

NAVIGATING THE STORM

Patrick M. Liedtke and **Kai-Uwe Schanz** provide an overview of the global credit crisis, and an outlook for the future.

The popular view is that the credit crisis is simply the manifestation of an unprecedented failure of capitalism. Not so. Rather, it reflects a complex blend of market and public policy flaws that have led to a dislocation which even the most sophisticated risk models and stress scenarios failed to anticipate.

Short-term incentives that encourage excessive risk-taking certainly have contributed to the crisis. The same is true of financial business models based on extraordinary levels of leverage that investors were only too eager to support in their quest for return in what seemed to be a time of perennial low-interest rates.

Yet the credit crisis cannot be blamed on the private sector alone. A loose US monetary policy that largely ignored asset inflation, combined with government-sponsored measures to promote private homeownership, were, in hindsight, a perfect recipe for disaster. Falling oil prices made profitable the development of land far from urban centres, contributing to an overexpansion in mortgages and ultimately a housing glut. Regulatory flaws also played a role: financial institutions were allowed to run leverage ratios of 25 or more and regulators did not interfere with those banks that assumed that markets would be constantly liquid. Financial innovation in derivatives also overtook regulators. The credit-default swaps (CDSs) market grew to a staggering notional value of \$62tr – with little oversight.

TRIPLE IMPACT

In its latest calculations the International Monetary Fund (IMF) puts worldwide losses on mortgage-related debt originated in the US at \$1.4tr, up by almost 50% from its previous estimate in April this year. So far, about \$760bn has been written down by financial services companies. Banks account for the lion's share with credit losses of about \$600bn.

From an insurance perspective, three different kinds of impact need to be carefully distinguished: the direct impact of first-round effects related to credit losses on subprime mortgages; the impact on those financial institutions with specific exposures such as CDSs, banking operations and financial guarantee business; and, finally, the general impact



of the asset meltdown which accelerated dramatically in September.

Illustration Colin Anderson

AIG may have grabbed the headlines, but most insurers escaped largely unscathed from the first-round of the crisis - no small achievement as they are major players in the financial markets. In 2006, the insurance industry had \$18.5tr of assets under management, or 11% of global financial assets. This put them only slightly behind pension funds (\$21.6tr) and mutual funds (\$19.3tr).

The wide diversification in insurer's investment portfolios also lessened the direct impact on the industry. Insurance economists expect investment write-downs directly related to subprime mortgage instruments not to exceed \$80bn. This corresponds to around 3.5% of the global (re)insurance industry's capital or a mere 0.5% of invested assets.

On the product side, insurers are being exposed as providers of Directors and Officers (D&O) as well as Errors and Omissions (E&O) policies. It is difficult to gauge claims arising out of litigation, especially following September's dramatic events. Estimates

“Even under the bleakest scenario, the insurance industry will not destabilise the financial system as the banks did.”

relating to before September put likely claims at less than \$10bn.

In financial institutions where the core insurance business was complemented through other activities - most prominently AIG and Fortis – there were significant losses on financial prod-

ucts (mainly CDSs and other financial guarantees) and banking activities. But their insurance operations repeatedly have been reported as sound by the supervisory authorities whose stringent controls have had a positive effect.

Realised and unrealised investment losses, are impossible to gauge at present. There is no doubt that the insurance industry as one of the world's biggest asset managers will suffer from falling stock market valuations and dramatically widening bond spreads. But the sector is relatively less at risk from the retrenchment of stocks than during 2001-03, as many insurers have reduced their equity ratios in recent years. Losses on government bonds and commercial fixed-income securities, however, will affect the portfolios directly.

FROM CRISIS TO RECESSION

Continued market turbulence, with a protracted slowdown in global economic activity, is likely to generate further, substantial declines in asset values. Up to now, even the current drastic deterioration in the financial markets generally has fallen within the range of standard stress scenarios performed by most leading insurance companies. The industry will cope reasonably well in such an adverse environment, but there is a threshold – even if at levels considerably lower than today's – where profit concerns will develop into real solvency concerns. Insurance supervisors and regulators will hopefully abstain from pro-cyclical behaviour.

On the liabilities side, claims tend to increase in a weakening real economy. This adverse effect, however, should be mitigated by falling inflation and declining commodity prices.

Insurers and reinsurers must maintain strict underwriting discipline and a cautious, ALM-driven investment profile to preserve their capital base. Hardening rates, especially in commercial lines, will help companies navigate through the credit crisis-induced turmoil.

Even under the bleakest scenario – a prolonged

9 tips for 2009

Although a soft market has dominated for years now, there are signs that prices have stabilised in some sectors, and maybe are starting to rise. Investment income almost certainly will dip, putting more emphasis on underwriting profit. In the current uncertain conditions, **Liz Booth** gives some advice.

1 CREDIT Keep a tight grip on credit control. It's vital that insurers have their houses in order, and tighter credit controls are a good place to start. Making sure the operation is functioning in as lean a way as possible will help cut costs and help with discipline.

2 DISCIPLINE There is always talk of underwriting discipline but it becomes critical in an economic downturn.

3 WORDINGS Check policy wordings – have they remained as tight as possible? Too often underwriters will use clauses or wordings that have been in place for years. Reread them and make sure they are still appropriate for the risk.

recession and continued erosion of asset prices –the insurance industry as a whole will not destabilise the financial system as the banks did. Insurers are not affected by liquidity risks in the same way as other financial institutions - at least if they abstain from conducting that sort of financial business that resulted in such dire problems elsewhere. They are not subjected to the kind of liquidity risk affecting banks as they are prefunded by a relatively stable flow of premiums and generally do not rely on short-term market funding. The industry also has rediscovered the crucial role of asset-liability management and the need to maintain a strong focus on well diversified investment portfolios.

The credit crisis has not questioned the industry's basic business model, insurance risk underwriting. There is no shortage of cover for life or non-life insurance. Capacity appears to be abundant even though prices have started to harden in certain lines. However, banks have reined in lending and are reviewing their securitisation and originate-to-distribute business models. Investment banking is changing with traditional Wall Street firms disappearing or being morphed into universal banks.

The current level of regulatory activity in financial

services means that the insurance industry faces the danger of collateral damage if this regulation is based on the inaccurate assumption that banks and insurers offer similar services and pose similar threats to financial stability. They differ considerably, something that must continue to be reflected in different regulation and capital requirements for both industries.

The new Solvency II framework also must be implemented without delay. It will introduce a holistic view to an insurance company's business, investment and operational risks, and places a strong focus on the quality of internal risk management. From an economic point of view, Solvency II offers the best possible regulatory framework to implement the lessons learned from the crisis and to ensure the sector's long-term viability.

Patrick M Liedtke is secretary general and managing director of The Geneva Association.

Kai-Uwe Schanz is adviser to The Geneva Association and chairman and principal partner of Dr Schanz, Alms & Company.

"The new Solvency II framework must be implemented without delay."

4 STRATEGY Check the business model. Reconsider the strategy of the business – is it right in these changing times? Is the firm attracting the right type of insured? As certain markets start to harden, you will consider insureds more carefully but that investigation needs to become ever more active now.

5 VULNERABLE INDUSTRIES Claims always rise in an economic slump, particularly from certain classes – construction, for example, as the building industry collapses. Claims may also rise in the liability markets; companies will look for people to blame, or to claw money back from, so professional advisers may well turn to the insurance market to transfer some of that risk. Each insurer will need to decide how much of that business they are prepared to take on while maintaining a disciplined and balanced book.

6 FRAUD An economic slump also boosts the number of fraudulent claims. Disciplined underwriting at the start of the process can help reduce these.

7 WORKFLOW As demand for certain types of insurance rises, firms need to manage the workflow to ensure there is sufficient time and resource to properly underwrite every risk. Money invested here may well be recouped by a reduction in claims.

8 BROKERS Make sure that, as an insurer, the right broker is in place and that, in turn, he or she is reaching the right insureds. Look at the broker's exposure and factor that into the underwriting decision. Look too at any direct operations and consider the information required from insureds to ensure that the underwriting discipline can be maintained. Work closely with others along the chain so that everyone is working towards the same goal and at the same standards.

9 SECURITY The importance of financial security has become crystal clear. Check your clients carefully before providing cover. Those who appeared financially sound just a few months ago may well be in a different position today. Check and recheck the latest position.