**Dagong's 2017 Credit Outlook for the Global Insurance Industry**

Global insurers' credit risks are expected to increase in 2017. The extremely complex operating environment is characterized by an ultra-low interest rate intertwined with rate hikes by US Federal Reserve. Insurers' profitability continues to be under pressure due to varying interest rate sensitivity; the rising of underwriting investment pressure, as well as other uncertainties such as investment risk appetite, have not yet decreased, thereby rendering insurer's capability to resist risks as weakening. Meanwhile, the already stressed global insurance industry will be further challenged due to the transformation of the European insurance market, which has been induced by Brexit's (the UK's exit from the EU) commencement in 2017, and an increasingly volatile global financial market suggestive of evidently escalating worldwide uncertainties.

**I. Global insurers' credit risks will increase, although finding some variance, with rising global economic uncertainty and a prolonged ultra-low interest rate in 2017.**

The prolonged low interest rates in developed countries, along with rising global economic uncertainty, will continue to push up global insurers' credit risks in 2017. Furthermore, global monetary policies will more noticeably be differentiated, with the euro zone and Japan continuing their unconventional loose monetary policies, due to the lack of endogenous economic growth and domestic deflationary pressures. Meanwhile, the US Federal Reserve's accelerating rate hikes to improve domestic economic fundamentals will place pressure upon the stability of the exchange rates of emerging markets and thus lower their interest rate policy. However, taking high domestic debt pressure into account, which will render the US Federal Reserve increasingly prudential in rate hikes, developed countries will continue their comprehensive low interest rate policies, resulting in downward pressure upon investment yield and the continued erosion of profitability for insurers in developed countries, thereby consequently increasing their credit risk. Meanwhile, emerging economies will continue to be the main driving force for the global insurance industry in 2017, although major economies (such as China, Brazil, and South Africa) will continue to confront economic downturn pressure due to rate hikes by the US Federal Reserve, further structural reforms in China, as well as their own increasing political risks and declining anti-risk capability, which will increase policyholders' prudence and result in insurers' limited overall profitability, consequently increasing their credit risk.

The credit risks of insurers in major countries and regions will be significantly prominent due to varying interest rate sensitivity as well as political and economic uncertainty. In general, the interest rate sensitivity of insurers amongst differing regions of the world varies as a result of varying percentages of interest rate sensitive products, guaranteed interest rates, trends of domestic long-term bond yields, gaps in duration of both assets and liabilities, as well as space to adjust guaranteed interest rates. The guaranteed interest rate of long-term life insurance products amidst a low interest rate environment is typically not easy to be adjusted due to competitive pressure[1]. Therefore, insurers will bear greater interest rate risks with high debt costs, causing them to increase their investment risk preference and consequently their own credit risk.

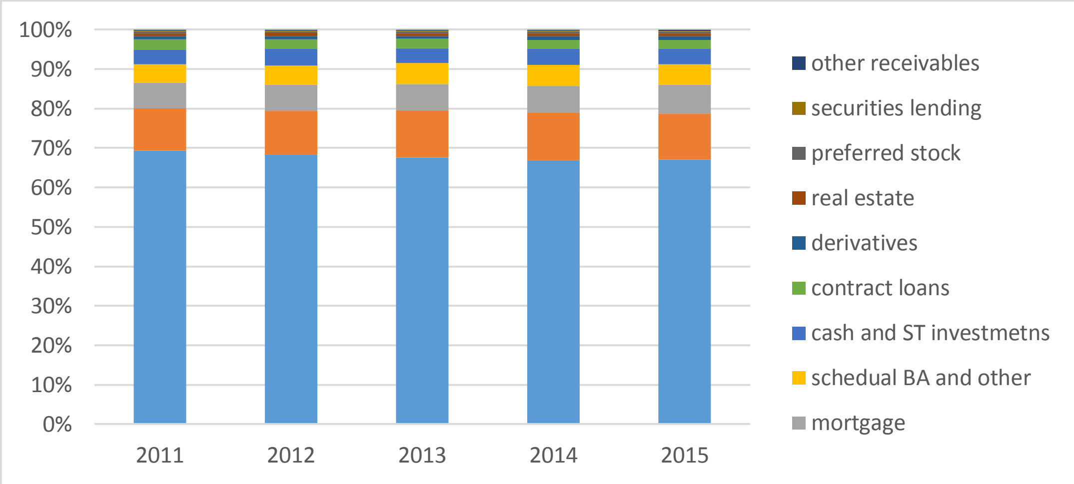
Amongst the world's leading insurance markets, Germany, the Netherlands, Taiwan, Japan and South Korea will face a greater risk of deterioration in both profitability and capital amidst the low interest rate environment of 2017 due to their high interest rate sensitivity. In addition, taking Brexit's commencement in 2017 and uncertainty in political elections amongst Eurozone's core countries into account, the competitive landscape of the European insurance industry may witness a huge transformation in the medium-term.

**II. The US Federal Reserve’s accelerating rate hikes along with improving domestic economic fundamentals help alleviate insurers’ credit risk, although the decreasing premiums render property insurers’ credit risks under pressure.**

The continuing improvement in the US economy and the Federal Reserve’s progressive rate hikes will ease pressure upon insurers’ profitability to a certain extent, with life insurers’ credit risks steadily declining. In 2017, the US' macroeconomic fundamentals will continue to improve and interest rates will trend upwards, which will release previously accumulated credit risk to certain extent, and life insurers’ credit risk will more noticeably decrease due to their significantly higher interest rate sensitivity in comparison with property insurers. Since the global financial crisis, prolonged low interest rates have compressed the downward space of guaranteed interest rates of US life insurers’ business balance, rendering their profitability to face increasingly severe challenges. Therefore, US life insurers try to mitigate the effects upon profitability of low interest rates by hedging interest rate risk, actively managing investment and re-pricing new policies, as well as stabilizing their investment income by means of increasing their investment risk preference, resulting in an increased exposure to high-risk assets and the continued accumulation of credit risk (Figure 1). Although in 2017 strong economic growth and rising inflation expectations will accelerate the rate hike by the US Federal Reserve, considering that the current interest rate is still at a low level, insurers’ risk appetite will further be pushed upwards. However, life insurers’ exposure of high-risk assets is limited, and upwards inflation expectations for the US in 2017 are anticipated to stabilize the trend of steep bond yields, which have been active since the end of 2016, ultimately aiding life insurers in particular to increase the investment spread. It is expected that risks accumulated amidst the previous prolonged low interest rate environment will be alleviated to a certain extent and that life insurers’ credit risk will steadily decline.

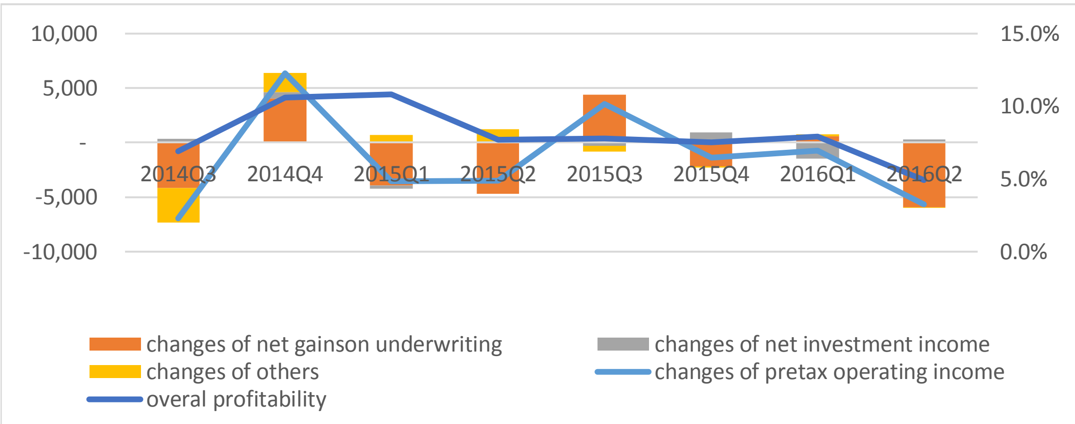
[1] See the Dagong’s report "Credit Outlook for Global Insurance Industry 2016” released in March 2016.

Figure 1 US Life Insurance Investment Portfolios (%)




Source：NAIC，Dagong

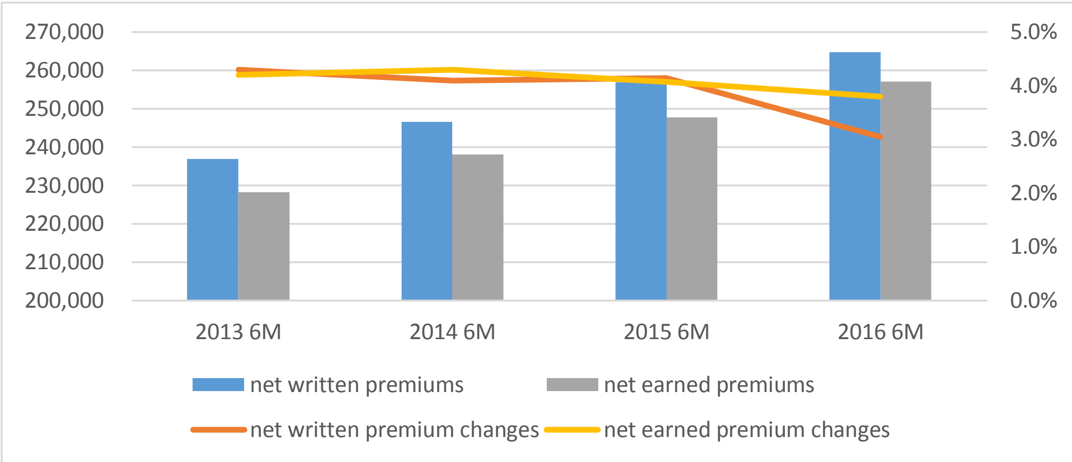
Figure 2 US Property Insurance Investment Portfolios (Million, %)




Source：Verisk，Dagong

US property insurers' anti-risk capability is weak on behalf of their profitability structure, and currently declining premium rates will continue to render their credit risk under pressure. During the prolonged low-interest-rate period, US property insurers have coped well through active investment management without large investment income fluctuations (Figure 2), although the underwriting performance with a limited premium rate will remain as the biggest threat to stable profitability in the future. Considering US property insurers' abundant underwriting capacity in 2017, premium rate competition continues to be very intensive and premium rates are expected to decline in the future and perhaps accelerate their decline, along with the expectation of natural disaster losses to return to their long-term average. Therefore, premium income growth will continue to slow down as it did in 2016 (Figure 3) and the risk of deterioration in underwriting profitability will increase, which could continue to impact property insurers' overall profitability even with a relatively stable return on investment. In summary, US property insurers' credit risks will continue to be under pressure in the near future.

Figure 3 US Property Insurance Net Written Premiums and Net Earned Premiums (Million, %)




Source: Verisk, Dagong

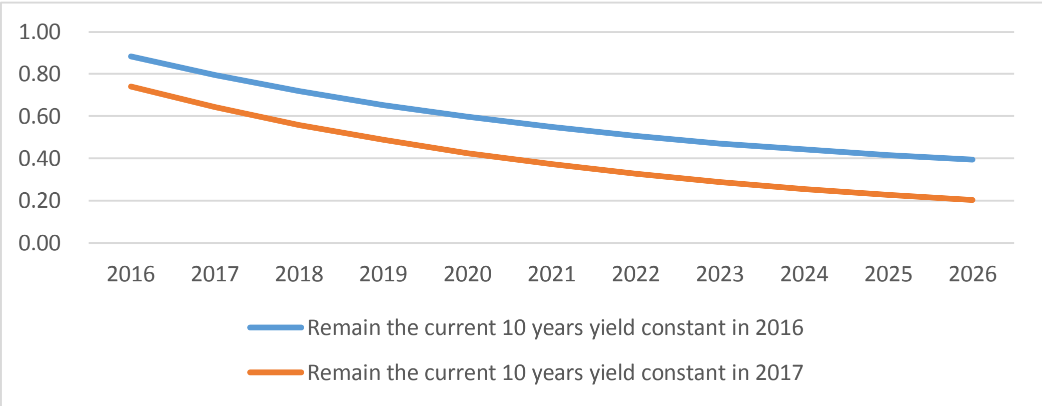
## III. In an ultra-low interest rate environment, credit risk of the Japanese insurance industry will rise due to profitability pressure and the increase of liquidity risk.

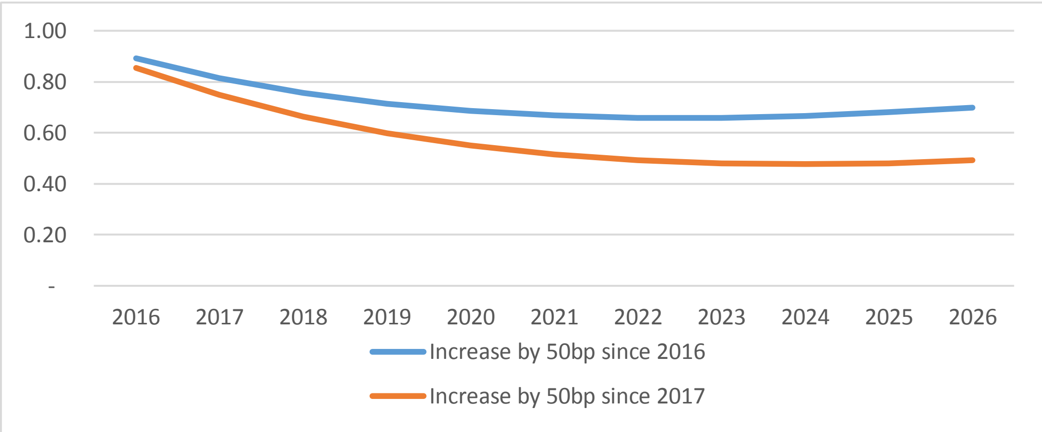
In an ultra-low interest rate environment, credit risk of the insurance industry is expected to further accumulate due to impaired profitability. Life insurance accounts for a large proportion of profit in the Japanese insurance industry and the percentage of interest-rate-sensitive products in life insurance is high (approximately 75%). As affected by an ultra-easing monetary policy, the guaranteed rates of Japan's currently employed life insurance policies are much higher than the yield of Japan's long-term government bond. In 2016, a negative interest rate policy was introduced by Japan's Central Bank. In September 2016, the objective of the monetary policy was adjusted to control short-term interest rates, with the target yield of 10-year government bonds being set at 0%. Constrained by the sluggish structural reformation, the Central Bank will continue imposing its ultra-easing monetary policy due to the lack of an endogenous economic growth momentum and deflation pressure. Seeing how Japan has entered the era of negative interest rates, Japanese life insurers attempt to progressively reduce the guaranteed rates of new policies, although under competitive pressure it is challenging for them to completely transfer the impact of negative interest rates to customers. Therefore, the profitability of Japanese life insurers will be squeezed, which is detrimental to its capital level.

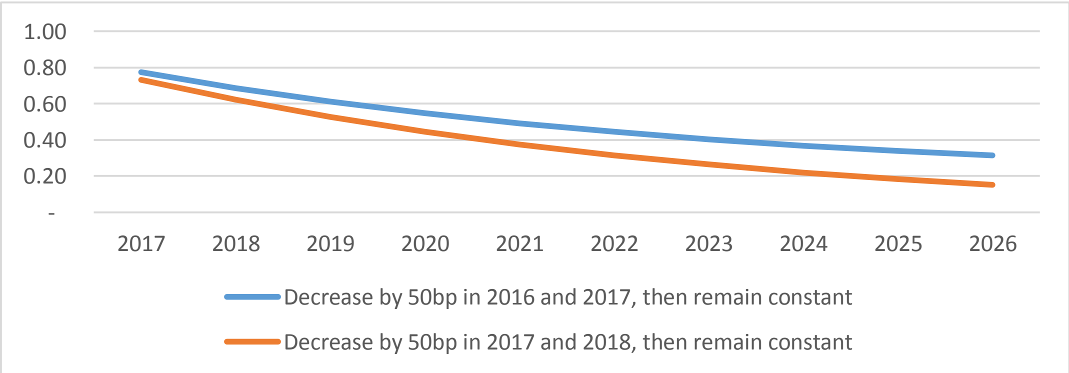
Meanwhile, a decline in the return of investment portfolio, as triggered by ultra-low interest rates, will impose increasing pressure upon the profitability of insurers. The continuous decline in long-term yield will prolong the time required to restore previous investment return. Three scenario analyses are conducted with the appropriate assumptions. (Figure 4)
Scenario 1: Remain the current 10 years yield constant in 2016/2017
Scenario 2: Increase by 50bp since 2016 and 2017
Scenario 3: Decrease by 50bp in 2016 and 2017, then remain constant, decreasing by 50bp in 2017 and 2018, then remaining constant

In the second scenario, approximately a 200 bps decline in the 10-year treasury yield will prolong the downward pressure posed by low interest rate upon fixed-income portfolio by 1-2 years, up to 9 years. With the expectation that long-term treasury yields still bear a high downward pressure, Japanese insurers need longer time to restore their previous investment return.

Figure 4 Japan Fix Income Portfolios Analysis (%)



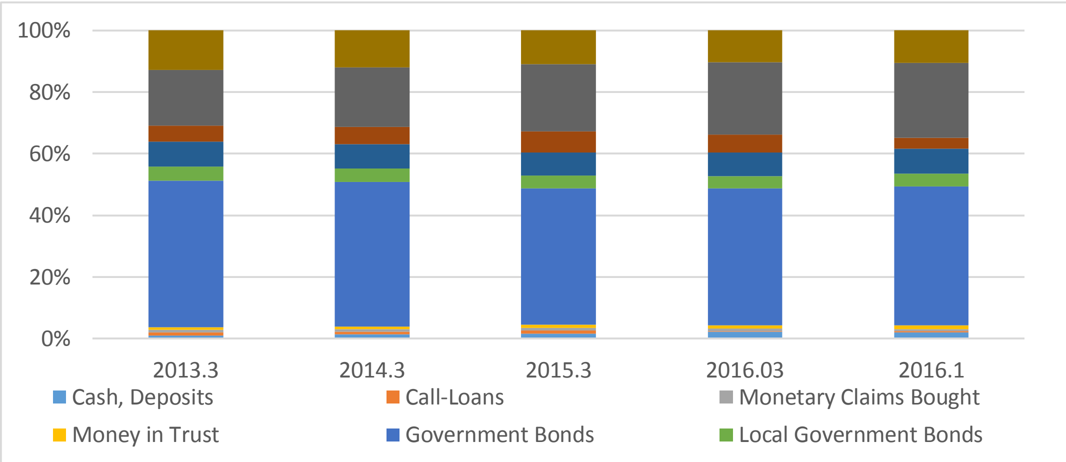




Source: Bloomberg, Dagong

Assumptions: the reinvestment proportion of Japan, are 10.0%, 10.0%, 10.0%, and15.0% respectively; Incremental investment proportion are 4.6%, 5.0%, 5.0%, and 10.0%;the yields to maturity of 2016 outstanding fixed-income investments equal to the 10-year average yield to maturity of government bonds.

In addition, due to profit pressures, a rising investment risk appetite increases the credit risk of the industry as a whole. In order to mitigate the narrowing profit margin caused by a negative-interest-rate policy, Japanese life insurers are expected to continue extending the portfolio duration and increasing allocation to high-risk assets. Both measures will further worsen the credit risk of life insurers. For many years, Japanese life insurers have extended the portfolio duration by purchasing long-term treasury bonds, reducing the asset-liability mismatch gap to 2-3 years. The negative-interest-rate environment will result in a worsened operating environment, forced by operating pressure, small and medium-sized life insurers will allocate excessive long-term risky assets, increasing the asset-liability mismatch risk, thereby exposing the company to higher liquidity risk. In terms of asset allocation, since the beginning of the ultra-low interest rate environment, the investment strategy of Japanese life insurers has generally been robust and portfolio allocation has remained stable (Figure 5), however it is large foreign asset allocation and other active high-risk investment operations which will increase the credit risk of the industry as a whole.

Figure 5 Japan Life Insurance Investment Portfolios (%)



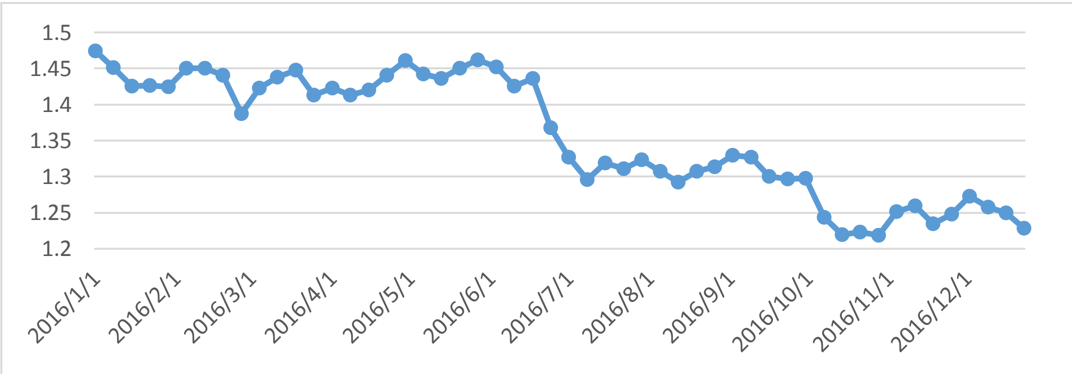

Source: LFJ, Dagong

**IV. Affected by the current low interest rate environment and political events, the UK's economy is experiencing great downward pressure, exposing insurers to increasing credit risk.**

Affected by the prevailing macroeconomic downturn in developed economies and a low interest rate environment, the growth prospects of the UK in 2017 are grim. The growth of insurance premiums of the insurance industry are expected to decline significantly, with factors of political instability such as Brexit exposing the UK's insurance industry to increasing credit risk.

The initiation of Brexit in 2017 has a limited impact upon the credit risk of the UK's insurance industry. In 2017, the UK will start its Brexit negotiations. Seeing as how the time of commencement, method of withdrawal, and specific details are not yet clear, the wait-and-see atmosphere prevails throughout the market. It is not entirely possible that financial institutions will exit the UK on a large scale before the situation is made clear. Since the UK non-life insurers' business is mainly focused upon the domestic market, while life insurers operate globally with a diversified geographical footprint, their reliance upon the EU for business is not excessively high. Therefore, Brexit has a limited impact upon UK insurers. Foreign insurers which make use of the UK as their single access into the EU market are most strongly influenced. Nevertheless, the UK will lose the right to access the EU single market following Brexit negotiations, which is adverse to its business in the EU. However, the UK government will secure the status of London as an international financial center by imposing a freer trade policy. By that time, the UK insurance industry is expected to have greater development opportunities outside the EU market and benefit from it.

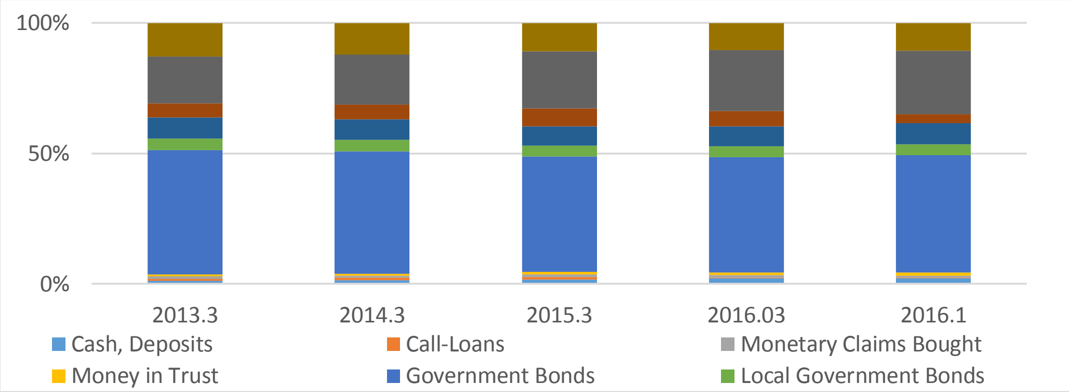
Figure 6 GBP/USD Exchange rate




Source：Bloomberg，Dagong

Global economic uncertainty is rising and the financial market will affect British insurers' investment income threat in credit risk. In recent years, British insurers have been forced to increase trust fund exposure which is mainly comprised up of stocks amidst a long-term low interest rate environment. During 2008-2014, the percentage of unit trust portfolio has increased from 11.9% to 19.1%, further uplifting British insurers' credit exposure. Future negotiations concerning Brexit and the rate hike by the US Federal Reserve will further increase global financial uncertainty, and market volatility is expected to rise again, thereby threatening the stability of British insurers' investment performance. Meanwhile, low interest rates in recent years have forced British insurers to increase the proportion of overseas asset allocation, given that market concerns concerning economic development following the UK's Brexit will again to force the British pound into a depreciation channel in 2017 (Figure 6), and the rate hikes by the US alongside Chinese economic restructuring will increase global economic uncertainty. In the future, British insurers' overseas assets will be under pressure, and overseas assets will be allocated to the US and other countries experiencing a stable economic environment.

Figure 7 British Insurance Investment Portfolios (%)



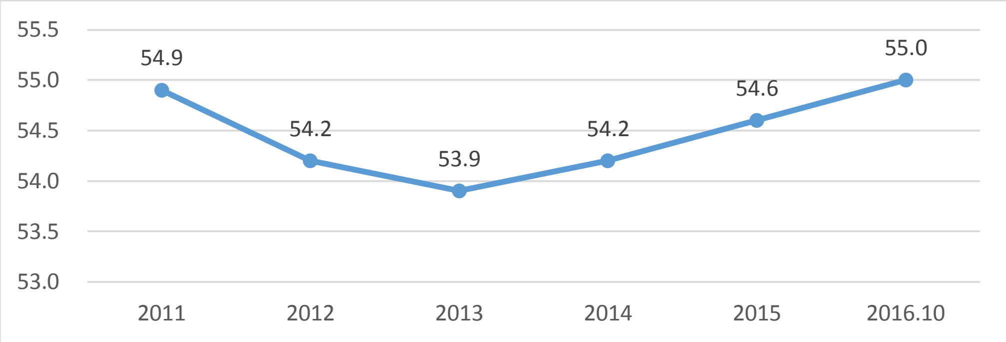

Source: ABI, Dagong

**V. Credit risk upon the Chinese insurance industry will increase in the short-term, while a higher industrial concentration ratio and tighter industrial regulation will contribute a promising improvement to its overall credit risk.**

The expanding trend of vehicle insurance reformation and the slowing trend of vehicle sales will result in a negative impact upon the efficiency of coverage ability, threatening the possible credit risk of property insurance in the short-term, with the possibility of future amelioration. The amount of vehicle insurance premiums in China affects the overall performance in the insurance market as it hovers around 72%. Overall, there are 32 cities or provinces[2] successively incorporated into the reform experimentation of premium rate progress, and seeing how further reform expansion will continue in 2017, a lower premium rate is be prospected as an increasing trend of fierce competition amongst property insurance companies ensues, which will largely be occurred in around the area of premium rate and services. The settlement of purchase tax has caused a significant reduction of vehicles prior to 2016 and it is predicted that China's vehicle sales growth will substantially decline to 6.5% in 2017. Therefore, the pressure caused by the opposing movement between vehicle insurance rate and compensated payments to cover services can hardly be neutralized through the blooming scale of insurance premiums, and this dual pressure will continue to impede the growth rate of premiums in 2017 (Figure 9). Additionally, the short-term industrial credit quality will also be confronted with a downside risk. Amongst increasingly fierce competition, the ability of remarkable cost control and claims services will be strong guarantees to enhance the competitive advantage for companies as a commercial union (Figure 8), and the long-term industrial credit quality will be elevated as the upsizing trend of insurance company continues in the future.

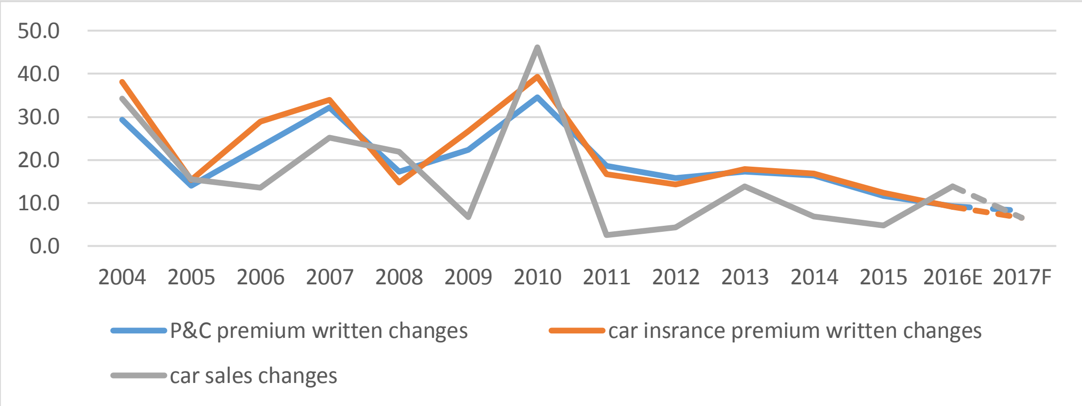
[2] The first batch: Heilongjiang, Shanxi, Shandong, Chongqing, Qingdao and Guangxi; the second batch: Tianjin, Jilin, Inner Mongolia, Henan, Anhui, Hubei, Hunan, Guangdong, Sichuan, Qinghai, Ningxia and Xinjiang; the third batch: Beijing, Shanghai, Tianjin, Chongqing, Hebei, Shanxi, Liaoning, Gansu, Jiangsu, Zhejiang, Jiangxi, Fujian, Hainan, Yunnan, Guizhou and Tibet

Figure 8 Chinese Property Insurance CRn (%)




Souce: Wind, Dagong

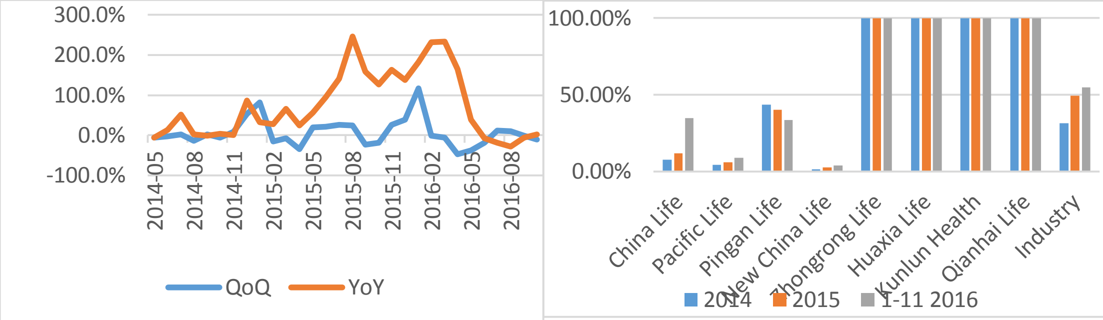
Figure 9 Chinese Property Insurance Premiums Written and Car Sale Changes (100 Million)




Souce: Wind, Dagong

For life insurance, the increasing pressure of liquidity risk and earning capacity will deteriorate the credit policy of life insurance to a great extent. Firstly, a higher proportion of universal insurance and a lower growth of premiums have raised the pressure of liquidity. In recent years, a good deal of small and medium-sized insurance companies have expanded their assets scale through high cash value product sales and universal insurance, which are combined with a high liability cost, and the industry's liquidity risk aggravated as the proportion of insurance premiums amongst universal insurance raised from 31.66% in 2014 to 54.69% in 2016. In order to control the abnormal growth of universal insurance premiums, China's Insurance Regulatory Commission announced 'the regulation of intermediate-short-term duration of the insurance product', the major constituent business involved as universal insurance and participation insurance rapidly decreased (Figure 10), further impeding the growth of life insurance premiums in 2017. By that time, life insurance companies will experience a co-existence of increasing liquidity risk and decreasing premium growth, and it remains possible for several small and medium-sized insurance companies to suffer from liquidity risk due to their high liability cost businesses. In 2017, the credit risk of life insurance companies will face a more crucial test than ever before.

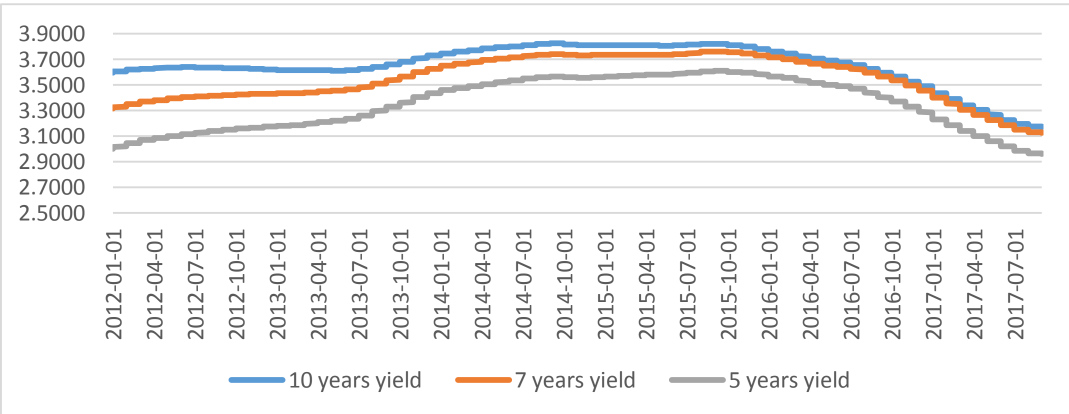
Figure 10 China Life Insurance Universal Insurance Changes (%)




Souce : CRIC, Dagong

Secondly, the prolonged low interest rate environment and increasing pressure upon provision will deteriorate the profitability of insurers. On the one hand, the low interest rate environment has squeezed the profitability of life insurers. Operation pressure gradually transfers from investment asset side to liability side. Although the monetary policy in China will tend towards neutrality in 2017, the relatively low interest rate and competitive pressure will render life insurers continuously exposed to high pressure upon profitability. Amongst all insurers, the advantages of large insurers upon pricing, sales, and other aspects will ensure their ability to take the lead to lower debt costs (2%) and remain a certain profit margin, while asset-driven small and medium-sized insurers will be exposed to greater spread risks due to high debt cost pressure (6%) and relatively poor profitability resilience. On the other hand, pressure upon life insurance provisions will increase slightly in 2017 and thereby affect the profitability of life insurers. The 10-year 750-days moving average yield is expected to fall 46 basis points (Figure 11) and a year-on-year decline will be expanded. Pressure upon life insurance provisions remains increasing and the negative impact upon net profit before tax of the industry may approach 66%.

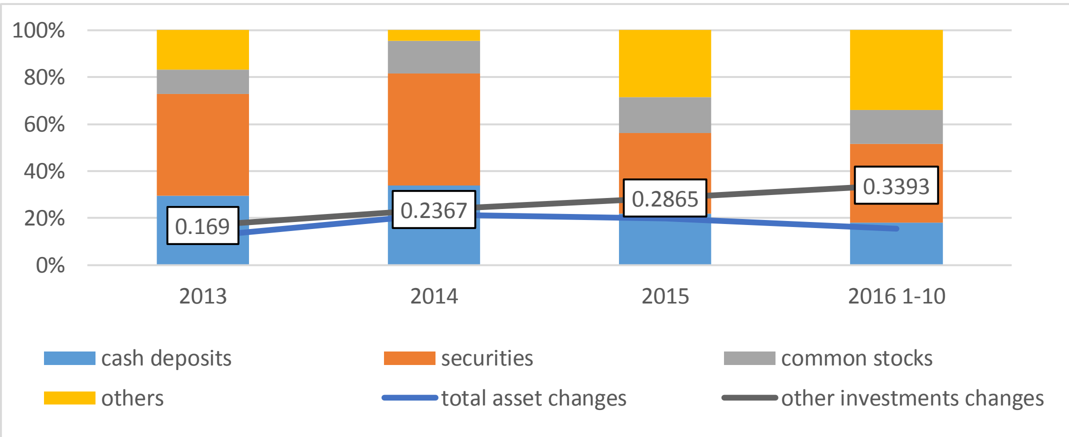
Figure 11 10-year 750 days moving average yield (%)




Souce: Wind, Dagong

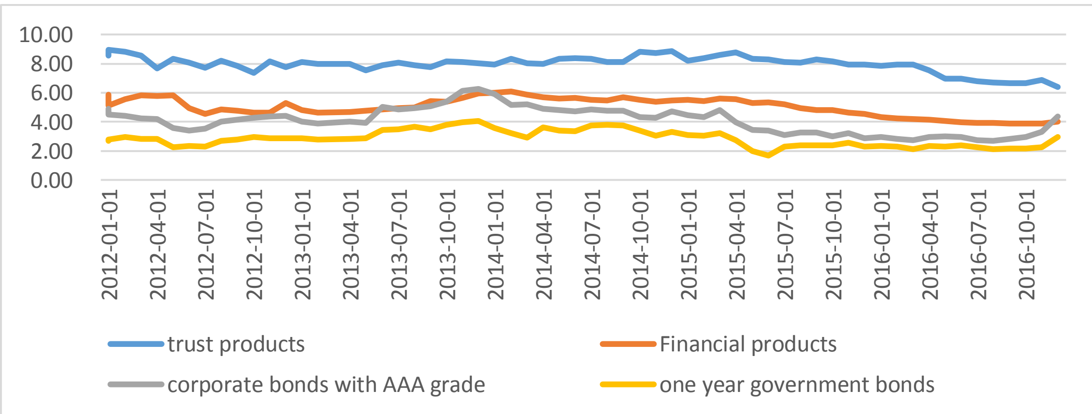
The short-term macroeconomic downturn will increase the credit risk of the insurance industry, yet increasingly stringent regulations make this risk rather controllable. Under the background of a prolonged low interest rate environment and the lack of high-quality assets (Figure 12), the investment performance of insurers demonstrates a downward trend. It is expected that under the pressure of high costs upon liability side, the risk appetite of insurers will rise continuously and the proportion of other investment assets will rise again. Amongst all investment assets, the credit risk of some investment subjects, such as bank financial products, trusts, and asset support plans, will further increase with the further slowdown of the Chinese macroeconomic environment in 2017, and investment risk amongst the insurance industry will increase simultaneously. In order to prevent financial risks, the China Insurance Regulatory Commission will successively introduce and implement policies to further strengthen regulations upon the use of insurance funds, which will help to reduce the liability costs of insurers and regulate their investment behaviors, as well as keeping the credit risk of the industry within a controllable range.

Figure 12 China Insurance Investment Portfolios (100 Millions)




Source：CIRC，Dagong

Figure 13 China Insurance Main Products Investment Income (%)




Source：CIRC，Dagong

**VI Subject to macroeconomic downward pressure, credit environment of insurance industry in emerging countries will generally face deterioration risk.**

Emerging countries will continue to be the main driving force of the global insurance industry growth in 2017, although deterioration of the economy will challenge credit quality in the insurance industry. Insurance penetration is much lower in emerging countries than that in developed countries, and the insurance industry is more likely to dominate the market by lower price, loose underwriting standards and increase marketing costs, effecting premium growth to continue to outperform economic growth. However, an increasing dependence upon exports and external capital in 2017 will leave emerging countries unable to get rid of global economic cycle fluctuations caused by the economic restructuring of the core powers such as the US and China. The deepening adjustments upon China's economic structure and increasing interest rates of the Fed will respectively place pressure upon merchandise trading and the liquidity of international funds, leading to unavoidably rising credit risk in the insurance industry. As Brazil and South Africa have accounted for a large regional market share, the insurance industry risk concerning these two countries will be thoroughly analyzed in the following breakdown.

As the largest insurance market in Latin America (insurance premium share of approximately 50%), Brazil’s insurance industry is rather insensitive to interest rate changes, although the credit risk within the industry is nevertheless likely to increase due to macroeconomic influence. Income guaranteed life insurance products in Brazil have accounted for a very limited volume (approximately 5% of total insurance), as the floating rate of return is most likely related to the interest rate; besides, the investment of treasury bonds for life insurance companies mainly focus on inflation hedged types, with the impact of interest rate volatility weakened, resulting in a lack of sensitivity from life insurance companies concerning interest rate fluctuation. Despite the high inflation rate, currency devaluation and capital outflow pressure following the Fed’s increasing interest rate could altogether trigger a tightened monetary policy for Brazil, although the impact on insurance companies is limited. However, high inflation, high deficit and debt issues might restrict the adjustment space of the monetary policy, as economic stagflation intensifies social unrest, and deteriorates its external financing capacity, thus continuing the substantial depreciation of domestic currency. The above mentioned, along with a decline in risk resistance ability, will weigh upon Brazil’s macroeconomic performance. Affected by those problems, insurance applicants might take a more cautious approach in carrying out their insurance policy. Increasing pressure in profitability upon the insurance industry has become the major reason for a rising credit risk.

Exposure to interest rate risk within the insurance industry in South Africa is low, although continuous downward macroeconomic conditions might lead to higher credit risk in the industry. South Africa is the largest insurance market in Africa, underwriting income accounting for 75% of total insurance. Although the volume of income guaranteed life insurance products continue to increase, currently insured policies are mainly benefit sharing with floating income and have medium interest rate sensitivity, aiding to smooth out the volatility of earnings. However, South Africa is affected by increasing policy instability, tightening fiscal and monetary policies, decreasing commodity prices and weak driving forces for global economic growth, as both short-term economic growth rate and growth potential are constrained. As insurance penetration and concentration in South Africa are relatively high, its insurance development potential is lower than other emerging countries, and under the expectation of a sluggish macroeconomic environment, the insurance industry faces deteriorating operational conditions and a decreasing market demand. As a result, the overall credit risk in South Africa will increase to a certain extent.