

# Insurance Executive Review

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Market Commentary on Current Developments within the P&C Insurance Industry

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## **Economic uncertainty and sovereign debt crisis could disrupt the cyclical change in commercial risk market ... from orderly to treacherous conditions ahead !**

Our focus in recent issues of our Newsletter has been on commercial direct insurance industry trends in overhead expense growth, declining revenues, excess capacity, reduction in claim reserve strength and investment yields among other concerns. The development of excessive global natural catastrophe events and uncertainty over regulatory jurisdiction has been among the external issues we discussed as well as the slow recovery process from the recent Great Recession. As we look at the world beyond the insurance industry today we are concerned that the global economic recovery is not only running out of gas (i.e. government stimulus) but is also facing some new credit issues that could turn ugly and drag us back into recession mode. Let's take a look at what has us concerned and how that might cause the insurance market cycle change to be extremely disruptive. This Newsletter might be a little longer than usual as there are an important graphics included.

### **In the beginning.....**

The recent Great Recession was perceived to be a cyclical event as we have experienced in prior episodes where over time the economy improves and employment returns. But while the last recession may have looked similar to past events, it now seems evident to be more structural in nature. It was a credit driven event where acceleration in asset values (real estate), availability of credit capital, and relaxation of processing fueled consumer spending. This was coupled with the lack of any focus on the potential for a normal market correction. When this asset did bubble burst, it caused a domino effect via reduced spending, credit defaults, capital reductions further imploding real estate asset values. An economy built on consumer spending now became dependent on federal government spending when public budgets were already stretched. With the degree of uncertainty over government spending, curtailment of commercial credit, foreclosures, bankruptcy rates, unemployment rate and regulatory activity, the business community have been wary or hesitant to pursue growth strategies based on economic expansion that may simply not materialize. This has contributed to the lack of insurance demand, increased competition for the available business, low investment yields and a slide in operating margins. Under normal market conditions this would lead to a market pricing correction in a controlled fashion. But what if a "new normal" set of conditions applied?

### **...and then there was.....**

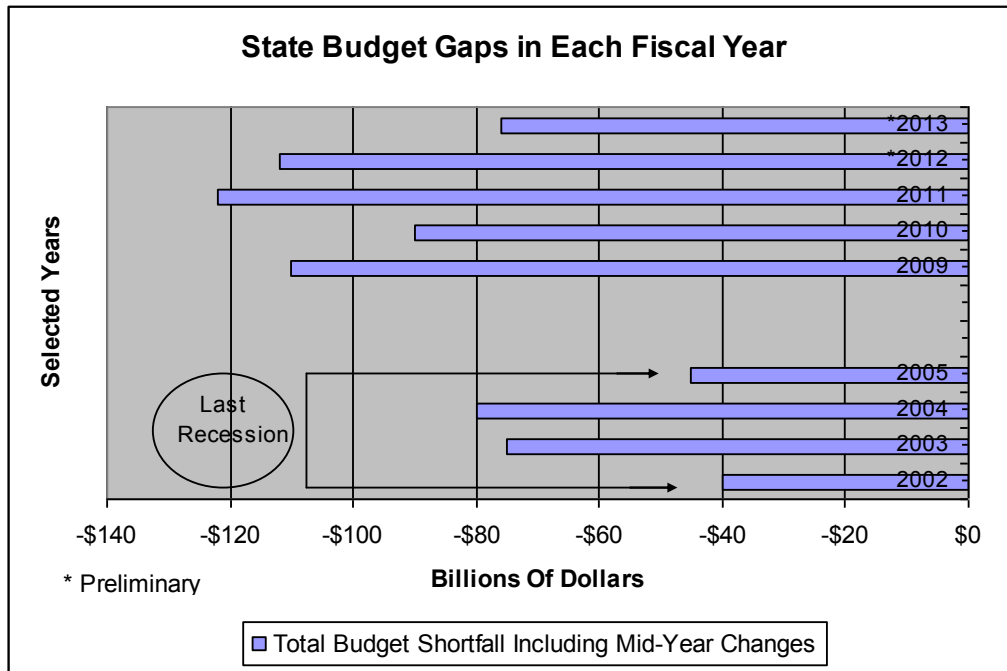
While the official end to the Great Recession was in 2009 the recovery has been uneven with lagging indicators including new concerns over job creation, home foreclosures and credit markets frozen while commodity prices rise, interest rates continue suppressed, deflation worries giving way to inflation concerns and the emergence of sovereign debt concerns in the industrial nations of Europe. Along with these national and global issues the fiscal problems within the governmental entities in the U.S. both federal and state have raised doubts about our ability to achieve budget and debt constraints at home. Is the federal debt out of control?

United States Federal Debt position at:

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September 30, 2000.....\$5.674 trillion  
 September 30, 2010..... \$13.561 trillion  
 June 12, 2011..... \$14.285 trillion.... \$46,304 per citizen...\$129,315 per taxpayer

Source: US Debt Clock.org



In addition, the fiscal budget position and debt obligations of the various states are of added concern.

Source: Center on Budget and Policy Priorities

In addition to fiscal budget issues every state faces an ongoing debt load with the following having the largest burdens:

States with Largest 2010 Debt Burden  
 Based Upon Debt per Resident

Source: Center on Budget and Policy Priorities

These present local state governments with serious problem to maintain services at a time of declining tax revenues. If this is but a cyclical problem that will be erased as the economy recovers, what happens if it becomes a structural problem where tax revenues do not return to their former level? If that is the case what happens to federal revenue expectations?

Rank	State	Total Debt (Billions)	Debt per Resident
1	Massachusetts	\$71.9	\$11,063
2	Alaska	\$6.5	\$9,459
3	Rhode Island	\$8.9	\$8,481
4	Connecticut	\$27.5	\$7,869
5	Delaware	\$5.7	\$6,554
6	New Jersey	\$52.8	\$6,079
7	New Hampshire	\$7.9	\$6,010
8	New York	\$114.2	\$5,861
9	Vermont	\$3.4	\$5,427
10	Montana	\$4.9	\$5,090

All of this weighs heavily on the ability of the U.S. economy to recover.

....so how are we doing?

The economic recovery is noticeably slowing and while some would suggest that it is a temporary condition, we

believe these conditions have longer term implications. Let's take a look at some of the key issues and where we think they might be headed;

- Residential Real Estate- continues to see little construction growth (now employing about one-half of the 1 million workers in 2006) lag behind as more foreclosed properties ( about 2 million homes) are being placed on the unsold inventory so supply is saturated;
- Foreclosure process- remains a long and difficult task in "court processing" states such as New York where 213,000 homes now in serious default or foreclosure would take lenders 62 years to process at the current pace. Other states such as Florida, Massachusetts and Illinois would take 49 years (per LPS Applied Analytics);

- Home Prices- continue to fall as this unsold inventory is depressing prices...national home prices hit a new low falling 4.2% in Q1-2011 after a 3.6% drop in Q4-2010 (Case-Shiller Index). These value declines contribute to further potential mortgage industry difficulties;

- Unemployment- has remained at an extraordinary high level longer than any previous recession suggesting structural based recession rather than a cyclical recession.



The longer term unemployed is fast approaching 50% of all unemployed workers....a serious issue. In combination with the real estate market the lack of mobility of labor is a real constraining factor;

**Summary of Employment Data  
Private non-farm payroll change  
(in thousands)**

Report for Month of:	Labor Department Report Release Dates*						
	January	February	March	April	May	June	July
January	→	36,000	63,000	68,000			
February	→		192,000	194,000	235,000		
March	→			216,000	221,000	194,000	
April	→				244,000	232,000	217,000
May	→					54,000	25,000
June	→						18,000

Note: Source BOLS Establishment Data report, seasonally adjusted

\* Data is considered preliminary for first two months and then final in third release date

- The July report showed only a June gain of 18,000 jobs with data for April and May revised downward. The unemployment rate moved up to 9.2% so the economic "soft-patch" may be a sign of a more worrisome trend for our economy and domestic insurers;
- Small Business- as expected the recession saw above average bankruptcy and closure of small business firms as evidenced by empty storefront locations in virtually every town and city. New business start-ups are at an all time low as credit availability is limited and the outlook for business growth, regulatory changes and tax matters has dampened prospects for success;
- Large Business Organizations- large firms have enjoyed somewhat better business conditions through cost

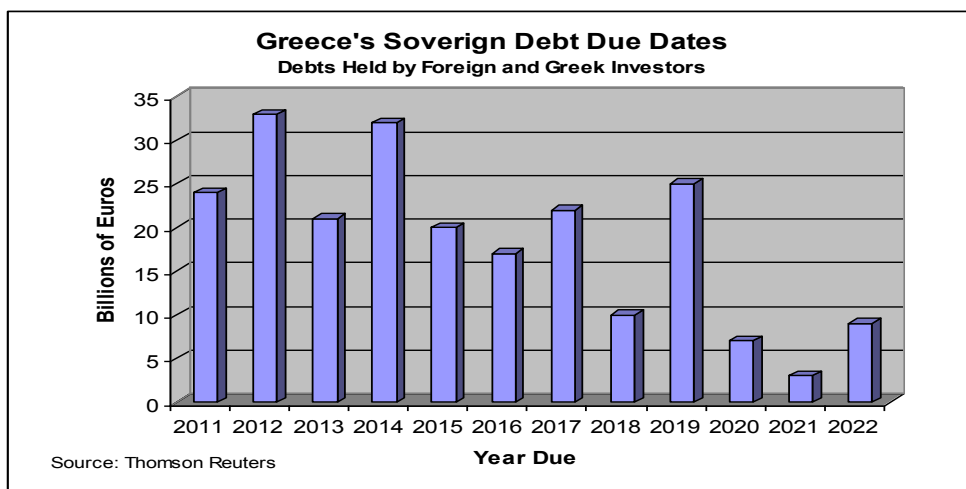
saving initiatives more than top-line revenue growth. These productivity gains have been rewarded with upward gains in stock prices but these are now feeling the pressure of a general business slowdown. Productivity has been a two-edged sword damping employment growth;

- GDP Growth- we now see further recognition that the economic slowdown may be more than just an isolated bump in the recovery as Wall Street has started to lower GDP expectations for the remainder of this year. We are likely to see these concerns spread to the global developed market as the issue of public budget deficits and potential for sovereign debt default looms;
- European Union- the creation of the European Monetary Union that was central to a single currency system, was based on the assumption that structural reforms would accelerate leading to convergence of economic growth and productivity rates rather than increased divergence. That endgame strategy has now been replaced by the urgency for reforms to prevent default and if that fails, how the burden of financial pain will be distributed.

...a new threat of financial crises those U.S. regulators missed?

The sovereign debt problem appears to be a realization that previous excessive private borrowing has now led to massive public debt. This is most pronounced in the industrialized countries of Europe where economies are struggling to recover

and has been an ongoing issue being addressed jointly by the European Central Bank and the International Monetary Fund. The Greek debt in particular (now the lowest rated sovereign debt by S&P) was addressed once but now requires a second solution that may require



haircuts by debt holders that was avoided in the first round. But since almost all of the direct obligations of the so called "PIG" countries are in Europe, how is this issue for the U.S.?

Sovereign European Debt Exposure  
Year end 2010

	Debt issued by		
	Greece	Ireland	Portugal
Total Debt held by foreign creditors, bn\$	\$206.3	\$679.1	\$295.4
Direct exposure of creditors	\$145.7	\$461.2	\$202.4
Indirect exposure of creditors	\$60.6	\$217.9	\$93.0
% of total creditor exposure that is indirect	29.4%	32.1%	31.5%
European foreign creditors			
Europe's direct exposure as % of world's direct exposure	93.5%	81.6%	96.1%
Europe's indirect exposure as % of the world's indirect exposure	43.1%	71.8%	54.9%
US creditors			
The US's direct exposure as % of world's direct exposure	5.0%	11.1%	2.6%
The US's indirect exposure as % of the world's indirect exposure	56.3%	24.8%	44.3%

Source: Bank of International Settlements 146 page report

As illustrated above the direct exposure to these PIG debt obligations are held primarily by European financial

institutions but the U.S. exposure is significant on the “indirect” obligations that consist of derivatives or credit default obligations (“CDS”) issued or held by U.S. financial institutions (banks and insurance companies). So U.S. institutions didn’t participate in the direct obligations of PIG’s. Rather, they sold most of the default protection to those that did purchase these debts. Looking more closely at these obligations reveals that the risk of default falls on institutions in France, Germany and the United States.

**Sovereign European Debt Exposure  
Year end 2010**

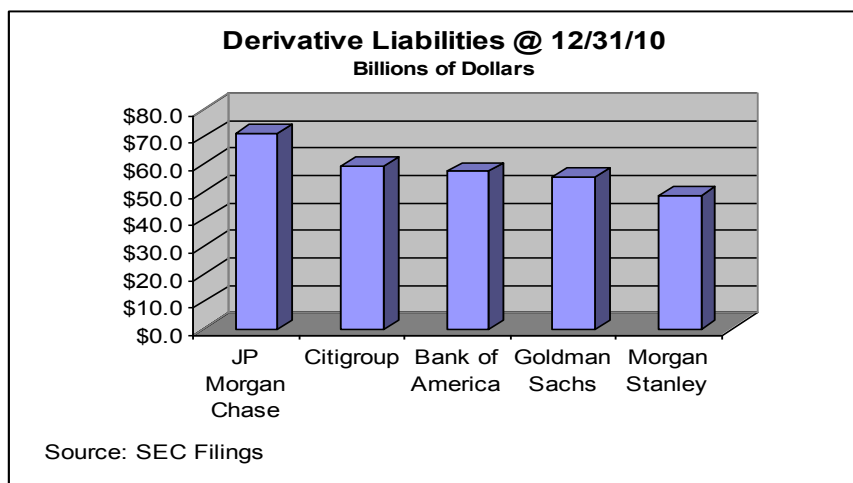
Exposure to debt- direct and indirect	Debt issued by		
	Greece	Ireland	Portugal
<b>France</b>			
Direct exposures	\$56.8	\$29.6	\$27.0
Default insurance sold (indirect exposure)	\$8.3	\$26.4	\$5.2
Total net exposure	\$65.1	\$56.0	\$32.2
% of which is indirect	12.7%	47.1%	16.1%
<b>Germany</b>			
Direct exposures	\$34.0	\$118.1	\$36.4
Default insurance sold (indirect exposure)	\$5.9	\$40.4	\$13.8
Total net exposure	\$39.9	\$158.5	\$50.2
% of which is indirect	14.8%	25.5%	27.5%
<b>United States</b>			
Direct exposures	\$7.3	\$51.0	\$5.3
Default insurance sold (indirect exposure)	\$34.1	\$54.0	\$41.2
Total net exposure	\$41.4	\$105.0	\$46.5
% of which is indirect	82.4%	51.4%	88.6%

Source: Bank of International Settlements 146 page report

So the US institutions that sold large amounts of default protection have as much to lose as those in Europe. U.S. institutions must be hoping for only a partial default or restructuring, as that would perhaps not trigger any insurance payments. In the event of a default by Greece the impact to U.S. institutions would appear limited to a total of \$7.3 billion except that nearly 5 times that amount (\$34.1 billion) is in additional indirect CDS obligations. This raises a lot of questions but perhaps the most interesting is that U.S. financial institutions sold some \$120 billion of PIG credit default swaps to European institutions. Since the derivatives market is not completely in the sunlight (not traded on an Exchange) regulators may have missed an opportunity to get better disclosure of potential risks. Under SEC reports banks are required to provide only an overview of their derivative exposure without specific linkage to specific risk issues.

Derivatives were at the center of the last financial crisis and central to the AIG bail-out by the federal government. The concern here is that our prior “too big to fail” financial institutions are now bigger than ever with more concentrated risk exposure that among other things includes a \$288 billion derivatives business among just these 5 institutions. The BIS data shows a substantial amount of CDS activity and potential risk by U.S. institutions

but it is impossible to find details from bank regulatory filings. We may only get the real story if Greece hits the wall and the US bets come due.



So why is this matter of concern for the U.S. insurance business?

These issues have concerns for the U.S. economy as well as the potential health of the global financial system. As stated on page 1 we created an asset bubble that was built upon excessive leverage by household spending (credit) and the commercial financial system (borrowing) that ultimately collapsed, bringing about a global financial and credit crisis that developed into a worldwide recession among the developed nations. These nations of the world including the U.S., embarked upon public spending/borrowing to replace household and commercial activity withdrawn as a result of the recession. The injection of financial liquidity into the global financial and banking system contained the economic collapse but has not totally revived it. What if the global economy does not regain a growth posture and falls back into another recession? A more disastrous event would be the default of Greek debt leading to a contagion of failures among holders of this debt and the pressures placed on institutional holders of CDS obligations that now become due.

While a slowing of the economy would jeopardize economic growth, it would also delay the expected commercial pricing upturn expected in 2012. The sovereign debt default scenario would present serious financial crises that would have wide-ranging implications for the world economy and the global insurance industry. The former would present implications that carriers with modest financial resources may be unable to sustain their market position with some eventually ceasing operations in one or more markets. The latter situation is more onerous resulting in a potential contagion that would directly involve European banks and insurers who provide substantial catastrophe risk relief to domestic insurers including the U.S. based carriers. This potential exposure by comparison, could make "Hurricane Katrina" look like a modest windstorm event! The CDS exposure could withdraw conventional reinsurance risk capacity from traditional insurance markets or make such capacity suspect from a security perspective. It could cause a repeat of the 1985 insurance market crises where public and private facilities were forced "to go bare" without adequate insurance protection. That could again give rise to the creation of alternative risk transfer (ART) products which might expand federal intervention into a broader spectrum of "self-help" risk financing that would further undermine the state regulated insurance market. Just as such conflicts have developed in the implementation of the Dodd-Frank regulations on banking institutions, we could see the further expansion into insurance matters in both commercial and personal insurance matters.

The recent pending 17 billion euro bailout of Greece is only a temporary reprieve from that current debt situation that "kicks the can further down the road" and symbolic of regulator hope that conditions will improve with time. Realistically this only works with the maturity of fine wine! The world economic conditions in the developed countries suggests further potential difficult times ahead for the global insurance and reinsurance markets that are directly tied to the fortunes of such markets. A serious financial contagion in such markets could engulf the basic foundation of global commercial insurance market.

Our next Newsletter will look at the first quarter 2011 financials for the U.S. Private Insurance Industry market and specifically attempt to separate the specialty operations of reinsurance and financial guaranty segments from the core P&C operations....just how do the returns look?



**Charles L Ruoff CPCU**

CR Market Strategies  
cmarketstrategies.com

Mr. Ruoff is President of CR Market Strategies Inc. an insurance marketing and risk management consulting organization based in Garden City, New York. Mr. Ruoff has been involved in insurance underwriting, international insurance brokerage and alternative risk management businesses having held executive management positions with Continental, AIG, Johnson and Higgins, Sedgwick James, and Acordia (Wells Fargo). He has been a speaker/panel member at numerous industry events during his over 40 years in the insurance industry including RIMS, CPCU and other conferences. His articles have appeared in many industry publications and is a member of the Advisory Board of St Johns School of Risk Management and Actuarial Science.

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