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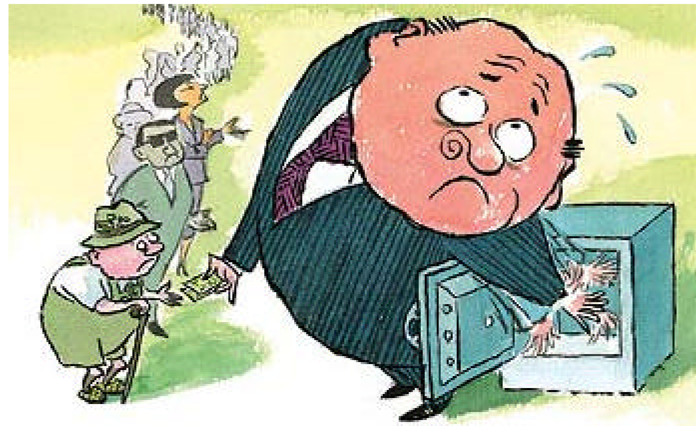
German insurers

Twist, twist, bust?

Nov 14th 2002 | FRANKFURT
From The Economist print edition



Germany's life insurers have gambled away their strength

HAD they played their hand differently, this could have been a time of modest satisfaction for Germany's life insurers. Right now, you might expect German savers—a cautious bunch at best—to place a special value on boring security. The economy is anaemic. The public's torrid love affair with the stockmarket has ended painfully. The state pension system is beginning to crack. And the government is prodding savers, with subsidies and tax breaks, to put money into personal and company pension plans.

So what could be better than good old life insurance? Life policies, provided they run for 12 years or more, are tax-favoured. Insurers are obliged to pay out more than 90% of their post-tax profits to policyholders. It is no surprise, then, that insurance policies make up one-quarter of German households' financial assets (only bank deposits have a bigger share, and this is declining). Last year, life insurance accounted for more than half the accumulation of new assets.

Until now, policyholders have done nicely. On endowments, which account for more than half the premiums paid, they are guaranteed a minimum annual bonus of at least 3.25% for policies started since 2000, and 4% on those taken out in the six years before that. In fact, they have been promised, and are getting, much more: about 6%, this year and last, after several years of 7%-plus. But unfortunately market reality has now caught up with the life insurers.

Next year's bonuses, which will be announced in the next few weeks, are unlikely to exceed 5% on average, says Dirk Popielas of Goldman Sachs. Fitch, a rating agency, thinks several firms will come down to the minimum. Life insurers' problems, says Mr Popielas, stem partly from the way that bonuses are fixed. They decide at the end of one year what they will pay the next, and then have to find the money to keep their promise. This makes them, he points out, “12-month investors”.

That is risky, since liabilities last for decades. Certainly, if insurers suffer the odd bad year, they can dip into their reserves (and build them up again in times of plenty). But they have now had three lean years on the trot. Low inflation has meant low yields on bonds, their staple assets. Because bond yields were so disappointing and stockmarkets were roaring, German life companies waded into shares in the late 1990s. Then came the stockmarket crash. Many portfolios are probably under water—if they have not had to be sold.

The result has been a dramatic erosion of the industry's former financial strength. At the end of 1999, according to a Fitch survey covering 75 of Germany's 118 life firms, the average capital-adequacy ratio (capital plus reserves, divided by an actuarial assessment of capital required) was an “exceptionally strong” 185%. By the end of 2001, it was a “moderately weak” 76%. Three firms did not have enough capital and reserves to cover the bonuses they promised in 2002; another 39 insurers were less than two times covered. The position has surely deteriorated since.

Not surprisingly, regulators are watching some companies nervously. The portfolio of Familienfürsorge, a mutual serving mainly clergy, was taken over by another insurer, HUK-Coburg, earlier this year. Hannoversche Leben, also a mutual, replaced its management last month at the regulator's behest. Smaller companies, which tend to have thinner hidden reserves, are most at risk.

Rumours that some firms might go under are the wildest speculation, said the German Insurance Association on November 13th. Nonetheless, the industry is setting up an organisation, called Protector, to take over the obligations of life firms that get into trouble. Goldman's Mr Popielas thinks that 30% of companies could disappear in the next three to five years, through mergers, via Protector's intervention or by ceasing to write new business. Such a consolidation has long been predicted, gleefully, by the industry's (basically healthy) bigger firms. The top four groups already account for 40% of premiums. There is a long, thin tail of smaller companies.

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For those that survive, does a brighter future beckon? Maybe, but it will help to be big, or at any rate well-capitalised. German pension reform should push a lot of cash the insurers' way: Goldman Sachs estimates that life insurers will scoop two-thirds of the *euro*310 billion ($310 billion) expected to be poured into company and personal schemes by 2010. However, the take-up, especially of personal plans, has been disappointing.

Most of the business is likely to come from providing or administering company or industry pension schemes, rather than writing personal life contracts. That favours big firms ahead of the minnows. So might the government's requirement that private pension-scheme investors get at least a zero return. This is not costless. Larger insurers should find it easier to budget for possible losses, just as they have been better able to bear a performance falling short of guaranteed returns.

The industry can ill-afford another wretched year. Lower minimum guarantees—or none at all—would help. Deciding on bonuses at year-end, rather than competing to make rash promises, would make risks easier to manage, and might also educate investors that their savings are not immune from market swings. In any

event, Germany's insurers will have to match their risks and liabilities much more closely than they have done so far. “We believe”, write Mr Popielas and his colleagues in a recent study, “that risk management will be the trend of this decade.” Shame it wasn't the trend of the last.

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