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RatingsDirect®

November 11, 2008

Credit FAQ:

Global Insurers Take A Hit In The Third Quarter, But Ratings Should Withstand The Test

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In our opinion, most global insurers, with the exception of the relatively small number of bancassurers, mortgage insurers, and bond insurers, proved their resilience in 2007 and the first half of 2008, although the third quarter of 2008 has taken its toll on insurer balance sheets and the deterioration has continued in October. In this article, Standard & Poor's Ratings Services examines whether, in our view, global insurers can maintain their resilience following these negative developments. Based on current conditions and our medium-term expectations, we believe that the majority can, although there could be an increasing number of exceptions if financial and economic conditions deteriorate more than expected.

What potential factors would cause Standard & Poor's to make widespread ratings downgrades in the insurance sector?

In our opinion, the following conditions--either in combination or potentially in isolation--could cause widespread downgrades if they persisted over the next 12-18 months:

- Protracted and severe global economic slowdown resulting in moribund equity and property markets and corporate default rates in excess of those seen during previous downturns.
- Continued low activity levels in the banking system and capital markets, particularly if coupled with further very large systemic losses on either side of the balance sheet.
- Continued softening of non-life markets.

How have insurers generally managed to avoid the recent problems faced by banks?

In our view, insurance and bank business models are very different. While both are confidence sensitive, we have observed that the loss of confidence in a bank can sometimes be terminal, while the loss of confidence in an insurer would more likely result in an orderly run-off of liabilities over several years, with the exception of a limited number of insurers with large books of liabilities with liquidity triggers (see "Evaluating Liquidity Triggers In Insurance Enterprises," published Nov. 11, 2008, on RatingsDirect). On the other hand, loss of confidence in a bank is more likely to be terminal. In our view, this contrast exists because insurers tend to be naturally liquid, since most of their liabilities are not as confidence sensitive or cannot be surrendered. Insurers receive their revenues (premiums) before they pay their expenses (claims), and typically they keep more than 90% of their assets in readily realizable form. That said, we expect that hurricanes Gustav and Ike will create liquidity demands on insurers and reinsurers, although most settlements will be made over the next year or so and, in our opinion, can largely be financed from cash flows. Insurers also generally have lower levels of leverage and therefore lower levels of dependence on capital markets than do banks. Furthermore, securitization is still in its infancy in the insurance sector.

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What caused the generally poor results among insurers in the third quarter?

In our view, the balance sheets of most insurers were generally in good shape at June 30. This was fortunate for them as capital-raising was, and remains, problematical. The period until June 30 was affected by insurers' investments in corporate bonds and structured credit instruments and the decline of equity markets (the S&P Global 1200 Equity Index fell 12% in the first half of 2008), although we believe that since then, the stress on the global banking system has moderated as governments begin to execute their coordinated plans to restore confidence. However, just as the banking system crisis has moderated, this has in our view been offset by the threat of global recession. In response, we observe that equity markets have continued on their downward path. The S&P Global 1200 Equity Index fell a further 15% in the third quarter and, at its low point on Oct. 27, had fallen a further 30%. Corporate bond credit spreads have also widened markedly. In addition to asset side pressures, Hurricane Ike is proving to be a bigger event than first thought, and it now looks possible that it will be the third most damaging insured natural catastrophe in history.

For these reasons, we observed that third quarter results were typically very poor throughout the global insurance industry. Many insurers posted third quarter losses and most insurers' net asset values ended the quarter below where they had started (reflecting unrealized investment losses going directly to shareholder equity and bypassing net income). For some insurers, the depletion was sufficient to offset the value created in the first half of 2008. At this point in time, we expect year-end balance sheets to be further depleted.

How are non-life insurers responding to these difficulties?

We believe that non-life reinsurance markets have quickly switched from "softening" to "hardening" mode for many lines of business over the past month. The pace of change for commercial lines insurers has so far been less pronounced, but we are observing that prices in these markets are starting to firm. We expect that the switch will be most marked in lines affected by Ike (property, marine, and energy, and reinsurance thereof). We also expect the rise in prices which started earlier in the year in workmen's compensation, errors & omissions liability, and directors & officers liability, will be reinforced. We also expect that the many reinsurers who have suffered dented balance sheets on the asset and liability side from Ike will impose significant rate increases and tougher conditions. In particular, we expect that reinsurers will not continue to expose themselves to further significant losses from natural catastrophes without greater compensation for risk, especially while their financial flexibility is constrained. Similarly, we expect catastrophe-exposed primary insurers to seek more reinsurance to compensate for their lost financial flexibility, while the reinsurers themselves will be looking to reduce exposure.

And the life market response?

In general, life markets move more slowly than non-life markets. Their risk profiles tend to have greater exposure to trends rather than events. Life insurers in most parts of the world tend not to be prone to "run on the bank" liquidity scenarios, given the influence of disincentives built into life policies (which can be applied where policyholders withdraw funds before the maturity date). However, we do expect products to be progressively re-priced to reflect the emerging economic and financial environment. We observe that consumer preferences generally shift from variable benefit to fixed benefit products in times like these. The second-order effects can also be

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more marked, with volatile investment markets constraining demand for savings products and sluggish property markets negatively affecting the demand for more traditional mortgage related offerings. Furthermore, in spite of the disincentives referred to above, recessionary conditions tend to result in higher lapse rates as consumers reduce their outgoings or face an urgent need to access funds.

What role is mark-to-market accounting having on insurer balance sheets?

In our opinion, depleted balance sheets are attributable to a mixture of economic and accounting issues. To a large extent, Standard & Poor's in its rating analyses tends to focus beyond the accounting issues, and this is particularly true of life insurers' fixed income investments. Insurers are typically not forced sellers, since their fixed income investments are usually used to back long-term liabilities to policyholders. We will continue to analyze the likely ultimate economic losses as part of our earnings and capital analysis and the same is true of accelerated writedowns of deferred acquisition costs and reductions in embedded value. We are, however, focused on current investment valuations to the extent that they directly affect future earnings through charges on unit-linked business/separate accounts and asset management subsidiaries.

Non-life insurers also tend to invest in equities and corporate bonds, although to a lesser extent than life insurers. In the case of corporate bonds, durations tend to be much shorter than for life, which limits the downside risk. The same focus on economic losses as for life insurers applies here too, although tempered for (re)insurers prone to sudden liquidity demands from catastrophic events.

We also observe that regional differences exist, partly due to regulatory incentives. Although much diminished, European and Asian insurers generally have a stronger bias toward equity risk than U.S. insurers, where credit risk is more prominent.

We do not expect insurers to benefit significantly from the recently announced relaxations of fair value accounting by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB).

What do we consider are the ratings prospects for the insurance industry in the coming months?

2008 is likely to go down as a "capital event", similar to 2001 when insurers and reinsurers were affected by the events of September 11. Unlike 2001, however, in our view the financial market turmoil is primarily responsible this time for the greater risks to the insurance industry. The significance of a capital event is such that for 2008 we will exclude from earnings the exceptional asset-side impact of the turmoil (realized and unrealized losses and impairments) in our operating performance analysis, and our focus will be on capital. While we expect many insurers to post losses for the year, our ratings actions in this sector have been modest, given the capital strength and liquidity of the industry.

However, if insurers' balance sheets continue to weaken either on the asset or liability side, the resilience of insurer ratings exhibited so far will likely be challenged. In this case, the outliers that would emerge may attract outlook or rating changes. Our primary measure of capital adequacy is based on our risk-based capital adequacy model.

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Capital adequacy started the year at a cyclical high for most insurers following two years of record-breaking profitability and, as a result, has spent most of the year at levels at least consistent with rating levels. We consider a rating action when capital adequacy falls, or is expected to fall, below levels consistent with the public rating. However, this does not automatically result in a rating action. Capitalization is just one of eight categories of ratings analysis we apply. Highly rated insurers normally enjoy access to financial flexibility in the form of several sources of capital which may generally serve to offset concerns regarding capital adequacy. Today, however, those sources of capital are limited in availability and, where available, are expensive. More fundamentally, in our analysis we also look to insurers' expected future operating performance as a potential way to replenish capital. Earnings capacity is in turn influenced by insurers' competitive position. We also look for highly rated insurers to adjust and execute their risk tolerance in accordance with their enterprise risk management (ERM) capabilities.

How much further can capital adequacy fall without affecting insurer ratings?

We believe that most insurers still have headroom in terms of capital adequacy before their ratings would be adversely affected. Although outliers will begin to emerge if investment markets continue their downward path--thereby giving rise to more negative outlooks and downgrades--we do not believe that we are currently on the verge of industry-wide capital-related downgrade activity.

The extent to which capital adequacy may fall below the level consistent with the rating depends on the extent of the offsetting factors referred to above. For example, at the end of the first quarter of 2003, when equity markets bottomed out, many highly rated insurers' capital adequacy was significantly below the level consistent with their ratings (up to two rating categories). Our criteria generally includes a greater tolerance for higher rated insurers' capital falling temporarily than lower rated insurers, where the latter's competitive positions and therefore earnings capacity are usually weaker. As a rule of thumb, this tolerance would be influenced by the amount the insurer is likely to retain from its earnings over the rating horizon--that is, the next two years. Where we cannot see a path that returns capital adequacy closer to a level consistent with its rating over that period, we would likely take rating action.

What effect could regulatory responses have on our ratings?

In our view, further depletion of balance sheets may increase the incidence of insurers testing regulatory solvency tolerances, although we don't expect sudden responses from regulators. Indeed, we have already seen certain regulators relax their capital requirements given the investment market stress and, by implication, take a more economic view of balance sheets, in which their treatment of assets and liabilities is more closely aligned with Standard & Poor's treatment. However, there may be outliers where regulators ultimately intervene. The regulators' view of capital adequacy heavily influences our own view when regulatory capital reaches marginal levels, and in this case a rating action would likely result. However, based on current market conditions, we are not expecting such actions to be widespread.

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And what about governments' responses?

In our view, due to the generally less confidence-sensitive nature of insurers' operations compared with banks, governmental efforts to restore confidence have focused on the latter. AIG is an exception, although its difficulties are related to its unique financial product operations. Some bancassurers, such as ING and KBC, have benefited from government capital injections, as did Aegon following the Dutch government's decision to make funds available to all financial institutions, including insurers. However, we haven't built in any future expectation of government support into our ratings.

What will insurers do to further protect their capital base?

We expect that insurers will most likely seek to protect their capital base using the financial flexibility that remains to them--through measures such as hedging, buying additional protection against catastrophic loss, suspending of share repurchase programs, and reducing dividends. For the (few) insurers that have hybrid instruments approaching their call date, we expect they will closely examine their capital needs before calling those instruments. The same applies to senior debt approaching maturity, although this is mainly concentrated in North American markets. We expect some outliers to raise additional capital, although this will likely be expensive. We do not expect significant M&A activity amongst insurers in the current economic climate.

Do we believe enterprise risk management (ERM) is helping insurers to better manage their risk profile?

We are currently experiencing the first real stress test of ERM since we introduced it as an analytical rating category in October 2005. However, we believe that few insurers would have contemplated the current stress in the markets in their scenario testing. To a significant extent we believe ERM is helping insurers to better manage their risk profile. We believe that the strongest proponents of ERM have generally fared better than others, and insurers as a whole have transformed their risk management practices over the past five years. In our view, the stronger proponents of ERM include some of the major European groups, Bermudian reinsurers, and U.K. life insurers.

Where is the evidence that ERM is enabling insurers to better manage their risk profile?

In our opinion, insurers were mostly successful in limiting the impact of subprime investments on their balance sheets. On the liability side, we believe the several hundred class action filings related to the consequences of the financial turmoil will be material for non-life insurers but not life-threatening. The more recent decline in equity markets, and impairments and unrealized losses on fixed income instruments, seem thus far to have been contained within risk tolerance by those insurers with excellent and strong assessments. Insurers have used hedging programs extensively in an effort to achieve this. Some non-life reinsurers have led the way in strategic risk management and we believe that the pricing trend in the reinsurance market could be about to change to positive from negative without significant underwriting losses having damaged balance sheets. Non-life primary insurers are generally less advanced in their ERM programs, and a number in the U.S. have suffered substantial retained losses on Hurricanes Gustav and Ike. Like capitalization, ERM is just one category in our rating. Although ERM will not in and of itself

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dictate a rating, in our view, it has significantly contributed to improving risk management practices for rated insurers.

Related Articles

"Global Insurers Weather The Credit Turmoil--Thus Far", published Oct. 21, 2008, on RatingsDirect.

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