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Global insurance review 2008 and outlook 2009: Weathering the storm

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1. Executive summary

Economy and capital markets

- As a result of the most severe financial crisis since the 1930s, the world will see a severe recession. A rebound of the economy cannot be expected before mid 2009 and market uncertainty will continue well into 2010.

- Given the efforts made by central banks and governments – liquidity injections into the banking system, guarantees, recapitalising of banks, and, increasingly, fiscal stimulus packages – we expect the credit crunch to gradually diminish in the first half of 2009. Nevertheless, even in 2010, economic growth will most likely be below trend in most of the developed economies. Inflation will be low in 2009 and 2010 due to the soft economic activity and lower commodity prices.

- Capital markets are under a lot of stress. Volatility is very high, many markets show signs of fire sales, including huge sections of the corporate bond market and, in particular, markets for structured products. We expect stock markets to begin recovering as soon as it is clear that economic activity is improving. Improvements to credit spreads typically follow a few months later.

Insurance

- Insurers are not immune to the crisis. Insurers hold about USD 18 trillion of assets world wide (as at end 2007). Insurers invest assets to match their liabilities, and are invested in a diversified set of high quality assets. Of the USD 18 trillion, they hold around USD 2.2 trillion of shareholder capital to cushion fluctuations in both claims and asset prices.

- Most insurers have mark-to-market losses on their asset portfolios. In non-life, the losses will eventually be borne by shareholders. In life savings products, losses are usually shared between policyholders and shareholders.

- Unlike many other institutional players in the financial markets, insurers are not generally confronted with the risk of funds being withdrawn. The exception is where life insurers specialise in savings products, but stiff penalties for early withdrawal by policyholders make it unlikely. In non-life, it is not possible because payouts from reserves require an insured loss, and are not made on-demand by policyholders. Insurers are therefore not forced to sell assets in down markets, but can hold them until maturity and thereby avoid a realised loss.

- Unlike the banking system, the insurance industry continues to function well in all countries. Only a few insurers have needed support by governments and usually not because of the insurance part of their business but due to the financial services division.

- By September 2008, non-life insurers have lost 10% to 15% of their shareholder equity compared with end-2007. In life, it is somewhat higher with 15% to 20%. Unless markets deteriorate substantially further, we would not expect to see many, if any, insurance companies fail.

- Typically, non-life premiums are hardly affected by economic downturns — only a few lines of business have strong links to economic activity. Claims may even grow more slowly as inflation decelerates.

- In life, however, new business is suffering from a drop in unit-linked and single premium business. Though growth will slow down, it will not be dramatic and growth will recover as soon as capital markets stabilise. Reserves for future claims are secure and there is no shortage of available coverage.

- Most life and non-life insurers will show substantially lower ROEs in 2008 and 2009, compared with 2007. Despite declining asset values, ROE is still expected to be positive in 2008 and probably also in 2009. If stock markets bounce back, there is a good chance that ROEs will return to pre-crisis levels by 2010.

- Life insurance, and non-life too, might even be among the industries which will most profit from improved capital market conditions.

Reinsurance

- While the underwriting side of reinsurance is very solid, both in life and non-life, reinsurers are also suffering from losses on assets. For the top 20 reinsurers, shareholder capital is down 10% to 15% from end-2007.

- Both in life and non-life reinsurance, prices are expected to harden. This is due partly to the fact that less alternative capacity is available nowadays. The cost of capital has risen: Equity markets are depressed and hybrid capital is expensive. Also, securitisations of insurance risks have been disrupted in the market turmoil. For example, embedded value securitisations in life reinsurance, a form of asset-backed security, are currently on hold.

- Reinsurance premium volumes are expected to accelerate as the need for protection increases given the lower capitalisation of primary insurers, who use reinsurance as a substitute for shareholder capital.

- Given the importance of investment results, a recovery of credit and stock markets will lead to a strong recovery in reinsurance.

Regulation

- The crisis will also give rise to a re-think of insurance regulation. For the insurance industry, it is important that regulation takes into account the unique characteristics of insurance which does not face the same risks as banks.

- In this discussion, the issue of pro-cyclicality needs to be addressed. There are elements in accounting, ratings and capital requirements that have the potential to amplify cyclicality in times of stress.

- Group supervision is another important issue. Collateral requirements should be addressed in this context: They are not only costly but may also result in increased liquidity risk in times of crisis.

2. Difficult macroeconomic and capital market environment

We are experiencing a major economic downturn as a result of the most severe financial shock in mature markets since the 1930s. Many industrialised countries entered recession in 2008 and growth has started to slow sharply in some emerging markets.

As a response to the rapid deterioration of the economic outlook, central banks are cutting interest rates. After rising in the first half of the year, government bond yields have dropped sharply in the second half and were roughly 100 basis points lower at the end of November than at the beginning of 2008 in both the United States and the euro area. Corporate bonds suffered a massive sell-off due to rising default expectations and a surge in risk aversion. Investment-grade borrowers currently have to pay a spread relative to government bond yields of around 600 basis points in the United States and around 430 basis points in the euro area – up from 200 and 110 basis points respectively at the beginning of the year. High-yield spreads surged above 1800 basis points, up from around 500 basis points at the beginning of the year and as low as 230 basis points (US) and 180 basis points (euro area) in summer 2007, before the crisis started. These levels clearly exceed those reached in the previous credit cycle in 2001. Equity markets also performed poorly, with the major benchmark indices down between 35% and 45% at the end of November.

In our baseline scenario we expect the industrialised economies to be in a recession with many economies, including the United States and Europe, experiencing severe recessions. Two alternative scenarios are outlined in the following paragraphs: First, a pessimistic scenario with a prolonged and deep recession and very low inflation or deflation in the major economies; and, second, an optimistic scenario with a moderate recession followed by a relatively quick rebound in the second half of 2009.

Baseline scenario: Global recession (70% probability)
In the baseline scenario, we expect the crisis to last until about mid 2009. The reduction of leverage in the economy is likely to continue into next year, reducing the availability and affordability of credit for companies and consumers. The International Monetary Fund (IMF) estimates that recessions following banking crises in developed economies tend to be more severe than in others, leading to an average cumulative reduction in economic output of about 6% below trend. Our baseline outlook is consistent with a downturn this deep. Economic activity has already dropped sharply in the second half of 2008. Growth will be negative in the United States and Europe next year and continue to be weak in Japan. The expected recovery in 2010 is likely to be gradual and modest.

Inflation will decline due to lower energy prices and increasing slack in the economy. The United States is likely to have a short period of negative inflation rates. In the United Kingdom, too, retail prices are expected to decline temporarily. However, due to the swift monetary and fiscal policy response, we do not believe that sustained deflation, ie a prolonged fall in the general price level, is likely.

Central banks around the globe have slashed interest rates and are expected to cut them further. The Fed funds rate will be cut to 0.5%, the European Central

Bank and the Bank of England are expected to lower rates to 1.5% and the Bank of Japan is likely to keep rates close to zero until mid 2009 at least. In addition to cutting interest rates, central banks have resorted to various unconventional measures to support the economy. The Federal Reserve has announced a lending programme aimed at lowering borrowing rates for mortgages and other consumer loans. The Fed is also buying commercial paper to provide direct short-term financing to non-financial companies.

In addition to monetary stimulus, if necessary, governments will be providing further support to the banking sector in the form of capital injections and guarantees. In recent weeks, several governments have announced direct fiscal stimulus packages to support economic demand. This monetary and fiscal support, coupled with some relief from lower oil prices, will likely prevent the global economy from a prolonged slump.

Government bond yields are expected to drop somewhat further after their recent declines, but should recover in 2010. Corporate credit spreads are likely to remain wide in 2009 as default rates rise. Equity markets are assumed to recover from current depressed levels in 2009 and 2010 as fears of a deflationary depression fade.

Pessimistic scenario: Credit crisis deepens (25% probability)
There is a significant risk that policy measures will fail to unlock the credit markets. We therefore see a 25% chance that the credit crisis could be prolonged and deeper than expected in the baseline scenario, lasting throughout 2010. In this scenario, inflation declines substantially and growth is negative during 2010. Emerging markets are also in deep recession. Central banks keep interest rates low during 2010. There is an elevated risk of deflation becoming entrenched in expectations, leading to a severe slump over a longer period.

Under this scenario, equity market volatility remains high and markets are unlikely to post significant gains either in 2009 or 2010. Corporate credit spreads may well rise further and remain high for a prolonged period. Government bond yields would decline substantially due to low growth and inflation expectations.

Optimistic scenario: Mild recession followed by quick rebound (5% probability)
With the massive capital injections into the financial system and the banking system awash with central bank liquidity, the financial system may start to function properly sooner than expected in the baseline scenario. In addition, the drop in oil prices may support consumer demand, with the effect similar to a tax cut. The recession would be short and growth would return to potential by the end of 2009.

In this scenario, central banks are likely to reverse their monetary easing, starting as early as mid 2009. Equity markets will rebound quickly as growth recovers. Corporate bond spreads will drop from their distressed levels and government bond yields will rise. Given the current state of the financial system, however, such a scenario has a low probability.

3. Asset meltdown: Insurance weathers the storm

The insurance industry has lost a fair amount of capital this year, but is generally robust and able to weather the financial turbulence. If corporate bond prices are sustained at current levels and equity markets fail to recover, the declines in surplus this year can be expected to be approximately 10% to 15% for non-life since year-end 2007 and around 15% to 20% for life.

Insurance activities are different from other financial activities because they are pre-funded by premiums. Unlike many other institutional players in the financial markets, insurers are not generally confronted with risk of funds being withdrawn. The exception is where life insurers specialise in savings products, but stiff penalties for early withdrawal by policyholders make it unlikely. In non-life, it is not possible because payouts from reserves require an insured loss, and are not made on-demand by policyholders. Insurers are therefore not forced to sell assets in down markets, but can hold them until maturity and thereby avoid a realised loss. The funding aspect is of particular importance in the current situation.

Insurers also typically invest conservatively, normally focusing on highly-rated assets. Furthermore, insurers' invested assets are generally well diversified. In most countries this is enforced and controlled by regulation. Unless markets deteriorate substantially further, we would not expect to see many, if any, insurance companies to fail.

The financial crisis is affecting both the liability and the asset sides of insurers' balance sheets, but the degree of impact varies significantly by business line and by individual company. Companies that entered directly into credit guarantees of one form or another will be among those hardest hit by the financial crisis. Mortgage guaranty insurers' losses are projected to be USD 10 billion, around half of their total capital. Monoliners' (financial guarantors) exposure to Collateralised Debt Obligations (CDOs) and other mortgage-related structured finance products have resulted in losses (realised and unrealised) of USD 50 billion.

Life insurers generate a major part of their income by investing the incoming premiums and receiving returns on these invested assets. As a result of this business model, their leverage is higher than non-life insurance and they are relatively strongly affected by the financial meltdown. Recent falls in equity values, along with widening credit spreads, have put significant strain on their balance sheets.

Non-life insurance is less leveraged than life insurance. According to estimates by Swiss Re Economic Research & Consulting, non-life insurance asset-equity leverage is around 250%. Nevertheless, realised and unrealised investment losses have caused balance sheet impairments for non-life insurers.

Going forward, given that the risk-bearing capacity in the industry has been squeezed, insurers are expected initially to focus on capital preservation measures. Share buy-back programmes, for example – heavily used by insurance companies in recent years – are frequently postponed or reconsidered. Several life companies have raised capital. Asset risks will be reduced further in many cases. Also, drawing on past experience, some companies are likely to exit non-core business lines. In response to the 2001–

2003 crisis, when European life insurers were subject to huge investment losses, life insurance companies restructured their business portfolios, exiting capital-intensive lines of business or parts of the value chain and focusing on profitable lines. Finally, a turbulent climate such as the current one often leads to opportunities for stronger firms to act as consolidators, acquiring the business of weaker firms at attractive discounts. We therefore expect to see increased M&A activity in the financial sector in the coming years.

4. Regulation: Learning from the crisis

Compared with banking, insurance has been much less affected by the financial crisis and has not contributed to the systemic problems being faced by financial systems world wide. But, as a result of the crisis, the regulation of insurance will be reviewed along with banking supervision. Besides the need to strengthen risk management and transparency, regulatory issues needing to be addressed include:

- Maintaining distinct regulations as between banking and insurance
- Securitisation and liquidity
- Avoiding pro-cyclical regulatory and accounting rules
- Reinforcing international cooperation (group supervision)

Most of the above issues have already been addressed by the European Solvency II project.

To reflect the differences between the two systems, regulation must take account of the different nature of risks in banking and insurance, and acknowledge that the two industries are fundamentally not the same in presenting a systemic risk to the financial system. The industries can be under one regulatory umbrella, but the specific regulations need to reflect the differences.

Securitisation and liquidity issues have received increased attention in this latest crisis. Currently, securitisation in insurance has been fairly limited and has generally avoided the pitfalls of poor transparency or irresponsible underwriting seen in the sub-prime mortgage securitisations. Prudent securitisation makes insurance safer by providing needed capital for 'peak' risks (eg, California earthquake). Liquidity can also be a problem in insurance, though liquidity risk is generally very low. The AIG case revealed, however, that liquidity sometimes can become an issue for insurers as a consequence of capital market activities beyond the core insurance business. In general, enterprise risk management should be strengthened, which is a focus of Solvency II.

Another important point is the issue of pro-cyclicality. There are elements in accounting, the use of ratings, and in capital requirements which have the potential to amplify cyclicality in times of financial stress. This creates volatility to an inherently stable system and must be addressed. The valuation of assets is a related issue. The current crisis shows that, if panic rules, market prices are a poor measure of value for long-term assets and liabilities.

Group supervision is a necessary precondition to ensure that regulatory loopholes are avoided. This area will require increased and more encompassing transparency to ensure that all the risks faced right across an insurance group are identified and addressed. It also necessitates greater expertise and international cooperation among supervisors. One key topic in the area of group supervisions is collateral requirements. Requests by individual market supervisors for increased collateral were already a topic of discussion before the crisis. However, the crisis emphasises the importance of finding better solutions in this important area.

The crisis provides an opportunity to learn from shortcomings and build a stronger financial system for the future. This entails sensibly addressing the accounting issues that can become pro-cyclical, reviewing any problems with group supervision and finding a suitable solution which avoids the deficiencies of collateral regimes imposed by individual markets. Problems stemming from mortgage-backed securities should not inhibit the further successful development of insurance securitisation: In the case of catastrophe bonds, the two genres are really quite distinct from one-another. The difficulties arising from excessive leverage in the banking sector should not be used as an excuse to increase solvency requirement for insurers. Nor should insurers be severely restricted in their use of financial instruments, many of which are very useful and efficient for asset-liability management or for diversifying asset portfolios. Finally, a review of the role of rating firms is necessary to ensure transparency and the quality and independence of rating securities.

5. Non-life insurance and reinsurance: Underwriting side remains strong

Non-life insurance

With the exception of financial guaranty insurance in the United States and credit insurance, the global non-life insurance industry has been faring comparably well during the financial crisis. This a remarkable result for an industry which depends heavily on its investment returns. Indeed, invested assets have been significantly affected by declining stock markets, and increasing write-downs and impairments on their fixed income portfolios – resulting in low or even negative investment results and a decline in shareholders' equity. Underwriting, which has continued to post solid results, has proved to be a stabilising factor.

Despite an increasingly competitive market, the underwriting results in the largest markets have mostly been positive, delivering combined ratios of below 100%. The main exception is the US market, where Q3 results suggest an industry-wide combined ratio of around 103%, up from 95% in 2007. The main reasons were:

- The high catastrophic property claims amounting to about USD 30 billion following the devastating hurricanes Ike and Gustav, along with a number of mid-sized catastrophes during the first half of 2008.

- Significant underwriting losses reported by mortgage and financial guaranty insurers.

- The continued competitive pricing in almost all lines of business and geographic areas, which reduced the underlying underwriting profitability.

The European markets had a comparably benign year in terms of large natural catastrophes and man-made disasters. With winter storm Emma costing USD 1.4 billion, there was only one event exceeding the billion-dollar threshold. However, compared with previous years, underlying underwriting profitability slightly deteriorated, but still provided positive results.

Growth was sluggish – below GDP growth – in most mature markets due to a gradual weakening of premium rates. Premiums in the United States declined and, in the United Kingdom, Continental Europe, Canada and Japan grew in the low single-digit range. Hong Kong, Taiwan and Australia were also affected by further price softening in major lines, causing premium growth to be lower.

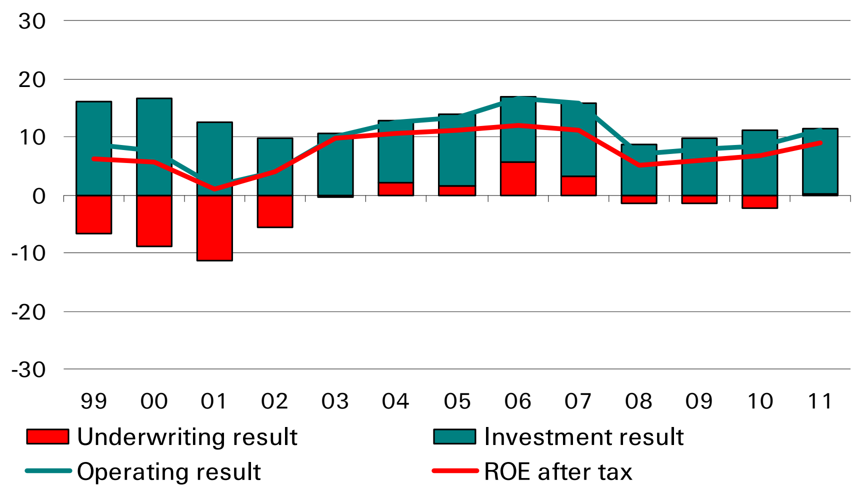
Real growth of direct non-life premiums in major countries, 2005–2008

Country	2005	2006	2007	2008
US	-1.5%	-1.1%	-3.2%	-4.3%
Japan	0.9%	0.5%	-1.0%	0.6%
UK	3.0%	-3.7%	-0.7%	-0.4%
France	3.6%	1.4%	0.4%	-0.5%
Germany	0.1%	-1.1%	-1.5%	-1.8%
Italy	0.5%	0.3%	-0.5%	-1.4%
Spain	4.0%	3.1%	1.7%	-1.8%
World	0.6%	3.1%	0.2%	-0.8%

Source: Swiss Re Economic Research & Consulting

Profitability of the six major non-life primary markets, 1999–2009

as % of net premiums earned, ROE as % of average shareholder equity



Source: Swiss Re Economic Research & Consulting

The contribution of the investment result to the operating result is expected to decline from 13% to 8%. Together with a negative underwriting result of –2%, due to the underwriting losses in the US non-life market, the operating result declined from 16% to 7% of the net premium income between 2007 and 2008. ROE declined accordingly.

Along with its results, the capital of the non-life industry also declined in 2008. This stems from unrealised losses on invested assets, which are not recognised in the profit and loss account, but are directly booked as change to shareholders equity. Preliminary estimates suggest a decline of capital of between 10% and 15% since the end of 2007. Solvency declined from 113% to 97%. The decrease is significant but not alarming for the industry as a whole, because the level of average solvency of non-life insurance is still comfortable: It is well above the trough of 2002 and stands at about the same level as end-2004.

Outlook 2009

Against the background of the financial crisis and the deepening global recession, the non-life insurance industry is expected to follow a 'safety-first' strategy, in order to avoid capital issuance in the current difficult capital market situation. This implies:

- De-risking the asset side of the balance sheet, meaning a conservative investment approach with low but secure returns.

- De-risking the liability side of the balance sheet, reflected in an increased demand for reinsurance, in order to reduce underwriting risk. This contrasts significantly to the previous trend of insurers reducing their reinsurance spend and retaining more underwriting risk on their own balance sheets.

- Re-focusing on underwriting profitability, with the practice of chasing after market share at the expense of profitability no longer being sustainable. There will be rate increases in segments where underwriting results had suffered from increasing losses (namely US property cat, aviation, D&O and credit). In other lines, there will be an end to the trend of declining rates. A general hardening of rates across all lines will be slow to emerge in the poor macroeconomic environment. However, the default expectation for rate changes will be a shift from softening to hardening in 2009, reflecting the increased costs of insurance production due to higher capital costs and lower investment returns.

Therefore, barring any extraordinary catastrophic losses, the underwriting results of the most important markets will be stable in 2009 or even improve in some segments. Premium income is expected to be subdued because of the economic downturn. While some lines of business – such as engineering, which is linked to infrastructure investment activities – will face significant declines, for most of the business premium income is expected to be stable.

While prospects for 2009 are not very encouraging, 2010 may well be one of the better years. Underwriting performance should be very good and, if capital markets bounce back, it may well be an excellent year.

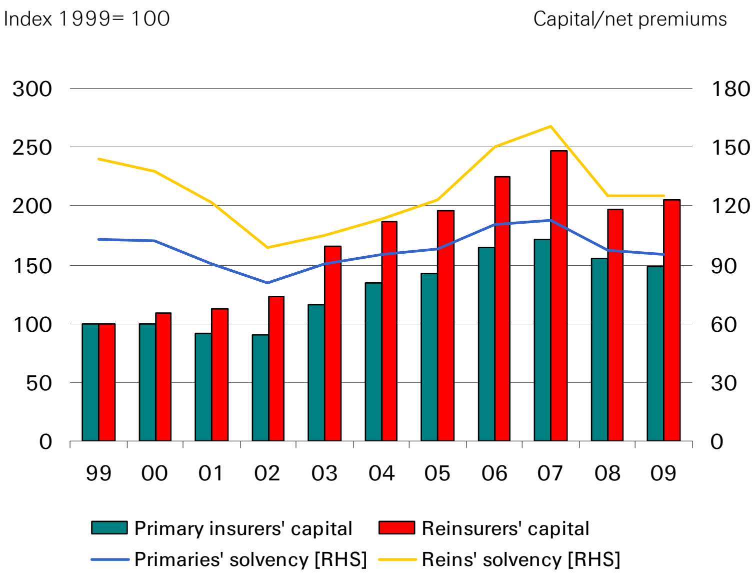
Real growth of direct non-life premiums in major countries, 2007–2010

Country		2007	2008	2009	2010
US	Forecast 12/2008	-3.2%	-4.3%	3.0%	6.6%
	Forecast 8/2008	-3.2%	-5.0%	0.0%	5.0%
Canada	Forecast 12/2008	1.5%	-0.4%	0.4%	2.8%
	Forecast 8/2008	1.5%	-0.4%	0.4%	2.8%
Japan	Forecast 12/2008	-1.0%	0.6%	1.2%	1.9%
	Forecast 8/2008	-1.0%	0.6%	1.2%	1.9%
UK	Forecast 12/2008	-0.7%	-0.4%	0.1%	2.6%
	Forecast 8/2008	-0.9%	-1.8%	-1.2%	2.1%
France	Forecast 12/2008	0.4%	-0.5%	0.0%	-1.6%
	Forecast 8/2008	-1.2%	-2.4%	-0.7%	0.7%
Germany	Forecast 12/2008	-1.5%	-1.8%	0.3%	1.4%
	Forecast 8/2008	-1.5%	-1.9%	-1.1%	0.0%
Italy	Forecast 12/2008	-0.5%	-1.4%	0.4%	2.7%
	Forecast 8/2008	-0.5%	-1.6%	0.1%	1.9%
Spain	Forecast 12/2008	1.7%	-1.8%	-1.5%	-0.2%
	Forecast 8/2008	1.7%	-2.3%	-1.8%	-0.2%
World	Forecast 12/2008	0.2%	-0.8%	2.3%	4.3%
	Forecast 8/2008	0.1%	-1.2%	1.0%	3.5%

Source: Swiss Re Economic Research & Consulting

It seems a paradox that the forecasts for non-life premiums have been raised compared with our original estimates in August, despite the further worsening of the credit crisis and the deteriorating prospects for the real economy. The reason is that, as a result of the crisis becoming more severe, we expect more price discipline. This effect will dominate the impact of reduced demand for insurance cover.

Capacity and solvency of non-life (re)insurers



Source: Swiss Re Economic Research & Consulting

Non-life reinsurance

The non-life reinsurance sector has been affected relatively more greatly by the financial turbulence. Operating results declined from 33% to 13% and ROE from 17% to 4%. The capital base shrank by 10% to 15%. However, solvency levels are comfortable, and comparable with the situation at the end of 2005.

In terms of underwriting, the reinsurance sector had a combined ratio of around 97% – a positive underwriting result, and one which underpins the solid conditions in which the reinsurance markets operate. However, for several reasons underwriting profitability declined in 2008 compared with 2007:

- Higher property cat losses stemming from natural catastrophes, namely the severe hurricanes Gustav and Ike which devastated the Caribbean before making landfall in the United States. While an unusually high fraction of the losses was carried by the primary insurance companies due to extraordinarily high retentions, the loss burden was significant, in particular for most of the cat reinsurers in Bermuda.

- A number of costly man-made disasters totalling USD 5 billion.

- Mounting losses in financial guaranty and credit reinsurance due to the financial crisis.

- A creeping erosion of underwriting profitability due to years of rate softening.

Catastrophe and investment losses have probably absorbed most of the excess capital at an industry level. Leveraged capital (hedge funds) is withdrawing capacity from the reinsurance and retrocession markets. Lower investment yields are reducing the operating profitability of the current new business. The industry's performance for 2008 will be disappointing for investors. The cost of capital has increased substantially for the medium and longer-term horizon while access to capital is essentially shut down at the moment.

Outlook 2009

The outlook for the non-life reinsurance industry into 2009 is better than for primary non-life insurance markets. The expected increase in reinsurance demand from primary insurers will foster an increase in premium income. Also, reinsurers will benefit to a relatively greater degree from rate increases. Reinsurance is more capital intensive, and the demand is increasing while the supply is declining due to the withdrawal of alternative capital. Overall, underwriting conditions will improve in the reinsurance industry with property cat leading, and casualty lines lagging somewhat behind. Looking further ahead to 2010, this may again be a year when both come together, ie good underwriting results and strongly improved investment results.

6. Life insurance and reinsurance: Weak unit-linked business

Life insurance

The impact of the worsened economic outlook and the financial crisis on the life sector has intensified. The sharp deterioration in the investment environment has weakened life insurers' balance sheets and led to an erosion of capital. However, the industry is weathering the financial storm without major solvency problems thanks to very strong capital positions prior to the crisis and good risk management being in place.

Demand for life insurance has slowed and is expected to continue weakening as the impact of the financial crisis on the real economy and on consumers deepens. In-force premiums are expected to decline 2% in 2008, a far cry from an outstanding 2007. The greatest impact will be on products considered 'discretionary', such as term life, and unit-linked saving products, which are declining due to the poor returns and continuing high volatility in the stock markets. This is especially true in countries where single-premium business prevails. There is also a shift to fixed-benefit products which have been less affected by the economic downturn.

Real growth of direct life premiums in major countries, 2005–2008

Country	2005	2006	2007	2008
US	-3.5%	3.4%	5.4%	-1.2%
UK	12.9%	17.9%	24.9%	-13.1%
Japan	5.2%	-2.2%	-2.7%	-3.2%
France	12.8%	14.2%	-4.8%	-10.9%
Germany	0.7%	2.1%	-1.7%	-0.8%
Italy	9.7%	-7.5%	-4.2%	-0.6%
Netherlands	-3.4%	3.3%	1.2%	0.3%
Spain	4.7%	5.7%	2.8%	2.1%
World	4.9%	5.8%	8.8%	-1.9%

Source: Swiss Re Economic Research & Consulting

Sales of traditional protection products are trending down in most major markets. In countries where mortgages are secured with term insurance, such as in the United Kingdom, Ireland, Spain and, to a lesser degree, France, the decline has been substantial. In the United States, where business is to a far lesser extent mortgage-related, term sales have dropped slightly. Group business is also losing momentum due to weakened job and salary growth.

The marked slowdown in sales will negatively impact the profitability of the life industry. The other main driver of profitability, investment returns, declined sharply this year. Falling equity markets, widening credit spreads, and exposure to sub-prime and Alt-A investments have caused significant losses for some life insurers.

Most exposed to the fall in stock markets and impaired investments have been life insurers in the United States. In Japan, one small company filed for bankruptcy due to losses related to the global financial crisis. In the United States, realised capital losses reached USD 37 billion in Q3 2008, or 12% of the level of capital in the industry in 2007. In the United Kingdom, some insurers also suffered from exposure to equities. Continental European companies are affected least of all due to their very limited exposure to impaired assets.

In addition to mounting asset impairments, life insurers in the United States, Japan and Canada struggle with variable annuity (VA) business, whose guarantees have increasingly become 'in-the-money' for policyholders. Ideally, gains from effective hedging would offset such increases in liabilities for insurers. But hedging has become more difficult and costly in the current environment. According to Fitch, the level of reserves required to support VA business in the United States has increased by USD 15 billion in the year to date. Additional reserve strain is expected to be suffered by companies who have opted to reduce hedging due to the steep rise in costs.

The cost of capital has increased, and access to bank lending remains constrained. Shares in life companies have been hit hard since the Lehman default, impairing the sector's ability to raise equity. Additionally, access to the capital markets is temporarily very difficult and it is unclear at this time when life securitisation activity will bounce back. The lack of availability and the high cost of capital have impacted financing of XXX/AXXX business in the United States. As a result, term rates have stabilised and are expected to start trending upwards.

Some life insurers have taken steps to bolster their capital positions, while others have already received government aid or are seeking to qualify for it. In most cases this is not to prevent insolvency, but for other strategic reasons. Some life insurers are in a good position to grow their business by acquiring companies that have become attractive targets due to the currently depressed share prices, or by taking on some of AIG's life operations that are up for sale.

The financial crisis has caused erosion of shareholder equity. Shareholder equity of the world's largest public life insurers declined by an average of15% in Q3 2008, year-on-year. For the industry as a whole, we expect a drop of 15% to 20%. However, since life companies often hold securities to maturity or until prices recover, some of the unrealised losses may reverse over time as financial markets stabilise.

Outlook 2009

The challenges being faced by the life sector from a slowing economy and continuing turbulence in financial markets are likely to last until the end of 2009 or early 2010. Profitability is expected to remain impaired due to pressures from declining sales, lower investment returns, lower asset management fees from equity-linked business, higher hedging cost of the guarantees and possibly higher surrenders on some products. The negative impact will be temporary in nature. Assuming economic recovery, the industry is expected to be back on track in 2010 or 2011. For as long as capital markets are weak, life insurers' balance sheets will remain under stress. This will change when capital markets bounce back, and then life insurance will be among the industries which will profit most. Regarding long-term prospects, nothing has changed. The future remains favourable in view of the global impact of an ageing population.

Due to the worsening of the credit crisis, we have generally revised premium growth estimates down for 2008 and 2009. The figures in the table show our in-force premium estimates and forecasts, compared with what we expected in August this year. For 2010 we are more optimistic with respect to top line growth. The assumption here is that capital markets will recover by then.

Real growth of direct life premiums in major countries, 2007–2010

Country		2008	2009	2010
US	Forecast 12/2008	-1.2%	3.2%	5.0%
	Forecast 8/2008	-0.3%	2.7%	3.4%
UK	Forecast 12/2008	-13.1%	-1.3%	4.4%
	Forecast 8/2008	-13.1%	2.2%	2.9%
Japan	Forecast 12/2008	-3.2%	-1.7%	0.3%
	Forecast 8/2008	-0.3%	1.5%	2.0%
France	Forecast 12/2008	-10.9%	-0.7%	3.6%
	Forecast 8/2008	-8.0%	7.0%	7.6%
Germany	Forecast 12/2008	-0.8%	-0.7%	0.6%
	Forecast 8/2008	0.6%	-0.3%	1.4%
Italy	Forecast 12/2008	-0.6%	2.3%	5.5%
	Forecast 8/2008	-0.9%	2.0%	4.8%
Netherlands	Forecast 12/2008	0.3%	2.6%	3.4%
	Forecast 8/2008	1.9%	2.8%	2.6%
Spain	Forecast 12/2008	2.1%	1.6%	2.1%
	Forecast 8/2008	1.5%	3.3%	3.0%

Source: Swiss Re Economic Research & Consulting

Life reinsurance

Despite the temporary slowdown in life insurance demand, traditional reinsurance may benefit from the loss of shareholder capital in the direct market and constrained access to funding. Primary life insurers may seek traditional reinsurance to cope with the capital strains they face. As in the direct market, lower investment results will hurt the profitability of life reinsurers.

The economic slowdown will affect life reinsurers, too, but to a lesser extent than primary insurers: A large part of of the decline of new business is unit-linked sales, which are usually not reinsured. Traditional life reinsurance is hit more by the fall in mortgage-related protection business, which is caused by the contraction of the housing market in various countries. Lower term and group life sales also contribute to a depressed outlook.

Consolidation will lead to opportunities in non-traditional life reinsurance areas. Pricing of block transactions may become more attractive as some competitors, such as investment banks, leave this space or find it harder to raise capital.

7. Insurance in emerging markets: Temporary setback

Economic growth in the emerging markets seemed healthy in the first half of 2008, but the severe global financial turmoil weakened it in the second half of the year. With the major industrialised countries in recession in 2008 and into mid 2009, emerging market growth will be significantly affected, particularly those countries who are dependent on external financing or exports.

In response, emerging markets are expected to pursue aggressive monetary and fiscal policies to sustain domestic demand growth. As a whole, emerging markets' strong foreign exchange reserves and low levels of domestic and government debts should add credibility to their government interventions. However, individual countries are vulnerable. For example, Hungary and the Ukraine needed IMF support, while the Russian government has injected billions into its banking sector in an effort to stabilise it. At the same time, persistent high inflation in some Latin American markets could limit the scope of monetary easing.

Against this backdrop, insurance business growth in emerging markets, which has so far grown robustly in 2008, is expected to slow in the coming quarters. The moderation is expected to be more pronounced in life than in non-life insurance, since the latter will benefit from government infrastructure projects designed to boost domestic growth.

Non-life insurance

Non-life business performed well in 2008, but it is likely to slow down, notably in 2009.

Non-life premiums grew steadily in emerging Asia in 2008. In China, premiums expanded rapidly – by 18.4% (inflation adjusted) between January and October compared with a year earlier. Profitability is likely to have deteriorated due to higher claims arising from the snow storm in early 2008 and the Sichuan earthquake. The government's proposed CNY 4 trillion (USD 0.6 trillion), two-year economic stimulus package will bring some relief to insurers. In India, premium growth is also moderating, but overall business growth is being sustained by a strong increase in health insurance.

Latin America's non-life insurance markets continued to grow at a fast pace in 2008. This was driven by Argentina (+23.7% in H108) and Brazil (7.4%), both due to motor insurance, which benefited from strong car sales. However, premium growth was sluggish in Mexico (–0.6%) mainly because a state-owned oil company policy did not renew this year. The outlook for 2009 is clouded by a deepening economic crisis in Latin America. There will be some upside from the government stimulus packages.

Non-life growth in Central & Eastern Europe is expected to hold up well in 2008, driven by the two major markets, Russia and Poland. In Russia, compulsory medical insurance and, to a lesser extent, property insurance contributed most to the non-life insurance market expansion, estimated at 12% taking inflation into account. In Poland, growth was broad-based, with accident, disability and motor premiums having double-digit growth. In the other major markets – the Czech Republic, Hungary and Slovakia – non-life insurance premiums are expected to remain stable in real terms in 2008, since the contraction of motor premiums will be offset by growth in other lines.

Life insurance

Life business in the emerging markets has been affected by the slump in equity prices since early 2008. The short-term outlook remains uninspiring but longer-term prospects are still favourable due to increasing risk awareness, the continued increase in wealth and the expected reduction in state social security benefits.

Investment-linked products have been a major driving force behind the growth of Asia's life insurance business in recent years. In China, life premiums rose by 58% in January to October 2008 year-on-year, aided by strong sales of unit-linked products through bank branches. However, growth has slowed recently on more depressed equity prices and is expected to trend lower in 2009. In India, new business rose only 4% between April and September, weakened by an 8% decline in individual new business.

In all Latin America countries, life insurance markets grew more rapidly than economic activity in 2008, particularly in the two biggest life markets, Brazil (+19.2% in H108) and Mexico (+10.4%). The former benefited from the vibrant performance of VGBL (+24.6%), which is an investment-related retirement product that is responsible for almost one third of the regional life premiums. The current turmoil in capital markets and ongoing uncertainty will, however, have a negative impact on the segment.

In Central & Eastern Europe, the sharp fall in equity prices has negatively impacted the sales of unit-linked insurance policies. Consequently, life insurance premium growth in Hungary – which is a major unit-linked market – is expected to contract in 2008, while premium volume should remain stable in the Czech Republic in real terms. Poland and Slovakia, on the other hand, are still benefiting from strong economic growth and ample credit lending by banks. This development has led to an almost doubling of Polish life premiums in Q3 2008 compared with the same period last year. Given Poland's large share of the region's life premiums, this development is expected to lift regional life insurance premium growth into double digits in 2008. With the economic slowdown expected for 2009, however, regional life insurance growth is expected to moderate.