

EXECUTIVE SUMMARY

The current report presents the results of the analysis performed by the Portuguese Insurance and Pension Funds Supervisory Authority (ISP) to the situation and performance of the Portuguese market over the year 2007. It identifies, characterizes and evaluates not only current specific issues but also broader trends related to the behaviour and management of the risks to which the market is exposed, namely by means of a profit/loss analysis. These aspects are assessed both under the national and the international context, from a technical, financial and macroeconomic point of view.

In 2007 the global economy maintained a high growth rate (4.9%), and trade volume of goods and services across the world also increased by 6.8% (above its long term average, although about 2.5 percentage points below the value of the previous year). Nevertheless, these rates decelerated in the final part of the year (fourth quarter), due to the effect of the rising prices of raw materials in the international markets, and the deterioration of financial markets.

Worldwide inflation increased (4%, compared to 3.7% in the two previous years), under the pressure of higher food and energy prices. Nonetheless, those effects were mainly felt in emerging and developing economies (6.3%), as this indicator presented a slight decrease (reaching 2.2%) in the group of advanced economies.

Over the year of 2007 capital markets accumulated gains, especially during the first semester. However, high volatility dominated the second half of the year, stemming from the liquidity shortage induced by the subprime crisis in the North-American real estate market. Important falls in share prices took place in July and August, but some recovery during the last quarter allowed the main stock indexes to close the year with a positive overall performance.

On the other side, due to the climate of uncertainty and to the deterioration of the levels of confidence that characterized 2007, credit spreads increased markedly both in North-America and the Euro Zone, reflecting the higher risk premium required for private debt when compared to public debt. The association of this effect with higher inflation perspectives led to higher interest rates in fixed-rate long term bonds issued during the second half of the year, causing a depreciation of fixed income investments.

In Portugal, inflation and GDP growth rates amounted to 2.5% and 1.9%, respectively. Premium income from direct business also recovered (considering all undertakings operating in the market), reaching a value of about 14 thousand million euros, that reflected mostly the 7% growth in the life business, as non-life business only increased by 0.7%. The number of undertakings domiciled in the country enlarged from 76 to 86, as did the number of entities operating under the freedom to provide services regime, which raised from 377 to 414.

Pension funds market increased 5.5%, reaching an amount of 22,356 million euros in 2007 (about 13.7% of the GDP), in spite of a 39% reduction in contributions and a 5% increase in benefits paid (which amounted to 1,121 million euros). The stable ratio of the amount of pension funds in respect of GDP, combined with a 9.8% growth in the amount of investments representing the technical provisions of the insurance undertakings (to 44,711 million euros) led the global portfolio of the two sub-sectors (67,067 million euros) to represent 41.2% of GDP, one percentage point above that of 2006.

In 2007 the profits made by the insurance and reinsurance companies supervised by ISP reached a pre-tax amount of 838 million euros and a net amount (after taxes) of 653 million euros, i.e., approximately 10.8% less than in 2006. The technical profits were highly influenced by the evolution of the financial performance both in the life business (371 million euros) and in the non-life business (334 million euros), although a small decrease in value has been observed in the latter.

Regarding the annual evolution of the financial and patrimonial situation of the insurance companies under the ISP supervision, on average a similar relative increase of 7% was observed in the value of the Assets and Liabilities and the value of Equity progressed by some 7.5%. This was notionally consistent with the combined evolution of premium production, the increase in value of the assets' portfolio invested in shares (the Dow Jones Eurostoxx index increased by some 17% on an annual basis) and the slight depreciation in the assets' portfolio invested in bonds (which was of about 1.5% in the five year term government bonds), account being taken of the structure of the Liability portfolio (which is highly concentrated around the life assurance business).

Globally, in 2007 the technical provisions of the life assurance business represented about 82.1% of the total liabilities of the insurance sector and grew by 7.9% – strongly supported by the expansion of the “unit-linked” liability portfolio, whose amount increased by 13.8% – whereas the technical provisions of the non-life business displayed a relative weight of about 13.8% and a growth rate of 3.9%, supported by an increase of the provisioning ratio of its main lines of business, namely in motor insurance (where the provisioning ratio evolved from 92.9% to 96.2% of premiums) and in workmen compensation (where the ratio evolved from 79.9% to 80.4%).

On the Asset side of the balance sheet – where investments have a relative weight of about 90% – the value of the assets representing the coverage of insurance companies technical provisions grew by 8.1% in annual terms. The generic structure of the investments' portfolio by nature of the assets remained pretty much similar to that of previous years, although some reinforcement has been observed in the component of corporate bonds at the expense of the component of government debt. The exposure to shares remained subdued, with a slight increase translated into an overall relative weight of about 7.5%.

An analysis by components reveals that Equity – which by the end of 2007 reached an amount of 4,127 million euros – produced a pre-tax averaged rate of return (ROE) of some 17% essentially due to the evolution of profits carried forward from previous years (422 million euros) and the amount of the net profit from the year under analysis (653 million euros, of which about 317 million would later be allotted to dividends and productivity premiums to be distributed in 2008). Over the last five years, all the Equity components showed stable growth trends that allowed a consolidation of the financial situation of the insurance market.

Within the context of the previously described developments, the solvency margin required for the totality of insurance companies registered a 5% increase in value (under the influence of the production growth) whereas the available solvency margin suffered a decrease of 1.2% – in line with the effects of a slight reduction in the annual net profits and of a profit distribution rate of 48% (52% one year earlier), partially offset by an increase in other elements of the margin such as the amount of subordinated loans. The combined effect of these influences led to a decrease in the coverage ratio of the solvency margin, which reached a value of 169% (against the 180% registered in 2006).

Concerning the solvency of pension funds – in whose global amount the component of defined benefit plans clearly prevails (with a relative weight of 95.3%) – the “fund financing level relative to the regulatory minimum solvency benchmark” decreased from 123% in 2006 to 116% in 2007. On the other hand, the “fund financing level relative to the benchmark corresponding to the contribution financing scenario” – which is based on consistent valuation assumptions for both assets and liabilities and, as such, possibly more adequate than the prior benchmark – evolved from 100%, in 2006, to 105% in 2007.

The present report is composed of nine chapters. It starts by establishing the relevant national and international macroeconomic context, necessary to the understanding of the main events and trends in the insurance and pension funds'

sector and, subsequently, provides a description and analysis of the structure and technical and financial performance of the insurance sector, its intermediary activity and reinsurance function, extending a similar assessment to the pension funds' characteristics and management. Two further chapters have been dedicated to the analysis of the insurance companies and pension funds' investments and of insurance and pension funds products such as the PPR/E and PPA (Personal Retirement Plans).

The exercise of specialised analysis culminates in a chapter that contains technical studies on matters such as the productivity of the insurance sector, the coverage of seismic risk in Portugal and, finally, the current status of market commercialization of the existing compulsory insurance contracts.

The ninth and final chapter describes the juridical framework for the insurance and pension funds' sector laid down in the course of the year.