The Austrian Insurance Industry from a Financial Stability Perspective: an Analysis of the Period from 2002 to 2008

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This study, which arose under the OeNB's expanded financial stability mandate, provides the reasoning for an integrated approach to financial stability analysis. It takes stock of the Austrian insurance sector and provides an assessment of the sector in respect of financial stability.

This study is based on data provided by the Financial Market Authority (FMA) that the OeNB periodically analyzes under its expanded financial stability mandate. In order to monitor longer-term developments and trends, the period under review ranges from 2002 to 2008. We find that concentration in the Austrian insurance market and competition have increased and that insurance companies have made efforts in cost and claims management. Compared with the rest of Europe, the Austrian life insurance market still has growth potential. Austrian insurers have diversified their quite considerable debt security portfolios at an increasingly international level. Following the outbreak of the U.S. subprime crisis, profitability fell sharply after having previously grown at a steady rate on the back of a favorable financial market environment, a positive insurance claims trend and Austrian insurance companies' expansion in Central, Eastern and Southeastern Europe. Although the Austrian insurance industry's financial ties with the banking sector deepened on the whole, they remained at a relatively small scale.

JEL classification: G22, G28
Keywords: Austrian insurance market, financial stability, financial turmoils

The reform of the supervisory framework in Austria in 2008 explicitly regulated the financial stability mandate of the Oesterreichische Nationalbank (OeNB) stipulated in Article 44b of the Federal Act on the Oesterreichische Nationalbank (Nationalbank Act) of 1984. In particular, the OeNB shall monitor in the public interest "all circumstances that may have an impact on safeguarding financial stability in Austria." To this end, the OeNB was also granted access to the data of nonbank financial intermediaries. These data are used for comprehensive financial stability analyses, which include all relevant components and segments of the Austrian financial system. The FMA periodically provides the OeNB with data on the business situation, financial results and financial assets of insurance companies at a segment level, i.e. life, property, casualty and health insurance. The supervision of insurance companies remains the FMA's responsibility.

An integrated approach to financial markets analysis, which includes all the relevant components and segments of the financial market is indispensable for a sound financial stability analysis. Insurance companies are relevant not least owing to their role as risk takers and investors in the financial market. At end-2008, the total assets of Austrian insurance companies amounted to about EUR 92 billion. Potential contagious effects within the financial system are twofold: there may be direct effects owing to credit obligations and indirect effects due to similar risk positions and, for instance, via the transfer of risk. In addition, cooperation agreements, such as those between banks and insurance companies, as well as interlocking ownerships, such as in the

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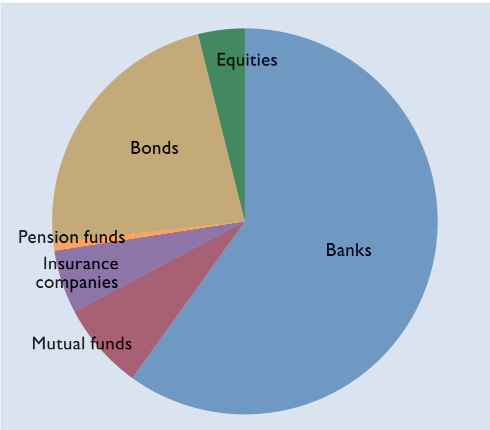
case of financial conglomerates, can transmit shocks. Not least, the ongoing financial crisis has shown that financial market confidence is of key importance and that financial players' trust in the financial soundness of, say, an insurance company can be curtailed even if the latter is not affected directly. This is why insurance companies are mindful of their reputation. In addition, owing to the growing importance of private retirement provision and to a change in households' investment behavior, the impact of insurance companies on financial stability continues to increase.

Chart 1

Importance[1] of the Relevant Components of the Austrian Financial System



[1] *In term s of total assets, outstanding amount, invested assets and market capitalization as at June 2009.*

Source: OeNB.

This study provides an overview of the development of the Austrian insurance industry from 2002 to 2008 and examines the relevance of this sector for financial stability. In this respect, the study also casts light on the Austrian insurance industry's expansion in Central, Eastern and Southeastern Europe (CESEE) and its development in the wake of the economic and financial crisis. The data available mainly go back to 2002, which is why the period from 2002 to 2008 was chosen for this study. Developments from the first half of 2009 and the latest assessment of the financial stability of insurance companies can be found in the report section of this Financial Stability Report. Since this study particularly examines contagion risk between insurance companies and banks, liabilities (especially, insurance technical reserves) play a secondary role in this analysis.

1 The Austrian Insurance Industry from 2002 to 2008

1.1 Structure of the Austrian Insurance Market[2]

In recent years, the Austrian insurance market has become more concentrated, which can be attributed to fiercer competition. Compared with its international counterparts, the Austrian insurance sector has growth potential particularly in Austria (life insurance) and in CESEE (in both life and nonlife segments).

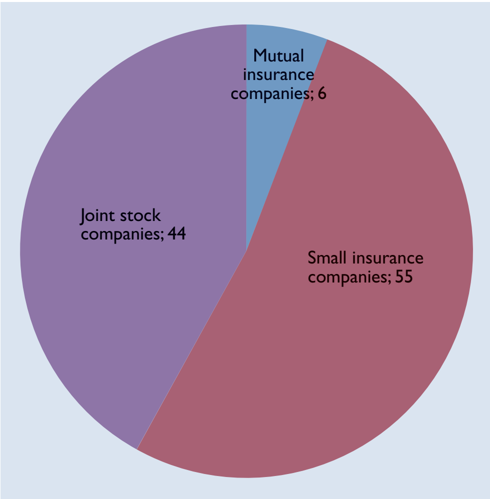
At end-2008, 105 Austrian insurance companies were active (11 less than in 2002). Most were joint stock companies (44) or small insurance companies (55). In the period under review (i.e. from 2002 to 2008), the number of mutual insurance companies rose from 5 to 6 companies whereas the number of stock corporations fell from 48 to 44 and that of small insurance companies from 63 to 55. Of particular relevance from an economic perspective and as regards financial stability analysis are insurance companies that trade as joint stock corporations.

Composite insurers, which are insurance companies active in more than one insurance segment (life, health,

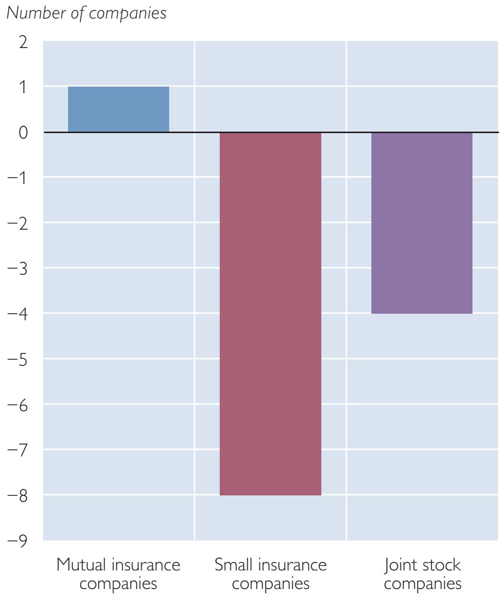
[2] *Source: Annual reports of the FMA.*

Chart 2

Number of Austrian Insurance Companies by their Legal Form in 2008



Change in the Number of Insurance Companies since 2002



Source: FMA.

property and casualty insurance), traditionally dominate in Austria. Many insurance companies operating several segments in Austria alongside each other were not affected by the regulation on the separation of insurance classes[3] insofar as they were already active as composite insurers before the Agreement on the European Economic Area (1992) was signed and can thus continue operating on an unrestricted basis. Of the 50 insurance companies (excluding the small insurance companies) in 2008, 47 were active in property and casualty insurance, 31 in life insurance and 9 in health insurance.

The Austrian insurance market has become slightly more concentrated in recent years. In 2004[4], the five largest insurance companies held 50% of aggregated total assets, whereas they held 51.5% (life: 57%, property/casualty: 68.2%) in 2008.

Likewise, the Herfindahl index[5] rose from 6.5% to 7% within the same period.

Insurance density and penetration ratios indicate the degree to which a country's insurance industry is developed. Insurance density is expressed by per capita premium received and, in Austria, rose by some 22% on 2002 (life: +28%; property/casualty: +18%).

Insurance penetration is defined as the ratio of insurance premiums relative to GDP. In Austria, it was 6.4% in 2008, falling just short of the 2007

[3] *The regulation on the separation of insurance classes states that the authorization to operate life insurance business and the authorization to operate other insurance classes are mutually exclusive.*

[4] *The annual accounts of these insurance companies were available to the authors of this study only for the period from 2004.*

[5] *The Herfindahl index is a measure of market concentration, the calculation of which here is based on unconsolidated figures.*

level of 6.6%. According to Swiss Re (2009), insurance penetration in Western Europe fell to 8.3% in 2008, but is still 2 percentage points higher than in Austria. This comparison highlights not only the important role of the public pension system in Austria but also the growth potential of Austrian insurance companies in their domestic market.

1.2 Asset and Investment Structure of Austrian Insurance Companies

Insurance companies hold assets in order to cover the claims of policyholders. As a result, the assets side of the insurance sector's balance sheet is heavily dominated by financial assets, i.e. by securities, in particular. From 2002 to 2008, the importance of bonds and other debt securities grew considerably. In 2008, equity interests, in particular, were more strongly weighted. This portfolio composition suggests that credit and market risks play a significant role and, consequently, financial market shocks may be quickly transmitted to insurance companies.

In the period from 2002 to 2008, the aggregated total assets[6] of the Austrian insurance sector increased from EUR 60.1 billion to EUR 92.3 billion, i.e. by slightly more than 50%.

At end-2008, debt securities accounted for almost 40% of the assets invested by insurance companies, which basically suggests an overall relatively conservative investment strategy. Compared with end-2002, this share had even increased (by slightly more than 7 percentage points). This increase is primarily attributable to the higher weighting of foreign debt securities. At end-2008, their share in aggregated total assets was slightly more than one quarter. By contrast, the share of domestic debt securities held steady at around 13%. Insurance companies reduced their positions in domestic government debt securities and, instead, purchased issues of Austrian credit institutions (in 2008, their share was 10.6%) and other domestic issuers (corporate bonds, with a share of 1.1% in 2008).

In 2008, the second major assets item for insurance companies consisted of equity securities and equity interests, which in 2002 together still constituted the most important class of assets. In the period under review (i.e. from 2002 to end-2008), the share of this asset class increased to 36.7%, driven in particular by domestic equity interests (2008: +3.1 percentage points to 8.6%) and stronger international diversification in the case of equity securities (2008: +1.4 percentage points to 5%). With a share of just under one quarter, domestic equity securities remained a key investment class, albeit down somewhat since 2002 (–2 percentage points). They were followed by deposits with Austrian credit institutions (2008 share: 4%), which were boosted in the wake of the financial crisis, and by loans, which were down, in particular, owing to general government redemption payments (2008: –9 percentage points to 4%). Almost 9% of investment was made indirectly via mutual funds.

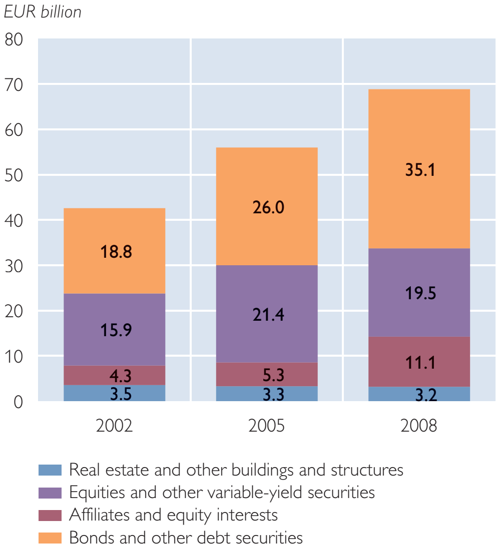
At end-2008, insurance companies[7] held investments of EUR 76.8 billion, of which life insurance accounted for EUR 54.8 billion, property and casualty insurance for EUR 22.9 billion and health insurance for EUR 4.5 billion. Since 2002, investment has grown on an aggregated basis across all segments

[6] *Source: OeNB insurance statistics.*

[7] *Source: FMA insurance statistics (available at www.fma.gv.at).*

Chart 3

Development of Investment Classes of Austrian Insurance Companies



Source: FMA insurance statistics (website).

by more than 40% (life: +38%, property/casualty: +57%, health: +44%). Clear differences in investment strategy existed between individual insurance segments. In life insurance, for instance, debt securities accounted for more than 50% of investment, followed by mutual funds, stocks and real estate. In property and casualty insurance, by contrast, (unlisted) equity securities accounted for the lion's share of investment, which to a higher degree involve liquidity risk and a higher exposure to the economic cycle. In the current uncertain macroeconomic climate, this can give rise to increased risks. Hedge funds and derivatives played an insignificant role in insurance companies' overall investment.

1.3 Business and Profit Growth of Austrian Insurance Companies

The gross premiums of Austrian insurance companies amounted to EUR 18 billion in 2008. From 2002 to 2008, they grew by some EUR 4 billion, with property and casualty insurance accounting for more than 50%, life insurance for around 40% and health insurance for almost 10%. In the period from 2002 to 2008, the proportion of gross premiums shifted slightly toward life insurance (2002: 48%).

At over 33%, life insurance gross premiums registered the strongest growth in the period from 2002 to 2008, with gross premiums in property and casualty insurance as well as in health insurance up by some 22%. Life insurance's more robust growth is attributable to the increasing importance of private retirement provision as well as to tax-advantaged private pension plans promoted by the government.

An insurance company's profitability critically depends on actuarial business and investment income. For insurance companies, the expected value of the actuarial result is ideally within quantifiable limits. In reality, however, the probability of occurrence of loss events can change. For instance, demographic change can pose a potential risk in life insurance.

To measure the sector's profitability, claims and operating expenses are compared against gross premiums. Chart 5 shows that operating expenses that can be controlled by management remained constant over the period while insurance claims were subject to sharper fluctuations. In the last two years, the difference between gross premiums and operating and claim expenses narrowed owing to only modest growth in gross premiums as payouts for insurances claims have risen.

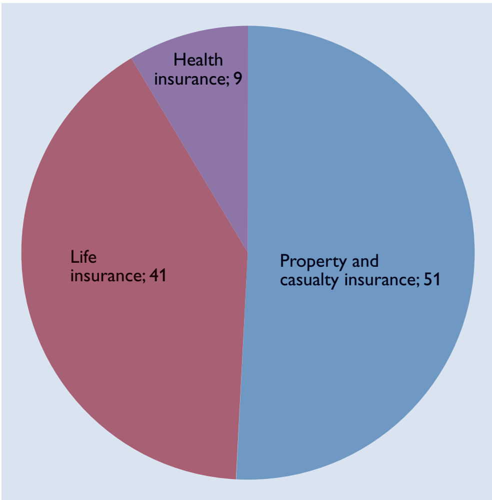
The combined ratio, used worldwide as an indicator to measure the profitability of actuarial business in property and casualty insurance, specifies the share of operating and claim expenses as a percentage of gross premiums. A high level of claims can push up this ratio. A value above 100 corre-

Chart 4

Situation and Development of Gross Premiums from 2002 to 2008

Gross premiums in 2008 (total: EUR 18 billion)

Share in %



Development of Gross Premiums from 2002 to 2008

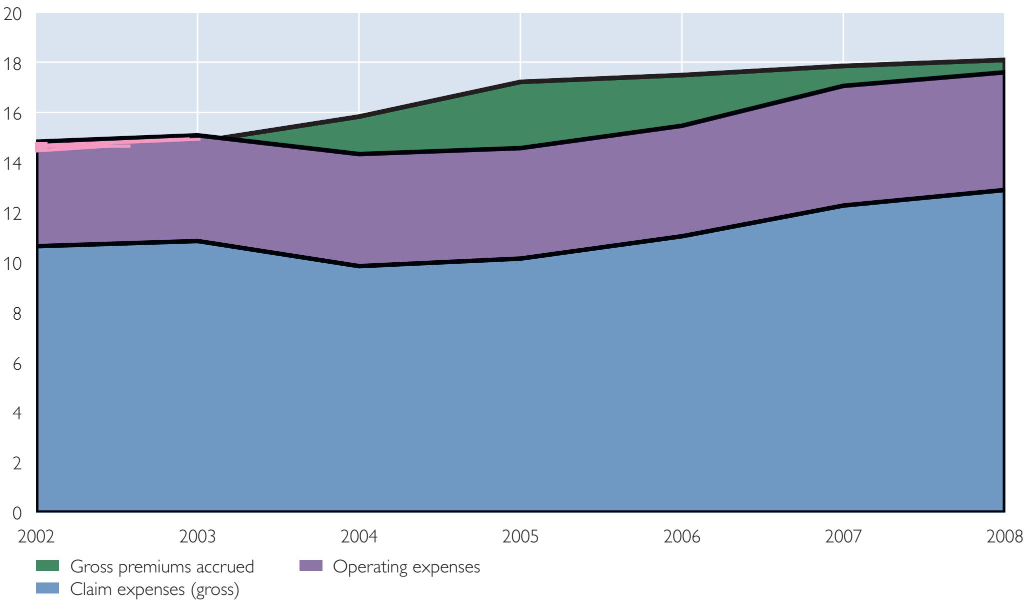
EUR billion

Source: FMA insurance statistics (website).

Chart 5

Development of Gross Premiums and Insurance Expenses

EUR billion



Source: FMA insurance statistics (website), OeNB calculations.

Table 1

Profitability Ratios by Insurance Segment

	Combined ratio	Acquisition cost ratio			Expense ratio			Loss ratio		
	Property and casualty	Life	Property and casualty	Health	Life	Property and casualty	Health	Life	Property and casualty	Health
2002	119.3	12.5	24.1	9.6	17.7	39.8	14.6	65.7	79.5	76.6
2003	106.8	14.6	19.1	9.5	19.9	37.0	14.6	77.4	69.8	76.1
2004	104.4	12.9	19.1	9.6	17.9	38.1	14.7	53.9	66.3	74.9
2005	100.1	12.0	19.1	9.5	15.8	35.4	14.3	49.0	64.7	74.0
2006	101.9	12.3	18.8	9.5	16.1	34.4	14.3	56.0	67.5	72.1
2007	105.5	11.7	22.8	9.4	15.5	37.7	14.1	69.3	67.8	71.6
2008	105.5	11.2	22.4	8.9	14.9	36.7	14.5	74.4	68.9	71.0

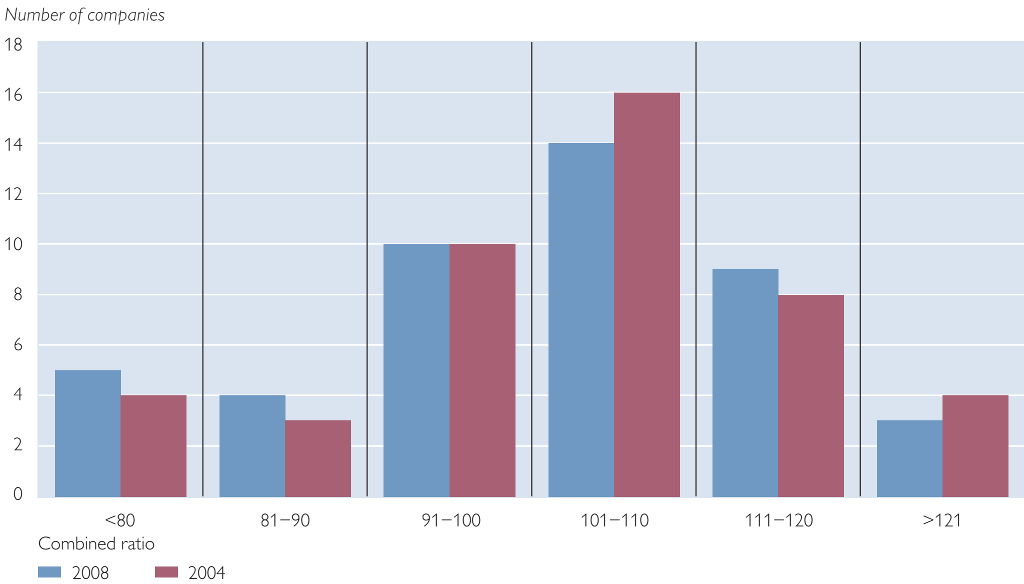
Source: FMA insurance statistics (website).

sponds to a loss in actuarial business, which can be offset by positive investment income to generate improved income from ordinary activities.

The period since 2002 has seen only values above 100 for property and casualty insurance. Until 2007, however, this negative result was offset by correspondingly positive investment income. In a climate of higher volatility and unfavorable financial market developments, investment income can, of course, make a smaller contribution to the profitability of property and casualty insurance. Tackling this challenge, which will go hand in hand with the need to reduce the expense ratio, will be one of the key issues in property and casualty insurance over the next few years.

Chart 6

Distribution of the Combined Ratio for Property and Casualty Insurance



Source: FMA insurance statistics (website), OeNB calculations.

The histogram in chart 6 shows that the relative majority of Austrian property and casualty insurers have a combined ratio ranging between 101 and 110 and that the distribution of the combined ratio in these segments has moved to the left. A positive point to highlight is that, from 2004 to 2008, the number of insurance companies with poor (i.e. high) combined ratios has fallen and the number of companies with a profitable actuarial business has increased.

The expense ratio is the ratio of operating expenses (administrative expenses ratio and acquisition costs) to revenues earned from premiums. This ratio indicates the efficiency of the operating side. As mentioned already, the expense ratio is more than twice as high in property and casualty insurance than in life and health insurance. This may be attributable to tightly priced premiums, higher acquisition costs and a large number of small policies with shorter periods, which imply higher administrative expenses.

The loss (benefit) ratio is claims payable as a percentage of premium income and measures over the insurance cycle insurers' discipline and ability to assume risks only at an adequate price. This ratio is particularly volatile in life insurance, as payouts not only have stochastic components but can also be influenced by both fiscal policy and macroeconomic conditions.

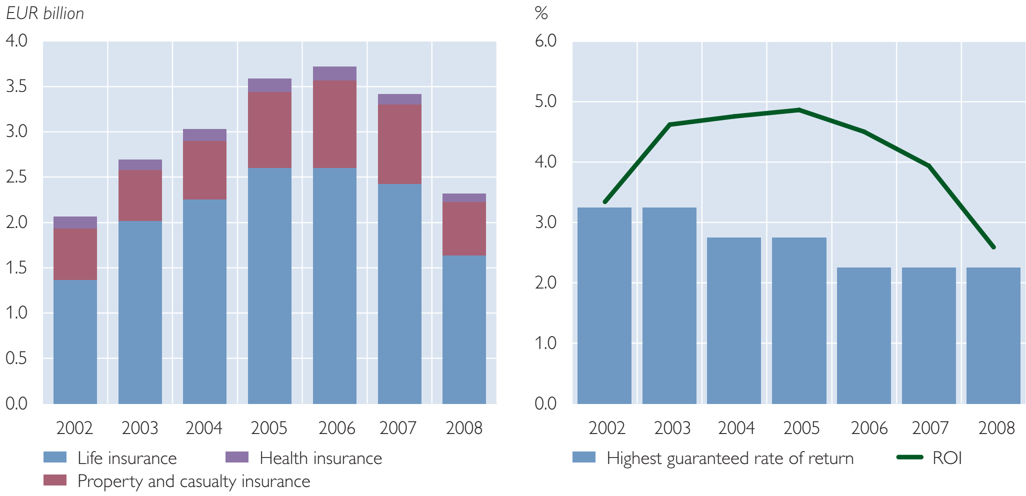
In addition to actuarial business, an insurance company's profitability also depends on investment income. The latter is influenced by developments in the financial markets, investment strategies, the willingness to take risks and risk management. Until 2006, the investment income of Austrian insurance companies rose steadily in line with favorable financial market developments. Investment income in life insurance registered particularly positive growth. While the downturn was still rather modest in 2007, the financial crisis made a strong impact in 2008, squeezing investment income by 32% to EUR 2.3 billion. This trend is mainly attrib-

Chart 7

Investment Income and ROI

Net investment income of the entire insurance sector

ROI and the highest guaranteed rate of return of Austrian life insurances



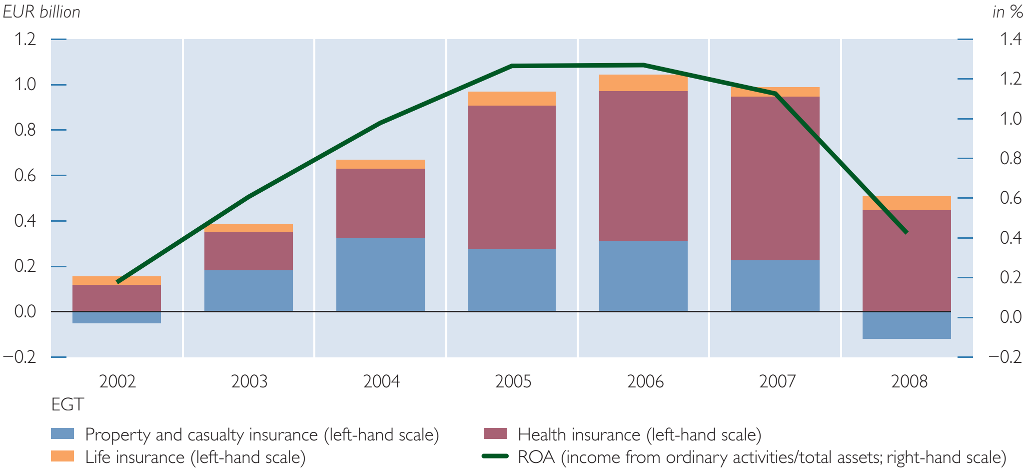
Source: FMA insurance statistics (website). OeNB calculations.

utable to the increase in credit risk premiums and to lower stock prices. In nominal terms, however, investment income in 2008 exceeded 2002 levels. In terms of return on investment (ROI) – i.e. the ratio of investment income to the amount invested – ROI declined in life insurance as early as 2006, as the amount invested grew more steeply than the investment income earned. In 2007, the financial climate turned bleaker and ROI fell sharply. This trend continued in 2008, resulting in an ROI which was 1% lower than in 2002. A positive point to highlight however is that, in the period under review, ROI in life insurance did not fall below the highest guaranteed rate of return[8] set by the FMA and thus insurance companies generated a higher return than their guaranteed rate.

Income from actuarial business and investment combine to form income from ordinary activities. In the period under review, income from ordinary activities had a trend similar to that of investment income. At the level of individual insurance segments, it is evident that investment income plays a comparatively important role in property and casualty insurance. In a benign financial climate, in particular, investment income has a greater impact. The opposite is obviously true in the event of negative financial market developments, such as those seen since the outbreak of the U.S. subprime crisis in the summer of 2007. In 2008, income from ordinary activities declined by 60% year on year to EUR 0.4 billion on the back of lower investment income. Except for the life insurance segment, income from ordinary activities in all other segments has, however, remained wholly positive despite having fallen sharply. In both 2002 and 2008, income from ordinary activities was negative in life insurance, primarily owing to actuarial income, which was negative in these years. Owing to the repercussions of the bursting of the dotcom bubble, the year 2002 was on the whole a tough year for the global insurance industry. Owing to its small share of pure

Chart 8

Profitability of the Austrian Insurance Sector



Source: FMA insurance statistics (website), OeNB calculations.

[8] *A maximum rate of return set by regulation, which is based on long-term interest rates and which prohibits life insurance companies from guaranteeing policyholders a rate of return higher than this maximum rate.*

equity investment, the Austrian insurance sector was less detrimentally affected than, for instance, many a German insurance company and succeeded in generating for the sector as a whole total income from ordinary activities of EUR 0.1 billion.

Return on assets (ROA) is the ratio of income from ordinary activities relative to the Austrian insurance sector's total assets. After peaking at almost 1.3% in 2005 and 2006, it plummeted to 0.4% by 2008 although even this level is higher than that of 2002 (0.2%).[9]

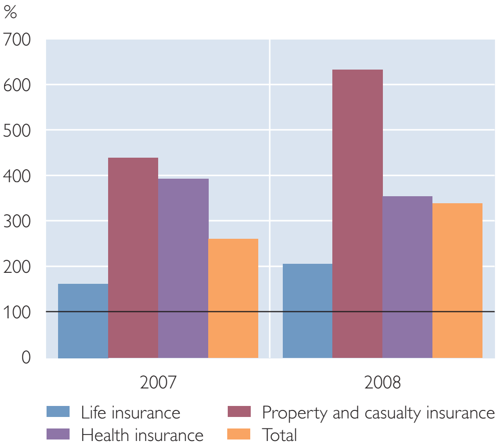
1.4 Capital Adequacy of Austrian Insurance Companies

The capital adequacy of insurance companies is a measure of their risk-bearing capacity. An insurance company's solvency ratio, which is the ratio of the company's available capital relative to its regulatory capital requirements, must therefore exceed 100% for the company to be solvent from a regulatory perspective. Despite continued bleak conditions, the solvency ratio was increased in 2008 – except in health insurance. In property and casualty insurance, the solvency ratio rose particularly sharply by about 200 percentage points, induced by, in certain cases, substantial capital measures carried out by some insurance companies in 2008. Overall, the Austrian insurance sector is well capitalized, as the capital available exceeds the capital requirements considerably in certain cases. Compared with Europe, the solvency ratio of Austrian insurance companies approached the average in life insurance and, in nonlife, exceeded it by a wide margin (CEIOPS, 2009).

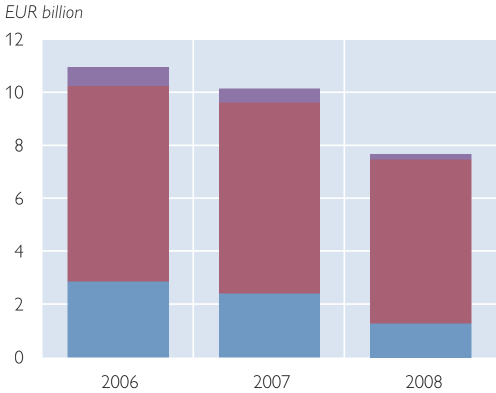
Undisclosed reserves, which are defined as the difference between the book value stated on the balance sheet and a market value in excess of the book value, constitute a buffer particularly for actively traded securities in the event of any negative market developments. In the past, it was customary practice to release undisclosed reserves (i.e. to sell assets) to improve profit-

Chart 9

Solvency Ratio



Undisclosed Reserves



Source: FMA.

[9] *ROI measures the rate of return on capital invested whereas ROA also includes actuarial income and measures the rate of return on total assets.*

ability and to positively influence payouts to policyholders. Since the start of the crisis in 2007, however, undisclosed reserves have been halved in life and health insurance after market values plummeted. Some insurance companies have already built up unrealized losses. The decline in undisclosed reserves, which was modest in property and casualty insurance compared with other segments, is attributable to the significant impact of unlisted equity securities. In this respect, it should be remembered that, owing to an amendment to the Insurance Supervision Act[10] in fall 2008, depreciation on probably not long-term impairment may be forgone a certain while provided the total amount does not exceed 100% of net reserves. The undisclosed reserves of the aggregated Austrian insurance sector amount to around 10% of its investment.

1.5 Austrian Insurance Companies' Activities in CESEE

CESEE has been the key growth market also for Austrian insurance companies in recent years. Having placed their business activities on a broader basis and entered the market fairly early, Austrian insurers successfully established a good foundation for investment.

In 2008, four Austrian insurance groups (Vienna Insurance Group, UNIQA Group Austria, GRAWE Group, Wüstenrot) were active in 21 CESEE countries. Their subsidiaries had aggregated total assets of EUR 10.6 billion, up 20% on 2007. In 2008, these Austrian subsidiaries in the region earned premiums of EUR 5.6 billion and generated income from ordinary activities of EUR 241 million. At end-2008, CESEE business accounted for around 12% of the aggregated total assets, 30% of the premiums earned and 41% of the income from ordinary activities of these four groups.

Chart 10

Importance of CESEE Business in 2008

Source: FMA.

The international business of Austrian insurance companies is strongly concentrated in the CESEE area. In 2008, the importance of CESEE business even grew at a disproportionately fast rate, as income from ordinary activities fell by 40% in the relatively well-established Austria business while increasing by 13% in CESEE business. The share of CESEE income from ordinary activities as a percentage of total income from ordinary activities of the four insurers mentioned above almost doubled to about 41% within a mere year. The largest exposures in terms of both value and market share were exclusively in A-rated countries (according to Standard & Poor's).

At 35%, the Czech Republic accounted for the largest share of aggre-

[10] *Austrian Federal Law Gazette I no. 138/2008*

gated CESEE total assets, followed by Slovakia (16%) and Poland (13%). The investment portfolio was concentrated on relatively stable economies.

Owing to their (in some cases) early market entry and to their comparatively high growth in the past due, in part, to acquisitions, the four Austrian insurance companies controlled quite a considerable slice of the local markets. At end-2008, their market share in Slovakia was some 36%, in the Czech Republic around 30%. In Bulgaria and in Romania, their market share came to around 24% and 23%, respectively. In nominal terms, premiums earned were the highest in the Czech Republic (EUR 1.7 billion), followed by Poland (EUR 1.3 billion) and Slovakia (EUR 755 million).

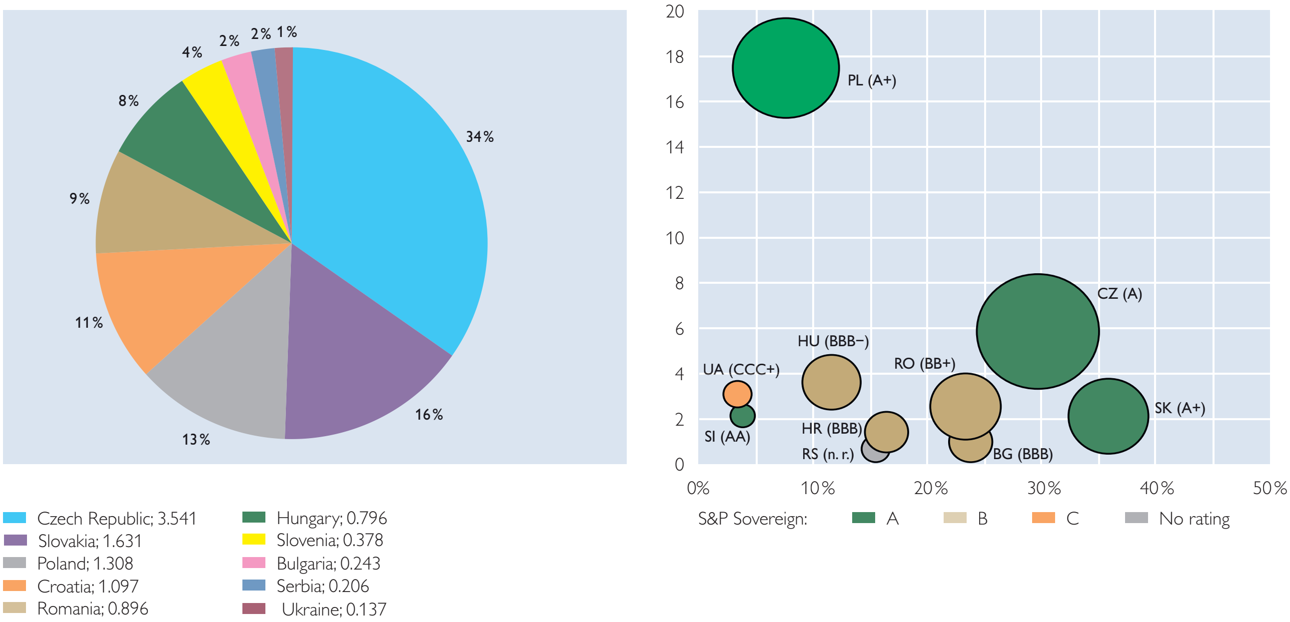
After double-digit inflation-adjusted growth in 2006 (12%) and 2007 (13%), the expansion of the Austrian insurance industry in CESEE in general slowed to 9% in 2008. Life insurance, expanding by 19% in nominal terms, provided the largest contribution to growth[11]. However, growth was driven strongly by Poland, the largest life insurance market in the region, somewhat obscuring the visible slowdown of some insurance markets in the wake of the deteriorating international financial crisis. Poland, Slovakia and Romania registered double-digit growth also in 2008, a difficult year. In the region's other countries, the weakening sales of primarily unit-linked life insurance policies resulted in a decline in premi-

Chart 11

Market Shares of Austrian Subsidiaries and Breakdown of CESEE Exposure

Share in total assets of Austrian insurance companies in CESEE in %

Aggregated national premium volume in EUR billion



Source: FMA, Swiss Re, S&P, OeNB calculations.

Note: Country; total assets in EUR million.

Note: The individual countries are charted according to the market share of Austrian subsidiaries (x axis) and the aggregated premium volume of the local market (y axis). The size of the circle corresponds to the premium volume of Austrian companies in the relevant country. The circles are colored in accordance with Standard and Poor's country rating key.

[11] *Source: Swiss Re (2009)*

ums earned. Nonlife insurance registered only sluggish growth in almost every country; the Czech Republic and Hungary even suffered a decline in real terms. In this sector too, however, Poland registered growth of 8.1%.

Owing to the financial crisis rapidly spilling over to the real economy, jobless numbers sharply rising in some countries, and to related declining household wealth, premium growth will slow sharply in CESEE in the foreseeable future. Market observers therefore expect the insurance sector, which has grown very strongly in recent years, to consolidate. However, the competitive situation is not likely to ease significantly. From a current perspective, Austrian insurance groups have invested in relatively stable countries and posted a comparatively good performance in 2008, a year overshadowed by the financial crisis. Austrian insurance groups will also suffer the expected slowdown in CESEE business since negative premium growth that cannot be offset is also anticipated in 2009 for the Austrian business. In the long term, there is still catching-up potential despite the current crisis, but the pace of this process will slow.

1.6 Contagion from a Financial Stability Perspective

The identification of a contagion channel is a key component of the OeNB's integrated financial analysis. In the following, we briefly discuss and quantify this potential.

To measure the contagion between the banking and insurance sector, we analyze the overall exposure of Austrian insurance companies to domestic credit institutions.[12] At end-2008, this exposure amounted to EUR 17.4 billion and increased during the financial crisis, suggesting that Austrian insurance companies contributed to the refinancing Austrian banks to a greater extent. The exposure equaled 18.4% of the insurance sector's aggregated total assets. In 2008, deposits other than overnight deposits shifted in favor of deposits payable on demand, which indicates insurance companies' increased preference for liquidity. This can also be attributed to the fact that securities have become increasingly illiquid, as a result of which liquid funds have become more concentrated on bank demand deposits. Insurance companies' greater role in the (partly, longer-term) refinancing of banks is evident in the growing importance of debt securities and loans to Austrian credit institutions.

We then carry out a more detailed analysis of concentration risk and counterparty risk in Austrian insurance companies. To this end, the 30 largest individual investments[13] of Austrian insurers were analyzed. At end-2008, these investments totaled EUR 22.8 billion (stocks and bonds) and accounted for a third of total investment. A large portion (EUR 8.1 billion) was invested in Austrian banks, somewhat more than EUR 7 billion in government bonds and EUR 6.6 billion in international banks, with German banks playing a key role. It is striking that since the outbreak of the U.S. subprime crisis, insurance companies have increased their positions in the debt securities of domestic credit institutions, thus contributing to the refinancing of banks.

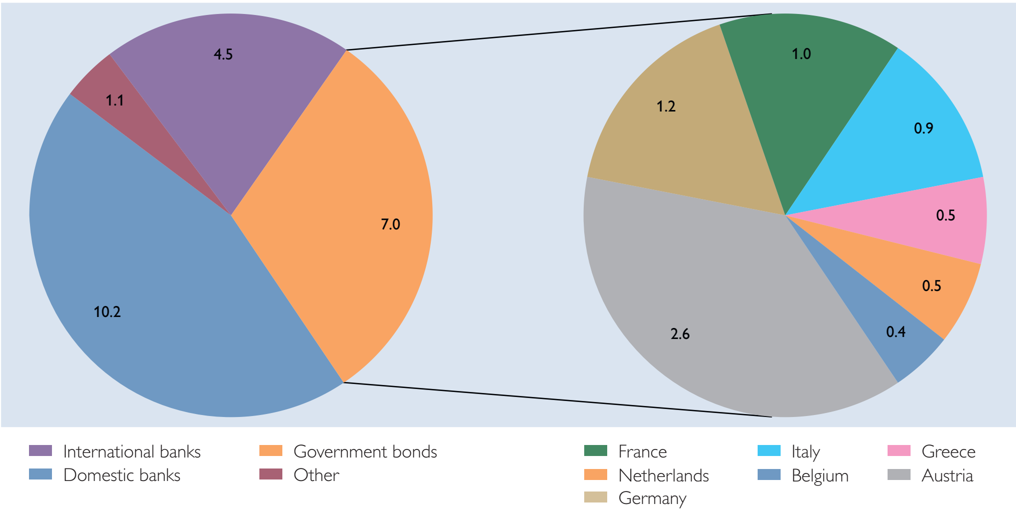
[12] The exposure of banks to insurance companies is not quantifiable owing to missing data. In principle, this exposure entails primarily investment in insurance stocks and bonds, as well as in loans and over-the-counter business. In addition, banks can also be insurance policyholders.

[13] These investments include (calculated) stocks, bonds and mutual funds.

Chart 12

Key Investment Positions of Austrian Insurers in the Fourth Quarter of 2008

EUR billion



Source: OeNB.

The aforementioned investments in government bonds were all within the euro area and largely directed at AAA-rated borrowers.

Financial conglomerates[14] such as Fortis or Allianz together with Dresdner Bank came under pressure in the wake of the financial crisis. The close ties between banks and insurance companies within financial conglomerates involve additional risks. The key risks of financial conglomerates are concentration risk and contagion risk. Other risks include the side-stepping of sectoral regulations (supervisory arbitrage), conflicts of interest within a relevant conglomerate, the lack of an overall view of a relevant company or problems of risk aggregation within individual sectors. To avoid these scenarios, integrated risk management is indispensable. Companies in this sector are subject to the Financial Conglomerates Act and, consequently, to special supervision by the FMA.

At the end of the third quarter of 2008, the largest financial conglomerate in Austria was dissolved with Erste Bank's sale of S-Versicherung, thereby reducing the level of the interlocking ownership of banks and insurance companies.

However, close cooperation exists between banks and insurance companies in life insurance, in particular. 60% of life insurance policies are marketed via banks.[15] This enables insurance companies to use bank branch networks for marketing purposes, while banks can realize commission income. In addition, the strong increase in bullet loans, mainly in foreign currency, has resulted in steady demand for life insurance policies as repayment vehicles. In this respect, it should be remembered that the sale of life endow-

[14] *These conglomerates are groups of companies, in which at least one company is active in the insurance industry and at least one active in the banking and investment services sectors.*

[15] *Source: The Boston Consulting Group (2008, Exhibit 15).*

ment insurance policies depends to a certain extent on the credit cycle.

Potential contagion between banks and insurance companies has increased somewhat in the last few years and can be seen to be manageable on the whole.

1.7 Impact of the Financial Crisis on Austrian Insurance Companies

The U.S. subprime crisis, which commenced in spring 2007, initially triggered turmoil in the international financial markets and subsequently had a negative impact on the real economy, particularly following Lehman Brothers' insolvency in September 2008.

Austrian insurance companies were hit by the crisis primarily on the assets side due to investment losses and reputation effects stemming from their exposure to CESEE. The first wave of turmoil-induced impairments on structured U.S. subprime securities only had a slight impact on Austrian insurance companies, as their exposure was limited on the whole. The successive waves, followed by the substantial widening of credit risk premiums, the slump in stock prices and the devaluation of CESEE currencies all took their toll on Austrian insurance companies, causing a sharp fall in investment income, a significant decline in income from ordinary activities and lower undisclosed reserves.

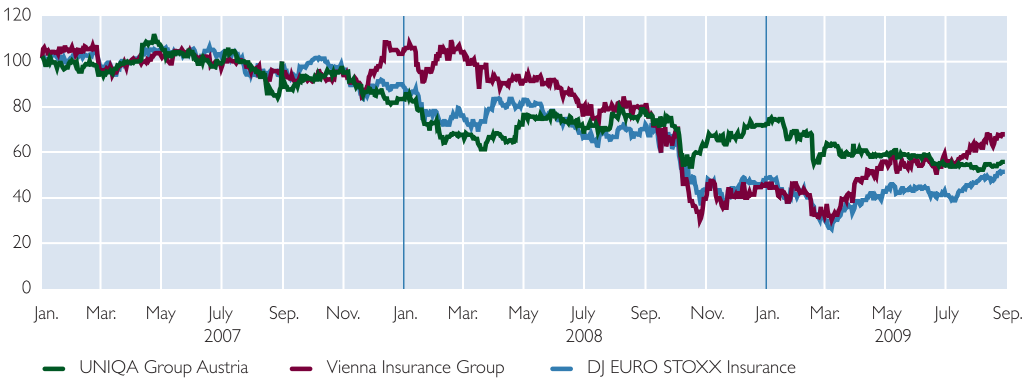
In addition, owing to their exposure to CESEE, where growth was still positive in 2008, and to their focus on traditional insurance business, Austrian insurance companies were less badly affected than some international companies (particularly, those active in the U.S.A.). The unfavorable economic situation also had a somewhat delayed effect on the insurance market in CESEE, triggering a visible slowdown in premium growth in the first half of 2009 after double-digit growth in some markets in 2008. This decline is closely associated with the macroeconomic situation deteriorating significantly at end-2008 and early 2009 and turning into recession in almost all CESEE markets.

The financial crisis did not result in any major perceptible changes to Austrian insurance companies' business and investment strategy. Those active in CESEE confirmed that they would remain committed to the region, thereby helping stabilize the situation. In view of the current overall difficult market environment, the lower dis-

Chart 13

Stock Price Trend of UNIQA Group Austria, Vienna Insurance Group and DJ EURO STOXX Insurance

Stock prices normalized to 100 as at January 1, 2007



Source: Bloomberg.

closed reserves and a continued uncertain outlook, insurance companies have turned to improving their cost basis. They are also likely to place a greater focus on the writing of "profitable" policies. The balance sheet risk of the CESEE affiliates appears to be limited owing to the subsidiaries' extremely low book values.

The stock prices of insurance companies also reveal the worsening of the financial turmoil and the outbreak of the crisis in September 2008 as well as the deep recession in the first quarter of 2009. The stock price of UNIQA Group Austria has reflected these movements only to a certain extent. The stock of Vienna Insurance Group (VIG) even adopted a contrary trajectory and rose when the insurance index initially slumped in March 2008. At end-2008 and early 2009, however, significantly deteriorated CESEE economic prospects had a detrimental impact on the VIG stock price. A positive point to highlight is that the stock market rally since March 2009 has been stronger for the VIG stock than for benchmarks.

2 Summary and Outlook

From 2002 to the outbreak of the U.S. subprime crisis in the summer of 2007, the Austrian insurance sector benefited from a favorable macrofinancial climate. Growth in the industry was driven by life insurance, above all. Insurance companies' profitability rose primarily owing to higher investment income, while fierce competition made actuarial business difficult.

Risks in property and casualty insurance are changes in the probabilities of major loss events occurring. Furthermore, the relatively unfavorable cost/premium ratio has a detrimental effect in times of poor market conditions. In life insurance, a protracted phase of low interest rates, coupled with growing life expectancy could become a problem in guaranteed products.

Expansion in CESEE resulted in higher growth and rises in profitability. Despite high growth rates, these markets still hold catching-up potential although the financial crisis has put a brake on the adjustment process.

The crisis also hit the Austrian insurance industry: Investment income fell sharply and undisclosed reserves declined. Austrian insurance companies' comparatively conservative investment strategy and their focus on core business helped make the impact manageable, however.

The still uncertain economic outlook, the low level of interest rates, the lower undisclosed reserves and fierce competition all indicate that Austrian insurance companies will continue to face major challenges in the foreseeable future.

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