PLUS Europe
Euro Collapse – Insurance Fallout
Who is at risk?

Carrie-Anne Holt
Managing Editor, Debtwire Europe
Holders of Greece’s EUR 352bn sovereign debt mountain (in EURbn)

Source: Barclays Capital Research
No-one knows where the bulk of the debt lies…

- ‘Other’ holders – highlights the implications of contagion. No-one knows where the bulk of the debt lies...
- Complete fluidity of movement in total exposure to sovereign debt (note the date on the BarCap statistics)

**Holders of Greece’s EUR 352bn sovereign debt mountain (%)**

- Insurance: 3%
- NCBs: 4%
- Bank of Greece: 4%
- IMF: 7%
- S/Wealth funds: 8%
- Greece public sector: 13%
- Eurosystem: 15%
- EU loans: 17%
- Banks: 23%
- Others: 15%

*Source: Barclays Capital Research*
Last year’s big holders of Greek sovereign debt in the insurance market

Source: Barclays Capital Research
But consider an institution’s indirect exposure to sovereign debt.
Contagion spreads from the periphery to the core

Consolidated foreign claims by banks on individual countries:

Source: BIS
France’s combined banking claims on Greece, Italy and Spain are equivalent in size to the $700bn bailout of the US financial sector in October 2008.
Rating agency fever: a 2011 snapshot

- A total of 73 sovereign downgrade announcements in EU17 across 11 issuers in 2011 (not inclusive of each individual notch, which significantly increases the tally). This is equivalent to a European Union downgrade announcement every five days last year. Imagine heightened frequency on action from S&P, Moody’s and Fitch.

- 4 issuers in sub-investment grade territory (junk status) with one rating agency: Greece, Ireland, Portugal, Cyprus

- 2 issuers in sub-investment grade territory with two rating agencies: Greece and Portugal

<table>
<thead>
<tr>
<th>Sovereign</th>
<th>Moody's</th>
<th>S&amp;P</th>
<th>Fitch</th>
<th>No. of downgrades</th>
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<td><strong>Total</strong></td>
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</table>

Source: Moody’s, S&P, Rating agencies
Greece stands on the brink of the abyss, suffering like Argentina from the hangover that follows a borrowing binge.

But in contrast to Argentina, Greece’s incorporation into the European Union has been feeding and financing a fiscal disequilibrium that has become unsustainable in the last two years.

“The combination of lax fiscal policies and euphoric international markets decanted into a spiral of real exchange rate appreciation, loss of competitiveness, recession, persistent current account and fiscal deficits and high indebtedness.”

Daniel Marx, former Secretary of Finance of Argentina during the 2001 crisis
What makes Greece so different from Argentina

• For all the logical arguments in favour of a Greek exit, the repercussions of such a development will be felt throughout the system in ways likely to be as painful as they are hard to determine.

“Banks are not only exposed directly to the peripheral eurozone countries such as Greece, but also indirectly via their lending to banks that hold significant peripheral claims,”

Richard McGuire, senior fixed income strategist at Rabobank
What to watch out for in 2012

- Rating agency fever
- Interbank tensions – e.g. Dexia
- Central bank action
- Greater liquidity in sovereign debt movements
- More tremors in financial institutions – MF Global 2.0 and Dexia 2.0
- Market evolution: more resilience in core markets and a stronger backbone in the average underlying investor.
- We were unprepared for 2008.
Industry Briefing

The Collapse of the Euro - Reinsurance implications

PLUS Europe
January 19, 2012

Geoffrey Bromley

Your source for professional liability education and networking.
Launch of euro currency
2011 – A Year of Major Changes

USA
Steve Jobs
1955-2011

Greece
No Jobs
2009-2011

Italy
Blow Jobs
1994-2011
It’s time to start thinking differently about the debt crisis

**EIOPA Financial Stability Report - Dec 20, 2011**

“The sovereign debt crisis is now negatively affecting the European insurance sector, not only by declining assets values, but also by reduced demand for insurance as economic growth prospects deteriorate...EIOPA concludes that sovereign risk and the lack of a definite and comprehensive political response to the sovereign crisis, are the main sources of risk that can jeopardise the financial stability of the European insurance sector going into 2012.”

**Economist Intelligence Unit - Dec 14, 2011**

“The EIU continues to attach a 40% probability to the break-up of the euro area in the next two years. Were that to happen, the implications for countries and companies in the eurozone and globally would be severe – far worse than during the 2008-09 recession...Economic output (measured from peak to trough) in the eurozone as a whole could contract by at least 10% and possibly by as much as 25%.”
The scale of the problem

Source: Eurostat data as at June 30, 2011
Focus on the periphery

Source: Eurostat, Bloomberg

Government debt outstanding, Maturing by year-end 2012
A vicious circle

Excessive sovereign debt

Greater cost of issuance

Sovereign rating pressure

Debt service difficulties

Austerity measures

Lower economic growth
Financing Needs: Troubled Economies

Gross Financing Needs in % of GDP

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**PIIGS & Germany**

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* Fiscal balance = Government’s tax revenue + Proceeds from Assets Sales – Government Spending

Sources: Bloomberg L.P.; and IMF staff estimates and projections
## Sovereign Debt Ratings

<table>
<thead>
<tr>
<th>Country</th>
<th>Moody's Sovereign rating</th>
<th>Outlook</th>
<th>Downgrade notches since Jan 2011</th>
<th>Standard &amp; Poor's Sovereign rating</th>
<th>Outlook</th>
<th>Downgrade notches since Jan 2011</th>
<th>Fitch Sovereign rating</th>
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Source: Moody's, S&P, Fitch (ratings as at January 13, 2012)
Who’s in charge?

- The bond markets always react first
- The politicians have failed to prevent contagion beyond the 3 bailed-out countries
- The regulators remain preoccupied with Basel 3 and Solvency II
- The rating agencies are now playing catch-up

S&P - Dec 5: “In our view, systemic stress in the eurozone has risen in recent weeks and reached such a level that a review of all eurozone sovereign ratings is warranted.”

A.M. Best - Nov 21: “The recent worsening economic environment and outlook have significant implications for insurers with assets in the eurozone and for those operating within the region.”

Fitch - Dec 16: “Following the EU Summit on 9-10 December, Fitch has concluded that a comprehensive solution to the eurozone crisis is technically and politically beyond reach.”

Moody’s - Dec 12: “In view of the continued absence of decisive policy measures...Moody’s is reiterating its intention to revisit the ratings of all EU sovereigns during the first quarter of 2012.”
Who’s most affected?

1. Banks (currently on ECB ‘life support’; EUR794bn of debt matures in 2012)
2. Life insurers (particularly those domiciled in PIIGS)
3. Non-life insurers (particularly those domiciled in PIIGS)
4. Reinsurers (indirect exposures are the main concern)

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*Before policyholder participation and tax
**Only the US entities are rated
***Fitch downgraded by 3 notches to 'A-' on Dec 13

CWN = CreditWatch negative
URN = Under review with negative implications

Aon Benfield Analytics | Market Analysis
Proprietary & Confidential
Some of the Issues we need to think about

- European clients face a very difficult operating environment
  - lower economic activity means lower demand for insurance
  - claims frequency may increase (recessionary impact, political intervention, insolvencies)
  - the outlook for investment returns is poor
  - exchange rates may become more volatile
  - Inflation will hit us at some stage – the only question is when!

- Falling asset values/impairments are pressuring capital adequacy
  - the need for solvency relief should be reflected in higher demand for reinsurance capital solutions
  - there will be M&A opportunities through business restructuring/non-core asset sales

- The main issue is on the asset side
  - “Asset risk” is now one of the major risks faced by (re)insurers. No longer do we focus on a ‘return on equity’. Now it is a focus on the ‘return of equity’.

  - Financial strength ratings are coming under increasing pressure which will include heightened focus on counterparty credit.

  - The difficult investment and credit climate with all its attendant uncertainty has, together with the large volume of non US and non European cat losses, definitely contributed to the hardening of the reinsurance market.
The Insurance Company’s Risk Register

• Investment
  – Contagion of sovereign debt and banking debt
  – Impact on non European yields ( eg yields on US & UK debt much lower )
  – Currency rates change as the crisis deepens. Think about unhedged exposures.
  – Default on corporate bonds and/or equities

• (Re)Insurance
  – Increased D&C, FI & PI claims as well as trade credit and export credit
  – Political Risk losses
  – Motor claims tend to rise during recessionary times. This is also true for many other lines of business
  – Reduced (re)insurance demand
  – General inflationary pressures. ( Extreme inflationary pressures if a country leaves the Euro )
  – Generally increased reinsurance costs due to loss of investment income and uncertainty regarding capital availability
  – Potential reduction in the level of risk management amongst insureds
  – Potential fx issues
  – Legal Uncertainties
The Insurance Company’s Risk Register

- Operations
  - IT system changes
  - Legality of insurance contracts and interpretation of particular provisions
  - Increase in capital requirements as local regulators demand more locally to protect policyholders
  - Potential increased cost of servicing capital for those with known European exposures
  - Potential tax changes as governments seek to increase their own local revenue
  - Issues with outsourcing suppliers who may have been badly effected
  - Internal fraud
  - Likely legal changes (from confiscation of assets through to mandatory contribution to insurance funds)
  - Increased counter-party credit risk
  - Further uncertainty regarding Solvency II timeline and implementation
Potential consequences of a eurozone break-up

- A disorderly default would generate massive dislocation in global financial markets.

- Political/social/economic conditions will be extremely difficult in any country leaving the eurozone.

- Sovereign/financial strength ratings will be under severe pressure.

- Traditional capital markets may be closed.

- The legality of insurance contracts may be brought into question.

- Tax system changes may influence company domicile.
Likely Reinsurance Consequences of the Crisis

- Seen as mainly an asset risk rather than having huge liability consequences at this stage.
- Asset risk concerns and continuing low investment climate, together with doubts regarding availability of replacement capital, will tend to add to upward rate pressure globally, particularly in loss affected areas, from a reinsurance perspective.
- Reduced economic activity in part offsets the changes we are seeing in cedant companies’ risk appetite, which are being reviewed and are generally reducing.
- Reinsurance market tends to be passively managing their areas of concern—largely renewing existing portfolios but reluctant to add significant new aggregate in perceived areas of exposure.
- Perhaps one of the main concerns for the industry is a spectre of continuing claims inflation against a continuing low investment yield backdrop. Whilst a concern for both insurers and reinsurers, insurers have in recent years assumed far greater retentions and therefore will bear most of this reserve deterioration/tail risk, should there be significant disequilibrium. I see this as a potentially major risk for insurers.
Euro crisis – do we care?

Luke Savage – Lloyd’s, Director, Finance, Risk Management & Operations
How is Lloyd’s Exposed?

- **£50bn of cash and securities**
- **£36bn of claims**
- **£10bn of unearned premium**
- **£9bn of reinsurance receivable**
- Operational issues in support of the above
£50bn of cash and securities

- 1/3rd Cash and LoCs – unsecured creditors in the event of a default
- 1/3rd Government bonds – with governments no longer seen as risk free
- 1/3rd Corporate bonds – with 80% of bond issuance from financial institutions, predominantly banks
- “Safe haven” yields breaking through 0% with only one realistic direction of travel
- Corporate debt markets highly illiquid
Inflation rapidly reaching well into double figures for peripheral countries

• FX rates currently at parity that could reach 3:1*

• Contract dispute over currency of settlement

* Source: Credit Suisse estimate of DEM:GRD in event of euro break up

£36bn of claims

£50bn of cash and securities
• Potential for proliferation of D&O, PI, FI claims

• Potential voiding of contracts

£50bn of cash and securities

£36bn of claims

£10bn of unearned premium
- Triggering of collateralisation off the back of credit downgrades
- Liquidity squeeze driving “won’t pay” as apposed to “can’t pay”

£50bn of cash and securities

£36bn of claims

£10bn of unearned premium

£9bn of reinsurance receivable

£9bn of reinsurance receivable
- Need to transact in “new” currencies driving need for new banking arrangements

- Asset segregation issues in case of bank default
  - Lehmans
  - MF Global

- Intra Euro currency exposures (assets in Germany versus liabilities in peripheral country)

£50bn of cash and securities

£36bn of claims

£10bn of unearned premium

£9bn of reinsurance receivable

Operational issues in support of the above
• It won’t happen and people are over-reacting
• They are blowing the risks out of all proportion
• That means there is an opportunity to write well priced protection!
The Corporation is not full of natural borne optimists!

• Promoting awareness around market
  – Two Eurozone workshops in the past week with c150 attendees
  – Supporting initiatives such as this
• Corporation monitoring underway for over a year
  – Positioning asset base defensively
  – Ensuring no operational impediments to a timely response
• Recommend you do the same
The Collapse of the Euro – Professional Liability Insurance Implications

Stephen Burnhope

Gallagher London
• Joachim Fels, Economist, *Morgan Stanley* – 2004:

  • “Investors who make decisions for the long term should allow for the risk of the Euro falling apart.”
Three Questions:

• What is the nature of the risks?
• Is it possible to mitigate the risks?
• What is an appropriate response to the risks?
• Conclusions?

• A state of affairs, not an ‘event’ as such

• The Euro crisis is part of an environment of increased risk, along with other global factors

• Insurers’ *fundamental* challenge is (1) price adequacy and (2) loss-cost *distribution*, rather than loss-cost *avoidance* per se
THE END

of the Presentation, not the World ...