and deposits products are improving equity market performance and lower benefits payments. Deposits and unit-linked products are also receiving a boost from a desire for riskier products that offer greater yield potential.

Total life insurance premiums continued to decline during the first six months of 2015. After very positive growth in single premium savings products during 2011, the sector has been contracting in response to the effect of low interest rates hurting the attractiveness of life insurance as a guaranteed savings vehicle.

Spanish households continue to show a preference for more traditional investments, such as bank deposits, and bancassurance is still the predominant distribution channel for life insurance products. The recent restructuring and consolidation of the Spanish banking sector has substantially changed the picture with regards to exclusive agreements and other third-party arrangements to sell through bank branches. New technologies have enhanced the ability to reach out to potential customers, but Spanish consumers seem to be very reluctant to transform price comparison searches into final purchases of both life and non-life insurance products.

Although it will take some time to assess the effects of changes to the banking sector and their impact on distribution, in A.M. Best's view, life insurance product sales through bank branches will remain very important in the near future.

Profitability in the life insurance sector has remained broadly in line with previous years during 2014 and in the first three months of 2015 has only shown a minor deterioration. Life insurers are issuing new products that transfer a significant amount of the investment risk to the policyholder. This is helping insurers offset the negative effects from low interest rates impacting mainly legacy books.

Overall, A.M. Best considers Spanish life insurers well-placed to continue producing positive technical results. In the near future, significant demand pressures will remain and top-line levels will be depressed, in line with record low investment yields that will influence the value proposition of life insurance products. On the other hand, the fee business in which the investment risk is borne by policyholders, should benefit from the flight to yield and the growing belief among Spanish households of the need to start taking responsibility for their financial futures in light of the increasing challenges faced by public sector finances.

Spanish Insurance Sector Performance

While total GWP has contracted in the past few years, the Spanish insurance market has maintained its underwriting performance. According to A.M. Best's analysis, the sector had an average return on equity (ROE) of 14% between 2010 and 2014, fluctuating in a tight range of approximately 330 basis points. The traditional nature of Spanish management seems to be present in all domestic (re)insurers, and appears to be the reason behind what is fundamentally a risk-averse approach. In good times, prudence hurts margins and erodes competitiveness; meanwhile, in bad times, a cautious approach provides better rewards to all stakeholders involved.

In A.M. Best's view, the Spanish insurance sector continues to execute its business plans according to its traditional roots and remains relatively resilient. Although ROEs have come under pressure during the first half of 2015, Spanish insurers seem to avoid complicated formulas for growth or profitability, preferring the simplicity and reliability of a good wine over the paraphernalia of a fancy cocktail.

The capitalization levels of the Spanish insurance sector remained broadly unchanged during 2014. Sustained earnings levels and stable dividends have been the tonic of the market. Aggregated capital and surplus increased by 8% during 2014 in the context of stagnant GWP levels. Capital generation has received additional support since the beginning of 2013 from fair value items (particularly unrealised gains in "available for sale" securities), which is the accounting treatment most Spanish insurers choose to use to classify their fixed-income holdings.

Additionally, currency developments have been favourable during the last few months for Spanish insurers with consolidated entities in countries in which the exchange rate relative to the euro has increased as a consequence of monetary policy in the Eurozone and renewed geo-political risks during the early summer of 2015.

A.M. Best views these factors resulting in increases of risk-adjusted capitalisation levels, a natural consequence of the pro-cyclicality embedded into fair value accounting of fixed income holdings. Although the capital cushion is correctly valued, in A.M. Best's opinion, most insurers hold their fixed income investments until maturity and their investment decisions are largely driven by asset liability matching (ALM) and cash-flow matching considerations, which limit the real economic impact of swings in surplus accounting measures.

Moreover, the vast majority of Spanish insurers are in the advanced stages of implementing Solvency II, and some have been able to publicly report estimated ranges for their Solvency II ratios at year-end 2014. Spanish insurers are, in general, well-prepared for the new directive that will come into force at the beginning of 2016, although at the same time, the smaller players face substantial cost burdens in implementation.

Investment Portfolios Remain Conservative

The Spanish insurance market's preference for sticking to the basics is also reflected in conservative investment profiles. The latest data from the DGSFP shows a continuation of existing trends, with insurers investing more than two-thirds of their assets in fixed income securities. Bank deposits and money market placements remain as the second choice, followed by equities and real estate. In A.M. Best's view, the rationale to invest in fixed income securities is in the majority of cases driven by ALM rather than by opportunistic trades looking to take advantage of certain views on credit spreads.

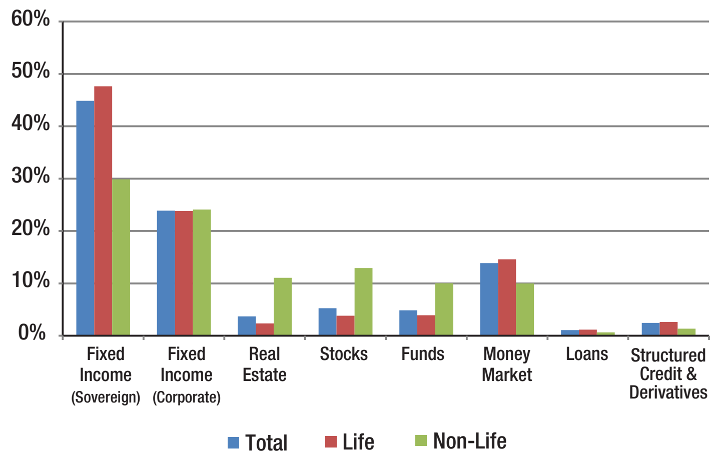
In recent years, the preference of insurance companies for domestic corporate debt has shifted toward sovereign paper. This has been driven by better than expected total return profiles, fuelled by a narrowing of spreads in line with improved economic and fiscal prospects in Spain. Additionally, supply side effects have contributed toward this trend, with outstanding Spanish sovereign debt securities increasing consistently since 2008.

In A.M. Best's view, the risk appetite of Spanish insurers as institutional investors remains stable and is not expected to change materially over the coming years. Domestic insurers are likely to explore alternative ways of increasing investment yield, but with a conservative approach. A.M. Best expects the weight of any alternative assets in investment portfolios will remain minimal.

The allocation of assets backing life liabilities did not change dramatically during 2014. Sovereign debt represents approximately half of investments, followed by corporate paper (which accounts for 24%) and money market instruments that make up 15% of the overall investment portfolio. Equity holdings represent 4% and real estate accounts for 2.3% of life insurance investments.

The different cash flow pattern of non-life insurance liabilities permits a slightly riskier allocation of assets backing non-life provisions, compared to life companies. However, Spanish insurers continue to demonstrate a low appetite for market risk. Fixed income (sovereign and corporate) remains the predominant asset class, adding up to more than half (54%) of investments (**Exhibit 3**). Equities, funds, money market instruments and real estate each represent slightly more than 10% of total non-life investments.

Exhibit 3
Spain Non-Life & Life - Investments
As of Dec. 31, 2014.



Source: Dirección General de Seguros y Fondos de Pensiones

Ratings Environment for Spanish Insurers Is Stable

Spanish insurers rated by A.M. Best display financial indicators that continue to exhibit signs of robustness. Operating margins in the sector contracted in the first three months of 2015, reflecting the effect of the challenging environment in life technical results. Overall, however, insurers have demonstrated the ability to withstand demand pressures on the back of a recessionary economic environment and pricing challenges coming from increased competition. Although risk-adjusted capitalization decreased during 2014, Spanish insurers' surplus levels are generally strong and debt leverage is not substantial.

A.M. Best rates a range of entities in Spain, with all Financial Strength Ratings (FSRs) and Issuer Credit Ratings (ICRs) comfortably within the investment grade range (**Exhibit 4**). Financial flexibility levels are generally good across all rated entities, with low or nil debt on the balance sheet and supportive majority shareholders.

Limited rating actions were taken by A.M. Best in Spain during the double-dip recession that started in 2008 and then again in 2011, which demonstrates the excellent capitalization of rated domestic participants. However, risk-adjusted capitalization levels after stress tests did decrease by the end of 2012, as a direct result of the exposure of Spanish insurers to domestic corporate and sovereign fixed income securities. Concerns related to the credit quality profile

Exhibit 4
Spain - Life & Non-Life - A.M. Best-Rated Companies
Ratings as of Oct.15, 2015.

AMB #	Company Name	Best's Financial Strength Rating (FSR)	Best's Long-Term Issuer Credit Rating (ICR)	Best's FSR & ICR Outlook	Best's FSR & ICR Action	Rating Effective Date
83556	Bilbao, Compañia Anonima de Seguros y Reaseguros S.A.[1]	A-	a-	Stable	Affirmed	20/2/2015
56998	Casiopea Re S.A.[2]	A-	a-	Stable	Affirmed	7/10/2015
83565	Compañía Española de Seguros y Reaseguros de Crédito y Caución, S.A.U.[1]	A	a	Stable	Affirmed	3/10/2014
86801	MAPFRE GLOBAL RISKS, Compania Internacional de Seguros y Reaseguros S.A.	A	a	Stable	Affirmed	14/10/2015
86277	MAPFRE RE, Compania de Reaseguros, S.A.	A	a	Stable	Affirmed	14/10/2015
85481	Nacional de Reaseguros, S.A.	A-	a-	Positive	Affirmed	22/9/2015
85823	Ocaso, S.A. Seguros y Reaseguros	A	a+	Stable	Affirmed	1/5/2015
84142	Seguros Catalana Occidente, S.A. de Seguros y Reaseguros[1]	A-	a-	Stable	Affirmed	20/2/2015
86153	Solunion Seguros de Crédito, Compañía Internacional de Seguros y Reaseguros S.A.	A-	a-	Stable	Assigned	22/9/2015

Notes:
[1] Owned by Groupo Catalana Occidente S.A.
[2] Captive based in Luxembourg, owned by Spanish company Telefónica
Source: BESTLINK Best's Statement File - Global, A.M. Best data and research

of The Kingdom of Spain have substantially dissipated in the last two years and the weighted average yield of 10-year sovereign bonds has contracted from 6.7% in July 2012 to historical lows of 1.0% in March 2015, according to data from the Bank of Spain. In A.M. Best's view, the investment exposure of domestic insurers to sovereign paper will continue to be substantial in the foreseeable future, driven by the local nature of the liabilities of the majority of Spanish insurers.

A.M. Best's country risk methodology analyses country-specific factors that influence the credit quality of insurers. A.M. Best has classified Spain as CRT-2 (Country Risk Tier 2) – the same as Ireland and Italy. There are five different CRT categories, with CRT-5 representing the countries with more risk and CRT-1 denoting the lowest degree of risk. Central to A.M. Best's rating methodology is the ability to differentiate levels of risk exposure among competing insurers in a given market. For this reason, rather than applying a blanket sovereign ceiling to all insurers in a country, a stress-testing approach is used. In A.M. Best's opinion, Spain has low levels of economic, political and financial system risk. The economy recovery is expected to strengthen into 2015 at a rate of 2.5%, driven largely by improved business and consumer sentiment, lower commodity prices and accommodative monetary policy.

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