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French Life Insurance

Stable Outlook For French Life Insurance Reflects Strong Balance Sheets And Shareholder Support, But Also Low Profitability Of New Business And Intense Competition. New Pension Products May Provide New Opportunities While Relative Positions Of Existing Players Could Potentially Be Affected.

Company Name	Insurance Financial Strength Rating	Rating Outlook
AXA France Vie	Aa3	Stable
AGF Vie	Aa3	Stabke

Summary Opinion

Moody's has reaffirmed its overall stable credit outlook for France's principal life insurance companies, reflecting their key role in accounting for a large proportion of the country's savings in addition to their low risk profiles, positive growth prospects and stable operating environment. However, despite these strengths, the industry faces not only pressures on financial margins and growing competition but also various challenges relating to the introduction of increasingly sophisticated products and accounting and regulatory developments.

Life insurance remains the preferred form of long-term savings for the French population and should continue to account for a very high proportion of individuals' assets and savings (39.7% of the country's financial assets in 2002, up from 20.8% in 1992). French insurers also enjoy low asset risk thanks to their relatively high level of investment in highly rated bonds, which offered good diversification benefits during the recent equity and credit market crises and enabled them to maintain their solid solvency positions while limiting the scope of assets impaired.

In addition, the sector generally displays a sound liability structure based on low investment guarantees, minor exposure to guaranteed minimum death benefits (GMDBs) and negligible mortality risk given the small proportion of annuity policies sold in France.

Positive growth prospects should be fuelled by new money flows as a result of the government's recent reforms to introduce tax-efficient pension products and to reduce the appeal of regulated bank deposits. In addition, the recent pick-up in unit-linked sales should continue to be sustained by increased policyholder confidence in light of the improving equity markets.

The French insurance sector benefits from a relatively stable operating environment compared to that in other European countries, given a flexible regulation on pricing and product innovation and a stabilised tax regime. Nonetheless, the industry faces a number of significant challenges. Notably, profitability is being pressured by declining investment income and intense competition, thus restricting its ability to cut bonus rates proportionately.

Competition is likely to intensify as insurers fight hard to capture shares in the new pension market, which is expected to remain particularly stable given that early surrender on such policies will not be permitted, and as new entrants such as non-life mutuals appear on the scene. However, we expect banks to continue to be successful in gaining market shares based on their strong client relationships and extensive branch networks.

The introduction of the new pension products is likely to pose some challenges given their annuity payout, which will require French insurers to further develop their skills at managing mortality risk, and their greater administrative complexity, resulting in high fixed costs.

At the same time, the changeover to International Financial Reporting Standards (IFRS) could give rise to operational, regulatory and financial communication risks given their considerable dissimilarity from current French GAAP. By contrast, the introduction of Solvency II, which aims to better reflect the asset and business risks of companies, should further highlight the French life insurance industry's low risk profile.

We also note that the industry's regulatory solvency relies on large unrealised gains on bonds and insurers are therefore exposed to a rapid rise in interest rates. Mitigating this risk, the solvency coverage with core capital has been gradually improving over recent years, while French life operating companies typically continue to benefit from the strong support of their shareholders, whether these are large international groups or French banking groups.

Credit Strengths

- Positive growth prospects related to the introduction of new pension products, lower appeal of regulated bank deposits and recent pick-up in unit-linked sales helped by recovering equity markets
- Low liability risk due to limited options and guarantees embedded in life products
- Well-diversified distribution channels with a relatively greater importance of proprietary networks
- Solid bond asset quality and relatively modest exposure to equity markets.
- Stable operating environment as compared to other countries
- Strong shareholder support

Credit Weaknesses

- Pressure on new business profitability due to deteriorating financial margins in the current low-yield environment
- Heightened competition ahead of the introduction of new pension products and in light of the growing ambitions of mutuals in the life sector
- Moderate capital formation and regulatory solvency reliant on unrealised capital gains on bonds

Relative Size And Product Mix

One Of The World's Largest Life Markets

France's high life insurance penetration and density ratios compared with other EU countries underpin its position as one of the world's largest life markets. Despite some fluctuations in premiums collected for savings products in recent years, the market has enjoyed nearly continuous growth over the past 20 years.

Table 1:Top 10 European Life Insurance Markets (2002)

		Life Premium Income (€ million)	Share of European Market
1 -	United Kingdom	182,059	34.3%
2 -	**France**	86,300	16.3%
3 -	Germany	65,700	12.4%
4 -	Italy	55,298	10.4%
5 -	Netherlands	27,200	5.1%
6 -	Spain	27,000	5.1%
7 -	Switzerland	24,152	4.6%
9 -	Belgium	14,500	2.7%
8 -	Sweden	11,614	2.2%
10 -	Finland	9,812	1.8%
	Total - European Union	480,875	90.6%
	Total - CEA members(1)	530,517	100.0%
	Japan	347,009	
	USA	492,223	

Data Source: Comité Européen des Assurances (CEA) and Sygma
(1) Based on the 29 CEA members, all belonging to the European Economic Area

Recent shift from unit-linked products towards traditional with-profit policies…

After enjoying strong growth in the late 1990s, unit-linked policies ('*multi-supports*' policies – a life insurance wrapper offering a choice of investment funds) suffered a severe downturn (sales declined 40% in 2001, 30% in 2002 and a further 7% in 2003), reflecting the collapse of equity markets, as unit-linked products were primarily invested in equity funds. However, this drop in unit-linked premiums was compensated by a shift back towards traditional with-profit products (+18% in 2001, +14% in 2002 and +13% in 2003), demonstrating the resilience of French demand for long-term savings products (overall life insurance market: -6% in 2001, +1.1% in 2002, +9% in 2003).

…Is resulting in lower risk-based profitability for the industry

Unit-linked products effectively offer higher risk-based profitability given:

- Their lower solvency capital requirements (1% of policyholders' reserves versus 4% for traditional products), justified by the absence of investment risk for insurance companies
- Their fee-based rather than spread-based nature which offers higher margins in a low-yield environment

Indeed, business considerations are limiting insurers' ability to further lower their bonus rates on with-profit policies, which Moody's expects to be increasingly paid out of low-coupon bonds as old bonds mature, thus compressing insurers' new business margins.

Table 2: Unit Linked As A % Of Gross Technical Provisions	2002	2001	2000	1999	1998
Cardif Assurance Vie (BNP-Paribas)	48.9%	56.1%	59.5%	56.0%	48.7%
Sogécap (Société Générale)	37.4%	44.5%	46.9%	37.9%	29.4%
Natio Vie (BNP-Paribas)	29.8%	33.0%	33.3%	27.9%	23.2%
La Féderation Continentale (Generali)	22.5%	27.8%	35.3%	29.3%	18.7%
AXA France Vie	22.3%	26.7%	27.6%	22.1%	16.2%
Aviva Vie	22.1%	25.5%	27.9%	25.2%	20.3%
Les Assurances Fédérales Vie (Crédit Agricole/Crédit Lyonnais)	21.8%	24.8%	24.7%	21.4%	15.7%
AXA France Collectives	15.4%	28.3%	30.2%	26.9%	11.1%
ABP Vie (Banques Populaires)	14.6%	17.8%	19.1%	14.8%	8.6%
Groupama Vie	14.4%	15.7%	15.4%	11.8%	7.2%
ACM Vie SA (CMCEE)	13.3%	16.4%	17.4%	11.0%	4.4%
Socapi (Crédit Mutuel)	13.1%	15.8%	17.5%	15.5%	11.9%
Generali France Assurances Vie	11.6%	16.3%	20.0%	16.7%	11.1%
CNP Assurances (Caisses d'Epargne, La Poste)	10.3%	12.8%	14.0%	10.6%	6.5%
AGF Vie	9.3%	11.8%	11.7%	10.2%	7.2%
La Mondiale	9.2%	9.7%	14.0%	22.7%	12.4%
Ecureuil Vie (Caisses d'Epargne)	7.8%	7.3%	7.5%	5.1%	1.9%
Prédica (Crédit Agricole)	7.4%	8.8%	9.8%	6.6%	2.8%
GPA Vie (Generali)	3.7%	4.7%	5.6%	4.0%	2.7%
Mutavie (MACIF)	1.3%	2.1%	3.1%	2.7%	0.7%
Equally-weighted average	16.8%	20.3%	22.0%	18.9%	13.0%

Source: Moody's Insurance Statistical Supplement: French Life Insurance, February 2002.
Note: The relative share of linked business in total life reserves has evolved based on sales volumes and changes in asset values.

Development of "exotic" life policies could carry some reputation risk…

In response to declining equity markets and growing risk aversion from customers, many companies have marketed index-linked products that carry capital protection features or some form of Guaranteed Minimum Investment Performance, in exchange for a cap on the maximum future performance of the underlying assets. In fact, in a shrinking market, capital-guaranteed products have been the only way to attract further unit-linked sales. We believe that these guarantees should not weigh on French life insurers, as the companies managing the funds (usually insurers' subsidiaries or banks' affiliates in the case of bankinsurers) have fully hedged associated risks and protection is purchased from excellent banking counterparties.

At the same time, policyholders may become dissatisfied with these products as they may ultimately realise that the potential investment performance that they have foregone and the high fees typical of these products are disproportionate with their real benefits and performance.

…However unit-linked sales could recover

Moody's expects unit-linked sales to progress, driven by lower customer risk aversion in light of improving equity markets, and the launch of new pension products, which are likely to be based mainly on unit-linked products. In this respect, Moody's is comforted by the recent sales performance of linked policies which were up by 58% over the first two months of 2004 compared with a year ago. This possible trend reversal in favour of fee-based products, in a context of rising asset values, could therefore mitigate the various risks mentioned earlier. In our view, such a scenario would favour bankinsurers, given their greater emphasis on the unit-linked segment (please see table above).

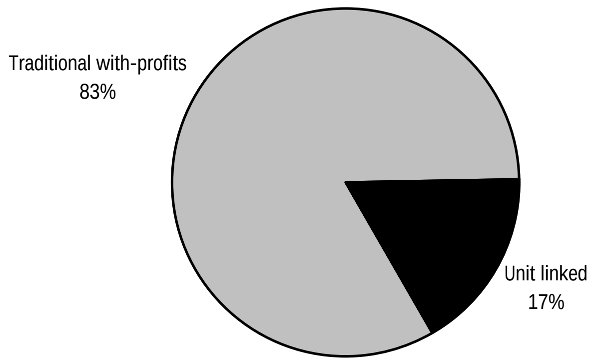
Interest-rate deficiency risk remains moderate

Although the current low-yield environment may have some negative business impact for life insurers (lesser capacity to attract customers with policies offering high returns, margin pressures), it does not compromise their ability to meet their commitments to policyholders. The majority of individual policies sold in France carries low guaranteed rates (between 0% and 3.5%, although most of the new business carries a 0% guaranteed rate), with policies offering the higher guarantees usually being backed by older, higher-coupon bonds. In addition, those companies with the greater exposure to guaranteed-rate policies are pursuing an active policy of hedging the related risks and accelerating the surrender and renewal of old policies on more favourable terms.

While exposure to GMDBs is insignificant

As regards linked business, the main asset and liability management (ALM) risk resides in the guaranteed minimum death benefits (GMDBs) embedded in some policies. During the recent equity slump, Moody's believes that most GMDBs have become 'in the money', a feature that was not fully recognised in insurers' balance sheets. However, the relatively large proportion of bonds in linked assets (as compared to other countries) – coupled with recovering equity markets – have mitigated the risk associated with these guarantees which now appear to be more adequately provisioned. In addition, the cost of such guarantees is most often passed onto clients through charging them specific loadings, and insurers' liability under such contracts is generally capped. More importantly GMDBs only concern part of the linked book which itself represents only 17% of French insurers' mathematical reserves. However, although the overall industry exposure to GMDBs is minor, we note that there might be a greater contrast as regards the situation for individual companies.

Breakdown Of 2002 Mathematical Reserves



Source: Fédération Française des Sociétés d'Assurance or FFSA

Recent Savings Reforms Could Create Significant Growth Prospects

France's new pension reform could offer significant growth opportunities…

The forthcoming launch of new pension products (see box below) could offer substantial long-term business opportunities for life insurers, given their tax-incentives and French households' increasing awareness that pensions received under the current pay-as-you-go system will have to be supplemented by additional savings revenues. (The pension reform of summer 2003 highlighted important issues pertaining to (i) the gradual phasing in of a longer working life between 2003 and 2012, (ii) the phasing out of the pension privileges of public workers and (iii) the increase in pension contributions of 0.2 percentage points starting 1 January 2006.) The Fédération Française des Sociétés d'Assurance or FFSA, a French insurance professional association, expects *Plan d'Épargne Retraite Populaire* or PERP products to attract over €1 billion of new money in 2004. The PERP market should, however, develop at a gradual pace due to:

- Its expected contribution pattern (regular but modest contributions given the tax-deductibility cap).
- Its main attraction to the higher-rate taxpayers in France (although only 50% of households pay taxes in France)
- The already high French savings rate (16%), which indicates that new pension flows are likely to result from a reallocation rather than an increase in household savings.

In addition, we believe that the success of the PERP will be dependent on:

- The ability of the distribution channels to (i) persuade French households to commit their savings until retirement age (early surrenders will not be possible but switching between providers will be allowed) and (ii) educate them about the annuity payment of accumulated pension savings, given French people's greater familiarity with, and preference for lump sum payment.
- The stability of their fiscal status, subject to political changes.

The "Fillon" Law on pension reform, which was enacted on 24 July 2003, creates two supplementary voluntary pension vehicles: the *Plan d'Épargne Retraite Populaire* or PERP and the *Plan d'Épargne pour la Retraite Collectif* or PERCO. The PERP is an individual annuity policy that can be subscribed by anyone on a voluntary basis. The PERCO is a collective investment vehicle which can only be subscribed to by salaried employees in the framework of their company. Subscribers to PERCO can choose to receive their pension either in the form of annuities or through a lump sum payment. Both products will offer tax deductibility of the funds invested into them.

…While the concomitant reform of regulated savings should boost money transfer to life insurance and new pension product

In Moody's opinion, the recent government reforms of regulated banking savings deposits should further contribute to the success of the new pension vehicles. The measures (see box below) have so far reduced their attractiveness by cutting their deposit rates and tax-benefits. This should reduce the overall cost to the government and possibly direct households' savings into higher yielding investments such as the new pension vehicles.

Measures specified in reforms of regulated savings are as follows:

- More stringent conditions for the granting of a state lump sum payment for Plans Epargne Logement or PEL mortgage saving plans opened since December 2002.
- The rates payable on the main savings accounts, including "*Livret A*", "*Livret Bleu*" and "*Codevi*", were cut by 75bps in July 2003 (to 2.25%), and should be correlated with the short-term risk-free rate as of July 2004.
- Plans d'Epargne Populaire (PEP) accounts were withdrawn in September 2003. PEP accounts offered capital guarantees and tax exemption on gains, provided funds remained invested over an eight-year period.

However, challenges remain as to their effective management

Although the introduction of PERP and PERCO offers significant long-term growth opportunities, Moody's notes that they also entail some challenges in terms of ALM, given their particular features as compared to traditional life insurance policies. The new pension products will potentially have a longer investment horizon and hence a higher focus on maintaining the real value of accumulated savings. In theory, it should therefore have a higher allocation to more volatile assets (such as equities) than traditional insurance policies. However, in practice, this is unlikely to be the case due to the protection rules governing the product, which require that a minimum percentage allocation to liquid assets should be held on a customer's behalf, based on its remaining term to retirement. In order to ensure that they meet this condition, insurers are likely to have a more conservative investment approach than first suggested by their longer time horizon. Furthermore, PERP assets will be held in separate funds — clearly segregated from assets backing other policies. Each PERP performance will therefore have to be built from nil, which will be more challenging in the current low-yield environment. In the longer term, PERP products will also require that insurers further develop their skills at managing mortality risk given their annuity payout.

In addition, Moody's expects the fee structure for PERPs to be slightly higher (some hidden commissions becoming more apparent) than for existing products with entry fees at around 4% to 5% (unlike in the UK where insurers' loading ability for equivalent pension products was restricted to 1%). However, we also note that PERPs entail greater administrative complexity[1] than usual life policies, and could hence incur higher management costs. Moody's also highlights that the tax benefits granted to the new pension vehicles might ultimately justify the gradual phasing out of those attached to traditional life products, thus triggering a "cannibalisation" effect.

Competitive Environment

After recent mergers and acquisitions, the focus is now on integration

Consolidation between traditional domestic players in the late 1990s (AXA-UAP in 1997 and Groupama-GAN in 1998) has been followed by the combination of insurance operations resulting from:

- Bank mergers (CMCEE-CIC in 1999, BNP-Paribas in 2000, Crédit Agricole-Crédit Lyonnais in 2003)
- Strategic reassessments by large international groups of their presence in France (Zurich Insurance Company withdrew from the French market and Italy's Toro Assicurazioni SpA sold its French operations to Generali in 2003) owing to the recent adverse environment

Today, the market appears fairly well distributed between banking subsidiaries, large international groups and subsidiaries of mutual insurance, and according to Moody's any further large deals appears relatively unlikely in the short-term. In contrast, most groups are focusing on optimising their internal organisation as evidenced by:

- The recent combinations of insurance affiliates of banking groups under single holding companies (CIC transferred its insurance subsidiaries to CMCEE's own insurance group; and both Banques Populaires and BNP Paribas united their insurance companies under the control of holding companies respectively called Natexis Assurances and BNP Paribas Assurance).

1. *PERP will be subscribed by an association called Groupement d'Épargne Retraite Populaire or GERP, supplemented by a supervisory board and an assembly of policy-holders to ensure an adequate level of governance. In addition to dealing with PERP representatives, insurers will also have to appoint separate auditors for each PERP.*

- Internal reshuffling, including portfolio transfers and legal mergers, to achieve greater consistency and efficiency across operating entities at Groupama and Generali (organisation based on distribution channels), as well as AXA (client-focused approach).

Moody's believes that consolidation has helped to enhance the franchises of the groups involved while cost synergies should continue to filter through to their earnings, given their efforts to rationalise their distribution networks and to realise cost saving opportunities (e.g. combination of transversal functions, cross-fertilisation of best practices).

Top Life Insurance Players
French Insurance League Table 2002

Rank in Life	Direct premiums in € billions Source:L' Argus de l'Assurance	In France Life	P&C
1	CNP	16.3	1.0
2	Crédit Agricole/Crédit Lyonnais *	13.2	1.0
3	AXA	9.3	5.7
4	BNPP	6.0	0.3
5	Generali France	5.9	2.4
6	Société Générale	4.9	-
7	AGF	4.4	5.1
8	Groupama *	3.7	5.9
9	Crédit Mutuel Centre Est Europe *	3.5	1.0
10	Aviva France	3.3	1.0
12	La Mondiale *	2.8	-
13	Société Suisse	2.3	1.0
14	Banques Populaires *	2.0	0.3
15	MMA MAAF *	1.5	4.0
	Total top 15	**79.1**	**28.9**
	Market total	**95.3**	**36.4**
	Top 15	83%	79%
	Top 10	74%	65%
	Top 5	53%	29%
	Total bankinsurers	48%	10%
	Total mutual groups (*)	28%	34%

Source:L' Argus de l'Assurance

Background consolidation to arise from alliances

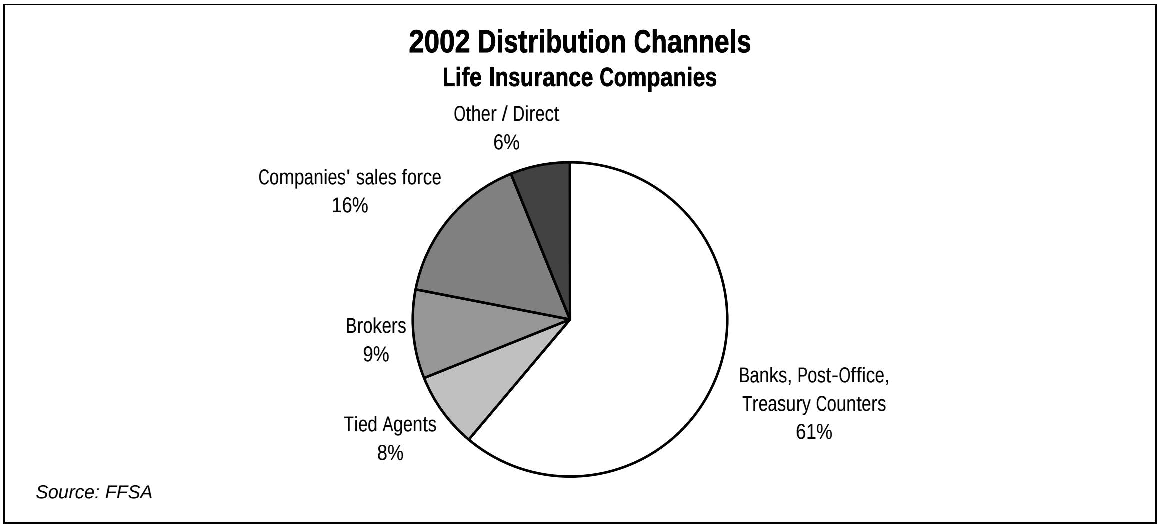
Looking ahead, Moody's believes that extensive consolidation in the industry could be fuelled by further restructuring actions from international groups, and by the formation of additional alliances between smaller companies, notably those controlled by mutual insurance groups. In this regard, Moody's notes that consolidation in the mutual sector could be facilitated by the creation of a new set of legal vehicles, thereby allowing non-stock companies to form flexible alliances without having to abandon their mutual status.[2]

Some companies may also team up with mutual (usually smaller) institutions that fall outside the insurance regulatory framework. These smaller companies provide protection and other insurance products (via '*Mutuelles 45*' and '*Institutions de Prévoyance*'), and are particularly strong in the field of health insurance and workers' compensation. Cases in point are the partnerships between (i) Aviva and Médéric, in the field of life and savings, and (ii) La Mondiale, a mutual, and Aegon, with a view to developing pension and retirement products in France.

Extensive branch networks and increased sophistication underpins banks' dominance

An essential feature of the French market is the very high market share that banks have achieved in distributing life insurance products.

2. *Please refer to Moody's SPECIAL COMMENT: Sociétés de Groupes d'Assurance Mutuelle (SGAM), April 2004*



We believe that banks will continue to put pressure on other distribution channels, increase their market penetration and improve their cross-selling rate to their customers as:

- Insurance activities are very significant contributors to the earnings of the banks' retail activities (up to one-third based on Moody's analysis)[3].
- Insurance products are seen as very powerful instruments that enhance the loyalty and profitability of individual banking relationships. At this high level, all the largest retail banks, in practice, have their proprietary life insurance companies which usually distribute policies exclusively at the banks' counters.
- Banks also leverage their cheaper distribution, lower cost structure (most of the back office work is actually carried out by the staff in the branch network) and their critical mass in asset management (banks dominate the French market in asset management and mutual funds).

Although banks have built their market dominance on the distribution of simple, commoditised savings products, we expect bankinsurers:

- To continue to diversify their product offering, in areas such as risk products, as they see protection business (e.g. term-life, casualty & health) as an opportunity for further growth.
- To upgrade the advice skills of their staff, as clients are increasingly requiring counselling in wealth and protection products.

Banks are particularly targeting supplemental health and accidental death and disability covers. These products usually carry a small premium, but, mass-marketed on a massive scale, they add significantly to the cross-selling rate and the profitability of life insurance operations.

If successful, new pension products could further challenge the relative market positions of traditional insurers and banks

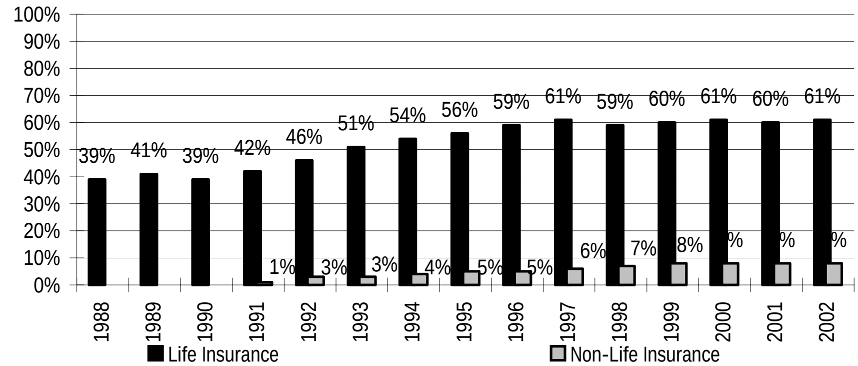
Banks will be able to leverage their strong client relationships in the field of individual pension schemes…

The introduction of PERPs could intensify competition between players, given the perception that market shares in this segment are likely to be sticky: although customers will be able to switch providers, early surrender on such policies will not be permitted (except under exceptional conditions).

Over the past decade, banks have continuously taken market shares away from traditional insurers, despite the insurers' 'first-mover' advantage.

3. See Moody's Special Comment entitled "Growing insurance operations are positive for French banks' credit strength", December 2000.

Market Share Of Banks, Post-Office And Treasury Counters



Data Source: FFSA, market shares based on total premiums

Although the PERP will be regulated as a life insurance policy, it is not positioned as such because life insurance products have traditionally served as savings vehicles. This, coupled with banks' aggressive marketing campaigns, is likely to pose a significant challenge to traditional insurers. Banks intend to market the new PERP as part of a global financial planning offer which includes mutual funds, traditional life insurance and investment advice. We believe that French banks are well positioned in the market of individual pension schemes based on their strong client relationships and their wide product offerings, which enable them to incorporate their pension products into a complete financial planning solution. In response, traditional insurers aim to implement a more advice-intensive sales approach in order to achieve their natural market share in this segment.

…And draw on the progress made in the field of employee savings plans regarding collective pension schemes

Relative market positions for the collective pension scheme (PERCO) are as yet uncertain, given the present difficulty of gauging (i) whether the new schemes will be successful, and if so, (ii) whether insurance companies or banks will capture the greater share of the new market. Both types of institution are well positioned as banks could leverage the efforts already achieved in the context of employee savings plans, while insurance companies could profit from their historical positions in group life business.

Mutual companies are trying to diversify into life business

French mutual companies have traditionally had a greater franchise in non-life retail businesses, aside from a few exceptions, such as La Mondiale. However, they are increasingly seeking new growth opportunities and diversification through the development of life insurance operations. Mutuals have either set up their own life affiliates such as Maif with Maif Parnasse and Macif with Mutavie, or tied up with provident associations as in the case of AG2R and La Mondiale, or Mederic and MMA. In this field, Mutuals are positioning themselves not only on businesses close to their core values of mutuality and universal protection such as supplemental health, accidental death and disability covers, but also on the developing segment of complementary pension. In this respect they can leverage their ties with other non-stock collective social institutions such as pension schemes belonging to ARRCO or AGRIC (complementary pay-as-you-go pension regimes based on compulsory contributions from employees and employers) or provident associations (which offer a third protection layer based on voluntary contributions from employees and employers).

In Moody's view, mutuals could put additional competitive pressure on traditional networks based on their strong ties with affinity groups, their low cost structure relying (in most cases) on proprietary (salaried) distribution and their ability to re-invest profits in very competitive product pricing. However, their tight solvency capital could also restrict their ability to accompany the business development of PERPs, while the tax-incentive attached to the new pension vehicles is least likely to appeal to their financially-modest client base. In addition, the high fixed costs implied by the heavy legal structure of PERPs might lead smaller mutuals to outsource their pension business to partners with sufficient scale.

Traditional distribution tries to improve the profitability of its client base

Traditional insurance companies selling mainly through tied agents and their own sales forces, and to a lesser extent through brokers, remain under pressure to restructure their distribution channels in order to compete effectively against banks. Key efforts have so far consisted of:

- Segmenting their agents according to their sales performance, client orientation or product mix, in order to apply differentiated strategies and optimise the support (marketing and back-office) provided by the overhead entity.
- Strengthening their client relationships through increasing their cross-selling rates and targeting the specific needs of clients based on credit risk management (CRM) tools.

- Expanding their offer to banking products in order to enhance their distribution power and the profitability of their customer bases. Both AGF and AXA have launched direct banking subsidiaries (although customers will also be able to transact through their agents), while Groupama has set up its own banking affiliate in a joint venture with Société Générale.

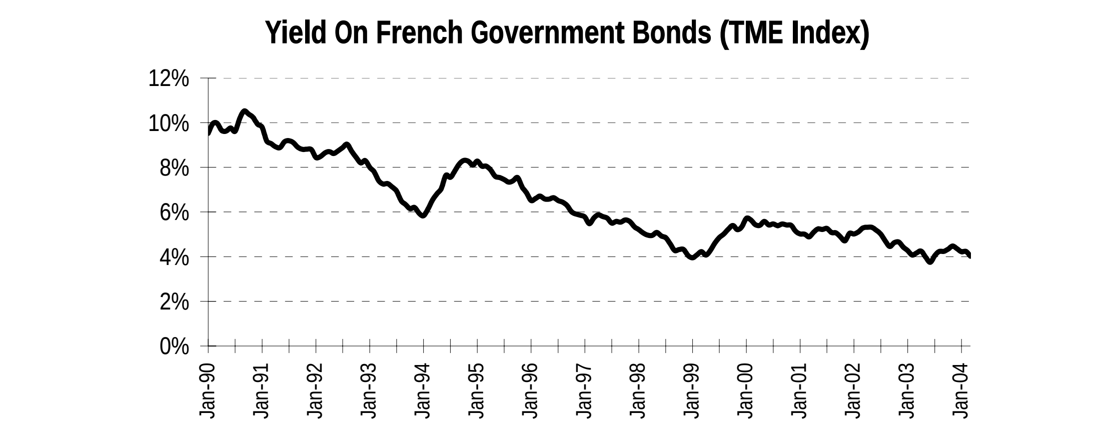
In contrast with the more “mass-market” approach of banks and mutuals, traditional insurers have also set up a highly specialised distribution workforce, focusing on wealth management to address the affluent segment.

More generally, the importance of tied distribution – either through bank branch networks or tied agents – has created strong barriers to entry on the French market, thereby protecting the incumbents controlling strong distribution channels.

Sound Financials Although New Business Profitability Is Declining

Lower financial income is pressuring future margins

As mentioned above, life insurance in France is essentially a spread business; the sector’s profitability being largely correlated with the financial margins extracted from the total assets managed, with the evolution of mortality and surrender rates playing a relatively marginal role. Surrender rates are indeed relatively low in France due to the loss of tax-benefits, surrender penalties and customer loyalty. While assets managed should continue to enjoy positive growth, the secular decline in yields – coupled with relatively high bonus rates – is denting the profitability of the business currently written. Although insurers have sought to lower their crediting rates, their ability to continue further is limited by competitive pressures and the risk of massive surrenders in case of rising yields.



TME index: monthly average yield on fixed rate government bonds with maturities greater than 7 years
Data Source: Bloomberg

In this regard, Moody’s believes that insurers with sophisticated asset management capabilities, strong cash flows and solid solvency position, will be better positioned to achieve yield enhancement through opportunistic trading or greater allocation to risky assets.

Moody’s also highlights that the introduction of the new pension products could introduce greater flexibility in the management of with-profit business, and could thus mitigate the “scissor” effect currently observed. The longer time horizon of these products should enable insurers to achieve smoother investment returns in order to meet their relatively sticky policyholders’ commitments. PERPs’ greater persistency (no-early surrenders, few substitutes as they are not positioned as savings products) and longer time horizon should thus provide lower exposure to varying market environments.

Despite the recovery in equity markets, provisions should continue to impact 2003 earnings

Provision for permanent impairment (*Provision pour dépréciation durable* or PDD) and liquidity provision (*Provision Exigibilité des Engagements* or PRE) are expected to continue to dent earnings due to their smoothed recognition in the accounts, and due to the fact that they were only partially applied in 2002 due to accounting and regulatory waivers. French GAAP does not require companies to mark-to-market their assets, but instead requires them to distinguish between a permanent and a temporary shortfall in value, and, in the case of the former, to provision the asset based on its long-term expected value. Whilst the percentage shortfall required to trigger an impairment test has traditionally stood at 20% of the carrying value, an Urgent Issues Taskforce recommended the application of a looser requirement of 30% in 2002, given the exceptionally high market volatility.

For 2003, improved market conditions justified a shift back to the stricter 20% rule, on the expectation that provision charges in 2003 would be equivalent to those passed in 2002. The renewal of the PRE, which was waived by some companies in 2002, also accounts for the continued asset provisioning in company accounts (PRE does not apply to consolidated accounts) despite recovering equity markets. A new rule stipulates that one-third of unrealised losses on equities and real estate should be provisioned, and possibly the whole amount for companies with weak solvency positions.

We expect companies to continue to be impacted differently, depending on (1) their equity exposure and real estate exposure, (2) the seasoning of their equity portfolio and the amount of capital gains they had already realised in the past and (3) their own risk-attitude, given that companies benefit from the flexibility of determining the level of adequate impairment provisioning. However, we stress that these charges primarily reflect falls in equity values that occurred prior to 2003, while equity markets appear to be gradually recovering.

French insurance regulations require that the following provisions be booked, if needed:

- **Provision for permanent impairment (*Provision pour dépréciation durable* or PDD)**

  The provision must be made whenever the appraisal value of an investment (equity, real estate, bond) is deemed to be permanently below its carrying value. Assessment of the provision is a management decision, subject to review by the auditors and the regulators. All equity investments whose market value had been below 20% of its carrying value over six months should be considered for provision.

- **Liquidity provision (*Provision Exigibilité des Engagements* or PRE)**

  The provision is the difference between the appraisal (market) value of real estate and equity investments and their total carrying value. The provision, calculated company-by-company – i.e. not on a consolidated basis – recognises the potential shortfall in value that the company would face if it were forced to liquidate all its investments to meet all its policyholder liabilities. A new law passed in 2003 specifies its mode of enforcement: one-third of the gross unrealised losses on equities and real estate should be provisioned or, in the case of insolvent companies, entirely taken to the income statement. In addition, the Insurance Commission will no longer be authorised to partially waive this requirement on a company-by-company basis. However, the liquidity risk that is covered by the provision remains highly theoretical as the liability profile of life insurers is very long-term, and there is no certainty that there will still be an unrealised loss on real estate and equities when the policyholders' liabilities are repaid.

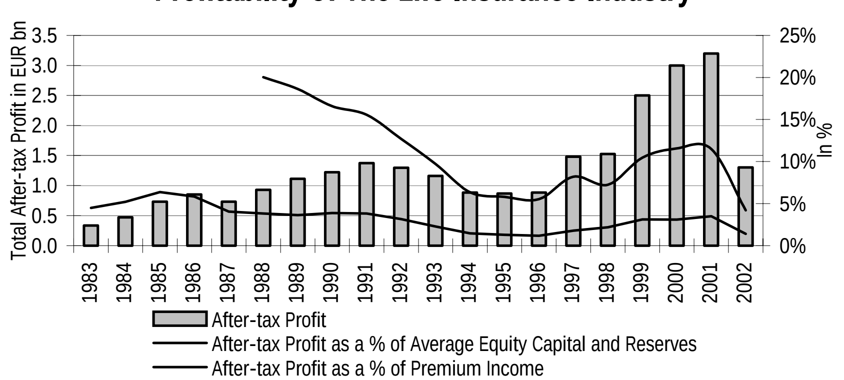
- **Provision for spread deficiency risk ("Provision pour aléa financier" – PAF)**

  The provision must be made when the yield on assets becomes lower than the yield rate due to policyholders multiplied by 1.25

Merger of operating companies and focus on cost control is positively impacting earnings

Moody's believes that a large part of the cost-saving potential related to the mergers in the late 1990s has yet to be realised. Strict labour regulation and strong corporatist culture amongst agents in France make it difficult to undertake large-scale restructuring immediately. Poor financial results and mounting competition should accelerate this trend, as reflected in companies' focus on cost control.

Profitability Of The Life Insurance Industry



After-tax profit is an aggregate for the market; premium income is gross of reinsurance; equity capital & reserves includes the profit for the year. Data is for operating companies, not groups. ROE not available for 1987 and before
Data Source: FFSA

In the recently troubled environment, cost efficiency has not been a determining factor of performance (which has been impacted by asset impairments and lower financial income), but it could become a greater competitive advantage when operating conditions return to normal given the wide disparity that already exists between players in this domain:

Life Gross Acquisition And Administration Expenses As A % Gross Premium Income	2002	2001	2000	1999	1998
Mutavie	2.5%	2.8%	3.0%	2.9%	3.4%
Les Assurances Fédérales Vie	3.5%	4.0%	3.6%	5.0%	4.8%
AXA France Collectives	5.0%	8.5%	6.9%	7.0%	8.1%
Sogécap	5.1%	5.0%	4.3%	5.0%	5.5%
La Féderation Continentale	5.7%	5.8%	5.4%	5.7%	7.6%
Socapi	5.9%	6.0%	5.5%	4.6%	5.3%
Prédica	6.0%	5.7%	5.1%	5.8%	5.8%
Natio Vie	6.2%	5.8%	5.5%	5.1%	4.9%
ACM Vie SA	6.3%	5.6%	4.0%	3.8%	3.9%
ABP Vie	6.8%	7.1%	5.2%	5.1%	5.4%
Ecureuil Vie	6.9%	7.3%	6.1%	5.3%	5.1%
CNP Assurances	7.1%	6.0%	6.1%	6.1%	6.1%
Groupama Vie	7.8%	7.1%	7.5%	8.5%	8.6%
La Mondiale	8.1%	8.4%	7.1%	9.9%	11.9%
Cardif Assurance Vie	9.1%	9.0%	7.3%	7.3%	7.4%
Generali France Assurances Vie	11.6%	16.4%	8.3%	7.7%	8.7%
AXA France Vie	12.7%	10.4%	7.9%	9.9%	13.4%
Aviva Vie	13.1%	12.5%	13.8%	9.9%	13.7%
AGF Vie	16.2%	14.6%	11.9%	14.0%	14.5%
GPA Vie	16.7%	18.0%	17.5%	17.6%	18.2%
Equally-weighted average	8.1%	8.3%	7.1%	7.3%	8.1%

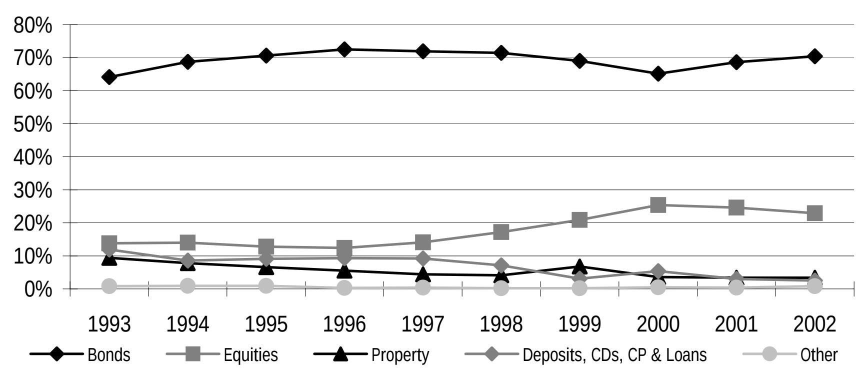
** For 2002, the equally-weighted average was 8.4% for the whole French market according to the Insurance Commission*
Source: Moody's Insurance Statistical Supplement: French Life Insurance, February 2002.

In this regard, banks and mutuals appear to have an advantage over traditional insurers in terms of cheaper distribution and higher efficiency. In addition, looking at the profitability of subsidiaries of banks also ignores the fact that commissions (on acquisition and on assets) are paid to the bank – thus the profitability of insurance operations for bankinsurers is likely to be materially higher than it may appear at first sight.

High quality non-linked assets, moderate equity exposure

Strong asset quality remains one of the key strengths of French life insurance. Bonds account for more than 80% of insurers' non-linked ("general account") portfolio assets, and half of these are Aaa-rated Treasuries or issued by state-controlled entities. Anecdotal evidence shows that the weighted average rating of bond assets of large life insurers is in the upper Aa-rated range, reflecting *inter alia*, historically lower investment choice than in more developed corporate bond markets such as the US, but also stringent regulations governing admissible assets (high-yield bonds are typically excluded).

Investments Outstanding 1993-2002 (In %)



Investments at acquisition cost on the balance sheet of life and life/casualty & health insurers, including unit-linked investments
Data Source: FFSA

Equities represent around 10% of non-linked assets, which is significantly lower than in many European countries. Although the sector may not be totally immune from the current market downturn (as seen in the provisioning needs in 2002 and 2003), French companies' earnings and solvency have been far less affected than some of their European peers. They have not been compelled to sell their equities at market lows and are therefore well positioned to benefit from their on-going recovery.

Overall, we believe that the investment strategy of insurance companies remains very conservative and prudent, but we note that a greater allocation to risky assets could be progressively triggered by:

- The need to enhance investment yields in a context of low interest rates.
- The longer investment horizon of the new pension products which enhances insurers' focus on preserving the real value of invested assets while increasing their ability to absorb greater short-term volatility.

However, Moody's expects this trend to reflect higher return requirements, lower liquidity needs and longer investment horizons rather than a greater appetite for risk. In addition we positively note:

- A growing European diversification of investments, benefiting from the disappearance of foreign exchange risk within the eurozone, and obtaining better yields outside the traditional French Aaa-rated government bond market
- A greater interest in corporate bonds to enhance yields and in variable-interest bonds to hedge against increases in interest rates
- Renewed, but cautious investments in commercial property as a long-term protection against inflation
- The increasing use of derivative instruments to manage their exposure to key factors (market risk, interest risk)

Regulatory solvency is good, but highly dependent on interest rates

French companies must comply with the European Insurance Directives' minimum solvency margin requirements, both at a company level and, since 2001, on a consolidated basis. Admissible elements of the solvency margin are mainly equity capital and other free reserves, including the '*Réserve de Capitalisation*' used to smooth yields on bonds, unrealised capital gains on invested assets and the proceeds of certain subordinated debt issues.

Average Regulatory Solvency Of The Sector

	1999	2000	2001	2002
Solvency margin coverage with core capital	121%	127%	128%	131%
Solvency margin coverage with core capital and unrealised capital gains	334%	317%	261%	242%

Source: CCA, the French Supervisory Authority

Industry data shows that solvency is good, although not ample, and has been declining mainly because of lower unrealised capital gains on equities, partly compensated by higher unrealised gains on bonds. Therefore, regulatory solvency is highly dependent upon the level of interest rates, because rising rates would wipe out unrealised gains on bonds and realised capital losses on bonds would erode the '*Réserve de Capitalisation*'. In addition, as most of the remaining unrealised capital gains relate to invested assets backing policyholder liabilities, they do not constitute true capital surpluses available to shareholders. That said, lower solvency levels compared to some other European countries is also commensurate with lower asset risk. Furthermore, if insurers were to increase the risk profile of their assets due to a change in their business mix, Moody's believes that this would be justified by a less risky liability profile, with no dramatic impact on the amount of capital economically required.

Limited capital formation capacity is compensated by strong shareholder support and high unallocated bonus provisions

Capital formation within the industry has been constrained by tight product margins and new business strain due to the strong growth enjoyed throughout the 1990s. However, solid shareholder support from banks or large international groups that control French life insurers mitigates thinner capital bases and lower financial flexibility, and is therefore reflected in the credit strength of these companies. Capital held at operating companies should remain sufficient to accommodate their business development, although investment write-downs and strong sales growth have occasionally required parental support through the provision of equity capital or subordinated debt. Most subordinated debt issuance among French life insurers has in fact remained primarily intra group, and very few companies have actually issued bond debt to institutional investors.

Finally, the industry's economic solvency also benefits from substantial provisions for future policyholders' bonuses (€15.5 billion at year-end 2002 which compares to the industry's total shareholders' equity of about €33.6 billion). Highlighting prudent financial management, French life companies have taken advantage of high financial income in recent years (1997-2001) to hoard bonus provisions on which they have already started to draw in order to meet declining financial returns.

Evolution Of Bonuses 1998 - 2002 (Source CCA)					
In € millions	1998	1999	2000	2001	2002
Total bonuses	23,237	25,661	27,814	26,344	25,963
Bonuses credited to policyholders	20,549	22,467	23,751	25,161	26,068
Bonuses credited to bonus provision	2,689	3,194	4,064	1,183	-105
Portion credited to bonus provision	11.6%	12.4%	14.6%	4.5%	-0.4%

Regulatory And Accounting Risk

IFRS carries some accounting risk

Different measurement of assets and liabilities during the transition period is likely to increase balance sheet volatility

As with all listed companies in the European Union, French insurance companies owned by public issuers are expected to adopt International Financial Reporting Standards (IFRS) by 2005. IFRS, which is based primarily on fair-value accounting, substantially differs from French GAAP, which is itself based on historical cost accounting. The changeover to IFRS will therefore entail greater investment and operational risk for French insurers. However, this will be a two-stage process given that IFRS 4 – the policy specific to insurance contracts – is still awaiting finalisation.

During Phase 1 (starting from 2005 until the completion of IFRS 4, possibly by 2007/2010) companies will, however, have to apply the Interim IFRS 4 as well as the other finalised IFRSs relevant to their activities. In particular, under IAS 39, they will be required to mark-to-market all securities classified as "trading" and "available for sale". These should encompass most of their invested assets, including bonds. Although bonds are generally intended to be held to maturity, Moody's does not expect insurers to commit to this objective, and they will therefore be prevented from reporting them at amortised costs.

On the other hand, the Provisional IFRS 4 exempts insurers from other IFRS requirements for insurance contracts, which will continue to be reported under local accounting rules until IFRS is enforced. In this respect, insurers will first have to split their policies into their various components: insurance, savings and derivatives, as the two latter parts will fall under IAS 39. Although traditional life policies in France provide maturity values that could be regarded as deposit components, IFRS 4 will not require them to be unbundled on the basis that such liabilities depend on the returns on invested assets and are gradually recognised in the accounts.

On balance, during the transition period, French insurers' assets will be reported at fair values while their liabilities will be shown at historical costs (as is currently the case under US GAAP). This mismatch will trigger greater balance sheet volatility; a risk that insurers will have to manage given its implications in terms of public policy issues and investor confidence. In addition, Moody's notes that the surrender risk faced by insurers could become more visible under the new accounting standard. Although unrealised gains should be credited to unallocated bonus reserves, unrealised losses could be debited from shareholders' equity once the unallocated bonus reserve is depleted. If the trend in declining interest rates were to reverse, Moody's believes that the bond portfolios of insurers (which could, by then, mainly consist in low-coupon bonds) could display unrealised losses. The resultant reduction in the bonus reserves and possibly equity funds, alongside constant policyholders' liability, would give clear evidence of the surrender risk being faced.

We also caution the possible ALM impacts of the new standards: insurers could seek to minimize their asset-liability mismatch by investing in low-risk assets. This approach would be unsuitable for insurers with long-term investment objectives that require investing in high-yield assets with short-term price volatility. Such concern over balance sheet volatility could interfere with the proper asset allocation and management of the new pension products.

Phase 2: Fair value of insurance liabilities should not differ considerably from current accounting value

The IASB's next step in its insurance project entails re-measuring insurers' commitments to policyholders on each reporting date. Although the methods for assessing the fair value of with-profit contracts have yet to be defined, the outcome should not differ dramatically from existing disclosures:

- Policyholders' liabilities (technical reserves) currently recognised in French GAAP accounts roughly equate to surrender values – a valuation approach reminiscent of the IASB's with regards to demand deposits. However, French insurers may call for lower liabilities to be recognised, based on the fact that most policies are actually not early-surrendered. A first proposal consists of reducing the surrender value of a policy by the present value of its expected future profits. Another alternative would be to reduce it by the value of the non-exercised surrender option granted to the policyholder.

- Embedded options attached to traditional with-profit and unit-linked contracts should not fall under the scope of IAS 39 (unlike those attached to the recent more "exotic" products but they do not represent a major proportion of the life market). Their treatment should therefore not be affected until IFRS 4 is finalised. By that time, such options should not raise much concern given their limited scope (although this might depend on each company's particular exposure), and the expectation that a growing number of them would have lapsed (as in the case of 4.5% guaranteed rates attached to older policies).

French GAAP could continue to serve as the basis for regulatory supervision

Although we recognise the benefits of the new standards in terms of greater comparability of insurers from different countries, the application of IFRS could create greater confusion at the domestic level due to the greater flexibility given to management for some accounting decisions. The French supervisory authorities might therefore require insurance companies to continue to submit French GAAP accounts for supervisory purposes. In such case, we would also continue to examine local statutory accounts because their greater uniformity amongst French players.

Solvency II: Conservative claim reserves and low asset volatility should benefit French insurers

Parallel to the work conducted by the IASB on the accounting front, in 2001 the European Commission (EC) initiated a project to review current EU solvency regulations. The goal is to take better account of the various risks faced by insurers and to foster a greater consistency across countries. In contrast with the previous regime, which was mainly focused on liability risk, 'Solvency II' should better allow for the business profile of an insurer as well as for its asset risk. This should benefit French insurers as compared to some of their European peers, given the low volatility of their assets (mainly invested in high quality bonds) and their conservative claim reserves.

The new regime could thus envisage two types of quantitative financial requirements – a base level derived from the existing regime, and a target level, capturing more fully the specific risks faced by the company. This latter calculation should enable supervisors to take preventative actions while fostering a greater risk culture at insurance companies. However, discussions are continuing as to how this target ratio will be established, notably as regards the adequate level of provisioning that could serve as its basis. In this regard, French insurers have expressed their concern about the possible use of a Risk-Based Capital (RBC) model that would be overly complicated while failing to reflect the specific risk faced by companies. The standard model could, however, be overridden by internal risk models subject to approval by local supervisors. This could benefit companies with internal models that are sufficiently robust to appraise their actual economic capital needs (and to be regulated on that basis), since requirements under a standard RBC model are expected to be larger due to their failure to adequately reflect the imperfect correlation between various risks.

Related Research

Analysis

AXA France Vie, April 2004 (86956)

Insurance Statistical Supplement

French Life Insurance, March 2004 (81761)

French Property & Casualty Insurance Industry Outlook, October 2003 (79861)

Special Comment

Sociétés de Groupes d'Assurance Mutuelle (SGAMs), April 2004 (81852)

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