

# IMPACT OF THE CREDIT CRISIS ON GENERAL INSURANCE COMPANIES

On October 7, 2008, International Monetary Fund increased its estimate of global losses from the financial meltdown to USD 1.4 trillion, driven by asset write downs, credit losses, downgrades of structured finance pools, bond insurers and banks. Although some of the less traditional activities of insurance groups have been impacted, so far the general insurance sector appears to have proved relatively insulated from the hardest impacts of the credit crunch, with relatively few rating actions affecting insurer financial strength. However, as we move toward the Q3 earnings reporting season this sector will be under increasing scrutiny with a number of losses being preannounced already.

Although some of the less traditional activities of insurance groups have been impacted, the evidence to date suggests that general insurance operations have incurred relatively low exposure to the direct impacts of this credit crunch.

Unlike banks, general insurance companies did not play a key role in each link of the chain of transactions that originated mortgage loans and subsequently bought, warehoused and distributed the derivatives to investors throughout the financial sector. General insurance companies did not become as leveraged as many other institutions to positions in those securities, nor did their business models involve being "risk traders" in these credit products. Their investment portfolios typically contain smaller proportions of subprime-exposed collateralised debt obligations and lower tranches of mortgage-backed securitisations compared to banks, while their underwriting portfolios typically avoided offering credit protection for assets impacted by the credit crunch. Furthermore, unlike investment banking, it is not generally within the business model of an insurer to rely on ultra short term funding. When the short term funding markets ceased to function normally, the immediate exposure had costly and rapid implications.

Ironically many of the insurers' strategic ventures that have been impacted by the credit crunch were those that could only be entertained because of their strongly rated businesses. They include Banking, Mortgage Lending, Mortgage Insurance, Financial Guarantee and Capital Markets activities, including the underwriting of Credit Derivatives. None of these activities are traditionally characteristic of the general insurance sector, but some insurance groups have ventured into these lines through subsidiaries or affiliates. Thus the headline issues that have afflicted a small number of nevertheless prominent insurance groups tend to relate to issues more often associated with banks and financial superstores than general insurance. It is important to note that within such groups, the insurance operations will not necessarily be burdened by the results of these non-traditional activities where they are tied to other legal entities of the group.

The extent to which general insurance operations are being indirectly impacted by the turmoil is likely to become clearer over the coming reporting periods.

## INVESTMENT ACTIVITIES AND RESULTS

The majority of major insurance companies have reported falling investment income in recent quarters due to deteriorating investment returns. All general insurance companies hold significant portfolios of fixed interest securities, including Government, 'Agency' and (largely high investment grade) corporate debt. During Q3, the continued

credit market dislocation has caused fixed income corporate spreads – particularly financial sector corporate debt – to widen markedly. These changes result in adjustments – usually accounted as temporary – that will continue to impact insurance company balance sheets as provision is made for unrealised investment valuation changes. Whether or not these are reported as a loss within the income statement depends on accounting basis, but the effect is to reduce shareholder funds. Further declines are also anticipated for those insurers with sizeable equity portfolios, where significant volatility and declines in valuation will result in insurance companies making provisions for these portfolios too. Regulatory regimes and rating agency models tend to be more punitive against insurance companies holding equity portfolios. General insurance companies are typically less leveraged to equities than other financial institutions. Other sectors of the insurance industry, specifically the life sector, are expected to experience greater volatility in this respect.

## UNDERWRITING ACTIVITIES

General insurance companies rarely undertake insurance of structured finance assets such as collateralized debt obligations or mortgage backed securities; these tend to be the realm of the monoline specialist bond insurers. The direct impact on insurers' underwriting portfolios has been mainly within E&O and D&O lines where liability claims may be made. Again, those insurance companies holding significant portfolios of D&O and E&O business have tended to be stronger, more highly rated companies. Claims related to subprime-related litigation will take time to evolve; the aggregate estimates of insured market loss in this regard vary significantly – ranging from around USD 6 billion to USD 20 billion. To date, insurance companies have absorbed D&O and E&O losses within their overall reserved loss ratios or have modestly increased their ongoing forecast ratios.

For other lines of business, there is some argument that, historically, market dislocation has resulted in an increased focus on pricing discipline and therefore the current environment may result in moderation of the soft market phase of the insurance cycle.

## FINANCIAL FLEXIBILITY

Even though general insurance companies have avoided the spectacular charges seen by banks, investor sentiment has moved adversely against the whole financial sector over the past year and, within recent weeks, insurers have not been immune to this. General insurance companies are trading at lower multiples than for many years, spreads on their corporate debt are higher and their ability to raise capital or borrow is more restricted than would have previously been the case. Arguably, in many cases, insurance companies went into the crisis better capitalised as a result of retained earnings and higher rating agency requirements than had been the case before. However, with the continued market dislocation and higher catastrophe and large losses reported in Q3, a number of general insurers have undertaken actions to maintain capital levels for example reducing dividends or ceasing share buyback activities. With anticipation of reductions in both book value and market capitalisation of general insurance companies in the coming reporting seasons and debt markets continuing to be cautious, the ability of general insurers to raise additional capital, should it be required, will be reduced.

## OUTLOOK

A number of pre-announcements of earnings statements have forewarned that Q3 results will be impacted by asset write downs, corporate defaults and increasing bond spreads.

In determining the extent of the impact of the credit crisis on the sector in the longer term there are, however, still several uncertainties:

- The impact of current and future government intervention on the financial markets
- How the insurance industry would respond to and recapitalise from a mega catastrophe or series of major losses
- The extent to which the housing sector continues to deteriorate
- Whether other areas within the financial sector still have exposure that spill over into the insurance sector
- The extent to which economic changes impact the claims environment

The effect on specific insurers is difficult to assess. In analysing any particular general insurance company there are a number of factors that must be considered. These include the risk appetite of the general insurance company both from an underwriting and investment perspective. The impact of an insurance company having to rapidly liquidate its investment portfolio and the resulting realisation of losses should also be taken into consideration. The valuation method utilised for certain assets will also impact. Mark-to-model valuations are likely to be less reliable than mark-to-market methods as they rely upon assumptions in the models which could assume a degree of liquidity that is achievable.

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Recent corporate failures have highlighted the need to consider the level of exposure a general insurer has to these instruments and others which may be impacted by the credit crisis for a considerable period.

The extraordinary circumstances experienced in recent months in the financial markets also emphasise the significant impact of regulatory and market sentiment and demonstrate the challenges in assessing the impact of the credit crunch on market participants.

## RATING AGENCY ASSESSMENT

Rating agencies continue to have significant importance in assessing the financial strength of insurance companies. The recent turmoil highlights the importance of them combining an understanding of the financial strength of individual operating entities, group structures and their interaction with and dependence upon global financial markets.

To date major rating actions within the general insurance sector have been few and far between with the notable exceptions of AIG, Fortis and XL, which remain within the strong rating categories. The rating agencies are largely maintaining their stable outlooks on the general insurance sector as a whole but note that further market disruptions could generate downgrades.

## CONCLUSION

The general insurance sector as a whole appears to have remained relatively isolated from the direct impact of the credit crisis so far. Whilst there have been some notable exceptions these have been companies that have stretched the boundaries of traditional insurance taking them to more of a 'financial superstore' structure. There will inevitably be some wider impact on the investment portfolios and investment returns of general insurance companies which will become evident throughout the coming reporting seasons. With the anticipated moderation in the soft phase of the insurance cycle, the relatively stable rating outlook for the general insurance sector currently appears reasonably justified, but will inevitably be subject to review as financial market turbulence and attendant market sentiment plays out over the coming months.