

Article Title: ARCHIVE | Criteria | Insurance | Health: Distinctive Features Set German Private Health Insurance Sector Apart From Counterparts Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled "Criteria | Insurance | General: Insurers: Rating Methodology," published on May 7, 2013.) Executive Summary Distinctive features inherent in Germany's private health insurance sector set it apart from most counterparts elsewhere in the world from a Standard & Poor's Ratings Services credit analytical perspective. The sector, totaling approximately €26.4 billion in gross premiums written in 2004, enjoys a high degree of participation by a large cross-section of the German population--that is, civil servants, self-employed, and a substantial number of higher-earning individuals. Pricing and reserving is strictly and prudently regulated, and insurers guarantee lifelong cover. Consequently, while only those insured--and not insurers--have the right to cancel a policy or to transfer to an alternative provider, the likely loss of accumulated benefits is usually such that local health insurers in practice are ensured an unusually high degree of very long-term policyholder loyalty. Moreover, the level premium regime acts as a powerful financial incentive for individuals to take out a policy as early in life as possible to 'lock in' a premium at a low annual rate. This article seeks to describe those factors that concur to stabilize the German private health market, while at the same time outline the analytic tools that can be applied by Standard & Poor's to highlight any company or market specific risks that may nevertheless cause the financial strength of individual health insurers to deteriorate. In Germany, private health insurance can provide either a total substitute for state health insurance or simply provide supplementary cover. Standard & Poor's interactive assessment of private health insurers in Germany builds on its established rating methodology profile, placing particular emphasis on a company's ability to demonstrate strong risk-management capabilities together with a high degree of control over underwriting, loss prevention, claims management, and cost containment. These essential aspects of performance will likely be reflected in a track record of limited premium price adjustments. This said, premium price adjustments are a regular feature of private health insurance in Germany, although these generally occur because the actuarial basis for premium calculations does not permit any allowance for future inflation of medical costs. Instead, the insurer is obliged to collectively raise premiums as soon as incurred claims differ by more than a certain threshold from the actuarial assumptions. Despite this mechanism, the level of premium adjustments can vary widely between companies. This reflects company specific factors such as the quality of the underwriting and claims process, cost efficiency, and investment performance. Standard & Poor's assessment therefore focuses in particular on an insurer's effectiveness in controlling premium price adjustments relative to competitors. Increasing tariffs will not only directly influence an insurer's competitive position, but also its ability to avoid adverse risk selection through the loss of good business due to perceived high pricing, resulting in an increasing concentration of less satisfactory risks, which may in turn raise the prospect of further price rises and a further loss of residual good quality business. As is the case for other types of insurance and reinsurance companies, Standard & Poor's rating profile for private health insurers covers an organization's competitive position, management and corporate strategy, operational analysis, investments, capitalization, liquidity, and financial flexibility (defined as the ability to source capital relative to capital requirements). The analysis combines qualitative and quantitative factors, and examines both historical and future financial performance using projections. A principal factor in the effectiveness of the methodology is the attention paid to subjective elements and to potential future risks facing an insurer and its sector. Through discussions with management, Standard & Poor's can better evaluate how an organization plans to respond to any changes that may occur, and how its business, operating, and financial strategies might influence its financial strength. Industry Risk Industry risk involves a macroeconomic analysis of the business in which the insurer is operating. Among the key elements that Standard & Poor's considers are the potential threat of new entrants into the market, the threat of substitute products or services, the sector's competitiveness and volatility, and the strength of regulatory, legal, and accounting frameworks in which the insurer operates. In the specific case of German private health insurance, Standard & Poor's believes that legislative change remains the main risk to the sector, which due to its social-political importance remains more tightly regulated than any other insurance sector in Germany. Private health sector closely linked to state health system The private health insurance system continues to be inextricably linked to the state health insurance scheme, with any change to the

state system likely to have repercussions for the private system as well. The state system has been subject to regular legislative changes and the German government continues to discuss different models in an effort to find ways to finance sharply rising health care expenditure. The challenges and opportunities ahead following the upcoming election are potentially more far-reaching and more dramatic than the changes health insurers have already encountered during the past few years. Meanwhile, despite the private health insurers' substantial exposure to political risk, Standard & Poor's believes that the likelihood of an organization defaulting on its obligations solely due to generic industry risk factors is rather limited given the sector's high degree of regulation. Nevertheless, an insurer's ability to respond quickly and effectively to legislative changes by adjusting its business model via innovative products and services remains an important consideration in Standard & Poor's analysis.

Competitive Position An insurer's competitive strengths and weaknesses are intricately tied to the appropriateness of its strategies and to its overall operational effectiveness, with all these factors strongly influencing its financial profile. It is through the review of a company's competitive position that Standard & Poor's determines whether there is solid potential for sustainable, satisfactory performance. In its analysis of German private health insurance, Standard & Poor's therefore places particular emphasis on evaluating an insurer's current and ongoing competitive position, as this will often be one of the more decisive factors underlying the final rating decision. In the highly competitive German health market, which is largely driven by brokers, insurers can only continue to win high quality business if they are able to retain the confidence of brokers through the offer of competitive products and services and superior financial strength. In addition, the perceived prospect of well-managed, restrained premium price adjustments during the future long life of the contract will be vital for an organization if it is to continuously attract young and healthy individuals as policyholders, thereby helping to build and maintain a well-balanced age composition across the portfolio. In contrast, limited new business growth may leave the insurer with an increasingly over-aged portfolio, resulting in escalating claims costs. As a consequence, the company will eventually have to raise its premiums, which will likely weaken its competitive position even further. In the case of private health insurers, a company's competitive position will therefore be very closely tied to the quality of its underwriting and claims management standards. Meanwhile, the success or failure of its investment strategies will also have an important bearing on performance, with investment returns that are prudently, but consistently ahead of the peer group, potentially implying a competitive advantage that might help moderate prospective premium price adjustments. Standard & Poor's also reviews the competitive position of an entity relative to its immediate peers as well as against the industry as a whole. Evaluating a company's relative competitive position involves substantial subjective interpretation of the basic facts and data associated with lines of business, premium volumes, market shares, and technical performance. Product diversification and preventive programs may bring long-term advantage. As part of its analysis, Standard & Poor's evaluates the degree of competitive advantage enjoyed by the organization through its product lines, service capabilities, cost structure, and distribution systems. The company's lead products and their 'value added' are examined, also to ascertain whether the insurer is dependent on just one or several products, or whether it provides a whole range of diversified product offerings. Loss prevention, including preventive health and disease management programs, is an area that only a few health insurers have ventured to explore so far, largely to address the steep increase in the costs of medical care. More sophisticated activities in this area are likely to provide an important long-term strategic advantage to the most efficient of providers, and will potentially allow them more flexibility to respond to the seemingly continuous changes in the legal framework. Quality relationships with brokers central to success. A private health insurer's service capability also strongly influences its competitive position. In a mainly broker-driven market--such as German private health insurance--an insurer's ability to interact with and facilitate the task of brokers and independent financial advisors will be a key competitive factor. Standard & Poor's discusses the quality and stability of broker relationships, any potential concentration risks, and the quality of technical support provided to intermediaries. Service excellence in respect of policyholders is also important in underpinning a company's reputation and competitive position, notably the accessibility, responsiveness and speediness of its claims handling and payment. Furthermore, an insurer with strong competencies in providing health care and other protection services alongside traditional insurance covers is likely to further enhance its ability to

expand its business through cross-selling opportunities. Niche players or new activities require appropriate tools and resources. In this latter context, it is worth pointing out that Standard & Poor's always assesses a rated company's degree of business diversification, and the appropriateness of strategy if a niche position is deliberately being pursued. A sufficient degree of size and diversification at an insurer is essential to cover fixed costs, to avoid adverse selection, and to enjoy the benefits and predictability brought by the actuarial 'law of large numbers'. When consciously foregoing diversification while seeking to maintain financial strength, management at a focused, niche insurer must be absolutely confident that its company can sustain its viability in traditional activities and regions in the long term. The same applies when companies introduce new lines of business or new, remote operations. Consideration should be given as to whether they have the skills, the means, and the infrastructure to achieve a similar level of ultimate success in the new activity that they currently enjoy in their existing principal operations. If the new undertaking risks seriously underperforming relative to the traditionally core range of activities, then arguably management is gambling with the company's financial strength by assuming higher levels of exposure in lines or areas where the increased risk is unlikely to be compensated by sufficiently increased earnings. In this context, therefore, far from being seen as either positive or even neutral, ill-conceived diversification beyond the German health sector would quite likely be perceived as a significantly negative risk factor. However, to the degree that the passage of time proves diversification to have been successful and sustainable, then it will be increasingly regarded as a strength relative to an otherwise similar, but nondiversified peer.

Management And Strategy Although management has little control over industry risk, altering the company's competitive position to its advantage and managing its resources and finances in a prudent and ultimately profitable way are internal factors over which management can exert significant influence. Therefore, no company analysis would be complete without an assessment of the formulation and implementation of strategy by management. The areas of inquiry comprise a review of strategic positioning, operational effectiveness, financial risk tolerance, organization structure, management breadth and experience, and how all of these tie in with declared strategy. This process allows Standard & Poor's to develop a consistent and organized view of each company's management and corporate strategy which, in turn, provides the necessary perspective for the rating committee to evaluate a company's prospective competitive position and, more objectively, its future operating performance and capitalization. Plans and goals When assessing the company's strategic positioning, it is important to establish what management's goals are and how its strategy was developed. The analyst must discern whether the goals and objectives are market-share-oriented or financial, and if they are internally consistent. The analyst then projects what their implications are for the company's future. Standard & Poor's will also want to investigate management's record of translating plans into action and if effective systems are in place to communicate both strategic and tactical plans to lower management and, in due course, to assess actual performance against plan. Executing chosen strategy Operational effectiveness, meanwhile, essentially involves assessing a company's ability to execute its chosen strategy. Standard & Poor's evaluates management's expertise in operating each line of business and assesses the adequacy of audit and internal control systems. A particular focus of Standard & Poor's when analyzing private health insurers is on the quality of management information systems and on the tools and techniques used for underwriting, including denials, deductibles, exclusion riders, and additional risk charges to reflect the physical condition of individual policyholders. An effective information platform to gather information, select appropriate risks, and accurately assess and price these are vital to a health insurer's success given the long-term nature of the business due to the absence of insurer cancellation rights. Effective claims management, including loss prevention and minimization strategies, is equally important. In addition, Standard & Poor's also determines whether the insurer applies its policies consistently. It is mainly in these areas where a private health insurer can enhance its efficiency and gain significant competitive advantage over peers. Financial risk tolerance Evaluating financial risk tolerance allows Standard & Poor's to understand management's views on financial goals, capital structure, financial and accounting conservatism, board oversight, and risk acceptance. Meanwhile, the organizational structure must support the strategy to produce the desired results. It is essential to assess: Who are the senior managers? What are their functional backgrounds? How long has the team been together? Why are certain operations run as separate subsidiaries rather

than as departments? Operating performance Standard & Poor's assessment of a health insurer's earnings performance is an integral part of the overall rating analysis. The measurement of earnings focuses on a company's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable margins on its revenues. A health insurer's profitability is vital to its long-term success as it strongly influences its ability to smooth premium price adjustments, which in turn directly impacts its reputation and competitiveness. The overall analysis of health insurers operating performance therefore focuses on the areas that could significantly affect results: the effectiveness of underwriting; the conservatism applied in actuarial assumptions; the ability to manage both medical claims and administrative costs; and the effectiveness of the investment strategy. The evaluation includes both historical and prospective earnings trend analyses, and combines qualitative and quantitative elements. Old-age provision keeps private premiums in check Similar to life insurance, private health insurance in Germany is characterized by a level premium, as the law does not permit companies to increase individual premiums as a policyholder grows older or as his/her health condition deteriorates. This feature of the sector necessitates the calculation of a mathematical reserve or a so-called "old-age provision" ("Alterungsrückstellung") to allow for increasing claims in older age. Legal requirements regulate the actuarial methods underlying the calculation of premiums and old-age provisions. In addition, an independent trustee verifies that a company's premium calculation complies with the law. Despite tight regulations, some room for maneuverability As opposed to the German state health system, premiums in private health insurance are calculated individually and depend on coverage provided, sex, and a policyholder's age and physical condition at the time of application. The actuarial assumptions are based on mortality and lapse tables, a technical interest rate of currently 3.5%, and claims per capita tables. Loadings include acquisition and administration expenses. Since January 2000, companies have also been required to charge policyholders an additional ten percent of gross premiums up to the age of 60 to smooth future premium increases after the age of 65. All assumptions have to be set cautiously and the law requires an additional safety margin of at least 5%. Despite tight regulation, insurers have some room for maneuverability in their calculations. Standard & Poor's will closely examine an insurer's actuarial assumptions and the level of conservatism applied to its calculations. In addition, an insurer that benefits from a sufficiently large portfolio and which displays sophistication in the compilation and analysis of its database is regarded as gaining a competitive edge through enhanced accuracy in its risk pricing. Ratings analysts also examine an insurer's assumptions on lapses compared with actual experience. In German health insurance, existing reserves built up in respect of the individual policyholders are forfeited to the benefit of general policyholder reserves in the event of the policy lapsing. If actual lapses are significantly lower than assumed by the insurer, this means that windfall gains will be reduced and overall premiums may have to be raised. Similarly, Standard & Poor's discusses the claims per capita tables used and whether an insurer's calculations include a safety margin of more than 5%. Obligation to up premiums if deviation exceeds a given threshold Tight regulation, including the existence of a so-called premium adjustment clause ("Beitragsanpassungsklausel"), significantly limits private health insurers' underwriting risk. Insurers are obliged to compare annually incurred and expected claims and are obliged to raise premiums if the deviation exceeds a certain threshold. This threshold is generally set at 10%, but could be less based on an individual insurer's terms and conditions. At this point in time, the insurer also has the opportunity to review the appropriateness of all other actuarial assumptions, including the technical interest rate. Any revision in the premium calculation will also affect existing business, as discussed above under 'Competitive Position'. Underwriting ratios studied to determine trends Quantitatively, Standard & Poor's analysis of underwriting performance examines loss ratios and acquisition and administration expense ratios, and places particular emphasis on the so-called underwriting ratio ("versicherungsgeschäftliche Ergebnisquote"). This ratio is defined as gross earned premiums less claims, technical interest, and costs as a percentage of gross earned premiums. This ratio is generally seen as a main indicator for the quality of underwriting. The underwriting ratio equals a company's safety loading in the case where actuarial assumptions have been accurate. A negative underwriting ratio, however, indicates one or more miscalculations. Standard & Poor's studies all actual ratios over a time frame of at least five years to identify underlying trends and, where possible, to extrapolate forwards. Investment income an important source of earnings Apart from underwriting results,

investment income is another important source of earnings. Similar to German life insurers, a private health insurer's profits are shared between policyholders and, where these exist, shareholders. Private health insurers also build a policyholder bonus reserve, which is used to smooth premium price adjustments. According to Section 12 of the German supervisory law ("Versicherungsaufsichtsgesetz"; VAG) a private health insurer must allocate at least 90% of its interest surplus on old-age provisions to policyholders. The majority of this interest surplus is directly allocated back to the old age provision, while the rest is allocated to the policyholder bonus reserve ("Erfolgsunabhängige Rückstellung für Beitragsrückerstattung"). This part of the policyholder bonus reserve is only used to smooth premium increases for those policyholders over the age of 65, with the aim being to subsidize and, in effect, to moderate the premium increases required for older policyholders. In addition, insurers have to allocate 80% of the technical surplus (including mortality, lapses, and expenses) and of the remaining interest surplus to the policyholder bonus reserve ("Erfolgsabhängige Beitragsrückerstattung"). This part of the policyholder bonus reserve is available for all insured and either serves to limit premium increases or to finance the premium refunds that are regularly offered in the event of a policyholder remaining free of claims during the year. A successful investment policy can therefore prove highly instrumental in limiting premium price adjustments and may significantly enhance a health insurer's attractiveness to current and would-be policyholders. Investments, Asset-Liability Management, and Liquidity

Owing to the considerations discussed immediately above, it is of fundamental importance to understand how a health insurer's investment strategy fits with its liability profile and to what extent investment results contribute to total company earnings. Although health insurers generally have conservative investment philosophies, Standard & Poor's is aware that investment strategies can differ between companies, and it will incorporate these differences in its evaluation of any health insurer's particular situation. Major investment issues assessed by Standard & Poor's include: Management's approach to accepting, measuring, and managing risk from investment activities, including market and credit risk; Asset-allocation strategies; Asset credit quality; Asset diversification (by asset class, sector, maturity, and issuer); Portfolio liquidity; Investment returns (current yields and total returns); Asset valuation (hidden asset values, or market values versus book values); Capital gains realization strategies; Asset-liability management; and Use of derivatives and other financial instruments. Standard & Poor's forms an opinion about the health of the invested asset portfolio in terms of asset quality, liquidity, concentration risks, and returns. Strategies for realizing capital gains are also explored in detail. Political debate continues on individual's right to transfer ageing provision when switching insurers

Private health insurers generally benefit from strong monthly premium inflows, which usually are more than sufficient to cover the cash requirements relating to ongoing claims and expenses. Nevertheless, insurers might have to liquidate assets quickly to pay claims, especially in the case of catastrophic events such as a pandemic. The current political debate to potentially allow policyholders to transfer their individual ageing provision in the event of their transfer to an alternative health insurance carrier might also impose new liquidity requirements should large transfer payments ever need to be made between an individual's former health insurance company and their new company. One of the principal considerations regarding liquidity is therefore the percentage of short-term assets versus long-term marketable assets, and how long-dated the portfolio is relative to liabilities. Naturally, the asset portfolio is also assessed for its exposure to additional risks, such as market-value volatility, interest rate changes, and credit losses. Capitalization

The highly stable, highly conservative nature of the German private health insurance market allays Standard & Poor's concerns about the possibility of a rapid deterioration in a company's capitalization. The existing premium adjustment clause significantly mitigates underwriting risks. The fact that private health insurers can also adjust the guaranteed technical interest rate as part of this process somewhat reduces market risk. However, it should be noted that premium price adjustments are only explicitly triggered by an increase in medical costs and will normally only occur with a time lag of one to three years. In the interim, companies have to fully cover any technical losses due, for example, to a change in lapsation or an increase in longevity, as well as any investment losses that may occur. Similarly, companies will have to absorb large losses in the event of catastrophic events such as an epidemic or, less dramatically, incremental losses due to claims volatility following a random deviation in frequency or severity. Standard & Poor's risk-based capital model adjusted for specifics of sector Capitalization can also be dependent on the interaction of

all the other analytical categories discussed in this article. Standard & Poor's does not use a single measure when analyzing capitalization. However, an important tool used by the analyst is the Standard & Poor's risk-based capital model, which has been further adjusted to appropriately reflect the specific features of the German private health insurance market. In particular, charges have been introduced that are in most instances similar to those already applied in the analysis of German life insurance, with a standard 2.5% charge on the net ageing reserve to reflect underwriting risks. The charge replaces the existing premium and reserve charges. In the case of health insurance products calculated in the same way as indemnity insurance (such as health travel insurance), Standard & Poor's maintains its existing premium and reserve charges of 12% and 5%, respectively. In addition, Standard & Poor's has introduced a generic charge of 2.0% on gross premiums written to reflect operational risks. Furthermore, and again like with life insurance investment risk, charges have been adopted as a capital requirement that relate to assets backing relevant health insurance liabilities. Naturally, all these charges can be adjusted whenever the rating committee has particular concerns or is keen to see how resilient capitalization is to 'What if...?' scenario testing. Embedded value calculations still in their infancy Regarding future profits, these may to some extent be recognized in the form of embedded values; in which case, to avoid double counting, up to a maximum of 50% credit is given, and even then only in respect of the value of in-force (VIF) component of the embedded value number net of related deferred taxation. At this stage, however, embedded value calculations for German health insurance are still in their infancy. As a result, Standard & Poor's may reduce its credit for a company's calculation of VIF or may even decide to give no credit at all, indicating that a significant degree of uncertainty still exists in respect of the parameters used. Reinsurance does not play significant role In addition to capital modeling, Standard & Poor's will also separately analyze the quality of capital, reserves, and the utilization of reinsurance. However, the use of reinsurance does not usually play a significant role for German health insurers, as coverage is normally only purchased to eliminate peak risks. Financial Flexibility Financial flexibility is an important part of Standard & Poor's analysis and is defined as the ability to source additional capital and liquidity relative to requirements. An analysis of financial flexibility takes into consideration the health insurer's needs for, and availability of, capital and liquidity in the future. However, short of the most obvious risk of substantial capital losses due to asset volatility, and in the absence of merger and acquisition activity within the sector, the financial flexibility of German private health insurers is likely in the majority of cases to be found entirely satisfactory relative to a low perceived level of need. Group E-Mail Address InsuranceInteractive_Europe@standardandpoors.com