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Deutsche Rueckversicherung Group

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Deutsche Rueckversicherung Group

Major Rating Factors

Strengths:

- Very strong capitalization.
- Strong underlying underwriting performance.
- Unique competitive position as the main reinsurer for the German public-law insurance (PLI) sector.

Weaknesses:

- Currently declining business volumes.
- Relatively lower competitive strength in non-PLI business.

Operating Companies Covered By This Report
Financial Strength Rating
Local Currency
A+/Stable/--

Rationale

The ratings on Germany-based Deutsche Rueckversicherung AG (DR) and its core Switzerland-based subsidiary, Deutsche Rueckversicherung Schweiz AG (DRS), which together form the Deutsche Rueckversicherung Group (Deutsche Rueck), reflect Standard & Poor's Ratings Services' view that the group's capitalization is very strong. Further rating strengths, in our view, are Deutsche Rueck's strong underlying underwriting performance and its unique position as the main reinsurer for the German public-law insurance (PLI) sector. Against these strengths we note a decline of the group's overall business volumes in 2010 and a consolidation in 2011. This is after growth in recent years, however.

We consider Deutsche Rueck's capitalization to be very strong, based on excellent risk-based capital adequacy, very strong quality of capital, and a conservative reserving policy.

We view the group's underlying nonlife underwriting performance as strong. This segment dominates the group's activities, and the contribution of life business remains very limited. The reported net combined (loss and expense) ratio weakened to 103.4% in 2010 and the five-year reported average net combined ratio increased to about 99.2% against the previous five-year average of 97.7%. However, we consider the overall underlying performance as sound.

The increase in the net combined ratio was due to claims stemming from storm Xynthia and other natural catastrophe events and the group's efforts to build strong additional reserves for new casualty business. We note that, after adjusting for expected ultimate claims, the five-year average combined ratio for the group's traditional business was 98% and 95% for the past five and 10 years, respectively. Importantly, from an adjusted standpoint, the underlying performance of the non-PLI traditional business is, in our view, similarly profitable. Consequently, we believe that the expansion of the non-PLI business would not hamper overall profitability at this stage. Because of the group's weakened investment and underwriting performance in 2010, the reported nonlife return on revenue (ROR) reduced to 3.4% against a five-year average of 5.5%.

We consider Deutsche Rueck's competitive position to be strong, largely thanks to DR's role as the main reinsurer for the regional public-law insurers in Germany. Over time, the group has become one of the major reinsurers of non-life risks in Germany and posted gross premiums of €920 million (net premiums: €601 million) in 2010. In addition, the group has made good progress in expanding business with non-PLI cedants, geographically and by line of business, by focusing on selected clients and on long-term customer relationships. In 2010, non-PLI business represented 38% of the group's consolidated net non-life premiums, and we expect this trend to continue.

We note that, in 2010, business volumes from the PLI sector declined, due to higher net retentions of large clients. By contrast, in the preceding four years, we observed smaller increases for this segment. The group also executed a planned decline in non-traditional third-party business in 2010. As a positive, the traditional third-party business, which is the group's defined future growth area, showed 29% growth to €148 million.

In our view, the group still has to demonstrate a sustainable track record of building a competitive edge in its non-PLI segment, while maintaining currently strong underlying underwriting profitability in this segment.

Outlook

The stable outlook on Deutsche Rueck reflects our expectation that the group's business model will remain robust and successful and anchored in the German PLI sector. Nevertheless, we estimate that Deutsche Rueck's net premiums written could decrease by about 4% to about €570 million in 2011, before stabilizing in 2012 and showing some growth in 2013. This would be mainly because of a somewhat reduced level of business from the PLI sector and DRS' lower prospects for nontraditional business. We expect the group to continue diversifying into good quality, non-PLI business.

In view of the very competitive environment, we believe the reported net combined ratio should be about 100% in 2011 and 2012, in the absence of major natural catastrophe losses. We expect Deutsche Rueck's consolidated ROR to slowly recover toward the five-year average of 5.5%. In addition, capitalization should, in our view, remain very strong. We expect management to adhere to its conservative reserving approach.

We consider upside potential for the ratings remote at this stage. We believe downside risk would most likely arise if the underlying underwriting performance of the group's business were to decline or if capitalization were to weaken substantially.

Corporate Profile: In Transition From A Public-Law Reinsurer To Becoming A European Multiline Reinsurer

DR is the parent company and German operating entity of Deutsche Rueck, which also includes core Swiss subsidiary DRS. Deutsche Rueck is cautiously transforming itself from a captive PLI reinsurer into an international Europe-focused multiline reinsurer. Based on gross written premiums of €920 million in 2010, DR contributed 72% and DRS 28%.

The group's main objective is to provide stable reinsurance coverage based on long-term customer relationships, particularly in property lines. DR is a long-standing professional reinsurer that is 100% owned by members of the German PLI sector. DR's portfolio is mainly concentrated in property business, which represents about 60% of net premiums written. The strong position of the public-law insurers in fire insurance business stems from their historical monopoly in this segment in many regions until 1994, and we note that DR has been able to protect its high share of PLI business. The public-law insurers transfer the portions of their property risks that exceed their net capabilities to DR to reduce their volatility risk. DR, in turn, transfers large portions of this business back to the PLI sector.

DR owns 75% of DRS, and Hannover-based VHV Holding AG (BBB+/Stable/--) has a 25% stake. DRS commenced reinsurance operations in 2001, and its operations complement DR's products and services for the PLI sector. Additionally, it is helping the group develop its franchise with non-PLI cedants. DRS provides traditional and nontraditional reinsurance solutions, particularly in long-tail lines, such as motor and general liability, for which claims are usually settled long after policies may have expired.

The German public-law insurance sector

The German PLI sector comprises 12 primary insurance groups, which have strong regional franchises and together reported €19.7 billion in gross premiums written in 2010. The public-law insurers are represented by the German Association of Public Law Insurers (APLI), which, to a significant extent, operates jointly with DR. APLI also acts as a kind of cooperative reinsurer for the sector by pooling reinsurance protection for standard motor, casualty, accident, and life business.

Competitive Position: In The Consolidation Phase Of A Successful Business Model

Table 1

Deutsche Rueckversicherung Group/Competitive Position

	--Year ended Dec. 31,--				
(Mil. €)	**2010**	**2009**	**2008**	**2007**	**2006**
Total gross premiums written	919.9	1,007.8	1,016.1	1,019.1	982.2
Annual change (%)	(8.7)	(0.8)	(0.3)	3.8	7.6
Non-life gross premiums written	876.6	956.9	955.5	962.3	932.5
Annual change (%)	(8.4)	0.1	(0.7)	3.2	7.5
Non-life net premiums written	558.6	614.7	641.1	637.6	616.9
Annual change (%)	(9.1)	(4.1)	0.5	3.4	13.3
Non-life net premiums written by line of business (%)					
Accident and health--other	1.3	1.6	1.1	1.0	1.5
Motor	23.7	27.8	24.7	23.8	14.5
Marine, aviation, and transport	0.5	0.0	0.5	0.4	0.3
Property	51.4	48.6	55.0	47.0	41.0
Liability	8.7	7.9	7.0	15.3	9.8
Other	14.4	14.2	11.7	12.7	32.9
Life gross premiums written (mil. €)	43.3	51.0	60.5	56.8	49.7
Annual change	(15.1)	(15.8)	6.6	14.2	9.7

Standard & Poor's regards Deutsche Rueck's competitive position as strong. The group is one of the largest reinsurers of German non-life risks, owing to its unique position as the main property reinsurer in Germany's PLI sector. In addition, the group benefits from its indepth expertise in the German non-life market and the services it provides to the public-law insurers.

These strengths are, however, partly challenged by concerns about growth prospects for the PLI business. Given the already very high share of reinsurance business from the sector, some of the public-law insurers may further reduce the amount of business they transfer. Potential future PLI consolidations would likely have similar results.

Moreover, the German non-life market is very saturated, in our view. Nonetheless, we believe that, based on past experience, the effects of PLI-sector consolidation should remain generally moderate and that Deutsche Rueck's unique historical business model should remain robust.

To compensate for declines, the group is expanding outside the PLI sector, to a significant extent through its core subsidiary DRS, and focusing on selected clients and long-term customer relationships in Europe. In addition, Deutsche Rueck is gradually expanding its life reinsurance business, which currently contributes 8% of net premiums.

Deutsche Rueck's total net premiums written decreased more than 8% to €601 million in 2010, due to higher net retentions with some large PLI clients and DRS' planned lower business volumes in nontraditional business. DR and DRS each contribute about 57% and 43%, respectively, of the group's total net premiums. DR's net premiums written decreased by 6.4%, whereas DRS' premiums decreased by 14%. For DRS, we expect further smaller declines in the short term because the company is cutting back nontraditional business that requires less risk capital, which is typically low risk and provides relatively low accounting profits. As a positive, the group was able to expand its non-PLI traditional business in 2010 to €148 million from €115 million, translating into a contribution of almost 25% to the group's net premiums.

In 2010, the PLI sector accounted for about 52% of the group's overall net premiums, which was significantly lower than 73% in 2003. In recent years, the group has increased its geographic diversification, mainly in Western and Central Europe. The proportion of non-German business was about 12% in 2010, significantly higher than the 3.5% seen in 2003.

Property business comprises the bulk of the group's portfolio, representing about 48% of net premiums written, followed by motor (22%), life (8%), and liability (7%) insurance. In 2010, about 70% of the non-life business was written on a proportional basis and mostly acquired directly from the cedants.

Prospective

We expect the group to maintain its strong competitive position. Considering the very competitive and saturated European insurance markets, small decline of PLI business volumes, and DRS' lower business potential, we expect Deutsche Rueck's net premiums written to decrease to about €575 million by 2011, before stabilizing in 2012 and showing some growth in 2013.

Management And Corporate Strategy: A Strong Track Record, But Some Challenges Lie Ahead

In our view, Deutsche Rueck's strategy is clear and achievable. However, it faces the challenge of transforming its historically successful business model into a cautious and profitable expansion in Europe.

Our view of Deutsche Rueck's management is based on its focus on core lines of business, profitability, and its efforts to cautiously expand the group's business model by:

- Continuing to act as the German PLI sector's captive reinsurer, providing sustainable reinsurance coverage, especially in property, and improved diversification by pooling and spreading the risks of the regionally concentrated public-law insurers;
- Expanding into non-PLI business--significantly via DRS--to counteract the lack of growth potential in the PLI

sector and become an international multiline reinsurer; and
- Securely maintaining its currently very strong capitalization through sound sustained earnings and strong reserving.

The execution risk that is usually associated with expanding a business model is, in our view, largely reduced by the group's underwriting and enterprise risk management (ERM) capabilities and its concentration on clients seeking long-term, reliable relationships. The group appointed a new CEO in 2009 and a new chief underwriting officer in 2010. We believe Deutsche Rueck is maintaining its strategy and underwriting approach.

In the PLI sector, Deutsche Rueck is--together with the APLI--the lead reinsurer and a high-level service provider of all the main lines of reinsurance business. DRS' operations are fully integrated into DR's organization.

Operational management

Deutsche Rueck benefits from its focus on long-term customer relationships and has implemented strict underwriting tools to ensure profitability, underpinned by minimum internal rates of return.

In addition, the group has, in our view, built up advanced controlling and risk-management systems and processes. Deutsche Rueck manages its operations in conjunction with APLI's reinsurance business, which generates a high level of knowledge sharing, streamlining effects, and cost advantages.

Financial management

We consider the group's financial management conservative. Deutsche Rueck primarily uses its capital to support underwriting rather than investment risk. Deutsche Rueck's main performance metric is the underlying combined ratio, and its target is less than 100% on average. Furthermore, the group has clearly defined its risk appetite, as follows:

- After a 200-year catastrophe event, the group's capitalization should still be at least consistent with the 'A' rating category and an EU Solvency I and Solvency II ratio of 125%; and
- A negative net result should have a maximum probability of 5%.

In addition, the group's retrocession program is structured to protect its capital base. The group also aims to securely maintain its capitalization at what we would consider to be very strong levels under our risk-based capital model.

Enterprise Risk Management: Adequate With A Positive Trend

In our view, Deutsche Rueck's group ERM is adequate with a positive trend, given the further enhancements made to risk models and an overarching ERM system. Further supporting factors are a strong risk-management culture and strong controls for the group's main risks.

ERM is generally a moderate rating determinant because of the group's moderately complex business model, but it is of high importance for one of the main risks, natural catastrophes in Germany. A sound governance structure, clear risk policies, and regular risk reporting broaden risk awareness across the organization and support the group's risk-management culture.

We consider the group's controls for underwriting, non-life, catastrophe, and market risk to be strong. Controls for reserve risk, operational risk, and emerging risk are adequate, in our view. We consider the group's risk-modeling capabilities sound. For Deutsche Rueck's main risk, non-life underwriting, an internal model approach is already in place. Furthermore, Deutsche Rueck has enhanced its risk models by continuously integrating EU Solvency II and Swiss Solvency Test methodologies. We understand that a partial internal model will be implemented before year-end 2011.

Strategic risk management is adequate, in our view, but the group continues to make considerable progress toward an overarching ERM system. This is demonstrated by the implementation of a risk-information system, which provides an excellent insight into the group's risk positions, is largely accessible for all employees, and encourages a groupwide risk-management culture. Furthermore, the group has made significant further steps in developing a comprehensive concept for the return on risk-adjusted capital.

Accounting: A Conservative Approach

Both DR and the group report their results according to German generally accepted accounting principles (GAAP), whereas DRS' financial statements are prepared under Swiss GAAP. Our analysis is based mainly on the consolidated accounts. Pension reserves are reported in accordance with International Accounting Standard No. 19.

We assessed the group's capital adequacy based on the reported local GAAP equity. The main adjustments are the inclusion of:

- Off-balance-sheet unrealized gains other than life bonds;
- Equalization and similar reserves (€320 million at the group level in 2010); and
- 50% of non-life reserve redundancies and 67% of the non-life loss reserve discount not included in the balance sheet.

The company's conservative reserving policy, in our view, means that the underlying strength of the technical result is stronger than the published figures suggest.

Operating Performance: Historically Strong Results

Table 2

Deutsche Rueckversicherung Group/Operating Statistics

	—Year ended Dec. 31—				
(Mil. €)	**2010**	**2009**	**2008**	**2007**	**2006**
Net income before movements to equalization reserve	4.2	57.1	3.8	4.8	24.3
Net income as reported	3.7	19.5	2.2	15.2	13.4
Return on adjusted equity (%)	1.0	13.8	1.0	1.2	6.2
Return on equity as reported (%)	1.9	10.5	1.3	9.5	10.0
Non-life return on revenue (%)	3.4	7.0	7.5	2.7	7.1
Non-life net loss ratio (%)	73.6	68.3	71.0	73.0	65.0
Non-life net expense ratio (%)*	29.8	30.4	25.4	28.2	31.3
Non-life net combined ratio (%)*	103.4	98.7	96.5	101.2	96.4

*Excluding other underwriting expenses/income.

Overall, we continue to view the group's underlying underwriting performance as strong. Our analysis takes into account the group's conservative reserving policy, as well as the low-risk and low-profit characteristics of significant parts of DRS' business. In our view, the underlying technical results are therefore stronger than the published figures suggest. This is, for example, reflected in a five-year adjusted combined ratio (based on expected ultimate claims development) of about 98% and a 10-year average ratio of about 95%. Nevertheless, the group's reported net combined ratio is currently somewhat higher than that of rated peers.

Deutsche Rueck's reported net combined ratio weakened to 103.4% in 2010, and the five-year reported average net combined ratio increased to about 99.3% compared with an average of 97.7% for the previous five years. The claims ratio increased to 73.6%, compared with 68.3% in 2009 and a five-year average of 70.2%. This reflects relatively high claims from natural catastrophes, which contributed about three percentage points to the claims ratio. Importantly, the higher combined ratio also stems from the group's policy of building up high incurred-but-not-reported (IBNR) reserves for new casualty business.

Our assessment of Deutsche Rueck's reserving practices as strong is underpinned by the group's continually strong reserve run-off results over the past 10 years. The net expense ratio, at 29.8%, remained comparatively high against that of peers. However, we understand that this due to a relatively high share of proportional reinsurance treaties, which generally pay high commissions to the cedants. Despite this, the group's net administrative cost ratio is about 3.9% and compares favorably with that of peers.

The group's reported non-life ROR was 3.4% in 2010 after 7.0% in 2009, influenced by the write-ups of investments after significant and conservative write-offs in 2008 caused by the turmoil in capital markets. The five-year average ROR was 5.5%. The return on adjusted equity was 0.9%, compared with 13.4% in 2009 and a five-year average of about 5%.

We expect that, in the absence of major natural catastrophe losses, the group's consolidated, reported net combined ratio will be about 100% in 2011 and 2012. So far in 2011, the group has not suffered from the natural catastrophes in Japan and Australia and South East Asia, but continues to build up high IBNR reserves for new casualty business. In addition, we anticipate the ROR to slowly recover toward the five-year average of 5.5%. The ratings on DR and DRS also incorporate our assumption that the group will be able to maintain the underwriting performance of its non-PLI business in line with that of its PLI business.

Investments: Conservative Investment Strategy

Table 3

Deutsche Rueckversicherung Group/Investment Statistics

	--Year ended Dec. 31--				
(%)	**2010**	**2009**	**2008**	**2007**	**2006**
Net investment yield	3.8	4.0	3.9	3.7	3.4
Net investment yield including all capital gains/(losses)	3.7	5.7	1.1	4.5	3.6
Non-linked portfolio composition					
Cash and cash equivalents	5.2	4.0	8.2	8.2	7.2
Bonds	69.3	72.4	69.7	67.3	68.1
Common stock and other variable interest securities	20.7	19.0	16.4	19.1	16.5
Real estate	0.3	0.3	0.3	0.3	0.4
Mortgages and loans	0.8	0.2	0.5	0.6	0.6

Table 3

Deutsche Rueckversicherung Group/Investment Statistics (cont.)					
Delinquent mortgages	0.0	0.0	0.0	0.0	0.0
Investments in affiliates	3.8	4.0	4.1	4.4	4.7
Other investments	0.0	0.0	0.7	0.0	2.7

Standard & Poor's regards Deutsche Rueck's investment strategy as strong. This is based on the group's high-quality investment portfolio, good diversity, and very conservative management approach, which favors writing off equity holdings in the profit and loss account over accumulating off-balance-sheet losses. Consequently, the group's overall investment return reduced to 3.7% in 2010, from 5.7%, and compares with an average return of 3.7% over the past five years. Because of the low-interest-rate environment, we expect investment returns to decline gradually in 2011.

Market risk

The group's market risk is limited, in our view. Deutsche Rueck has limited exposure to equities of 3.9% (after hedging) of its total investments as of year-end 2010. We expect the group to maintain its conservative investment strategy, with only moderate equity exposure. Furthermore, the group makes limited use of derivatives and applies tactical asset allocation and hedging, such as buying protection for parts of the remaining equity exposure. Asset-liability management risk is also limited because the duration of assets and liabilities is closely matched.

Credit risk

We consider credit risk to be low. More than 90% of the group's fixed-income securities are rated 'A' or better, and there is no significant concentration risk. Investment in government bonds of Portugal, Italy, Ireland, Greece, and Spain is very low at less then 2% of total investments.

Prospective

We don't expect the group's asset allocation to change materially in 2010 and 2011. Deutsche Rueck is likely to maintain a fairly low proportion of equities and a high-quality investment book, with a somewhat higher percentage of corporate bonds.

Liquidity: Strong, And Cash Flows Are Sound

In our opinion, Deutsche Rueck's liquidity is strong. The group benefits from the strength of available liquidity sources and robust cash flows. Furthermore, we consider more than 80% of all invested assets to be liquid. Additionally, liquid assets represent 161% of technical reserves and we expect liquidity to remain strong.

Capitalization: A Clear Rating Strength

We view Deutsche Rueck's capitalization as a significant rating strength. We expect the group's prospective risk-based capitalization and the quality of its capital to remain very strong.

Capital adequacy

We regard the group's risk-based capital adequacy as excellent and expect it to remain at least very strong. Capitalization benefits from conservative reserving and continuously increased amounts of retained earnings.

Quality of capital

The quality of the group's capital is very strong, in our view, with shareholders' funds and the equalization and similar reserves representing a significant proportion of the group's total adjusted capital.

Reserves

Standard & Poor's believes that Deutsche Rueck continues to apply conservative reserving practices, reflected in a strong ratio of non-life loss reserves to net premiums written of 150%.

Retrocession

Deutsche Rueck employs a prudent retrocession program, in our view, which strongly emphasizes proportional coverage and comprehensive protection against natural catastrophes. To balance the exposure to the PLI sector--primarily property and catastrophe risks--DR pools the risks and transfers large portions to the primary insurers. It transfers the remainder of its retrocession business to reinsurers outside the PLI sector that are generally rated at least 'A'.

Financial Flexibility: Strong, Reflecting Capitalization And Earnings

Table 4

Deutsche Rueckversicherung Group/Financial Statistics					
	--Year ended Dec. 31--				
(Mil. €)	**2010**	**2009**	**2008**	**2007**	**2006**
Total reported assets	1,820.0	1,769.4	1,706.2	1,536.2	1,407.9
Change in total assets (%)	2.9	3.7	11.1	9.1	15.4
Total adjusted equity 5	446.8	440.5	388.2	373.6	370.1
Change in adjusted equity (%)	1.4	13.5	3.9	0.9	(0.7)
Shareholder equity as reported	199.8	194.1	179.4	166.8	152.9
Change in shareholder equity as reported (%)	3.0	8.2	7.5	9.1	32.7
Non-life (%)					
Reinsurance utilization ratio	36.3	35.8	32.9	33.7	33.8
Loss reserves/net written premiums	150.1	134.0	122.9	114.1	98.5

We consider Deutsche Rueck's financial flexibility to be strong, reflecting very strong capitalization, strong earnings, and a very low financial leverage. Additional financial means are generally only necessary to fund the group's organic growth, and the need for them should be relatively low in the medium term, in our view. Acquisitions appear very unlikely in the medium term. If the group were to need additional funds in the event of unforeseen extreme financial stress, we believe it could rely on its shareholders.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

- Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk- Based Insurance Capital Model, June 7, 2010
- Holding Company Analysis, June 11, 2009
- Interactive Ratings Methodology, April 22, 2009

- Group Methodology, April 22, 2009
- Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008
- Counterparty Credit Ratings And The Credit Framework, April 14, 2004

Ratings Detail (As Of September 30, 2011)*	
Operating Companies Covered By This Report	
Deutsche Rueckversicherung AG	
Financial Strength Rating	
Local Currency	A+/Stable/--
Counterparty Credit Rating	
Local Currency	A+/Stable/--
Deutsche Rueckversicherung Schweiz AG	
Financial Strength Rating	
Local Currency	A+/Stable/--
Issuer Credit Rating	
Local Currency	A+/Stable/--
Domicile	Germany

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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