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Investment Opportunities in the German Life Insurance Market

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The freedom-of-services rules established by the Third European Union (EU) Directive in 1994 allow an insurance company established in any EU country to sell into the entire EU, which, following the latest enlargement, comprises 27 individual countries. A number of European insurance companies are successfully using a cross-border approach to expand their business in this single market that has a combined population of nearly 500 million. While some European markets are approaching saturation, among the larger life insurance markets Germany stands out because of the relative lack of penetration by existing insurers.

The following article provides the reader with key information and background on the German life insurance market and discusses market opportunities for cross-border business into Germany.

WHY IS GERMANY AN INTERESTING TARGET MARKET?

Insurers based in a country with a saturated home market—which includes many of the insurance markets in the EU—are looking for international opportunities to further grow their business. Germany, located in the heart of Europe, is the largest economy in the EU and, with 82.5 million people, has Europe's second-largest population, after Russia. This makes Germany attractive to foreign companies as a target market. In addition, based on life insurance penetration, after Spain, Germany has the most growth potential of any market in Western Europe.

Growth in the life and pensions market in Germany will also be boosted by the large volumes of inheritance sums and maturing savings contracts that will be released during the coming years and will need to be reinvested. A survey performed by Delta Lloyd leads to an estimate for the payments to be made from maturing contracts of about €450 billion for Germany only until 2012.[1] Many insurance companies recognize maturing contracts as a good source for increasing their new business. Despite their efforts to retain these monies, however, insurance companies have had limited success to date, with only 11% of maturing contracts reinvested with the same provider,[2] and the vast majority are invested in alternative investments or with a different provider.

TABLE 1: LEADING LIFE INSURANCE MARKETS WORLDWIDE; PREMIUM INCOME, GDP, AND MARKET PENETRATION

	COUNTRY	PREMIUMS 2005 (IN USD MILLIONS)	GDP NOMINAL (IN USD BILLIONS)	MARKET GENETRATION (PREMIUMS / GPD)
1	UNITED STATES	517,074	12,487	4.14%
2	JAPAN	375,958	4,521	8.32%
3	UNITED KINGDOM	199,612	2,201	9.07%
4	FRANCE	154,058	2,101	7.33%
5	ITALY	91,740	1,713	5.36%
6	GERMANY	90,225	2,808	3.21%
7	SOUTH KOREA	58,848	809	7.27%
8	CHINA	39,592	2,226	1.78%
9	TAIWAN	38,808	347	11.18%
10	CANADA	34,456	1,130	3.05%
11	NETHERLANDS	31,914	624	5.11%
12	BELGIUM	31,026	371	8.36%
13	SPAIN	25,518	1,124	2.27%
14	SWITZERLAND	22,747	367	6.20%
15	INDIA	20,175	798	2.53%

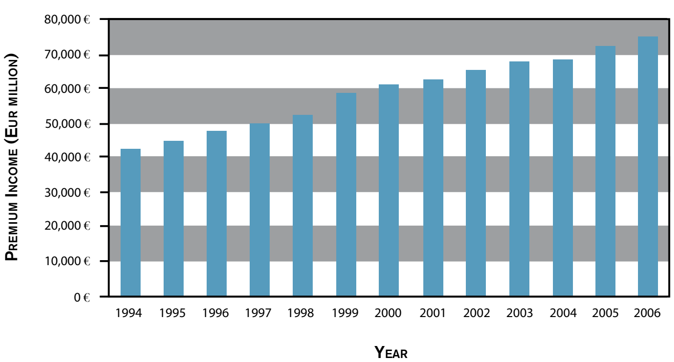
SOURCE: SWISS RE: SIGMA - WORLD INSURANCE IN 2005 (NO. 5/2006)

[1] SOURCE: BBW SURVEY AND OWN CALCULATION
[2] STUDY SMC MANAGEMENT CONSULTING 2006

WHAT DOES THE CURRENT GERMAN LIFE INSURANCE MARKET LOOK LIKE?

The German life insurance market offers a wide range of products that satisfy basic customer needs. Life insurance products are used as investment and savings vehicles as well as for financial protection, providing payments in case of death, disability, longevity, and illness. The market has grown steadily in recent years. The table below shows the overall development of premium income since 1994, when writing business on a freedom-of-services basis first became a possibility.

Chart 2: Life insurance premium income (EUR million)



Source: GDV

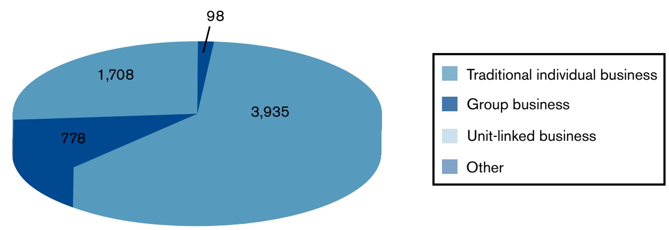
Investment and savings business is the most attractive market niche for insurers, although the coverage of the above biometrical risks gives life insurance products unique selling points compared with other types of investments.

Customers see life insurance products as long-term, secure investments. Products usually have a fixed end age on which the survival benefit is due for payment; for tax reasons, products usually have a term greater than 12 years. For short-term investments (up to five years), several other financial vehicles are available that are usually more attractive to customers in terms of flexibility and performance.

Most life insurance is regular-premium business, with a significant increase in single-premium business recently, due to tax changes introduced in 2005.[3]

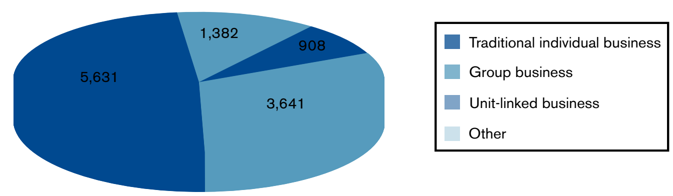
The tables below show the 2006 new business life insurance premium income split for regular- and single-premium business. This covers traditional and unit-linked products, as well as individual and group business.

Chart 3: New business premium income for 2006, regular-premium business



Source: GDV

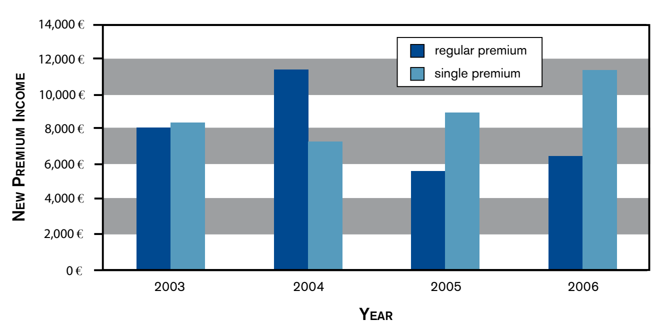
Chart 4: New business premium income for 2006, single-premium business



Source: GDV

During the last few years, the market has switched to a significantly greater share of single-premium business, as the following statistics show:

Chart 5: Development of new premium income, split by regular- and single-premium business



Source: GDV

[3] In 2005, a tax reform was enacted that treats regular-premium and single-premium products in the same way.

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In 2004, the regular-premium share increased significantly because of strong year-end business, which was prompted by the removal of most of the previous tax advantages for regular-premium life insurance for policies taken out after 1 January 2005. The tax reform also caused a temporary decrease in new business premium income, from €18.8 billion in 2004 to €14.7 billion in 2005. There was a rebound in 2006.

Often, single premiums are used to buy an immediate annuity or for medium-term investments, i.e., five to 12 years. The target customers for single-premium products are people aged 50 and older. Also, high amounts of inheritance sums and maturing contracts are boosting single-premium business.

All major market players in Germany offer traditional as well as unit-linked products. Allianz Leben, the life insurance provider of the Allianz Group in Germany, dominates the market with a market share of around 15%. The market is fairly fragmented with around 100 active life companies in total. Below is a table of the main players in German life insurance.

Table 6: Main players in the German life insurance market

Rank		Prem. Income (EUR bn)	Growth 2005/04	Group
1	Allianz Leben	12.23	+12.2%	Allianz
2	AachenMünchener	3.47	+7.2%	AMB Generali
3	R&V Leben	3.27	+6%	DZ Bank
4	Hamburg Mannheimer	3.06	-4.4%	Ergo/Munich Re
5	Deutscher Herold	2.88	+4.6%	Zurich
6	Debeka Leben	2.45	+12.5%	Mutual
7	Volksfuersorge	2.37	+0.9%	AMB Generali
8	Victoria Leben	2.16	-4.6%	Ergo/Munich Re
9	AXA Leben	2.05	+0.5%	AXA
10	Bayern Versicherung	1.87	+5.5%	Regional Public Insurer

Source: Milliman research

WHAT KINDS OF PRODUCTS DO COMPANIES OFFER?

The German life insurance market centres on two primary types of life insurance products. The main product features are largely determined by regulatory and tax requirements, which apply to companies that are subject to German financial supervision.[4] These usually are not relevant for companies selling via freedom of services, but we mention them here to give an overview of the market.

Traditional products

A traditional with-profits product is a regular- or single-premium contract that provides a guaranteed maturity value. The two main types are endowments and annuities, both deferred and immediate.

The products currently open for new business have an annual 2.25% technical interest rate guarantee (reduced from 2.75% at the start of this year), which is applied to aggregated savings premiums[5] and the annual profit-sharing account.

The savings premiums are invested in an internal fund that has a low equity content, currently less than 10%[6] (although legally up to 35% is allowed for German life insurers). The majority of the premiums are invested in bonds and real estate. The investment risk is borne by the company.

Various rider products are available, e.g., disability income and waiver of premium and sometimes additional life insurance as a rider.

Traditional products have a profit-sharing "buffer" (RFB) that the company can use as a source of additional finance to pay out the required level of profit sharing if investment returns are less than expected. Or they can pay in amounts when returns are higher than the amount needed to finance the required bonus rates. This smooths the annual performance and restricts greater movements in bonus rates.

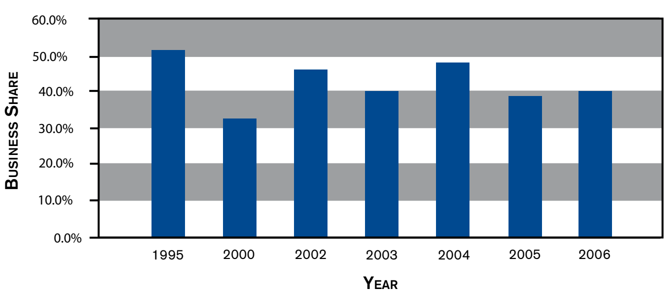
Profit sharing arises from investment, expense, and biometrical gains. It is a legal requirement that at least 90% of the investment gains and a reasonable share of the biometrical and expense gains be allocated to the RFB.[7]

[4] Insurers selling through a branch or via freedom of services are subject to financial supervision by their home country, i.e., the country where their parent company is located
[5] Premium after costs and risk cover charges
[6] Market average
[7] ZR-Quotenverordnung

German accounting rules allow for hidden reserves in the balance sheet, which is the difference between book and market value of assets. This is an additional financial risk-management tool for the appointed actuary.

The following table shows the development of the market share of traditional individual new business.

Chart 7: New business share of traditional individual business



Source: GDV

Unit-linked products

A typical unit-linked product is a regular- or single-premium contract, where the policy value is based on the value of the underlying investments. Previously no guarantees were generally provided, e.g., at maturity or on surrender, but in recent years companies have introduced various types of solutions to meet the demand from consumers and intermediaries for investment guarantees.

Companies offer a wide range of funds for the investment, including externally managed funds, particularly in the broker market. Usually there is a limit of five different investment funds per contract.

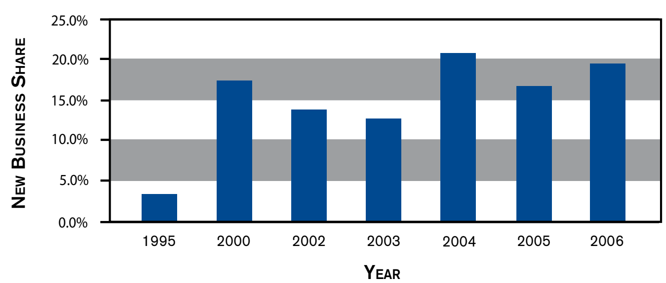
The two main unit-linked product types are endowment and annuity products. Both product types cover biometrical risks, i.e., endowment products basically cover mortality risk and annuities longevity risk.

As for traditional products, various rider products are available.

The main differentiation between competitors from a product point of view is the fund choice and level of guarantees.

Unit-linked products do not have an RFB, and there are no hidden reserves. In some cases, profit sharing is applied, e.g., on expense loadings. Because of customer demand for more attractive investment performance, the insurance industry increasingly focused on unit-linked products in the mid-1990s. Nevertheless, the share of unit-linked products remains low compared with many other EU markets, due to the relatively cautious attitudes of German savers. The following table shows the development of the unit-linked new business market share.

Chart 8: New business share of individual unit-linked business



Source: GDV

After the stock market decline in 2001, unit-linked products lost some market share because customers lost confidence in equity investments. Sales increased again after 2003 with the recovery in financial markets.

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Table 9: Summary of main product type characteristics in Germany

PRODUCT	GUARANTEES AT MATURITY	CURRENT GUARANTEED TECHNICAL INTEREST RATE (TIR)	SURRENDER VALUES	PROFIT SHARING	RIDERS
TRADITIONAL ENDOWMENT	GUARANTEED MATURITY VALUE	2.25% (PRESCRIBED BY THE REGULATIONS)	PRESCRIBED BY THE REGULATIONS: THE GUARANTEES ON SURRENDER VALUES ARE DETERMINED ANNUALLY AND ARE BASED ON THE TECHNICAL RESERVE APPLYING THE TIR (2.25%). SURRENDER PENALTIES MAY BE DEDUCTED.	PROFIT SHARING ARISES FROM INVESTMENT, EXPENSE, AND BIOMETRICAL GAINS AND IS GIVEN TO THE POLICYHOLDER IN ACCORDANCE WITH THE LEGAL REQUIREMENTS.	DISABILITY, ACCIDENT, LIFE
TRADITIONAL ANNUITY	GUARANTEED ANNUITY; OFTEN THERE IS ALSO THE OPTION TO CHOOSE A GUARANTEED MATURITY VALUE INSTEAD.	2.25% (PRESCRIBED BY THE REGULATIONS)			
UNIT-LINKED ENDOWMENT	USUALLY NO INVESTMENT GUARANTEES BUT THESE CAN OPTIONALLY BE INCLUDED, E.G., GUARANTEED FUNDS.	NO GUARANTEED RATE ON PURE UNIT-LINKED	NO GUARANTEED SURRENDER VALUES ON PURE UNIT-LINKED	IN GENERAL, NOT USED (PROFIT SHARING IS APPLIED ONLY IN SOME CASES, E.G., ON EXPENSE LOADINGS).	
UNIT-LINKED ANNUITY	USUALLY NO INVESTMENT GUARANTEES BUT THESE CAN OPTIONALLY BE INCLUDED, E.G., GUARANTEED FUNDS. A GUARANTEED ANNUITY CONVERSION FACTOR IS SOMETIMES INCLUDED.				

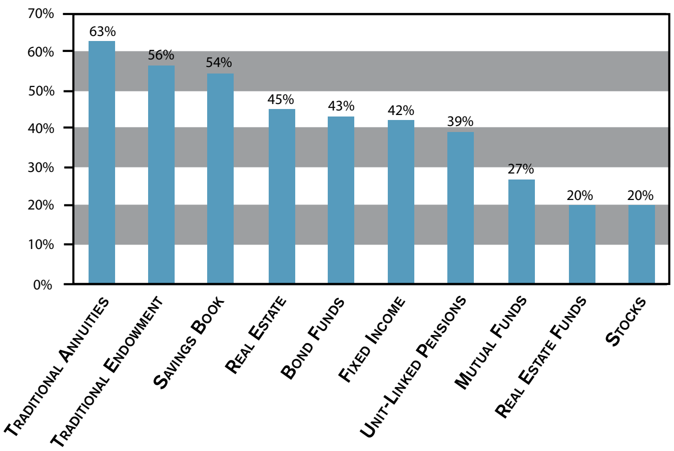
Source: Milliman research

Attractiveness of saving for retirement vehicles

As shown in chart 10 on the next page, traditional endowment and annuity products have a great importance in Germany's private retirement sector. Unit-linked pensions also have gained consumer acceptance in recent years. As in many other EU countries, over the next few decades, a large percentage of the German population will reach retirement age, but these people will not be able to rely on state pensions to the extent they do now. Currently, state pensions represent around 72% of the average net income of pensioners, compared with 19% from private savings and 4% from occupational pensions.[8] These demographic changes obliged the government to introduce pension reforms starting in 2002, to reduce the level of state pensions and encourage private pension provision, supported by tax incentives. This should lead to an increase in personal financial management and growth in annuities and unit-linked products in the coming years. Already, pensions business represents nearly half of all regular-premium new business for the German life market as a whole.

[8] Source: DIA

Chart 10: Summary of private pension product types in Germany



Source: Versicherungsjournal, 2007

HOW DOES DISTRIBUTION WORK?

In Germany, several distribution channels exist. The table below describes the main ones.

Table 11: Distribution channels for life insurance products

MAIN DISTRIBUTION CHANNELS IN GERMANY	DESCRIPTION
TIED AGENTS	FOR THE LIFE INSURANCE MARKET AS A WHOLE, TIED AGENTS STILL DOMINATE WITH AN OVERALL ESTIMATED SHARE OF 40% TO 45%.
BANCASSURANCE	THE LEADING COMPANIES MOSTLY HAVE AN EXCLUSIVE BANCASSURANCE PARTNER; EXAMPLES (BANK/INSURANCE COMPANY): DRESDNER BANK/ALLIANZ, VOLKSBANKEN/R+V, DEUTSCHE BANK/ ZURICH, HVB/ERGO.
BROKERS/ MULTI-TIED AGENTS	BROKERS AND MULTI-TIED AGENTS DOMINATE IN UNIT-LINKED DISTRIBUTION, WITH A SHARE OF CLOSE TO 50% BASED ON NUMBER OF POLICIES, ACCORDING TO AN ANNUAL MARKET SURVEY. LEADING FINANCIAL ADVISER FIRMS INCLUDE DVAG (TIED TO AMB), AWD, MLP, AND OVB.
DIRECT	THIS HAS A SMALL SHARE. THE BIGGEST MARKET PLAYER IN THIS SECTOR IS COSMOS LEBEN (PART OF THE AMB GENERALI GROUP) WITH AROUND €1 BILLION PREMIUM INCOME IN 2005.

Source: Milliman research

The following statements elaborate on the table:

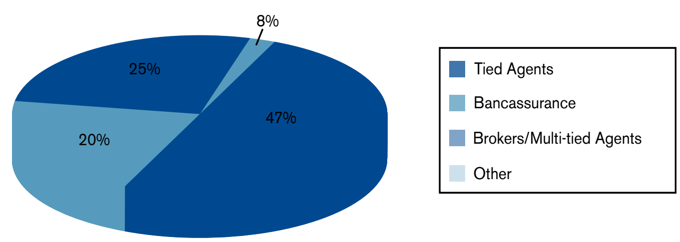
- The most important distribution channel for the larger insurance companies is the tied-agent channel. Similarly, the larger companies also tend to dominate in bancassurance distribution (as an example, see the distribution split of Allianz Group in Germany below).

- A few large companies (e.g., Allianz) are also major players in the broker market, but the tied-agent channel tends to be the main distribution channel for medium-sized and smaller insurance companies, which usually lack the scale or resources to build their own national tied-agent channel. Brokers and financial adviser networks are also often the main channel for new entrants in the German market.

- A small number of insurance companies are specialised direct insurers; they distribute their business mainly through call centres and via the Internet.

- Some regional state-owned insurance companies also operate via tied agents and bancassurance, but only with a regional presence.

Chart 12: Relevance of distribution channels for Allianz group



Source: Annual report 2006 Allianz group, page 37

As mentioned, unit-linked business has attracted increasing interest because of the performance of the stock market in recent years. It is noticeable that in this segment brokers and multi-tied agents have a much higher market share than in the traditional segments (especially endowments).

WHAT ARE THE KEY EU REGULATORY RULES?

The regulation of EU insurance markets reached a milestone in 1994 with the implementation of the Third Directive. In addition to introducing deregulation in more tightly regulated markets such as Germany, the most important element of the directive is the single-passport principle. This makes cross-border business possible, allowing companies based in the EU to write business in any other

EU country from their home country (freedom of services) and thereby establishing a common EU insurance market. Insurers also have the right to write business in another EU country by establishing a branch in the target country.

Both methods require supervision by the insurance supervisory authority of the home country. For example, a company with its head office in Ireland selling business on a cross-border basis in Germany is supervised by the Irish financial regulator; if based in Luxembourg, it would be supervised by the Luxembourg regulator.

Because some countries take a more flexible approach to insurance supervision than Germany does, there can be important regulatory advantages for companies writing business on a cross-border basis.

Ireland, Luxembourg, and to a lesser extent Liechtenstein[9] have since become popular locations for companies that have established insurance subsidiaries to write business on a cross-border basis in Germany and other EU markets. Even some German companies have established Luxembourg subsidiaries in order to sell business back into Germany.[10] Taxation is another important attraction because these three countries have the lowest tax rates in the EU.

Companies selling on a cross-border basis are subject to consumer protection requirements and policyholder taxation rules applicable in the target country, regardless of whether the company sells via freedom of services or via a local branch.

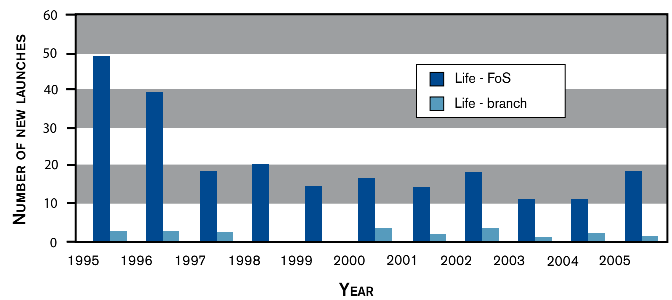
If companies base their cross-border operations in countries like Ireland, Luxembourg, and Liechtenstein, the authorities usually require that administration be performed in the home country. Some customer servicing is done in the target country, as it is easier to access local language skills. Also, sales functions are usually based in the target country.

Most companies deciding to sell into EU countries on a cross-border basis apply the freedom-of-services approach because it is easier to adopt and also cheaper than establishing a branch in the target country. Nevertheless, a few companies have decided to adopt the branch approach, mainly in order to provide more extensive service and support to local distributors and customers.

For non-EU-based companies that decide to expand their business into the EU, the simplest approach is to establish a subsidiary in any EU country—if they don't have one already —and to sell into the entire EU through freedom of services.

The following table shows the number of new companies that have launched cross-border business into Germany since the Third Directive in 1994.

Chart 13: Launches of cross-border life insurance business into Germany



Source: GDV

The table shows that the vast majority of new launches choose the freedom-of-services (FoS) option rather than a branch approach. After the deregulation in 1994, many companies took the opportunity to sell life and non-life business into Germany. The number of new launches has since fallen, but there remains a steady number of new players.

Several companies that write cross-border business in Germany are also active in the Austrian life insurance market. There are synergies available for insurance providers because of the strong similarities between the markets in terms of products, distribution, and regulations, as well as language.[11]

WHAT ARE THE MARKET OPPORTUNITIES?

- In the savings and investment segment, the market tends to focus on flexibility and higher-performance products. Innovative unit-linked products that can offer attractive investment performance but combined with optional investment guarantees will attract the broadest potential market.
    - An interesting example is AXA, which in 2006 launched the first variable-annuity type product in Germany, designed for the retirement savings market. The product is written on a cross-border basis from Ireland, and AXA has applied its successful US experience with its "Accumulator" product to launch similar products in other EU markets.

[9] Liechtenstein is not part of the EU but part of the EEA (European Economic Area), which allows companies to sell into the EU countries from Liechtenstein as well.
[10] i.e. R+V, Ergo Group, Talanx Group
[11] Clerical Medical (UK) and Standard Life (UK) are examples.

  - Another example of a new entrant is Royal London, a UK insurance company that began writing business in Germany in 2002 and still offers just one main single-premium unit-linked product. In 2006, it reached a premium income of almost €100 million, distributing via three big broker firms and only a small local sales support staff.

- The demand for private pensions business will remain strong because of demographic changes, high consumer awareness, and the tax incentives available.

- Given the high volumes of maturing life insurance and other investment contracts, the market segments aged 50+ and 65+ will become more interesting for life insurance companies.

- Because of the demographic trends, products for elderly people, immediate annuities and protection products such as long-term care and health products become more attractive.

- The decrease of state benefits for disability will increase the demand for protection products for ages 30-50, e.g., disability and critical illness policies.

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